Folder Title:	Mr. Moeen Qureshi - Operations Committee Files - Meeting Files
Folder ID:	1682765
Series:	Operations Committee records of the Chairman (Moeen Qureshi)
Dates:	03/05/1991 - 05/16/1991
Fonds:	Records of the Operations (Loan) Committee
ISAD Reference Code:	WB IBRD/IDA LC-04
Digitized:	6/19/2020

M. QURESHI'S
OPERATIONS CMTE

March 19 - May, 1991

May 16,1991

91052302 9

THE WORLD BANK

Operations Committee

CONFIDENTIAL

DECLASSIFIED
AUG 02 2013
WBG ARCHIVES

Minutes of the Operations Committee meeting to consider JORDAN - Country Strategy Note

Held on Thursday, May 16, 1991 in Room E-1243

A. Present

Committee	Others
Messrs. M. A. Qureshi, Chairman	Messrs. V. Bhargava, EM3IE
W. Wapenhans, EMNVP	S. Chitale, EM3CO
I. Shihata, LEGVP	R. Chopra, EM3DR
J. Wood, FPRVP	P. Crevier, SEC
D. Bock, OPNSV	S. El Serafy, EAS
F. Aguirre-Sacasa, AFRVP	E. Grilli, EASDR
N. Hicks, LACVP	J. Hamid, CMED1
P. Isenman, DECVP	P. Hasan, EMNVP
D. Ritchie, ASIVP	A. Heron, COD
J. Shilling, CFSVP	Ms. K. Hudes, LEGEM
	M. Kelada Antoun, CMED1
	R. Laslett, FRSCR
	Mrs. N. Okonjo-Iweala, OPNSV
	G. Reif, PRDRA
	S. Voyadzis, EM3CO
	S. El-Khouri, IMF

B. Issues

1. The Operations Committee (OC) met on May 16, 1991 to consider a Country Strategy Note (CSN) for Jordan covering the period to the end of FY92. The discussion followed broadly the issues identified in the EAS agenda. This covered the relevance and realism of the high case; sectoral priorities, including water scarcity; the core lending program; debt restructuring options; and creditworthiness.

C. Discussion

2. The Chairman began by offering his perception of certain aspects of economic developments in Jordan, and invited the Region's reactions. For a number of years, he said, we had watched negative domestic savings, high military expenditures, substantial inflows of remittances and aid which supported the budget and the balance of payments, and yet against normal standards we considered Jordan creditworthy for IBRD lending. The situation seemed now to have changed, and the high case presented contested the viability of our posture. "Keeping the powder dry," as it were, and contemplating structural adjustment lending begs the question as to what

exactly Jordan would be adjusting to? Any prospects of the high case materializing as outlined in the CSN must rely on a significant response from the donors. He understood the Region to be saying that we needed the core program to explore the possibility of playing a longer-term role in support of Jordan's development -- a role which would clearly depend on the resources we would be able to mobilize for Jordan.

3. The Region responded that we did not really have any options. Jordan needed a significant level of highly concessional resource flows to prevent economic collapse. In order to reach that objective, we would work on a core program of highly needed investment projects. For the longer term, however, it was not unlikely that export markets would return, services revive, and reconstruction in neighboring countries benefit the economy. The Region was not now in a position to say a great deal about the high case, which would be covered in a full CSP later. In the past Jordan enjoyed much support from the Gulf Arabs who now had reason to be indignant with Jordan. A Bank-Fund mission would go to Jordan in September and would re-assess potential aid assistance, and this should provide a better basis for the Region to proceed. If we did nothing meanwhile, the risk would be higher that Jordan might default on its obligations to the Bank.

4. The Region added that dealing with the new situation, including the sharp drop in income, should best be coupled with a reform package until conditions returned to normalcy. But adjustment could not be pursued without a non-standard approach to the restoration of aid flows. The Region were seeking authority for a core program until the end of FY92. Meanwhile it would work on improving the chances for restoring financial flows by helping Jordan to develop a medium-term domestic reform program. A joint Bank-Fund mission had just returned, and a pleasant surprise was that short-term conditions were less severe and less chaotic than had previously been thought. Some re-orientation of exports toward the USSR, Libya and Eastern Europe had taken place, and accumulated arrears had dropped from $400 million to $300 million. Reserves now stood at four months of imports, and it looked as if Jordan could endure another six months without taking up a strong adjustment program. On the other hand it was quite possible that arrears would accumulate again and reach $1 billion by end-1991.

5. In answer to a question by the Chairman, the Region added that of the $1.1 billion earmarked for Jordan in the context of the Gulf Crisis, some $500-600 million had been disbursed. Jordan wanted the Bank and the Fund to return in September to help design a reform package that would be taken to Parliament and get incorporated in the budget for the next fiscal year, beginning January 1. The high case outlined in the CSN indicated the kind of scenario that would materialize if Jordan were to move in a reform direction.

6. A member said that the fact that Jordan was not creditworthy posed a problem even for the small core lending program proposed. If we proceed with lending under present circumstances, we should be aware that we are making a gamble and should accordingly expect that lending operations provide not only direct benefits but also indirect benefits, such as drawing in substantial volumes of concessional funding from external donors. Above all, we should reject the notion that we were lending only to get our debt serviced. There was need to come back to consider the high

case strategy at a later stage. He emphasized that any viable medium-term program would require strong domestic adjustment. He expressed surprise that more compression of domestic expenditure was not being sought. In particular, he thought it implausible that Jordan would get any write-off of past military debt without seriously constraining military expenditures. Considering the great stress on resources, he found the indicated adjustment not all that draconian. He would put at least as much emphasis on limiting domestic expenditure as on trade liberalization. Indeed Bank operations addressing the social costs of adjustment could be quite helpful if additional external resources were to be mobilized. We should make careful soundings of aid prospects and take care not to design a program that was based on the continuation of past patterns of aid.

7. A member asked if Jordan would be eligible for IDA resources, but the Region said that current income per capita at $1,100 was well above the effective cut-off level. Another member said he saw the wisdom of an active Bank role in Jordan as a short-term strategy. Maintaining a policy dialogue would help compress public expenditure, and re-orient it toward development, and hoped the Region would pursue this objective vigorously. He was gratified to see long-term development issues such as the environment and population addressed and welcomed the devotion of an annex to the latter. The water issue raised in the CSN, however, was not one confined to Jordan and within its control, but a regional issue that could be resolved only in a regional context. He said he had difficulty understanding some of the macroeconomic projections -- a view which the Chairman said he himself also shared. The member continued by saying that workers' remittances were projected unconvincingly to play a huge role, while economic growth would continue at positive rates simultaneously as consumption was declining and imports' elasticity to income dropped sharply. Maybe the difficulty lay, he added, in lumping public and private consumption together, but what the CSN projected tended to strain economic logic. Another member agreed, saying that in Jordan's conditions trade liberalization and tariff reductions should be viewed as of lower priority than addressing the fiscal balance. He thought that the projection of public expenditure to fall slightly from 47% to 41% of GDP after five years of so-called strenuous adjustment did not make sense.

8. Another member thought that the Bank had a responsibility to continue supporting adjustment in Jordan, and if by lending $10 or $20 million we could help mobilize the financing needed to restore Jordan's creditworthiness, then the risk was well worth taking. He perceived the Bank's major role now as mobilizing donors' assistance, and for this a larger Bank program would be more effective than merely a program of $10-20 million. In particular, he regretted that the Gulf Crisis most affected countries, including Jordan, were receiving very limited assistance from the Bank, and feared that assistance to Jordan from the Gulf countries was not likely in the near future because of the strong feeling still prevailing in the Gulf against Jordan. In his view it would take time to return Jordan to pre-crisis conditions, and for this reason he saw the usefulness of an active Bank role. Any adjustment program for Jordan, however, must not push too hard beyond the ability of the country to cope with a most difficult situation.

9. The Chairman said that he did not believe that an extra $10-15 million over and above the core program would have much impact on potential donors, but we needed to tell them that we were putting in these notional

amounts in order to catalize their assistance with the objective of making Jordan creditworthy. The Region said it was their intention to investigate possible sources of finance. In respect of the social impact, recent government changes had brought into the Cabinet members of Parliament that had previously been in opposition. While co-financing would be pursued, the emergency loan, approved earlier, had to be scaled down in view of limited donor support, and the social fund would be much smaller than previously envisaged. When it came to reform priorities, the Region agreed that the budget represented a higher priority than trade, but maybe this did not come through in the draft. A special public expenditure report had been produced and discussed by the recent Bank-Fund mission, with a view of compressing non-military public expenditure. The Region added that the core program stance was not in fact sustainable: it would give way to higher lending if Jordan properly adjusted and the donors proved responsive; otherwise core lending could not go on indefinitely.

10. The Chairman remarked that the member who had viewed the Bank's role as catalytic had chosen his words carefully: he had not insisted that each core operation be co-financed, but rather that the core program be used to mobilize extra resources. The Chairman's own feeling was that the current difficult situation would not last, and Jordan would be helped greatly by Bank support for greater aid. However, we must start with the recognition that we could not assume a high share of exposure unless military expenditures were contained. He realized that, for Jordan, that was a difficult issue as defense probably meant survival, but it was imperative that Jordan should not use other resources to replace aid in order to maintain military expenditures. This was what needed to be done; whether it could be done was a different matter. He agreed that we need not be too zealous on trade liberalization until economic viability was seen to return to Jordan; once the normal flows of exports and imports were restored, trade liberalization would assume special importance. The fiscal balance clearly assumed priority in the short term. Where conflicting objectives had to be reconciled, judgment was clearly required.

11. A member referred to the negative transfer to Jordan under the core program and asked if Jordan was aware of this; and whether Jordan was current in its service of Bank debt. The answer was yes to both questions and that Jordan had on the whole striven to meet its debt obligations.

12. Replying to an earlier question the Region said that it agreed that the water issue transcended Jordan, and had a lot to do with riparian countries such as Lebanon and Syria, besides the fact that Israel was drawing water that belonged to Jordan. The problem was clearly one that needed a regional solution. As to military expenditure, the Region thought that it would be difficult to shift Jordan's position on this matter without a Middle East settlement.

13. A member noted that with regard to debt, a debt and debt service reduction operation should not be considered at present. The immediate task was for holding action as a temporary device. He added that the reduction of per capita consumption for some years to come might indicate the unsustainability of the core program scenario. The Region responded that since the opposite view had been expressed to the effect that the adjustment was not drastic enough, it was conceivable that the CSN had just got it right.

D. Decision

14. The Chairman remarked that he was comfortable with the core program, but it was imperative that the donors be told that the Bank could not do more without their help, and would be prepared to continue only if their assistance was forthcoming. He sensed that there was enough support in the Committee for the Region to proceed along the lines proposed in the CSN. Finally he directed that the CSN be forwarded to the President for review.

May 23, 1991

SESerafy/lcu

91050701l 1.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: May 7, 1991

TO: Operations Committee

EG

FROM: Enzo Grilli, Director, EAS

EXTENSION: 81934

SUBJECT: JORDAN - Country Strategy Note
- Proposed Agenda

1. The Operations Committee (OC) will meet on Thursday, May 9, 1991 at 12.00 noon in Room E-1243 to consider a Country Strategy Note (CSN) for Jordan covering the period extending to the end of FY92, with a full CSP to be produced later. The CSN covers also a longer-term strategy based on a higher case. The OC may wish to take up for discussion the issues identified below.

Background

2. Jordan was in the process of implementing a radical adjustment program supported by the Bank, the Fund and external creditors when the Gulf crisis disrupted the process. The influx of 200,000 returnees (5% of the population), and the loss of workers' remittances, export markets, tourism and transit trade, have resulted in widening the current account and fiscal deficits, arrears accumulation and reversal of reform measures. It is not certain when conditions can be restored to the pre-crisis situation; when exports will revive; if and when tourism will return; and workers again resume their previous work in the Gulf.

3. When Lebanon's and Iraq's reconstruction begins, and when Syria opens up for trade, Jordan will be well placed to expand its exports and engage, once more, in profitable transit trade. But even if the Regional environment were to return to normal in the latter half of 1991 (most unlikely), the government were to implement the strongest feasible adjustment program, and if the needed financing were to materialize, the macroeconomic future would still remain dim, and per capita consumption will have to fall progressively before it can stabilize (see CSN, Annex VI, Table 3).

4. Meanwhile, the CSN foresees poor prospects for tourism, workers' remittances, and regional exports, with the implication that fiscal and balance of payments deficits would widen. The Region therefore advocates an intensified outward-oriented, private-sector-led development strategy, to be supported by a "larger volume of concessionary resources." A long list of reforms, ranging from infrastructure to the financial sector, is listed in para. 8, with advice that Jordan should "make a concerted effort to raise additional resources on highly concessional terms," including debt relief, and, besides, shift human development from the public to the private sector, and further attend to the growth of population and water scarcity.

- The OC might enquire about how realistic the longer term prospects are, particularly the materialization of external assistance on the requisite scale?

- From this list of reforms, what in the Region's opinion should be the focus during the next year or so?

Two Scenarios

5. Though the CSN has a limited purpose, providing the context for a core program in the remainder of FY91 and for FY92, it also elaborates a higher case beginning with FY92, whereby annual lending would rise to about $120 million in the period FY92-94, including a high content of adjustment lending. Country economic and sector work in FY91 and FY92 is proposed at the same high levels in the high and core cases.

- The Committee may wish to discuss if the high case is not too speculative to be considered at this stage, and focus instead on the core case.

CSN Objectives and Creditworthiness

6. Once the CSN is viewed largely as providing a context for the lending program in the remainder of FY91 and in FY92, creditworthiness becomes the focus. Total external debt is said to be $7.3 billion in 1991; equivalent to 180% of GDP. Before rescheduling, interest would amount to 14.9% of GDP in 1991, and the debt service ratio 61.8%. "As the situation now stands, Jordan is not creditworthy for Bank lending" (cover memorandum, para. 4). Multilateral debt in 1990 was $945 million, including $587 million owed to IBRD and IDA, and this is being regularly serviced, but arrears on non-preferred creditor debt now amount to $400 million. During FY92 projected disbursements from the Bank under the core scenario [excluding the second tranche of the Industry and Trade Policy Adjustment Loan (ITPAL) whose implementation has been disrupted] will be more than offset by debt service. The Region judges that a total halt to lending would increase the risk of default as well as impede external financing and the possibility of reform. The case for core lending ($25 million in FY91 of which $10 million has already been approved; and $20 million in FY92 for social development, and transport) is that it will give an important role to the Bank, enhance the prospects of outside assistance, and set the stage for future reform. The Region is thus seeking authority to pursue the following: (a) an adjustment program with a joint Bank-Fund mission in May; (b) a donors' meeting; (c) preparing options for debt restructuring in cooperation with the IMF and FAS; and (d) undertaking the core program through FY92.

- The OC may wish to consider these requests and to indicate which of these tasks, if any, can be deferred or diluted.

Longer-Term Objectives

7. If the OC endorses the EMENA's plans to pursue the core program as preparation for a higher case, and considers that there is enough justification for pursuing the higher case, the longer term objectives need to be examined. These are said to be based on the implementation of a private sector and growth-oriented adjustment strategy, involving release

of the second tranche of ITPAL, and pursuing a high level of adjustment lending that would address various reforms in public expenditure, the energy sector, the financial sector and transport rehabilitation. It would also aim at a restructured human resource development strategy including population planning, and water resource management, while attending to women in development and the environment. The Committee may wish to consider:

- If it is premature to attend to these longer-term issues, considering the highly precarious base from which we are starting?
- If the sectoral priorities identified in the CSN are the right ones to pursue, and in particular if they give the private sector adequate incentives to grow.
- If water management, including groundwater, is not an issue that lies largely outside the control of Jordan, and touches on highly political regional factors.

Operations Committee

Messrs. Qureshi, OPNSV
Husain, LACVP
Jaycox, AFRVP
Karaosmanoglu, ASIVP
Wapenhans, EMNVP
Rajagopalan/Summers, PRE
Shihata, LEGVP
Kashiwaya, CFSVP
Wood, FPRVP
Bock, OPNSV

cc: Messrs./Mmes: Thahane/Burmester, Picciotto, Goldberg, Wyss, Sandstrom, Isenman, Linn, Stoutjesdijk, Okonjo-Iweala, Hovaguimian, El Serafy, Parmar, Rao, Kavalsky, Pfeffermann, Liebenthal, Kilby, Robless, Walton, Khanna, Shakow, Chopra, Hasan, Voyadzis, Tyler.

SESerafy/lcu

91050301 1.

THE WORLD BANK/IFC/MIGA
OFFICE MEMORANDUM

DATE: May 3, 1991 **- CONFIDENTIAL -**

TO: Mr. Moeen A. Qureshi, OPNSV

FROM: R. K. Chopra, Acting RVP, EMENA *RChopra*

EXTENSION: 32707

DECLASSIFIED
AUG 02 2013
WBG ARCHIVES

SUBJECT: **JORDAN: PROPOSED APPROACH UNTIL THE END OF FY92**

1. Attached for OC review is a Country Strategy Note (CSN) which analyses the current situation facing Jordan and suggests a Bank approach limited to the next fifteen months, (i.e., until the end of FY92). At the end of that period, a full Country Strategy Paper will be prepared to propose the strategy to be followed in the light of evolving circumstances. A draft CSN was reviewed at a Regional Management Group (RMG) meeting on April 24, 1991, chaired by Mr. W. A. Wapenhans.

2. Undoubtedly, the situation we are facing is complex and contains risks. Although Jordan has, so far, been current in its payments to the Bank, the country has built up almost $400 million in arrears on servicing the non-multilateral debt. By end FY91, the total Bank debt, outstanding and disbursed (DOD), will amount to about $545 million, or 8% of the total DOD. Our disbursements and the total debt service payments during FY92, under current circumstances (core program), are projected to be $91 million and $97 million, respectively. Both the DOD and the disbursements exclude the release of the second tranche of the Industry and Trade Policy Adjustment Loan (ITPAL).

3. The current situation in Jordan cannot be maintained for long. The financing which Jordan obtained through the Gulf Crisis Coordination Committee (GCCC), amounting to $1.1 billion, will provide the country with breathing space for the next six to eight months. After that period, we expect the situation to either improve, i.e., a reform program supported by the necessary financing is in the making, or to dramatically deteriorate.

4. As the situation now stands, Jordan is not creditworthy for Bank lending. We have before us, therefore, two possible choices on the level of our operational involvement in Jordan. We could either call a total halt in our operations or maintain a core program over the next fifteen months, consisting of a minimum presence in terms of new lending, the regular economic and sector work and the policy dialogue. The former, i.e., an "inactive" approach, will increase the risk of default as well as preclude any possibility that a reform program or the necessary financing will materialize. Adopting the core program, on the other hand will allow us to play an important

RZaborski|SChitale|HHashimoto|SVoyadzis/jtc
<M:\SHARED\JOR\QURESHI2.MEM> May 3, 1991

role in eventually helping the Government to formulate a strong reform program and mobilize international financial assistance, possibly by organizing a donors' conference. A key element of such a program would be the active participation of the IMF for designing a stabilization program and monitoring the exchange rate, budget deficit reduction and monetary policies.

5. While the present political support for Jordan from the Gulf countries is lukewarm, there is an increasing realization among the non-Arab donors of the geopolitical importance of and the need to support Jordan. Moreover, while the size of financial flows required to lead to a viable balance of payments situation is large in relation to the Jordanian economy, it is modest in relation to the other crisis flows being generated in the region. Finally, Jordanian skill levels are comparatively higher than those of other countries in the region, which provides some comfort for eventual resolution of the issues facing them.

6. Based on the above, we seek senior management approval for the following:

(i) Continue to work in close collaboration with the Government and the IMF to design, implement and monitor an adjustment program. The first step in this direction would be a joint Bank/Fund mission in May, to review the status of the economy and initiate the discussions on the reform program. In parallel, we propose to pursue our efforts (so far unsuccessful) to sensitize donors on Jordan's financial needs, and lay the groundwork for an eventual donors' meeting. Finally, we will work closely with our Financial Advisory Services (FAS) and the IMF, to prepare options for restructuring Jordan's debt ranging from DDSR, conventional rescheduling at the Paris or London Clubs to issuing long-term bonds for buying back expensive shorter maturity debt.

(ii) Undertake the core lending program through FY92 as set out in Annex III.[1/] In addition to the Emergency Recovery Loan already approved by the Board this fiscal year, we will present the Dead Sea Exports Project ($15 million) to the Board in FY91 and both the Social Development ($5 million) and Transportation III ($15 million) projects in FY92. These operations are designed to help the Government deal with the most immediate problems related to the physical and human effects of the

---

1/ It is the entire program taken together, rather than the promise of additional lending, that will be a decisive factor in persuading the Government to work with us and service our debt. As indicated in para. 3, Annex II, net flows from the Bank would turn negative under both the high and the core case by FY92 and FY96, respectively. This is, however, bound to happen since during the late 1980s Jordan received a very high level of Bank lending, a large part of which was fast disbursing operations.

RZaborski|SChitale|HHashimoto|SVoyadzis/jtc
<M:\SHARED\JOR\QURESHI2.MEM> May 3, 1991

Gulf crisis, by increasing exports of goods and services[2/] and addressing poverty. This is the minimum level ($5 per capita) of lending which we think will allow us to play a role in the international donor community in assisting Jordan.

(iii) Our economic and sector work for the period is designed to provide the intellectual underpinnings for the adjustment program which we hope will be adopted by the Government. Given the importance of the economic dialogue, we are proposing a fairly substantial CESW effort (see Annex IV). A key study will be a Country Economic Memorandum, which will review Jordan's current economic situation, make recommendations for needed reforms and develop a menu of options for a debt work out to restore creditworthiness. The CEM is also expected to form the basic documentation for a possible aid group meeting.

ATTACHMENT

Distribution:

Committee Members: Husain (LACVP), Jaycox (AFRVP), Karaosmanoglu (ASIVP), Rajagopalan (PRSVP), Summers (DECVP), Shihata (LEGVP), Kashiwaya (4) (CFSVP), Wood (FPRVP), Bock (OPNSV)

Other Participants: Thahane/Burmester (SECGE), Picciotto (CPB), Goldberg (LEGOP), Grilli (EAS), Wyss (COD), Sandstrom (EXC), Isenman (PRD), Linn (CEC), Stoutjesdijk (FRS), Okonjo-Iweala (OPNSV), Pfefferman (IFC-CEI), El-Serafy (EAS)

For Information: Parmar (IFC-CIO), Rao (IEC), Kavalsky (FRM), Liebenthal (PRD), Kilby (FRS), Robless (OPNSV), Walton (DECVP), Khanna (EXC), Tyler (EM3DR), Shakow (EXT)

cc: Mesdames/Messrs. Hasan, Grais, Blanchi (EMNVP), Kohli (EMTDR), Zulfiqar (EM3DR), Bhargava, Garg, Keare, Pommier (EM3), Hovaguimian (IFC), Burmeister, Vedavalli, Kolan, Nyberg, Prenoveau, Bonney, Espiritu (CSN Team), Hudes (LEG), Chabrier, Yaqub, El Khoury (IMF)

EMENA Information Center

2/ The Transportation III project rehabilitates the highways from Aqaba, inland to Syria, eastern Saudi Arabia and Iraq. This is a major source of earnings on transit traffic.

RZaborski|SChitale|HHashimoto|SVoyadzis/jtc
<M:\SHARED\JOR\QURESHI2.MEM> May 3, 1991

May 13, 1991

91052002 1

THE WORLD BANK

Operations Committee

CONFIDENTIAL

Minutes of the Operations Committee to Consider the

NICARAGUA - Initiating Memorandum for an Economic Recovery Credit

Held on Monday, May 13, 1991, at 10:30 a.m. in Room E-1243

A. **PRESENT**

Committee		Others	
Messrs.	M.A. Qureshi (Chairman)	Messrs.	C. Bertao (LEGLA)
	C. Blanchi (EMNVP)		E. Grilli (EAS)
	D. Bock (OPNSV)		T. Hutcheson (PRDRA)
	D. De Tray (DECVP)		F. Kilby (FRS)
	S. Husain (LACVP)		A. Ray (EAS)
	J. Niehuss (CFSVP)		I. Rivera (LA2C2)
	S. O'Brien (AFRVP)	Ms.	J. Salop (COD)
	I. Shihata (LEGVP)		R. Steckhan (LA2DR)
	A. Stoutjesdijk (FPRVP)		T. Thahane (SECGE)
	O. Yenal (ASIVP)		B. Tuncer (LA2)
			M. Voljc (LA2C2)
			C. Lee (IMF)

B. **ISSUES AND DISCUSSION**

1. The meeting was called to discuss the Initiating Memorandum for an Economic Recovery Credit in Nicaragua in the amount of $100 million. The discussion was based on an agenda prepared by EAS. In its opening remarks, the Region mentioned that the incoming Government has spent the past year in sorting out the politics of the situation. Nicaragua's initial conditions are extremely complex: in addition to hyperinflation, the economy has suffered heavily from the destruction due to the war and from the severe brain drain that has occurred. On top of this a centrally-planned economy needs to be transformed into a market-based economy. At this time there is broad support, including the Sandinistas who control labor and army. The rate of inflation is coming down, but the prospects for sufficient external financing are still

uncertain. The Government has a strong willingness to implement the program. Also the indications are that they will be able to build up the required administrative capacity through the technical assistance that is being provided.

2. The Chairman questioned the realism of the proposed program, and asked if it would not be better to focus on stabilization before going for the much broader programme proposed. In fact, the suggested measures on the public deficit may be inadequate. The Region responded that stabilization and structural adjustment measures cannot be easily separated in this case. For example, the large amounts of labor to be released from public employment under the stabilization program would need to be absorbed elsewhere . A fast supply response is needed if the stabilization program is to succeed; for this, Nicaragua needs to rehabilitate the financial system and develop market mechanisms for international and domestic trade.

3. On the question of macro-policy and the adequacy of the proposed stabilization measures, the Region suggested that the fiscal program is very much in place. The proposed reduction in the deficit from 14.5% to 11% of GDP would in fact be much greater because there will be no extra-budgetary expenditures on defense (the "true" reduction will be from 26% in 1990 to 11% in 1991). On exchange rate policy, the nominal-anchor approach would need to be reviewed in a few months. Credit from the Central Bank, which accounts for some 95% of total credit, would be strictly based on accumulated foreign exchange reserves, and the multiplier effect of intermediation by the Commercial banks would be very limited.

4. The Chairman suggested that the Matrix be represented in such a way that the policy measures listed there are not confused to be legal conditionalities. The limited importance of QRs on trade (confined to imports of basic grains), and their proposed removal, should also be highlighted.

5. On financing, the Region noted that the prospects of Nicaragua receiving some $300 to $350 a year, plus additional support to clear arrears, are good, but this would only be sufficient with "Trinidad" terms. The Chairman noted that the IDA allocations implicit in the Region's lending proposals are much higher than the "norm". He would like to see a separate note that explores this question, and would also like to review the matter with the President. Another Committee member enquired about the implications for retroactive financing. The Region explained that it is proposing 100% retroactive financing for the first tranche, but only a small amount for the second. On defense expenditures, the General Counsel suggested that this matter not be dealt with explicitly but rather by specifying conditionality on total expenditures and on economic and social components which fall within the Bank's mandate and competence.

6. The Chairman concluded that in view of the issues raised by this operation, the IM be sent to the President for review.

May 13, 1991

ARay:pl

Country Strategy
3 year allocation

91050909 1

THE WORLD BANK/IFC/MIGA
OFFICE MEMORANDUM

Country Strategy Note

Nicaragua ...
Get the country functioning again.
Very comprehensive, Chamorro Gov not very effective –

Major Rush problem Situation – Nicaragua
Not all of this will get done

DATE : May 8, 1991

TO : Operations Committee

FROM : EG Enzo Grilli, Director, EAS

EXT. : 81934

SUBJECT: **NICARAGUA - Initiating Memorandum for an Economic Recovery Credit - Agenda**

1. The Operations Committee will meet on **Monday, May 13, at 10:30 a.m. in Room E-1243** to consider the IM for an Economic Recovery Credit of $100 million, to be disbursed in two equal tranches against general imports subject to a negative list. Board presentation is expected to be in late September.

2. This operation would be our first in Nicaragua after an absence of some ten years. We are proposing to resume lending in an unprecedented situation. As far as initial conditions go, the 4 percent decline in output and the 7,400 percent inflation during 1990 are comparable to those in Bolivia in the early 1980s before its highly successful anti-inflation program was launched. But the situation is much more difficult in Nicaragua today; first, there already have been several failed attempts at stabilization by the previous Sandinista government, and second, the economy has essentially been a command economy, so that transformation issues arise along the lines of Eastern Europe in addition to the usual stabilization and adjustment concerns. Furthermore, because of the 10-year hiatus, our investments in ESW and strategy work need to be deepened.

3. As the Chairman of the Consultative Group, the Bank has been playing a key role in coordinating assistance programs for Nicaragua. If the Bank endorses the idea of this credit, which has been prepared in close association with IMF staff, it would give a positive signal to other donors, help lay the basis for the clearance of arrears to the Bank and IDB (there are no arrears to the Fund), and facilitate mobilization of the required financial support. As pointed out in Section VI, a viable financing scenario would only result from very generous Paris Club actions (similar to Trinidad terms).

4. The Committee might wish to discuss the following issues concerning the design of the credit and our overall assistance strategy:

Credit design

- The stabilization program (paras 18-23) envisages a reduction in the overall deficit from 14.5 percent of GDP in 1990 to 11 percent in 1991; this would result from a 6 percent (of GDP) increase in tax revenues and a 9 percent drop in current

Amount of loan - burden sharing. Deficit/GDP ratio of 30%

Program - well designed. Is it too ambitious

Priority [illegible] since [illegible] stabilization - 3% reduction is [illegible].

trade off stabiln for structural growth

expenditures. The fiscal actions would be combined with strict ceilings on the amount of domestic bank credit. Large upfront increases in public sector wages and salaries have been made to compensate for increases in the prices of public utilities, main food items, and petroleum. What are the main assumptions and uncertainties regarding the required compression of fiscal deficits and control of domestic credit? What precedence or experience do we have for being confident that the suggested policies will work? How do the key political groups, such as labor and the military, view the program?

- in particular, would it be wise to freeze the nominal exchange rate after the 400% depreciation (amounting to only 25% real depreciation)? If the inflation rate does not drop to target levels immediately, this policy might lead to rapid appreciation of the real exchange rate,

- the adjustment program described in the Policy Matrix, to be reflected in the Letter of Development Policy, is comprehensive and thorough. It includes significant actions, at least by second tranche, in such areas as public expenditures and taxation, public sector employment, restructuring of public utilities, privatization of state enterprises in the CORNAP group, restructuring of state-owned banks, liberalization of interest rates, more uniform and lower tariffs, liberalization of agricultural output prices for the important traded commodities, and finally, satisfactory progress in mounting targetted programs to assist the vulnerable groups. How realistic is this program in current Nicaraguan circumstances? While the proposed conditionalities listed in para 95 are only a subset of the Matrix, the proposed operation might still be overambitious. The Committee might consider whether we can be confident of progress in such areas as the privatization of CORNAP enterprises and the restructuring of the state-owned banks. Moreover, would the proposed measures under trade liberalization reduce revenues when they are most needed?

- the IM suggests that technical assistance would be of critical importance in implementing the economic program. What has been the experience with the quality of technical assistance being organized by the UNDP? Is there scope for us being more directly involved in strengthening technical assistance programs?

Assistance Strategy

- this credit is envisaged as the first of a series of Bank operations. It is to be accompanied by a Social Sector project in FY92, and followed by a second policy credit and an agricultural sector credit in FY93. Two more sector operations are being envisaged in FY94. This lending program assumes therefore quite rapid progress not only in stabilization and economy-wide adjustments but also in creating the preconditions for traditional operations at the sector level. While these matters might be better discussed in a country strategy note (which might be presented to the Committee at the Green Cover stage), the Region might comment on the overall IDA needs for supporting the recovery program.

- in informing the CG that we are prepared to proceed with this credit, what kind of progress in stabilizing the economy do we have in mind (there will be a track record of six months before we go to the Board)? Should a Fund Stand-by and an agreement on Trinidad terms for debt relief be preconditions? What IDA resource parameters should be reflected in the Bank's discussions of burden-sharing with other donors?

Operations Committee

Messrs. Qureshi, Husain, Jaycox, Karaosmanoglu, Wapenhans, Rajagopalan/Summers, Shihata, Kashiwaya, Wood, Bock.

cc: Messrs/Mss. Thahane/Burmester, SECGE; Picciotto, CPB; Goldberg, LEGOP; Wyss, COD; Sandstrom, EXC; Isenman, PRD; Linn, CEC; Stoutjesdijk, FRS; Okonjo-Iweala, OPNSV; Parmar, IFC-CIO; Rao, IEC; Kavalsky, FRM; Pfeffermann, IFC-CEI; Liebenthal, PRD; Kilby FRS; Robless, OPNSV; Walton, EXC; Khanna, EXC; Selowsky, Steckhan, Voljc, Clifford, LA2; Institutional ISC.

ARay:pl

May 9, 1991

910520008 1

THE WORLD BANK
Operations Committee

CONFIDENTIAL

Minutes of the Operations Committee meeting to consider EGYPT - STRUCTURAL ADJUSTMENT LOAN - Green Cover Package

Held on Thursday, May 9, 1991 in Room E-1243

A. Present

Committee	Others
Messrs. M. A. Qureshi, Chairman	Messrs. A. Abu-Akeel, LEGEM
S. Husain, LACVP	S. Burmester, SECGE
A. Karaosmanoglu, ASIVP	S. El Serafy, EAS
I. Shihata, LEGVP	E. Grilli, EASDR
K. Kashiwaya, CFSVP	M. Giugale, EM3CO
J. Wood, FPRVP	P. Hasan, EMNVP
D. Bock, OPNSV	A. Hovaguimian, CEMDR
R. Chopra, EMNVP	Mrs. N. Okonjo-Iweala, OPNSV
S. O'Brien, AFRVP	G. Reif, PRDRA
J. Linn, DECVP	Ms. J. Salop, CODDR
A. Stoutjesdijk, FPRVP	W. Tyler, EM3DR
	S. Voyadzis, EM3CO
	C. Yandle, IMF

B. Issues

1. The Operations Committee (OC) met on May 9, 1991 to consider the Green Cover package for a Structural Adjustment Loan to Egypt in the amount of $300 million. The Committee concentrated on the macroeconomic framework which had to await IMF preparation of a Stand-by. The discussion followed broadly the EAS agenda which raised the issues of compatibility between output reductions and the scaling down of the fiscal deficit, the impact of the contraction on program implementation; consistency between raising import tariffs for stabilization and lowering them for trade liberalization under structural adjustment; the social and political sustainability of the program; prospects for debt reduction and future aid flows; and the productivity of investment.

C. Discussion

2. The Chairman began by asking the meeting to focus on the macroeoconomic framework, and the Region to explain if the macroeconomic balance being sought was appropriate and adequate, besides being socially and economically feasible. The Region responded that some $13 billion of debt cancellation had already been secured from the US and Arab creditors, but more debt relief would be forthcoming from the Paris Club following the

expected approval by the Fund Board of a Stand-by arrangement on May 17. Further relief might amount to an extra $10-13 billion, but its precise level and modalities cannot be ascertained in advance. The implications of further debt relief for investment (both public and private) and for consumption, have not yet been worked out. The extra resources would give the room for maneuver on policy action to which the EAS agenda had alluded. The reduction in FY92 of the public sector's deficit by 12 percentage points of GDP would not be excessive since 6-1/2 points represented a one-time extraordinary budgetary burden in FY91, associated with the recapitalization of public banks. The budget deficit reduction (outside this latter factor) was therefore in the neighborhood of 5% of GDP, which was still considerable.

3. To a question by the Chairman as to whether expenditures were being tightened up, the Region said these were being constrained by money and credit ceilings. Public enterprises would be cut off from easy access to the banking system, which was being restructured and capitalized. A 3% decline in output this year and 1-1/2% next year were consistent with about 6% net decline in the fiscal deficit.

4. To a question as to how much decline in the deficit reflected debt service reduction and how much was due to domestic efforts, the Region estimated the net decline in the public sector deficit as 5.2% of GDP, largely through a fresh tax effort. A member remarked that the relative size of Egypt's public sector exceeded all such levels in his experience, and asked what the share was of the deficit generated by public enterprises against that by the general government. The Region responded that a comprehensive public sector accounting system did not exist to permit a precise answer, but the existing system picked up all the deficits created by the enterprises. Answering a question by the Chairman, the Region estimated that the public banks as a credit channel for public enterprises were responsible for about 10% of the fiscal deficit.

5. The Region said that the draft President's Report (table 5) projected central government revenue to rise by 10 percentage points of GDP between 1991 and 1995. After a jump in tax revenue between 1991 and 1992, largely due to the sales tax, tax revenues in relation to GDP would remain at the same level afterwards. In other words, half of the rise of revenue was already in hand. A member, however, queried whether this in fact could be in hand: the legal basis might have been provided, but surely there was no fiscal infrastructure yet in place to raise the revenue? He asked if the Bank had a handle on expenditures, including interest on debt, and whether current expenditures would be kept in check. He expressed concern also about the need to adjust public investment with the objective of improving its allocation and weeding out waste.

6. At that point IMF staff were asked to respond, and said that the fiscal picture would be altered by the exchange rate adjustments and this would have a major effect on expenditures as well as revenues, including customs returns and income tax collections. Also non-tax revenues such as the Suez Canal would rise. On the expenditure side, no reduction should be expected in nominal terms for government subsidies since final prices would rise. The sales tax had been devised with help from USAID, and this took eighteen months to develop. As to public investments, these appeared well

controlled by Planning, and progress was likely to continue in this area, especially as some public enterprises were being privatized. Control by the Ministry of Finance of current expenditure was impressive, but excessive squeeze placed on maintenance, for instance, should be avoided.

7. The Region drew attention to table 2 on page 14 of the draft President's Report which detailed the fiscal targets under the program, adding that additional debt relief would give latitude to the government either to reduce revenue or expand expenditure and allow consumption to rise. Fund staff added that they would contribute during the Fall review of the Stand-by program to the process of utilizing resources released by further debt relief.

8. A member thought that some Board presentation conditions in the package were not realistic and could be redesigned as conditions for signature, effectiveness or second tranche release. He also urged the Region to pay greater attention to the social implications of the program and the impact on the poor. Poverty alleviation, he added, should continue to be a major concern of the Bank.

Decision

9. Summing up the discussion, the Chairman said that the meeting had been very useful and that the Region provided adequate grounds for proceeding with negotiating the program.

May 17, 1991

SESerafy/lcu

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

9c05080V4 1.

DATE: May 7, 1991

TO: Operations Committee

FROM: Enzo Grilli, Director, EAS EG

EXTENSION: 81934/5

SUBJECT: EGYPT: Structural Adjustment Loan, Green Cover Package - Agenda

1. The Operations Committee will meet on Thursday, May 9 at 12:00 noon in Room E-1243 to consider the Green Cover Package for the Structural Adjustment Loan for Egypt in the amount of $300 million.

Background

2. The IM for the Egypt SAL was considered by the OC on November 21, 1990. Missing at the time was the macroeconomic framework for the proposed loan, whose elaboration was awaiting completion of the policy discussions between the Government of Egypt (GOE) and the IMF. The Region was instructed by the Chairman to circulate to the OC members a note on the macroeconomic framework upon its completion. As indicated in Mr. Chopra's cover memorandum of May 6, because of delays in completing the work for the short-term framework under the Fund's Stand-by and the need to move quickly, the Region could not prepare a separate note on the macroeconomic framework, but instead discussed it extensively in the President's Report. As the reform program agreed with the GOE during appraisal remains substantially the same as that examined by the OC in November 1990, the Committee may now wish to focus on the macroeconomic framework for the SAL.

Short-term Macroeconomic Policies and Economic Performance

3. Given (a) the immediate need to deal with the profound macroeconomic disequilibria that exist in the economy, and (b) the proximate need to control the increase in the general price level that will likely derive from decontrol of prices of goods and services (including energy and electricity), and exchange and interest rates adjustments, and in order to keep inflationary expectations in check, the short term posture of fiscal and monetary policies are sharply contractionary. For example, despite a reduction of 12 percentage points in the budget deficit/GDP ratio in one year, the loss in real output is expected to be relatively modest: -1.5% in FY91 and -3.0% in FY92:

- Are these expectations realistic?
- Should a much deeper downturn in activity be caused in the short run, how would it affect the capacity and determination of the GOE to go on with the reform program?

4. Given that the short-term stabilization program has been set in the framework of the GOE-IMF agreement over the Stand-by, the Committee may wish to know if in the Region's opinion the policy measures envisaged fit into the medium-term economic strategy being supported by the SAL. In particular:

- How can the increase in customs duty rates (a condition of prior action under the Stand-by arrangement) be reconciled with the tariff cutting objectives of the SAL?

Medium-term Sustainability of the Reform Program

5. Structural adjustment will have to follow the stabilization period, and be accompanied by effective social policies. The region stresses that all three legs of the program must be pursued, and that none can be forgone. The sustainability of macroeconomic policies in the medium term becomes, therefore, a critical issue. The success or failure of the reform program will depend on it. Several questions arise at this point:

- As per capita consumption is expected to decline sharply for 5 consecutive years, before recovering slowly in the latter part of the 1990s, is it reasonable to expect that the social conditions will allow the continuation of an ambitious reform program touching on many key areas and having far reaching effects on the economy? Put in different terms, is the pace of reforms envisaged in the program consistent with the path that the economy is expected to follow in the medium term?

- If the sustainability of reform is at serious risk, what is the room for maneuver left to the government, aside from what could come from a sharp reduction of debt/debt service from the Paris Club (which the President's Report does not fully spell out)?

- If part of that room for maneuver is expected to come from external aid flows, is there going to be a trade-off from the standpoint of industrial country aid donors, between debt relief and aid flows, particularly in the medium term?

- If room for maneuver is, instead, to be found internally, is there a basis for expecting better output results from domestic investments, which are envisaged to recover, in relation to GDP from 19% in FY91 to 24% in FY96? Why the efficiency gains expected from price liberalization, trade liberalization, public enterprise reform and greater private sector activity don't get reflected in larger and quicker improvements in the productivity of investments? In this respect, the size and time profile of the ICOR indicated in the Table on page 1 of Annex 1.A require some explanation.

6. Aside from depending on large flows of external resources, the medium term macro projections presented in the President's Report

(and spelled out in the Appendix) are conditional upon the achievement and maintenance of a certain budgetary stance, which in turn is predicated on a 5 point reduction in the ratio of government expenditure to GDP and a 10 point increase in the government revenue to GDP ratio between FY91 and FY96:

- o <u>What is the likelihood of achieving and maintaining such a profound and drastic change in the fiscal balance (and what are the risks of under-achievement)? Is a 0.4 ratio between government revenue and GNP sustainable in a country like Egypt</u>?

<u>Board Presentation Conditions</u>

7. The Region may wish to update the Committee on the status of government compliance with the two actions, among those to be taken prior to negotiations, that the GOE is having some difficulty with (i.e., the submission to Parliament of the new Public Investment Law, and the submission to the Bank of the plan to increase cotton procurement prices for the current crop year to bring them to 60% of international prices on a <u>variety by variety</u> basis)? The Region may also wish to elaborate on the strategy that it plans to pursue, should government action on these two important aspects of the program be delayed.

<u>Operations Committee</u>

Messrs. Qureshi, Husain, Jaycox, Karaosmanoglu, Wapenhans, Rajagopalan, Summers, Shihata, Kashiwaya, Wood, Bock.

cc: Messrs./Mmes.
Thahane/Burmester, SECGE; Picciotto, CPB; Goldberg, LEGOP; Wyss, COD; Sandstrom, EXC; Isenman, PRD; Linn, CEC; Stoutjesdijk, FRS; Okonjo-Iweala, OPNSV; El Serafy, EAS; Parmar, IFC-CIO; Rao, IEC; Kavalsky, FRM; Pfeffermann, IFC-CEI; Liebenthal, PRD; Kilby, FRS; Robless, OPNSV; Walton, DECVP; Khanna, EXC; Hasan, Chopra, Voyadzis, Tyler, EMENA. Institutional ISC.

EGrilli:vl

Page 36
Growth component - Page 29
Social safety net
1.3 million people will be displaced
400,000 a year will be displaced
Inflation: L3 to L5.

91058300 8 1.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: May 3, 1991

TO: Mr. Moeen A. Qureshi

FROM: ES Enzo Grilli, Director, EAS

EXTENSION: 81934

SUBJECT: EGYPT SAL - Green Cover Package

You will recall that at the OC discussion of the IM for this operation (on November 21, 1990), the macroeconomic framework had not been finalized. Now that the Fund has completed its macroeconomic work on Egypt, we have a framework. However, this raises many issues, including the political and social viability of the program, and we feel that it would be prudent to get a good discussion of the program at an OC meeting.

The Region, of course, is pressed for time, and you may judge that the package may go to the OC on a no-objection basis. Your guidance on this will be appreciated.

cc: Mr. Bock; Mrs. Okonjo-Iweala

SESerafy/lcu

for the OC:
Program needs more
consumption protection

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

910508003

DATE: May 7, 1991

TO: Operations Committee

FROM: Enzo Grilli, Directory, EAS

EXTENSION: 81938/9

SUBJECT: INDIA - Country Strategy Paper - Agenda

1. The Operations Committee will meet on Thursday, May 9, 1991 at 11:00 a.m. in Room E-1243 to discuss the Country Strategy Paper for India.

2. As spelled out in this CSP, India has not been able to sustain the momentum of the early 1980s; the reform process has stalled since 1988, and the fiscal and balance of payments positions have progressively worsened to the point where India might well encounter a near-term payments' crisis unless exceptional financing becomes available. Thus, there appears to be an increasing awareness in India that substantive policy changes are needed and that stabilization and adjustment measures must go hand in hand. However, the present political situation has paralyzed economic policy making. Although the elections scheduled for the later part of May offer the prospects for a more decisive political leadership, the outcome is in no way given.

3. The CSP outlines a policy of response to the Indian situation, graduated according to the degree of policy change that may occur. It articulates an "adjustment" scenario in detail: this involves extensive structural reforms, supported in part by policy-based IBRD loans ($0.8 billion per year) and by policy-based IDA credits ($0.2 billion in FY92 and FY94). In a second scenario, the Region assumes no serious structural adjustment measures and no policy-based lending (even though there would be a Fund-supported stabilization program). In this less favorable case, the Bank's annual commitments would be restricted to no more than $1.2 billion of investment operations. In a third, even worse scenario, Bank lending would be reduced to no more than $200 million p.a. (IDA amounts would remain unchanged).

The Transition

4. The political and social uncertainties at this time makes it difficult to forecast how economic policies and the balance of payment situation will evolve over the next six months or so. The Committee might first wish to focus on the operational imperatives during this period of transition. Would the Region elaborate upon:

- the short-term prospects of the Indian economy and the status of current discussions between the GOI, the Fund and the Bank. What steps are being followed to meet the near-term external payments needs? What effects will these have on economic output in the short-term? To what extent have the modest trade liberalization of the 1980s been reversed to the detriment of long term export prospects? How great is the risk that foreign financing will dry up further and the payment crisis becomes acute? What would be the likely impact of a default on future financing flows and long term growth prospects?

- the most likely scenario in terms of stabilization and adjustment policies. When and how does the Region expect to conclude that one or the other of the three scenarios is going to materialize? To what extent should we be prepared to process a SAL or a FSAL during the immediate future without a sufficient track record to indicate a serious commitment to reforms?

"Stabilization without Adjustments"

5. The CSP proposes that, if India undertakes a Fund-supported stabilization program, it should qualify for up to $1.2 billion of annual IBRD lending for traditional operations, even if there are no structural reform measures that can be supported by policy-based lending. This "muddling-through scenario" would probably represent the least departure from recent policy trends, and may constitute the result of a less than clear-cut election outcome. Would the Region elaborate upon:

- the basic realism and viability of this scenario. How would India adjust its fiscal and balance of payments disequilibria without undertaking strong reforms in such areas as trade and taxation, unless it accepts continued low growth? In such circumstances, even though India might meet such criteria as "share in Bank portfolio," etc., would it really be creditworthy for lending at commercial terms? How would external lenders respond to a poorly managed transition and limited policy reforms over the next few years? Might their response not force India into a prolonged period of sluggish export performance?

- whether it would really be possible to have "quality" projects with "halting structural reform efforts" (does our project implementation record warrant such optimism?);

- whether the maximum potential amount of financing for traditional operations should be much reduced from the proposed level of $1.2 billion. Should there be any IBRD lending (beyond a core) in this case at all, and if so which sectoral policy changes should be proposed as preconditions? Should we, for example, insist on reforms of prices and institutions before contemplating any further lending in energy? Should we address issues of pricing in the agricultural sector (correcting the relative prices of wheat and rice may do more for poverty alleviation in the northeast than socially-oriented investments)?

- whether India's IDA allocation should be delinked from macro-performance, as proposed. In the absence of comprehensive reforms, it is not clear that IDA credits can effectively promote growth and poverty alleviation; consequently, should the Bank be prepared, as in other countries, to consider a much reduced volume of IDA?

The "Adjustment" Scenario

6. The adjustment scenario may be seen as a high case, in which the policy response of the GOI is tightly phased and reform occurs on a scale that warrants strong Bank support. With respect to the "adjustment" scenario, the Region might elaborate upon:

- the reform priorities (paras. 39-45). If there is a SAL, what should it primarily consist of? Should the Bank suggest first priority for trade reforms (in conjunction with compression of aggregate demand and a maxi-devaluation)? If so, should we propose rapid liberalization instead of the gradual approach adopted by the last Gandhi government? Or should the Bank instead pursue fiscal reforms as the main policy priority? If we plan to seek a combination of policy changes, should we also propose, on a priority basis, changes in labor policies and in policies on foreign direct investments?

- tranching and prior action. The GOI would prefer policy-based operations to be based entirely on prior actions. Should we be prepared to consider single-tranching, and if so, do we anticipate a sufficient amount of prior actions on which the SAL and the first SECALs can be based? No

- risks. The adjustment scenario implies a departure from the limits for the "Preferred Creditor share in MLT Debt Service" and "the share in IBRD Portfolio" (Table 3, p.16). Does the strength of the adjustment program envisaged in this case warrant a deviation from Bank norms?

7. The Committee might also consider the proposal to extend, beyond December 1991, the increase in disbursement percentages on existing projects (para. 94).

8. Finally, the Region proposes that the next CSP be reviewed in July 1993, with an update in June 1992. Should the Committee ask for an earlier update - say, December 1991?

Operations Committee

Messrs. Qureshi, Husain, Jaycox, Karaosmanoglu, Wapenhans, Shihata, Kashiwaya, Rajagopalan/Summers, Wood, Bock.

cc: Messrs. Grilli, Ljung, EAS; Okonjo-Iweala, OPNSV; Isenman, PRDDR; Sandstrom, EXC; Stoutjesdijk, FRS.
Institutional ISC

ARay:vl

The World Bank/IFC/MIGA
O F F I C E   M E M O R A N D U M

DATE: 08-May-1991 06:54pm

TO: Moeen A. Qureshi (MOEEN QURESHI)

FROM: David R. Bock, OPNSV (DAVID BOCK)

EXT.: 82856

SUBJECT: India CSP

CONFIDENTIAL NOTE

Moeen,

In addition to the questions raised in OC Agenda, I find the India CSP disappointing in three respects. First, there is no mention of central government vs. state issues. From my limited understanding of India, I believe that fragmented governmental power and state/center disputes over expenditures and revenues are critical to any serious reform effort. Why no discussion of these subjects?

Second, I come away with a very uneasy feeling about the prospects for serious reform, more importantly for reforms that will achieve the necessary result of much greater efficiency and less distortion in economic incentives, etc. The CSP says that "bold" structural adjustment is required. Yet it makes clear that there is no consensus within India on the need for rapid and comprehensive moves to deregulate the domestic economy, liberalize external trade and investment, and reduce the role of government in the productive sectors. On privatization, for example, all that is considered is 20% private shareholdings in the public enterprises as a way of tapping private savings to finance these (inefficient) institutions appetites for capital. Is this realistic? It sounds like India is still in the very early stages of thinking about de-socialization. Typically, the socialists start with this notion but it never works and simply forestalls serious reform for a season. Should we back such a timid approach to restructuring of the economy?

I fear that the vision of reform is still lacking in India, and the region seems willing to accept rather low standards, given the history and politics of India (and the Bank's relationship).

Third, I found the discussion of risk very disappointing. I would have preferred something along the following lines. India's economic performance and creditworthiness is deteriorating. Commercial creditors are withdrawing. On risk management grounds alone, we should also be scaling back unless the Indian authorities come up with a credible adjustment program that we can support. The question then is what level and composition of lending can we justify (a) if there is no adjustment program and (b) if there is?

Such an approach would have produced a realistic assessment of risks, core lending program, etc. as a base line scenario, with some better definition of the conditions under which we would be willing to not reduce lending and/or actually increase it in support of a program. Equally important, it is the right way to approach the Indians from a risk management standpoint. What we don't want is a "reform or else" posture that would stimulate arrears/rescheduling (the Indians know from experience that the Bank does reschedule). Instead, we want to keep them on the defensive with a "your performance is forcing us to cut back as any prudent lender would, but if you take steps to correct the situation, we will be the first to help you" approach.

David

CC: Enzo Grilli (ENZO GRILLI)
CC: Ngozi Okonjo-Iweala (NGOZI OKONJO-IWEALA)

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: May 8, 1991

TO: Mr. Moeen Qureshi

FROM: Lawrence H. Summers

EXTENSION: 33774

SUBJECT: Re: India Country Strategy Paper

1. I welcome the development of three sharply differentiated scenarios in response to the highly uncertain situation now faced in India. However, I am not convinced the adjustment scenario as now laid out is credible. In contrast to a common tendency to think of India as unique, I believe international experience is highly relevant to the current crisis. This experience indicates a stronger program will be necessary. I hope that concern to maintain external confidence does not in any way moderate the message the Bank gives as to the gravity of the situation and the scale of policy action required.

2. The priority now should be to develop a coherent set of recommendations for the adjustment scenario in the event a new government comes in with a will for action. I would be happy to provide staff support for this. This case would warrant both substantial IBRD and IDA support. I found the intermediate scenario insufficiently well-specified to comment on. While its probability may be higher than the adjustment scenario, it would be preferable to revisit the situation later rather than agree to any substantial support for this case now.

3. There are four areas where I believe the current adjustment scenario needs modification.

(a) **The pattern of macroeconomic adjustment.** The projections look too smooth. Successful adjusting countries usually have temporary declines in investment and, to a lesser extent, output. An investment decline helps smooth consumption and makes sense if the period of transition is used to put in place policies that can underlay a subsequent investment recovery. It can also bring valuable gains in reduced import demand, that can be appropriately distributed between a reduced current account deficit and higher consumption: a back-of-the-envelope calculation suggests a decline of investment of 3 percent of GDP could lead to a reduction in import demand of 0.9 percent of GDP.

(b) **The scale of fiscal adjustment.** The public accounts are a major part of the macroeconomic crisis, but the proposed pace of adjustment looks very modest by international standards. As the attached note shows, successful adjustors, such as Malaysia, Mexico and Morocco, moved much more decisively. Failed fiscal adjustment, as in Brazil, leads either to accelerating inflation or repeated foreign exchange crises. In addition, the design of fiscal adjustment places too much emphasis on current spending. While reducing subsidies should have high priority, more attention needs to be given to capital spending, especially outside essential infrastructure (central government spending for industrial investment is one percent of GDP, for example), and on revenue increases, from both user charges and taxation. Our tax work shows the potential strength of a VAT; broadening India's present VAT-type tax could be a promising area. Structural reforms would need to be designed with attention to their fiscal impact.

(c) **Structural reform.** More work on design and sequencing is needed here. India is more likely to pursue a path of fundamental reform over an extended period, as in Indonesia, than a Mexico-style big bang. However, Indonesia's experience is not one of overall gradualism, but of a sequence of decisive actions in the most pressing areas. I expect the priorities for early, decisive action in India would lie in the areas of removal of import licensing (that is also a form of domestic control), further deregulation of investment, especially for foreign investors, and exchange rate action. More fundamental deregulation of the labor market, relaxation of exit restrictions and privatization are also of great importance, but may take more time to implement. While some tariff adjustments may be necessary as quantitative controls are relaxed, a broader tariff reducing trade liberalization will be of lower priority in India than a small open economy and can come later. In the financial sector, early action to tackle losses due to directed credit and loan forgiveness is urgently required, but financial liberalization could come later, after the fiscal deficit comes down and the product and labor markets are in better shape. Such a sequence, if combined with early fiscal action, is consistent with the results of the RALs. Any adjustment loans should be designed in accordance with an appropriate sequence of policy change.

Does not [illegible] does not matter for India

Lack of sequencing is a problem

(d) **External finance.** This looks too optimistic with respect to private money--from banks and via NRIs. I am also very worried that the dynamics of IBRD creditworthiness and portfolio considerations mean we have three to four years of high positive net transfers followed by significant negative net transfers. Every effort to raise concessional inflows in the event of strong reform should be made--including increasing or accelerating IDA flows--but a smoother path of non-concessional money seems essential for a sustainable effort in what will certainly be both a prolonged and uncertain process. This is likely to imply a need for a lower current account deficit--and my above remarks on imports and sharper fiscal deficit reduction are directly relevant to this. While optimism on short-term foreign investment inflows would be foolhardy, a couple of facts give some hope for the future: foreign investment inflows to India were \$1 bln in 1986-90, compared with \$11 bln for China, and the performance of the Bombay stock exchange prior to the recent crisis would give heart to potential investors.

4. Finally, I am fully aware of the need to manage any support for policy action in a manner that is sensitive to India's political circumstances. I would support as low-key approach as is feasible, provided it is linked to strong policy action.

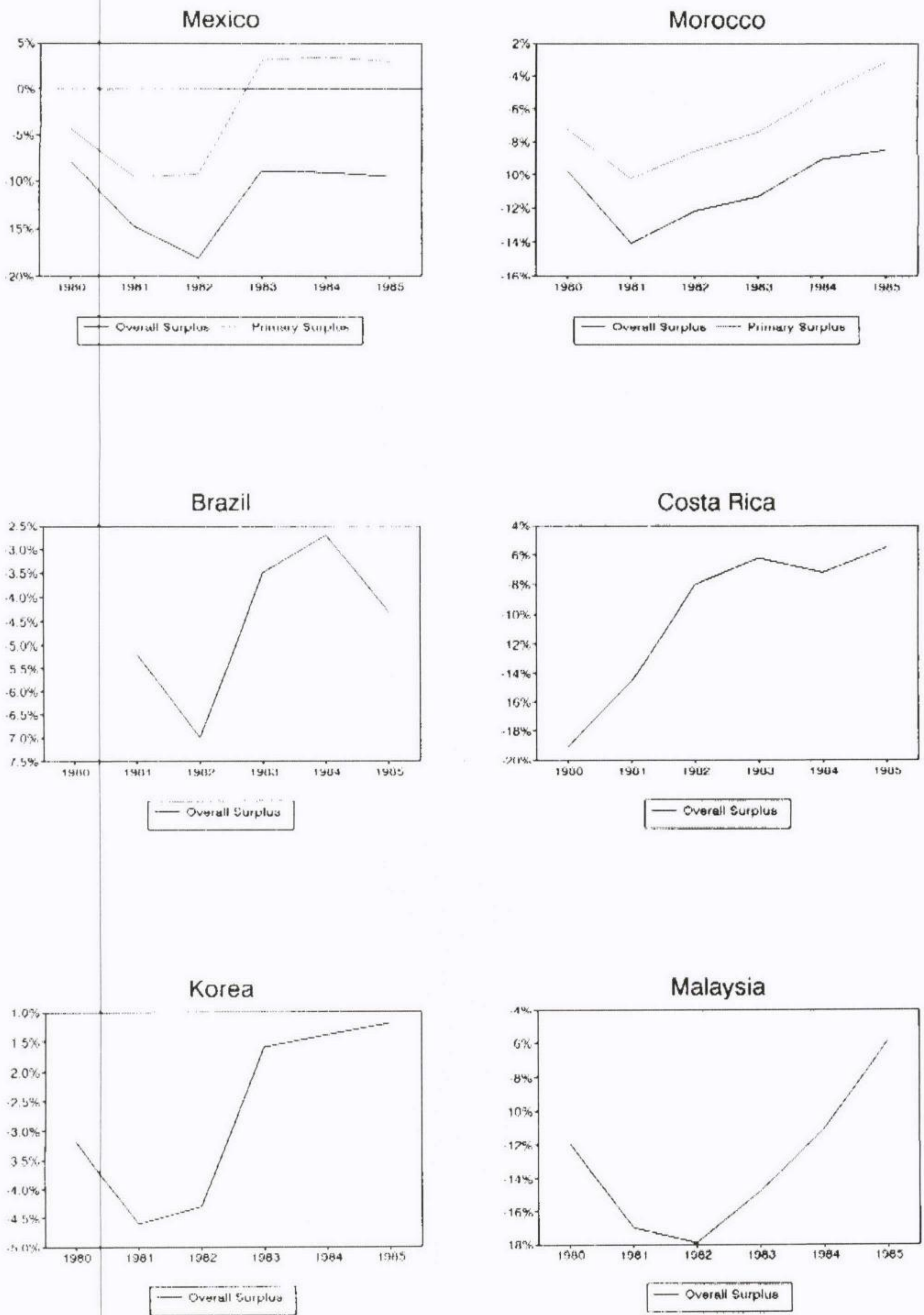
cc: Messrs. W. Thalwitz, E. Jaycox, A. Karaosmanoglu,
S. Husain, V. Rajagopalan, I. Shihata,
K. Kashiwaya, J. Wood, D. Bock, E. Grilli,
P. Isenman, H. Vergin, J. Khalilzadeh-Shirazi

Some International Experiences with Fiscal Adjustment

The pace and scope of fiscal adjustment in some selected countries in the aftermath of the debt crisis are shown in the attached graphs. The sharpest adjustment was that of Mexico, which improved its primary balance by around 12 percent of GDP in just one year. Costa Rica also succeeded in reducing quickly its public imbalance: the deficit of the overall public sector (including those of the Central Bank and the public enterprises, that accounted for most of the public imbalance) was cut by over 10 percent of GDP in only two years. In Morocco, the adjustment was somewhat less dramatic, but still substantial (a 7 percent of GDP increase in the primary surplus in four years). Moreover, these three countries succeeded in maintaining the fiscal adjustment in later years. In contrast, Brazil only managed to reduce its fiscal imbalance by less than 3 percentage points of GDP in 1981-85, made no further progress in later years, and ran into increasing difficulties in terms of inflation and external payments.

What is the experience of Asian countries ? Malaysia and Korea also succeeded in adjusting their public finances in the early eighties. Malaysia adjusted sharply, reducing its public deficit by 12 percent of GDP in three years. Korea (whose public imbalance was much more modest than those of the other countries in the figures) also adjusted quickly, cutting the public deficit by 3 percent of GDP over just two years. As before, both countries have succeeded in preserving their fiscal improvement.

Fiscal Adjustment in Selected Countries (Percent of GDP)



910524003

1.

THE WORLD BANK

Operations Committee

CONFIDENTIAL

Minutes of the Operations Committee Meeting to consider
ALGERIA - Enterprise and Financial Sector
Adjustment Loan: Initiating Memorandum
Held on Wednesday, May 1, 1991 in Room E-1243

A. Present

Committee	Others
Messrs. M. A. Qureshi, Chairman	Messrs. M. Ahmed, EM2IE
S. Husain, LACVP	M. Ayub, EM2CO
I. Shihata, LEGVP	K. Dervis, EM2DR
K. Kashiwaya, CFSVP	F. Earwaker, PRDRA
J. Wood, FPRVP	M. El-Erian, LEGEM
J. Linn, DECVP	S. El Serafy, EAS
R. Chopra, EMNVP	E. Grilli, EASDR
O. Yenal, ASIVP	P. Hasan, EMNVP
S. O'Brien, AFRVP	S. Kjellstrom, EM2IE
	Mrs. N. Okonjo-Iweala, OPNSV
	K. Siraj, COD

B. Issues

1. The Operations Committee (OC) met on May 1, 1991 to consider the Initiating Memorandum (IM) for a $350 million Enterprise and Financial Sector Adjustment Loan to Algeria. The discussion followed broadly the agenda prepared by EAS, which raised the issues of links with the earlier Economic Reform Support Loan; progress on the Stand-by; the future of inflation and capital inflows; identification of a core set of conditions; role of the specialized funds; interest rates and banking reforms; the operation's risks; and previous observance of conditions relating to audited Statements of Expenditure.

C. Discussion

2. In response to the Chairman's request to the Region to compare the reform proposals for Algeria with those for Eastern Europe, the Region said there were similarities as well as differences. Like Eastern Europe, Algeria was pursuing political democratization and economic liberalization in parallel. The first free elections, preceded by very lively debates in the media, were scheduled for end-June, and some 40 parties would be contesting them. Unlike Eastern Europe, privatization was not spearheading reform, though it was very much in the program. Private ownership in Algeria had historically been associated with colonialism, whereas in Eastern Europe it had previously existed and been displaced by a foreign-imposed system. At independence in 1962 the Algerians themselves chose a system based on public ownership. The government had come to realize that

in order to encourage competition in the final goods markets, the factors markets themselves had to be competitive, and agricultural landholdings, therefore, had been privatized. Private sector ownership was broadened by the 1989 Constitution, and the new Commercial Code provided scope for competition between the private and public sectors. The Region added that all remaining issues with the Fund had been resolved, and the IMF Board was scheduled to consider a Stand-by for Algeria in the first week of June. The Fund-negotiated program covered major exchange rate adjustments and trade liberalization measures, but some restrictions remained on payments for imports. All quantitative controls had been removed, and the Region judged that the Algerian economy was set on an opening-up course.

3. The Region stressed three elements in the Algerian reform strategy viz: (a) ensuring competition, largely through import liberalization, in order to undermine the monopoly enjoyed by many large public enterprises; (b) forcing public enterprises to operate as commercial units [the new commercial code also permitted a variety of forms for public and private sector collaboration, including joint ventures, and trading in shares in public enterprises was expected]; and (c) identifying and isolating a core group of large loss-making public enterprises whose losses would be reduced by 70% in 1991 through constraining their wage increases and access to credit, and by substantial increases in output prices. Their access to foreign exchange would also be limited. Diagnostic studies would be conducted to identify solutions and follow-up actions in early 1992, including possible restructuring or closure. A key objective of financial sector reform, the Region added, was to impose a binding budget constraint on financing public enterprise deficits. Public enterprises accounted for 60% of bank loan portfolios, and new prudential regulations were in the process of being formulated and gradually implemented, setting asset classification standards and rules for bank certification. New rules, however, were not sufficient, but a different mode of thinking, as well as political support for the reforms were also essential. In the Region's judgment such elements were now present.

4. The Chairman said that it was possible that what the Region was witnessing in Algeria was a forced reaction by the authorities to a difficult situation, and that commitment to reform might be lacking. He asked specifically if the Region did obtain any undertaking from the authorities on the liquidation of loss-making enterprises, or for privatization, with a defined plan of action covering restructuring. He further wanted to know how much trade liberalization had been achieved, cautioning that liberalization had to be carefully coordinated with price deregulation. To this the Region responded that liberalization and deregulation had progressed in tandem in recent years. Foreign exchange allocation procedures had been reviewed in 1988-90. The system had moved away from the old centralized pattern of allocating foreign exchange by sector and firm, which crowded out the private sector. The new system, supported by the proposed loan, would replace administrative allocation by a market mechanism. To achieve this the exchange rate had been adjusted in late 1990 from 10 to 18 dinars per US dollar, and effectively to 22 dinars per US dollar if a general import surcharge of 25% was included. Further exchange rate adjustments had been agreed with the Fund, linked to import liberalization and reserve accumulation. Under this mechanism imports, with few exceptions, would not be administratively controlled, but could be imported freely at the official exchange rate.

5. The Chairman then asked if trade liberalization was part of the Fund's concern, and the Region said it indeed was. Now that quantitative restrictions on imports had been removed, the Chairman asked, was not the trade regime heavily distorted by tariffs? The Region responded that tariff adjustments would be the next stage in the trade liberalization program. Reforming the whole system was indeed the Region's objective, and would be addressed under a Trade and Fiscal Reform loan now being prepared. Altogether the tariff structure -- which was rather irrelevant when trade was tightly controlled -- was not heavily distorted, with the highest tariffs in the range of 40-45% and the average around 20%.

6. A member asked if what the Region was saying was that public sector reform would be combined with trade liberalization in order to generate competition. The macroeconomic tables showed that 70% of the foreign exchange earned would be going to service the debt. He asked if this ambitious reform program could be sustained in the absence of enough foreign exchange to finance imports, and particularly as exports were inelastic to the exchange rate. In response the Region said that imports were already high at 25% of GDP, and no dramatic import growth was therefore expected. As ICORs revealed, foreign exchange had been misused, financing a distorted pattern of imports. Lower public sector investments would save foreign exchange which, with a unified official and parallel rates, would be available to the private and public sectors alike. One potentially important source of foreign exchange was workers' remittances which should respond positively. The average Algerian worker remitted home only one tenth of his Moroccan counterpart.

7. Other speakers came back to the issue of privatization, and asked if more could not be done under the proposed operation. Would it be easy to move a public-sector dominated system toward a market economy? Was it realistic to expect public enterprises to be insulated from political interference? Was it not necessary to exact a government commitment that a portion of the large public enterprises would end up in the private sector? And finally, was the government prepared to go through with the painful process of enterprise restructuring?

8. The Chairman said that there was clearly a group of reformers within the government trying to turn Algeria into a market economy, and wanting to reduce the public sector and enhance private enterprise. They might not be enthusiastic for privatization per se, but were aware of the wastefulness of the public sector and the distortions under which it worked and also generated. As elections were due in a few weeks, the form privatization might take could not be determined today. He noted that the Region judged the prospects of economic reforms to be good, even under a post-election government led by the Islamic Salvation Front (FIS). The Region added that FIS was in fact advocating full privatization within six months, and that the whole issue of privatization needed careful handling in view of the fragility of Algeria's society. There was no crisis at hand, but with 20% unemployment some degree of gradualism should be entertained.

9. A member said the Bank was barred legally from taking ideological positions based on political considerations, including a position on privatization. He saw no reason for the Bank's insistence on privatization if public sector units were working efficiently under competitive conditions, and suggested that privatization be taken up as a practical matter, based on considerations of efficiency and economy, with emphasis on

openness and competitiveness. He also thought that creating a legal code was not enough, and that time was needed to develop a coherent legal framework and set up implementation regulations. It made no sense to pile up conditions for this loan without being clear on the implementation capacity of the borrower. He thought that the social dimension was also important and this should be viewed in the cultural context of the country.

10. Other speakers asked what would happen to those enterprises whose losses were diagnosed as unavoidable. What pressure could be brought to bear on the government to liquidate those? The Region said that the bulk of the additional revenue accruing to the Treasury (as a result of higher export value due to devaluation) would be set aside for debt-service and public enterprise restructuring. The diagnostic studies would show which enterprises were not viable and how to make them viable. Before second tranche release action plans would be initiated for 15 out of the 22 enterprises in the core group. Once the price structure had changed viability would also change; and pressure would continue (after consolidation of part of the debt and transferring its responsibility to the government) on the restructured entities.

11. Another member noted that we did not have answers yet to many questions, including an appropriate debt management strategy and that we should perhaps concentrate on reforming the public sector until we saw a clear commitment to privatization. In time we could come back. Meanwhile the main issue, he said, was whether we had the right lending instrument for the objective being sought which he considered as a long term one, and largely institutional. He wondered whether a quick-disbursing operation was the right one in the current political environment. Would it not be better to have an extended tranche operation geared to the needs of public sector reform? Government commitment on privatization was at best unclear, and post-election government commitment was even more difficult to judge.

12. A member viewed the references to government commitment to privatization as lukewarm at best. He added that financial circles in London and Tokyo were apprehensive lest a decline in oil prices should lead to Algeria defaulting on its debt, in which case it might take five to ten years to roll over its debt obligations. The Region said that the stock of debt was not so great as to require rescheduling. The government was averse to debt rescheduling, which meant that it was subjecting itself to a tighter discipline in the short run.

13. Another member thought that the IM did not adequately demonstrate a balance of payments need in order to justify a quick-disbursing operation as the current account deficit was small. He did not doubt that a better case could be made in view of Algeria's heavy dependence on a single export. He thought this was a well worked out operation, but he was a little concerned over strategy. Bank money would finance a capital account restructuring of entities, raising Bank exposure and reducing exposure of commercial creditors. He was struck by the tripling of Bank exposure between 1989 and 1994. Was the large increase in Bank exposure necessary for the financing plan? In the light of this, he added, our strategy should be reviewed and quick-disbursing lending reduced.

14. The Region said there was a need to refinance maturing debt, and to manage the current account better. The current account did not present a problem as medium-term surpluses were projected. Support, however, was

needed from the Bank and the Fund, and Japan's Eximbank appeared ready to co-finance. The Fund's Stand-by was conditional on the Bank's program and vice-versa, and the commercial banks would not move without them. Beyond this operation, the Region was envisaging other adjustment loans over the next few years, including a trade and fiscal reform loan and an agricultural sector adjustment loan.

Decision

15. The Chairman summed up as follows:

(a) Clear criteria were required on how to translate intentions into actions regarding the future of the core group of public enterprises. Criteria should also be worked out with the Government before Board presentation on how the recommendations of the diagnostic studies would be implemented, including closures and privatization. The language used in the terms of reference for the consultants recruited to carry out the diagnostic studies, would have to be strengthened and made specific.

(b) Foreign direct investment, projected to remain modest at $160-200 million annually, appeared inconsistent with the spirit of the reforms and these projections should be reviewed.

(c) If oil prices were to rise above projections, future adjustment lending would have to be re-assessed, but second tranche release under the proposed operation should not be made dependent on oil price developments.

(d) The Region should seek to include a commitment on privatization in the Letter of Development Policy.

(e) The Fonds de Participation should be able to sell shares of public enterprises in their portfolio. Current ambiguity in the legislation should be removed, but such a legislative change might, however, have to await the convening of the new Assembly.

16. Concluding the meeting the Chairman cautioned that there would be pressures within Algeria to delay action. Some bureaucrats might not want to privatize, and needed a clear signal from the top that the Government was considering privatization as an option.

May 23, 1991
SES
SESerafy/lcu

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: May 1, 1991

TO: Mr. Kemal Dervis, EM2DR

FROM: Johannes F. Linn, CECDR

EXTENSION: 37458

SUBJECT: ALGERIA - Enterprise and Financial Sector Adjustment Loan -- Initiating Memorandum (IM)

The program which this loan proposes to support is complex and potentially farreaching. I am concerned, however, about the basic strategy on which the program appears to be based and about the implementation of the strategy as reflected in the Memorandum.

As for the strategy, the basic issue is whether the process of corporatization should be explicitly and directly linked to a commitment by the government to move towards privatization in the long term. Without such a commitment and clear initial steps towards its implementation, it is quite possible, if not indeed probable, that the participation funds that are to be set up under the program will in effect become just another layer in the public administration rather than a mechanism of efficient corporate management in a competitive environment. I believe the Region should seek a more explicit understanding with the government that the participation funds are a first step towards eventual large scale privatization, and that it should during appraisal identify ways to try and lock in such an agreement through appropriate legislative or regulatory steps to be undertaken as part of the loan. A greater commitment to move towards a private banking system would also be important.

As for implementation of the strategy proposed in the IM, I am concerned that the program for enterprise and financial sector restructuring seems to consist mainly of the preparation of studies and action plans, rather than of actions per se. Perhaps this is the necessary first step in the development of a well articulated process of long-term institution building. In that case, however, it would be preferable to support this effort through a technical assistance loan, rather than a large quick-disbursing adjustment operation. Another option would be an extended-tranche adjustment operation with a longer disbursement period and multiple tranches. However, even this would require considerably more specificity regarding the content of the action plans that would be the subject of second, third or more tranche releases. In any case, if an adjustment operation is to go ahead, one should seek more specific commitment up front regarding cost cutting measures in the loss making public enterprises and regarding the financial and regulatory measures to be taken in the banking system.

In two other areas we also miss specificity in the current program: First, there is no mechanism by which one can be sure that private enterprises get access to credit, which will be critical for them to be able to respond to the new freedom from restrictions. How about requiring a minimum and growing share of bank credits going to private enterprises? Second, the criteria for the application of the social safety net would only be developed late during program implementation. It would be preferable to develop these criteria right away as part of the appraisal, and then monitor the implementation of the safety net provisions according to these criteria during the program period. The need to be more specific regarding safety net provisions derives also from greater commitment regarding cost-cutting measures in loss-making enterprises which I believe would be appropriate.

cc: Messrs. Qureshi (OPNSV); Husain (LACVP); Jaycox (AFRVP); Karaosmanoglu (ASIVP); Wapenhans (EMNVP); Rajagopalan (PRSVP); Summers (DECVP); Shihata (LEGVP); Kashiwaya (CFSVP); Wood (FPRVP); Bock (OPNSV); Grilli (EAS); Isenman (PRDDR); (Ms.) McNaughton (CECFP); Liebenthal, Earwaker (PRDRA); Nellis (CECPS); Rocha (CECMG).

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

9(0430003

DATE: April 29, 1991

TO: Operations Committee

FROM: EG Enzo Grilli, Director, EAS

Para 43

EXTENSION: 81934

SUBJECT: ALGERIA - Enterprise and Financial Sector Adjustment Loan - Initiating Memorandum - Proposed Agenda

1. The Operations Committee will meet on Wednesday, May 1, 1991 at 4:00 p.m. in Room E-1243 to consider the Initiating Memorandum for a proposed $350 million loan to Algeria for an Enterprise and Financial Sector Adjustment Loan, which was forwarded to you under cover of Mr. Wapenhans's memorandum of April 24. The following issues may be taken up by the OC for discussion.

Background

2. The oil and gas resources of Algeria gave it an opportunity for development which has largely been missed as much of these resources were squandered on badly conceived capital intensive projects, with little attention to market forces, employment creation or environmental protection. The availability of the petroleum resources also provided an apparent collateral for external lenders and encouraged Algeria's excessive borrowing so that the debt service ratio reached 71% in 1988. In reflection of weakened oil prices, per capita consumption has fallen drastically during the past few years, and open unemployment is now estimated at a quarter of the labor force. Previous lack of response to Bank advice has given way since 1988 to a collaborative relationship, and half of the projected lending of $1.8 billion in the four years FY92-95 would be for adjustment. The proposed operation would be the second adjustment loan to Algeria. The first (an Economic Reform Support Loan for $300 million) had its second tranche disbursed in October 1990, but is not mentioned in the IM as being relevant to this operation. Mr. Wapenhans's cover memorandum stresses the interdependence in processing between the operation under review and a Fund Stand-by, with some outstanding issues for the latter, to be "clarified in the next few days."

- The Region might explain the link between the earlier operation and this one, and update the OC on compliance with earlier conditions for public enterprise reform from which a waiver was granted.

- The Region might update the OC on any progress made on the issues that might impede the Stand-by.

The Macroeconomic Framework

3. A medium-term macroeconomic framework, prepared (largely) with the Fund, is presented (IM pp. 32 ff), but this is said to be highly sensitive, particularly to petroleum prices (in view of the near total dependence of exports on hydrocarbons), and also to external financing since MLT debt service obligations are about $8 billion a year in 1991 and 1992, and are not projected to fall off much for many years afterwards.

The Dinar has been progressively devalued during the past few years, with a real effective devaluation of 29.3% in 1990 alone. Consumption has gradually eroded with little prospects for improvement in the near future, and this has triggered a social safety fund initiative still in the making, which may absorb 3% of GDP by 1992 (para. 87). The fiscal balance is projected to improve, however, and gross investment, traditionally high in Algeria, will be kept at about 30% of GDP. Capital requirements from abroad are therefore substantial, and are said to require special handling, which does not include debt rescheduling. The Region might explain:

- Whether the projected high inflows of foreign capital are realistic in view of the current political tensions and sensitivity of the projections to exogenous factors.

- Whether inflation, if it were to prove intractable, could jeopardize the whole basis of the financial adjustment program.

Loan Objectives and Conditionality

4. The program supported by this loan would seek (a) to accelerate trade and price liberalization, and (b) to implement structural reforms in the financial sector. On (a), it is envisaged that by mid-1992 all prices will be market-determined (save for a few basic products, including energy); QRs on imports removed (with some exceptions) and "all obstacles" to private initiatives lifted; public enterprises incorporated, their ownership separated from management, and restructured physically as well as financially, with focus on the largest loss-makers. For the financial sector, reforms will affect Treasury relations with the system; rationalizing interest rates and credit policies; supporting the Central Bank in regulating banking; and restructuring the existing banks.

5. A set of conditions for Board presentation is listed in para. 105 for price deregulation; diagnostic studies for the largest loss-making public enterprises; a commercial code; and criteria for disbursing bank restructuring funds. Another set of conditions for the financial sector includes: an accounting and auditing plan; bank inspection; prudential ratios; preparation of action plans for at least two commercial banks; and a modernization plan for the Central Bank. As to tranche release, two sets of conditions are elaborated (para. 106): more product prices to be liberalized; action plans agreed on restructuring 15 large-loss public enterprises, with credit ceilings for the rest; various reforms of Funds, and implementation of the commercial code. For the financial sector: adoption of plans for restructuring the Algerian Development Bank and the National Savings Fund; adoption of regulations on bank auditing and inspection and prudential ratios; presentation of restructuring plans for all commercial banks, and drafting a legal framework for the insurance industry, and allocation of equity funds to the banks.

- The Region might begin by giving the Committee an overall account of the financial sector institutions, pointing out their current functions, their financial viability, the number of commercial banks extant, and the modus operandi of the various parts of the financial system in relation to the Treasury and to the Central Bank, ending with a blueprint of the financial sector at the end of the process.

- Is not the reform program congested with too many measures which need time to put in place?

- Can the Region indicate what constitutes the set of core conditions to be met at Board presentation and at tranche release?

6. The following questions may be raised in respect of the two broad reform areas:

(a) General and Enterprise Conditionality

- Should the Bank seek to fine-tune deregulation by supporting mark-up margins?

- What is the rationale for specifying 16 joint ventures with foreign partners to be approved by the Council on Money and Credit (Matrix, p. 4)?

- Should not the price liberalization arrangements in the Legal Framework be dated, instead of taking effect eight months after the relevant imports had been liberalized?

- What are the objectives of employment policy reform? Is all that is envisaged compensation for displaced labor?

- Do the environmental provisions (training; preparation of a project; study of hazard wastes) make an integral part of the program, or is it just convenient to attach them to this operation?

- Why are all the specialized Funds necessary? How does the Region envisage their respective roles? How will competition be achieved among the enterprises in a Fund's portfolio?

(b) Financial Sector Conditionality

- Why should interest rates continue to be negotiated within a pre-determined ceiling, and how do the present ceilings compare with current and projected inflation? How will the lower rates targeted for the money market affect bank efforts to mobilize deposits? Why cannot real interest rates be mandated to be positive, and then liberalized in the context of Central Banking reform?

- What entry conditions are set out in the new bank certification rules, and are they to be consistent with banking stability and competition objectives?

- In the absence of portfolio audits, how was the DA 10.8 billion budgeted in 1991-92 reached for bank recapitalization (to attain a 4% capital-risk assets ratio in 1992)? Will additional funds be budgeted if needed?

Loan Risks and Tranching

7. The IM (paras. 107-110) highlights the political risk, the risk of adverse development of exogenous factors, and the complexity and comprehensiveness of the adjustment program which would take place in hitherto unfamiliar surroundings for the Algerians. The Committee may wish to consider:

- o If the proposed front-loaded conditionality and other arrangements are enough to redress the formidable risks indicated.
- o If disbursement should not extend over three rather than the two tranches proposed.
- o Whether audited Statements of Expenditures for the previous adjustment operation have been received and considered adequate.

Operations Committee

Messrs. Qureshi, OPNSV
Husain, LACVP
Jaycox, AFRVP
Karaosmanoglu, ASIVP
Wapenhans, EMNVP
Rajagopalan/Summers, PRE
Shihata, LEGVP
Kashiwaya, CFSVP
Wood, FPRVP
Bock, OPNSV

cc: Messrs./Mmes: Thahane/Burmester, Picciotto, Goldberg, Wyss, Sandstrom, Isenman, Linn, Stoutjesdijk, Okonjo-Iweala, El Serafy, Parmar, Rao, Kavalsky, Pfeffermann, Liebenthal, Kilby, Robless, Walton, Khanna, Hasan, Dervis, Ayub, Ahmed.

SESerafy/lcu

E -1241

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: April 24, 1991

TO: Mr. Moeen Qureshi, OPNSV

FROM: W. A. Wapenhans, EMNVP

WA

EXTENSION: 32676

SUBJECT: ALGERIA: Proposed Enterprise and Financial Sector Adjustment Loan

1. Attached please find for your review, and for consideration by the Operations Committee, the Initiating Memorandum for the above operation.

2. This operation is being processed in parallel with a second Fund standby arrangement for Algeria. Collaboration between Fund and Bank staff has been exceptionally close during project preparation. Moreover, given the close linkages between the programs being supported by the two institutions, our position has been that we would not proceed with Board presentation of the proposed loan until a Fund program was in place. The Fund has also taken the position that it's own standby would only be presented to the Board once the Algerian authorities reach substantive agreement with the Bank on the program of enterprise and financial sector restructuring, which is the focus of the proposed loan.

3. The Fund standby is now at an advanced stage of negotiations, although final agreement has still to be reached on the speed of price adjustments for certain subsidized commodities. We expect that this issue will be clarified during the next few days, as a result of the discussions Fund management will have with the Algerian delegation (led by the Governor of the Central Bank) to the Interim/Development Committee meeting.

cc. Mesrrs/Mmes. Qureshi, Bock (OPNSV), Jaycox (AFRVP), Karaosmanoglu (ASIVP), Husain (LACVP), Summers (DECVP), Wood (FPRVP), Shihata (LEGVP), Kashiwaya (4) (CESVP), Wood (FPRVP), Rajagopalan (PRSVP), Thalwitz (PRESV), Blanchi, Hasan, Fox (EMNVP), Stern (FINSV), Isenman (PRD), Rao (IEC), Linn (CEC), Churchill (IEN), Grilli (EAS), Wyss (COD), Thahane (SECGE), Picciotto (CPB), Goldberg (LEGOP), El-Serafi (EAS), Niehuss (CFSVP), Stoutjesdijk (FRS), El-Erian (LEG), Prefontaine (LOA), Frank (CFPVP), Parmar (CIOVP), El-Rifai (MIGPA), Dervis, Costa (2), Brizzi (EM2DR), Sandstrom (EXC), Kavalsky (FRM), Robless (OPNSV), Khanna (EXC), Walton (DECVP), Liebenthal (PRD), Pfefferman (IFC-CEI), Ahmed, Kjellstrom, Kumar (EM2IE), Ayub, Parks, Khadr (EM2CO), Kohli (EMTDR), Wackman, Baudon, Hinds (EMT)

MAhmed:cg

910510009 1

THE WORLD BANK
Operations Committee

CONFIDENTIAL

Minutes of the Operations Committee to consider
BULGARIA - Country Strategy Note and
SAL Initiating Memorandum
Held on Wednesday, May 1, 1991 in Room E-1243

A. Present

Committee	Others
Messrs. M. A. Qureshi, Chairman	Messrs. S. El Serafy, EAS
S. Husain, LACVP	W. Grais, EMNVP
I. Shihata, LEGVP	E. Grilli, EASDR
K. Kashiwaya, CFSVP	P. Hasan, EMNVP
L. Summers, DECVP	S. Hassan, LEG
J. Wood, FPRVP	T. Hoopengardner, EM4CO
R. Chopra, EMNVP	Ms. O. Kalantzopoulos, PRDRA
O. Yenal, ASIVP	E. Lari, EM4DR
S. O'Brien, AFRVP	Mrs. M. Mukherjee, CFSFA
	P. Nouvel, EM4CO
	Mrs. N. Okonjo-Iweala, OPNSV
	Ms. J. Salop, COD
	J. Shilling, CFSFA
	T. Thahane, SECGE
	M. Walton, DECVP
	J. Wilton, EM4CO
	T. Wolf, IMF

B. Issues

1. The Operations Committee (OC) met on May 1, 1991 to consider the Country Strategy Note (CSN) for Bulgaria, together with the Initiating Memorandum (IM) for a Structural Adjustment loan in the amount of $250 million. As the CSN was intended to provide a context for the SAL, the issues raised and the discussion at the OC were addressed jointly. The discussion followed broadly the issues identified in the EAS agenda which, for the CSN, covered the debt situation and the dialogue with the creditor commercial banks; the risks involved in the high level of lending proposed; the differentiation in terms of reform and macroeconomic outcome of the three scenarios presented; the realism of the projected capital inflows; and the Bank's role as aid coordinator. For the SAL, the agenda questioned the resting of structural reform on a stabilization base that is still unstable, and in the absence of a yet-to-be identified macroeconomic framework; whether second tranche conditions were too strong to be realistic; and the monitoring of implementation progress.

C. Discussion

2. Introduction. In response to the Chairman's invitation for the Region to initiate the discussion the Region said that the economy had been closely integrated with that of the Soviet Union, and that it had suffered greatly as a consequence of the collapse of CMEA. The stabilization program had to await the formation of a coalition government in early 1991, which had to address fiscal, monetary and wage policies in conditions of severe external debt. Structural reforms were needed to guide trade liberalization, with a new framework to be set up for legal institutions, banking sector privatization and public enterprise reform. Several months of dialogue have identified the need for priority reform in regard to privatization, the energy sector and debt management. The changes under the SAL were listed in the policy matrix. Already there had been serious movement on energy pricing, to be followed by further movements. An agricultural land law permitting the development of a private land market was enacted in February. The Bank needed to provide strong support for these reforms, coordinate bilateral and multilateral assistance in order to provide fresh money and help obtain additional debt restructuring -- all this to be done in difficult conditions, made worse by severe market losses.

3. The SAL as Part of a Structural Program. The Chairman recalled that he had visited Bulgaria in the Fall of 1990, and had observed that enterprise reform and stabilization measures were being pursued in the light of the Bank's economic report. Similar to reforms elsewhere, however, the momentum derived from Bulgaria's own past, and its political experience. The debt problem was in many respects similar to that of Poland, and wondered if we could afford to remain outside the process of debt restructuring. While he personally believed that Bulgaria was serious about reform, he would like a clear vision of a time-bound program, and where it would lead five or six years from now. Meanwhile, a definition is needed of a critical set of minimal objectives over the next two years. For our own purposes we needed to identify the support we should provide for the medium-term economic transformation in order to define what this operation should do. He did not want to give the impression that this operation would not be followed by SAL II and SAL III. For the Bulgarians it would help them to know what we expected of them during the next two years.

4. The Region responded that the government knew what the Bank expected, and that the Region did not expect any difficulty over this. The reform almost followed a textbook pattern which was being replicated elsewhere in Eastern Europe, but the issue was to define a credible framework. The Chairman, however, referring to privatization provisions listed in Table 1 on project conditionality, said "satisfactory progress" in this area was devoid of meaning. He knew that Bulgaria had a worthwhile reform program with two partial ingredients (a) ownership change, and (b) marketing and distribution, but the basic problem was how to get a supply response. Privatization would take time, and he did not accept the CSN notion that IFC had nothing to offer Bulgaria in the next few years, as this suggested that the Region did not expect the private sector to grow.

5. Scale of Bank Assistance. A member questioned the scale of Bank support proposed in the CSN. He acknowledged that the Bank had no previous exposure in Bulgaria as we were starting from scratch. Looking at the financial requirements, excluding the debt overhang, he observed a gap of

$1.3 billion a year, and wondered what an appropriate Bank contribution would be. A 20% share might make sense, he said, which would indicate a $250 million a year in disbursements, and a commitment level of $300-350 million, and asked if a higher level of lending was justified. He echoed the Chairman's concerns, realizing that there was a serious financing problem in the short run. However, we must realize that this was not a case that needed a "jump start" after which the economy would run satisfactorily, but that we ought to be clear that we were in for the "long haul," with a process that was bound to be slow, covering privatization, state ownership change, nurturing the private sector, and dealing with the debt overhang. He was bothered both by the scale of proposed lending to a country of 10 million people, and the high level of adjustment lending.

6. The Chairman said that he was flexible on the amount. Traditionally we would have some benchmarks that would indicate an appropriate level of lending. For Eastern Europe we should still pay attention to population, country size, balance of payments requirements, the role of other creditors, and of course exposure. To the same member's question as to whether $25 per capita in one operation was called for, the Chairman said that that was the case in some African countries, and that such a level was consistent with being close to a higher case. The Region added that the pace of privatization was far from being slow.

7. A Legal Framework. A member said that the priority in the near term was for action on the legal front; that we should avoid prescribing economic measures that could not be implemented for lack of a "legal framework"; and urged that a careful timetable be set for the privatization process.

8. Lack of an Ultimate Goal. Another member said what he missed in the documents, and generally also in respect of operations for Eastern Europe, a vision as to where these countries were going, and how long the reform process would take. It was not enough to say that they were doing everything possible, but we should be clear on how the process would be concluded, as well as its implications for efficiency, growth and, of course, viability.

9. A member observed that the debt problem seemed to dominate the analysis and determine the financial requirements. When it came to monetary and credit policy, controls rather than liberalization seemed to govern the process. Another member said he missed a good discussion of supply response, particularly from agriculture in reaction to land ownership reform, and also from small scale industry.

10. Priorities and Projections. Another member queried the realism of projecting a 40% increase in exports by 1995, and wondered if the IMF could ever be repaid if the high level of Fund lending materialized as projected.

11. In response to these questions the Region said that setting priorities was indeed essential; that while projecting the end-result of change in Eastern Europe could be useful, the solution differed from country to country. For Bulgaria a whole year had been lost as a similar program, presented by the then Prime Minister, had lacked political support, but that the new government was able to move faster. As to projections of IMF operations, the Region obviously was not in a position to commit the Fund,

but as for Poland, the projections were made on the assumption of the Fund's continued support. All the export projections were tentative and the Region would be reviewing them. The economy was likely to contract further in 1991, but it should be remembered that the export growth projected was built on a smaller base.

12. Lending, Debt and Privatization. Referring to the CSN the Chairman raised three points: (a) the total size of the program; (b) the debt problem in the strategy; and (c) the strategy for privatization and the role of IFC. Addressing a member's earlier question about the size of the program, the Chairman said this touched on the link between debt and the lending level. A debt and debt service reduction operation, he thought, was neither likely nor perhaps necessary in the near future. The history of commercial bank lending to Bulgaria indicated that the banks played a role worse than elsewhere, and debt service reduction should therefore be looked at as a separate issue. He thought that the high case presented in the CSN was really the base case, and the level of the lending proposed was therefore not excessive. In a year's time we should find out what the other creditors were doing and see what we could do on the debt problem. He cautioned the Region against hastening to settle the commercial debt reduction issue. As to the privatization initiative, the Chairman queried the statement in the CSN that the Region did "not expect IFC to play a major role in supporting private sector development in Bulgaria for the next few years." He asked if IFC was represented at the meeting and the answer was no, although of course they had been invited. The Region, however, referred to the IM, para. 42, where it was stated that the IFC saw no real barriers to its operations. But the Chairman wanted more of an IFC role in actually stimulating private initiative.

13. A member agreed, saying that the question should not be whether the domestic framework was or was not a barrier to IFC operations in Bulgaria, but whether domestic regulation of economic activity was at all acceptable. The Chairman added that he wanted a strong message passed to IFC that they should be playing a much more active role in the privatization program.

14. SAL Conditionality. Reverting to the SAL a member said the draft Letter of Development Policy seemed to cover conditionality quite adequately, but that a set of four or five conditions should be identified for tranche release. He thought that too much was written in the program to be accomplished in six months and that we should limit our sights to what could be realistically achieved. The Chairman commented that he thought that legislation might take longer than allowed for, and he therefore would advise using three tranches rather than two, although he had no problem with just two tranches. In this case he wanted the Region to go carefully through tranche conditions and prune them as much as possible. As it was, the program was more wide than precise.

15. A member thought that the tax proposals were vague and that it was desirable to work toward an explicit system of taxes that would include a value added tax. He said the CSN was particularly unclear over the labor issues and the social safety net. He was uneasy about everyone getting the same absolute rise in wages. Understandably some politicians would be linking this approach to a social safety net, but it would be better for the program if wages could be de-compressed. He added that if these equal increments were made in a situation of high inflation they would leave a legacy of relative wage rigidity. The Region said that the taxation

proposals were being worked out with IMF advice, and a major study had been undertaken to guide the changes. The Chairman added that options should be developed, and alternative approaches tried out, before settling on definite solutions.

16. A member said there was an important point regarding the pace of state enterprise reforms. There was reference in para. 67 of the IM to the provision of temporary subsidies to enterprises experiencing late payments by other enterprises which could undermine all discipline. As to the formation of a new unit to review inter-enterprise arrears he thought this had the whiff of sustaining non-viable units. The Chairman commented that the main purpose of restructuring in this area was to separate day-to-day management from the pursuit of social goals. He saw restructuring as a first step to privatization, but did not rule out privatization straight away, or even liquidation. Liquidation of enterprises could not be divorced from the provision of safety nets: they both had to go hand in hand.

D. Decision

17. Bringing the meeting to a close the Chairman urged the Region to rationalize the SAL conditions. If the Region wanted to stick to two tranches rather than three, the conditions should be made precise in regard to content and timing. A larger size of loan was possible over a longer period, but the Region should be aware of the possibility of slippages. Finally, he instructed the Region to proceed to appraisal subject to the observations and guidance provided by the OC and summarized above. He added that the Country Strategy Note provided an adequate basis on which to proceed.

May 9, 1991

SES
SESerafy/lcu

THE WORLD BANK INTERNATIONAL FINANCE CORPORATION MIGA

91042S019

1.

Office Memorandum

DATE: April 23, 1991

TO: Moeen A. Qureshi, OPNSV

THRU: John Niehuss, Director, CFS

FROM: John D. Shilling, Manager, CFSFA

EXT.: 80004

SUBJECT: Debt Reduction Programs in Bulgaria SAL IM

I am concerned that this IM contains an explicit discussion of debt reduction mechanisms, including a buyback price (however carefully caveated) at this stage of the debt discussions. The region was reluctant to include it, and CFS recommended against it; however, I gather FRS insisted. While it is appropriate for the analysis to indicate that debt relief is needed and roughly the overall amount, it is risky to discuss specific mechanisms at this point. FRS's desire to see the impact of debt relief on various indicators can be handled in a number of other ways that pose fewer risks. In fact, since the precise impact of a DDRS operation on the indicators depends on its specific structure, so basing the analysis on a premature and hypothetical mechanism may be misleading anyway.

It is potentially dangerous to a country's negotiation position and risky for the Bank to have an explicit DDSR mechanism in a document such as this. If that part of the document got out , the caveats would be ignored. The banks could well charge that the World Bank is trying to dictate terms of a debt reduction operation. Secondary market prices may react to such information. And the country may feel that the Bank is trying to preempt or undermine its negotiating position. Bulgaria has stated that it does not want to seek debt reduction along the lines of Poland's recent agreements, and that is the very target mentioned in the IM.

Since the proposal in the IM is entirely speculative at this stage, it is of little practical or analytic value, as the many caveats confirm. The IM is not the appropriate document for a serious analysis of debt strategy options. In addition, many readers in the Bank may be tempted to focus too much on the mechanisms of debt reduction, which is irrelevant at this point, and ignore the larger issue of the costs and benefits of debt reduction in relation to the country's adjustment strategy. In this instance, whether substantial debt reduction is compatible with Bulgaria's desires to obtain commercial financing in the near future.

CFS is working closely with the region on a detailed debt strategy analysis (which FRS is aware of) that is a much better place to examine specific mechanisms. That document can be kept more confidential and can address the full complexity of the issues. I would recommend that in the future, we adopt the policy of not including speculative debt reduction mechanisms in IMs and similar documents that receive relatively wide distribution.

cc: Messrs./Mmes. Kashiwaya, Wood, Stoutjesdijk, Bock, Grilli, Nouvel, Lari, Iweala

JDShilling:rmc

Qureshi

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: April 30, 1991

TO: Mr. Willi Wapenhans

FROM: Larry Summers L.S.

EXTENSION: 33774

SUBJECT: BULGARIA: Structural Adjustment Loan Initiating Memorandum and Country Strategy Note

1. I consider this a well-designed strategy and loan developed under highly unusual circumstances. The risks for the Bank are obviously high in Bulgaria, but I am persuaded that taking the initial step in the form of a large loan is well-justified, provided both the outstanding policy actions and the approach to external finance described in the IM are confirmed at appraisal. I would in particular support the provision of Bank adjustment support prior to a private debt reduction deal in this case, but would fully agree that the scale of future Bank support should be conditional on the Government pursuing a strategy vis-a-vis its private creditors broadly along the lines and terms outlined in the document. Should a deal on satisfactory terms be agreed in the future, Bank support in excess of current guidelines for DDSR may be warranted. There is a trade-off between supporting DDSR and financing economic activity, but a mix of both is clearly justified; both private debt reduction and economic growth are needed to reduce the risks faced by the Bank. Any support for DDSR should, of course, be linked to continued strong domestic policy performance, whether through use of funding out of adjustment loans or a stand-alone in parallel to such loans.

2. I have some specific comments:

(a) The short-run macroeconomic projection looks too optimistic, especially with respect to inflation. Bulgaria is unlikely to achieve the radical disinflation projected, and attempts to bring this about by a contraction in demand or real wages beyond that already envisaged could break the program. There are genuine risks of a sustained shift to high inflation, but I would advocate a short-run strategy of maintaining a strong underlying public finance position, but being prepared to live with somewhat higher inflation rates during the current period of transition. This is an area where more thinking is required. The further use of the nascent social contract (as in Mexico) or of other nominal anchors (as with the exchange rate in Poland) may be valuable complements to a sound fiscal position, and we should be exploring this for the next phase of reform.

(b) I am concerned that the transitional approach to wage policy could lead to future labor market problems because of wage compression. A change in the current wage policy appears to politically depend on development of an adequate social safety for the unemployed, but the links between the two are not fully clear. Moreover, both the design and finance of the safety net is less fully specified in the document than other parts of the policy framework; this could become a problem for implementation of the program on both political and fiscal grounds. I would emphasize the need to sort out both areas in the appraisal process: the design and finance of the social safety net; and ensuring the policy of wage compression is reversed in the near term.

(c) With respect to taxation, while the objectives of base broadening and greater neutrality are fine, the taxes discussed are a mixed bag: moving to a VAT and reducing corporate tax rates makes sense; export taxes and incentives for foreign firms may not. I would place greater priority to work on tax policy and less on the tariff study, where the Government is already making considerable progress.

cc: Messrs. M. Qureshi, W. Thalwitz, E. Jaycox,
A. Karaosmanoglu, S. Husain, V. Rajagopalan,
I. Shihata, K. Kashiwaya, J. Wood, D. Bock,
E. Grilli, P. Isenman, E. Lari, P. Nouvel

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

9104 29013

DATE: April 29, 1991

TO: Operations Committee

FROM: EG Enzo Grilli, Director, EAS

EXTENSION: 81934

SUBJECT: BULGARIA - Country Strategy Note
- SAL Initiating Memorandum
- Proposed Agenda

1. As announced earlier, the Operations Committee will meet on **Wednesday, May 1, 1991, at 3:00 p.m. in Room E-1243** to consider (a) a Country Strategy Note and (b) an Initiating Memorandum for a $250 million SAL to Bulgaria. The Committee may take up the following issues for discussion.

Background

2. Bulgaria has recently joined the World Bank Group. A Bank mission visited Bulgaria in the Summer of 1990 to produce a Country Economic Memorandum, and drew up a reform program that is being taken up in the CSN and the proposed SAL. The economy had previously been closely integrated with the Soviet block and has seriously suffered from the disintegration of the CMEA. With high external debt and a sharply deteriorating external account, Bulgaria's output declined by 12% in 1990 and will decline by a further 13% in 1991. After the formation of a coalition Government, a strong stabilization-cum reform program was initiated in early 1991, supported by the IMF (with a 12-month Stand-by, and Compensatory Contingency Financing Facility arrangements). Yet, to make the reform program viable in the medium term, substantial debt relief and official assistance are required.

- The Region may be asked to elaborate on the debt situation and on the recent developments, including the rescheduling (to 1991) of official debt, the plan to settle arrears and the dialogue with commercial banks on a possible workout scenario.

- Given that a commercial debt workout is essential to the medium-term prospects of Bulgaria and its reform program, the Region may wish to elaborate on the likelihood of satisfactory arrangements being made to reduce the debt and debt service burden sufficiently to render the adjustment program viable.

- Also, given the importance of inflation control in the ongoing stabilization effort, the Region may wish to update the Committee on progress being made on this front.

I. COUNTRY STRATEGY AND RISKS

3. The CSN is proposed as an interim device to provide a context for the SAL, to be updated in a year's time. It states that the history of reform is short, and its political support precarious. The stabilization program supported by the IMF may fail; the anticipated current account deficit may not be manageable; the debt workout may not materialize as envisaged; and external funding may prove to be insufficient (CSN, para. 37). And yet, the strategy proposed revolves around a base case lending of $340 million a year in FY1992-94, inclusive of the $250 million SAL and $25 million TAL being proposed now. A low case of annual lending of $130 million and a high case of $440 million are also envisaged, all with a high content of quick-disbursing operations. This would imply a substantial increase in the share of IBRD in total as well as in preferred debt.

- The Committee might consider whether the lending proposed in the base case is compatible with the risks described in the CSN and whether a low case scenario would not be more prudent at this stage and more likely to materialize.

- Can the Region indicate, at least roughly, how the base, low and high cases would be differentiated in terms of reforms, growth and the balance of payments outcome?

The Financing Gap and Burden Sharing

4. The CSN states that the sustainability of Bulgaria's reform requires adequate external funding. Funding for 1991 (para. 17) "appears adequate" (including $900 million from the OECD and $463 million from the IMF), but Table 4 (p. 15) shows total gross disbursements on MLT in the three years 1991-93 in the neighborhood of $6 billion.

- How realistic are such MLT flows, in particular the $2.2 billion expected from bilateral sources and the $1.4 billion from private commercial sources?

- How solid are staff expectations about IMF commitments in the medium-term?

- Is playing a role in aid coordination by the Bank justified in the context of Bulgaria? Would it push the Bank to take too large a share of the burden at this stage in the stabilization-structural reform process?

Privatization Initiatives and Sectoral Concerns

5. Bank strategy is said to aim at developing a dynamic private sector encompassing industry, energy and finance, with support from an enabling environment in which deregulation, trade liberalization and institutional reform will play parts. The CSN does "not expect IFC to play a major role in supporting private sector development in Bulgaria for the next few years" (para. 21), and privatization is likely to be "slow and painful" in industry (para. 22). The strategy envisages that the Bank will focus on improving state enterprise efficiency by exposing them to competition, and studies are planned in support of this strategy in industry, energy and banking.

- While emphasis on reforming the public sector as a first step appears prudent, the Committee might wish to know how far is this approach considered worth following. What would the limits of such an approach be?

- The Committee might also ask whether we know sufficiently about sectoral problems, particularly in the areas of industry and finance, to define meaningful sectoral strategies, and how far advanced we expect to be in FY92 in the preparatory work in support of SE restructuring and privatization of the larger firms.

- What is the rationale for lending to industry in the low case where policy reforms would be lagging?

Human Resources and the Environment

6. Given the recent sharp decline in economic activity, which is projected to continue for some time, social pressures are mounting, including high unemployment and drastically reduced real wages and consumption. According to the CSN the Bank will help Bulgaria develop a fully-funded, fiscally viable, social safety net that has well targeted objectives, including increased labor mobility (para. 29). As to the environment, the Bank would tackle this via energy sector deregulation and pricing reform, and carefully targeted investment lending.

- Considering the magnitude of income decline, how realistic is the social safety net approach; and where would the necessary resources come from?

- Are the environmental problems of Bulgaria confined to pollution? What about agricultural soil and other natural resources?

II. THE STRUCTURAL ADJUSTMENT LOAN

Simultaneity with Stabilization

7. The recently formed government has embarked on a "radical and comprehensive reform program" (para. 9) with the objective of containing the economic decline, reducing macroeconomic imbalances, developing an efficient market economy, restoring international creditworthiness and encouraging the inflow of private capital -- all this under conditions of "massive external shocks." The approach is based on pursuing structural adjustment and stabilization simultaneously. Stabilization has already been initiated, with important measures taken in the areas of the foreign exchange system, pricing, income, fiscal and monetary policies.

- In view of the fact that stabilization is at a very early stage, is it wise to push for structural reforms on such uncertain foundations?

- Since technical assistance is required to help implement the SAL [because implementation capacity is weak (para. 114)] how adequate is the implementation capacity for stabilization?

- Can a viable structural adjustment program be identified in the absence of a "credible" medium-term macroeconomic framework, which the SAL is yet to establish?

- As the same risks identified in the CSN for the overall lending program are repeated as risks also for this operation, should the Bank begin lending to Bulgaria with a SAL of this magnitude?

SAL Objectives and Conditionality

8. The program under the SAL incorporates stabilization as an essential element, and lists besides five objectives which the program will pursue: (a) developing a "credible" medium-term macroeconomic framework; (b) encouraging competition and appropriate pricing; (c) nurturing a private sector environment; (d) reforming and restructuring private enterprises; and (e) providing a social safety net and promoting effective labor markets. Towards these objectives the SAL would help create institutional capacities and develop a financing plan, reform trade policy, encourage deregulation, define ownership rights and devise policies for employment creation and labor compensation. Already some steps have been taken in these directions.

9. A set of program conditions is listed in Table 1 (p. 5) and elaborated in the policy matrix. The conditions for Board presentation appear to be soft while strong conditions come later on in the life of the program. The stabilization program being on track at the time of loan effectiveness and tranche release does not seem to be expressly listed as a condition. Establishment of a competitive environment awaits the second tranche. The same applies to public enterprise restructuring, privatization, trade reforms, and energy price conditionality.

- Is the proposed sequencing of conditions realistic? And will there be enough time and progress to render the strong conditionality of the second tranche fulfillable?

- Would it not be better to have three tranches rather than two?

Macroeconomic Indicators to be Monitored

10. The SAL contains a specific set of macroeconomic indicators (Table 6) that will be monitored every quarter during implementation, including real export growth and the private sector's share in the economy, government subsidies and total external debt relative to GDP.

- Shouldn't variables to be monitored lie within government control? In this respect, what is the significance of "monitoring" real export growth?

- How useful will be such monitoring, which will extend to 1994, when the loan will be disbursed by 1992?

- What is the precise role envisaged for the IMF in this monitoring?

Operations Committee

Messrs. Qureshi, OPNSV
Husain, LACVP
Jaycox, AFRVP
Karaosmanoglu, ASIVP
Wapenhans, EMNVP
Rajagopalan/Summers, PRE
Shihata, LEGVP
Kashiwaya, CFSVP
Wood, FPRVP
Bock, OPNSV

cc: Messrs./Mmes: Thahane/Burmester, Picciotto, Goldberg, Wyss, Sandstrom, Isenman, Linn, Stoutjesdijk, Okonjo-Iweala, Gustafson, El Serafy, Lysy (o/r), Parmar, Rao, Kavalsky, Pfeffermann, Liebenthal, Kilby, Robless, Walton, Khanna, Shakow, Hasan, Lari, Nouvel, de Melo.

SESerafy/lcu

9104250008

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: April 22, 1991

TO: Mr. Moeen A. Qureshi, OPNSV

FROM: W.A. Wapenhans, EMNVP

EXTENSION: 32676

SUBJECT: BULGARIA: Structural Adjustment Loan (SAL), Initiating Memorandum (IM) & Country Strategy Note (CSN)

1. Attached for your consideration is the Initiating Memorandum for the proposed SAL to Bulgaria in the amount of US$ 250 million. The IM is longer than normally required because Bulgaria is a new member and because substantial policy changes have taken place since the takeover of the new Government in December 1990 and the issuance of the gray cover CEM in January 1991. A Country Strategy Note outlining the Bank's assistance strategy is also attached.

2. The Government of Bulgaria (GOB) has started a radical reform toward a market-based, outward-oriented, mixed economy. Despite the deep economic crisis characterized by the decline in output by 12 percent in 1990 (and the expected decline of 13 percent in 1991), an acute shortage of foreign exchange, and a sharp curtailment of trade flows, the GOB embarked on a bold reform program early in 1991. The stabilization component of this program is supported by the IMF with a CCFF approved in February, 1991 (projected disbursement of SDR 93.2 million), a 12-month Stand-By Arrangement (SBA) which became effective in March 1991 (SDR 279 million), and an external contingency mechanism relating to oil and gas prices (SDR 77.5 million).

3. The proposed SAL would support measures taken by the Government under the stabilization program. The SAL aims at promoting an active supply response, helping to establish the policy/institutional basis for a market economy, and ensuring that legitimate social needs are adequately addressed. To achieve these objectives, the SAL focuses on policy reform across five broad areas: (a) developing a medium-term macroeconomic framework including a consistent financing plan, (b) increasing competition and creation of market-based relative prices through trade policy reform and demonopolization, (c) private sector development, including the regulatory and incentive framework, creating a modern banking sector and privatization of state-owned assets--including agriculture, services, and small and large enterprises, (d) reform of management and ownership, changes in energy policy and restructuring of SEs, (e) the improvement of social services to cushion the temporary costs of adjustment. The SAL would lay the groundwork for subsequent separate loans in priority sector areas, i.e., agriculture, banking, industry, and energy.

4. We propose that the SAL contain two equal tranches (US$ 125 million each) to be made available in August 1991 and March 1992. The proposed release date for the second tranche reflects the time needed

to implement this stage of the structural adjustment program. However, if during appraisal it appears that additional time may be required to fully satisfy some of these measures, we would reformulate the conditionality to permit disbursement in three tranches. Implementation of the Government's reform program is being supported by a technical assistance loan (TAL) in the amount of (US$ 25 million) developed in close cooperation with the EC and others. This project will support the management of the reform effort in all of the policy areas covered by the SAL, except agriculture which is covered by the EC-PHARE program. The TAL is designed to complement grant funding for priority activities financed by the EC and other donors.

5. The transformation of the Bulgarian economy will be particularly difficult. The economy had closer links with the Soviet Union than any other Eastern European country. In addition, the reform program is being implemented at a time when the economy is experiencing massive negative external shocks. The combined effect of the movement to world prices in the CMEA, the collapse in CMEA trade and the events in the Gulf, are estimated to result in an external shock equivalent to 17 percent of 1990 GDP, a level which is considerably higher than in other Eastern European countries.

6. Finally, Bulgaria has a major external debt problem. While on a per capita basis Bulgaria's debt is half of Hungary's, the country has practically lost access to the commercial bank financing which provided most of the external resources used in the '80s. In addition, the maturity structure of the existing debt is short, and--as argued in the CSN and IM--Bulgaria, like Poland, cannot engage in a sustained reform effort if a long-term solution on its debt, involving a substantial reduction of the existing debt on the order of 50 percent, is not in place in the near future. Even a generous rescheduling would not suffice, as the burden would simply be shifted to later years and become quickly unsustainable.

7. Projections underlying the SAL and CSN show that, provided a comprehensive debt workout is implemented and adequate new funding is mobilized, Bulgaria can sustain its reform program and progressively restore creditworthiness. Given the severe domestic adjustment that the Bulgarians have already undergone, we would recommend substantial levels of debt relief and official support. Consequently, the projections reflect external deficits that are considered to be at the upper end of the desirable range and debt indicators remain high. In the process of reaching an agreement with the authorities on a medium-term macroeconomic framework, we will review these projections, which will need to reflect the reform effort and Bulgaria's ongoing dialogue with both the Paris and London Clubs. Official debt due until 1991 was rescheduled on April 17, 1991, and an agreement to settle accumulated arrears is about to be finalized. If it appears that the financing plan is not sustainable, the need for a further downward adjustment in domestic absorption will be discussed. More specifically, the appraisal mission has been given instructions to carefully review the 1992 financing plan to determine whether further domestic adjustment will be required. In this connection, an agreement with the authorities will

be sought to establish an Aid Consortium Group to promote and coordinate official international assistance.

8. There are a number of risks associated with early, substantial support by the Bank in the form of a relatively large SAL. The Bank, like the IMF and the EC/G24, would provide BOP support while the major external conditions for reestablishing creditworthiness--i.e., debt reduction--are unlikely to be satisfied before mid-1992. Politically, the coalition governing Bulgaria is still fragile and the timing of the next general elections is uncertain. While there is full consensus among all parties and the population on the needs for, and objectives of, the reform, the short-term effects of restructuring the economy, combined with the adverse effects of the external shocks, may result in social tension that could undermine the ability of the Government to pursue its reform program effectively.

9. In our view these risks are worth taking. The authorities have made significant progress in securing the financing needed for 1991, with the EC and G-24 members indicating that they are willing to finance an IMF/World Bank supported reform program. The Bulgarians have responded by implementing the first phase of a radical and comprehensive reform program. In January of this year the authorities established a unified market-based exchange rate, raised the basic interest rate ten-fold (to 45%) and liberalized all prices except energy products. These measures are being supported by a tight monetary and fiscal program and a tripartite agreement between the Government, employers and trade unions, which aims to reduce real wages by about 35%. Implementation of structural adjustment reforms has also begun, although progress in some areas has been slow. To date, there has been a far reaching liberalization of the trade regime, a landmark Land Reform Bill has been passed, the process of demonopolization has started, and a bill to allow privatization via public auction has been passed. The authorities are now focussing on developing strategies for large privatization, increasing the efficiency of State Enterprises and reforming the banking sector. A major focus of the TAL is to assist the authorities in these priority areas.

10. As outlined in the CSN, the region expects that the Bank will play a major role in Bulgaria, if the reform program remains on track. This will require an exceptional level of support in the near term for two primary reasons. First, the Government's reform program, coupled with the problems associated with restructuring the economy and the size of the external shock, warrant our support via a quick-disbursing SAL. Second, the restoration of creditworthiness requires a debt workout which in turn requires extra resources to finance the debt deal. The region considers that our support during this difficult transitional period will yield high returns, because of the authorities commitment to continue their reform program and their responsiveness to Bank and Fund advice. In addition, the level of education is high in Bulgaria, and as the 1990 WDR pointed out, policy-based lending is likely to produce more success where the quality of human resources is high. Bulgaria also has the added advantage of a well-developed infrastructure which will facilitate trade and tourism. It should be noted that the

level of Bank support projected in the base case is consistent with the agreed business plan, plus the additional resources which would be provided under a DDSR operation. Nonetheless, given the risks we will keep developments under close review. Should the reform effort falter and/or should there be insufficient progress in restoring Bulgaria's creditworthiness, then we should be prepared immediately to retrench to a lower level of Bank support.

Attachments

Distribution:

Operations Committee Members

Messrs.: Husain (LACVP); Jaycox (AFRVP); Karaosmanoglu (ASIVP); Rajagopalan (PRSVP); Summers (DECVP); Shihata (LEGVP); Kashiwaya (4) (CFSVP); Wood (FPRVP); Bock (OPNSV)

Other Participants

Messrs./Mmes.: Wyss (CODDR); Grilli (EAS); Isenman (PRDDR); Linn (CECDR); Stoutjesdijk (FRSDR); Picciotto (CPBVP); Gustafson (CEMDR); Thahane, Burmester (SECGE); Goldberg (LEGOP); Okonjo-Iweala (OPNSV)

For information

Messrs.: Parmar (IFC-CIO); Rao (IEC); Kavalsky (FRM); Pfeffermann (IFC-CEI); Liebenthal (PRD). Kilby (FRS); Robless (OPNSV); Walton (DECVP); Sandstrom, Khanna (EXC); Institutional ISC

Regional

Messrs.: Blanchi (8), Grais (EMNVP)

Country Department

Messrs./Mmes: Thumm, Zaidan (EM4DR); Apitz (EM4IN); Harbison (EM4HR); Montfort (EM4EE). O'Sullivan (EM4AG); Sood (EM4IF); Hoopengardner, Wilton, Bogetic, Hilton (EM4CO);

Technical

Messrs.: Kohli (EMTDR); Wackman, Ewing (EMTIE); Baudon (EMTEN); Hinds (EMTTF); Hayward (EMTAG); Heyneman (EMTPH); Roa (EMTPR)

Bankwide

Messrs./Mmes.: Stern (FINSV); Thalwitz (PRESV); Lysy, Levy, Siraj (EAS); Petit (AGRDR); Pouliquen (INUDR); Churchill (IENDR); Piddington (ENVDR); Hamilton (PHRDR); Frank (CFPVP); El-Rifai (MIGPA); Niehuss (CFS); Elwan (CFSPS); Hassan, DeWitt (LEGEM); Fowler (LOAEL)

<u>Others</u>
Messrs./Mmes.: Anoop Singh, Peter White (IMF)

Cleared with and cc: Hasan (EMNVP), Lari, Nouvel, de Melo (EM4)

JWilton/THoopengardner\sr
M:\Bul\Wilton\memo.im

April 26, 1991

910576008 1.

DECLASSIFIED
AUG 0 2 2013
WBG ARCHIVES

THE WORLD BANK
Operations Committee

CONFIDENTIAL

Minutes of the Operations Committee to Consider the
MOZAMBIQUE - Commercial Debt Reduction Operation
Held on Friday, April 26, 1991 in Room E-1243

A. **PRESENT**

Committee	Others
Messrs. M.A. Qureshi (Chairman)	Messrs. F. Chaudhri (EAS)
D. Bock (OPNSV)	D. Cook (AF6IE)
S. Denning (AFRVP)	S. Gooptu (CFSFA)
W. Grais (EMNVP)	E. Grilli (EASDR)
I. Husain (PRSVP)	Ms. O. Kalantzopoulos (PRDRA)
S. Husain (LACVP)	Ms. N. Okonjo-Iweala (OPNSV)
J. Niehuss (CFSVP)	P. Patel (AF6)
I. Shihata (LEGVP)	Ms. J. Salop (CODOP)
J. Wood (FRPVP)	J. Shilling (CFSFA)
O. Yenal (ASIVP)	A. Toft (CFSFA)

B. **ISSUES**

1. The discussion of the proposed operation was based on the Agenda prepared by the Economic Advisory Staff. Some additional questions were also raised by Committee members. In particular, the Committee focussed on the country's track record in taking adjustment measures, the debt management strategy being followed, the price at which the commercial debt was being retired, the nature of benefits emanating from the operation, the question of materiality, and the proposed fee and commission to Merrill Lynch who are scheduled to implement the proposed transaction. At the outset, the Chairman asked whether the country's track record was good enough to justify the proposed operation and the debt management strategy being pursued was a sound one.

2. Responding to the question of the country's track record, the Region pointed out that the situation in 1987 was extremely critical: the mounting debt burden, the worsening of the civil war, and a substantial erosion of the production capacity of the country posed serious challenges. Under the circumstances it is remarkable that since then the country has substantially transformed itself from a socialist pattern of development to a market-oriented one, that several reforms have been introduced in the exchange rate system, the public investment program, as well as in the areas of prices and the financial system. At the same time the IMF-ESAF and the widespread

support during the recent CG and SAP meetings have given a much needed stimulus to Mozambique's adjustment and transformation efforts. Mozambique has earned this support by adopting innovative approaches enunciated in its Policy and Poverty Framework Papers. Given the depth of the problems, the Region stated that the country has made good progress on many important fronts. The Chairman advised the Region to indicate more clearly in the paper the achievements of Mozambique, especially in macro-economic areas, and spell out the Bank-Fund conditions that have been satisfactorily met by the country.

3. With respect to the debt management strategy, the Region stated that a major part of Mozambique's debt is with the Paris Club. Following two reschedulings in 1984 and 1987, in June 1990 the Paris Club creditors of Mozambique agreed to reschedule 100% of eligible current maturities (for June 1, 1990 to December 1992) and all arrears (accumulated through May 31, 1990) on Toronto terms. Mozambique has also initiated negotiations with its non-Paris Club creditors to reduce debt service due on the outstanding debt of approximately US$2 billion (as of end 1989). The Government aim is to secure at least as favorable terms as those reached with the Paris Club. No payments have been made to commercial bank creditors since the early 1980s. The proposed commercial banks debt reduction is a small but an essential operation to the cleaning-up of London Club debt. In response to the Chairman's further query why the government negotiations with the Eastern Block were not proceeding more rapidly, the Region stated that the Soviets were not well-organized to conduct negotiations in an expeditious manner, though substantial relief was expected.

4. One Committee member wondered why the discount on commercial debt to be retired had been fixed in advance. Another Committee member felt that in view of the secondary market price of the Ivory Coast's debt (4-5 cents to a dollar), the price of Mozambique's debt (10 cents to a dollar) looked high. A Committee member also questioned the level of service fee (0.5 percent of the face value of the principal to be retired or about 1.1 million) that would be paid to Merrill Lynch and felt that the level and amount of commission and fee seemed excessively high.

5. In the discussion that followed, the Region made it clear that there was no secondary market as such for Mozambique's commercial debt. The debt was held by about 30 banks and previously quoted prices of 6-9 cents for a dollar of debt was not expected to clear the majority of the debt. According to the Regional representative, Merrill Lynch had reached a judgement that 10 cents to a dollar would be needed to clear the outstanding commercial banks debt. The Chairman felt that even though Merrill Lynch had made that judgement, given the situation of Mozambique and its very poor market standing, the Region should satisfy itself that every effort had been made to obtain the lowest possible price. Another Committee member also stressed that the Region should let Merrill Lynch know of the Bank's unhappiness on the price issue and push them to make stronger efforts with debt holders to obtain a better deal for the country. Responding to these remarks, the Region felt that the primary objective was to find a price that would clear the creditor banks' balance sheets. The matter had been given

considerable thought and Merrill Lynch advice on price was by and large sound. To be considered was also the fact that the proposed 10 cents on the dollar was calculated on the stock of debt, net of interest arrears. If those were considered, the proposed retirement price would fall to 6-7 cents per dollar of debt. Another Committee member felt that the use of the Facility might increase expectations of the commercial banks (if they felt that the opportunity costs of the funds used to retire the debt was zero for the country) and hence prompt them to raise the price that they would demand. The Chairman doubted that the opportunity costs of the funds used by Mozambique under the Facility would be perceived to be non-existent, as these funds would otherwise be added to the IDA pool and thus become available for annual IDA use. One Committee member pointed out that Mozambique's situation was representative of a large number of similar cases. If the benefits to be gained in this case (i.e. improved creditor relations; reduced debt overhang) were not sufficient to justify the costs, then much of the original rationale for the Facility would be called into question.

6. A Committee member expressed skepticism over the materiality of the proposed operation. The Chairman observed that since Mozambique was vulnerable as an exporter and the creditors could hold legal actions against the country, it was to its advantage to solve its commercial debt problem in an orderly fashion and to avoid confrontation with banks, as happened in the case of Ecuador. With respect to the issue of materiality, the Region argued that materiality could not be established just for the commercial banks part of the debt, it was related instead to the satisfactory solution of the overall debt situation. The Chairman also pointed out that while the question of materiality was valid, it also related to the country improving its relationship with its creditors.

7. As to the threshold of the operation, the Region felt that it was necessary to keep it at 60 percent because one bank held 37% of the debt. A 70 percent threshold would have given an undue advantage to that particular Bank.

8. The Region was authorized to follow the next steps in the processing of the proposed operation, taking into account the remarks and observations made above.

May 16, 1991
FChaudhri:pl

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

9l0424016 1.

DATE: April 24, 1991

TO: Operations Committee

FROM: EG Enzo Grilli, Director, EAS

EXTENSION: 81934

SUBJECT: Mozambique: Comercial Debt Reduction Operation - Agenda

There will be a meeting of the Operations Committee on Friday, April 26, 1991 at 3.30 in Room E-1244 to discuss the Mozambique Commercial Debt Reduction Operation. The President's Report and covering memorandum from the Region were distributed separately.

Background

Mozambique is one of the poorest countries in the world, with an annual per capita income of about US$80. The country has considerable economic potential in agriculture, fisheries, transport services, tourism, energy and minerals, but it has also been facing heavy constraints to the achievement of this potential because of: (i) the protracted civil conflicts; (ii) an absolute poverty affecting about 60% of the population and food security, (iii) policy distortions and institutional deficiencies, (iv) damaged and poorly developed economic and financial infrastructure, (v) under-developed human resources in general and shortages of management skills in particular; and above all (iv) an oppressively heavy external debt ($4.4 billion) burden with a debt stock to GDP ratio of 340% in 1989 and scheduled debt payment equivalent to 178% of exports.

Mozambique's external debt is predominantly from official sources. Of the US$3.6 billion owed to bilateral creditors at end 1989, $1.6 billion was owed to creditors in OECD countries, about 1.4 billion to creditors in Eastern Europe and the remaining to creditors in OPEC and non-OECD countries. Multilateral institutions accounted for US$392 million, of which $176 million were IDA credits. Mozambique's commercial bank debt to 38 creditors was about $350 million of which $320 million consisted of debts owed to banks that was consolidated in the draft 1987 London Club debt restructuring arrangements and is being considered eligible for the proposed debt reduction operation (henceforth termed as "Eligible Debt").

The Government's external debt strategy aims at a substantial reduction of its outstanding external obligations to both official and commercial creditors. The Government of Mozambique (GOM) has rescheduled its debt owed to Paris Club in 1984, 1987 and, most recently, in 1990. This last one covers eligible current maturities (June 1, 1990 - Dec 1992) and all arrears (accumulated through May 31, 1990) and applies Toronto Terms. GOM has also initiated negotiations with its other non Paris Club bilateral donors on the outstanding debt of US$2 billion (end 1989). Mozambique's borrowings from commercial banks consist of medium-term (including syndicated) loans, short-term loans (mainly letters of credit) and overdraft facilities. GOM has not been servicing its London Club debt since the early 1980s and hence the short-term debt and overdraft have de facto become medium and long-term obligations. Government proposes to eliminate substantially its London Club debt by purchasing it with a grant of US$10 million from the IDA Debt Reduction Facility and approximately $12.75 million from bilateral donors. It is currently expected that all bilateral donor contributions would be deposited in the Facility for this operation.

The amount of eligible debt for buyback is estimated to be $320 million (as of end 1989), which consists of US$217.5 million in principal and US$102.9 million in past due interest. The report states that (i) Mozambique will offer to purchase the principal amount of the eligible debt at a discount of 90% of its face value; (ii) all unpaid interest, penalties, and commissions with respect to tendered principal will be cancelled simultaneously with the purchase of such principal; and (iii) a minimum of 60% of outstanding eligible claims must be tendered for the buyback offer to proceed. The report also proposes that the transaction fee for the operation, which has been set at 0.5% of each dollar equivalent of principal claims tendered, be paid for out of the proceeds of the overall grants to be made available to Mozambique for this operation.

Points of Discussion

The Committee may wish to seek from the Region further clarification on the following points:

brief us on what do we know in advance of the formal negotiations?

- If rescheduling alone -- even on Toronto Terms -- and the buyback operation in commercial bank papers would not provide balance of payments viability in the medium-term, how robust are the Government's debt management practices and strategy?

- In the absence of any secondary market for Mozambique papers, how realistic is it to assume that the deep discount of 90% for buyback purposes would result in substantial participation of commercial creditors?

- What is the rationale for establishing a 60% threshold when the recent Niger operation required a 70% minimum participation?

- Have all the commercial banks agreed or are likely to agree that all unpaid interest, penalties etc. will be cancelled with the purchase of the principal, as the report assumes?

- How strong are the material benefits from the buyback operation for the country's growth and development prospects?

Not paying anyway

Operations Committee

Messrs. Qureshi, Husain, Jaycox, Karaosmanoglu, Wapenhans, Rajagopalan/Summers, Shihata, Kashiwaya, Wood, Bock

Others

Messrs. Thahane/Burmester, Picciotto, Goldberg, Wyss, Sandstrom, Isenman, Linn, Stoutjesdijk, Ms. Okonjo-Iweala, Chaudhri, Parmar, Rao, Kavalsky, Pfeffermann, Liebenthal, Kilby, Robless, Walton, Khanna, Duvall, Shilling, O'Brien, Denning, Patel, Cook, Daffern, Ms. Jones, Institutional ISC

FMChaudhri/YJones:gs

THE WORLD BANK INTERNATIONAL FINANCE CORPORATION MIGA

Office Memorandum

Page 17

DATE: April 10, 1991

TO: Mr. Moeen Qureshi, Senior Vice President, Operations

FROM: Edward V.K. Jaycox, AFRVP and James Chaffey, Acting Vice President, CFS

EXT.: 34000/80809

SUBJECT: MOZAMBIQUE: Commercial Debt Reduction Operation

1. Attached is the draft President's Report to the Board proposing that Mozambique receive US$22.84 million from the Debt Reduction Facility for IDA-Only Countries to carry out an operation to reduce its commercial bank debt. (The final allocation will depend on the exchange rate at which the amount of eligible debt is calculated. At current rates a smaller amount of resources will be required to buy back 100 percent of the debt.) We are seeking Operations Committee authorization to negotiate the grant agreement with the Government of Mozambique. The proposed grant consists of US$10 million contributed to the Facility from IBRD's FY89 net income and US$12.84 million to be contributed to the Facility for this operation by the Governments of Netherlands, Sweden and Switzerland. (In the event, however, that one or more of these donors choose to participate in this operation in a manner other than by way of a contribution to the Facility - e.g. provide a grant directly to Mozambique - the Facility grant will be adjusted downwards to reflect this fact.) The Report has been scheduled for consideration by the Board on May 21, 1991. The information memorandum for this operation was reviewed by the Board on March 13, 1990 (IDA/Sec M90-84), at which time an approval in principle was given for the allocation of up to US$10 million for this operation.

Issues

Structure of the Operation

2. Counsel to the Government of Mozambique's financial advisor for the operation (Merrill Lynch) has informed the Bank that waivers are not required for this operation from Mozambique's commercial bank creditors. Therefore, we do not anticipate any of the issues which arose concerning waivers for the Niger operation. The transaction currently proposed by Mozambique and Merrill Lynch consists of a straight cash buyback offer of 10 cents on the dollar of the principal amount of eligible debt. Merrill Lynch is currently carrying out market soundings with key creditor banks to ascertain their interest in the proposal and whether it would be desirable to also offer a long term fully collateralized non-interest bearing bond with a net present value equivalent to the buyback price in order to appeal to banks that would not participate in a buyback for tax, regulatory or accounting reasons. However, given the complications such a feature would add to the proposed debt reduction operation, this will only be offered if the market soundings indicate significant demand for it.

(Only four creditors took this option in the Niger operation.) If this second option is required, part of the proposed grant would be used to collateralize the bonds.

Donor Contributions

3. The Report states that the Netherlands, Sweden and Switzerland will contribute a total of US$12.84 million to the Facility for the operation. This approach, rather than separate grants to the Government by those donors, is proposed in order to simplify the implementation of the operation. Confirmation from donors that they will participate in this particular manner will be obtained before the end of April. We expect to enter into contribution agreements with the donors prior to Board approval of the grant so that the Board may approve a grant amount which includes their contributions. The contribution agreements would become effective upon Board approval of the grant. The contributions would be disbursed *pro rata*. There is a possibility that other donors may contribute to the operation. If so, the donors' contributions would be reduced *pro rata*.

Price

4. The Report states that Mozambique will offer to purchase the eligible debt at a discount of 90 percent of its face value. The offer will apply only to the principal amount of eligible debt. All unpaid interest, penalties and commissions will be cancelled simultaneously with the purchase of the principal. The price proposed for the repurchase of Mozambican debt is significantly lower than that paid by Niger. It is our view that the lower price is warranted by the country's relatively more depressed economic prospects and by the protracted period of arrears which characterizes Mozambique's relationship with its commercial creditors. Mozambique's financial advisors believe the proposed price will encourage the majority of commercial bank creditors to participate in the debt reduction operation, but there remains a risk that at the proposed offer price, the proportion of debt that will be tendered for repurchase may not be as high as that achieved in the Niger case. This is a risk we recommend worth taking.

Transaction Fee

5. The contract between Mozambique and Merrill Lynch stipulates that Merrill Lynch be paid a performance based transaction fee of 0.5 percent of the face value of the principal retired, resulting in an all-in buyback cost to Mozambique of 10.5 cents on the dollar. The contract was awarded on the basis of a competitive procedure in which three other proposals were also considered. The compensation feature in each of these proposals (including that of Merrill Lynch) was substantially the same. If all of Mozambique's commercial debt were retired, the transaction fee would total $1.1 million. It is proposed that this item be included as part of the cost to Mozambique of executing the deal and that IDA and other donors contributing to the deal share this cost on a *pro rata* basis. If the proposed operation does not go through, Merrill Lynch will receive only a retainer fee, which will be paid with technical assistance grants from Switzerland and Japan.

Critical Mass

6. The Report proposes that the operation be consummated only if a threshold amount of 60 percent of Mozambique's eligible commercial debt is tendered. This is below the 70 percent threshold established for the Niger operation. The lower threshold is proposed because one creditor holds 35 percent of Mozambique's commercial debt. If the 70 percent threshold were to be maintained, this creditor could prevent the execution of the deal. Were a threshold of 65 percent to be established, it would require that every other creditor participate in the transaction. The Region and CFS recommend that the lower threshold be accepted in this case.

Composition of Eligible Debt

7. The debt eligible for purchase would consist of all London Club debt, which is comprised of medium-term loans, short-term loans and overdraft facilities. The operational guidelines approved by the Board for the Facility state that Facility resources are to be used to support operations reducing public external medium- and long-term commercial debt. In view of the fact that Mozambique has not serviced the short-term debt since the mid-1980s, we believe that such debt should now be considered *de facto* medium-term debt (as it is so treated by members of the London Club) and therefore eligible for purchase with Facility resources.

8. The Report will not be circulated to the Board until the final structure of the operation is finalized and related documentation is found to be satisfactory.

Attachment

Cleared with and cc: Messrs. Toft, Cook

cc: Operations Committee

Messrs./Mesdames: Husain (LACVP), Karaosmanoglu (ASIVP), Wapenhans (EMNVP), Rajagopalan (PREVP), Shihata (LEGVP), Wood (FPRVP), Bock (OPNSV)

Wyss(COD), Grilli (EAS), Isenman (PRD), Linn (CEC), Stoudjesdijk (FRS), Burmester/Thahane (SEC), Goldberg (LEGOP), Okonjo-Iweala (OPNSV)

cc: Mozambique Task Force

YJones/TDuvall:lrd

April 9, 1991

9W507010 1.

THE WORLD BANK
Operations Committee

CONFIDENTIAL

Minutes of the Operations Committee to Consider the Czech and Slovak Federal Republic: SAL and Country Strategy Note

Held on Tuesday, April 9, 1991, at 4:30 p. m. in Room E-1243

A. Present

Committee

Messrs. M. A. Qureshi, Chairman
N. Hicks (LACVP)
E. Jaycox (AFRVP)
A. Karaosmanoglu (ASIVP)
R. K. Chopra (EMNVP)
L. Summers (DECVP)
I. Shihata (LEGVP)
J. Chaffey (CFSVP)
D. Wood (FPRVP)
D. Bock (OPNSV)

Others

Messrs./Mmes E. Grilli (EAS)
P. Lysy, (EAS)
N. Okonjo-Iweala (OPNSV)
E. Lari (EM4DR)
P. Nouvel (EM4CO)
P. Hasan (EMNVP)
U. A. Hewer (EM4CO)
W. Grais (EMNVP)
A. Revenga (DECVP)
P. Rashid (COD)
G. Reif (PRD)
N. DeWitt (LEGEM)
A. Khanna (EXC)
P. Hansen (FRSCR)
K. Zamani (IFC)
B. Aghevli (IMF)

B. ISSUES

1. The Operations Committee met on April 9, to discuss the Initiating Memorandum for the proposed SAL and the Country Strategy Note (CSN), both for Czechoslovakia. The discussion focussed on the following broad issues:

(a) The macro framework for the SAL and the Bank's lending program;

(b) The proposed Bank lending strategy for Czechoslovakia;

(c) Specific aspects of the proposed SAL.

C. DISCUSSION

The Macro Framework

2. The discussion opened with consideration of the macro projections of the Region contained in the SAL and CSN documents. The Chairman noted that the projected growth, particularly for exports and GDP, appeared to be disappointingly low. This is especially surprising given the strong human capital base in Czechoslovakia. Instead, the projections show a large jump in aggregate consumption at the beginning of the period, which leads to the large

current account deficit (of almost 7% of GDP) and therefore the need to borrow such amounts. There would appear to be something wrong, either with the model or with the set of policies we would be supporting under the SAL. And if there is in fact expected to be the lack of dynamism shown in the projections, then the strategy of high levels of borrowing early in the period must be questioned. This borrowing would not generate a rate of return sufficient to justify it (and to re-pay the accumulated debt), but rather would just support consumption. A member of the Committee noted that projections for countries (such as those in Eastern Europe) undergoing radical reform are particularly difficult to make, and Bank projections tended to be more optimistic than those of other experts. What often happens is that in the short-term output declines or does not grow, but then at some point in the medium-term, which is very difficult to predict, there are spurts in growth to rates higher than most would project. The understandable tendency among Economists is to smooth this, by predicting higher growth rates in the short-run, and lower ones over the medium-term. He also pointed out that post-war Germany achieved pre-war GDP levels only in the mid-1950s.

3. The Region responded by noting that the data presented in the SAL IM tables show a strong decline of both total consumption and private consumption by capita in 1991 and 1992. On the longer term prospects, it was noted that the basic human resources and the traditions in Czechoslovakia are favorable for growth, but that there were also policy problems, and uncertainties about the ability of the economy to respond quickly to external shocks it faces at present. Institutions are still weak, there is no financial sector yet, there is political fragility, and the country is open to external shocks. The reform program adopted, however, is a very strong one. A big bang approach was adopted, with the major changes on January 1, 1991, and with strong efforts continuing. The approach adopted by the Government merits strong up-front support by the Bank. On the trade projections, the Region noted that the shock resulting from the break-up of the CMEA system is very large, and that from the new (low) base, the recovery is good. The Region provided concrete examples why Czechoslovakia exports to western and developed countries markets are likely to grow slowly rather than quickly. However, the Chairman questioned this.

4. Following up on the issue of the lack of dynamism shown in the projections, a member of the Committee noted that if the expected recovery in growth will in fact be so low, then there should not be so much borrowing up-front. The scenario being projected is one of consumption smoothing, not one of investment and growth. Second, the SAL IM and the CSN says the growth that there is would be private sector led, but the projected borrowing would be done by the public sector. If the growth will indeed be led by private investment, then the private sector should be able to obtain the external financing required directly, and not have the Government borrow for it. The projection appears to have just focussed on traditional gap-filling. There should also be a major IFC role in this strategy, but what is proposed on this is not clear. Finally, the tables show an explicit external financing gap (which would seem to indicate the scenario is not viable) but at the same time reference is made to the IMF and other sources of finance that could close this gap. The scenario presented to the OC should show a consistent projection of what is expected. Another member of the Committee noted that he was also worried over the projected jump in the consumption share and consequent growth in debt. He noted also that with the policies being implemented and the stated private-led strategy, he would have expected the

projections to show a greater growth in the share of investment in GDP over time. The current projections have the investment share rising only very slowly. The Region repeated that the scenario presented is not one of consumption smoothing, but agreed that it would re-examine the growth in the investment share over time, but also noted that an investment share of about 20% of GDP should be adequate in the short-run if used efficiently. On the financing gap shown in the tables, the Region stated that they could not show what is expected to come from the IMF and Japanese co-financing in the projections, although such flows are expected. Finally, their clear intent is to encourage private capital flows.

5. To conclude, the Chairman directed the Region to highlight the role of the private sector in obtaining the external capital flows that will be required over the medium-term. Second, the SAL documentation to be prepared for the Board should also emphasize the need for private foreign investment, its role, and the steps being undertaken to encourage it. Third, given the quality of the human resource base in Czechoslovakia, one should expect a stronger response to the reform program than what is shown in the projections of the SAL IM and the CSN. New projections should be developed to reflect this. Finally, one should not expect such a jump in consumption. Rather, the policies being followed (or that should be followed) should lead one to expect the marginal savings rate will be fairly high. This should be reflected in the projections.

Proposed IBRD Lending Strategy

6. The Chairman opened by noting that the proposed lending strategy has an appropriate focus on encouraging private investment. However, while such a focus is appropriate, there is still an issue of balance in the overall program. Specifically, the current proposed program has only one operation in the Social Sectors, and that only in FY95. There should be more than one such project, the Chairman directed, and they should be brought forward. Issues of the social safety net will be important to the success of the economic transformation program. The Region responded that while they agreed, the problem was that the Minister of Finance did not yet believe Czechoslovakia should borrow from abroad for such operations. The Social Sector Ministries, in contrast, were in favor of such assistance from the Bank. However, the position of the Minister of Finance has been evolving. A year ago, he was opposed to any external borrowing for the transition. The Chairman noted that he would have, of course, no objection to the EEC or someone else providing the funding required. It did not have to be the Bank. However, the issue should be dealt with in some way.

7. The Chairman also noted the importance of co-financing in the overall financing program, and inquired whether there were plans for co-financing operations such as under the ECO or EXCEL programs. The Region noted that there is a good case for ECO or EXCEL operations in Czechoslovakia, but that the Government was not at this point very interested. The Chairman directed that such operations should not, of course, be pushed by the Bank, unless they will be important to obtain access to capital markets. Any ECO operation should also be for specific projects only.

8. A member of the Committee questioned the size of the annual lending program proposed. In his view, $400 million in annual commitments should be sufficient for the Bank Group as a whole, and this should include any ECO

operations as well as commitments from the IFC. He also noted that the CSN gave no rationale for why the Bank should ever proceed to a High Case. Another member of the Committee noted that the size of the proposed SAL, at $450 million, was large for a country of the size of Czechoslovakia. Such a loan would be equivalent to almost $30 per capita, or roughly 1% of GDP. He asked whether the counterpart funds generated by this operation would go to the private sector. The Region responded that the counterpart would be used as is normal for a quick-disbursing loan. The Region also noted that since the Government accounts were in surplus, the counterpart would go to the enterprise sector. The member of the Committee asked whether this would be consistent with a hard budget constraint for the enterprises.

9. In conclusion, the Chairman directed that the lending program presented in the CSN and other Bank strategy documents should be comprehensive. The program amounts should include any ECO's or similar operations being proposed. There should be a clear private sector development strategy developed, with an integrated approach for the Bank with the IFC. On the overall Bank lending level, the Chairman would not rule out an amount of $400 to $500 million per annum. But the basic point is that whatever level is proposed must be derived from a careful analysis of the financial needs of Czechoslovakia, and the Bank's role in helping to provide what is needed. The Bank should be considered the lender of last resort in this. The lending program proposed should be fairly precise for the next three years or so, and can be more general for the longer term.

10. Finally, the Chairman directed that the CSN should go to the President for his review.

Specifics of the Proposed SAL

11. The discussion of the specifics of the SAL operation opened with one member noting that the program being supported is an ambitious one, perhaps overly ambitious. The privatization program, for example, will likely take longer than the authorities anticipate and conditions for its successful implementation should first be in place. It was also noted by this member that privatization per se is not the goal--successful privatization which brings in greater efficiency is. He also stated that the SAL should not therefore contain specific numerical goals on the pace of the privatization program. Rather, there should be agreement on the criteria to be used on which enterprises would be privatized, with progress then judged relative to the application of these criteria. Third, he noted that the proposed TA loan for Czechoslovakia will come too late to be of much assistance to the SAL program. Finally, he noted that legal issues arising from the uncertain status of the Republics vs. the Federation will need to be dealt with as Czechoslovakia enters into a borrowing relationship with the Bank. Another member of the Committee noted that this issue of Republics vs. Federation should clearly be listed as a risk. The Region responded on this point by noting that although a vocal minority in Slovakia was pushing for a break-up of the Federation, polls indicate that 75% of the population are opposed. A break-up should not be expected soon.

12. The Chairman noted that more than in most countries, the program being supported is genuinely that of the Government. Because of this, and because some of the specifics have yet to be worked out by the Government, the IM is not always clear on precisely what is planned. This leads to problems in the

wording of the conditionality at this point in time. Second, the time frame of the program will clearly be longer than the time frame of the proposed SAL. The Region should therefore consider again whether this should be the only SAL (or other policy-based operation) planned for Czechoslovakia. The time frame of the SAL should also be reconsidered. A member of the Committee stated that given the inherent complexity of the program (as for privatization), the conditionality should be developed in terms of the critical "break-points" in the program, where the program will be particularly tested. Progress should be judged in the conditionality by whether the Government proceeds through these break-points, despite the possible political difficulties.

13. The justification of the size of the operation was discussed. One member noted that $450 million is very large for a single operation to a country of Czechoslovakia's size. The program in Czechoslovakia is a good one, and merits a high level of support, but consideration should be given to stretching out our financial support, rather than providing it all through one, very large, loan. Another member of the Committee stated that the program in Czechoslovakia is an excellent one, which goes far beyond what we would have ever asked for. We should support it boldly, with support that is up-front and which goes beyond what we would normally do.

14. The adequacy of the social safety net was also considered. One member noted that with such a large loan size, there should be a strong emphasis on the use of the counterpart funds for financing of the social safety net. This would relieve the enterprises (that are to be privatized and are to operate in a market-oriented way) from this burden. But this has not been emphasized in the proposed operation. The Region responded that although the IM may not have made this clear, the social safety net is fairly well developed in Czechoslovakia and is not a primary concern for the Bank. There are some targeting issues that need to be better addressed, plus the introduction of modern techniques, but the ILO (and others) are working with the Government on this.

15. The Chairman concluded by stating that the program will clearly require a longer time frame than that of the SAL in its current proposed structure. The Region should therefore structure the operation in three tranches, with the support stretched out. The Region should be careful to be realistic on the specific tranche release conditions, and should word them in a way which centers on the "break-points" in the program, as discussed above. It was also noted that on the specific second tranche condition on public enterprise wages, the condition should be worded in terms of the average wage rate, and not the total enterprise wage bill. On the size and phasing of the loan, the Region noted that there is a large financial gap to be closed for 1992. The Chairman responded by stating that he is not opposed to a high level of financial support if it is justified, but the IM does not provide such a justification. He noted that the operation is large and complex, and the Region could consider splitting it into smaller operations. He also noted that it would be preferable that all of the Bank's support <u>not</u> be only through quick-disbursing loans at the beginning. He fully agrees that the Bank should make a clear and strong statement of support up-front, through a high level of financial support, but this did not all have to come from a single operation.

D. **DECISIONS**

16. The Region was cleared to proceed to appraisal with the proposed SAL, with changes made as noted above. Also as noted above, the SAL documentation and the Country Strategy Note should be sent to the President.

FJLysy:vl

April 23, 1991

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: April 7, 1991

TO: Operations Committee

FROM: Enzo Grilli, Director, EAS

EXTENSION: 81934

SUBJECT: CZECHOSLOVAKIA - Structural Adjustment Loan Initiating Memorandum and Country Strategy Note; Operations Committee Meeting Agenda

---

1. The Operations Committee will meet on **Tuesday, April 9, 1991, at 4:30 p. m. in Room 1243** to consider the Structural Adjustment Loan Initiating Memorandum and Country Strategy Note for Czechoslovakia. The following is a proposed agenda for the meeting.

Background

2. The SAL being considered today by the Operations Committee (along with a Technical Assistance loan 1/) would be the first operations of the Bank in Czechoslovakia. These operations will initiate what is planned to be a major Bank program to a new member, which is expected to last at least through the decade. The SAL would provide financial assistance (in coordination with assistance from the IMF, the European Community, and the G-24) in support of the Government's economic transformation program. The SAL (and the TA loan) would be the only Bank loans of this calendar year; the next Bank operation planned is a Hybrid operation for Financial Sector Development, which may go to the Board sometime next Winter. The SAL and this Hybrid are the only two operations in the current Bank lending program which would provide policy-based, quick-disbursing, funds in support of the Government's reform program.

3. The reform program began immediately with the new Government in early 1990, although through-out 1990 most of the reforms were more of a stop-gap nature rather than measures that were considered permanent. Thus, there was limited reform of the exchange rate system, as well as price and subsidy changes. Total Government subsidies were reduced from 16.0% of GDP in 1989, to 12.1% of GDP in 1990 (average for the year as a whole), and a level of no more than 6% of GDP is expected for 1991 2/. There was a tight budget, with a fiscal surplus for the consolidated general government of 0.5% of GDP. There were also

---

1/ This TA Loan is being processed approximately in parallel with the SAL. There are important links to the SAL, but unlike in most such cases, this TA operation is not directly tied to the SAL program. The documentation for the TA operation was therefore not distributed by the Region to the OC for today's meeting.

2/ The IMF Recent Economic Developments report projects an even lower level, of just 4.7% of GDP in 1991.

numerous and important legal framework changes in 1990, in preparation for a market-based economy.

4. The most important change in policies was implemented on January 1, 1991. This date was chosen in part to coincide with the end of the CMEA trade system. On that date, an exchange rate system was implemented which allowed free convertibility of the Czechoslovak Crown for all current account transactions. The previous multiple exchange rates were unified, with the new rate (initially Kcs.28 per US dollar) tied to a basket of five Western currencies. The auction rate for the Crown had been in the range of about 26-32 Kcs./$ for most of 1990. Also as part of this set of reforms, most prices were decontrolled (except for a transitional basket, which is scheduled to be decontrolled in April or May), while most foreign trade QR's were lifted. The existing tariff structure is low (but was largely meaningless in the previous price control system), but there will be a temporary flat 20% duty on certain foodstuffs and consumer goods imports. As a consequence of these measures of January 1, general prices rose about 25% in the first few weeks of 1991, but have since stabilized. The Government has also been proceeding with its Privatization program (with auctions of small shops begun), and efforts to introduce a financial system where there was basically none before.

5. The IMF is supporting this program with a 14-month Stand-by Arrangement, which was approved on January 7, 1991. The Stand-by is for SDR 619.5m (about $836m at the current SDR/$ exchange rate), while an accompanying CCFF will potentially total (depending on oil prices) SDR 631.3m (about $852m), of which SDR 314.5m ($448m) was drawn on approval of the program. The financing program contained in the IM for the SAL has no further IMF program, but one would clearly be possible if needed. In particular, an EFF Arrangement might be possible.

6. A full CSP could not be developed in time for the consideration today of this SAL. The Region has therefore circulated a brief Country Strategy Note along with the IM for the SAL, to provide an initial over-view. It is suggested that the discussion today of these two documents follow the following order. The meeting would first consider the basic economic projections that underlie both the SAL and the CSN's proposed Bank strategy. The meeting would then consider the Bank strategy proposed in the CSN, and lastly the specifics of the SAL.

ISSUES

Projections of the Balance of Payments and External Financing Needs

7. The key feature of the projections presented by the Region in the SAL IM and the CSN, is that the current account deficit is projected to jump from just 0.8% of GDP in 1990, to 6.8% of GDP in 1991. It would then stay high, at 6.0% of GDP in 1992, 5.4% in 1993, and 4.4% in 1994. It would be 2.8% in 1995 and average 0.9% in 1996-2000. As a result of the financing required for such a deficit (plus a build-up of reserves), Czechoslovakia's total gross debt (including in

non-convertible currencies) would rise from $9.1b at end-1990 to $20.7b in 1995, and then stabilize. The total gross debt would rise from 20% of GDP in 1990 (although 24% at the 1991 real exchange rate projected) to 50% of GDP in 1993, then stabilizing 1993-96, and then falling. In terms of net debt, the picture is much better. As of end-September, 1990, Czechoslovakia formally had external assets (excluding gold reserves) of $10.2b, vs. an external debt of $9.0b. However, a significant share of the external assets (probably in the range of $2 to $3b) are loans to Third World countries which will probably not be collectible. Assuming $3b will not be collected, Czechoslovakia's net debt would then rise to just $10b in 1995 (about 25% of GDP).

8. The cause of the 1991 jump in the current account deficit (by 6% of GDP) might also be discussed. The proximate cause of this jump (in terms of the national accounts) is a rise in the consumption share of GDP by 14% points, while the investment share falls by over 8% points. The rise in the consumption share implies gross domestic savings collapses, from 28.6% of GDP in 1990, to just 14.6% in 1991. The underlying cause is a projected loss in the external terms of trade (as a consequence of the end of the CMEA, with oil now priced at international levels), which the Region estimates will equal the equivalent of 8% of GDP.

(a) The OC might wish to focus on these projections of the balance of payments in 1991, with the consequent growth in Czechoslovakia's gross external debt.

9. The projections of growth over the medium term are conservative. GDP recovers only slowly, and reaches 1989 levels only in 1998 in the Region's projections. Exports fall sharply in 1991 (17% in volume), and then average a volume growth rate of just 4.4% a year over 1992-2000, despite the fundamental trade reforms recently implemented (and manufacturing wages of just $120 per month, on the German and Austrian border). Imports are projected to fall 32% in volume in 1991, and average only 2.6% growth over 1992-2000. In the year 2000 they are still 14% lower in real terms than their level of 1990, and the implicit import elasticity over 1997-2000, when GDP growth is projected to have recovered to 5.1% per annum, is only 0.65. The resulting profile of external borrowing need is therefore one where there is a very large jump in 1991 (due to terms of trade changes, as discussed above), but where this declines over time due to low import growth. Borrowing to finance consumption

(a) The OC might wish to discuss whether such a borrowing profile is reasonable.

10. The financing projections leave an explicit financing gap for 1992 and beyond, which totals $3,260m over 1992-95. However, the projections also leave out certain potential sources of financing. For example, net short-term trade credit was set at zero, but given the rise in convertible currency imports (to a large extent diverted from the CMEA) one might expect trade credit lines to grow by perhaps $3.2b. The projections also have a decline in MLT financing from private

[illegible] incomplete. In several years, there will be a drop in production

sources (for supplier's credits and other MLT financial market credits) by $500m in 1992 relative to the 1990 actual and the 1991 planned. These would then slowly rise, and exceed 1990-91 levels (as well as 1988-89 levels) only in 1995. The projections also have no IMF program following the current Stand-by.

(a) The OC might wish to consider the projected financing gap, and its mplications for creditworthiness.

11. The Government accounts are expected to be in surplus by 1% of GDP in 1991 under the IMF program, and a continued positive balance is expected thereafter. Yet an external current account deficit of 6.8% of GDP is projected for 1991, with high deficits thereafter, and a consequent high level of external borrowing. Most (perhaps all?) of the external borrowing will be done through the Government or at least with Government guarantee. This implies that the Government will be taking responsibility for a large rise in external debt, for on-lending to the domestic enterprise and private sectors.

(a) The Region might be asked by what mechanisms this will be done. Are institutions available (given the weakness of the financial sector) which will allow such on-lending to be done effectively? And is it prudent?

World Bank Lending Strategy

12. The Country Strategy Note (CSN) provides just an initial outline of the Bank's lending strategy for Czechoslovakia, in order to place the proposed SAL in context. A full CSP is planned to be available for OC review by March 1992.

13. The strategy proposed in the CSN is built in part around the assumption that Czechoslovakia will not graduate out of eligibility for Bank lending in this decade, but that such might be possible early in the next decade. In part for this reason, the lending program proposed starts at a relatively high level, at about $500m in annual commitments, but this is scaled down over the course of the decade to about $400m per annum in the middle and perhaps about $200m at the end. The resulting exposure ratios would be extremely modest. IBRD debt service as a ratio to the country's exports would only be 1.4% in the year 2000 (only one-quarter of the guideline limit of 5.5%).

(a) How strong is the expectation of graduation? If, by the mid-1990's, it is clear that graduation should not be expected soon, and hence a scaling back of lending not warranted, would there be consequent excessive risks to the Bank by the proposed level and profile of lending commitments?

14. The specific lending program proposed for FY91-95 is heavily focussed on the development of the industrial sector. Five of the 14 proposed operations (for $825m, or 35% of the total lending program planned) would provide direct support for industrial (including agro-

industrial and financial sector) development. However, a further five operations (for $800m, or 34% of the total) would be for energy, the environment, and telecommunications, with each of these operations closely linked to industrial development or the problems it has caused (i.e. environmental problems, energy efficiency investments, and telecom support). One could also argue that the SAL and the TA loan (21% of planned lending) are also heavily oriented to industrial development; the operations focus on the development of the Government's privatization program, enterprise reform, trade policy, pricing policy for energy and other inputs, the labor market, and financial sector development. Finally, the sole social sector project planned, would be for the development of Higher Technical Education. In total, 13 of the 14 planned Bank loans, and 94% of the lending, would be closely linked to industrial development. The remaining Bank operation, for Municipal Development and Housing, would be in FY95.

13 out 14 proj...

(a) The OC might wish to consider the appropriateness of the focus on Industry. Is there a role for the Bank in other areas, such as the social sectors (other than technical education), agriculture, or infrastructure?

Environment for the Private would Catalyze ...

15. The CSN notes that co-financing of Bank operations will be important.

(a) The Region might be asked to discuss more specifically what is planned.

(b) Would ECO and/or EXCEL operations be appropriate?

(c) If the Bank's sector investment operations are to be used as vehicles for co-financing, from official or private sources, they will need to be of greater scope or coverage than would be the case if Bank financing alone was involved. Will budgeted staff resources allow this?

Page 41

The SAL Program

16. The SAL operation would provide financial assistance (as part of a broader program of financial assistance involving the IMF, the European Community, and the G-24) in support of the Government's economic transformation program. Key elements of this strong program have already been implemented, as discussed in the Background section above, particularly with the January 1 changes. The SAL itself will focus attention on the areas of Privatization and Enterprise Reform, Prices and Subsidies, Trade Reform, Energy Pricing, the Financial Sector, the Labor Market, and the Social Safety Net.

17. The Macro Framework has been developed within the context of an IMF Stand-by Arrangement. The Region might be asked:

(a) To summarize briefly the status of the IMF program.

(b) The IM notes that inter-enterprise arrears grew to the equivalent of 4% of GDP in 1990. How much was the growth in 1990 (as opposed to the stock outstanding), and are "arrears" defined as an excess above some normal amount of inter-enterprise "float", or the entire amount of such credit? Is a problem anticipated in this area?

(c) The IM notes that the Consolidated Government surplus defined in the IMF program (at 1% of GDP planned for 1991) excludes the net revenues being received under the Privatization program. These proceeds will instead go into "National Property Funds", where they will be "neutralized". What level of net receipts are anticipated for 1991 and 1992 (as a per cent of GDP), and will this possibly have a significant deflationary impact?

18. The social impact is likely to be severe, as firms shed excess labor that was previously on the payroll. The key issue may have more to do with the Government's institutional capacity to deal with open unemployment than with policy changes per se. Thus, for example, the only Board Presentation condition in the social sector area deals with the financing of sick pay, while for second tranche (planned for 1992) understandings will be reached on the staffing of unemployment offices, etc. The Region might be asked:

(a) Its assessment of the institutional capacity in place to deal with a substantial growth in open unemployment. Is there a role for the Bank for assistance in this area?

(b) For Second Tranche release, there will be a condition that the Government have no labor market controls other than the minimum wage and, for public enterprises, control of the total enterprise wage bill. Could control of the total enterprise wage bill have the effect of precluding the hiring of new labor in those (perhaps few) enterprises where there might be such hiring? Could the control be on the average wage instead?

19. The SAL and the planned Financial Sector Hybrid operation are the only currently planned Bank operations in Czechoslovakia which would have quick-disbursing, policy-based, components. As such, the policy coverage of the SAL is broad, covering most areas of policy concern that are best addressed through such policy-based operations (with only the financial sector area left for follow-up by a quick-disbursing operation).

(a) The OC might wish to discuss whether the coverage of the SAL is therefore appropriate. Have areas been left out that would best be addressed through such a policy-based loan?

Operations Committee

Messrs. Qureshi, OPNSV
Shihata, LEGVP
Wood, FPRVP
Summers, DECVP/Rajagopalan, PREVP
Kashiwaya, CFSVP
Jaycox, AFRVP
Karaosmanoglu, ASIVP
Wapenhans, EMNVP
Husain, LACVP
Bock, OPNSV

cc: Messrs./Mmes Lari, Goldberg, Wyss, Isenman, Linn, Stoutjesdijk, Picciotto, Gustafson, Burmester/Thahane, Nouvel, Hasan, Thumm, de Melo, Okonjo-Iweala, Hewer, Parmar, Pfeffermann, Rao, Kavalsky, Shakow, Sandstrom, Walton, Liebenthal, Kilby, Robless, Blanchi, Khanna

FJL

FJLysy:

91040 2005
.1

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: April 1, 1991

TO: Mr. Moeen A. Qureshi, OPNSV

FROM: W. A. Wapenhans, EMNVP

EXTENSION: 32676

SUBJECT: **CZECHOSLOVAKIA: Structural Adjustment Loan (SAL) - Initiating Memorandum**

1. Attached for your consideration is the Initiating Memorandum for the proposed SAL to Czechoslovakia in the amount of US$450 million. A Country Strategy Note outlining the Bank's assistance strategy is also attached.

2. The SAL would support the rapid transformation of Czechoslovakia into a market economy. By adjusting, the country seeks to restore competition and growth, and achieve higher standards of living. The SAL's principal focus is on fundamental systemic reforms in (a) ownership and management of enterprises; (b) price and trade liberalization, including active enhancement of competition, and (c) provision of an adequate social safety net for those population segments most adversely affected during the transition process. These reforms are expected to promote private entrepreneurship and improve the allocation of resources. At the same time, the loan would help initiate restructuring of the financial sector, address urgent pricing and regulatory issues in energy, and put in place a basic institutional and policy framework for protecting the environment. The reforms take place in the context of a sound macroeconomic framework conducive to medium-term balance of payments viability and investment by local and foreign investors.

3. In order to achieve a rapid transition to a market economy, Czechoslovakia is implementing very strong structural reform and stabilization policies simultaneously, which, in our opinion, justify such a large per capita loan. The Government introduced important reform measures immediately after the national elections in June 1990 that were then amplified and intensified in January 1991 in connection with the demise of the CMEA. Retail subsidies on food were removed in July 1990, prices for gasoline and industrial energy as well as transport were raised substantially in the second half of 1990, and budgetary subsidies were cut from 16 percent of GDP in 1989 to a budgeted 6 percent in 1991. The Koruna was devalued by 75 percent vis-à-vis the dollar (in nominal terms) in late 1990, and convertibility of the currency for current account transactions was established on January 1, 1991. A far-reaching price liberalization was accompanied by an equally significant trade liberalization. Key elements of a social safety net to protect the most vulnerable population groups during the transformation process have been put in place, and the 1991 budget contains provisions for covering the benefit payments associated with the projected significant rise in unemployment. In spite of these particular expenditures, total budgetary expenditures are budgeted to

decline, so that the 1991 budget plans a surplus of about 1 percent of projected GDP. This fiscal restraint, combined with cautious monetary and wage policies should prevent the price jump in early 1991 associated with price and trade liberalization from developing into an inflationary spiral.

4. The Government considers a well-planned but speedy transfer of state ownership to the private sector and stimulation of domestic and foreign investment, the centerpiece of its transformation program. It has therefore put in place a legislative framework for privatizing small and large enterprises. Privatization of small businesses is in full process and the regulations and procedures for implementing the large privatization law are currently being prepared. Administrative obstacles for creating new small businesses have been removed and direct foreign investment is being encouraged by only light registration requirements. A major tax reform, scheduled for 1993, is under preparation.

5. Czechoslovakia is under a 14 months stand-by arrangement (SBA) of SDR620 million with the IMF, starting in January 1991. This SBA is supplemented by access under the compensatory and contingency financing facility (CCFF) of up to SDR484 million. The first review of the stand-by is scheduled for the second half of April 1991. The IMF supports both the stabilization policies and some structural aspects of the transformation program, such as price and trade liberalization. The IMF is also providing technical assistance to the State Bank in the area of monetary policy and management, and to the Ministry of Finance for tax reform. The staff of the Bank and the IMF have collaborated closely and jointly discussed key policy issues with the authorities.

6. Czechoslovakia's economy will undergo massive shifts in the allocation of resources resulting in far-reaching structural change. This by itself can be expected to lead to significant efficiency gains in the medium term. GDP has been projected to grow by about 5 percent during the second half of the 1990s, compared to somewhat less than 3 percent between 1992 and 1995. In the short run, Czechoslovakia faces, however, drastic shocks that will cause very large internal and external imbalances during the early years of the economic and social transformation. In the wake of the demise of the CMEA and with an oil price forecasted at US$20.5 per barrel, Czechoslovakia's terms of trade have been projected to decline by 27 percent in 1991 on a permanent basis. Import prices can be expected to increase by almost 85 percent in dollar terms, and the projected terms of trade loss due to the move to world prices in former CMEA trade has been estimated at US$3 billion in 1991, or some 8 percent of projected GDP (assuming no trade level changes). Exports to former CMEA countries have been projected to fall by about 25 percent in real terms in 1991. Exports to the Soviet Union in particular are likely to decline by some 25 percent in real terms in 1991, due to the economic decline, a shortage of foreign exchange and uncertainties regarding the mechanisms of allocating it between the Soviet importers, difficulties in agreeing on products and prices to be traded under barter arrangements during a transitional period, and also political difficulties. Export expansion to convertible currency

countries, although supported by a large devaluation of the Koruna, will take some time. Consequently, Czechoslovakia's current account deficits have been projected to amount to almost 7 percent of projected GDP in 1991 and to remain at the 4-5 percent level during 1992-95, before they fall to around 1 percent in the second half of the 1990s.

7. To support the implementation of its transformation program, including the necessary build-up of foreign exchange reserves to about a month and a half of projected imports in 1991, Czechoslovakia needs medium and long-term external financing of US$4.8 billion in 1991, and about US$3.8 billion a year during 1992-95 (gross financing requirements). Czechoslovakia's domestic adjustment efforts are substantial on all accounts. Most significantly, real private consumption per capita has been projected to drop by about 5 percent a year in 1991 and 1992. Large capital inflows to complement the comparatively low national savings are needed to finance a massive modernization of the industrial capital stock.

8. In spite of significant projected external capital inflows throughout the 1990s, the financing plan presented in the IM contains an important financing gap of some US$800 million a year during 1992-95. The projected underfunding of the transformation program after 1991 could be even larger if the projected disbursements from private commercial and bilateral sources turn out to be too optimistic. On the other hand, additional funding from the IMF, possibly in the form of an extended arrangement, together with a continuation of support from the EEC and the G-24 group, and an increase in the Bank program to about US$700 million (instead of the US$500 million currently planned) would close this gap, provided Czechoslovakia enjoys continued access to the financial markets.

9. If Czechoslovakia continues to implement a strong transformation program the chances are good that it will succeed in securing the needed financial support. The Bank will play a prominent role in assisting the country to mobilize funds from other sources. If Czechoslovakia does, however, not receive the large external financing needed to support its transformation program, the economy could probably be forced to adjust in a disorderly fashion to the drastic terms of trade deterioration. Economic growth would slow down considerably, since the critical modernization of the industrial capital stock could not take place. Without the prospect of a fundamental and lasting transformation of the economy, the Bank assistance program would have to be reduced to much more modest levels.

10. Czechoslovakia's debt burden is expected to increase rapidly during the early years of the transition to a market economy, and the creditworthiness indicators will deteriorate accordingly. This is also due to the projected decline of GDP in 1991 and 1992, accentuated by the depreciation of the Koruna against the dollar. Since Czechoslovakia has embarked on its transformation program from a position of moderate debt burden, total debt has been projected to surpass 50 percent of GDP only during a few years in the mid-1990s before declining rapidly towards the end of the decade. Projected Bank exposure would rise from 2.4 percent

of total debt in 1991 to slightly more than 10 percent in the late 1990s.

11. The SAL would be the first loan to Czechoslovakia since it re-joined the Bretton Woods institutions in September 1990. It would therefore serve as an umbrella loan under which the Bank's first operations in support of the economic transformation would take place. A Technical and Financial Advisory (TFA) loan, under preparation in parallel with the SAL, would help strengthen economic management during the initial transformation phase and provide financing for professional advisory services to enterprises and particularly commercial banks. Other operations are briefly discussed in the attached Country Strategy Note.

Attachments:
SAL Initiating Memorandum
Country Strategy Note

Distribution:

Operations Committee Members
Messrs.: Husain (LACVP); Jaycox (AFRVP); Karaosmanoglu (ASIVP); Rajagopalan (PRSVP); Summers (DECVP); Shihata (LEGVP); Kashiwaya (CFSVP); Wood (FPRVP); Bock (OPNSV)

Other Participants
Messrs./Mdmes.: Wyss (CODDR); Grilli (EAS); Isenman (PRDDR); Linn (CECDR); Stoutjesdijk (FRSDR); Picciotto (CPBVP); Gustafson (CEMDR); Thahane, Burmester (SECGE); Goldberg (LEGOP); Sandstrom (EXC); Okonjo- Iweala (OPNSV)

For Information
Messrs.: Parmar (IFC-CIO); Rao (IEC); Kavalsky (FRM); Pfeffermann (IFC-CEI); Liebenthal (PRD); Kilby (FRS); Robless (OPNSV); Walton (DECVP); Khanna (EXC); Shakow (EXT); Institutional ISC

Regional:

Country Department
Messrs./Mdmes.: Dervis, Blanchi; Hasan (3) (EMNVP); Lari (EM4DR); Farsad, Vita o/r (EM4CO); Apitz (EM4IN); Harbison (EM4HR); Montfort (EM4EE); O'Sullivan (EM4AG); Sood (EM4IF); Levine, Dado (EM4CO)

Technical
Messrs.: Kohli (EMTDR); Wackman, Ewing (EMTIE); Baudon (EMTEN); Hinds (EMTTF); Roa (EMTPR)

Bankwide
Messrs./Mdmes.: Stern (FINSV); Thalwitz (PRESV); Lysy, Levy, Siraj (EAS); Petit (AGRDR); Pouliquen (INUDR); Churchill (IENDR); Piddington (ENVDR); Hamilton (PHRDR); Frank (CFPVP); El-Rifai (MIGPA); Niehuss (CFS); Elwan (CFSPS); Hassan, DeWitt (LEGEM); Perera (LOAEL)

Others:
Messrs./Mme.: J. Holsen (PADSS); B. Aghevli, J. Carter; T. van der Willigen (IMF)

Cleared and cc: Messrs. Nouvel (EM4CO); Thumm (EM4DR)

UHewer:sw

April 3, 1991

9105070041.

THE WORLD BANK
Operations Committee

CONFIDENTIAL

Minutes of the Operations Committee to Consider the BURKINA FASO - Transport Sector Adjustment/Investment Credit; Initiating Memorandum

Held on Wednesday, April 3, 1991, at 4:30 p. m. in Room E1243

A. Present

Committee

Messrs. M. A. Qureshi, Chairman
I. F. I. Shihata, LEGVP
K. Kashiwaya, CFSVP
Mr. E. V. K. Jaycox, AFRVP
A. Karaosmanoglu, ASIVP
D. R. bock, OPNSV
K. T. Yurukoglu, FIN
L. Y. Pouliquen, PRE
W. Grais, EMN
H. W. Fleisig, LAC

Others

Messrs./Mmes E. Grilli, EAS
K. Marshall, AF5DR
P. Watson, AF5IN
B. Mitchell, AF5IN
R. Faruqee, AFRCE
J. Ingram, AF5CO
N. Okonjo-Iweala, OPNSV
R. Soopramanien, LEGAF
G. P. Sicat, EAS
P. Rashid, CODOP
F. Felah, FRM

B. Issues

1. In discussing the Transport Adjustment/ Investment Credit Initiating Memorandum, the Operations Committee took up the following issues: the role of the proposed transport credit within the country assistance strategy, the hybrid design for the credit, the transport policy components of the credit, and aid coordination.

Transport Investment Reforms and the Assistance to Burkina

2. At the outset, the Region emphasized the importance of the transport reforms in the context of the overall macroeconomic adjustment program. This was in line with the strategy outlined in the Country Strategy Paper which indicated that economy- wide measures would be supported through a SAL and important sectoral reforms in transport and agriculture would be pursued under sectoral adjustment operations. The Region further stressed that there were two notable features of adjustment in Burkina, namely, the broad- based commitment of the Government to the reform program, and the unusual depth of the program of reforms. The Region stressed that it was not seeking a change in the allocation of resources for Burkina and that the transport credit was prepared within these allocations.

Hybrid Credit Design

3. The Region stated that the credit was designed as a hybrid involving an adjustment component and a physical investment program in order to emphasize the sector- related issues, and to get the central ministries of Finance and Planning to focus, in allocating public resources, on the importance of the maintenance and rehabilitation of the existing transport facilities. This was particularly important in view of the fact that in Burkina the priorities of the Public Works and Transport Ministry for maintenance were often considered low. By focusing attention on the adjustment program component for the sector, the chances of the Transport Ministry of getting sufficient funding for essential maintenance needs would improve. One member, however, felt that this argument could be carried too far, since the Bank made credits to governments and not to ministries. But in the specific case, he observed that this argument might be academic since the disbursement of the adjustment component of the proposed credit was to be against a positive list of imports.

4. The Chairman pointed out that the approach taken in this proposed credit corresponded to the typical hybrid credit instrument involving sector-related reforms that were linked to a program of physical investment. It was helpful that the disbursement of the quick- disbursing portion of the credit was to be made against a positive list in this case. The Region sought further clarification on whether there was indeed a need for disbursement against a positive list. The point had been critical in guiding staff in the design of the appropriate hybrid. The Region felt that the objective of the hybrid credit was to focus mainly on the needs of the sector, but that disbursement of the adjustment component against a negative list of imports would be preferable, since it went to finance balance of payments need. Another member also emphasized that the disbursement of the quick- disbursing money against a positive list weakened the control of the central authority over the use of resources. If the objective was to provide greater flexibility for the government, it was important that the credit be disbursed against general balance of payments need. The Region pointed out that within the context of the CFA Zone, the currency was fully convertible so that in effect the only requirement for disbursement by the Bank was to put together the necessary import documentation.

5. Taking note of the above remarks, the Chairman clarified the policy on disbursement in the case of SALs and SECALs. He stated that in the case of SALs the disbursement against a negative list was in line with the need for broad balance of payments support. It would also be possible to disburse against a negative list in the case of broad sector reforms within a SECAL, but the preferred approach was to use a positive list, to emphasize the link to the sector requirements. However, he recognized that some flexibility to this rule was needed, especially in the case of sectors in which the direct import requirements were below the amounts allocated in the credit, as often the case in social sector adjustment operations. In view of the identified physical investment requirements associated with a hybrid credit, it would be expected that import needs could be identified much more easily, especially in the context of transport investments.

6. One member questioned the need for designing this credit as a hybrid since a SAL (which was recently approved for appraisal by the Operations Committee) would soon be in place. He suggested that in this case it seemed

more appropriate to put all the requirements for quick- disbursing resources in the SAL. Moreover, he stated that in the case of a railway project loan in his Region, the policy requirements in the sector appeared heavier than those proposed in the present credit. Another member found attractive the argument that the hybrid design would make the central ministries pay more attention to the requirements of the sector in their allocative decisions. He felt that the same argument could be extended to the case of other critical infrastructure, like water, energy, etc. The Region replied to these questions noting that the agenda for the SAL was already overloaded. They therefore felt that a sector adjustment credit supporting reforms in the transport sector was justified. The Region further noted that they were comfortable with the macroeconomic links of the proposed operation, and that they were planning to have further credits in agriculture linked with the macroeconomic framework.

Transport Sector Policy Reforms

7. The Committee discussed the reforms in the transport sector, dealing specifically with resource mobilization, the balance between investment and maintenance, institutional issues in railway operations, and the role of the private sector in transport.

8. Investment vs. Maintenance; Project Rates of Return. One member expressed surprise that the project envisaged only a cut- off rate of return of 12% for investments in road transport, since the usual returns for rehabilitation of roads were much higher. He further stressed that the amount of expenditure allocation for transport as well as for other sectors could be analyzed more correctly only after a thorough public expenditure review had been undertaken. After such a review, the proportion between investment and current expenditures would be better understood, both for overall public expenditure, and for transport in particular. The Region pointed out that in the past ten years investment in transport had absorbed a large amount of resources. Several white elephant projects had been funded, while the needs for appropriate maintenance and rehabilitation of existing network went unattended. The policy reform was designed to achieve a substantial reallocation of funds, from a ratio of 60%-40% for investment- maintenance to a ratio of 40%- 60% in favor of maintenance. This was a significant change in the resource balance, to be achieved over the five year project period. The Region further stated that even though rehabilitation and maintenance took priority, they did not want to penalize justified new transport investment, which would be included in the program only if they satisfied appropriate review criteria. The Region also stressed that within the framework of the SAL appraisal, investment reviews were being undertaken and that the findings would be fully reflected in the public investment program to be proposed by the Government. The Chairman recognized that there was a trade- off between maintenance and new investment in connection with a rate of return cut- off point. A low cut- off point increased the risks that poorer maintenance projects might be undertaken. But the same rate of return would provide a high enough threshold rate of return for investment projects. He therefore recognized the need for some degree of flexibility, having in mind that the intent was to produce a productive use of resource expenditure in every possible case.

9. Resource Mobilization. In answer to the Chairman's query on the financing of the transport sector program, the Region stated that no new

taxation of the transportation sector was needed. Transport taxes were already high in Burkina in relation to the Sub- Saharan region, and further taxation would make transport costs too high. To finance transport reforms and adequate infrastructure maintenance, the Region believed that a reallocation of taxes collected from the transport sector could be undertaken. The proceeds from road taxes and user charges allocated to finance the rehabilitation needs of the road transport sector could be increased from an average of about 10% of the total proceeds in the past five years to about 50%. With respect to the cost recovery of transport services, the Region stated that there was scope for further increases in tariffs, but this depended on the specific subsector. For instance, they felt that the cost of airline service could be raised, because present low fares provided an unjustified subsidy for the better off. There was less scope for large increases in the tariffs for urban transport. With respect to the railway sector, it was essential to provide it with some infusion of cash in order to improve its operating efficiency. The Region also stressed that the reallocation of resources for the transport sector would not be at the expense of the social sectors, but would be achieved through a reduction of non-essential expenditure, such as military spending.

10. A member asked why there was no scope for additional taxation as he felt that there was some room for some imports and also on personal travel. The Region responded that efforts to raise revenue were designed to be economy- wide measures. They felt there was a danger that the transport sector would become overtaxed. But they agreed that this was an important issue and that they would look into it more fully during appraisal.

11. An Institutional Issue. A member was concerned that the experience with the operation of joint commercial entities in this particular sector had not been successful, and yet in this project, there was a provision for a new joint entity to handle international traffic on the railway line between Burkina and Cote d'Ivoire. He asked what assurances there were that the joint entity would work this time and whether there were any simpler alternative mechanisms being explored. Another member asked whether, given that a joint entity was being used as a condition of tranche release for this project, there was a similar agreement being made with Cote d'Ivoire. The Region confirmed that a parallel agreement was indeed under discussion with Cote d'Ivoire. It also offered a brief background history of this recommendation. The railway had operated as a single entity until 1987, when it was separated into two national companies, mainly for political reasons. The donors felt that the issue of efficient handling of international traffic had to be resolved before any further financing of the railway component of the project could be considered, and that no rehabilitation type investments in the railways would be made unless a joint operation for international traffic could be put into effect. While the two railways were to remain as separate entities, the single entity would simplify procedures especially for the most important clients whose business provided the main justification for the continued operation of the railway. The Region felt that the successful financial restructuring of the railway depended on establishment of this joint commercial entity.

12. Private Sector Promotion in the Transport Industry. The Committee welcomed the emphasis placed in promoting a greater role for the private sector within the transportation industry. A member stressed that in the transport sector, especially railways, privatization had its limits.

Moreover, in view of their operations, financial independence was not an easy objective to achieve, especially since they would continue to require subsidies. Another member welcomed the efforts related to the encouragement of the private contracting industry. He stressed the importance of creating competitive settings by encouraging entry, and suggested that this was possible in the provision of urban transport. He also felt that in the interest of sustaining the build- up of the private contracting industry, the government could provide more financial contribution for periodic maintenance of the road network. Another member suggested that while it was possible that the regulatory barriers to entry could be reduced, the assignment of routes in urban transport often raised barriers to competition. The Region stated that some periodic maintenance would be financed by the government, even though it was already taking care of routine maintenance out of budgetary resources. With respect to barriers to competition, the Region said that in the particular case of Burkina, the main competition was offered by two- wheeled transport at the level of municipalities. They would however look further into the role of the municipalities in transport regulations during appraisal.

13. Aid Coordination. In response to the Chairman's query as to whether there was any aid coordination issue with respect to the objectives of the transport credit, since a large part of it was to be cofinanced by other donors, the Region stated that during the October donor meeting for Burkina, there had been a remarkable shift in their support for adequacy of financing of maintenance costs and in their acceptance of the need for an agreed rate of return for transport projects. This was, however, not yet unanimous, as some donors were still promoting their favored projects. There were nonetheless more donors who supported these priorities and backed them up with an increased volume of aid.

14. Environmental Impact. The Region stressed that there were no serious environmental aspects related to the transport investment. The government was engaged in the preparation of an environmental action plan in accordance with an agreement reached in the Policy Framework Paper.

C. Decision

15. The Chairman congratulated the Region for the careful answers provided to the questions posed by the Committee and for the design of the project. He then authorized the Region to appraise the proposed credit.

GS
GSicat:sb

April 17, 1991

91040200 1

1.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: April 1, 1991

TO: Operations Committee

FROM: Enzo Grilli, EASDR

EXTENSION: 81934

SUBJECT: BURKINA FASO -- Proposed Transport Sector Adjustment/ Investment Credit Initiating Memorandum; Operations Committee Meeting; Proposed Agenda

1. The Operations Committee will meet on April 3, 1991, at 4:30 p.m. in Room E1243 to consider the Inititating Memorandum for the proposed Burkina Faso Transport Sector Adjustment/ Investment Credit. The following represents a proposed agenda.

2. Background. On February 22, 1991, the Operations Committee met on the proposed SAL I Initiating Memorandum for Burkina Faso and agreed that it should be appraised. The Committee of the Whole of the Board also considered the first Policy Framework Paper for Burkina Faso recently. Burkina Faso, with a per capita GDP of $320, is endowed with poor natural resources, has a hostile climate, and has a high population growth rate. The population has an average life expectancy of 47 years and a low level of education, with only 28% primary school enrollment. Because of its landlocked geography, the transport sector is important as a land-bridge to the other countries and for internal commerce.

$ SAL 80 mil
Tr 56
136
56%

Issues

188 mill
$ 240 mill
Fy. 92-94

3. Proposed credit in the context of the country assistance strategy. According to the lending strategy for Burkina under the base case with adjustment, the proposed IDA allocation (totalling US $375.7 million for FYs1991-95) includes US$60 million "for sector adjustment operations in transport, and financial sector/ public enterprises, and the remainder for investment operations in natural resources, the environment, mining, and human resources." (see CSP, paras.70-74). Because the initiation of the country policy dialogue is only recent, the Region has not yet undertaken any formal public expenditure review. Within the above context, the Committee may want the Region to explain what the proposed credit hopes to achieve in the context of the Bank's lending strategy to Burkina, taking into account that (a) the SAL I is timed for implementation shortly ahead of the proposed transport credit; and (b) that the government faces other pressing priorities that compete for public resources. The present credit is likely to exhaust the portion allocated within the CSP for sector adjustment operations, leaving only a minimal amount for other sectors.

4. Hybrid credit design. The proposed credit is for the equivalent of US $56 million. This amount includes a quick disbursing component of US $20 million, to be disbursed in three tranches against a positive list of eligible imports. The investment component of the project is

Replating
Regional agreement
on transports of transport
Inter Country

therefore US $36 million, but the five- year investment and expenditure program for the transport sector is expected to amount to US$ 495 million. Rehabilitation and maintenance would provide a significant amount of the underlying expenditure priority. In justifying the hybrid design, the Region states (see their memorandum, para.2; see also I.M. para.3.05) that it hopes to promote "important sector policy reforms that depend for their success on the support of the central ministries of Finance and Plan ... [along the lines of] a significant shift between budget allocations for maintenance and for new investments; improved resource mobilization in the urban transport, railway and civial aviation subsectors... " The Committee may want the Region to explain why the use of a hybrid lending instrument was needed especially since SAL I would be effective during much of the early period of the investment project? If the hybrid design is motivated by further need for quick disbursing resources, such a deficiency could be justified within the SAL. On the other hand, it would be useful for the Committee to know if any quick disbursing resources from other sources would be triggered by the tranche release of this credit operation which would otherwise not be conditioned by the SAL tranche releases? Assuming that the hybrid design is accepted, the issue of providing a specific macroeconomic anchor for the release of the quick disbursing resources is relevant. Para.4.08 simply states that this would be consistent with the PFP objectives, "using specific criteria to be agreed at appraisal." The Committee may want to specify that SAL I or any succeeding adjustment operation be used as an anchor for this conditionality so long as the adjustment operation is effective.

5. Transport sector reforms. The transport sector reforms contain three elements (see paras. 3.02-3.04): (a) to give priority to rehabilitation and maintenance and to institutional strengthening, with new investments being confined to those with economic feasibility; (b) to promote increased private sector participation in construction and in transport services; and (c) to restructure the transport parastatals (in public bus transport, in railways and in airlines) to improve their financial and operational viability. The Committee may want the Region to elaborate on the following points:

♦ Investment vs. maintenance within the transport sector. Is the Region's analysis of the need for rehabilitation and maintenance predominant in roads alone or is it true also in the other modes of transport? Since the Region had pointed out that that the transport sector has "accounted for some of the more massive 'white elephants' on the investment scene" (see para. 3.07), are there any important areas where new transport investment would still have high productivity and have these been identified? To what extent are the present transport modes complementary (e.g., rails vs. roads, primary roads vs. country roads)?

♦ Financing the transport program. Paras. 3.09-3.11 details the resource mobilization issues related to transport. The financing strategy of the transport program recommends an increase in the allocation of budgetary resources for maintenance and rehabilitation.

Specifically, the Region proposes that the government finance the full cost of routine maintenance and the part of the agreed priority projects that is not funded by donors. This would require that about one- half of the total tax and other revenues collected from the road (and other road-user related) taxes be allocated towards maintenance of roads, in contrast to 10% of the proceeds in the past. This recommendation poses several issues: firstly, why there are no measures recommending the increase of taxation of the transport- using sector in this operation; secondly, to what extent is the principle of full cost- recovery applied in the sale of transport services (especially in the other transport modes); thirdly, if the transport sector were to receive more budgetary resources, would this not be at the expense of the social sectors such as education and health?

♦ Promoting the private sector. The proposed operation contains elements that are designed to strengthen contracting in the private sector, as well as to improve the regulatory environment with respect to transport services. In particular, the share of routine maintenance by private contractors would be increased and the payments to contractors would be made relatively on time. The Region might want to elaborate to what extent these desirable features, which are linked to tranche releases, would be monitorable. With respect to the transport sector service companies (bus, air, railways), the issue is whether the proposed program is going far enough in the direction of privatization or increasing the participation of the private sector. How deep are the measures designed to improve the regulatory environment for the viable operation of private transport companies, considering that some of the transport issues are partly determined by international (i.e., regional) accords on transport regulations?

tranche and relating to pvt payments

♦ Aid coordination. Table 1, p.22a, (text provided in French and also full of acronyms) shows the financing of the transport investment, by donors and type of investment. Of the US$ 495.5 million proposed investment program over five years, close to US$ 300 million has identified financing, although it is expected that donors will finance up to US$ 324 million. Are there elements within the unfinanced portion which are of higher priority? To what extent are the donors fully participating in the priorities of the program, which is to promote greater allocation of resources towards rehabilitation and maintenance?

♦ Other issues. (i) Are there any environmental aspects to the transport investment program that require any attention? If there are, should these not be carefully noted? (ii) Considering that construction is a major source of potential employment if the appropriate technology is employed, the Region may wish to elaborate on the employment- generating characteristics of the proposed investment program.

Operations Committee

Messrs. Qureshi, OPNSV
Shihata, LEGVP
Wood, FPRVP
Summers, DECVP/Rajagopalan, PREVP
Kashiwaya, CFSVP
Jaycox, AFRVP
Karaosmanoglu, ASIVP
Wapenhans, EMNVP
Husain, LACVP
Bock, OPNSV

cc: Messrs./Mmes Marshall, Goldberg, Wyss, Isenman, Linn, Stoutjesdijk, Picciotto, Burmester/Thahane, Watson, Okonjo-Iweala, Mitchell, Parmar, Pfeffermann, Rao, Kavalsky, Sandstrom, Liebenthal, Kilby, Robless, Khanna, Walton, Institutional ISC

GSicat:sb

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

9103270004
.1

DATE: March 25, 1991

TO: Mr. Moeen Qureshi, SVOP

FROM: Callisto E. Madavo, Acting Vice President, AFR CEM

EXTENSION: 34000

SUBJECT: BURKINA - Proposed Transport Sector Adjustment/Investment Credit - Initiating Memorandum (IM)

---

1. The attached Initiating Memorandum seeks Operations Committee authorization for appraisal of a hybrid Transport Sector Adjustment/Investment operation in Burkina, scheduled to start in early April 1991.

2. The proposed IDA Credit for the equivalent of US$ 56 million equivalent would finance a quick disbursing component of US$ 20 million equivalent and part (US$ 36 million) of a five year rehabilitation and maintenance program that is estimated to cost up to US$ 495 million equivalent, and for which cofinancing of some US$ 324 million was indicated during a Donors Meeting in October 1990 by eleven other donor agencies and the Burkina Government. The hybrid form of the project reflects the objective of promoting important sector policy reforms that depend for their success on the support of the central ministries of Finance and Plan, as well as on that of the technical ministries: they include a significant shift between budget allocations for maintenance and for new investments; improved resource mobilization in the urban transport, railway and civil aviation subsectors; measures to increase financial autonomy and operational efficiency of transport sector parastatals aimed at eliminating the need for operational subsidies from Government; successive transfer of works execution and provision of transport services from the Government to private sector operators; and actions to free up the regulatory environment and enable operators to provide more efficient and less costly transport services. The size of the quick disbursing component is conditioned by the overall IDA allocation for Burkina, its split between adjustment and investment credits, and its distribution among the SAL and the Transport and Agriculture SECALs.

3. This memorandum summarizes the main issues which the appraisal mission for the Transport Sector Adjustment/Investment Credit (TSAIC) would address. These are presented in more detail in the attached IM. The proposed operation promotes in the transport sector, the kind of policy reforms and reorientations that are being pursued economy-wide through the first Structural Adjustment operation for the country which has just been appraised, following recent approval of the Government's Policy Framework Paper by the Committee of the Whole.

4. For a landlocked country like Burkina, the transport sector has particular strategic importance for growth, especially so in agriculture and trade. On the basis of a series of diagnostic subsector studies, the operation proposes major adjustments in sectoral investment priorities and investment planning (establishment of three-year rolling investment programs based on sound economic evaluation, with a minimum ERR of 12% required for inclusion of projects in the program); improved resource mobilisation (urban public transport, railway, aviation tariffs) and allocation (reversing the 40-60 share of maintenance and investments respectively in overall road expenditure over the past decade; allocation of some 50% of revenues collected from vehicle owners and road users to road maintenance). It will contribute to the reduction of the public sector wage bill through gradual transfer of road maintenance works execution from force account to private contractors, with particular emphasis on the development of small local contractors using labor-intensive methods in routine maintenance, and to local capacity building through the development of local consultants for the contracting and supervision of small works. The operation supports operational and financial restructuring of sector parastatals, which are among the largest in the country and, in their present precarious condition, poor candidates for privatisation; and it promotes regulatory reform to permit free contracting and pricing between shippers and transporters, and reduced controls, simplification of procedures, and improvement of transit and terminal facilities to promote internal and external trade. Finally, it will contribute to capacity building for improved sector administration, accounting and auditing.

5. The program has the support of of the major donors active in Burkina's transport sector. Some eleven co-donors will be contributing to the financing of a carefully prepared five year sector investment and maintenance program, which will ensure that the agreed policy reforms can and actually will be put in place. For a number of the co-donors, this is the first time that they have participated in the financing of rehabilitation and maintenance actions, for which IDA traditionally had been the sole provider.

6. The Burkina Government and the donor community have already reached agreement in principle on the main policy and institutional reforms that are required in the different subsectors, if a growing trend of declining transport service levels, deteriorating essential infrastructure, and ill-adapted and poorly maintained transport equipment and facilities is to be reversed, and if subsidized sector parastatals are to become operationally sound entities functioning on a commercial basis. The major reorientations and reform measures are reflected in Government's Declaration of Sector Policy which was presented at the Donors Meeting; a number of them have already been launched.

7. There is substantial agreement on most of the components of the program presented in the IM. The schedule of detailed actions will be carefully reviewed during appraisal and finalized with technical assistance to be provided under a second PPF (the first PPF of US$ 750,000 equivalent having been exhausted in October 1990). No audit reports on earlier IDA projects in the sector are outstanding. Since

investments under the project are practically exclusively for rehabilitation and maintenance of existing infrastructure, the project has been classified in Category B for environmental purposes, for which environmental assessments are not required. The main issues to be addressed by the appraisal mission are: (a) clear understanding on the criteria for setting priorities for transport investments; (b) agreement on the increase in budgetary allocations necessary for the priority road maintenance program, and on the modalities of funding required to permit timely execution of programmed works; (c) modalities and timetable for reducing force account operations, and capacity building for works execution by small local contractors, and for efficient procurement, management and supervision of large numbers of small contracts by the public works administration; (d) firm implementation schedules for the restructuring of sector parastatals and agreement on Government's financial contributions during the transition period; and (e) agreement on indicators of financial and operational performance for the different subsectors.

Attachment

Distribution

Operations Committee

Mmes./Messrs. S.Husain (LACVP), Karaosmanoglu (ASIVP), Wapenhans, (EMNVP), Jaycox (AFRVP), Rajagopalan (PRSVP), Summers (DECVP), Shihata (LEGVP), Kashiwaya (CFSVP)(4), Wood (FPRVP), Bock (OPNSV)

cc: Thahane/Burmester (SECGE), Picciotto (CPB), Goldberg (LEGOP), Grilli, Sicat (EAS), Wyss (COD), Sandstrom (EXC), Isenman (PRD), Linn (CEC), Stoutjesdijk (FRS) Okonjo-Iweala (OPNSV)

Parmar (IFC-CIO), D.C.Rao (IEC), Kavalski (FRM), Pfefferman (IFC-CEI), Liebenthal (PRD), Kilby (FRS), Robless (OPNSV), M. Walton (DECVP) Khanna (EXC), O'Brien (AFRCE), Diogo (IMF)

Martinez, Edstrom, Ohri (AFRVP), Marshall, Laporte, Schebeck (AF5DR), Sarbib, Ingram, Jonas (AF5CO), Agueh (AF5PH), Bauer (AF5IE), Steeds (AF5AG), Watson, Lantran, Henault, Powers (AF5IN), Doyen, Budin (AFTIN), Soopramanian (LEGAF), Reed (LOAAF), Delapierre (Res.Mission), Africa Information Center

B.Mitchell
buocrev

April 1,1991

91050603δ

THE WORLD BANK
OPERATIONS COMMITTEE

CONFIDENTIAL

Minutes of the Operations Committee to consider the paper on Financial Sector Adjustment Lending: A Preliminary Assessment of the Bank's Experience

Held on Monday, April 1, 1991, at 4:30 p.m. in Room E-1243.

A. **Present**

Committee		**Others**	
Messrs.	Qureshi, Chairman	Messrs.	Thahane (SECGE)
	Karaosmanoglu (ASIVP)		Long (CECFP)
	Wapenhans (EMNVP)		Linn (CEC)
	Husain (LACVP)	Mrs.	Okonjo-Iweala (OPNSV)
	O'Brien (AFRVP)		Khanna (EXC)
	Summers (DECVP)		Siraj (COD)
	Shihata (LEGVP)		Levy (EAS
	Kashiwaya (CFSVP)		Hutcheson (PRDRA)
	Bock (OPNSV)		
	Wood (FPRVP)		

B. **Issues**

1. The Operations Committee met on April 1, 1991 to discuss the paper, "Financial Sector Adjustment Lending: A Preliminary Assessment of the Bank's Experience," prepared by PRE. Discussion broadly followed the agenda proposed by EAS.

C. **Discussions**

2. In their introductory remarks, PRE representatives explained that the paper had been developed during the RAL2 exercise. Inasmuch as it was a preliminary review, given the recentness of FSAL experience, it was not intended as a policy paper but rather to provide an input into the Bank's approach to adjustment lending in the financial sector. Several main messages were highlighted: (i) the need for an approach to financial sector lending that permitted but set limits on the use of directed credits and credit subsidies--e.g., a strong presumption against loans at negative real interest rates or at rates below those on risk-free assets; (ii) the need for increased toughness in FSAL conditionality--particularly as regards the macroeconomic environment and prices in the real sectors--and in the selection of intermediaries for Bank-funded credit lines; (iii) the desirability of greater policy conditionality being attached to financial intermediary loans (FILs); and (iv) the usefulness of technical assistance loans to build and strengthen the institutions and infrastructure of the financial sector, even when current policy and other conditions were not appropriate for FSALs and FILs.

3. The Chairman noted that the Bank had begun implementation of the 1989 report of the Task Force on Financial Sector Operations (TFR), whose recommendations were consistent with the apparent conclusions of the present paper. He asked whether the latter's authors had concluded that more needed to be done. He was particularly interested in the authors' views of the relevance for Bank operations of the experience with directed credit in Japan, Korea, and Taiwan, noting that, even in countries where the impact of such programs on financial sectors has been quite negative, some benefits had been realized in the beneficiary real sectors.

4. PRE representatives agreed that the TFR and present report were essentially consistent in their conclusions and recommendations. Both the TFR and the draft Operational Directive that had been developed were thought to provide good guidelines. As regards directed credit, they thought that the Bank should not be overly influenced by the experiences of the mentioned countries, which may have depended on unique circumstances. The Bank has come to recognize the importance of financial systems to overall growth, and the damage that has been observed in so many countries as a result of interventions in credit allocation needs to be avoided. Whatever benefits may have been enjoyed by agricultural activities as a result of directed credit, for example, may not have been worth the cost to the efficient development of the financial sector. In any event, governments have to be clear about their priorities and should keep the volume of any directed credit programs a small proportion of total credit. Interest rates should not vary far from market levels.

5. Committee members generally praised the report; one referred to it as one of the best to have come from PRE. One member asked what was meant in the report by "excessively high" interest rates, noting the tendency of nominal rates to lag behind the decline in inflation in adjusting countries. He asked whether central banks should act to lower interest rates in these circumstances, or whether they should be considered as a fundamental element of stabilization. Another member suggested that the report say something about what to do in countries in transition from centrally planned economies. Is there not a need in such situations for directing credit to small enterprises, for example? Should the Bank insist on broad financial sector reforms before or in the context of FILs in these countries? Can something more specific be said about the sequencing of financial sector reforms?

6. A third Committee member observed that interest rate subsidies were often more easily phased out than budgetary subsidies, and he pointed to the importance in all countries of farmers' access to credit. He argued that financial institutions could not be viewed as purely private sector institutions; lending must be sound and prudent, but government intervention was also very important for policy purposes. Another member disagreed, however, arguing that credit subsidies have often proven very difficult to get rid of. Moreover, it was not true that a large proportion of the agricultural sector could not be served on market terms. He noted that discussions of directed credit often left unclear whether such programs were intended to be permanent or transitional. He asked whether there was a case to be made for permanent programs--e.g., to direct credit to remote regions of a country. In any

event, there are limits to what governments can afford, and the costs of such programs should be made transparent. Advocates of directed credit should provide a rationale, demonstrate the proposed program's affordability, and indicate whether it is to be permanent or temporary. Another Committee member observed that, to draw the full benefits of this report, it would be necessary to define both the conditions under which directed credit could be justified and the criteria for phasing it out.

7. In response, a PRE representative noted that high interest rates were often caused by high inflation and an overvalued exchange rate. He acknowledged that rates may remain high after stabilization had been achieved, but he thought that artificially lowering them could undercut the stabilization. As regards the sequencing of reforms in socialist economies, he told the Committee that a recently completed paper on the transformation process in Eastern Europe contained an annex on sequencing, and an appropriate cross-reference will be added to the present report. He agreed that market failures existed in all countries, impeding some group's access to credit, and that there was a good case for helping such groups to gain access. It was important, however, to avoid directing credit to non-creditworthy borrowers, and the evidence from most countries is that directed credit programs frequently channel the money to the wrong people.

8. A Committee member remarked on the poor state of financial sectors in many countries and asked what is to replace the role played by government FIs if the government does not step in to direct the commercial banks. Another member found the paper's discussion of capital markets ambiguous. He asked what happens when the Bank's support to term credit lines is phased out. Why can term credit not be supplied by commercial banks? What are the lessons of experience in this regard? A third member expressed concern about the incestuous relationships that are often established between bankers and borrowing enterprises. He also noted that the paper had made no reference to the respective roles of the Bank and IFC in capital market development. A third member suggested that the paper could be enhanced by giving a greater sense of the wide variety of circumstances which the Bank confronts in this area. He thought that the paper focused implicitly on Latin American experience, which was quite different from either Eastern Europe or Africa. He asked what should be done in Eastern Europe to get credit to the growing private sectors, observing that the portfolios of the existing state banks were large unknowns. He noted that the financial sector was both vital and especially tricky to reform, and he asked whether the Bank was doing enough internally to make the best use of existing staff. The Chairman asked what the authors had in mind in their discussion of the size of FSALs, which he thought were typically among the most conditioned of policy loans.

D. **Decisions**

9. There was not enough time for the PRE representatives to respond to all of the above comments and questions, many of which went beyond the topic of FSALs. It was pointed out that there was little disagreement at the operational level on the issues of directed credit; the problems arose when one tried to set out explicit policy statements. Regarding alternative sources of term financing, they pointed to the importance of

developing contractual savings institutions in concert with the growth of capital markets. Commercial banks also do some term lending. What to do with existing development finance institutions remains an unanswered question. Concerning the roles of the Bank and IFC, the present paper predated the recent discussion of the issue but will now take it into account. In response to the Chairman's question, it was not intended to suggest that FSALs had been used as a "soft" lending option, and that will be made clear in a revised draft.

FDL

FDLevy:cmc
April 24, 1991

Mrs. Iweala

Need for an approach to this topic which permits some amounts of safe lending. Infant ind. Call for some increased toughness

THE WORLD BANK/IFC/MIGA
OFFICE MEMORANDUM

DATE: March 28, 1991

TO: Operations Committee

FROM: EG Enzo Grilli, Director, EAS

EXT. 81934

SUBJECT: Agenda: Financial Sector Adjustment Lending: A Preliminary Assessment

1. The paper, "Financial Sector Adjustment Lending: A Preliminary Assessment of the Bank's Experience," will be discussed by the Operations Committee on April 1, 1991, at 4:30 p.m., in Room E-1243. Following is a suggested agenda for the discussion.

Background

2. This paper, prepared by CECFP, derives from the RAL2 exercise and attempts to draw some preliminary lessons from Bank efforts to date to support financial sector reforms through adjustment lending. The paper notes that the financial sector has been receiving increasing attention by the Bank in recent years and that almost one-third of all adjustment lending involves some conditionality related to the financial sector. In preparing the paper, the authors examined 19 adjustment loans and credits approved by the end of FY 90, of which 15 were explicitly FSALs.

Issues

Overall Assessment and Conclusions

3. Although clearly labeled as a preliminary statement and not intended as a "grading" exercise, the authors seem to take, on balance, a favorable view of the Bank's efforts and experience thus far in FSAL lending. They note, however, that FSALs are particularly sensitive politically, and some have failed to achieve all their objectives because of political opposition (para. 3.2).

- **The authors might wish to summarize their conclusions, pointing out the major areas of accomplishment and the principal areas where a change in approach or greater attention might be needed.**

- **The Committee might wish to comment on the overall coverage and balance of the paper. Have the authors correctly identified the central issues emerging from FSAL experience thus far? Has the financial sector proven a more difficult area to work in than others because of its complexity and political sensitivity?**

- **The authors might be asked to explain how "Bank staff can help provide a political counterweight to be used by reforming governments against internal opposition"** (para. 3.3).

Administered Interest Rates and Credit Allocation

4. The authors observe that, while the liberalization of interest rates should not be rushed (paras. 2.12-2.14), most countries now recognize the desirability of positive real interest rates, so that this issue is disappearing as an issue in our country dialogues (para. 2.11). On the other hand, less progress has been made in eliminating directed credits at preferential interest rates (para. 2.18). While cautioning against a "doctrinaire stance" regarding government intervention in the allocation of credit, the authors do argue strongly against preferential interest rates (para. 2.21). They also assert broad agreement that it is better to target credit broadly (e.g., exports) rather than narrowly (e.g., textiles).

- **The Committee may wish to ask the authors to elaborate their views in this regard. What criteria should be applied in justifying credit interventions? While the broad targeting of credit may reduce the likelihood of allocative distortions within the targeted group, does it not imply a larger volume of administered credit? Might not more narrowly focused credit lines be more precisely targeted to achieve specific catalytic objectives?**

5. The authors note the tendency of the Bank to move away from the traditional DFIs, because of the poor experience with them, and allude to widespread doubts about the ability of such institutions to survive in a reformed financial system (para. 2.39). Question is also raised, however, about the ability of commercial banks and emerging capital markets to fill the needs for term finance and development finance generally, and it is pointed out that FSALs have not been concerned, with the exception of Chile, with capital market development (para. 2.62). On the other hand, direct government promotion of capital markets can be counterproductive (para. 2.64).

- **The authors might be asked to elaborate on the implications of these concerns. How urgent is the possible shortage of term finance and development finance, and what should be the Bank's response? What support could the Bank be providing to nonbank financial intermediaries other than DFIs? Should the Bank intensify its support of capital market development? What should be the relationship of the Bank and IFC in this regard?**

Size and Type of Lending

6. The authors note (paras. 3.16-3.18) that the typical FSAL is large and is structured with two tranches to disburse over 12-18 months. They note that the size of FSALs is usually driven by balance-of-payments requirements rather than by any direct costs of the reforms being supported and they ask rhetorically whether this lack of a link between the use of the proceeds and the reforms make FSALs a soft option for

balance-of-payments support. In partial answer, they note that, even in the absence of direct cash costs, FSALs may entail significant political costs.

- **The authors might be asked to elaborate on this point and to clarify what they conclude. Is this considered an issue requiring resolution or action?**

7. The RAL2 recommendation, that longer disbursement periods should be allowed for complex sector reforms, is argued to be especially relevant to FSALs (para. 3.20). The authors also recommend that consideration be given to a broader array of lending instruments to support financial sector reform. In particular, free standing technical assistance loans might better serve the institution-building requirements of reform, in contrast to the low priority that technical assistance has been given in FSALs (para. 3.21). On the other hand, financial sector conditionality is found to have been enforced at least as effectively overall as in other sectors and to have been kept on track even in the face of negative shocks to the economy (para. 3.26).

- **Does the Committee agree that FSALs are generally more complex than other sector adjustment operations? Does the Committee agree with the recommended approach?**

Staff Resources

8. The authors find that the labor-intensive nature of designing and supervising many aspects of financial sector reform, and the particular skill mix required, are straining the resources of both the Bank and of the borrowing countries (para. 1.15). They call for greater efforts to establish a pool of the needed expertise.

- **The authors might be asked to elaborate on the skill shortages that appear most serious, and from where the recommended pool of expertise might be drawn.**

- **The Committee may wish to comment on the extent to which staff constraints are in fact constraining what the Bank is able to do to support financial sector reforms.**

Operations Committee
Messrs. Qureshi, Husain, Jaycox, Karaosmanoglu, Wapenhans, Rajagopalan, Summers, Shihata, Kashiwaya, Wood, Bock

cc: Messrs./Mme Thahane/Burmester, Picciotto, Goldberg, Wyss, Sandstrom, Isenman, Linn, Stoutjesdijk, Okonjo-Iweala, Parmar, Rao, Kavalsky, Pfeffermann, Liebenthal, Kilby, Robless, Walton, Khanna, Long, Institutional ISC

FLevy

9/0329 025

THE WORLD BANK INTERNATIONAL FINANCE CORPORATION MIGA

Office Memorandum

DATE: March 29, 1991

TO: See Distribution Below

FROM: Koji Kashiwaya, CFSVP

EXT.: 80809

SUBJECT: **Review of Financial Sector Adjustment Loans**

1. I have reviewed "Financial Sector Adjustment Lending: A Preliminary Assessment of the Bank's Experience," and find the thrust of this paper to be more realistic and flexible, as compared to other recent financial sector papers prepared in the Bank. Given the complexities of real-world financial sector development, this is a sound attitude. There are , however, certain weaknesses in our approach to financial sector development that do not come across clearly in this paper. Therefore, I would like to offer the following observations.

2. The financial sector is different from any other economic sector in that it has basically a public character. Even when it is strictly privately-owned and market-based, the integrity of the financial sector is based on social acceptance of and public trust in the system. The stability of the system also requires sound fiscal management by the government. To the extent that the financial markets provide indispensable services that pervade every aspect of the modern economy, it needs to be subjected to a set of rules and supervision by a neutral body. For all these reasons, adjustment programs must place a special importance on protecting the integrity of the financial system and strengthening public confidence in it.

3. There is another perspective that I believe is crucial in financial sector work but is often missed. We tend to think of financial market development as improving "the system" (market-based interest rates, division of central banking and development financing businesses, removal of artificial segmentation, etc.). Even when we speak of institution building, often what is meant is developing a "system" of regulation, supervision, accounting, etc. In reality, however, the essence of financial market development is building of institutions and associated human resources. The history of financial market development in OECD countries makes it clear that it is the history of deepening professional capacity of the people involved in the business. While certain structures of the system may cause problems, most problems are not caused by the "system" as such.

4. As an economy goes through business cycles, commercial banks are bound to encounter borrowers in distress. One of the basic functions of the financial system is to cushion the impact of cyclical downturns. Therefore, a financial system that can tide fundamentally sound firms over periods of poor business conditions gives the economy added strength. The decisions to cut off credit to distressed firms or to help them with both additional credits and management support are not a function of the system as such but of the institutional and professional capacity of its operations. A financial sector that can make the correct judgments and decisions and time the interventions with firms effectively adds great strength to the economy.

5. Likewise, when the economy faces insolvency of a financial institution, a question of whether to liquidate it or restructure it arises. My strong belief is that liquidation of a bank should be avoided strenuously even if depositors are protected by a deposit insurance scheme. Any liquidation undermines the public confidence in the ability of the financial institutions and the government collectively to protect the integrity of the system. Financial institutions in distress should be basically merged with healthier institutions. Again, whether this can be arranged effectively is a matter of institutional capacity and professional skills. It cannot be assumed that the system can correctly judge the appropriate strategy or course of action.

6. Having stressed the importance of the public character of the financial sector and the importance of institutional capacity, I would like to touch on three additional aspects of the financial system.

Government Bond Market

7. No financial system can function well without fiscal responsibility on the part of the government. Large budget deficits in many countries that cause inflation and crowd out private borrowers are the most important impediment to sound financial market development. Therefore, no financial market adjustment effort should take place without the governmental responsibility on fiscal policy. At the minimum, the government should agree to eliminate current deficits (i.e., the current spending must remain within the current revenue). In principle, domestic financing of deficits for investment programs should be always done through government bonds. This will contribute to the development of the government bond market, which is an important element of financial market development, as noted below.

8. The government bond market is the linchpin of most financial systems. It provides the benchmark instrument. Especially in the counties where interest rates are not effectively arbitrated, rates on short-term government bills can serve as key reference rates. It is also a necessary condition for developing a corporate bond market. Given the small size of corporate bond issues, corporate bonds can be liquid only if securities companies stand ready to buy them. They, in turn, will be willing to do so, only if they can take a short position in the government bond market to hedge interest rate risks involved in holding corporate bonds. The government bond market also imposes a degree of financial discipline on the government, since fiscal irresponsibility will lead to increasing costs of funding. A stable bond market could also avoid capital flight and even serve to attract foreign investors.

9. In order to develop the government bond market, institutional investors (e.g., insurance companies, investment funds, pension funds) should be allowed and encouraged to buy and sell government bonds actively. It is also important to create a bond exchange where bonds are openly traded. This gives transparency to the process of bond pricing. The development of the market should typically start with short-term bills, but it is important to encourage development of long-term bonds.

Equity Market

10. As less developed economies mature, the equity market need to be developed as a way of mobilizing risk capital that is needed in greater quantities. This requires establishment of the corporate ownership structure, the stock exchange, disclosure requirements, regulations on trading, the supervisory system for securities firms, investment funds, etc. Again, putting in place an institutional skeleton is not sufficient. To give flesh to the system, human resources and public confidence in the system must be built up. This requires tremendous time and effort.

11. Privatization of sound and stable public enterprises (e.g., power, and telecommunication) is one of the most effective ways of developing the equity market. It creates a large number of relatively safe and liquid shares, which encourages broad participation of investors. A sound equity market must be built slowly, starting with the simplest element.

Ensuring Adequate Financing

12. One of the most fundamental public functions of the financial system is assuring availability of credit to a broad range of economic agents in the economy. In less developed economies, financial institutions are often geared toward serving commerce and large firms, if they exist, and the public sector. In the process of economic development, it is important to provide adequate financing to other segments of the economy, especially small operators in agriculture and small and medium enterprises (SMEs). Therefore, any attempt at "rationalizing" the financial system ensure that these borrowers have access to credit at reasonable rates. This often can be achieved only with some government intervention.

13. The importance of interest rate liberalization and abolition of directed credits as a way of strengthening the market function needs to be carefully balanced against the need to ensure availability of financing to important segments of the economy. As you know by now, I feel strongly that under certain conditions directed lending is an essential tool of development strategy.

Distribution: Messrs. Qureshi, Stern, Shihata, Rajagopalan, Roth, Wood
Husain, Jaycox, Karaosmanoglu, Wapenhans
Bock, Grilli, Niehuss, Taylor, Chaffey, Shilling, Elwan

KK/KO

March 22, 1991

9104160/1

1.

THE WORLD BANK
Operations Committee

CONFIDENTIAL

Minutes of the Operations Committee to Consider the POLAND - Financial Institutions Development Loan Initiating Memorandum; Privatization and Restructuring Hybrid Project; and Country Strategy Note

Held on Friday, March 22, 1991, at 10:00 a. m. in Room E1243

A. Present

Committee

Messrs. M. A. Qureshi, Chairman
D. J. Wood, FPRVP
L. Summers, DECVP
K. Kashiwaya, CFSVP
A. Karaosmanoglu, ASIVP
S. S. Husain, LACVP
H. N. Scott, LEGVP
F. S. O'Brien, AFRVP

Others

Messrs./Mmes E. F. Lari, EM4DR
P. Hasan, EMNVP
A. Sood, EM4IF
P. Nouvel, EM4CO
Y. A. Duvivier, EM4IF
J. G. Toureille, EM4IF
I. M. Hume, Poland
J. E. Loos, EM4CO
U. R. W. Thumm, EM4DR
A. Ray, EAS
N. Okonjo-Iweala, OPNSV
N. K. DeWitt, LEGEM
S. Burmester, SEC
K. Siraj, CODOP
T. Kodaki, PRDPD
I. I. Elwan, CFSPS
A. Khanna, EXC
D. Burton, IMF
R. L. Berney, CEMDR
I. Kuczynski, CBSDR
C. L. Robless, OPNSV
J. D. Shilling, CFSFA
A. Revenga, DECVP
F. J. Lysy, EAS

B. Issues

1. The Operations Committee met on March 22, to discuss the Initiating Memorandum for the Financial Institutions Development Loan, the Draft Staff Appraisal Report for the Privatization and Restructuring Project, and the Country Strategy Note (titled "Poland: Balance of Payments, Creditworthiness and Bank Strategy"), all for Poland. The discussion focussed on the following broad issues:

(a) Poland's balance of payments, its debt situation, and its ultimate goals for the structure of its economy;

(b) Specifics of the Financial Institutions Development Loan;

(c) Specifics of the Privatization and Restructuring Project.

C. Discussion

Background, the Balance of Payments and Debt Situation, and Poland's Ultimate Goals on Economic Structure

2. The Region opened the discussion with a brief review of the present situation in Poland. It was noted that Poland is setting an important example for the rest of Eastern Europe. The new Government in Poland (under Walesa) is keeping to the reform program set by its predecessor, and is in fact accelerating its implementation (for example in privatization). The results so far under the stabilization program have been good, with the previous hyperinflation stopped and unexpectedly good performance on the fiscal and external trade accounts. However, aggregate output (at least in the short-run) has declined significantly. In response to a query of whether the decline has been greater than that expected, the Region noted that while the decline has been larger than that expected by the government, it has, in fact, been close to the Bank's projections. The reported drop has also been greater than the actual since many private sector activities are not adequately covered in the official statistics. On the other hand, bankruptcies of some of the larger, inefficient, state enterprises, have not yet occurred only due to special short-term factors in 1990, such as an advantageous exchange rate, still subsidized energy prices, and the ability to sell-off excess stocks. The Region also noted that progress under the SAL program has been good overall, although actions are required in three areas before the Second Tranche can be released. These are: certain energy prices must be raised; preparation of action programs for strengthening certain commercial state banks must be completed, based on the results of diagnostic studies now underway; and unemployment benefits must be limited to a maximum of twelve months.

3. A member of the Committee noted that Finance has had three principle concerns on our overall program in Poland. The first has been that the Bank should not proceed on a large scale until a debt reduction program had been worked out. This bridge has now been crossed, he noted, with the recent Paris Club announcement that the Club would reduce Poland's debt to it by 50%. He argued, however, that there is also a need to reach agreement with the London Club on the reduction of Poland's commercial bank debt, and that we should push for this. The second and third concerns have been regarding the overall size of the Bank program for Poland, and the share of fast-disbursing lending in this program. He stated that, in the view of Finance, a program at a level of $2.3 billion for FY92-94 should be considered a High case level of commitments, rather than a Base case, and that there is no agreement yet on whether the Bank should commit $0.4 billion in support of a commercial bank DDSR package. On the level of fast-disbursing lending, he noted that since the Paris Club agreement will be heavily front-loaded (with 80% interest reduction in the initial three years), there is now less need for fast-disbursing lending from the Bank in these early years. And the fast-disbursing lending that is provided should be linked to a DDSR package from the banks (through set-asides).

4. Another member of the Committee noted that we must be careful so that World Bank funds are not in effect used to increase the payments that the commercial banks would otherwise receive from Poland. He noted that the price of Poland's commercial bank debt had risen in recent days following the Paris Club announcement (from about 18 cents on the dollar of face value to about 30

cents), and was worried that this might be a sign that the banks now expect to receive more from Poland as a consequence of the Paris Club agreement. He also stated that when showing non-debt relief alternative scenarios, we should not assume the banks will be paid in full. A different member of the Committee argued that commercial bank debt reduction might not necessarily be best for Poland, since banks would not then provide new money. Finally, another member of the Committee noted that he shared the concern expressed above on the size of the overall program in Poland.

5. The Region responded that the London Club was in fact meeting right now (the date of the OC meeting), and that a Brady Package of some form is expected. A discount comparable in value to that granted by the Paris Club is likely. The Region also argued that the proposed size for the Bank's program in Poland is not excessive, and is, for example, substantially smaller in per capita terms than the approved program for Hungary. There would be a 30% share of quick-disbursing funds over the next several years in the Base case, and a smaller share than this in the High case, since in the High case several regular investment loans would be added. The Chairman concluded by directing the Region to proceed quickly to finalizing the CSP now being drafted. The CSP should be clear on the triggers that would be used in deciding under what conditions we would proceed from a Base case to a High case program. It should also look closely at the new financing gap projections, taking into account the specific terms of the new Paris Club agreement, and would assess the appropriate level for the Bank's quick-disbursing lending.

6. A member of the Committee raised the broader issue of the ultimate objectives of the Polish reform program. Does the Government have a clear vision of what kind of economic system it would like to see in place ten years from now, for example? What will be the place of foreign ownership in this system? What is the Privatization program working towards? The Region responded that the Government's aim is a mixed economy similar to that found in Western Europe. The private sector would be extremely important, but the public sector would still play an important role in such areas as public utilities. The Chairman directed that the forthcoming CSP should address this issue directly.

Financial Institutions Development Loan

7. The Chairman opened the discussion by stating there were two key issues. First, the overall objective was not clear to him. If it is to move to a basically privatized financial system, why is the focus of the operation on assistance to improve the operations of the nine existing state-owned commercial banks, rather than on a relatively rapid privatization of these institutions? Second, even though several of the six specialized state-owned financial institutions (for foreign trade finance, agriculture, and housing finance principally) were larger than the state-owned commercial banks, it was not clear to him what was intended for these institutions. Is the intention to privatize them soon, or would they remain in the public sector? Furthermore, the more important distortions in the credit system stemmed from policies implemented through these specialized banks, in particular the directed credit requirements to agriculture and housing. Directed credit growth would be capped as a condition for this operation, but it would still be allowed to grow by an amount equal to 30% of total credit growth. Is this justified? A member of the Committee also raised the more general point of

whether the Government is clear on where they want the financial system to be in five years. Will it be almost all private?

8. The Region responded that the Government's medium-term goal is clearly that the financial sector be largely private, but that this will take some time. In the meantime, there are immediate problems that it must contend with to ensure that basic financial services are being provided throughout the country. It has to be recognized that Poland had no financial system at all, really, just a year ago. It may take 7 to 10 years to develop an efficient banking system. The strategy is therefore to push first on introducing sound financial sector policies (i.e. liberalization of interest rates, curtailment of directed credit, introduction of adequate supervision and prudential regulation, etc.); this is well underway. Second is institutional development, but this by its nature will take longer. This will assist in the move to eventual privatization, but the banks cannot be privatized right away due to the uncertainties that are still pervasive. The portfolios are of questionable quality, and there is a worry that if the banks were privatized and one then failed, there would be a loss of confidence in the financial system while it was still fragile. The Government does plan, however, to submit to Parliament within a year a plan on privatization of the system. On the directed credit issue, the Region stated that while even though the 30% figure was not desirable, their calculations indicated that under the current system, directed credit could account for up to 70% of new credit growth if nothing were done. Also, only about 25% of directed credit for agriculture is subsidized, and the proposed program would cap this subsidy.

9. The Chairman responded that the proposed approach on the nine state-owned commercial banks stretches plausibility. Sixty new private banks have been allowed within the same regulatory framework, and the authorities would allow any of them to fail; why not one of the nine currently state-owned commercial banks? Also, why not allow a foreign bank to come in on a joint venture basis in conjunction with one of the nine? The Region responded that the 60 new private banks are all still very small. Many are just representative offices of foreign banks, with a small office in Warsaw. Both the Region and IFC representatives at the meeting noted that the Poles would very much prefer that the state-owned financial institutions be privatized quickly, and would consider sales of shares to foreign banks, but there was little outside interest in taking them over. The portfolios are largely an unknown, as are the entities themselves. There is also a worry that if they were in fact put up for sale, there might be no takers, or the price might be embarrassingly low. On this point, a member of the Committee stated that they should certainly not be embarrassed by a low price, and that this should not be considered a valid excuse for delaying any privatization. He also noted that a sensible strategy was to allow many of these big, state-owned, institutions to eventually whither away, to be replaced by newly-created private entities. The goal should not be to try to ensure the survival of all of these state-owned banks. And there should be a sunset provision that sets a clear date by which the public banks that do survive would be privatized. Another member of the Committee voiced agreement that not all of the nine banks should necessarily survive.

10. The Region responded that there would be nothing to prohibit any of the banks from being shut down at some point. As per the findings of recent audits, the capital ratios appeared strong so several would likely survive, but not all necessarily would. It was noted that while a large amount would

be spent on technical assistance, these funds should be viewed as being spent on the training of individuals, not on the propping-up of institutions that might eventually fail. These individuals would be needed in Poland by the financial system, regardless of what happens to specific institutions. Some general concerns were also expressed by the Committee over the twinning arrangements being set-up to provide assistance to these banks, but it was acknowledged that this might be the best approach in a difficult situation to convey the practical expertise that was needed. However, there would be a need for great care on this, to reconcile it with competitive procedures for selection.

11. The Chairman concluded by noting that the existence of a financial sector was of course vital, and that the Bank had an important role to play. The question was rather one of approach. The issue was one of balance between the Bank assisting in trying to strengthen and restructure the existing state-owned banks, and privatizing them quickly. The current balance was too much on the former, and there should be greater attention paid to the latter. The Chairman stated that a clear strategy statement for the sector should be developed and provided in the eventual loan documentation. The Region should also investigate further the interest of external banks in investing (perhaps on a joint venture basis) in the Polish banks. The possibility of establishing a debt/equity swap system for this should be investigated.

12. The Chairman also directed that the Region examine more closely the agriculture and housing credit issues, and particularly the target on overall directed credit. The Chairman stated that consideration should be given to expressing the target in terms of the share of directed credit in the total stock of credit in the system, rather than as a share of the growth in credit.

13. The Chairman also noted that the role of the IFC should be very important in this operation, and should be made clear in the loan documentation. The documentation should be clear on the division of responsibilities between the Bank and the IFC here, where the IFC has a clear role to play in the individual bank restructurings that will be necessary.

14. On the technical assistance issue, the Chairman noted that the operation is proposing to make available a very large amount of funds, which will be on hard (market-rate) terms. Yet Poland has just had half of its debt forgiven by the Paris Club, and external donors have at least stated publicly that they are willing to provide TA funds to Poland on a grant basis. These grant funds should be used as the first priority, and borrowed funds from the Bank used only if absolutely necessary. Special efforts should be applied to try to obtain these grant funds. It was recognized that this may be difficult, but the Chairman noted that if it would prove helpful, he would be quite willing to send a letter to Mr. Delors (the EC) to facilitate release of such funds.

Privatization and Restructuring Project

15. The Chairman opened the discussion of this operation by stating that there were three key issues. First, the privatization strategy of the Government was not clear to him. Second, the Government intends to establish a number of Privatization Funds, Holding Companies, and Venture Capital funds, as part of its privatization program. Is this realistic? Such institutions

are very complex, and are difficult to run soundly. And third, there are the same concerns as expressed above for the FIDL over the proposed TA program.

16. On the issue of privatization strategy, the Region noted that the Government's objectives of both speed and fairness were difficult to reconcile. Speed was its primary goal, and it is beginning to sort things out and move with implementation of the program. The Region noted that the Privatization Law was passed by the Parliament last July, but that the Ministry created to run the Privatization Program was only really operating last December. Since then, under the new Government, implementation had progressed rapidly. The Government had privatized (through commercialization or asset sales following liquidation) 150 companies as of mid-March (versus only about 20 as of the end of 1990, with only 7 of these sold).

17. The specific justification for a quick-disbursing component in the proposed hybrid operation was also queried. Would not the SAL and other policy-based operations perhaps serve better as venues for such quick-disbursing assistance? The Chairman noted that the explicit conditionality recorded in the draft Appraisal Report at least appeared to be thin. The main item appeared to be agreement on an action plan for the Privatization Program, but the report did not make clear what the key elements of this plan would be. What would the Bank be looking for in this plan for it to be considered acceptable? A member of the Committee noted that in the present proposed sequencing, the Hybrid (quick-disbursing) element looks like an after-thought, since the policy conditions would not be required for loan effectiveness. Rather they would simply be required for release of the policy-based component. Were the policies really necessary for the investment component? This member also noted the procedures required for the line of credit seemed unduly complicated; would the funds move? He noted, for example, that it was not the usual policy to require separate environmental assessments to the standards of O.D. 4.00 for each sub-loan. Would the participating financial intermediaries be able to make proper project appraisals? Another member of the Committee asked about the enabling environment. The goal of the strategy should not be privatization per se, but rather a competitive and efficient market. Was the enabling environment adequate for this? Another member of the Committee noted that there appeared to be contradictory statements in the draft Appraisal Report on the Government's objectives. In the text, it was clearly stated that it will not be the role of the Government to take primary responsibility for restructuring these enterprises prior to their privatization, but in the draft LDP (Annex 4), this was not so clear.

18. The Region responded that the Poles are proceeding with an extremely strong reform program, that the privatization and enterprise restructuring programs are key parts of the overall reform program, and that balance of payments support from the Bank is being provided in support of the overall program. The privatization and restructuring policy reforms will be necessary to the effective use of the line of credit the Bank would provide in support of the restructuring investments needed, so a Hybrid operation is logical. On the Government's objectives issue, the Region noted that the Government's primary objective was rapid privatization, preferably without prior major restructuring, and that it did not intend to pick winners and losers. The Region will review the documentation to make sure this is clear. The Region also noted that the enabling environment is very good, and that this was a primary area of focus of last year's SAL. Finally, the Region noted that there is much that is happening on privatization and restructuring in Poland

right now, and that they would re-examine the loan documents to make sure this is clear. The core of the conditionality for the policy-based component is on the implementation of a detailed action plan that is being worked out with the Bank. The Chairman directed the Region to circulate this action plan to the Operations Committee as soon as it is ready.

19. The IFC role in the operation was also discussed. IFC representatives at the meeting noted that the IFC is involved in the privatization and restructuring of several specific enterprises in Poland, as well as working with the Government in implementing the program of privatization of specific enterprises (i.e. preparation of prospectuses, etc.). The Chairman stated that there should be an explicit and specific role for the IFC in the proposed operation, and that this should be discussed with the Executive Vice President of the Corporation. The proposed operation is an ideal place for an explicit collaborative effort between the Bank and the IFC, as the Board has been encouraging. The Bank's role would be to focus on the basic framework, while the IFC should focus on the individual privatizations.

20. Concerns were again expressed on the massive TA component, similar to the concerns expressed on this issue for the FIDL. The Chairman directed that every effort should be made to utilize grant funds for such TA, with borrowing from the Bank only as a last resort. The Region agreed that the proposed TA program <u>is</u> massive, but that so are the needs. The Government (as well as the Bank) clearly would prefer to use grant funding for such TA, but in practice it has been hard to mobilize the grant funds that have been publicly offered. The Government also respects the neutrality of the experts that would be contracted through use of Bank loan funds. The Region also noted that the individual firms that would use the TA funds would be charged for their use and would be obliged to re-pay the loans.

21. In conclusion, the Chairman directed that the following be done for this operation. First, the detailed action plan for the privatization program must be circulated to the Committee as soon as it is available. It is well-known that the Privatization program in Poland is a strong one, but the specific plans must be documented if they are to be a policy condition for the operation. The Region should also investigate whether the conditions could be incorporated into a regular project loan, perhaps with a mid-term review, rather than as a Hybrid. The Region should consider this possibility. Second, the role of the IFC in the overall process should be spelled out, with an explicit cooperative effort with the IFC worked out for this specific operation, if possible. And third, the TA program should be re-examined. Every effort should be made to utilize grant funds in preference to our own, and the Chairman would assist in making high level contacts with the authorities that have offered such assistance, if this can be of help.

D. Decisions

22. In conclusion, the Chairman directed that the operations could proceed to the next stage of their processing. The directives noted above under the individual operations should be followed.

FJLysy: FJL

April 4, 1991

THE WORLD BANK/IFC/MIGA
OFFICE MEMORANDUM

DATE: April 1, 1991

TO: Mr. Moeen A. Qureshi, OPNSV

FROM: W. A. Wapenhans, Vice President, EMN
WQ.

EXTENSION: 32676

SUBJECT: POLAND: Privatization and Restructuring Project
Conditionality for the Quick-disbursing Component

1. This memo follows up on the OC review of March 22 of the Poland Privatization and Restructuring Project, scheduled for Board presentation in June 1991. As proposed in the package submitted to the OC, we recommend a hybrid Bank loan of US$300 million equivalent, with three integrally related components including: (i) a policy component of US$75 million in support of the Government's privatization program; (ii) a technical assistance component for which US$75 million equivalent would be provided for the finalization of the privatization program and its implementation; and (iii) an investment component of US$150 million equivalent which would provide financing for restructuring investments in privatized enterprises or enterprises in the privatization process. At the OC meeting, you requested clarifications on the conditionality of the policy component. This memo is in answer to your request.

2. Adoption of general guidelines for privatization and preparation of a basic institutional framework to support enterprise reform, have been implemented as conditions of the ongoing SAL. The proposed Project will considerably expand and reinforce the process of enterprise reform and divestiture through the policy component, which would secure the Government's commitment to: i) implement the Privatization Program following Action Plans agreed with the Bank; ii) adopt a sound approach for enterprise restructuring ; and iii) address a wider range of related issues, such as management of state assets and industrial policy, on a longer time period as privatization and restructuring are being carried out. These commitments will be spelled out in the Letter of Policy. Detailed objectives and key steps of the Privatization and Restructuring Programs, and intended measures on the related issues, are given in attached matrix (Annex 1) which will be annexed to the Policy Letter. Key steps and proposed core conditions are summarized in Annex 2, which indicates the current status of execution of some conditions and the proposed sequencing of the other conditions.

3. On the basis of the OC discussions and the latest progress in Poland, we have reassessed the list of conditions as follows. First, we now propose to put up front, as conditions of Board presentation, three key items of the implementation plans for privatization and one critical condition for restructuring, plus the signature of the Policy letter. This would be in addition to four key steps that the Government has just accomplished or is about to

complete, including the plan for compensation of nationalized property ("reprivatization"). Second, the other key item for the implementation of privatization, the finalization of an agreed plan for mass privatization is dependent on two critical studies (vouchers scheme, privatization funds) and cannot be completed before August: we therefore recommend to keep it as condition of disbursement of the policy component (in one tranche) and, also of the investment component as strongly suggested by the OC. It would not be a condition of effectiveness for the whole project, nor a condition of disbursement of the technical assistance component, since early availability of the technical assistance funds is essential to finalize the action plans for the privatization program. Third, other conditions related to the management of state assets, industrial policy as well as privatization, are expected to be met in the later part of 1991 or early 1992; we therefore propose to deal with these through dated covenants.

4. If you concur with the above, we will prepare the project's documents with this set of conditionality, with the objective of having negotiations in early May.

Attachments

cw&cc: Messrs. Nouvel, Sood

cc: Messrs./Mmes. Blanchi, Hasan (EMNVP); Lari, Zaidan, Thumm (EM4DR); Nouvel, Loos, Lav (EM4CO); Hume, Cordet-Dupouy, Duvigneau (RMP); Lysy (EAS); Ewing (EMTIE); Al Jabri (LEGEM); Fowler (LOAEL);Duvivier, Aghdaey, Kochav (EM4IF).

YDuvivier
plprcond

POLAND - Privatization and Restructuring Program

Subject/Objective/Approach	Actions to Date	Commitments / Further Actions
PRIVATIZATION		
Strategy		
Privatize state assets with the long-term objective of achieving an ownership structure similar to that of Western Europe, and an intermediate objective of having 50% of state-owned assets in private hands within three years.	Adoption by Parliament of an overall strategy for privatization and establishment of the Ministry of Ownership Changes (MoOC). Preparation and approval by Parliament of a detailed privatization strategy (March 1991)	Finalize implementation plans and the legal framework for privatization as further detailed below; develop programs for privatization of such assets as Foreign Trade Companies, cooperatives, and enterprises governed at the level of the wojewoda or municipality (91/92)
Three main routes to privatization are envisaged: • Individual transactions (including public offerings, private placements, etc) • Dissolution (liquidation) and sale or lease of assets • "Mass" privatization aimed at passing ownership of enterprises to Polish citizens through privatization funds and a voucher distribution system	Preparation of Government's plan for compensation of former owners of unduly nationalized property, to clarify framework for subsequent privatization of this property ("Reprivatization")	Develop: i) criteria/mechanisms for the selection of enterprises for privatization through various mechanisms; ii) plans for decentralization of privatization and establishment of regional offices of MoOC. **(Board Condition)** Finalize implementation plan for mass privatization upon establishment of its feasibility **(Disbursement Condition of Policy and Investment Components)** Plan for debt/equity swaps in individual privatization of enterprises **(Dec. 91)** Statement of policy on contingent liabilities for new owners of privatized SOEs (environmental clean-up costs) **(Dec. 91)**
	• 8 enterprises have been individually privatized; about 50 more are being considered for this option • 143 enterprises have been privatized through the dissolution route; another 57 are being prepared	• Privatize in 91 approximately 40-60 firms through individual privatizations • Privatize 50-60 enterprises per month through dissolution
Legal Framework		
Establish appropriate legal framework for the transformation of the economy and ensure its efficient functioning in the market economy.	Passage of key implementing legislation: . Privatization Law for SOEs (1990) . Anti-monopoly Act (1990) . Securities Law (1991)	Amend, revise or replace Law on Economics of SOEs, Commercial Code, Bankruptcy Law. Prepare new legislation for land ownership and privatization of cooperatives. Enact laws on reprivatization and securities exchange regulations. (91/92)

Subject/Objective/Approach	Actions to Date	Commitments / Further Actions
PRIVATIZATION (continued)		
<u>Institutional Arrangements</u>		
Adequate institutional arrangements must be in place to deliver adequate numbers of enterprises and ensure the smooth transformation of the economy	An Interministerial Committee has been created to oversee the whole process of privatization and ensure the elimination of any bureaucratic or other impediments	Statement on coordination between Ministries (MoOc, MoOI) on preparation and implementation of restructuring/privatization of individual enterprises **(Board Condition).**
Key institutions include: • <u>Founding organs</u> (ministries, wojewodas, municipalities, etc) together with enterprise managers and workers' councils prepare privatization proposals for SOEs for consideration by the MoOC • The <u>Industrial Development Agency</u> • The <u>Anti-Monopoly Agency</u> • The <u>Ministry of Ownership Changes</u> • The <u>Foreign Investment Agency</u>	Incentives are in place to encourage enterprises to commercialize as the first step to privatization. 107 enterprises have been commercialized to date. A comprehensive program of technical assistance has been designed which will add capacity and strengthen the diverse institutions involved in the privatization process	Monitor the overall progress of privatization and take active measures, including measures to modify institutional structures and operations as necessary, to ensure that it continues to operate rapidly and efficiently (91/92). Commercialize a further 1000 SOEs preparatory to privatization during 1991; prepare an additional 1700 enterprises at the municipal level for privatization through commercialization during 1991. Continue to strengthen all agencies through a comprehensive program of technical assistance financed through Government resources supported by the World Bank and other multilateral and bilateral financial institutions
<u>Foreign Investment</u>		
Foreign investment, primarily through the formation of joint ventures, has been a major route to privatization until now but the results have not been very impressive.	New law on foreign investment to replace the "Law on Joint Ventures" has been prepared and is currently before Parliament.	Enact new law (91)
Object is to remove real or perceived barriers to foreign investment and to redirect activities of Foreign Investment Agency away from regulation and towards promotion	Foreign Investment Agency has prepared a promotional program and is currently making arrangements for its implementation	Implement promotional program (91/92)

Subject/Objective/Approach	Actions to Date	Commitments / Further Actions
RESTRUCTURING Restructuring is envisaged at: (a) The sectoral level; primarily through the dissemination of sectoral information (such as comparative competitive data) which will be made available to both existing enterprises and potential new investors; and (b) The enterprise level: • By new private owners; • Only in those cases where private investors cannot be found, in commercialized state-owned enterprises where it can be clearly demonstrated that they will be viable (and potentially attractive for privatization) after the restructuring has been undertaken There is no intention to use "restructuring" as a vehicle for providing support loans to non-viable enterprises	Competition has been improved by the anti-monopoly agency which, during 1990: • Reviewed 1500 antitrust cases and ruled that 200 cases represented monopolistic practices and that 200 enterprises required changes in their structure • Completed a special analysis of 15 large monopolies in the context of the commercialization/privatization of the se enterprises The MOI has set up an enterprise monitoring system to give early warning of enterprise financial difficulties. In 1990, MOI: • Liquidated 16 enterprises and is initiating procedures for 7 more • Began recovery programs for 3 troubled enterprises • Bankrupted 3 enterprises The Industrial Development Agency (IDA) has been set up to provide technical assistance for restructuring enterprises. IDA has already undertaken detailed studies for 37 such enterprises The Polish Development Bank (PDB) has been set up to provide long-term refinancing at market terms to the financial sector. PDB will act as an apex institution for (EG) World Bank loans	Interministerial task-force will be established with specific guidelines for speedy decision on critical restructuring cases (**Board Condition**). During 1991, the Government will focus on strengthening institutional capacity for restructuring. In particular: (i) improving systems for monitoring enterprise performance and speeding up and improving diagnosis of problem enterprises; (ii) adding capacity to help overly integrated enterprises to develop feasible plans for break up; (iii) adding capacity to deal with the growing number of liquidations; and (iv) accelerating procedures for assessing monopoly and dominant situations Restructuring efforts will be decentralized with creation of regional restructuring agencies (91/92). Special programs are being developed for sector-wide restructuring and for groups of enterprises which will likely face financial difficulties: • Sector studies/development of restructuring plans for detergents, construction, packaging, steel and components will start in 1991 • Diagnostic studies/preparation of restructuring of groups of enterprises which may face difficulties because of CMEA-dependance, high energy use, environmental problem, etc (91/92) • Regional studies in three hard-hit areas being initiated in 1991. IDA will refocus its activity and expand its program and in 1991/92 will undertake 150 diagnostic studies and 100 full restructuring studies.

Subject/Objective/Approach	Actions to Date	Commitments / Further Actions
MANAGEMENT OF STATE ASSETS		
Policies for exercise of ownership rights of state assets are to be defined. The privatization law envisages a State Treasury which would be the central repository for state assets but there is concern that this could become a giant, centrally-managed holding. Additional work is required before this concept can be finalized.	In program to develop suitable legislation for a "Law on the State Treasury", advice is being sought from the Governments of EC and other countries as to an appropriate model for the management of assets which remain in state hands In the meantime, improved management of state-owned enterprises is being driven by: • Competitive forces in a rapidly opening-up market with minimal protection from import competition • Hard budget constraints which have been in place since January 1, 1990 • The additional discipline imposed by a mandatory "dividend" based on the value of assets In addition, for those enterprises which become "commercialized" on the way to becoming privatized, a supervisory board of directors representing the owners must be appointed. To ensure an initial supply of suitable board members, MoOC has undertaken a selection process followed by a training course and has thus prepared 300 directors	Elaborate/implement guidelines for directors representing state in supervisory boards of fully or partly state-owned companies; define mechanisms for delegation of state ownership of enterprises **(Dec. 91)**. Review existing incentives and elaborate/implement as needed new incentives/other measures to force SOEs to commercialize in order to bring them under a more tightly managed structure. **(Dec. 91)** Continue and review alternatives and eventually develop a workable model for the control of state assets which represents a suitable balance between decentralization and improved governance (91/92).
INDUSTRIAL POLICY		
Develop new industrial policy and reorganize MoI to implement it.		Complete study on industrial policy and review it with the Bank **(Oct. 91)**. Complete reorganization study for MoI **(Oct. 91)**. Implementation of recommendations (beginning **Dec. 91**).

POLAND - Privatization and Restructuring Program
Key Steps and Proposed Core Conditions

1. Steps already accomplished

. Approval of Privatization Strategy by Parliament
. Presentation of new Foreign Investment Law to Parliament
. Enactment of Law on creation of Stock Exchange and of Securities Law
. Elaboration of Government's plan on compensation of former owners of nationalized property, slated for privatization (Reprivatization)

2. Conditions of Board Presentation

. **Signature of Policy letter on Privatization and Restructuring**

. **Action Plan for privatization** (agreed with the Bank)
- Criteria/mechanisms for selection of enterprises to follow specific privatization tracks.
- Detailed plans for decentralization of privatization: program for the establishment of regional offices of Ministry of Ownership Changes and guidelines on privatization to regional/municipal authorities.
- Statement on coordination between Ministries (Ownership Changes and Industry) on preparation/implementation of restructuring and privatization of individual enterprises.

. **Restructuring**
- Establishment of interministerial task-force with guidelines for speedy decision of critical restructuring cases (large SOEs)

3. Condition of Disbursement of Investment and Quick-disbursing Components

. Plan for implementation of Mass Privatization, on the basis of studies on vouchers distribution and creation of Privatization Funds.

4. Main Dated Covenants

. **Privatization**
- Plan for application of debt/equity swaps in individual privatization of enterprises
- Statement of policy on environmental contingent liabilities for new owners of privatized SOEs.

. **Management of State Assets**
- Guidelines for directors representing state in supervisory boards of fully or partly state-owned joint stock companies; definition of miscellaneous mechanisms for delegation of state ("Treasury") ownership of enterprises.
- Review/elaboration of new incentives/other measures to cause SOEs to "commercialize" (acceleration of commercialization as needed)

. **Industrial Policy**
- New Industrial Policy
- New structure of Ministry of Industry

9103 21009

1.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: March 20, 1991

TO: Operations Committee

FROM: Fred David Levy, Acting Director, EAS

EXTENSION: 81947

SUBJECT: POLAND - Financial Institutions Development Loan Initiating Memorandum; Privatization and Restructuring Hybrid Project Draft President's Report; and Country Strategy Note; Operations Committee Meeting Agenda

---

1. The Operations Committee will meet on **Friday, March 22, 1991, at 10:00 a. m. in Room E-1243** to consider the Financial Institutions Development Loan Initiating Memorandum; the Privatization and Restructuring Hybrid Project Draft President's Report; and the Country Strategy Note (titled "Poland: Balance of Payments, Creditworthiness and Bank Strategy), all for Poland. The following is a proposed agenda for the meeting.

Background

2. The Operations Committee is being asked to consider two operations at this meeting: a policy-based Financial Institutions Development Loan (for $200 million), and a hybrid operation, the Privatization and Restructuring Project (for $300 million). In addition, in lieu of a detailed review of the macro and debt situation, and Bank strategy, in each of these two project documents, the Region has circulated a self-contained strategy note that considers these issues. A full CSP is now being drafted, and is scheduled to be presented to the OC late this Spring. The Committee should also be aware that a third operation with a policy-based component, a hybrid operation for the District Heating sector, will likely be circulated to the OC fairly soon.

3. The Polish reform program continues to impress most observers. There has been continued rapid progress in key structural adjustment areas, and reforms implemented early in 1990 (such as the complete opening of the trade system) have been sustained. There was a marked change in the fiscal accounts in 1990, with the government budget moving from a deficit of 7.4% of GDP in 1989, to a 2.4% of GDP surplus in 1990. This swing in the fiscal accounts can all be accounted for by the reduction in government subsidies from 16% of GDP in 1989, to just 6% of GDP in 1990 (and scheduled to go to 4 1/2% of GDP in 1991). Along with tight credit policies, the hyperinflation of late 1989 was stopped. However, with such adjustments in the system, total GDP fell by 12% (although private sector industrial production rose 8.5%), and open unemployment came into existence. On the external side, the new trade regime and exchange rate system (as well as depressed domestic demand) led to a growth of convertible currency exports of 35% in real terms and 43% in nominal dollar terms. Despite the depressed economy,

real convertible currency imports rose 6%, with much of this concentrated late in the year. There was a positive trade balance of $2.2 billion (about 3.5% of GDP), and an unexpected current account surplus of $650 million. Coupled with a generous Paris Club rescheduling, IMF purchases of $600 million, and other factors, Poland's reserves rose by an unexpected $4.3 billion.

4. There were worrisome developments on the macro front in the second half of the year. Domestic credit expansion was greater than permitted under the IMF program, and hence the IMF Standby program purchases linked to the end-September and end-December targets were not released. Monthly wage adjustments, which had been below the levels permitted under the program in the first half of the year, started to catch up in the second half of the year, and the monthly changes went above the program targets. Inflation, which reached a trough of about 2% per month in the summer, began to rise, and reached a level of about 5% per month late in the year. The rate of inflation was 12% for the month of January, but this was in part due to administrative price changes associated with the program.

5. Recent measures (including a tightening of credit) have been undertaken to reverse these trends. With this, negotiations are underway (with agreement in principle announced) for a three-year IMF EFF Arrangement. Final agreement is expected very soon, and a Board date of April 18 has already been set (in part due to Paris Club considerations). And as was well publicized, last Friday the Paris Club announced their readiness (subject to agreement on the IMF EFF program) to reduce Poland's debt to the Club by 50% (on a net present value basis). The Club agreed that individual members could also grant additional relief, on an individual basis, equal to 10% of the debt owed (although news reports indicate George Bush announced on Wednesday that the US would provide a total of 70% relief). The 50% reduction in the Paris Club framework would be carried out in two stages: an immediate cut by 30% (in NPV terms) and a reduction after the successful completion of the EFF program of a further 20%. Also, as part of the initial 30% NPV reduction, the Club would reduce interest payments due during the three-year period of the EFF by 80%. The Club plans to meet on April 19 to finalize this agreement, assuming the EFF is approved by the Fund Board on April 18. Since the Paris Club debt of Poland is about $33 billion (as of end-1990), the 50% reduction will be equivalent to a $16.5 billion reduction in the debt. Finally, with the Paris Club agreement reached, negotiations with the London Club on its $11 billion of debt owed by Poland are expected to now move more quickly. The goal is a Brady Plan type of agreement, with a debt reduction comparable in value to that granted by the Paris Club.

6. It is proposed that the discussion of the OC be structured as follows. First, the status of the reform program, the status with the IMF and the Paris Club, the balance of payments, and the Bank strategy, would be reviewed. It is proposed that the specifics of the Financial Institutions Development Loan, and then the Privatization and Restructuring Project, then be discussed, in all aspects but the technical assistance components of the two operations. Finally, since many of the issues are similar, the TA components of the two operations would then be discussed together.

Status of the Reform Program, and Bank Strategy

7. To open the discussion, it might be of use to ask the Region to review briefly the current status of the Polish reform program. Specifically, the Region might be asked:

(a) Focussing in particular first on the basic structural reform aspects of the program, how has progress been, especially in the period since the new Government (with Lech Walesa as President) took office? What are the key strategic areas of the program?

(b) How has progress been under the SAL approved in July 1990? What is the status of the second tranche release conditions?

(c) In the shorter-term macro situation, what was the principal cause of the difficulties that developed in the second half of 1990, and what is expected now? Have the causes of these difficulties been satisfactorily addressed?

(d) What is the current status of the IMF program, specifically the EFF?

(e) What is the assessment of the Paris Club agreement? Is the 50% reduction in the present value of the debt (with interest reduced by 80% in the first three years) likely to suffice?

(f) What is the status of the London Club negotiations? Is there any basis yet for a prediction of when an agreement might be reached, and on what terms?

8. The strategy note circulated to the Committee contains a brief summary of the strategy the Bank is following in Poland. The note is not intended to replace a full CSP (which is now in preparation), but rather provides the Committee the basis for assessing the context of the two specific operations being considered today.

(a) The Region might be asked to summarize the basic strategy being followed, and in particular the nature and phasing of the mix of lending instruments being proposed.

(b) How do the two proposed operations being discussed today fit into this strategy? What are the main linkages with other operations in the program?

9. Financing Plan and Burden Sharing: The proposed IBRD base program would provide \$1.3 billion in new commitments in FY91 and an average of about \$900 million per year thereafter. In per capita terms, such a program is moderately large (about \$34 per capita in FY91, and \$24 per capita per annum thereafter). It is, however, substantially below the program being followed for Hungary (\$41 per capita per annum for FY91-93). In the financing program projected by the Region for Poland, such commitments would lead to disbursements such that Poland's debt to the Bank would grow from zero in 1990, to

$4.0 billion in 1995. Debt to the IMF would grow from zero to $2.3 billion, while that to the EIB and the EBRD together would grow from zero to $2.6 billion. In this program, the Paris Club contribution would be to reduce the present value of its debt by 50% (or perhaps more, on an individual basis), i.e. by about $16.5 billion (based on end-1990 exchange rates). The Governments that are members of the Club are also projected to provide a total of $2.6 billion in net new bilateral lending. A 50% reduction by the London Club (i.e. comparable to that of the Paris Club) would lead to a reduction of its debt by $5.5 billion in value. It should be noted that the Paris Club contribution through debt reduction is in essence all up-front (even though 20% points of the reduction will only be carried out upon successful completion of the EFF).

(a) The Operations Committee may wish to consider whether the burden sharing implied in this financial plan is appropriate.

(b) What price for oil was used in the projections underlying this financial plan? Does this price take into account the recent easing following the Gulf War?

Such an IBRD lending program would lead to a moderate rise in Bank exposure as measured by the IBRD debt service to exports guideline: in the base program, this ratio would rise to only 2.1% in the year 2000 (where the guideline limits are 4.5% for countries rated IIIb and below, and 5.5% for others). Due to the Paris Club and London Club debt reductions now anticipated, Poland's total debt would reach rather low levels under these projections: only 82% of exports in the year 2000, and 24% of GDP. Because of this, the shares of the Bank and of Preferred Creditors in this low debt would be close to the traditional exposure guideline limits: in the base case program, the Bank and Preferred Creditor shares would be 17% and 31%, respectively, where the guideline limits are 20% and 35%, respectively 1/. In the high case lending program, the shares would be exactly at the guideline levels in the year 2000, i.e. 19.9% and 35.3%. However, it is of interest to note that in the scenario where there is no debt reduction, but rather the gap is closed as it has in the past (i.e. Paris Club capitalization of interest, and commercial bank new money or arrears), then the Bank share of this now much higher debt is well within the guidelines if mechanically applied: the Bank share of the debt would only be 7.3%.

(c) The Operations Committee might wish to discuss whether the resulting Bank exposure is acceptable.

Bank's exposure acceptable

The Financial Institutions Development Loan

10. The basic goal of the Financial Institutions Development Loan (FIDL) is to assist the development of a viable financial sector in

1/ Technically, these exposure guidelines are defined in terms of debt service, not the stock of debt. However, the strategy note reported only the debt stock numbers. The figures should be close.

Poland, where basically no financial sector existed until very recently. There are three basic areas in the operation: 1) Financial policies (including issues of non-market credit allocations, interest rates, reserves and Central Bank re-financing policy, and special issues regarding foreign exchange deposits); 2) the Legal Framework (especially a new Banking Law and Central Banking Act); and 3) Institutional Development (especially focussed on the nine state-owned commercial banks that were split off from the Central Bank in 1989). The following specific issues regarding the proposed program might be discussed.

11. The most important financial market distortions currently in Poland are for the Agriculture and Housing sectors. These sectors account for a large share of directed credit in Poland, and the credit to these sectors is heavily subsidized when inflation is high. These sectors are also politically very sensitive. The basic strategy proposed by the Region is to reach agreement to cap the subsidies in the context of the current operation, and then to address the phasing out of the subsidies in the context of forthcoming operations planned for the Agriculture and Housing sectors. Agreement would also be reached to limit the share of all directed credit (including for agriculture and housing) in total credit growth in 1991 and 1992.

(a) The Region might be asked to describe the formulas that would be used to calculate the interest rates to be charged, and what these rates would be at current and expected inflation rates.

(b) In the case of Housing, the portion of the interest that would be due at market rates but which is not currently paid, is instead capitalized. Is some capitalization of interest reasonable in a situation of high inflation (to keep the real value of the outstanding debt about constant)? Is this being exceeded in the case of Poland?

(c) Is the proposed division of responsibilities between this operation and the planned sectoral operations reasonable?

12. Directed credit (for agriculture and housing, but also for completion of central investments, mandatory reschedulings, or other purposes mandated by the government) will be constrained to 30% of total credit growth in 1991 and 25% in 1992, under the proposed program. However, the IM notes that based on simple assumptions under current lending plans, directed credit growth would account for 70% of total planned credit growth in 1991 if nothing is done.

(a) The Region might be asked whether the 30% target for 1991 is realistic.

13. As part of the program, the Government would establish and fund out of annual budget allocations a General Reserve Fund, which could be used to recapitalize the state-controlled banks, if necessary. It would grow to a target 3% of state-controlled banking assets after five years. The cost to the budget would be about $180 million per year (about 0.3% of GDP) to reach this target.

(a) The Region might be asked whether a fund of such size would suffice.

(b) The Fund would be built up over time, but major problems with the loan portfolios of these banks would likely reveal themselves early. Will this cause problems?

14. The preliminary indications are that the state-controlled banks will come out of the disruptions of the last several years (hyperinflation, and a major real devaluation) relatively well capitalized. It appears this may be due to the Central Government taking on the external liabilities of the banking system, coupled with the highly negative real interest rates paid on domestic currency deposits in the system during the hyperinflation. However, the budgetary cost of assuming responsibility for the external liabilities should be substantial. The IM calculates that for the program to issue bonds to cover the cost (resulting from the real devaluation) of the private foreign exchange deposits held in the banking system, the budgetary cost will be moderate (about $700 million equivalent per year, or 1.1% of GDP). However, could there be other costs, perhaps hidden in the bank's portfolios and not yet evident, that the budget will eventually have to cover?

(a) The Region might be asked to comment on this. Will the audits now underway of the banks uncover such costs?

15. More generally, the focus of the proposed operation is largely on the problems of, and the development of, the nine state-controlled banks that were split from the Central Bank in 1989. The IM does note, however, that there has been an explosion of applications for new wholly private banks, both domestic and foreign (including branches of foreign banks). Licenses for 60 such private banks have been approved, and licenses for another 40 are pending. The IM also notes, however, that such a rapid growth in private banks may strain the supervisory and regulatory capacity of the Government.

(a) The Region might be asked whether additional measures should be encouraged under the proposed operation (both in terms of policies, and perhaps in the TA component) that would support better the development of new private banks in Poland. Is it possible (and desirable) to shift the focus of the operation somewhat from the existing state-controlled banks and their problems, to issues surrounding the development of new private banking institutions?

(b) What has been the IFC's involvement in the development of this operation? Are they supportive?

Privatization and Restructuring Project

16. The proposed Privatization and Restructuring Project would be a hybrid in a total amount of $300 million: $75 million quick-disbursing, $150 million for a line of credit, and $75 million for technical assistance. Poland is of course following a very ambitious

program of privatization and enterprise restructuring. Although there would only be three specific conditions required for the release of the policy tranche, the program being supported is in fact much broader.

(a) To begin the discussion, the Region might be asked to summarize the current status of the Government's program in privatization and enterprise restructuring.

(b) How does the phase of the program now being supported go beyond that of the SAL approved by the Board last July? What are the relationships with the SAL?

(c) How has the IFC been involved in the development of the proposed operation? What is their position on it?

17. The first of the three tranche release conditions states that there would be agreement on the privatization strategy and on an action program to implement it.

(a) What would be the key specific elements that would be required for the Bank to provide its support? What are the main things being sought?

18. The other two tranche conditions relate to the enactment of two laws on enterprise restructuring and foreign investment.

(a) What would be the key characteristics in these laws that would be required for the Bank to provide its support?

19. One important innovation of the proposed operation would be that the Bank would permit a portion of its $150 million line of credit (no more than $20 million) to be on-lent to Privatization Funds, Holding Companies, and/or Venture Capital Funds, which in turn could take equity or quasi-equity positions in some of the enterprises to be privatized or restructured. The Region might be asked:

(a) What would be the financial and capital structure conditions required for the firms (the Privatization Funds, etc.) that would receive (indirectly) the World Bank funds, and which would in turn take equity or quasi-equity positions in the restructured enterprises? How would these conditions be monitored?

(b) The Polish enterprises which would ultimately receive the IBRD funds (either via the Privatization Funds, etc., or via regular bank intermediaries) will undoubtedly be risky entities, for receiving either loans or equity. Will the capital structures of the restructured enterprises be assessed as part of the analysis of their risk? Will a balance of loans and equity be minimally required?

(c) What types of quasi-equity instruments will be considered and permitted (or encouraged) for the Privatization Funds, etc. that would receive funds under the Bank's line of credit? Options might include loans or bonds with equity warrants attached, convertible bonds, or even simple preferred stock. In such instruments, the downside risk is partially limited, but some of the upside potential (in case the firm does well) can also be gained by the Fund.

20. The proposal in the loan documents would be that the cost of the Bank's line of credit to the financial intermediaries would ultimately be linked to the Bank's charge to Poland for the basket of currencies we provide. That is, the Bank would lend these funds to the Government of Poland at our variable basket rate; the Government would then lend these funds to the Polish Development Bank but in US dollars, at our basket rate plus 0.5% to cover cross-currency risk; and the Polish Development Bank would on-lend these US dollar funds to the financial intermediaries with an additional spread of 1.5% (with repayment due also in US dollars). The financial intermediaries would on-lend the funds at an individually negotiated rate to the restructuring enterprises, with repayment due also in US dollars.

(a) The Region might be asked whether this proposed structure is reasonable. Specifically, is the ultimate linkage to the IBRD lending rate a reasonable one?

(b) Have other lending rates been considered as the basis for the structure? For example, would US dollar LIBOR perhaps be a reasonable base, as an indicator of what the alternative market rate would be for non-IBRD funds?

21. The conditions for the release of the policy component of the operation would be independent of the conditions for loan effectiveness. It is therefore conceivable that the loan would be made effective, with the line of credit (and TA component) disbursing, even though the policy conditions for the policy component were not met.

(a) The OC may wish to consider whether this is appropriate for this Hybrid. Should the policy conditions be made conditions of loan effectiveness?

The Technical Assistance Components of Both Operations

22. A very large technical assistance component is proposed for both operations. This reflects Poland's great TA needs, as well as the fact both operations are viewed as the first of a series of operations that will address Poland's financial sector and enterprise restructuring/privatization needs. But the size of the components is immense, and are probably records for the Bank. In particular, the TA program to be managed under the Privatization and Restructuring Project will total $184 million, of which $147 million will be foreign exchange cost and of which the Bank would tentatively provide $75 million (depending on discussions with co-financiers, where grant funds are available). The TA component in the FIDL would total $50 million for expert assistance ($44 million of which would be to pay for the twinning programs being negotiated with foreign banks), plus $50 million for computer and telecommunications hardware. The Bank would

tentatively provide $50 million of the total (subject again to co-financing discussions). The Region might be asked:

(a) Its assessment of the manageability of TA programs of such a scale. This involves considerations of not only the Polish (demand) side of the program, but also of the external expert (supply) side of it. Are experts of the competence required available, considering also the demands for experts in other countries in Eastern Europe?

(b) The expert assistance under the TA component of the FIDL will focus on the twinning arrangements between Polish banks and external banks, now being established with the help of the IFC. Is there a possibility of conflict of interest in such arrangements? If so, how will this be managed?

(c) The TA programs are large in part since they will support not only the current operations, but also follow-on operations. The disbursement periods are also likely to differ from that of the other components in the current operations (especially for the FIDL). Although it is primarily a Regional decision to make, would administration of the TA components be more effective if they were formally separate operations?

Operations Committee

Messrs. Qureshi, OPNSV
Shihata, LEGVP
Wood, FPRVP
Summers, DECVP/Rajagopalan, PREVP
Kashiwaya, CFSVP
Jaycox, AFRVP
Karaosmanoglu, ASIVP
Wapenhans, EMNVP
Husain, LACVP
Bock, OPNSV

cc: Messrs./Mmes Lari, Goldberg, Wyss, Isenman, Linn, Stoutjesdijk, Picciotto, Gustafson, Burmester/Thahane, Sood, Nouvel, Hasan, Okonjo-Iweala, Duvivier, Toureille, Hume, Loos, Lav, Parmar, Pfeffermann, Rao, Kavalsky, Shakow, Sandstrom, Liebenthal, Kilby, Robless, Blanchi, Khanna, Walton, Institutional ISC

FJL

FJLysy/:

9103B002 1.

THE WORLD BANK/IFC/MIGA
OFFICE MEMORANDUM

DATE: March 12, 1991

TO: Mr. Moeen Qureshi, Senior Vice President, OPN

FROM: W. A. Wapenhans, Vice President, EMN

EXTENSION: 32676

SUBJECT: Poland - Financial Institutions Development Loan Initiating Memorandum

1. I attach for OC consideration the Initiating Memorandum for the proposed Financial Institutions Development Loan for an amount of US$200 million equivalent. This loan would assist in the modernization of Poland's financial sector, by supporting the Government's policy reform program, and institutional development in the sector through financing of technical assistance and automation programs for banks. The proposed Loan is intended to support and deepen the actions initiated under the SAL for the financial sector, as part of a medium-term strategy and program for the reform of this critical sector. It is being prepared in parallel with the proposed Privatization and Restructuring Project for Poland, documents for which have been distributed separately. A separate Memorandum on Poland's Balance of Payments, Creditworthiness, and Bank Strategy is attached.

2. The Government has requested Bank assistance to implement a far-reaching program for the financial sector. Emphasis under the SAL with respect to reforms in the financial sector was placed on the introduction of prudential regulations and the development of bank supervision, the introduction of accounting and auditing standards, and on preparatory actions for the strengthening of banks, in anticipation of the program planned to be carried out under the Loan. Actions undertaken under SAL I are detailed in Part III of the IM, while the program to be supported by this proposed Loan is detailed in Part IV. Incrementality with SAL I is also spelled out in the matrix attached to the IM.

3. Given the acceleration in the pace of reforms that began in 1990, there is a need to initiate a far-reaching and broad-based program of reform for the financial sector, in order to provide the needed back-up to the adjustment process. This program would be supported by the proposed Loan, which is envisaged as the first in a series of self-standing financial sector loans over a number of years. In addition to sector-wide reforms, the proposed Loan would support a program focussing on the nine commercial banks established in 1989, which currently hold over 80% of credit to enterprises, and would form the initial basis for extending general banking services to this sector throughout the country. These banks have so far made only limited progress towards functioning as full-fledged banks, and they largely reflect in their management, staffing, operational procedures, loan portfolio, and resource mobilization practices the legacy of the past. The proposed Loan is designed to support the development of other banking institutions as required. The Loan's main objectives are to support: (i) an action program on the policy, regulatory, and institutional fronts that would be needed to support and extend on-going reforms

in the financial system, as well as to underpin its longer-term deepening and strengthening; and (ii) a program for strengthening existing institutions, with a particular emphasis on the nine commercial banks. This program will rely on the provision of substantial technical assistance.

4. Given the need for supporting a strong program of policy reforms and simultaneously an extensive institutional development program requiring the provision of substantial technical assistance, it is proposed that the Loan include two components -- a quick-disbursing policy component (US$150 million) and an institutional development component (US$50 million). The major policy reforms urgently needed to permit a rapid transition towards a modern market-oriented financial system must be accompanied by significant, concerted efforts to develop efficient institutions and skilled staff. There is consequently a strong interrelation between the two components of this Loan, and the success of the reform program will closely depend on their timely joint implementation.

5. The policy component is articulated around four elements: (i) improvement of financial policies. The objectives are to shift further to indirect methods of controlling money and credit growth, ensure an efficient allocation of credit, and promote a banking system that relies increasingly on active mobilization of private sources of funds; (ii) modernization of banking legislation. The proposed program aims to foster the development of a legal framework conducive to sound and efficient operations in the financial sector. This will include legislation for establishing and safeguarding autonomy and accountability in the governance of state-controlled banks, prior to their privatization; (iii) bank restructuring. The program would a support a short-term program for ensuring the financial soundness of banks, relieving banks of the burden of non-performing loans extended to unviable enterprises under the past regime, and their corporatization (toward subsequent privatization); and (iv) development of financial markets. The development of financial markets will play a significant role in complementing structural reforms. Given the embryonic stage of development of these markets, the program will focus on fostering the introduction of a framework toward the prompt and efficient development of these markets.

6. The satisfactory implementation of the strong policy program supported by the proposed Loan will be monitored by a set of detailed actions spelled out in the matrix attached to the IM, with core conditionality summarized in Table 1 of the IM. The implementation of this action program will support the introduction of urgent reforms and facilitate the undertaking of a number of important measures, including budgetary financing of a program to eliminate the large mismatch between the foreign exchange assets and liabilities of domestic banks (currently estimated to exceed US$5 billion equivalent), and the constitution of a general reserve fund amounting to 3 percent of total state-controlled banking assets, which would be designed to cover recapitalization needs in state banks.

7. The Loan will also support a strong program of institutional development, aiming at strengthening the skills, procedures and capability of banks to operate effectively in a market environment. The core of the technical assistance relates to a program of institutional strengthening for commercial banks, and is based on the results of the diagnostic studies initiated under the SAL. The institutional strengthening programs are comprehensive, and will

require serious commitment and the dedication of qualified resources during the three-year period over which they are to be implemented. An innovative feature in the provision of this technical assistance is the recourse to twinning arrangements between Polish banks and foreign banks. At the request of the authorities, the Bank and the IFC have over the last months actively worked on initiating a program whereby each of the nine commercial banks would enter into a comprehensive twinning arrangement with a foreign bank. These arrangements are being facilitated under the Loan, with the objective that they may lead to a longer-term relationship between the Polish banks and their foreign partners. Progress under this program has been satisfactory, and it is anticipated that four twinning arrangements will be in place by June 1991. Costs related to the automation of banks, which will be closely tied to the elaboration of their strategic development, and definition of the information needs under the institutional strengthening component, will also be financed by the Loan.
The total cost of the institutional development component is estimated at US$100 million. Cofinancing is being sought for the amount of US$50 million -- discussions are being actively pursued with the EC (PHARE), and with the EBRD, which have both expressed an interest in the Project. In case cofinancing in the required amount is not available, it is recommended that the amount of the Bank Loan be adjusted accordingly.

8. Project preparation has been proceeding at a rapid pace, due in part to the keen interest shown by the Polish authorities in seeing this program promptly implemented. An important feature of project preparation has been the constitution at the request of the authorities of a Legal Advisory Group to provide advice on a broad range of new legislation contemplated for the financial sector. This Group, chaired by the Bank, and comprising representatives of the IMF, IFC, the EC, and foreign governments, as well as private sector firms, has already contributed to the drafting and review of several important pieces of legislation.

9. A number of actions are already well advanced, including policy reforms (particularly as regards the issue of foreign exchange deposits), legal reforms (substantial progress has been achieved with respect to the introduction of prudential regulations and of a reporting system for monetary and prudential purposes, the draft of a new Banking Law, the Law on Collateral Security, and the Securities Law), institutional strengthening (with the undertaking of extensive diagnostic studies conducted for the state banks, and important steps already taken towards strengthening their institutional capabilities, including the establishment of a bankers' training institute.)

10. The proposed program of reforms and technical assistance has already been largely discussed during previous missions. At appraisal, we will review in detail with the authorities and seek confirmation on the proposed program of policy reforms, with a view to reaching an understanding on its main features. The main areas where agreement is sought concern the monitoring of specialized credit (para 61 of IM), the reform of the legal framework and of banks' governance (paras 69-74), the restructuring of banks' portfolio (paras 83-90), and the Government's commitment to funding the program within the context of the financial discipline imposed by the stabilization program (para 97). The proposed reforms will be spelled out in a Statement of Policy, which will be prepared and discussed during the mission's visit, on the basis of the detailed

matrix attached to the IM. In addition, we will review progress on the preparation of the program for technical assistance, and discuss the appropriate implementation arrangements.

11. One uncertainty relates to the fact that recent changes have occurred within the senior management of the National Bank of Poland and that the new team will have therefore to fully familiarize itself with the Program. An element of comfort in that respect is that our main counterpart at the Ministry of Finance has been in place throughout Project preparation and is very supportive of the proposed Program, so that issues of continuity are not expected to be constitute a major impediment to further processing.

12. Close liaison has been maintained throughout project preparation with the IMF, whose staff has been associated with the review of the IM, and with the IFC, which is directly involved in the implementation of certain aspects.

13. Subject to your approval, the appraisal mission for this loan is scheduled to start in late March. Negotiations would take place in late April, and Board presentation is scheduled for June 11, 1991.

Attachments

Cleared with & cc: Messrs. Zaidan, Thumm, Sood (EM4)

Toureille
M:\pol\mem-2

Distribution:

Regional: Messrs. Blanchi (8), Hasan (3), Fox (EMNVP), EMENA I/C

Country Dept: Messrs./Mmes. Lari (o/r); (EM4DR); Nouvel, Loos, Lav (EM4CO); Apitz, Guarda, Thalwitz (EM4IN); Harbison (EM4HR); Montfort (EM4EE); O'Sullivan, Dethier, Ablasser, Luhman (EM4AG); Reyes-Vidal, Aghdaey, Singh, Brajovic-Bratanovic, Duvivier, de Bruyn Kops, Zurayk (EM4IF) Hume, Cordet-Dupouy, Duvigneau, Pinto (RMP)

Technical Dept: Messrs. Kohli (EMTDR); Wackman (EMTIE); Baudon (EMTEN); Hinds, Saldanha (EMTTF); Roa (EMTPR)

Bankwide:

Operations Committee Members:

Messrs. Husain (LACVP); Jaycox (AFRVP); Karaosmanoglu (ASIVP); Summers, Rajagopalan (PRE); Shihata (LEGVP); Kashiwaya [4] (CFASVP); Wood (FPRVP); Bock (OPNSV)

Other Participants:

Messrs./Mme. Wyss (CODDR); Grilli (EASDR); Isenman (PRDDR); J. Linn (CEC); Stoutjesdijk (FRSDR); Picciotto (CPBVP); Gustafson (CEMDR); Burmester (SECGE); Thahane (SECVP); Goldberg (LEGOP); Okonjo-Iweala (OPNSV); Lysy (EAS)

For Information:

Messrs. Parmar (IFC-CIO); Rao (IEC); Kavalsky (FRM); Pfeffermann (IFC-CEI); Liebenthal (PRD); Kilby (FRS); Robless (OPNSV); Sandstrom, Khanna (EXC); Stern (FINSV); Thalwitz (PRESV); Levy (EAS); Siraj (CODOP); Petit (AGRDR); Pouliquen (INUDR); Churchill (IENDR); Piddington (ENVDR); Ms. Hamilton (PHRDR); Frank (CFPVP); El-Rifai (MIGPA); Niehuss (CFS)

Messrs./Mmes. Long, McNaughton, Sheng (CECFP); Jensen (FRSFP); Hassan, DeWitt (LEGEM); Newport, Saaid (LEGPS); Talero, Ikramullah (ITFUS); Nangia (ACTCA); Perera (LOAEL)

IMF:

Messrs. Effros (LEG); Scott, Sunderarajan (CBD); Hole (EUR); Allen, Ossowki (RMPOL)

IFC:

Messrs./Mmes. Kuczynski, Chaudhry, Khambata, Hamilton, Soulard, Junker

Other:

Div. BB; Chron

91030B001 1.

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: March 7, 1991

TO: Mr. Moeen A. Qureshi, OPNSV

FROM: W. A. Wapenhans, Vice President, EMN

WA.

EXTENSION: 32676

SUBJECT: POLAND - Privatization and Restructuring Project
Presentation to the Operations Committee

1. I attach for OC consideration the Final Executive Project Summary (FEPS) and the draft Staff Appraisal Report (SAR) for the Poland Privatization and Restructuring Project (US$300 million). Originally, the project had been designed as an investment project primarily in support of industrial restructuring. In view of the Government's commitment to and progress in elaborating a comprehensive and fast privatization program, and subsequent to your visit to Poland, the proposed project was extensively modified to refocus it to include an emphasis on privatization. The modified hybrid design would respond to the Government's urgent need for support to its Privatization Program while at the same time providing incremental balance of payments support, through a small quick-disbursing component. A memorandum on Poland's balance of payments and creditworthiness outlook, as well as on the proposed Bank strategy is being distributed separately.

2. State-owned enterprise (SOE) privatization and restructuring, together with private sector development have emerged among the centerpieces of the Government's program to transform the Polish economy under its Economic Transformation Program (ETP). While pursuing an active approach in enterprise restructuring, the Government regards privatization as a critical step in the transition to a market economy. The Government, therefore, is embarking on a comprehensive Privatization Program with the ambitious objective of privatizing 50% of the SOEs within the next three years. Significant steps have already been accomplished. The Law on Privatization of SOEs was enacted in July 1990 and the Ministry of Ownership Changes was established in September 1990 to manage the privatization process. The Government has elaborated and is now submitting to Parliament a comprehensive privatization strategy with a multi-track approach, including corporatization of SOEs, followed by privatization on an individual enterprise basis or by mass privatization, or liquidation followed by privatization of assets. About 45 SOEs have now been privatized through these methods, and a further 100 have started the process.

3. The Government of Poland has requested Bank assistance to finalize the design of and implement its Privatization Program, devise an industrial policy framework and accelerate enterprise restructuring, and reorganize/restructure the relevant Governmental bodies. Initial regulatory measures, adoption of guidelines for privatization, and preparation of a basic institutional framework to support enterprise reforms, are being implemented in the context of the ongoing SAL. The proposed Project would considerably expand and reinforce the process of enterprise reform and divestiture (as detailed in the matrix on page 23 of the SAR), by: (i) assisting the

Government to elaborate its detailed Privatization Program, monitoring and adjusting the process during its critical initial stages, and promoting the necessary changes in the industrial policy; (ii) addressing the detailed institutional needs for implementation of the Program; and (iii) providing direct financial assistance to mobilize private sector (domestic and international) involvement in enterprise management and ownership as well as to restructure state-owned enterprises with a view to their privatization.

4. In order to support the project, we recommend a hybrid Bank loan of US$300 million equivalent. The loan would finance three integrally related components including: (i) a <u>policy component</u> for which US$75 million would be provided in support of specific policies essential to the Government's privatization program; (ii) a <u>technical assistance component</u> for which US$75 million equivalent would be provided and which would support privatization transactions and enterprise restructuring as well as key institutional and training activities; and (iii) an <u>investment component</u> of US$150 million equivalent which would provide financing for restructuring investments in privatized enterprises or enterprises in the privatization process.

5. The project design is complex and the project will require considerable supervision. Its broad scope and its three integrally related components are all needed in order to fully address Poland's needs. The quick-disbursing component is expected to sustain the momentum of and deepen our dialogue with the Government at this critical stage when the Privatization Program is being finalized and implementation is starting. At the same time, it will provide incremental balance of payments support to address Poland's expected severe problems in 1991, caused by the Gulf crisis, the collapse of the CMEA trade and the additional loss of the East German market (elaborated in the separate memorandum). The Privatization Program and the restructuring actions cannot be successfully implemented without the critical institution-building process and privatization transactions supported by the large technical assistance component. Concurrently, while assisting the development of the capabilities of the financial sector, the investment component will provide financing to the enterprises during the critical stages of transformation and restructuring. This component of the loan will finance only a small part of the restructuring needs of Poland's industrial sector, but will have a greater impact by mobilizing and helping to direct cofinancing from bilateral donors and financing agencies, domestic and foreign private sources, the country's own specialized restructuring institutions, local commercial banks, and the enterprises themselves.

6. The Government's commitments on privatization, restructuring and industrial policy will be detailed in a letter of policy [to be discussed at appraisal], for which a draft scope is annexed to the SAR. In addition to the significant measures already taken by the Government to initiate the Privatization Program, a set of key preparatory steps is needed: (i) adoption of a detailed privatization strategy (addressing inter alia the needs for acceleration and decentralization of the enterprise privatization/ liquidation process); (ii) amendment of the Law on Joint ventures, which is aimed at improving the environment for foreign investment; and (iii) enactment of the Law on State Treasury, to be the corner stone for the management of State assets in enterprises undergoing restructuring or in the transitory period before actual privatization, putting the emphasis on clear ownership and

proper corporate governance. Accomplishment of these steps, in addition to the satisfactory continuation of implementation of the Economic Transformation Program, will be the condition of disbursement of the policy component, independent of the effectiveness of the Loan. In the attached SAR, it has been proposed that the quick-disbursing component be released in a single tranche. Adequate progress in salient policy and institutional actions, financed under the technical assistance component of the Loan, would be assured through dated covenants. However, In view of the importance of these actions, the regional management has instructed the project team to explore, during appraisal, the possibility of designing the policy component in a way which could warrant two tranches of US$50 million each. These actions, include: implementation of the privatization program; build-up of capacity of State Treasury and implementation of instruments for effective ownership and management of State assets; definition and adoption of an industrial restructuring policy; and reorganization of Ministry of Industry, etc. as detailed in the matrix on page 23 of the SAR. During appraisal, the mission will identify specific actions which would trigger the release of the second tranche. Depending on the progress of the privatization program, this project could be followed by a subsequent operation with a primary focus on privatization.

7. The scope of the technical assistance requested by the Polish authorities and proposed under the project is clearly extraordinary and raises a number of questions about the implementation/absorption capacity as well as the appropriateness of using Bank lending to finance it. First, it must be noted that about two-thirds of the technical assistance is directed to supporting the design and implementation of transactions at the level of individual enterprises with committed counterpart capacity. Second, the balance of the assistance proposed is directed to six different agencies, each of which has carefully elaborated its specific requirements for training and counterpart support. Third, a key component of the proposed assistance program is a coordination unit specifically designed to facilitate implementation. Finally, the technical assistance proposed encompasses all of the assistance envisaged to support the entire privatization program over the next two years. The proposed US$75 million component of the Bank loan would finance less then half of this activity, and while the EEC has confirmed its interest in financing a substantial part of it (about $68 million), efforts are continuing to find additional grant financing.

8. By supporting the enterprise reform process, which will be vital in bringing about adequate corporate governance and paving the way for private investment in sound enterprises, the Project will support Poland's objective of developing sustainable employment. The financial sector issues, which are an important cornerstone of the success of any privatization/restructuring program are being addressed under the Financial Institutions Development Loan (FIDL), which is being processed in parallel with this operation. Simultaneously, the proposed Employment Promotion and Services Project (appraised in January 1991) would mitigate the negative employment and income impact of economic adjustment. In addition, a Small and Medium Enterprise Project (FY92) would further assist development of the private sector. Preparation of this project is well-advanced, with the sector report about to be discussed with the Government.

9. The project has attracted significant interest from co-financiers, as illustrated by the EEC's participation in the TA component. In addition, we have an active dialogue with EBRD regarding their participation in setting up holding companies and funds supported under the umbrella of the Project. CFSPS will participate in the appraisal mission with the view of possible future transactions within the framework of Privatization Program. IFC has been and continues playing an important role in the dialogue on privatization and foreign investment, concurrently with its program of individual investments and proposed new operations in capital markets. In addition to its informal advisory role on the legislative framework for the Foreign Investment law, IFC is currently undertaking a restructuring and privatization transaction for a furniture manufacturing enterprise group and is considering specific requests for its transaction services, on a fee basis, from enterprises in the pulp and paper and textile sectors. We are therefore also coordinating with IFC on key aspects of the project, especially the different privatization schemes and the framework for foreign investment.

10. Early processing of the project is recommended, in order to respond to the critical needs for support to the Program in its initial stages. Because of the large investment and TA components included in the project and the recent change in its nature to a hybrid, the project is proposed to be processed based on an SAR. To meet the urgent need for this operation, we recommend to keep with the proposed processing schedule with Board presentation in FY91. Subject to your approval, the appraisal mission for the loan is scheduled to start around the third week of March 1991. The project could then be presented to the Board in June 1991.

Attachments

cw&cc: Messrs. Zaidan (EM4DR); Sood (EM4IF)

Distribution:

Regional: Messrs. Blanchi (8), Hasan (3), Fox (EMNVP)

Country Dept: Messrs. Lari, Thumm (EM4DR); Nouvel, Loos, Lav (EM4CO); Apitz (EM4IN); Harbison (EM4HR); Montfort (EM4EE); O'Sullivan (EM4AG); Hume, Cordet-Dupouy, Duvigneau (RMP)

Technical Dept: Messrs. Kohli (EMTDR); Wackman, Ewing (EMTIE); Baudon (EMTEN); Hinds (EMTTF); Roa (EMTPR)

Operations Committee Members:

Messrs. Husain (LACVP); Jaycox (AFRVP); Karaosmanoglu (ASIVP); Wapenhans (EMNVP) Summers, Rajagopalan (PRE); Shihata (LEGVP); Kashiwaya [4] (CFASVP); Wood (FPRVP); Bock (OPNSV)

Other Participants:

Messrs. Wyss, (CODDR); Grilli (EASDR); Isenman (PRDDR); J. Linn (CEC); Stoutjeskijk (FRSDR); Picciotto (CPBVP); Thahane (SECVP); Burmester (SECGE); Ms. Okonjo-Iweala (OPNSV); Goldberg (LEGOP); Parmar (IFC-CIO); Rao (IEC); Kavalsky (FRM); Pfeffermann (IFC-CEI); Liebenthal (PRD); Kilby (FRS); Robless (OPNSV); Sandstrom, Khanna (EXC); Gustafson (CEMDR)

Messrs. Stern (FINSV); Thalwitz (PRESV); Lysy, Levy, Siraj (EAS); Petit (AGRDR); Pouliquen (INUDR); Churchill (IENDR); Piddington (ENVDR); Ms. Hamilton (PHRDR); Frank (CFPVP); El-Rifai (MIGPA); Niehuss (CFS); Elwan (CFSPS); Al Jabri, Ms. DeWitt (LEGEM); Fowler (LOAEL)

Messrs. Aghdaey, Kochav, Reyes-Vidal, Singh, Toureille (EM4IF)

YDuvivier
plprocme

FINAL EXECUTIVE PROJECT SUMMARY

POLAND - PRIVATIZATION AND RESTRUCTURING PROJECT

February 25, 1991

Borrower:	Republic of Poland.	
Beneficiaries:	Government, State Treasury, Ministry of Ownership Changes, Ministry of Industry, Foreign Investment Agency, Industry Development Agency, Polish Development Bank, Privatized enterprises and enterprises undergoing privatization.	
Financing Plan:	IBRD	US$300 million
	Enterprises	69
	EEC/other institutional sources/ and commercial sources	190
	Total	US$559 million

Tentative Appraisal Date: 03/18/91 Tentative Board Date: 06/11/91

1. Background: Poland has over 7000 state-owned enterprises (SOEs), of which 70% are in industry, and the remainder in the service, infrastructure, and agriculture sectors. Socialized industrial enterprises, i.e. state-owned enterprises and cooperatives, account for almost 95% of industrial production and employ about 90% of the industrial work force. Private sector activity is expanding rapidly, particularly in retail trade and services, but private activity in industry is limited, with a few sizable firms but mainly small firms as well as artisan and household operations. Despite its relative size, private industry, has shown remarkable dynamism and, since the early 1980s, has consistently grown more rapidly than the socialized sector.

2. To break the country out of a vicious circle of slow growth, low investments and low productivity, a far-reaching reform program is now being implemented in Poland, reorienting the country towards a market-economy with decentralized decision-making through the Economic Transformation Program (ETP). Recognizing the difficulty of achieving adequate supply response and efficiency gains in enterprises owned and operated in the public sector, the Government of Poland has decided that the preferred future for its state-owned enterprises (SOEs) is privatization. It is thus embarking on an ambitious and comprehensive Privatization Program with the objective of privatizing 50% of the SOEs within three years. The Law on privatization of SOEs was enacted in July 1990 and the Ministry of Ownership Changes was established in September 1990 to manage the privatization process. The Government has elaborated and is submitting to Parliament a comprehensive privatization strategy with a multi-track approach, including corporatization of SOEs, followed by privatization on an individual enterprise basis, or through mass privatization, or through liquidation followed by privatization of assets. About 45 SOEs have now been privatized through one or another of

these mechanisms, while a further 100 have started the process. Privatization has progressed at a fast pace in retail and services, with an estimated 80% of shops taken over by the private sector by the end of 1990.

3. <u>Rationale for Bank Involvement</u>: The Bank supports Poland's objectives to improve efficiency and productivity of the economy while upgrading socio-economic conditions, and this is being accomplished by supporting the market-oriented policies of the Government. Specifically, the Bank is assisting the Government in implementing its program to: (i) reform the economic system; (ii) restructure the productive base; and (iii) improve creditworthiness. Initial regulatory measures and preparation of a basic institutional framework to support enterprise reforms are being implemented in the context of the ongoing SAL, while the development of restructuring strategies in some key industrial subsectors are being initiated under the Export Development Project. The proposed Project would considerably expand and reinforce the process of enterprise reform and divestiture, by assisting the Government to elaborate its detailed Privatization Program, address the detailed institutional needs for its implementation, monitor and adjust the process during its critical initial stages, and promoting the necessary changes in the industrial policy. The proposed Project is expected to be the first in a series of such operations, providing the umbrella supporting further development and implementation of economic reform in Poland in general, with a primary focus on privatization of SOEs. Parallel Bank-assisted operations include the proposed Project for Financial Institutions Development, which would support the restructuring of the financial sector, and the proposed Employment Promotion and Services Project, which would help mitigate the negative employment impact of economic adjustment.

4. <u>Project Objectives</u>: The Project's objectives are to support Poland's efforts to develop and implement an effective enterprise privatization program, and implement restructuring across a major share of its industry, by: (i) assisting with the design of the necessary policies, the establishment and strengthening of the institutional framework, and the implementation of the Privatization Program; (ii) providing finance in ways which will mobilize additional resources for privatization; and (iii) providing finance for restructuring programs of privatized enterprises or enterprises in the privatization process. In broader terms, by supporting the enterprise reform process, which will be vital in bringing about adequate corporate governance and paving the way for private investment in sound enterprises, the Project will also support Poland's objective of developing sustainable employment.

5. <u>Project Description</u>: The proposed project includes three integrally related components: (i) support for the Privatization Program of the Government through the fast-disbursing component, to support the implementation of the necessary policy and institutional conditions facilitating privatization; (ii) technical assistance to support six key agencies involved in the privatization and restructuring process (the Ministry of Ownership Changes, the Ministry of Industry, the Industry Development Agency, the Polish Development Bank (PDB), the Foreign Investment Agency, and the State Treasury); and (iii) a line of credit through the Polish Development

Bank (PDB) as an Apex institution, to finance foreign exchange costs associated with privatization and/or restructuring of Polish enterprises. The Project has been reviewed and placed in environmental screening category B/C, consistent with the provisions of Operational Directive 4.00, Annex A. The proposed subprojects will be subject to the preparation of an environmental assessment.

6. Actions to be Agreed: in the context of the proposed loan, agreement from the Government will be sought on: (i) the adoption of a privatization strategy and of an action plan for its implementation; (ii) the submission to Parliament of the amendments to Law on Joint Ventures; (iii) the submission to the Parliament of the Law on the State Treasury and the establishment of instruments for the management of state assets; (iv) the implementation of a comprehensive technical assistance program; and (v) the eligibility criteria for participating banks and specialized financial institutions as well as on-lending arrangements and criteria for investment financing. (the Government will confirm its commitment (i) through (iii) above in a "Letter of Policy") In addition, agreement from PDB will be sought on: (i) its Statement of Operating Policy; and (ii) the on-lending arrangements to the participating financial intermediaries.

7. Benefits: The proposed project will yield major benefits to Poland in terms of establishing and testing the framework for effective privatization and restructuring, while directly supporting the privatization/corporatization of perhaps 10-15% of industrial enterprises. In addition, implementation of the Project will lead to: (i) improvements in enterprise management; (ii) economic benefits (related to returns on investment in subprojects); (iii) convertible currency earnings derived from the increased availability of quality products both for exports and as substitute for imports; and (iv) environmental, institutional, social and demonstration benefits. It will also support efforts to stimulate private sector developments and privatization in the ongoing move towards a true market economy. While not directly addressing the social cost of reform, the Project will help to maintain jobs in efficient enterprises, and reduce the loss of jobs in enterprises facing difficulties by helping to restore them to viability. For the long term, the Project will assist in paving the way for the further development of employment in privatized/restructured enterprises.

8. Risks: In the short term there could be delays in implementation associated with the scale and complexity of the privatization program, and the enterprises' willingness to privatize. The Government's limited implementation capability, the slow and difficult build-up of the new institutions, and the lack of skills of the enterprise managers may introduce some delays which would be minimized by the inclusion of the comprehensive technical assistance component. In the longer term, a risk that could adversely affect the indirect benefits of the project stems from the ambitious program of adjustment and stabilization. While the Government's current plans are satisfactory, the major institutional and systemic reforms are unprecedented in Poland and may take longer than currently planned. The Bank's on-going economic and sector work dialogue will be important in helping to identify and overcome weaknesses in implementation of the reform and to support the Government's overall industrial policy reform program. In addition, to minimize this risk, major TA will be provided to develop the regulatory and institutional framework of Poland.

March 20, 1991

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: March 18, 1991

TO: Operations Committee

FROM: Fred D. Levy, Acting Director, EAS

EXTENSION: 81947

SUBJECT: ZIMBABWE: (i) Country Strategy Paper
(ii) Structural Adjustment Loan
- Initiating Memorandum (IM)
- AGENDA

GNP per capita
[illegible]

The Operations Committee will meet on Wednesday, March 20, 1991 at 9.30 a.m. in Room E-1243 to consider the CSP and IM for the first Structural Adjustment Loan (SAL) for Zimbabwe.

Background

Since 1980, Zimbabwean growth has been uneven, ranging from more than 10% in real terms in 1980 to minus 1.5% in 1987 but subsequently recovering to a 5-6% range in 1988-89. The average growth rate of about 3.2% during the 1980s has been barely above the population growth rate. Employment generation has been slow and the high level of unemployment (26%) has now emerged as a critical problem. Investment/GDP levels have remained stagnant, exports have not grown sufficiently (3.5% per annum in real terms) to sustain the required level of imports, thereby keeping the external sector and foreign exchange situation in a precarious situation. The Central Government's fiscal deficit exceeded 10% of GDP for much of the 1980s. However, the Government did achieve substantial progress in the provision of vital social services such as health, education and family planning.

Zimbabwe has now initiated policy reforms to increase investment and enhance growth. The exchange rate has been adjusted, an export retention scheme has been established, the government deficit has been considerably reduced, price controls have been progressively relaxed, financial institutions have been given increased flexibility to set interest rates, the investment approval process has been streamlined, and institutional improvements have been made for collective bargaining together with a mechanism for quicker retrenchment of labor.

A. Country Strategy Paper

In organizing the discussion of the proposed country assistance strategy, the Operations Committee may wish to consider the principal issues in the following order: (a) the macroeconomic framework, including the issue of the fiscal deficit, and debt management, (b) trade liberalization and exchange rate management, (c) alternative growth scenarios, (d) external financing requirements and burden sharing, (e) the proposed scale of IBRD lending and trigger points for moving to a higher lending program, and finally (f) the case for limited IDA eligibility. Most of the sectoral issues appear to have been correctly identified by the Region and are being pursued through investment operations.

Issues

Macro Framework

Achieving more rapid and sustainable growth will be critical for increasing living standards, expanding employment and further improving the delivery of social services. The management of the fiscal deficit will be key to Zimbabwe's prospects. Under the full reform program, the Central Government deficit/GDP (based mainly on expenditure reduction and not revenue enhancement) is projected to decline from 10.4 percent in 1989 to 5 percent in 1995 with the private investment/GDP ratio improving from 9.8 percent to over 16% in 1994 and beyond. The Committee may wish to discuss:

(a) In the absence of a Fund program, what mechanism would be adopted to monitor the macroeconomic aggregates?

(b) Is the proposed fiscal deficit reduction the maximum that can be achieved in 5 years and is the remaining deficit in 1995 sustainable? Would not the likely increase in interest rates and the dynamics of debt management create problems in the reduction of these deficits and in the execution of the future fiscal policy?

(c) Are the civil service reform (25% retrenchment) and reduction in the state enterprise subsidies the only two major measures to improve the fiscal account? What are the political and social risks of implementing policies in these two areas?

(d) Is there no scope for increased revenue mobilization through tax administration, if not through tax increases? How would the overall issue of tax reform be addressed?

(e) Is it realistic to assume that, despite the remaining fiscal imbalances in the years leading up to and in 1995, the investment/GDP ratio in the private sector would rise at a rapid pace as indicated above.

Trade Liberalization and Exchange Rate Management

The trade liberalization strategy is better spelled out in the SAL IM than in the CSP. It is proposed that the Open General Import Licensing (OGIL) will be progressively expanded starting with raw materials, to be followed by intermediate and capital goods with consumer goods coming at the end in 1994 and 1995.

- What are the political economy considerations underlying a rather slow approach to liberalization, and what are the risks to the manufacturing and other sectors of opening the system more rapidly than currently envisaged?

- Why is it not possible to phase out import licensing sooner than 1994, with the help of concurrent and forceful actions on the tariff and exchange rate fronts?

- In order to achieve liberalization, expand exports and reduce the current account/GDP deficit, would it not be necessary to accelerate real depreciation?

Alternative Growth Scenarios

The CSP presents a Full Reform (FR) and a Limited Reform (LR) scenarios. Even in the FR Scenario, a relatively high 24-25% of GDP gross domestic investment ratio engenders only 4-5% GDP growth.

- What particular measures are needed to enhance the efficient use of investment in the Zimbabwean economy?

- What are the implications of the two scenarios for (i) the fiscal imbalance, and (ii) the level of unemployment in the country.

External Financing Requirements and Burden Sharing

Under the FR scenario, total financing requirements for 1991-95 would be US$ 3.46 billion -- US$700 million a year, or twice the trend of recent years. Of the total requirement, about 60% or $2.0 billion would need to be met by disbursements on new loan commitments of which more than 40% is projected to be provided by commercial creditors.

- Despite Zimbabwe's good payment record, is it realistic to assume that new disbursements from commercial banks would be of the magnitude projected in the financing plan?

- In the interest of both macroeconomic discipline and a more balanced financing plan, why should Zimbabwe not be asked to obtain the Fund resources?

- Why is foreign direct investment assumed to contribute very little (less than 8%) to the annual funding requirements?

Proposed Scale of IBRD Lending, Trigger Points and Limited IDA Eligibility

The CSP proposes a two-tier assistance program: a FY91-95 base lending program of $391 million to be raised to $741 million, of which $245 million would consist of two fast disbursing adjustment operations, making the raised level of lending contingent on the pace and scope of reform. The base case assumes continuation of trends towards economic liberalization and fiscal deficit reduction and represents an increase of 55% over the FY86-90 lending program of $218 million.

The raised level of lending, associated with a full implementation of the Government's reform program, includes two fast disbursing operations: FY92 SAL I ($125 million) and FY94 Industrial Rehabilitation ($120 million), as well as additional project lending ($105 million).

The trigger points for the raised lending program are: (i) significant and measurable progress on OGIL (e.g. 30% imports on OGIL before effectiveness of SAL I) and adherence to a mutually agreed schedule of the liberalization of imports and (ii) significant progress in reducing the Government deficit with clearly specified yearly targets.

The Committee may wish to discuss (i) whether the proposed tripling of lending over the next 5 years in the raised case is justified, and (ii) whether the trigger points currently related to the pace of the reform program in two areas - import liberalization and deficit reduction - are the most appropriate triggers. Would it be desirable to include certain other triggers such as the change in the effective exchange rate, or continued satisfactory allocation of public sector resources to the social sectors, or measures to reduce the high level of unemployment.

The Committee may also consider the Region's request for granting Zimbabwe a limited blend status. Even though Zimbabwe's 1989 GNP per capita ($640) was below the operational cut-off point of $700, does the Region believe that Zimbabwe would satisfy two important criteria to become IDA eligible: (i) using the Atlas methodology Zimbabwe's GNP per capita will remain below the projected operational cut off point for the foreseeable future, and (ii) Zimbabwe's access to the commercial sources of borrowing even with improved policies cannot be ensured. The financing plan does not indicate that the latter would be the case.

Under the FR scenario, with higher lending volumes -- including fast disbursing operations -- the Bank's share of total long term debt outstanding and disbursed rises to 20% by the end of 1990s thereby threatening to violate the Bank's exposure guidelines. Among other actions, e.g. cofinancing, the Region wishes to use IDA funds to reduce this exposure.

Decision Points

The Committee is requested to decide upon the following propositions on which the Region is seeking its approval:

52

78

(a) a base lending program of $391 million for FY91-95 (compared with actual lending of $218 million during FY86-90). If the Government implements its planned program on schedule, the lending program would be further increased to $741 million and include fast disbursing adjustment operations in FY92 and FY93 or FY94.

(b) limited IDA status with about $15 million per annum for project investment, if policy reform is sufficient to trigger the higher lending program with its fast disbursing operations;

(c) proposal to use about 165 staffweeks per annum on CESW during FY91-93.

Nor. 3.3 staff years

B. The Structural Adjustment Loan SAL)

The proposed first SAL for US$125 million is an integral part of the CSP's enhanced level lending strategy. Its central components include: (a) fiscal deficit reduction through prudent budgetary and monetary policy; (b) trade liberalization; (c) domestic deregulation of price controls and amendments in trade restrictions, and labor regulations and other economic activities, and (d) programs to protect the poor during the adjustment period.

Zimbabwe's reform program is considered "home grown" and substantially underway. It is viewed as fairly strong. Most of the general issues pertaining to the proposed SAL have been raised in the context of the CSP. It is therefore suggested that the Committee first discuss the proposed conditionality, and then address the issue of the financing need for such a quick disbursing operation.

Proposed Conditionality

Most of the monitorable actions to be supported by the proposed SAL -- especially those designed to reduce the deficit -- including cost recovery and reduced overall parastatal subsidies -- appear to be generally well formulated. However, it would be desirable to discuss (a) the status of Zimbabwe's relations with the Fund; (b) whether the financial sector in Zimbabwe is comprehensive and efficient enough to provide full support to the proposed adjustment process; (c) whether it is realistic to assume that all commercial parastatals will introduce market based pricing before the second tranche; (d) the desirability of privatizing some state enterprises under the program.

Financing Need

Several considerations have gone into assessing the need for external financing over the program period. Two important factors in determining the need at US$3.5 billion for the five year period, 1991-95 are: (i) supporting a 8% per annum real increase on imports during the first two years and a rise in total investment from 21% of GDP in 1990 to 25% in 1995. About US$850 million of the $3.5 billion is expected from existing commitments, leaving $2.65 billion to be obtained as disbursements from new grants (US$550 million) and loan commitments ($2.1 billion), with 20% of these additional loan disbursements from IBRD, 18% from other multilateral, 20% from bilateral loans and a hefty 42% from commercial sources.

a year
52 million
78 million

The Committee might wish to discuss whether this is a feasible and viable financing scenario, whether this is consistent with the Region's request for limited IDA eligibility, and whether without Fund involvement the burden-sharing is appropriate and commercial banking funding would be forthcoming.

Operations Committee

Messrs. Qureshi, Husain, Jaycox, Karaosmanoglu, Wapenhans
Rajagopalan/Summers, Shihata, Kashiwaya, Wood, Bock

cc: Messrs. Thahane/Burmester, Picciotto, Goldberg, Wyss, Sandstrom,
Isenman, Linn, Stoutjesdijk, Ms. Okonjo-Iweala, Chaudhri,
Parmar, Rao, Kavalsky, Pfeffermann, Liebenthal, Kilby,
Robless, Walton, Khanna, O'Brien, Shakow,
Denning/de Ferranti, Patel, Imam, King, Elbirt,
Institutional ISC,

FMChaudhri:gs

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: March 14, 1991

TO: Mr. Moeen A. Qureshi, Chairman, Operations Committee

FROM: Jean-Louis Sarbib, Acting Vice President, AFR

EXTENSION: 34946

SUBJECT: ZIMBABWE - Structural Adjustment Loan Initiating Memorandum

1. The attached Initiating Memorandum (IM) seeks authorization from the Operations Committee to appraise the Structural Adjustment Loan for Zimbabwe. This would be the first structural adjustment loan in Zimbabwe. An early draft of the IM was discussed in a working level review meeting. Concerns were expressed about the pace of adjustment of the Government's program, particularly external trade liberalization and Government deficit reduction. These concerns will be taken into account during the processing and monitoring of the operation. Some changes were introduced in the draft IM as a result of the working level review.

2. The proposed Loan would be for the equivalent of US$ 125 million. This amount is based on the overall financing package including commercial borrowing anticipated by Government. It would be complemented by other financial contributions (AfDB, IFC, Japan, EEC, USA, etc.) in the form of cofinancing or parallel financing.

Proposed SAL

3. This operation is an integral part of the CSP strategy to support Zimbabwe's move to liberalize its economy and accelerate growth. It would be geared to support implementation of the initial stage of the Government's five year program stated in the document "Zimbabwe: A Framework for Economic Reform 1991-95". The framework was the result of a long process of consensus building within Zimbabwe and was produced with technical assistance from the Bank and IMF. Its central components are: (a) fiscal deficit reduction coupled with prudent monetary policy; (b) trade liberalization; (c) domestic deregulation; and (d) measures to alleviate the impact of reform on vulnerable groups.

4. Budget deficit reduction will be pursued mainly through a comprehensive program to phase out subsidies to public enterprises, a substantial reduction in the civil service, and a restrictive public sector wage policy. Trade liberalization will consist of a systematic increase in the number of goods under Open Generalized Import Licensing (OGIL) system. By 1995 all goods with few exceptions based on security and/or overwhelming public welfare could be imported through OGIL. Supportive tariff reforms and exchange rate policy will complement trade liberalization. Domestic liberalization will include the total removal of price controls on goods placed under OGIL (elimination or relaxation of price controls on domestically-produced goods has been proceeding

relatively fast), the elimination of trade restrictions on grains between communal areas, amendments in labor regulations so workers can be retrenched with compensation and relaxation of regulations on economic activities. In order to protect the poor from the transitory impact of adjustment measures, several programs will be implemented. The emphasis will be on retraining for retrenched workers and food security for the poor and vulnerable groups.

The Pace of Reforms

4. The Government program is comprehensive and provides a sound basis for structural adjustment. The Government has chosen a gradualistic approach which, it feels, represents a politically feasible path for economic reform. On balance, we agree with this approach.

5. A gradual program avoids unrealistic targets. The announcement of the measures well in advance provides the right signals to investors while allowing the authorities to deal with the delicate problems underlying the political economy of the country. Given Zimbabwe's relatively diverse and highly organized industrial sector, the supply response will depend crucially on the perception of entrepreneurs that they will have the opportunity to adjust to the new regime through modernization and additional investments before they are exposed to drastic changes in the economic environment. Finally, the country could always advance the implementation of reforms if good results are realized in early stages of the program.

Risks

6. Policy slippage. There is a risk that the program could slip as a result of the opposition of vested interests. Such a risk, however, should be measured against the window of opportunity created by the present political commitment to reforms that need to be encouraged and supported. In that regard, it should be mentioned that the Government has already implemented several actions: the real exchange rate has been depreciated by more than 20 percent during the last two years, the budget deficit has been reduced, the OGIL system has been initiated, some measures to deregulate local trade and transport have been implemented, price controls on several goods have been abolished or relaxed, and interest rates have been increased. Clearly, the measures are only the beginning of a process that needs to be strengthened. This operation would be crucial in that regard. Conditions for Board presentation and second tranche release have been carefully selected to maintain the momentum of reform.

7. Financing. The nature of this program requires that measures be implemented in a coordinated and synchronized fashion. The availability of financing is a key element for the implementation of the program, particularly external trade liberalization. External financing should come from a wide range of sources, including commercial ones. While the difficulties to obtain the required financing should not be underestimated, we think that Zimbabwe is in a favorable position to

mobilize the required funds. Undoubtedly, the implementation of the adjustment program should attract the support from multilateral and bilateral sources while the good record of Zimbabwe should facilitate commercial borrowing. This operation would provide resources to implement the structural adjustment program thus taking advantage of this unique opportunity for Bank support to a "home-grown" program. It would encourage other donors to firm up their support.

Coordination with IMF

8. The Bank and the Fund staff have been consistently and regularly consulted on issues regarding the Zimbabwean program. The Fund has expressed its support for the Government program at different levels, including the Managing Director during his recent visit to Zimbabwe. Zimbabwe has not requested IMF financing for the execution of its program mainly because of concern about the cost of Fund resources. However, the Government appreciates that some arrangement with the IMF is desirable and discussions have started in that regard with the Managing Director. While these discussions take place, we believe that we should not delay our operation because that would risk missing this unique opportunity. The Fund staff will be invited, in any case, to participate in the appraisal and supervision of the SAL, as they participated in the technical assistance to the framework paper.

Key Issues for Appraisal

9. Since this operation supports Zimbabwe's own framework where the timetable for the most important actions is already established, the observance by Government of its own program will constitute the determinant factor for this operation to be processed as programmed. The key issues that need to be resolved during appraisal are:

(a) significant progress in moving imports to unrestricted OGIL in line with the schedule of the Framework;
(b) consistency of the government budget under preparation with the reduction in deficit equivalent to 2 percent of the GDP; and
(c) advanced preparation of the studies to improve the legal and institutional framework for parastatals.

10. The agreement on the issues mentioned above would make possible the full appraisal and would allow negotiations to follow. The presentation of the SAL to the Board is planned for October 1991.

Attachment

DISTRIBUTION: Messrs. Husain (LACVP); Jaycox (AFRVP); Karaosmanoglu (ASIVP); Wapenhans (EMNVP); Rajagopalan (PRSVP); Shihata (LEGVP); Kashiwaya (CFSVP); Wood (FPRVP); Bock (OPNSV); Grilli (EAS); Wyss (COD); Niehuss (CFS); Thalwitz (PRESV); Isenman (PRD); Linn (CEC); Rao (IEC); Ofosu-Amaah (LEGAF); Stern (FINSV);

Stoutjesdijk (FRS); McAfee (LOOAF); Frank (CFPVP); Parmar (CIOVP); El-Rifai (MIGPA); Bornemann, Burke, Dillon, Kimaro (IMF); Danforth (SEC); Africa Regional Files; O'Brien, Armstrong (AFRCE); Denning (AF6DR); Patel, Grawe, King, Muganda, di Girolamo (AF6CO); Ali, Moreithi, Okidegbe, ter Vrugt, Christiansen, McNamara (AF6AG); Cook, Belli, Broadfield, Daffern, Telahun, Seibert (AF6IE); Sam, Jensen, Racki, Crookes (AF6IN); de Ferranti, Hecht, de Beyer (AF6PH); Drum, Cohen (AFTPS); Strongman, Bolte (AFTIE); Culagovski (AFTTF); Hill (AFTPN); Gopalkrishnan (AFTIN); Poortman (AF6ZB); Armar (IENHE); Rivera, Richter (IENEE); Saito (PHRWD); Dailami (CECFP); Mawere, Ramaswami (CA2D2); Walton (DECVP); Kavalsky (FRM); Pfeffermann (IFC-CEI); Liebenthal (PRD); Kilby (FRS); Robless (OPNSV); Khanna (EXC).

THE WORLD BANK
Operations Committee

CONFIDENTIAL

Minutes of the Operations Committee to Consider the BANGLADESH - Second Industrial Sector Credit - I.M.

Held on Wednesday, March 20, 1991, at 11:00 a. m. in Room E-1243

A. Present

Committee

Messrs. M. A. Qureshi, Chairman
E. Segura (LACVP)
E. Jaycox (AFRVP)
A. Karaosmanoglu (ASIVP)
W. Grais (EMNVP)
L. Summers (DECVP)
H. Scott (LEGVP)
K. Kashiwaya (CFSVP)
B. Kavalsky (FPRVP)

Others

Messrs./Mmes F. Levy, (EAS)
P. Ljung, (EAS)
S. Asanuma (AS1DR)
O. Yenal (ASIVP
F. Temple (AS1IE)
P. Mitra (AS1CO)
C. Draper (AS1IE)
N. Okonjo-Iweala (OPNSV)
M. Walton (DECVP)
T. Hutcheson (PRDRA)
K. Siraj (COD)
K. Nordlander (LEGAS)
P. Gotur (IMF)

B. Issues

1. Bangladesh is a predominantly agrarian society. Still, the industrial sector must play a key role in the country's development since agriculture is unable to provide productive employment for the large and growing population. In spite of rapid growth of some export industries, the performance of the manufacturing sector was sluggish throughout the 1980s. Manufacturing now accounts for only 10 percent of GDP and employs around 8 percent of the labor force. As indicated by the success of the garment industry, Bangladesh has a large pool of potential entrepreneurs. However, they face a number of structural constraints and radical changes in the policy environment are needed to encourage private investment--especially in small scale, labor intensive and export oriented activities. Building on reforms initiated under a 1986 adjustment operations (ISC-1), the proposed Second Industrial Sector Credit (ISC-2), would seek to reform the incentive environment and the regulatory system. The discussion of the ISC-2 broadly followed the agenda prepared by EAS.

2. In opening the discussion, the Chairman asked about the progress on the policy front in Bangladesh. The Region briefly explained that since the spring of 1990, the Government of Bangladesh (GOB) had started to correct the major macro-economic imbalances and shown an increased interest in structural reforms. GOB had taken prompt and decisive measures to deal with the adverse impact of the Gulf crisis. It had also moved ahead with the prioritization of

the investment program. The new Cabinet and Parliament were expected to emphasize prudent economic management and further liberalization. It was still too early to say how far the Government would go.

3. The IMF representative reported that the ESAF program was broadly on track. The Government was likely to meet the revenue targets. However, high arrears on excise taxes and a--hopefully temporary--revenue shortfall in February were of some concern. GOB had shown extraordinary restraint on the expenditure side but public investments appeared to be too compressed. Since Government borrowing were well below the ceiling in the ESAF program, a recent Fund mission had encouraged GOB to step up investments. The introduction of the value added tax had encountered some delays but it was expected to become effective on July 1, 1991. The Fund would not proceed with the second year ESAF arrangement until GOB has implemented this reform. Growth during FY91 was likely to be below the ESAF target, in part due to a fall in private investments--from an already low level. Finally, the IMF representative reported that, due to the balance of payments impact of the Gulf crisis, the Government had requested a rephasing of the ESAF releases. The Fund was likely to approve this request.

4. The Chairman noted that a flexible exchange rate regime was essential for success of the trade liberalization program. The IMF representative responded that the present exchange rate provided appropriate incentives. The 10 percent nominal devaluation of the taka last year had restored Bangladesh's international competitiveness to the November 1988 level. Although the liberalization of imports of consumer goods might lead to a need to depreciate the real exchange rate, the improved availability of imported intermediate goods should strengthen Bangladesh's international competitiveness. Consequently, it would be prudent to wait and see how exports, imports and reserves responded to the package of trade reforms. The ESAF program provided for a close monitoring of the situation and allowed flexible exchange rate adjustments. The Chairman noted that, should liberalization result in greater imports, the Fund should be willing to provide additional support quickly if the balance of payment situation deteriorated. The Region added that it was studying, together with the Fund, the exchange rate regime followed by its main clients, including Bangladesh.

5. The Region described recent structural reforms. There had been significant progress under the on-going Financial Sector operation. A recent mission had found that most conditions for release of the second tranche had been met or were on track. Further actions were needed in two areas: (i) improving the recovery of loans from the enterprises with the largest overdues; and (ii) recapitalization of the nationalized commercial banks. The dialogue on restructuring of public enterprises was moving ahead at a modest pace. The Asian Development Bank was also involved in this dialogue and was considering an adjustment operation aimed at public enterprise reform. The Government had recently agreed that the Bank would do a study of the jute sector which, hopefully, would lead to an adjustment operation. The recent political uncertainties had meant slow progress in the dialogue aimed at defining an adjustment operation supporting better management of public expenditures. Similarly, the dialogue on the next steps in energy sector reform had as yet produced few tangible results.

6. As explained in the Initiating Memorandum, all the essential reforms under ISC-1 had been implemented although usually with some delays. However,

it was noteworthy that the Government had continued the reforms. Last year it reduced quantitative restrictions further and lowered the top tariff rate to 100 percent. Administrative actions aimed at promoting export production (including streamlining of the duty draw-back system) and liberalizing investment sanctioning procedures had been implemented. What remained of the ISC-1 agenda was primarily a further liberalization of imports for the textile sector.

7. Several members noted that reform of the tax system was essential to ensure proper incentives for the business community and to reduce dependence on tariff revenue. The Region readily agreed and noted that the revenue/GDP ratio in Bangladesh was exceptionally low. Bank studies on tax policy and administration had concluded that a partial value added tax (VAT) was the best solution. (The VAT would be collected from importers and manufacturers but not from retailers.) The VAT was expected to give the tax system a new buoyancy. Other tax reforms were also under preparation or implementation. Technical assistance on tax administration was being provided by UNDP. The Region also stressed the importance of the new system for pre-shipment inspection and customs duty assessment.

8. The Chairman emphasized the need to deal simultaneously with the trade regime and the regulatory system. The regulatory environment should be streamlined not only for foreign and large local investors--which was being done with FIAS assistance--but, especially, for medium sized and small indigenous enterprises. He was concerned that it might not be possible to transform the Board of Investments (BOI) from a regulatory body to a promotional agency. The Region noted that domestic deregulation was a new topic in the dialogue with GOB and that our understanding of the regulatory system was still not fully developed. Consequently, the proposed reforms in this area were somewhat less concrete than in the field of trade policy. Special attention would be paid to the structure and role of BOI to ensure that it would be able to fulfill its new role. One member added that GOB should move more decisively in privatizing public enterprises.

9. Several members discussed the nature and scope of the operation. One member of the Committee noted that the reforms to be supported under ISC-2 were quite modest. Perhaps, he suggested, it might make more sense to use the limited amount of quick disbursing lending to support urgently needed social sector reforms. The Chairman and others, however, stressed the need to improve the conditions for development of the private sector and enhance the competitiveness of manufacturing industries. Thus, the proposed operation was an essential element in the Bank's assistance strategy. Another member also noted the limited scope of the operation and suggested that it was justified only if it was part of a longer term strategy for industrial sector reforms. Thus, the Region should seek an agreement with the Government on such a strategy and on monitoring, by the Bank, of its implementation. In this connection, one member wondered if the maximum tariff rate should not ultimately be reduced well below 50 percent.

10. The Chairman noted that the credit amount should be derived from the country's balance of payment needs. It should not be regarded as a "reward" for undertaking essential reforms. Rather, it should be adjusted only based on the potential BOP impact of additional measures that GOB might agree to implement. In general, it would be desirable to keep the credit amount low in

order to maintain some pressure on the Government to undertake budgetary reforms. 1/

C. Decision

11. The Region was authorized to proceed with the appraisal of ISC-2 along the lines set out in the Initiating Memorandum. The credit amount was, for the time being left open, subject to the observations made in paragraph 10. The concerns expressed by the Committee should be taken into account in finalizing the design of the operation. The core conditions should be derived from the comprehensive action program attached to the I.M. It was also important to make clear in the policy matrix what was carry-over action from ISC-1 and what genuinely represented new "prior action" supported by ISC-2.

PLjung:vl
March 21, 1991

1/ The Regional member of the Committee noted that there appeared to be a general tendency--at least in the Asia Region--for quick disbursing lending to lead to an increase in current expenditures, sometimes on low priority activities. Thus, he requested that the member from PRE should ask his staff to analyze this issue to see (i) if this was a universal problem; and (ii) if there was some way in which the Bank could ensure that the counterpart funds were used for desirable investments and for urgent maintenance or social sector expenditures. The member from PRE agreed that this was an important topic and he would follow-up with his staff.

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: March 18, 1991

TO: Operations Committee

FROM: Fred D. Levy, Acting Director, EAS

EXTENSION: 81947/8

SUBJECT: BANGLADESH: Second Industrial Sector Credit Initiating Memorandum - Agenda

Streamlining? Conditionality — Other action on Value added + other taxes Tax rules modernization Also budgeting import etc

1. The Operations Committee will meet on Wednesday, March 20, 1991 at 11:00 a.m. in Room E-1243 to review the Initiating Memorandum (IM) for the proposed US$100 million Second Industrial Sector Credit (ISC-2) to Bangladesh. The document was circulated to you under Mr. Karaosmanoglu's signature on March 11, 1991.

Background

2. Towards the end of the 1980s, short term economic management in Bangladesh deteriorated. The real exchange rate appreciated while foreign exchange reserves fell to $450 million--less than 1-1/2 months of imports-- in March 1990. Poor expenditure control and optimistic revenue projections led to large public sector borrowings and accelerating inflation. At the same time, there was a hiatus in the structural reform process. Most ominous was the steady decline in investments from 16 percent of GDP in FY81 to 11 percent in FY89 and the virtual disappearance of domestic savings.

3. In the spring of 1990 the Government took a series of steps to correct macro-economic imbalances and an ESAF arrangement was approved by the Fund Board last July. GOB's response to the Gulf crisis was prompt, both in terms of increasing domestic petroleum prices and in taking measures to restrain current expenditures. It appears that political and economic uncertainties led to a compression of imports and--in spite of the negative balance of payments impact of the Gulf crisis on oil imports, exports and remittances--the foreign exchange reserves rose to around US$775 million at the end of January, 1991.

4. During the last year there has also been a renewed interest in structural reforms--although many decisions have been delayed pending the recent election. The incoming administration--with its backing of the business community and the civil service--is expected to emphasize the role of the private sector and deregulation of the economy. The rapid growth of garment1/ and other non-traditional exports during the

---

1/ Over the 1980s, garment exports increased from around US$3 million to over US$600 million or 1-1/2 times the exports of raw jute and jute products.

1980s have demonstrated that Bangladesh has a significant pool of entrepreneurial talent that can respond favorably to new incentives and opportunities. Thus, the prospects are fairly good for an acceleration of growth from the sluggish 3.8 percent rate recorded during the 1980s.

5. The proposed ISC-2 would build on the initial tariff and regulatory reforms that were supported by the first Industrial Sector Credit approved in 1986. It would complement on-going financial sector reforms and potential operations aimed at further reforms of public enterprises and public sector resource management. The policy and procedural changes and institution building actions to be taken under ISC-2 would be designed and phased to achieve the following specific objectives by FY93 (while enhancing the potential for futher progress on liberalization and deregulation thereafter):

(a) most significantly, the removal of almost all import restrictions and simplification of import procedures, transferring protection to the tariff and exchange rate regimes;

(b) completion of the process of providing a free trade regime for most export production, at least with respect to imported inputs, and adoption of a strategic approach to export promotion;

(c) necessary preparation for and significant progress towards the establishment of a moderate, uniform protection structure, complementing improved and more equitable revenue collection through structural and administrative tax reform; and

(d) substantial deregulation including the replacement of public control over private investments with a strong promotional stance towards efficient production.

6. Against this background the Committee might want to consider the issues described below.

Issues

7. Exchange Rate Management. The maintenance of external competitiveness is essential to the success of the trade liberalization and tariff reforms under the proposed credit. This might require future nominal (and real) exchange rate devaluations. Unfortunately, the Government's record in this area has been mixed. In the early 1980s, the Government pursued a flexible exchange rate policy which contributed to the rapid growth of non-traditional exports. During the late 1980s, however, the taka was allowed to appreciate by about 10 percent in real terms. A couple of exchange rate adjustments in 1990 have now restored Bangladesh's export competitiveness to its 1988 level. The Region might want to explain (i) the exchange rate policy that Bangladesh is expected to pursue under the present ESAF arrangement; and (ii) the nature of the macro-economic conditionality--especially how it would address the concerns regarding the real exchange rate.

Action Exchange Rate Policy

8. Budgetary Impact. Throughout the 1980s, the Government demonstrated its inability to contain current expenditures (that grew from 5.6 percent of GDP in FY81 to 8.4 percent in FY90) and to raise revenues (that ended up at 9.3 percent of GDP in FY90 or exactly where they started in FY81). Consequently, public savings have dropped dramatically and donors now finance--directly through project aid and indirectly through commodity aid--some 90 percent of the Annual Development Plan. Since customs duties account for about one-third of Government revenues, there is a need to closely coordinate the tariff reforms under ISC-2 and the proposed introduction of the value added tax and the supplementary excise duty on luxury goods. Thus, the Region might want to explain: (i) the likely revenue impact of the tariff reform; and (ii) the institutional arrangements and time schedule for the implementation of the tax reform measures.

9. Institutional Reforms. A couple of agencies would get their mandate strengthened and redirected. ISC-2 would enhance the formal status and the technical capability of the Tariff Commission (NTC). Inter alia, the commission would be able to analyze nominal and effective protection provided by actual and proposed tariff regimes. The NTC would be expected to make substantive and authoritative contributions to future import control and tariff changes. As indicated by the experience from some other countries, attempts to fine-tune and micro-manage trade reforms based on technical criteria might not be successful. Thus, the NTC might become the focal point for domestic lobbying efforts which might slow down the trade reform process. The Region might want to explain: (i) the overall commitment to tariff and regulatory reforms that would be sought from the Government; and (ii) the anticipated role of the NTC in the implementation of the Government's trade policy.

10. The Board of Investments (BOI) would be transformed from a regulatory body concerned with investment sanctioning to an agency promoting local and foreign investments. Indeed, it is expected that BOI would become a force for industrial deregulation. Since this would represent a drastic change in BOI's mandate, the Region might want to explain the nature and scope of BOI's restructuring. The Region might also want to discuss the arrangements for the preparation of the Government's comprehensive export promotion strategy and the key elements of this strategy.

11. Conditionality. The IM contains a comprehensive action plan for implementation of the policy reforms that would be supported under ISC-2. Most of the action would be taken up-front during the next month or two (before the Negotiations) or before the release of the first tranche (in July or August 1991). The Committee might want to discuss the feasibility of taking major regulatory measures shortly before the end of FY91 and introducing many further measures in the FY92 budget a couple of months later. Especially, the Committee might want to consider if the proposed timing of the conditionality will increase the risk of severe slippages in the release of the first tranche. In this connection, the Region might also want to explain which of the actions will be made into formal tranche release conditions.

Which actions tranche release conditions

12. Credit Amount. The credit amount in the lending program is US$100 million but the Region suggests that a somewhat lower amount--perhaps US$75 million--would be appropriate if the new Government were unable to commit itself to most aspects of the proposed action program. Especially, the Region notes that if agreement were not reached on the reduction of the standard maximum tariff rate to 50 percent, the credit amount might be lowered. The Committee might want to discuss if this is an appropriate trigger for moving to a lower credit amount and if there are some other conditions that also might be regarded as triggers.

Size of the credit keep it Loan money Put it into some other investment program

Operations Committee

Messrs. Qureshi, Husain, Jaycox, Karaosmanoglu, Wapenhans, Rajagopalan, Summers, Shihata, Kashiwaya, Wood, Bock.

cc: Messrs/Mss. Thahane/Burmester, SECGE; Picciotto, CPB; Goldberg, LEGVP; Wyss, COD; Sandstrom, EXC; Isenman, PRD; Linn, CEC; Stoutjesdijk, FRS; Okonjo-Iweala, OPNSV; Parmar, IFC-CIO; Rao, IEC; Kavalsky, FRM; Pfeffermann, IFC-CEI; Liebenthal, PRD; Kilby, FRS; Robless, OPNSV; Walton, EXC; Khanna, EXC; Yenal, Asanuma, Temple, Draper, ASI; Institutional ISC.

PLjung:vl

ESAF

91031200 4 1.

THE WORLD BANK / IFC / MIGA

OFFICE MEMORANDUM

DATE: March 11, 1991

TO: Mr. Moeen A. Qureshi

FROM: Attila Karaosmanoglu AK.

EXTENSION: 81430

SUBJECT: BANGLADESH : Second Industrial Sector Credit
Initiating Memorandum

1. Attached is an Initiating Memorandum for a proposed Second Industrial Sector Credit in Bangladesh. After a long preparation period, we hope to appraise the operation as soon as your clearance is obtained. A March appraisal could enable the Credit to be presented to the Executive Directors in this FY with a view to its effectiveness about July/August 1991 (after the Budget) and a second tranche review the following July. This timing would be consistent with GOB making significant reforms with its FY92 and FY93 Budgets -- notably the replacement of import controls which generally provide scarcity premia in the 25-50% range by tariffs in that range, and removal of most tariffs above 50% -- while enabling our timely delivery of needed program assistance.

2. The proposed Credit would support a significant program of deregulation and trade policy reforms to promote industrial sector development, private investment and export diversification. It is a further adjustment operation under the lending strategy for Bangladesh, in which a mix of sector and structural adjustment credits are being used to achieve broad policy and institutional reforms while transferring quick-disbursing money to be used primarily to finance general imports with Taka proceeds applied to appropriate public expenditure.

3. The party that has now won the recent General Election and is on the verge of forming the new Government is committed to the economic reforms ongoing in Bangladesh, and is aware of the Policy Framework paper which expects GOB to implement, *inter alia*, a program of industrial deregulation and trade liberalization. Moreover, the program enjoys the support of the Interim Administration and our counterparts in the Civil Service.

Bangladesh's Requirements for Program Assistance

4. Bangladesh will need about $6.3 billion in external financing over FY92-94. Of this about one-quarter is expected to be in the form of quick-disbursing aid in the form of commodity or adjustment-related assistance. An additional 10 percent is expected to be in the form of food aid. Total IDA disbursements over this period are expected to be about $1.5 billion, of which about a quarter is expected from adjustment operations and the balance from a diversified portfolio of investment operations. The figure for non-project lending reflects the country's dependence on substantial aid inflows to cover structural weaknesses of Bangladesh's external and internal resource position. Despite recent successes in non-traditional exports, exports continue to finance only about two-fifths of imports. It is also expected that imports will grow strongly in FY92 as a result of resolution of the

uncertainties caused by the Gulf crisis and domestic political situation and because of actions under the proposed ISC-2 operation. The proposed operation would help finance part of the additional imports. In addition, as international reserves currently stand at about $700 million, equivalent to just over two months' imports, the country will need to improve this situation over the medium term as indicated in the ESAF program.

5. At the same time, foreign resources finance nearly half of total public expenditures. Thus counterpart funds are used to augment inadequate budgetary revenues to cover local currency funding for the investment program and project maintenance requirement. This is particularly useful in the context of the Government's ongoing prioritization exercise aimed at improved utilization of project aid.

The Proposed Sector Credit

6. The industrial sector must play a key role in Bangladesh's development, since agriculture is unable to provide sufficient employment for the very large and growing population. Manufacturing now accounts for only 10% of GDP and 8% of total employment, however, and has stagnated over the past decade in spite of the rapid growth of some export industries, notably garments. The main problems preventing the sector from making its potential contribution to employment and growth are structural, and their solution requires further radical changes in the policy environment to encourage private investment -- especially in efficient, small scale, labour intensive, and export oriented production activities -- rather than in the large scale, mainly public, capital intensive, and often inefficient units. These continue to dominate the sector in spite of some progress in privatization and deregulation during the 1980s.

7. The Credit would support the Government's efforts to further the deregulation process and to move the trade policy regime towards one which would reward efficiency. It would further the reforms initiated under the first Industrial Sector Credit (1816-BD) which was approved in 1986, and would sharpen our focus on private sector development. A PCR for ISC-1, to be finalized prior to Board presentation of ISC-2, is expected to show that the policy measures required under the operation have been taken by GOB. Although there were delays in some cases and inadequate follow-up in others, important first steps were taken to improve the trade and investment policy regime: a significant proportion of import controls removed, the maximum tariff rate reduced to 100% for non-luxury goods, export procedures including import duty relief improved, and controls on private investment eased.

8. These preliminary steps have left a need -- and provided a comprehensive basis -- for further progress to be made under ISC-2, i.e. to:

- eliminate the remaining direct controls on imports, prices and private investment decisions,
- streamline the input duty relief schemes and launch a strategy to remove other constraints on export production,
- identify and commence the removal of other obstacles to efficient private production operations,

- continue to use the exchange rate in ensuring competitiveness and defending reserves, and

- rationalize the tariff structure to remove the most serious distortions, further reduce high rates, and prepare the way for future steps towards moderate, uniform effective protection.[1]

These and associated reforms in the indirect taxation system and collection procedures would occur in a way that should preserve or enhance public revenue, and deepen the structural adjustment of the economy within the macro framework which the Government has agreed with IDA and the IMF.

9. The program should complement ongoing financial sector and proposed public enterprise reform (also initiated under ISC-1), and improved public resource management. Together they should establish a policy framework that would facilitate disbursement of the current Export Development Credit (2000-BD), and justify the forthcoming Industrial Investment Credit and further such lending for industry. As indicated in the policy matrix (Annex A of the document), we expect much of the reform program to be at least partially completed before the Credit is effective, with some further implementation or deepening to occur a year later. To complete the industry and trade policy agenda, a third adjustment operation in this area could be envisaged for about FY94; this would support more radical protection reform and the removal of those obstacles to private sector development that may be identified but not yet eliminated under this operation.

10. In view of Bangladesh's continuing critical need for unconstrained program assistance -- exacerbated by the expected strong growth of imports as a result of the resolution of uncertainties caused by the Gulf crisis -- we recommend a credit amount of $100 million, the proceeds to be made available to finance general imports through the secondary foreign exchange market, as other recent adjustment credits have done.

Status of Credit Preparation

11. Considerable staff work has been undertaken during the previous and present fiscal years to prepare the Credit, including the preparation of studies on the import control regime, tariff structure, export incentives and investment regulation. Three pre-appraisal missions have occurred over the past eight months, and substantial agreement has been reached with the Government on most items in the matrix. Outstanding issues on which the appraisal will need to concentrate include recent enhancements to the program: abandonment of the "unofficial Indian border trade" argument for some import controls, the reduction of the top tariff rate to 50% rather than just to 75%, and the proposals that price control, import passbooks and investment sanctioning would be eliminated rather than just relaxed. It will be important also to ensure timely arrangements for the commencement of the import inspection service, introduction of the luxury tax component of the VAT system, and delivery of technical assistance for urgently needed institution building in investment promotion, tariff analysis and export

---

1/ Such steps could be taken only after the proposed operation has brought about clarification of the present tariff regime and strengthened the Government's capacity for protection analysis.

services. The responsible GOB officials (several of whom are recent appointees) appear to be fully aware of these requirements, action on which will need to be rapid to make up for delays during the recent political hiatus. Our latest pre-appraisal mission in January was assured that the officials would welcome a March appraisal to help prepare an agenda for rapid decision making as soon as a new Government is formed.

12. Although the reform program should enhance revenue, it will be necessary to allay Government (and the Region's) concerns about possible adverse effects of the limited but significant trade liberalization that would occur during FY92-93. Thus some technical work remains to be done during appraisal to ascertain the likely revenue impact of replacing quantitative controls with tariffs and replacing high tariff rates with trade-neutral taxes and exchange rate flexibility. It will be necessary also to determine whether any tariff rates presently scheduled for goods to be decontrolled before first tranche release may need adjustment, in order to avoid large, abrupt changes in effective protection pending the tariff analysis during FY92 that could justify such changes. A statistical basis for this preliminary work is in an advanced state of preparation, enabling the necessary analysis to be completed before itemized specifics of the reforms for each year (tranche) are finalized during negotiation of the Credit. It is hoped that negotiations could be completed by early May, enabling the operation to be taken to the Board within FY91.

cc: Messrs. Stern (FINSV); Thalwitz (PRESV); Hussain (LACVP);
Jaycox (AFRVP); Wapenhans (EMNVP); Rajagopalan (PRSVP);
Shihata (LEGVP); Kashiwaya (4)(CFSVP); Wood (FPRVP);
Summers (DECVP); Parmar (CIOVP); El-Rifai (MIGPA);
Frank (CFPVP); Bock (OPNSV); Grilli (2)(EAS); Wyss (CODDR);
Isenman (2)(PRDDR); Linn (3)(CECDR); Rao (IECDR);
Niehuss (CFSVP); Churchill (IENDR); Stoutjeskijk (2)(FRSDR);
Pfeffermann (CEI); Krishna (LEGOP); Brown (IMF);
Asanuma, Groves (AS1DR), Huang, Mitra, Westin (AS1CO);
Temple, Draper (AS1IE); Wiratunga (LOAAS);
Ms. Nordlander (LEGAS)
AIC

CDraper:bd

March 19, 1991

9/03 29010
.1

THE WORLD BANK
Operations Committee

CONFIDENTIAL

DECLASSIFIED
AUG 02 2013
WBG ARCHIVES

Minutes of the Operations Committee meeting to consider
UGANDA - Structural Adjustment Credit: Initiating Memorandum
Held on Monday, March 18, 1991 in Room E-1243

A. Present

Committee	Others
Messrs. M. A. Qureshi, Chairman	Messrs. L. I. Buntua, FPRVP
E.V.K. Jaycox, AFRVP	M. F. Carter, AF2CO
L. Summers, DECVP	S. El Serafy, EAS
D. Bock, OPNSV	Ms. O. Kalantzopoulos, PRD
A. Toft, CFSFA	K. Kapoor, AF2CO
P. Hasan, EMNVP	F. Levy, EAS
E. Segura, LACVP	C. Madavo, AF2DR
B. Kavalsky, FPRVP	Ms. O. Meesook, AF2CO
O. Yenal, ASIVP	P. Miovic, AF2DR
A. Rigo, LEGVP	Mrs. N. Okonjo-Iweala, OPNSV
	Ms. J. Salop, COD
	Ms. G. N. Swamy, AFRCE
	M. Walton, DECVP
	M. Edo, IMF
	G. Kalinga, IMF
	R. Schramm, IMF

B. Issues

1. The Operations Committee met on Monday, March 18, 1991 to consider the Initiating Memorandum for a proposed Structural Adjustment Credit (SAC) for Uganda in the amount of $125 million. The discussion followed broadly the agenda proposed by EAS which, among others, raised the issues of the long-term development goals and Bank strategy; the macroeconomic program and future adjustment operations; the relationship to the Agricultural Sector Adjustment Credit; the new arrangements for exports, imports and the investment authority; the tax reforms; public expenditure rationalization; and adequacy of the tranching and disbursement arrangements, and political risks.

C. Discussion

2. The Macroeconomy and Country Strategy. The Chairman requested the Region to give an account of how they saw the foreign exchange requirements of Uganda in the light of macroeconomic developments, outlining prospects for the medium term and the lending program. The Region said that after an initial period of economic stabilization and recovery, the emphasis now needed to move increasingly to structural reform to improve public sector efficiency, and to promote production and exports, which could only be achieved through the private sector. A broad spectrum of issues needed to

be addressed. In the public sector, these included increasing tax revenues, strengthening expenditure management and allocation, and civil service reform. To promote the private sector they covered improved incentives through liberalized crop marketing, convergence of the parallel and official exchange rates, and also trade policy reforms; continued reduction of inflation and rebuilding a financial sector capable of mobilizing and allocating savings; removal of infrastructure bottlenecks, particularly as concerns road rehabilitation and maintenance; and improving investors' confidence, particularly through parastatal reform and disposal of the Custodian Board properties. Given the broad range of this policy reform agenda, and Uganda's acute foreign exchange shortage, about half of IDA lending would be quick-disbursing and the balance would support priority investment needs in infrastructure, human resources, and capacity building. A base case lending program of $250 million per year was envisaged, assuming continued agreement with the Fund on stabilization and strong implementation of the reform agenda. However, if stabilization remained on track, but structural reform were slower than expected, the lending program would be correspondingly reduced, perhaps to below $200 million a year. A third scenario would be if stabilization efforts faltered, in which case the Bank would retreat to a core program. The proposed SAC operation addressed some of the key elements of the structural reform program, while other elements would be taken up through other operations.

3. Government Commitment and Recent Developments. The Chairman asked if the Government was committed to restoring the nationalized property to its former Asian owners, and whether this was an essential element in improving the investment climate. In response, the Region said that the return of the Asian property was important for restoring the investment climate for manufacturing and trade, but not essential for rural activities. As to Borrower commitment, this was strong at the highest levels, but less so at lower levels, where vested interests were at stake.

4. In response to a request for further discussion of the macroeconomic situation, a member said that the fact that private savings bounced around the way residuals usually did indicated some problems with the underlying macroeconomic framework. The Region added that the shortfall in coffee revenues had created a fiscal problem and affected the current account of the balance of payments, already made worse by high petroleum prices. Defense expenditure remained high, but the stabilization process appeared to be working. Inflation had fallen from an annual rate of 29% at end-1990 to 20% at end-February 1991, which was encouraging and compared with an inflation target this year of 15%. The balance of payments situation, however, was grim, due to a reduced volume of coffee exports, not just low prices. Disbursement of foreign assistance had also been reduced, and the donors had been approached to accelerate disbursements since input shortages had developed. Growth had now been adjusted down to 3-4% instead of 5% as previously projected. The Fund was in Uganda in February for a mid-program review, and would return in April so that a third-year program can be negotiated in May. When this operation is taken to the Board, probably in September 1991, there should be a satisfactory macroeconomic program in place. The Region added that these recent developments should be viewed in perspective, recalling that inflation had been 300% some three years before. In their view the Consultative Group's confidence in Uganda's economic management was on its way of being restored.

5. The Chairman remarked that while he saw many positive aspects in the strategy, it was necessary to demonstrate the Government's commitment to the program, and that the proposed reforms had internal consensus behind them and were not seen as exogenously imposed. The Region assured the Committee that they saw real signs of commitment at all levels to replace the initial hesitation over proposed reforms. The success of the stabilization program played an important role in the change.

6. The Financial Sector and the Financing Gap. The Chairman noted that the situation of financial institutions in Uganda was critical and asked what the Region contemplated for the sector by way of reform? The Region said that a financial sector review had just been completed and discussed with the Government. This indicated what had to be done, including strengthening the role of the Central Bank and restructuring the commercial banks. A future financial sector operation would be incorporating these reforms. To a question by the Chairman as to whether there were any other quick-disbursing operations expected this fiscal year, the answer was no.

7. A member then asked if failure to bridge the financing gap would jeopardize the macroeconomic program. The Region said that there was no rigid figure for a gap that would render the macroeconomic program unviable, but the present program was close to being under-funded. Another member noted the lack of a proper medium-term framework. While this might be difficult to define at present, he said it was necessary for adjustment lending. The current account deficit was projected to rise and fluctuate. Some of the deficit situation was accounted for by the terms of trade, but the reduction in the volume of coffee exports, as the Region had indicated, must be related to the fact that producers were getting only 25% of the export price. If IDA were to lend $250 million a year into a current account deficit of $425 million, was that fair burden-sharing? The Chairman asked if the low producer prices for coffee were consistent with a viable economic framework.

8. Coffee Pricing. The Region responded that they were fully aware of the need to improve incentives to the coffee producers, but during the past two to three years the focus of economic policy had been on stabilization. Now that inflation was reduced, the emphasis could shift to raising returns to the producers. A member asked if low coffee exports were not due in part to leakages across international borders, and the Region's answer was that that was partly true, but also that some coffee was not being picked. The export monopoly of the Coffee Marketing Board had been successfully broken despite initial Government opposition. As to burden-sharing, return of bilateral donor support had been slow and IDA was playing an active role for its restoration.

9. Savings and the Role of Agriculture. The Chairman then enquired about the low level of savings and the large projected balance of payments deficits and whether the answer was simply that IDA should continue to lend. He asked how future growth was to be financed. The Region responded that agriculture would provide the bulk of growth, and that there was great potential for non-coffee crops such as tea, tobacco, cotton and pineapple, and with better pricing and export encouragement these would pick up. Institutional problems needed also to be looked at. The credit under review would make a contribution to agriculture, as some 400 agricultural properties were among those to be returned to their former owners,

including large cotton estates and oil mills. These would now be brought back into production. Agriculture was also a high priority area for public expenditures, and allocations to extension services would be protected in order to raise cotton yields, for instance. Savings were indeed low, partly because real interest rates had been negative until recently. With the drop of inflation and the return of positive real rates, savings had increased. The Region added that they were counting on the private sector to react to the settlement of the nationalization issue. Imports had been high in the past couple of years because of defense expenditure, and it was essential that a satisfactory agreement to prevent its further growth be an element of the SAC. The Chairman said that the best way to handle this issue was to address it through indirect conditionality, and that IDA support should not be provided until that issue was properly taken care of. The Region affirmed that it had taken and would continue to take a strong position on the reduction of military spending.

10. Nationalized Properties, and Other Reforms. A member said that he was not impressed by the measures proposed to raise investment and asked why did we not seek resolution of the nationalized property problem in broad terms without getting enmeshed in details. He queried the significance of the Board presentation condition that 800 properties be disposed off without any indication of their size or importance. He failed to see what the Investment Code would do. The proposed tax reforms were also doubtful; exemptions and rates had already been reduced, and no measures were being proposed or given for technical assistance to improve tax administration and collection. He also noted that civil service reform was unlikely to reduce the fiscal deficit especially since it included significant salary increases.

11. The Chairman asked if there were any plans to help the large numbers of civil servants to be displaced by the reforms, and a member asked for clarification of the role the Investment Authority would play: whether it was regulatory or promotional, and asked how this operation related to the agricultural sector adjustment credit on the issue of coffee prices. He stressed the low level of coffee producer prices and asked if these were consistent with the objective of promoting the private sector. Another member enquired about the number of civil servants to be displaced, and what the wage policy was. Another said the tax provisions were unclear; so was the privatization initiative: what were its objectives and where did we stand now.

12. IFC Role. The Chairman asked whether IFC was represented at the OC meeting. On their absence, the Region noted that they had worked closely with IFC, particularly to review and shape the Investment Code. The Region was expecting the Government to move rapidly on matters of divestiture and privatization once the mechanism had been put in place. The Investment Code had recently been passed into law, and the Authority would license as well as provide incentives to promote investment.

13. Investment, Civil Service and Taxation. A member said that he was not familiar with details, but he saw a need to get the Government out of the role of restricting investment. If the objective was to promote investment, he asked what the instruments of promotion would be. He preferred a simple condition to the effect that the Authority would not restrict investment. The Chairman then said that a distinction should be made between the role of the Authority in respect of domestic and foreign

investments. He saw a potential for a promotional role to serve domestic investment, not via tax incentives, but through provision of advice to small entrepreneurs, improving accounting and auditing practices and the like. The Region said that this in fact conformed to their view and that technical assistance would be provided to help draft operational guidelines through a Technical Assistance operation in parallel with the SAC.

14. The Region added that the Government was now moving fast on civil service reform, and a 30% reduction in civil servants was being pursued. Salaries would have to be raised within the limits of the fiscal constraint. Better revenue performance would have to go hand in hand with increased salaries. Arrangements to assist those who lost their jobs would be an integral part of the program. The Government was looking to donors to provide assistance, and later that week a CG meeting would take place in Paris which would consider Government proposals for civil service reform. The Region was fully aware of the importance of developing long-term capacity in Uganda.

15. On taxes the Region stated that reforms in the tax structure had been addressed under the Second Economic Recovery Credit, but the task of improving tax administration remained. A PRE study had indicated that only 30-40% of potential tax revenue was being collected, and the preappraisal mission had included a tax expert from Ghana: hence the notion of a National Revenue Board. Ghana was able to double the ratio of tax collection to GDP and the hope was the same would happen in Uganda where the ratio would rise to 12-13% in three or four years. Technical assistance would be incorporated in a FY92 Economic and Financial Management Credit.

16. Defense Expenditure and Conditionality. As to conditionality and public expenditure, including defense, the Region said that in earlier credits the Region had sought only to protect education and similar expenditures through conditionality. Now, by constraining overall expenditure and obligating minimum levels of certain desirable expenditures, military expenditure would be squeezed. However, the effects of demobilization on the economy would also have to be considered.

C. Decision

17. In conclusion the Chairman directed the Region to proceed to appraisal along the lines proposed in the Initiating Memorandum, taking into account the guidance given in the OC discussion as summarized above. He asked the Region to pay special attention to the discussion of technical assistance in support of tax administration, the social sectors, the financial sector, civil service reform, nationalized property, and the Investment Authority. He thought the size of the credit was appropriate in the context of the lending program, and added that he looked forward to the CSP which the Region said had just been distributed.

March 29, 1991
SESerafy/lcu
JES

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: March 12, 1991

TO: Operations Committee

FROM: Fred Levy, Acting Director, EAS FL

EXTENSION: 81938

SUBJECT: UGANDA - Structural Adjustment Credit Initiating Memorandum; Operations Committee Meeting Agenda

Security Situation
Set no Macro Economic Poly.
Govt, vision of agri based growth to US
10th gomment committed to vision.
Adjustment process not clear
Civil Service Reform 37%
Social Safety net spent my
Cust Dev. Board
Free them to admin it
Size of the Loan

Monday March 19

1. The Operations Committee will meet on ~~Thursday, March 14~~, 1991, at ~~4:30 p. m.~~ 9.30 in Room 1243 to consider a Structural Adjustment Credit to Uganda in the amount of $125 million. The Committee may wish to take up the following issues for discussion.

Country Strategy

2. No country strategy paper has been produced for Uganda in recent years, and the CSP promised for FY 90 (CSP Initiating Memorandum of February 2, 1990) has not materialized. A Policy Framework Paper covering the period 1990/91 - 1992/93 was considered by the Committee of the Whole in September 1990, however, but this lacks a coherent country strategy for the Bank. Recommended IDA allocation for Uganda in FYs 92-94 is $652 million, i.e. $217 million a year (as compared with a "norm" of $189 million) and IDA lending was $214.5 million in FY 90. The MIS shows projected lending in the current fiscal year at $276.7 million; and in the next fiscal years at $240 million, $220 million and $208 million, respectively. Relative to total lending, adjustment lending was 59% in FY 90 and would amount of 37% in the current fiscal year, and is projected at 52% and 68% in the coming two fiscal years, respectively. Military takes 50%

- The Region might outline the salient features of the Bank's country strategy to realize Uganda's longer term development goals, and indicate the role of adjustment lending in the overall strategy.

- How would the level and composition of lending respond to performance and when can a CSP be expected?

Adjustment Lending and the Macroeconomic Program

3. Adjustment lending to Uganda began in FY 88 with the first Economic Recovery Credit, which, aside from shorter term issues, focused on public sector reform, including rationalizing foreign exchange allocation. This was followed by a second operation in FY 90 also attending to stabilization and rehabilitation concerns. Efforts towards economic recovery under these two credits were supported by an IMF arrangement under the Fund's Structural Adjustment Facility (SAF), in conjunction with substantial bilateral assistance, and later by an

Enhanced Structural Adjustment Facility (ESAF). Features of the programs have included exchange rate adjustments, price deregulation, public sector investment rationalization, rehabilitation of infrastructure and productive capacity, public enterprise reforms, financial sector reforms and social sector development, especially to improve access by the poor. Further improvements in the exchange rate and the trade regime were to follow.

4. "Economic recovery" has now given way to structural adjustment, starting from the current fiscal year, with an Agriculture Sector Adjustment Credit for $100 million, approved in December 1990, and the proposed SAC which is expected to be taken to the Board in September 1991.

- The Region might outline the process of structural adjustment envisaged for Uganda.

- The Region might also update the Committee on the state of the macroeconomic program and if this is likely to be acceptable at the time of Board presentation.

The Proposed Credit

5. The proposed credit would remove remaining constraints on the private sector and improve incentives and government effectiveness. Six components are delineated: (a) further trade liberalization; (b) the establishment of an Investment Authority; (c) resolution of claims on nationalized property; (d) establishment of an independent revenue authority to improve tax collection; (e) reorientation of public expenditures to protect health, education, road maintenance, water supply and agricultural extension; and (f) rationalization of the civil service.

- Are the objectives too numerous to provide the operation with a definite focus?

Coffee Prices and the Agricultural Sector Adjustment Credit

6. The Initiating Memorandum (para. 41) describes how coffee exporters cannot take advantage of the foreign exchange rates offered by the exchange bureaus, but that the government has sought to compensate them since July 1990 by raising the coffee producer prices; "although the share of the coffee producer price in the export price (valued at the parallel market exchange rate) has been rising, it is still below one-quarter". And yet, para. 89 of the President's Report for the Agricultural Sector Adjustment Credit stresses that "upward adjustments of coffee producer prices are necessary to prevent a decline in coffee production". The Initiating Memorandum further describes a process of moving the official exchange rate toward the parallel rate "at a brisk pace" -- faster in fact than had already been agreed under the 1990/91 - 1992/93 PFP (Initiating Memorandum, para. 44). So?

– Domestic Savings Inv.

–

- Would the Region explain the overlap between this operation and the Agricutlural Sector Adjustment Credit in respect of coffee prices, indicating the timetable envisaged for coffee producer price adjustments consistent with efficient resource allocation?

Export-Import Regulatory System

7. Progress has been made on adjusting the exchange rate with a 56% real effective depreciation occurring between the second quarter of 1987 and the third quarter of 1990. Progress has also been made on reforming the import regime, and improving access by importers to foreign exchange. An open general-license-type system assures access to foreign exchange by manufacturers in selected sub-sectors, supplemented by a Special Import Program serving all importers on a first-come first-served basis. Other importers suffer discrimination also as a result of many inefficiencies in program administration. The accelerated pace of exchange rate depreciation will hasten reforms of the administrative system, and help eliminate the subsidies obtained by the licensed importers. Negative import and export lists would be agreed by appraisal, and an export certification system set up by negotiations, requiring only exporter registration. A tax credit system and procedures for refunding import duties on inputs would also be firmed up at appraisal.

- The Region might clarify the differences between the old and new systems, and indicate if the new arrangements could survive a dip in foreign exchange earnings.

- What are the likely new exports and how elastic is their supply in response to currency depreciation?

The Investment Authority

8. A new investment code was announced in January 1991 simplifying regulations governing investments. By appraisal, it is expected that staff would be in place and procedures established for processing investment licensing. A review is also expected of the earlier (1969) Industrial Licensing Act, which would be repealed by the time of Board presentation, when the proposed Investment Authority would have been established.

Explain why you need it. Promotional role – // clearing role

- The Committee may wish to enquire why an Investment Authority is required at all?

- What connection, if any, would this Investment Authority have with settling outstanding claims of foreign investors (para. 50)?

9. Tax and Public Expenditure Reforms

- Can the Region outline the broad provisions of the tax reform, indicating what is structural and what is not in these reforms and when and by how much these reforms are expected to make a difference to revenues?

- Can a set of criteria be elaborated to clarify the intended improvement in public expenditure allocation beyond IDA satisfaction with expenditures?

Loan Amount, Tranching and Procurement

10. Two tranches are planned 12 months apart, to finance a negative list of imports. A special account will be established to facilitate disbursement. An inter-ministerial coordinating group will be established to oversee implementation. The Committee may wish to consider:

- If the reform program is adequate in comparison with the large amount of the credit.

- If the tranching and special account format are acceptable.

- If the risks to the program (mainly the political sensitivity of the Custodian Board property issue, and weak administrative capability) are acceptable.

Operations Commmittee

Messrs. Qureshi, OPNSV
Shihata, LEGVP
Wood, FPRVP
Summers, DECVP/Rajagopalan, PREVP
Kashiwaya, CFSVP
Jaycox, AFRVP
Karaosmanoglu, ASIVP
Wapenhans, EMNVP
Husain, LACVP
Bock, OPNSV

cc: Messrs./Mmes Madavo, Goldberg, Wyss, Isenman, Linn, Stoutjesdijk, Picciotto, Burmester/Thahane, Carter, Miovic, El Serafy, Okonjo-Iweala, Kapoor, Parmar, Pfeffermann, Rao, Kavalsky, Sandstrom, Liebenthal, Kilby, Robless, Khanna

SESerafy:sb

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

91030605 1.

DATE: March 5, 1991

TO: Mr. Moeen A. Qureshi, Senior Vice President, OPNSV

FROM: Michael J. Gillette, Acting Vice President, Africa Region

EXTENSION: 35040

SUBJECT: UGANDA: Initiating Memorandum for the Structural Adjustment Credit

1. Through the attached Initiating Memorandum we are seeking approval by the Operations Committee to appraise a US$125 million structural adjustment credit for Uganda. The proposed credit would reimburse 100 percent of the foreign exchange costs of eligible imports, with eligibility determined by a negative list, and would be disbursed in two tranches.

2. Uganda has been implementing an Economic Recovery Programme since 1987; this has been supported by IDA through two economic recovery credits and by the IMF through arrangements under the Structural Adjustment Facility and the Enhanced Structural Adjustment Facility. The fourth-year Policy Framework Paper (1990/91-1992/93) was discussed by the Committee of the Whole in September 1990. The Fund carried out its mid-term review of the second-year ESAF in February 1991 which will be concluded in April.

3. Over the past three years, the Government has made significant progress in restoring peace and security, facilitating general economic recovery, and achieving greater financial stability. The stage is now set for the Government to place greater emphasis on addressing underlying structural impediments not only to deal with critical short-term problems (particularly, further reducing inflation and coping with the difficult balance of payments situation) but, more importantly, to ensure sustainable growth and improved quality of life for its people in the medium-to-long term. This will require further reforms in the incentives and regulatory framework to facilitate and sustain sources of growth; significant improvements in the devastated economic and social infrastructure and services; and a concerted attempt at institutional strengthening and capacity building. In other words, emphasis now needs to shift from general economic recovery to structural reform and adjustment.

4. The proposed credit focuses on two themes. The first is the removal of the remaining constraints on the private sector and the creation of an environment in which private initiative can flourish and Uganda's comparative advantage can be realized. The second is the improvement in the effectiveness of the Government. The credit has six components. First, it seeks to improve the trade regime by further easing restrictions on exports and imports, and removing the implicit exchange rate subsidies given to selected importers. Second, it aims to promote investments through the establishment of an Investment Authority and its operational guidelines as provided for under the Investment Code. Third, it will speed up the resolution of claims on Custodian Board properties (ie. properties taken over by the Government when their owners were expelled from Uganda by the Idi Amin regime in 1972). This will provide an important signal to investors, particularly

foreign investors, that Uganda is once again ready and willing to work with them and no longer has a hostile attitude towards foreign investment. Fourth, the credit seeks to improve the Government's revenue collection through the establishment of an independent revenue authority and some tax measures such as removal of exemptions. Fifth, it aims to reorient public expenditure allocations; among other things, it will seek to protect a set of priority programs in primary health, primary and secondary education, road maintenance, water supply, and agricultural research and extension. Finally, the credit will support a program to transform the civil service into a small, efficient, effective and manageable service.

5. A major point of likely dispute with country authorities is the disposal of Custodian Board properties. This component has been included because it would be singularly beneficial to Uganda's investment climate for the Government to be seen to make a good-faith effort to resolve the Custodian Board issue. However, as may be expected, the matter is highly sensitive and, even though the Government asserts that its policy concerning the Custodian Board properties is clear and in place, in practice vested interests have thrown many obstacles in the way of a speedy disposal of the properties. Particularly worrisome is the apparent disagreement between the Government and the courts on some crucial legal aspects concerning the status of a large number of properties which the courts have ruled were never legally expropriated (even though the Custodian Board took custody of them) and hence are not covered by the Expropriated Properties Act passed by Parliament in 1982. The Government is proposing to amend the 1982 Act to legalize its own position, among other things; it is expected that this will be thrown out by the courts as being unconstitutional. The design of this component of the credit follows the position taken by the courts, and the Government may well dispute our position.

6. Another difficult area is civil service reform. The Government appears committed to carrying out a major reform based on the recommendations of the Public Service Review and Reorganisation Commission. However, some of them will be very difficult politically to carry out, for example the reduction in the number of ministries (and hence ministers) and a major retrenchment of civil servants (of the order of 30 percent of the total). It is not clear at this stage how intense the resistance to civil service reform will be.

Attachment

cc: Members of the Operations Committee:
Messrs. S. Husain (LACVP); E. Jaycox (o/r) (AFRVP); A. Karaosmanoglu (AS1VP); W. Wapenhans (EMNVP); V. Rajagopalan (PRSVP); L. Summers (DECVP); I. Shihata (LEGVP); K. Kashiwaya (CFSVP); D.J. Wood (FPRVP); D. Bock (OPNSV)

cc:
Messrs/Mmes. T. Thahane, S. Burmester (SECGE); N. Okonjo-Iweala (OPNSV); H. Wyss (COD); E. Grilli, F. Lysy, A. Ray, El Serafy (EAS); P. Isenman (PRD); Linn (CEC); A. Stoutjesdijk (FRS); R. Picciotto (CPB); D. Goldberg (LEGOP); S. Sandstrom (EXC); G. Swamy (AFRCE); G. Reif (PRDRA); C. Madavo, P. Miovic, F. Lethem (AF2DR); M. Carter, G. Gebhart, A. Vaughn, S. Pradhan, Y. Ansu, K. Kapoor, I. Knapp, L. Roberts, C. Obidegwu, E. de Leon (AF2CO); J. Shivakumar, L. Vidaeus, F. Walker, J.

Stemp, G. Mohadjer, K. Loganathan (AF2AG); R. Hindle, J. Franz, S. Dhingra, I. Aleem, A. Sparkes, A. Malik, J. Warren, D. White, A. Sumer, D. Bhattasali, R. Castro (AF2IE); J. Brown, H. Goris, G. Tschannerl, R. Beardmore, P. Sooh (AF2IN); D. Mahar, V. Jagdish, N. Colletta, J. Armstrong, B. Jones (AF2PH); I. Serageldin, L. E. Derbez (AFT); A. Taufique (IFC); A. Zerabruk (LEGAF); D. Reedy (LOAAF); A. Alizai (IFC); K. Miller (RMEA); S. Choi, E. Ablo (AF2UG); R. Williams, G. Kalinga (IMF)

cc for information:
Messrs/Mmes. J. Parmar (IFC-CIO); D.C. Rao (IEC); B. Kavalsky (FRM); G. Pfeffermann (IFC-CEI); R. Liebenthal (PRD); F. Kilby (FRS); C.L. Robless (OPNSV); M. Walton (DECVP); A. Khanna (EXC); S. O'Brien (AFRCE); AFR ISC

OAMeesook:oam