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M. QURESHI'S
OPERATIONS CMTE

January 18 - March 8, 1991

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Operations Committee

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Minutes of the Operations Committee to Consider the

MADAGASCAR - Investment & Export Promotion Adjustment Credit

Held on Friday, March 8, 1991, at 3:00 p.m. in Room E-1243

A. **PRESENT**

Committee	Others
Messrs. M.A. Qureshi (Chairman)	Messrs./Mmes. G. Swamy (AFRCE)
D. de Tray (DECVP)	N. Okonjo-Iweala (OPNSV)
W. Grais (EMNVP)	F. Aguirre-Sacasa (AF3DR)
M. Gillette (AFRVP)	A. Benbrahim (AF3CO)
S. Husain (LACVP)	M. Fardi (PRDRA)
B. Kavalsky (FPRVP)	N. Gorjestani (AF3CO)
K. Kashiwaya (CFSVP)	E. Grilli (EASDR)
A. Karaosmanoglu (ASIVP)	K. Larreq (FRM)
H. Scott (LEGVP)	P. Le Houerou (AF3CO)
	F. Peloschek (LEGAF)
	R.O. Carstens (IMF)

B. **ISSUES AND DISCUSSION**

1. **The meeting was called to discuss the Initiating Memorandum for the Investment and Export Promotion Credit in Madagascar in the amount of $50 million.** The discussion was based on an agenda prepared by EAS. In its opening remarks the Region noted the major economic policy achievements secured in Madagascar with Bank support. These included, inter alia, a reduction in the size and role of the State and a more open market-oriented economy. There has also been considerable progress on the political front. It also noted that the economy had deteriorated in 1990 but the devaluations in late 1990, and in January 1991, have returned the exchange rate, in real terms, to the same level as in 1989 when the trade account was in balance. The Region expects that the

exchange rate will be adjusted through a series of mini-devaluations to offset domestic/foreign inflation differentials as they occur. It also proposes that the foreign exchange allocation system be amended to liberalize the essential services that are needed to conduct business. More specifically the Region expects that by the time of the next adjustment credit following the proposed operation there will be liberalization of foreign exchange allocations for all goods and non-factor services. The ultimate goal would be to attain full convertibility of the local currency, something that has not yet been attained by Mauritius. As further evidence of the competitiveness of the currency, the Region cited the lack of a premium in the parallel market; it also noted that at current exchange rates local wages are about half the level in Comoros and one-quarter the level in Mauritius. The IMF representative supported the Region's assessment that the exchange rate was not overvalued at this time, being comparable in real terms to the level reached in 1987, after a 60 percent devaluation.

2. The Chairman asked why it was not possible to decontrol foreign exchange allocations faster if the exchange rate was correct. The Fund representative answered that the proposed decontrol of foreign exchange allocations would be a gamble since it was uncertain that enough capital inflows would occur. Another Committee member, who questioned the proposed credit, wondered why the Bank should be so involved in pushing for removal of foreign exchange controls while the Fund believes nothing is wrong. Another member suggested that there ought to be a mechanism for systematic revisions in the exchange rate regime. He also suggested that if the exchange rate was right then the vanilla sector reforms should be pushed harder. The Region responded that the "heart and soul" of this operation would be the elimination of policy distortions which undermined private sector confidence in the economy. To this end, the operation was linked to improvements in the foreign exchange regime and to the elimination of legal and regulatory restrictions on the establishment and closings of enterprises, on labor mobility and on other matters that hinder business such as the acquisition of real property by foreign investors. The conditionality related to improving the business environment would be upfront.

3. In answer to another question about potential exports and the debt situation, the Region identified textiles as the most promising non-traditional sector for foreign investors. On debt the Region noted that Madagascar has scrupulously serviced all debt on time. As a result, secondary market discounts on its debt are small. It will have to obtain further relief from the Paris Club. Even though the level of debt is very high at this point, both the level and the hardness are expected to go down gradually. In answer to another question on the assumed savings performance in the projections, the Region said that the framework, which was adopted from the PFP, needed to be reviewed in the light of 1990 data; it acknowledged that all macroprojections would need serious revisions if the projected major increase in national savings could no longer be assumed. However, the Region felt that the savings targets were reachable because of the financial sector reforms that have occurred and because of expected improvements in fiscal management.

4. The discussion then turned to vanilla and petroleum sectors. On vanilla, the Region said that the situation has not yet been fully analyzed. Our objective would be to open a dialogue and to study the situation in order to get a better handle on it before firming up conditionality. Regarding gradualism in the petroleum sector, the Region said that this is a very sensitive area politically, particularly in the wake of the Gulf crisis, but prices are not as distorted as was suggested in paragraph 60 of the IM. Here, again, more information is needed before specific conditionality could be designed.

5. The Chairman invited comments on the single-tranching approach proposed in the IM. One member said that there have been only a few exceptions to the multi-tranche rule - in China, Indonesia and Thailand. But the rationale for these exceptions was very different in those cases. In Indonesia, for example, the track record is very good which means that single-tranching carries little risk. To use that approach in Madagascar, however, would create a precedent for all countries with poor implementation records, and might create pressures for finding areas where the country's performance justified additional loans even though the country's performance as a whole was not on track. Another member said that single-tranching would create a discontinuity in dialogue. The Region acknowledged that single-tranching was not the only way to induce adjustment. Indeed the traditional multi-tranche approach has yielded some important benefits in Madagascar, albeit at some cost. The proposed approach would signal to the authorities that they need better management of the economy and that future adjustment operations would be "rewards" for up-front reforms. A series of single-tranche operations would be linked to a "road map" (the Letter of Development Policy and the PFP) which would be responsive to changing circumstances.

6. The Chairman said that while he is not against innovative and unorthodox approaches, he did not see the advantage that single-tranching would offer over the traditional approach in this case. Moreover, except when the track record is really outstanding, the multi-tranche structure is better suited for sustaining country dialogues and for ensuring ownership of policy reforms by the borrowers. With single-tranching, we must avoid creating any impression that the Bank is paying for policy actions by borrowers. Furthermore, the Board is unlikely to agree to any such proposal on single-tranching given that it is reluctant to extend the Indonesia approach to even good performers like Mexico.

7. The Chairman recommended that the Region revert back to the multi-tranche approach, and reformulate the presentation of the credit on the key issues of domestic deregulations and business environment. He also suggested that the Region seek faster elimination of exchange restrictions. Measures to promote exports should be built around the core focus on deregulations. The amount of the credit should be explicitly justified on BOP grounds, taking full account of the actions by others.

8. The Chairman also suggested that if second tranche conditionality cannot be precisely identified at this time, then one could initially consider using less well-defined conditions, with mid-term reviews between tranche releases being used to make them more specific. A member noted that these conditions would have to be worked out carefully to ensure that they are not so undefined as to raise concerns at the Board. The Region agreed to resubmit an operation with at least two tranches with conditionality and proposed credit amount spelled out, taking into account the Chairman's suggestions. The Region pointed out, however, that the suggestions in paragraph 4 of the agenda would not be appropriate conditions because they would tend to overlap with conditionality of existing credits.

March 11, 1991

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THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

I am basically looking to longer term arrangement 3-5 years, not shorten them

DATE: March 5, 1991

TO: Operations Committee

FROM: EG Enzo Grilli, Director, EAS

EXTENSION: 81934/5

SUBJECT: MADAGASCAR: Proposed Investment and Export Promotion Adjustment Credit (IEPAC) - Initiating Memorandum - Agenda

1. The Operations Committee will meet on Friday, March 8, 1991 at 3:00 p.m. in Room E-1243 to consider the Initiating Memorandum for the proposed credit. The credit would disburse in one tranche against general imports, subject to a negative list, and would be for $50 million. This amount corresponds to what would have been the first tranche of the multi-tranche credit of $125 million that was originally included in the lending program. This would be the fifth of a series of adjustment credits to Madagascar.

Issues

2. Despite the progress Madagascar has made in its adjustment program since 1985, there still remains basic worries about the macroeconomic fundamentals. For most of 1989 and 1990, the GOM refused to change the nominal exchange rate, a period over which the trade account moved into a large deficit. This in turn led to a sharp increase in the external current account, so that the level of discretionary reserves fell to nearly zero by the end of 1990. While the GOM did devalue the currency towards the end of 1990, and then again in January, the exchange rate remains highly overvalued, being supported by a wide array of exchange restrictions. The viability of Madagascar's development strategy continues to be a matter of concern because of the overvalued exchange rate, declining traditional exports and stagnating non-traditional exports, a very low domestic savings effort, and a large debt service ratio. It might be helpful if the Region elaborates upon its views of:

- the macroeconomic framework. Is there a basis for expecting the GOM to agree to frequent adjustments of the exchange rate? Is there a coherent strategy of reforms over the next few years?

  5 years to dismantle restrictions

- what is the attitude of the Fund and other donors? How secure is external financing and future debt reliefs?

3. Turning to the proposed credit, there are two types of issues: first, the significance of the proposed measures and their feasibility, and second, the importance of follow-up actions. It is important to review the dependence of the conditionality on follow-up

It looks as if you have picked a measure here + a measure there and then are mostly action PLANS not actions

since the Region wants the credit to be a one-tranche operation. While single-tranching would increase flexibility at subsequent phases, it would also entail higher risks of the necessary follow-up being abandoned or softened because of changing circumstances and priorities. The Committee might discuss:

- foreign exchange allocations. The credit would support the partial opening up of the capital and services accounts. It would also help relax the control of allocations for imports. The IM states that "further progress towards increased convertibility of the currency would be implemented in phases extending over a period of approximately five years (para. 28)." Would the Region explain (a) the significance of the measures to be taken by effectiveness within the overall program of dismantling the control system; why not also include measures to help exporters of non-traditional products (e.g., retention of some foreign earnings abroad, compensation for controls on imported inputs etc.); and (b) the possibility of expediting the reforms by further depreciations of the currency. What does the Region have in mind regarding minimum progress prior to the next adjustment credit in FY92?

  remove restrictions by depreciating state profits

- vanilla exports. The declining trend in Madagascar's share in world trade is a major concern and the IM rightly proposes moves towards an Indonesia-type of liberal policy. But we expect only an action plan by effectiveness. Would the Region explain the main difficulties, if any, likely to be encountered in the subsequent implementation of the action plan prior to the next adjustment credit in FY92?

- petroleum sector. The IM suggests that prices in this sector have little relationship to opportunity costs. The action plan to be agreed upon under this credit would not however be linked to the next adjustment credit, but rather to a future petroleum sector project in FY93 (para. 61). Would the Region explain the reasons for this gradualism? Is an action plan at all necessary before the main price distortions are corrected?

- the legal environment. How difficult is it to revise Ordinance #73019 restricting labor mobility, and entry and exit of firms, or to amend Law #62006 to allow foreigners to acquire real estate? Would the Region comment on how significant these and other measures in this category are, and the need to include them under this credit? Will these measures be enough or are there complementary actions that need to be taken to promote factor mobility, foreign investments, etc?

- single-tranching. The dependence on follow-up will be high for the insurance sector reform: the only action before effectiveness would be the elimination of restrictions on brokers' choice of the insurance company to represent (the elimination of state monopoly and privatization will follow later). Only in air transport would the follow-up action be relatively easy - transfer of responsibility for monitoring air safety rules from Air Madagascar to GOM. Given the poor implementation record in the country and given the high dependence of conditionality on follow-up, would it be advisable to adopt the single-tranching approach? Are there alternative ways of improving implementation: for example, backloading of money on later tranches to increase the penalty for delays and non-compliance, enhanced supervision, etc?

Absolutely

4. The Committee might also wish to consider whether this credit should be redesigned to support reforms in such other areas as trade, public enterprises, and public finance:

- trade. Now that the ITPAC credit is closed, there might be a need to assist the Government to carry out the fourth-year segment of its tariff reform program and to help it design the fifth-year program (para. 31);

Is it closed

- public enterprises. Similarly, there might be a case for including measures, additional to PSAC, to expedite the reforms of public enterprises;

Public Sector Card

- taxation. Given that Madagascar has one of the lowest tax/GDP ratios in Sub-Saharan Africa, it might be desirable to promote changes in the tax system to broaden the tax base and to improve collection of revenues;

- public expenditures. Should we consider conditionality regarding public expenditures, especially as they are directed to social sectors?

There are all good areas

What is the program in these areas

Operations Committee

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

cc: Messrs. Thahane/Burmester, SECGE; Picciotto, CPB; Goldberg, LEGOP; Wyss, COD; Sandstrom, EXC; Isenman, PRD; Linn, CEC; Stoutjesdijk, FRS; (Ms.) Okonjo-Iweala, OPNSV; Parmar, IFC-CIO; Rao, IEC; Kavalsky, FRM; Pfeffermann, IFC-CEI; Liebenthal, PRD; Kilby, FRS; Robless, OPNSV; Walton, DECVP; Khanna, EXC; O'Brien, AFRVP; Aguirre-Sacasa, Varon, Gorjestani, Benbrahim, Le Houerou, AF3.

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Possibly

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: February 21, 1991

TO: Mr. E.V.K. Jaycox, Acting Senior Vice President, OPNSV

FROM: Alain Colliou, Acting Director, AF3

EXTENSION: 34196

SUBJECT: **MADAGASCAR - Initiating Memorandum for a Proposed Investment and Export Promotion Adjustment Credit**

1. Attached for consideration by the Operations Committee (OC) is an Initiating Memorandum (IM) requesting authorization to appraise a proposed Investment and Export Promotion Adjustment Credit (IEPAC) in the amount of US$50 million in support of the next phase of the Government's adjustment program.

2. Since the mid-80s, Madagascar has made significant progress in opening and transforming its inward-looking, command economy and after almost two decades of continuous decline, the country has experienced GDP per capita growth since 1988. While encouraging, the recovery is fragile and its sustainability critically hinges on successful efforts to increase private investment -- particularly from abroad -- and to promote rapid export diversification and expansion.

3. In March 1990, the Government prepared, with the assistance of Bank and IMF staff, its third consecutive three-year PFP (1990-92) which charts new policies to promote private sector development while preserving international competitiveness and further improving public resource management. Cast within this framework, the main objectives of the proposed operation are to further foster the emergence of an enabling environment for private investment, export expansion and efficient resource allocation.

4. Madagascar's economic conditions are rapidly evolving and in 1990, financial performance was seriously affected by a surge in imports and a stagnation of non-traditional exports. The negative impact on the country's external position--owing largely to complacency on the part of the authorities in the areas of exchange rate and credit policy--was further compounded by a major rise in the oil bill, a continued trend decline in the value of traditional exports, and a shortfall in external assistance disbursements due to policy slippage. As a result, freely usable reserves, which earlier in the year averaged the equivalent of six months of imports were exhausted by end-1990. Given Madagascar's large debt overhang (service on its debt is equal to 60 percent of export receipts after rescheduling), the country's growth prospects and its ability to continue mobilizing external financial support could be endangered unless firm actions are taken to improve the viability of its external position in the context of prudent fiscal and monetary policy.

5. The 1990 setback notwithstanding, the Government remains firmly committed to the adjustment process. In a recent annual address to the nation and in a letter to Mr. Conable, the President of Madagascar confirmed his Government's determination to pursue and deepen the program of reform and announced major elements of the IEPAC-supported program including: (i) a 13 percent devaluation of the Malagasy franc; (ii) further reform of the foreign exchange regime including the opening up of the service account; and (iii) the revamping of the regulatory, legal and incentive framework governing private sector development. The President also announced a plan and timetable to revise the country's constitution, which is still imbued with socialist principles, with a view to adapting it to the evolving liberal economic environment. This development complements the advent of a multiparty system, increasingly open elections and, more recently, the formal abolition of press censorship. The planned revision of the constitution marks an important new step in the political liberalization that has accompanied the transformation of the economy, although clearly, the country is still in a period of transition on both fronts.

6. A special feature of the proposed credit is its one tranche design, whereby we would expect upfront implementation of all the key actions prior to credit effectiveness. Specifically, the Government's Letter of Development Policy would outline the immediate reforms to be taken under the IEPAC as well as a "road map" of further actions to be completed over the next three years to promote private investment and exports. We would make it clear to the Government that progress on "road map" actions would condition consideration of a follow-up single tranche operation next fiscal year. If implementation is not satisfactory, we would withhold the next operation, instead of delaying a tranche release, if this were a multi-tranche operation. The approach provides the Bank maximum flexibility to adapt adjustment lending to country performance and assistance requirements. If economic conditions so warrant, we would have the flexibility to add or modify the specific measures along the way. Finally, we would have the flexibility to modify the amount of the subsequent credit in line with the evolving assistance requirements.

7. An amount of US$125 million has been allocated for the IEPAC in the FY91 lending program to help meet Madagascar's financing requirements over the 1991-1992 period. However, we recommend a credit of US$50 million, in keeping with the design feature of the proposed credit. We would expect the follow up credit to be of a similar magnitude. The proposed credit amount is appropriate to make a major contribution to Madagascar's financing requirements in 1991, on the expectation that additional needs would be fully met from other sources which have been already identified in the framework of SPA II.

cc: Messrs. Hussain (LACVP), Jaycox (AFRVP), Karaosmanoglu (ASIVP), Wapenhans (EMNVP), Rajagopalan, Linn (PRE), Shihata (LEGVP), Kashiwaya (CFSVP), Wood (FPRVP), Bock (OPNSV), Wyss (COD), Grilli (EAS), Isenman (PRD), Stoutjesdijk (FRS), Rao (IEC), Picciotto (CPB)

Mesdames/Messrs. Sandstrom, A. Khanna (EXC), Robless, Okonjo-Iweala (OPNSVP), Burmeister/Thahane (SECGE), Goldberg (LEGOP), Kavalsky (FRM), O'Brien, Armstrong, Martinez, Ohri, Swamy (AFRVP), Serageldin (AFTDR), Fardi, Liebenthal (PRDRA), Ray, Sicat (EAS), Varon, Chevallier, Gorjestani, Benbrahim, Le Houerou, Schiavo-Campo, Demangel, Ordoubadi, Ibrahim, Eap (AF3CO), Otten, Blarel, Bolduc, Ribon, Siméon (AF3AG), Sarris, Millan, Nair (AF3IE), Colliou, Blay, de Gaiffier, Khan, Laederach, Pierre-Louis, Sherburne-Benz (AF3PH), Blanc, Benouahi, Bostrom, Dreau, Grimes, Labeau (AF3IN), Peloschek (LEGAF), Boulch (LOAAC), Carstens, Rajcoomar (IMF)

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Minutes of the Operations Committee to Consider the

COMOROS - Macro-Economic Reform and Capacity Building Credit (MERCAP): Initiating Memorandum

Held on Friday, March 8, 1991, at 4:00 p.m. in Room E-1243

A. **Present**

Committee

Messrs. M.A. Qureshi (Chairman)
D. De Tray (DECVP)
M. Gillette (AFRVP)
W. Grais (EMNVP)
S. Husain (LACVP)
A. Karaosmanoglu (ASIVP)
H. Scott (LEGVP)
J. Shilling (CFSVP)
(Ms.) L. Yap (FPRVP)

Others

Messrs./ Mmes. F. Aguirre-Sacasa (AF3DR)
P. Demangel (AF3CO)
M. Fardi (PRDRA)
N. Gorjestani (AF3CO)
E. Grilli (EASDR)
K. Larreq (FRM)
N. Okonjo-Iweala (OPNSP)
F. Peloschek (LEGAF)
A. Ray (EAS)
S. Schiavo-Campo (AF3CO)
G. Swamy (AFRCE)
A. Jbili (IMF)

B. **ISSUES AND DISCUSSION**

1. The Operations Committee met on March 8, 1991, to discuss the Initiating Memorandum for the above-mentioned credit on the basis of an agenda prepared by EAS. The Chairman opened the discussion with two sets of issues: a) the proposed amount is about half the three-year allocation; why such a large amount in the first year, and why so large in relation to the Fund's contribution? b) what will be achieved by this operation in terms of a lasting contribution to development? Given the very heavy dependence of Comoros on foreign grants, what is IDA's role? What is the justification for providing budgetary support in this situation rather than financing a traditional operation? The Region responded that this is a country with a very limited potential; in a recent review of country strategy, the Board suggested that the Bank should not abandon the country because of that limitation. This operation, in conjunction with what the IMF and African Development Bank are proposing to do, should result in financial stabilization and some preconditions for growth. The proposed civil service actions would be major; also, when this operation is done, the Government will be out of all activities in which it should not be

involved. The Region also noted that the increasing numbers of importers in meat, cement and rice, are reducing concentration of power. It further noted that the exchange rate issue cannot be resolved since Comoros is in the CFA zone.

2. The Chairman asked if the civil service wage reductions are going to be enough, an issue raised in paragraph 3 of the agenda. He also asked whether it would be better to reduce the quick-disbursing component, say by half, to finance a traditional operation aimed at the "little nitty gritty" things needed to boost productivity and growth", e.g. credit for small businesses. Regarding the adequacy of civil service wage reductions, the Region noted that the civil service is being cut by over 20%. This will reduce real wages and improve competitiveness, although not sufficiently to correct the overvaluation of the currency. Regarding financing, a member enquired whether it was realistic to assume positive net transfers on the part of each donor in addition to having all arrears cleared. The Region said that of the $8 million proposed for balance of payments support, $2 million would offset the effects of the Gulf war. The remaining amount is needed because we are concerned about underfinancing and because of its linkage to $18 million of cofinancing from the African Development Bank. It was noted that the Bank would not be financing the clearance of any arrears since that is a condition of the Fund's program in any event. It was further noted that $4 million is the maximum amount of Fund support under the SAF (under the present quota). According to the Fund representative, an ESAF might be considered next year to enable higher Fund support if the track record improves sufficiently.

3. Some Committee members supported the idea of splitting the credit evenly between the two types of operations outlined by the Chairman. One member wondered whether the program would amount to substantial liberalization or whether it would merely ease the life of the elite and the expatriates by liberalizing such items as luxury rice and cigarettes. He also wondered if the hotels were locally managed or managed by expatriates. The Region responded that full liberalization was the ultimate objective; in the case of the hotels, privatization would be a meaningful change since expatriates are not currently involved with management. The South Africans have expressed strong interest. The Region added that it would encourage the Government to subsidise ordinary rice and kerosene but without compromising budgetary targets. It would also encourage the Government to ensure adequate social safety-nets. The next IDA operation will deal more comprehensively with social problems.

4. In conclusion, the Region proposed to keep options open at this stage regarding the size of the proposed operation. The Chairman agreed, but he added that he has serious reservations about the proposed role for IDA, which is more like the Fund's traditional role. While he would readily support the idea of helping Comoros meet the adverse effects of the Gulf war ($2 million), he would look forward to a much stronger justification for providing the entire amount proposed; he suggested that the Region be "hard as nails" regarding burden sharing with other donors.

March 11, 1991

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THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: February 27, 1991

TO: Operations Committee

FROM: Enzo Grilli, Director, EAS

EXTENSION: 81934/5

$ 14
$ 20 million a year

SUBJECT: COMOROS: Macro-Economic Reform and Capacity Building Credit (MERCAP) - Initiating Memorandum - Agenda

(10)

Friday, March 8

1. The Operations Committee will meet on ~~Monday, March 4~~ at ~~12:00 noon~~ 4:00 pm in Room E-1243 to discuss the Initiating Memorandum for the above credit. This would be the first adjustment credit to Comoros, in the amount of $10 million (including a technical assistance component of $2 million). It is expected that this credit would be accompanied by a SAF from the Fund and would also allow Comoros to become eligible for SPA II.

2. The OC first considered an Initiating Memorandum for a macroeconomic management credit in June, 1988. Among the concerns expressed at that time were political instability and administrative weakness, difficulties in designing surrogate exchange rate actions and in reducing fiscal deficits, and burden-sharing with other donors. As explained in detail in this IM, much has happened since then, especially in the political arena. Since early 1990, general presidential elections have been held, a new constitution is being formulated and legislative elections are scheduled for this year. The Government intends to prepare a study of the country's long-term prospects and generate a national consensus around its structural adjustment program. The essential economic issues, however, remain the same.

3. Adjustments of the nominal exchange rate still remain a non-negotiable issue. While in theory there are alternative ways of reducing the relative prices of non-tradables, it is not obvious that these are practicable in Comoros. The measures thus far taken by the Government to reduce or eliminate export duties and Stabilization Fund levies apply only to the three traditional products, vanilla, cloves, and copra. On the import side, it remains unclear, despite the many references to the "liberalization" of imports in the IM and the draft PFP, just what has happened or is going to happen to the nominal protection coefficients. The actions on the civil service may, however, bring about some declines in real wages in both the formal and informal sectors, but would this be enough? Would the Region explain how it evaluates the GOC's surrogate exchange rate actions in this context?

4. On public finances, the GOC has been trying to increase budgetary revenues and contain the growth in current expenditures. The consolidated budget deficit (Central Government and local authorities), excluding grants, was about 19% in 1990. Because of the planned increases in capital expenditures this deficit is expected to increase

to about 22 percent in 1992-93. But if the expected amounts of external grants are included, the deficit will drop from 1.5 percent in 1990 to o.6 percent of GDP in 1991. This appears to represent a relaxation of the budgetary targets envisaged at the time of the 1989 PFP review. Nonetheless, the deficit targets presented in the IM are expected to be consistent with the elimination of all arrears on domestic and external debt. The Committee might consider:

- how much of the projected improvements in public finances will be due to additional tax revenues and what measures can be proposed to broaden the tax base? Is it possible to introduce or increase progressive direct taxes (income taxes, property taxes, etc)?

- what is the scope for accelerating the reductions in the civil service wage bill (through expediting cuts in excess personnel, for example)?

5. The Region might explain its overall economic projections. The resumption of growth is supposed to come from additional public investments, but this may be a treacherous path. The growth during the early 1980s was short-lived because the boom in public investments turned out to be mostly unproductive and was followed by the accumulation of large arrears. Are there profitable opportunities for public investments, and if so, where? What new arrangements can be made to ensure sound selection and implementation of projects? Would the investment program again increase the role of the State?

6. The Region might also comment on three additional issues discussed on earlier occasions:

- what is the scope for export processing zones, as in Mauritius?

- should the adjustment program address the issue of instability of export earnings as they affect domestic incomes? Given the elimination of the Stabilization Funds, income instability may deter entry into the traditional sectors, especially by small producers;

- what can be done to encourage broad distribution of the benefits from the reforms?

7. Finally, as mentioned above, the PFP assumes the elimination of all arrears by 1993. The Region might elaborate upon the progress being made in securing the necessary financing; what are the implications for burden-sharing between France, IDA and the Fund?

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; O'Brien, Aguirre-Sacasa, Gorjestani, Varon, Benbrahim, (Ms.) Eap, AF3; Institutional ISC.

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

Mr. Grill
E3069

DATE: February 22, 1991

TO: Mr. Edward V.K. Jaycox, Acting Senior Vice President Operations

FROM: Alain Colliou, Acting Director, AF3

EXTENSION: 3 4380

SUBJECT: COMOROS: Initiating Memorandum for a Proposed Macro-Economic Reform and Capacity Building Credit

Is there a sustainable program budgetary, b.o.p or growth?

OC 2/22

1. Attached for consideration by the Operations Committee (OC) is an Initiating Memorandum (IM) requesting authorization to appraise a proposed Macro-Economic Reform and Capacity Building Credit (MERCAP) in the amount of US$10 million, of which US$ 8 million in support of the Government's reform program and US$ 2 million for the capacity building component.

2. The objective of the proposed credit is to lay the bases for economic growth by expanding the scope of private sector activity, while streamlining the public sector and restoring financial stability. This operation is built on policies described in the draft Policy Framework Paper (PFP) for 1991-1993 and is tailored to address the most urgent issues facing this small Franc-zone country, with a weak administration and limited growth potential. Specifically, the proposed MERCAP would be a hybrid operation with a quick-disbursing component supporting policy reforms in (i) civil service; (ii) public enterprises; and (iii) incentives framework for private investment; and a capacity-building component providing technical assistance and training for public sector management. The proposed operation is the center piece of the Bank assistance strategy in the Comoros, which was discussed with the Executive Directors in January 1991.

3. There have been major political changes in the Comoros since the OC reviewed the previous PFP in March 1989. Following the assassination of President Abdallah in November 1989, foreign mercenaries were forced to leave Comoros, a multiparty system was introduced, and a coalition Government was formed after free Presidential elections in March 1990. Meanwhile, the economic and financial situation continued to deteriorate. The new Government has reiterated its request for Bank and Fund assistance for an adjustment program. It has demonstrated its commitment to reform by implementing a number of adjustment measures, including politically sensitive actions on civil service census, military wage bill reduction, and liberalization of the vanilla trade. On the exchange rate issue, Bank staff has raised it on several occasions, but neither the Comorian nor the French authorities are prepared at this time to discuss the adjustment of the parity. In the meantime, the Government has adopted alternative measures to improve export competitiveness by reducing and eliminating export taxes on traditional export crops while rationalizing the import tariffs.

4. A revised draft PFP for 1991-1993 was agreed ad referendum during a joint Bank/Fund mission in December 1990, a copy of which is attached for background reference. This revised PFP updates the previous draft PFP for

1990-1992, which had been reviewed by the OC in March 1989. It reflects the recent progress on the part of the new Government and contains stronger policy measures to reduce financial imbalances through major cuts in current expenditure, streamline the public sector through civil service reform and rationalization of the public enterprises, and improve the incentives for private investment. The PFP would be presented to the Committee of the Whole in May 1991. The IMF has prepared a SAF program which is currently being negotiated.

5. The proposed MERCAP, complemented by a SAF program, is expected to restore economic stability and improve incentives for private sector development. In addition, it would provide international recognition of the Government's efforts to deal with the economic situation and build a national consensus in favor of reform. However, there are political, financial, and technical risks in view of the history of the Comoros, a fledgling multiparty system, and a weak administrative capacity. These risks are minimized by the (i) frontloading of important measures; (ii) determination of the French authorities to assist in the civil service reform efforts, support open governance, and increase financial assistance; (iii) adequate provision of technical assistance to strengthen the institutional capacity of the Ministry of Economy, Finance, Budget, and Planning; and (iv) appointment of an IMF Resident Representative requested by the Government. In addition, to ensure a successful implementation of the adjustment program, the Government has established a Ministerial Commission, assisted by a Permanent Technical Committee (composed of qualified staff from key ministries) to monitor the program.

6. Bank staff have been working closely with the IMF, AfDB, UNDP, France, EC and other donors to assist the Government in its adjustment efforts and in mobilizing external resources as well as finding a resolution of the payment of the external arrears due to AfDB (US$ 10 million) and Arab donors (US$ 28 million.) AfDB has indicated its intention to cofinance the proposed MERCAP up to US$ 18 million, so as to ensure positive net transfer of resources during the program period. The EC has indicated willingness to support the program and France to increase its assistance, including a possibility of providing bridge financing to cover the AfDB's arrears. Government has approached the Arab donors for special assistance arrangements, but the process is being delayed due to the Gulf war. A Round Table meeting, organized with assistance from UNDP, is scheduled for April 1991. We intend to recommend to the forthcoming SPA meeting Comoros' eligibility for SPA II.

Attachments

cc:

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

T. Thahane, Burmester (SECGE), Wyss (COD), Grilli (EAS), Isenman (PRD), Stoutjesdijk (FRS), Rao (IEC), Picciotto (CPB), Sandstrom, A. Khanna (EXC), Robless, Okonjo-Iweala (OPNSVP), J. Linn (CEC), Goldberg (LEGOP), Kavalsky (FRM), Alizai, T. Mante (IFC/CA2), Liebenthal, Fardi (PRDRA), Ray (EAS), Shirley (CECPS), Parmar (IFC-CIO), Kilby (FRS), Walton (DECVP); O'Brien, Armstrong, Swamy (AFRVP), Serageldin (AFTDR),Aguirre-Sacasa, Varon, Chevallier (AF3DR); Gorjestani, Scanteie, Schiavo-Campo, Benbrahim, Demangel, Eap, Ordoubadi, Le Houerou, Ibrahim, Szaszkiewicz (AF3CO); Otten, Blarel, Sissoko (AF3AG); Sarris, Alikhani, Diop, Mikitin (AF3IE); Blanc, Labeau, Bostrom (AF3IN); Colliou, Blay, Schneidman, Sherbune-Benz (AF3PH); Sarbib (AF5CO), Peloschek (LEGAF), Boulch (LOAAF); Carsten, Jbili, Le gall, Alter (IMF); Amdiss, Daga (AfDB, Abidjan); Africa Information Center.

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March 7, 1991

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THE WORLD BANK
Operations Committee

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Minutes of the Operations Committee to Consider the KENYA - Education Sector Adjustment Credit; Initiating Memorandum

Held on Thursday, March 7, 1991, at 4:30 p. m. in Room E1243

A. Present

Committee

Messrs. S. S. Husain, Acting Chairman
K. Kashiwaya, CFSVP
A. Karaosmanoglu, ASIVP
H. N. Scott, LEGVP
G. Sengupta, FPRVP
A. O. Hamilton, PHRDR
M. J. Gillette, AFRVP
W. Grais, EMNVP

Others

Messrs./Mmes E. O. Adu, LEGAF
C. H. Allison, AF2PH
I. Bannon, AF2CO
M. F. Carter, AF2CO
H. P. Crevier, SECGE
S. El Serafy, EAS
E. Grilli, EAS
A. Khanna, EXC
C. E. Madavo, AF2DR
D. J. Mahar, AF2PH
N. Okonjo-Iweala, OPNSV
G. H. Reif, PRDRA
G. N. Swamy, AFRCE

B. Issues

1. The Operations Committee met on Thursday, March 7, 1991, to consider the Initiating Memorandum for an Education Sector Adjustment Credit to Kenya in the amount of $70 million. The discussion followed broadly the agenda proposed by EAS which, among others, raised the issues of the macroeconomic program and the impact of previous adjustment operations on budgetary allocations for education; the apparent failure of six earlier education credits to address policy reforms; the vagueness of program design and lack of a concise set of tranche release conditions; the content of the companion investment project for the universities; the adequacy of the three tranche format proposed; and the risk of opposition to the reform program.

C. Discussion

2. The Chairman invited the Region to address first the macroeconomic issue and to explain the area of disagreement between IDA-IMF and the government. The Region said that the Bank and the Fund had been discussing a third year ESAF and a fourth PFP. The Gulf Crisis had undermined the program, and in reaction the Fund had sought to tighten the macroeconomic conditions, specifically on the fiscal side. Slippages had been found relating to revenue

shortfalls; spending overruns by certain ministries including education; and difficulties with external debt servicing. Before negotiations could be concluded for a new program, the macroeconomy had to come back on track, including in respect of areas of Bank responsibility such as education. Commitment by the Treasury was not sufficient as the difficulties arose fundamentally from ministries such as education and also from the President's Office; hence the importance of this operation for the macro balance. The Fund would be returning to Kenya in April jointly with IDA.

3. A member queried about the rationale of combining macro concerns with sectoral issues in one operation, and noted that for him the operation appeared to lack focus. But the Chairman explained that that combination was standard in sector adjustment operations. The Chairman then asked the Region to summarize the record of adjustment lending to Kenya. In response, the Region stated that the two earlier SALs, made some ten years ago, had been over-ambitious in scope, aims and borrower implementation capacity. The sector-by-sector approach of adjustment lending pursued since 1986 had proved more effective and had covered agriculture, industry, and the financial sector among others. Under this approach, IDA had been keeping an eye on macroeconomic developments in close collaboration with the IMF, while pursuing reforms in individual sectors.

4. A member remarked that the macroeconomic combination of budget deficits, high protection, an overvalued exchange rate, and weak terms of trade implied fundamental macro problems which were not adequately treated in the Initiating Memorandum, and unlikely to be resolved by a sectoral approach. But the Region was adamant that the sectoral approach, particularly in regard to the fiscal balance, was not only appropriate but also effective since across-the-board expenditure reductions, of ten resorted to by the government, tended to be insensitive to sector-specific needs. Part of the problem was the impact of the Gulf Crisis on tourism and the terms of trade, but there were many other structural problems that also needed to be addressed. Another member asked if the proposed credit depended on a macroeconomic program being in place, and the Region said indeed it did. The Chairman then asked the Committee to focus on the education sector and the political economy of the program. To him the operation appeared to ask for major changes and some of the issues were highly political: would it create domestic tensions that might be counter productive? Another member added that the Region might also define the political debate.

5. The Region said that the operation had been preceded by a long and comprehensive dialogue with key individuals and institutions. Education expenditures were growing at unsustainable rates. While some growth must be accepted, a comprehensive program of structural reforms needed to be mounted covering enrollment, cost recovery, and teachers' numbers and training. That is why the credit would disburse over three years, and the signs appeared favorable for the actions to be taken. The Chairman persisted, however, asking if there was consensus behind the program, and whether there was support for some of its politically controversial aspects.

6. In reply, the Region stressed that the reforms proposed grew out of a Presidential Committee on educational reforms which had held meetings in different parts of the country. The report of that Committee was later debated in Parliament in the form of a "sessional paper". Even with broad agreement, certain reforms were still politically sensitive, and the operation

needed to be designed in such a way that if it were to come apart on account of opposition, the loss in objectives would be minimal. The Region added that the educational system of Kenya was facing a temporary explosion of demand for university enrollment coinciding with the phase-out of the old "A-level" secondary school graduation and the introduction of the new 8:4:4 system. Problems of education quality and job prospects after graduation were also acute.

7. A member asked what leverage the Bank would have if after release of the first tranche the program went off track, and if technical education should not be pursued. The Region said there was indeed strong demand for technical education, that 50% of primary school graduates went on to secondary education, and that with a population growth of 3.5% a year, there was hunger for more secondary education. Private education, particularly at the tertiary level, had an important role to play. University education was too academic at present and Polytechnics would have to be developed. Job prospects were dim and presented a serious problem, and Kenya was well aware of the necessity of linking training to employment possibilities. A member added that he thought the share of higher education cost in GDP was probably too high in Kenya and a less expensive approach was needed.

8. The Region stated that no break-up was foreseen after release of the first tranche as the process was a continuous one. The education program and the macroeconomic program were integral and mutually reinforcing. A one-year adjustment was needed urgently to give the system a breather over university admissions. A break then needed to be applied on teacher employment in primary and secondary education, and the Bank and Fund were in agreement on this.

9. The Chairman then raised the agenda issue of the lack of conditionality focus. The studies, he acknowledged, would illuminate areas of reform and indicate future conditions, but did the Region have no more focused views? A member thought that some studies would mature only too late in the life of the program. Another member raised the question of gender in enrollment and suggested that the studies should make a point of addressing equity in female enrollment. As studies would investigate equity of enrollment by region and income levels, it would not be too difficult also to cover gender. The Region responded that conditionality had indeed been a problem. There was a desire to confine conditions to a key set of critical issues. Four or five areas were critical: many teachers were not competent, but we must not think that "trained" teachers were necessarily better than "untrained" ones, especially as the latter cost about half, though the government was keen on training; textbooks were another critical area, as these should be made available; so were cost-sharing and sector management through institution-building. As to gender enrollment, no problem appeared to exist: female enrollment was already 49% at primary, 40% at secondary and 30% at tertiary education. Up to university level, most of the teachers were women. Female training was also addressed under other progrms such as agricultural extension. A member then remarked that we needed to define the numbers enrolled at various stages in order to be able to set criteria to achieve such numbers. The Region thought, however, that it was sufficient to control the process from the payroll end, and that the study of dropouts would also be helpful in this respect.

10. Another member thought that any squeeze on university enrollment would translate into reduced female enrollment; but the Chairman questioned this, and the Region said that the squeeze would only be temporary.

D. Decisions

11. The Chairman then asked for any further issues that needed to be discussed, and whether the three tranche format and the negative list of disbursement were acceptable. In the absence of dissent the Chairman instructed the Region to proceed with processing the operation along the lines proposed in the Initiating Memorandum, subject to the comments made at the meeting and summarized above.

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March 20, 1991

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: March 4, 1991

TO: Operations Committee

FROM: EG Enzo Grilli, Director, EAS

EXTENSION: 81938

SUBJECT: KENYA - Education Sector Adjustment Credit
Initiating Memorandum;
Operations Committee Meeting Agenda

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1. The Operations Committee will meet on **Thursday, March 7, 1991, at 4:30 p. m. in Room 1243** (not Wednesday, March 6, as previously announced) to consider the Initiating Memorandum for an Education Sector Adjustment Credit to Kenya in the amount of $70 million to be disbursed over three equal tranches, each a year apart. The credit is expected to be taken to the Board in September 1991, and would have a "companion" investment project in support of higher education, tentatively set at $20 million. The Committee may wish to take up the following issues for discussion.

Macroeconomic Background

2. Kenya's per capita income of $380 places it at the higher end of the low-income country range. Kenya has exhibited high growth rates, both of population and of GDP. The economy is largely agrarian, but tourism and manufacturing industry are becoming more important than before. The public sector is large and is the source of much macroeconomic imbalance. Efforts to contain the fiscal deficit have been focused on reducing development expenditures whereas recurrent expenditures have proved to be troublesome. External debt is also onerous, and worsened terms of trade (low coffee and high petroleum prices) have more recently affected the economy adversely. This has exposed the economy's fragility and widened the current account deficit. IDA's strategy stresses raising public sector efficiency, expanding and diversifying the export base and strengthening the basis for sustainable and equitable development. Human resource development, of which the program supported by the present operation is an example, thus assumes importance, and the sector adjustment approach is well suited to this purpose, complemented by other investment operations.

3. The economy has been subjected to a continuous stabilization and adjustment drive since 1986 (see para. 5 below). Already three Policy Framework Papers have been agreed, and a fourth is in the making. The Fund has also extended two ESAFs, and a third is under consideration. The current ESAF, covering the period 1989-91, is in its third year, and the cover memorandum states that a fresh ESAF cannot be negotiated now.

Country Strategy and the Lending Program

4. The OC considered a draft CSP for Kenya in June 1990 and an updated and revised draft of the CSP in February 1991. According to this, the base case lending program in the period FY91-95 is set at $240 million a year, to be spread over four operations a year. From about a half of total lending in FYs90 and 91, adjustment lending would fall to a third from FY92 onwards, and human resource development would receive special emphasis in the lending program. The proposed lending program as recorded in the MIS conforms with the above described strategy and is in line with IDA allocations.

- The Region might update the OC on the state of the macroeconomy, indicating the reasons why agreement with the Fund is proving to be problematic.

- In view of the difficulties being encountered over negotiating a macroeconomic program acceptable to IDA and the IMF, what are the chances of the base case for country strategy prevailing, and hence the prospects of processing this SECAL if performance is inadequate?

Antecedents

5. This adjustment operation comes in the wake of no less than ten adjustment operations: the two early SALs and eight SECALs since FY86 (two in agriculture; two in industry; one in export development; and three in the financial sector). It also follows six education development credits made in the period FY67 to FY86.

- As Kenya has been the ground of a major adjustment initiative continuously since 1986, why have the macroeconomic reforms not filtered down to the education sector whose share in the current budget is still 36% (para. 17)? In other words, is the contribution of this operation to the fiscal balance as a justification for a quick-disbursing operation warranted?

- Why didn't the earlier six education sector tackle fundamental policy issues such as those now to be addressed?

The Educational Reforms

6. The reforms sought under this operation aim at arresting rising education expenditures resulting from the uncontrolled hiring of teachers; better equity in access to the sector; redressing falling standards; and improving sector management. A "companion" investment project for the university sub-sector is under preparation (para. 14). The policy matrix is still somewhat undefined in regard to eventual conditionality: education investments would have to be "acceptable to IDA"; a teacher-containment plan in primary and secondary education lacks details which will have to await study; the availability of text books for primary schools appears in the policy matrix without

meaningful conditionality; the limitation of university enrollment and the responsibilities of an apex university body are yet to be defined; details are missing of the university student loan recovery scheme; provisions for curriculum reform, institution strengthening and reduction of teachers and improving of access to the poor are either undefined or have to await completion of studies.

- Can a core set of conditionalities be defined at this stage to govern tranche releases?

- The Committee may wish to enquire about the purpose of the companion university investment project and why is it not incorporated in this operation?

Tranching, Studies and Risks

7. Three tranches are proposed: in November 1991, November 1992 and November 1993, respectively of $30 milion, $20 million and $20 million, in order to facilitate implementation of the program. The operation would be presented to the Board in September 1991 and the first tranche released two months after expected Board approval (para. 51). Four studies are envisaged, all with action plans: (a) for recurrent cost implications of doing away with untrained teachers; (b) for a review of primary and secondary school curricula with targets determined for in-service teacher training and classroom material requirements; (c) for causes of non-enrollment and dropouts in primary edcuation; and (d) for enhancing the capacity of the Ministry of Education for management, planning and policy analysis and a review of the relevant legislation. The Committee may wish to consider:

- Whether the staggered disbursement of the credit over three tranches and three years, while good for implementation, is consistent with the nature of the operation as a quick-disbursing adjustment one.

- The reason behind the planned gap of two months between Board approval and effectiveness.

- If effectiveness is not to occur before November 1991, is it realistic to expect the first two studies, together with their action plans, to be completed by January 1992 and December 1991, respectively (para. 47)? And what will happen to program implementation if these are delayed?

- Whether the risk of opposition to the program (from would-be teachers, university students who have to contribute to costs and face fewer places, etc.) can be overcome simply by government commitment (para. 53)?

Operations Commmittee

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

cc: Messrs./Mmes Madavo, Goldberg, Wyss, Isenman, Linn, Stoutjesdijk, Picciotto, Burmester/Thahane, Okonjo-Iweala, El Serafy, Mahar, Allison, Parmar, Pfeffermann, Rao, Kavalsky, Sandstrom, Liebenthal, Kilby, Robless, Khanna

SESerafy:sb

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: February 21, 1991

TO: Mr. Edward V.K. Jaycox, Acting SVPOP,

FROM: Mr. Jonathan C. Brown, Acting Director, AF2DR,

EXTENSION: 34076

SUBJECT: KENYA : Initiating Memorandum for an Education Sector Adjustment Credit

0168

1. Through the attached Initiating Memorandum we are seeking approval by the Operations Committee to appraise a US$70 million education sector adjustment credit for Kenya. The proposed sector adjustment operation, which is one in a series for Kenya, is designed as a quick-disbursing credit, spread over three tranches, each a year apart. It is proposed that the credit be used to finance 100 percent of the foreign exchange costs of general imports not contained in a negative list. The reason behind the negative list approach is that, beyond the public universities for which a companion investment project is under preparation, the foreign exchange requirements of the sector are minimal. Where foreign exchange requirements do exist, financing by other donors is either already in place or anticipated.

2. Recent macroeconomic developments. Since 1986 Kenya has been implementing a major stabilization and adjustment program. This program has been supported by the IMF through an ESAF (covering the period 1989-91) and by the Bank through a series of sector adjustment operations (in agriculture, industry and finance). During the period 1987-90, Kenya enjoyed a marked economic recovery (GDP growth in the region of 5 percent per annum) although stabilization efforts produced mixed results -- public spending remained high, inflation accelerated, and the external position remained weak. Domestic and foreign events of recent months have highlighted the fragility of the Kenyan economy. Worsening terms of trade, rising oil prices, falling tourism revenues, strong domestic demand, and lower than expected inflows of foreign assistance have all contributed to a widening in the balance of payments deficit. A joint World Bank/IMF mission is currently in the field discussing the third year of the ESAF and the fourth PFP. At the time of the OC meeting, the region will provide a briefing on progress with these discussions. Current indications suggest, however, that the IMF will be unable to conclude its ESAF negotiations at this time, and that a further mission in mid-April will be necessary. It is assumed that by the time of Board presentation for this credit (September 1991) an agreed Bank/IMF program will be in place.

3. Macroeconomic relevance of the credit. Two key elements of IDA's country strategy for Kenya are (i) to achieve a stable macroeconomic environment, and (ii) to improve the efficiency of the public sector which would be accompanied by a substantial hardening of its budget constraint. The achievement of both goals will result in a reduction in the fiscal deficit by containing and rationalizing public

expenditures, further strengthening revenues, and limiting public sector employment. The education sector has unusual prominence in Kenya's macroeconomic scene. It accounts for more than a fifth of all voted government expenditures, more than a third of voted recurrent expenditures, and almost 30 percent of public sector employment. Fiscal restraint, cost recovery, and employment control within the sector are, therefore, of the uppermost importance in securing macroeconomic goals. These objectives are at the heart of this proposed adjustment operation.

4. Education sector reform. In addition to seeking macroeconomic goals, this credit aims to support the government of Kenya with the implementation of a broad reform program for the education sector. Building on the considerable progress that has been made since Independence in developing an education system that is at the forefront of sub-Saharan African countries, and taking its lead from a government Sessional Paper on education (1988), the reform program has four objectives: (a) expenditure adjustment within the education budget, with a shift away from such high levels of public spending on personnel into complementary inputs, and increased private funding of tertiary education to add to significant achievement with cost sharing at primary and secondary levels; (b) increased access to primary and secondary education, especially for children from disadvantaged parts of the country, and consolidation of recent rapid expansion in the public universities; (c) improved quality and relevance of education at all levels of the system; and (d) strengthened sector management, planning, budgeting and information systems.

5. Universities investment project. A free standing investment project in support of Kenya's universities is currently under preparation and scheduled for appraisal before the end of this fiscal year. The objectives of the project are to consolidate and develop the university sub-sector by (a) strengthening and deepening the policy reforms initiated under this adjustment credit; (b) support the reformed institutional framework for tertiary educations; (c) enhance the quality of university education; and (d) develop a framework for the expansion of other public and private tertiary education institutions.

6. Risks. Education is held in the highest esteem throughout all socio-economic strata of Kenyan society -- from the small-scale farmer to the head of state, all have a point of view as to how the sector should develop. Because of the highly politically sensitive nature of some of the policy measures proposed under this credit (e.g. containing the growth of the teaching force, controlling the expansion of the public universities, and increased cost-sharing in tertiary education), the risks of the reform program falling victim to public opposition and of failing government commitment are high. In designing the credit this far, three important steps have been taken to minimize risk. First, the process within Kenya. The credit is built on a Kenyan Government Sessional Paper which is derived from wide public consultation. Since adoption as government policy (in 1988) the consultation process has continued. Second, in developing the credit, IDA has accorded great importance to consensus building within government, especially in the Ministry of Education and the public universities. Any sense of urgency to finalize a program has had to

give way to the more important objective of ensuring that the reform program has full government commitment. Third, in designing the credit to include three tranches rather than the more usual two, critical policy reforms can be approached in a more politically sensitive way and, by developing the conditionality through the three tranches, continuous monitoring of progress is possible.

7. Processing Schedule. The following is the proposed processing schedule for the Kenya Education Sector Adjustment Credit:

Appraisal	-	March 1991
Negotiations	-	July 1991
Board	-	September 1991
Effectiveness	-	November 1991

Attachment:

Operations Committee Members:

Messrs: Qureshi o/r; Husain (LACVP); Karaosmanoglu (ASIVP); Wapenhans (EMNVP); Shihata (VPLEG); Wood (FPRVP); Rajagopalan (PRSVP)/Summers (DECVP); Kashiwaya (CFSVP)(4); Bock (OPNSV); ;

Other Participants:

Messrs/Mmes: Thahane/Burmester (SEC); Picciotto (CPB); Goldberg ((LEGOP); Wyss (CODDR); Grilli (EASDR)(2); Sandstrom (ECX); Isenman (PRDDR); Linn (CECDR); Stoutjesdijk (FRSDR); Okongo-Iweala (OPNSV)

For Information:

Hamilton (PHRDR); Rao (IECDR); Kavalsky (FRM); Liebebthal (PRDRA); Kilby (FRSCR); Robless (OPNSV); Walton (DECVP); Khanna (EXC); O'Brien, Swamy (AFRCE); Martinez, Ohri (AFRVP); Serageldin (AFTDR); Moock (AFTED); Christoffersen (ATFEN); Madavo (o/r), Lethem, Miovic (AF2DR); Carter, Bannon, Byam (AF2CO); Adu (LEGAF); Fernando (LOAAF); Eigen, Kamunge (RMEA); Mahar, Allison, Burnett, Jones, Mustakim (AF2PH); Brown (AF2IN); Hindle (AF2IE); Shivakumar (AF2AG); Fredriksen (PHREE); files.

February 22, 1991

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Operations Committee

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Minutes of the Operations Committee to Consider the BURKINA FASO - Structural Adjustment Credit (SAL I) Initiating Memorandum

Held on Friday, February 22, 1991, at 3:00 p. m. in Room E1243

A. Present

Committee

Messrs. E. V. K. Jaycox, Acting Chairman
D. M. Goldberg, LEG
B. G. Kavalsky, FIN
J. F. Linn, PRE
H. Vergin, ASI
W. Grais, EMN
P.-C. Loh, LAC
C. L. Robless, OPNSV
D. E. Flannery, CFS

Others

Messrs./Mmes K. Marshall, AF5DR
F. L. Laporte, AF5DR
C. M. Azi, AF5IE
J. K. Ingram, AF5CO
O. B. Jonas, AF5CO
R. R. Faruqee, AFRCE
E. Grilli, EAS
R. Soopramanien, LEGAF
J. Salop, CODOP
O. Kalantzopoulos, PRD
M. Muller, FRSCR
H. P. Crevier, SECGE
I. A. H. Diogo, IMF
G. P. Sicat, EAS

B. Issues

1. In discussing the proposed adjustment credit, the Committee concentrated on the following issues set out in the agenda: political risks associated with the operation, macroeconomic adjustment and the public resource management measures, government capacity to carry out the reform, private sector reforms and their sequencing, and tranching.

2. In introducing the proposed operation, the Region indicated that the key elements of the first Policy Framework Paper, which was negotiated in 1990 and which was due for consideration in early March 1991 by the Board's Committee of the Whole, were incorporated in the Inititiating Memorandum. The Region also said that the negotiation of the SAL was expected before the convening of an aid roundtable for Burkina.

3. Political Risks. In response to the Chairman's query on whether the impending political changes posed a threat to the timing of the operation, the Region explained that these changes were being sponsored by the present government, and therefore there were no major uncertainties related to them. The revision of the constitution, and the subsequent the referendum on it, the proposed multiparty system of government, and the elections that would follow

were to take place in the second half of 1991. All these changes were part of the policy of bringing about greater popular consultation within the political system. The government was taking the lead in these changes and therefore was very much in control of the situation. With respect to the timing of the SAL, the Region reported that the Burkina government had entertained high expectations that it would proceed as scheduled, especially since they had already undertaken policy actions anticipating the SAL. The Chairman said that he foresaw a new era of political reform in Burkina and added that the Bank President had recently visited Burkina and had come out with a favorable impression.

4. Macroeconomic Adjustment and Public Resource Management Measures. The Committee spent time discussing the link of the macroeconomic framework with the public resource management issues raised in the SAL. One member said that the main issue was whether the measures taken by the government would make the adjustment feasible, given the limitations imposed on Burkina as a member of the CFA Zone. He felt that the requisite fiscal stance that would attain a real depreciation of the exchange rate had to be demonstrated. While he was impressed with the components of the overall program, an improvement of the macroeconomic situation could only be possible if the cut in fiscal expenditure, the reallocation of expenditure to priority sectors within the budget, and the increase in revenue resources produced the desired adjustment effects. He suggested therefore that the appraisal should indeed ascertain the overall fiscal stance and that the SAL should be tracked by a macroeconomic conditionality. Could overall deflation be achieved especially in the context of an economy that was being opened? Another member stated that there was the additional constraint that the adjustment policies did not include any lever to reduce the real wage. Another member was puzzled that even though the real effective exchange rate had depreciated, domestic costs remained high so that the growth of tradables was not likely. Another member pointed out that while recognizing the inadequacy of government resources for all the good things that the government wanted to undertake, the core issue was how to get these resources funneled into the right sectors in a sustainable way, through a reallocation of the budget and through an increase in taxes.

5. The Region replied that there was a presentational issue in the current Initiating Memorandum which would be corrected by the time the President's Report was prepared, by discussing the macroeconomic framework more fully. The Region also pointed out that the PFP recently distributed to the Board discussed these macroeconomic issues adequately. Moreover, the Region stated that Burkina did not fall in the standard mold of CFA countries in Africa. A lot of the internal adjustment was taking place, and the program contained in the SAL included measures to deepen reforms, which would precede any devaluation of the CFA when it did take place.

6. On the invitation of the Chairman to elaborate on recent developments at the macroeconomic level, the Fund staff representative stated that for the 1991-93 period, the overall fiscal deficit would decline rapidly. During the fiscal year 1991, the overall budget deficit targeted under the proposed program would be 1 percentage point of GDP less than the 1990 deficit, despite outlays equivalent to 3.2% of GDP to finance the restructuring of the banking system. He also said that the overall wage bill, which was frozen in 1990, would be reduced from CFAF 55.2 billion to CFAF 54.7 billion in 1991. With respect to fiscal revenues, measures introduced in 1990

would be maintained. These measures were in the form of a reduction of exemptions and a switch of the import valuation system towards a c.i.f. basis, thus raising the tax base on imports. A technical assistance program from the Fund was directed towards fiscal reform, which would help to study the feasibility of a VAT and the improvement of revenue collection.

7. With respect to the effective rate of protection, the Region stated that Burkina had the highest protection rate at this time among Sahelian countries. The immediate agenda was to "free the economy" of quantitative, administrative, and regulatory restrictions in order to increase internal competition and make tariff protection more predictable. Within this framework, there could even be room for raising nominal tariffs for some products, including the possibility of an import surcharge. With respect to wages, the Region stated that while nominal wages in the government sector were not being reduced directly, since this was considered very difficult to do politically, other measures were being undertaken to reduce the real wage. This was done by freezing government wages in the short- term, and by removing allowances. In 1990, up-front actions related to the reduction of housing and clothing allowances were taken. In the longer term, the replacement of higher paid civil servants with younger and cheaper paid workers under the same salary schedule would result through the early retirements being planned in 1991 and under the program of voluntary departures. As a result, average wages in the civil service would decline. Moreover, the Region stated that the civil service in Burkina was relatively small and efficient within the region, and therefore cutting nominal wages was only likely to be counterproductive. Since the formal sector was one of the smallest in the Sahel region and mainly confined in the public sector, the high cost of labor in the formal sector did not affect competitiveness in the private sector.

8. With respect to other aspects of the measures in the public sector, the Region indicated the need to reallocate public resources in support of priority sectors, such as primary education, health services, and revenue services. Such a reallocation would be achieved in part from the cut in the military budget, which had already been reduced in 1990, and from further cuts that were planned in the future. In response to a question on the extent to which budgetary transfers were being made to the public enterprises and the extent of actions in this area, the Region stated that through the financial restructuring of these enterprises, concesssions in the form of credit and tax exemptions were being removed. To avoid costly public enterprise rehabilitation programs, the Region would work out a program with the aid donors so as to put the public enterprises on an "even playing field." In addition, legislative and legal reform would be worked out to facilitate divestiture.

9. In connection with the public expenditure and investment program, the Region stated that the government would continue to prepare a rolling three- year public investment program that required a minimum rate of return criterion. This investment program was to be in line with the sectoral priorities identified, which included health, primary education, the environment, and rehabilitation and maintenance of transport infrastructure. The Region reported that the government had dropped a number of questionable investment projects, such as a railway line through the desert, the dismantling and/or sale of an uneconomic cement plant, "social housing projects', and fancy investments in headquarters buildings. A monitoring

system for the budget would be set up, which would help to assure that the budgetary objectives would be met.

10. Government Capacity. With respect to the government capacity, a member asked how feasible were the extremely ambitious programs of reform within the private sector. Was there sufficient government capacity, and were these reforms therefore administratively feasible? The Region stated that it recognized the problem of capacity of the civil service to implement the reforms. At the same time, they preferred not to have the civil service expand in its functions. It was essential to maintain a fairly tight and effective civil service. But technical assistance resources were being lined up to address some needs which would improve the government's capacity in the medium- term. The Fund program and French technical assistance included support to the improvement of budgeting procedures, especially in auditing and accounting. The government was attempting to set up an office patterned after the General Accounting Office in the United States. The UNDP had an assistance program designed to improve public investment programming. Various technical assistance programs dealing with the revisions of the investment code, labor code, and the reinforcement of civil law were being put in place with various donors, including the UNDP, the Bank/ MIGA, and bilateral sources like the French.

11. Private Sector Reforms and Their Sequencing. The reforms in the private sector were wide-ranging, and the Region asserted that they would not be undertaken all at once. The Region, however, noted that in the case of Burkina, there were government- initiated reforms which were significant, unlike in other African countries. They recognized early enough the need for revisions in their labor code, for instance. They also abolished basically most of the price controls in place. Further, they would remove the remaining quantitative restrictions under this program. They also eliminated the export taxes. A revision of the land reform law was currently being worked out. However, the Region stated that the removal of excessive regulations, for instance, the abolition of monopolies, were in their initial stges only. Divestiture of public enterprises was to come within the framework of banking sector reforms. Tariff reforms would be part of a SAL II program. Feasibility studies were needed to undertake further actions, for instance the need for an interbank guarantee fund, in the context of the financial sector reforms.

12. Tranching. With respect to the issue of the timing of the tranche releases, a member suggested that given the difficult and complex adjustment issues to be faced, there was a case for considering a back- loading of the disbursements. The Region however stated that the the proposed front- loading was responding to cash- flow requirements at this time and to the substantial policy actions already undertaken by the government. The cash- flow deficiency was due to the uncertainty of cofinancing since aside from the Fund, the Bank was the only substantial cofinancier of the adjustment program at this point. This, however, could change, as aid coordination issues were resolved.

C. Decisions

13. The Chairman observed that it was remarkable that Burkina was brought into an economic reform program from the situation of about three

years ago in which hardly any economic dialogue with the Bank existed. He therefore congratulated the staff for achieving this. He stated that the Region could appraise the proposed SAL operation.

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March 4, 1991

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: February 20, 1991

TO: Operations Committee

FROM: Enzo Grilli, EASDR

EXTENSION: 81934

SUBJECT: BURKINA FASO - Structural Adjustment Credit (SAL I) Initiating Memorandum; Operations Committee Agenda

1. The Operations Committee will meet on **Friday, February 22, 1991, at 3:00 p.m. in Room 1234** to consider the Initiating Memorandum for a Structural Adjustment Credit (SAL I) for Burkina Faso. The following represents a proposed agenda.

Background

2. For many years, Burkina Faso had pursued stringent state-led economic development policies: centralized planning and economic management and direct involvement in productive activities through state enterprises. The government is now seeking to reorient these policies towards a greater degree of liberalization. It is trying to move reliance on state and state-led public enterprises and go towards developing the private sector. Especially over the last two years, efforts were undertaken by the government of Burkina to galvanize public support for these policy changes. The Operations Committee met on two occasions to assess these general policy directions: in April 1990 when it discussed the first Policy Framework Paper and, in July 1990, when it reviewed the Country Strategy Paper. The first PFP for 1991-93 is now scheduled to be discussed at the Board's Committee of the Whole on February 26, 1991. A Fund SAF arrangement is expected in March 1991.

3. The SAL and the country assistance strategy. The Region proposes to appraise the first Structural Adjustment Credit (SAL I) for Burkina in the amount of US $80 million. SAL I represents the beginning of an overall assistance strategy for Burkina, which includes SECALs (in Transport and Agriculture), investment operations in human resources development and in natural resource management, and possibly a SAL II phase. Under the "base case" scenario (with adjustment lending) for FY1991-95, the lending program is planned at US$375 million, of which US$200 million is for the period FY1991-93 (from CSP, annex 1).

Issues

4. Amount of proposed loan. The recent Business Plans and the CSP statements indicated that the amount of the SAL I would be around US$60 million. The Committee may want to ask the Region, first, what factors have led to an enlargement of the credit amount to US$80 million. Is this increase due to changing projections of the external gap or the shortfall in the financing from other aid sources? Second, the

Committee may wish to know how this proposed change would affect future assistance levels.

5. Timing of SAL I: political risks. Major political changes are taking place in Burkina, in parallel with the efforts under way to redirect the overall thrust of the economy. The political reforms include the adoption of a new constitution in June, 1991 and the subsequent holding of multiparty presidential elections and legislative elections in November and December 1991 (see para.5). In evaluating the benefits and risks to the present adjustment program, the Region notes that "vested interests -- military, ideological, or other -- outside the electoral process could seek to destabilize the reform, [or] a party with a different political agenda could be elected, [or] powerful groups opposed to aspects of the economic reform" could slow down the reform process (see para.87). On the other hand, the Region (see para.6, cover memo) hopes to make a presentation of SAL I to the Board on June 25, 1995. The Committee may want to discuss the implications of these political developments on the timing of Board presentation, considering that they have a bearing on the government ownership of the reforms, and examine whether there is a case in favor of waiting until the political picture becomes more definite?

6. Components of the SAL I reforms. The present SAL supports the reform program outlined in the PFP and focuses on two key areas: public resource management and private sector incentives (see paras.29-45). The social dimensions of the adjustment program are also discussed (see paras.71-80).

- Public resource management. The main elements of this program consist of containing the wage bill and reallocating resources to fund high priority sectors such as primary education, health care, transport maintenance and revenue services, and improving the public investment programming and coordination within the current budget. With respect to the wage bill, the program is to reduce the public sector payroll through a reduction of employment rather than a cut in pay. It is projected that the government would be able to reduce the wage bill to around 59% of the current government expenditure by 1993, from a level of 61% in 1990. Moreover, transfers (which account for 14% of current expenditures) would be cut through a reduction of university scholarships. The Committee may want to discuss:

(a) whether the public management envisaged would be adequate to achieve the program objectives, and where the required additional cuts in expenditures would be realized, since the program also includes a reallocation of expenditures to high priority sectors;

(b) to what extent resources for generating government revenues are being planned in order to meet growing expenditure (since very little is said on this (see para.41);

(c) considering the past history of unproductive public investments, what measures are being undertaken to assure an improvement in the productivity of public investment; and

(d) what actions are contemplated to reduce the size of the military payroll, which accounts for 40% of the total government payroll.

- Private sector development. The program to assist the private sector has several aspects: (a) public enterprise reforms, including privatization, liquidation, improvement of existing enterprises, and divestiture (paras.48-51); (b) financial sector reforms, including the elimination of directed credit and preferential interest rates, and the setting of free interest rates under under the BCEAO (regional central bank) framework, and an action plan for restructuring distressed banks (paras.52-56); (c) a progressive elimination of price controls, but leaving agricultural products under the prospective Agriculture SECAL (paras.57-59); (d) liberalization of import and export trade regimes (paras.60-65); and (e) reforms in regulatory and investment laws, dealing with investment and commercial legislation, labor laws, administrative reforms, and restoration of civil law over revolutionary courts (paras.66-70). All of these changes constitute a comprehensive set of reforms and are consistent with policies that the Bank had been supporting for similarly situated countries. The Committee may want to discuss the following:

(a) Government capacity. The government of Burkina Faso lacks experience in dealing dealing with private sector incentives. In addition, it has a very limited amount of administrative capacity, which is typical of countries at this level of development. Moreover, the work related to controlling the level and allocation of government expenditure would already tax a great deal of the existing government capacity to implement measures. What measures are being put in place to help the government carry out these proposed reforms? What technical assistance resources are being made available and in which areas of reforms are these likely to be applied to?

(b) Sequencing of reforms. In view of the extent of the reforms dealing with the private sector, as well as the problem of implementing capacity referred to above, the issue of whether the reforms are likely to take an appropriate sequencing is important. The Region may wish to elaborate on which reforms are likely to take a much longer gestation period and where the priorities of actions are to be emphasized for the period of the SAL I.

7. Macroeconomic adjustment and the CFA issue. Being a CFA country, the main tool of macroadjustment for Burkina Faso (to restore external and internal balance and competitiveness) depends mainly on the control of fiscal expenditure and the reduction of domestic production costs. The Region states that domestic costs are high in Burkina, because of high labor costs resulting from labor regulations and the high wages maintained in government. However, Burkina's wages

are still nearly as high as those in Cote d'Ivoire. (see para.15) On this basis, Burkina's competitiveness is impaired, especially with respect to non-CFA neighboring countries, in spite of the depreciation of the real effective exchange rate during the 1980s by around 20%. (Burkina Faso's main exports to date are livestock, cotton, zinc, and gold, although new commercial crops exported to Europe are emerging.) The Committee may want to discuss whether it would be sustainable to retain the level of high domestic production costs (since basically wages are not being cut) and still achieve competitiveness, assuming the inability to utilize more effective instruments of adjustment.

8. Conditionalities. The conditions for negotiations, Board presentation, and tranche releases are stated in para.84. Although these conditions are relatively few and most of the actions are monitorable, a number of them depend on "satisfactory performance". These are further elaborated in the policy matrix. It is expected that the Government's Letter of Development Policy would include the criteria for satisfactory performance. The Committee, however, may want the Region to elaborate on what may constitute satisfactory performance, for instance in the areas of trade and price reform and in the divestiture action plan, and on the criteria it plans to specify in the Letter of Development Policy.

9. Tranching. The Region proposes three tranches for this operation, with US$40 million released on the first tranche and the second and third tranches being US$20 million each. The Committee may want to discuss whether the front-loading of tranche releases is justified by the upfront actions of the proposed operation.

Operations Committee

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

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

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THE WORLD BANK/IFC/MIGA
OFFICE MEMORANDUM

22nd
3:00

DATE: February 14, 1991

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

FROM: Katherine Marshall, Acting Vice President, AFR

EXT: 36923

SUBJECT: BURKINA FASO: First Structural Adjustment Credit (SAL I) Initiating Memorandum

1. The attached Initiating Memorandum (IM) seeks Operations Committee authorization to appraise a first Structural Adjustment Credit for Burkina Faso (SAL I). This would be the first Bank adjustment operation in Burkina. A preparation mission for the proposed SAL took place in November 1991, building on a dialogue on structural reforms that began in 1988 with the preparation of a Country Economic Memorandum and continued during preparation and negotiations of a Policy Framework Paper, 1991-93.

2. The proposed IDA credit would be for the equivalent of US$80 million, to be disbursed in three tranches over approximately 18 months. Cofinancing or parallel financing from the African Development Bank, the EEC, France, Japan, Canada, and Germany is under discussion. The total financing expected to be made available during the SAL period is on the order of US$160 million equivalent.

3. Status of IMF Program. Burkina's first-year Policy Framework Paper is scheduled for review by the Committee of the Whole on February 26, 1991. The PFP and the first annual SAF arrangement in the amount of SDR 6.3 million (20 percent of quota) are expected to be presented to the IMF Board in mid-March.

4. Proposed SAL I Program. As noted in the IM, Burkina is emerging from a period characterized by interventionist policies and direct state involvement in productive and commercial activities. Over the past two years major progress has been achieved in re-orienting public policy and in mobilizing broad based public support behind the changes. The proposed SAL supports the overall adjustment program outlined in the PFP and focuses on implementation of reforms in two key areas: public resource management and private sector incentives. Specific actions would include reduction of the government wage bill, increase in expenditures on primary education and basic health, strengthening budgetary control and planning capacity, improving public investment programming, reduction of price controls, elimination of quantitative restrictions on imports, reform of the legal and regulatory framework governing enterprise activity, banking sector restructuring, and public enterprise sector reforms.

5. Key Issues. Important up-front action has already been taken on the public investment program by eliminating several politically sensitive projects; on the public wage bill by implementation of measures

to reduce its size in the 1991 budget; and in the banking sector by appointing receivers for the banks that need to be restructured or liquidated. Agreement in substance has been reached on most other key reforms. The two policy areas in which issues will need to be resolved during the appraisal mission are highlighted below:

(a) Restructuring of public personnel expenditures. The Government is in full agreement on the need to reduce the aggregate wage bill in order to make room for increased spending on materials and supplies needed to increase the efficiency of public administration, on maintenance of public infrastructure, and to meet local counterpart contributions to the public investment program. The Government has also agreed to hire 950 additional primary school teachers annually, to increase spending on basic health, and to strengthen tax collection agencies. To meet these priority targets, the Government will need to reduce personnel spending in non-development related ministries, including the military, and it is not yet clear to what extent this will be politically feasible. During preparation, the authorities, including the President, indicated a willingness to undertake the necessary reforms, and a number of options have been identified for reducing personnel spending. The 1991 budget reflects some of these options including a reduction in military expenditures. The appraisal mission will need to reach agreement on appropriate sectoral personnel expenditure targets for 1992 and 1993 and instruments for effective monitoring;

(b) Public Enterprise Divestiture Program. During SAL preparation, agreement was reached with the authorities on the objectives and a preliminary strategy for progressively disengaging the state from commercial and industrial activities. The objectives are defined in the Government's PFP. A preliminary strategy and action plan outlined in the policy matrix to the SAL IM have also been accepted by the authorities. The appraisal mission will need to agree with the Government on a detailed plan of action and calendar for implementation, including the definition and fate of so called "strategic enterprises", and the pace at which the divestiture program will take place during the program period.

6. If full agreement in substance is reached on these issues during the appraisal mission, we would seek to bring forward the proposed Board date of June 25, 1991, in line with a revised calendar for meeting the proposed Board conditions. At this stage we would not see any need for a post appraisal mission.

Attachment

Distribution:

Operations Committee:

Messrs./Mme: Husain (LACVP), Jaycox (AFRVP), Karaosmanoglu (ASIVP), Wapenhans (EMNVP), Rajagopalan/Summers (PRE), Shihata (LEGVP), Kashiwaya (CFSVP) (4), Wood (FPRVP), Bock (OPNSV), Liebenthal (PRDRA), Okonjo-Iweala (OPNSV), Grilli, Sicat (EAS);

cc: Messrs./Mmes. Wyss (COD), Isenman (PRD), Linn (CEC), Stoutjesdijk (FRS), Picciotto (CPB), Burmester/Thahane (SEGCE), Goldberg (LEGOP), Parmar (IFC-CIO), Rao (IEC), Kavalsky (FRM), Pfeffermann (IFC-CEI), Kilby (FRS), Robless (OPNSV), Sandstrom, Khanna (EXC), O'Brien (AFRCE), Diogo, Devaux (IMF), Sarbib, Ingram, Jonas, Samen, Traore (AF5CO), Agueh, Hamilton, Vitagliano (AF5PH), Bauer, Azi (AF5IE), Steeds (AF5AG), Watson, Pean (AF5IN), Laporte, Schebeck (AF5DR), Soopramanien (LEGAF), Suzuki (AFTPS), Humphreys (AFTTF).

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February 8, 1991

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THE WORLD BANK
Operations Committee

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Minutes of the Operations Committee to Consider the HUNGARY - Structural Adjustment Loan II, and Privatization and Enterprise Restructuring Loan; Initiating Memoranda

Held on Friday, February 8, 1991, at 4:30 p. m. in Room E1243

A. Present

Committee

Messrs./Mmes
M. A. Qureshi, Chairman
I. F. I. Shihata, LEGVP
K. Kashiwaya, CFSVP
L. Summers, DECVP
R. K. Chopra, EM3DR
R. B. Steckhan, LA2DR
K. Marshall, AF5DR
S. Asanuma, AS1DR
D. R. Bock, OPNSV
F. Kilby, FRSCR

Others

Messrs./Mmes
E. Grilli, EAS
E. F. Iari, EM4DR
P. Hasan, EMNVP
P. Nouvel, EM4CO
A. Sood, EM4IF
C. Pant, EM4CO
N. Fostvedt, EM4IF
G. Belanger, IMF
R. Al-Jabri, LEGEM
G. Reif, PRDRA
M. Walton, DEC
H. P. Crevier, SECGE
J. Salop, COD
N. Okonjo-Iweala, OPNSV
F. J. Lysy, EAS

B. Issues

1. The Operation Committee met on February 8, 1991, to discuss the Initiating Memoranda for the proposed Structural Adjustment Loan II and the Privatization and Enterprise Restructuring Loan, both for Hungary. The discussion focussed on the following sets of issues:

(a) The nature of the policy conditionality proposed for the SAL;

(b) The relationship between the two operations;

(c) The policy conditionality in the SAL;

(d) The policy conditionality in the Privatization and Enterprise Restructuring Loan; and,

(e) The external financing plan.

C. **Discussion**

The Nature of the Policy Conditionality Proposed for the SAL

2. The Chairman opened the discussion by noting that the SAL II had initially been planned to be processed later in the Bank lending program for Hungary, but had been brought up, in part due to the Gulf Crisis. As a consequence, however, it appears that much of what would be covered under the SAL duplicates programs that are being covered under other Bank operations in Hungary. He also noted that it was not clear to him from the IM what, in the Region's view, were the principal areas that had to be addressed for the adjustment program to succeed. What were the four or five key areas that were of strategic importance to the success of the adjustment program?

3. The Region responded by stating that the SAL II should be viewed as a "rounding-up" operation for the Bank, that would provide an umbrella framework for the reform program in its entirety. It was a continuation and acceleration of the program first supported under SAL I, where the new operation had been brought forward in the Bank's lending program in part because of the effects of the Gulf Crisis, the break-up of the CMEA system, and the effects of the severe drought. Another representative of the Region stated that the proposed SAL II supported reforms in four key areas: the macro framework, private sector development and privatization, competition policies, and social aspects. This agenda is the same as that of the SAL I and remains. Furthermore, key actions were recently taken in the context of the Second Tranche release of the SAL I. Several of the proposed conditions did duplicate conditions contained in earlier Bank operations (or in the proposed Privatization and Enterprise Restructuring operation), but this was to reinforce them. For example, in the financial sector area, the SAL II conditions were the same as commitments made by the Hungarians in an earlier financial systems modernization project. However, progress had been slow in this important area, and the SAL II would provide additional leverage. Finally, there was, indeed, a good deal of over-lap between this operation, earlier and planned other Bank operations, and the IMF program, but this should be expected since all were in support of the same Government program.

4. The Chairman responded by noting that all of these operations must, of course, be in support of a single overall program of the Government. Our program must also, of course, be worked out jointly with the Fund, where the programs of the Fund and the Bank must be consistent. However, one should not repeat explicit tranche release conditions (nor repeat commitments made in the context of earlier investment operations) in a proposed new policy-based operation such as the SAL II, which have already been contained in a previous Bank operation or in the program of the Fund (with the sole exception that all the operations should contain a similar "acceptable macro framework" condition, defined according to agreed indicators). The General Counsel of the Bank affirmed his agreement with this also. The Chairman noted in addition that if; a) due to a terms of trade shock, there was now a need for extra financing of some adjustment program, and b) it was the view of the Bank that the program should remain as it had been, then the proper vehicle for this support would be a supplement to a previous Bank operation.

The Relationship of the Two Operations, and The Overall Reform Program

5. A member of the Committee raised the question of why the Region was proceeding with two separate operations. If one excluded areas of conditionality covered under previous Bank operations (the issue discussed above), as well as conditionality covered under the proposed Privatization and Enterprise Restructuring operation (or perhaps should be covered under that operation, e.g. trade policy), plus conditions under the IMF program, there did not appear to be much that remained for SAL II. Was this, in reality, one large operation for $350 million (covering the two proposed loans)? The Region responded by stating that there were fundamentally different objectives in the two operations, although they supported each other. The SAL focussed on the overall policy framework, and provided an umbrella for the Privatization and Enterprise Restructuring Loan (as well as other operations in the Bank program), while the Privatization and Enterprise Restructuring Loan focussed on implementation of a specific area of the reform program. The loans were being processed as separate operations so that supervision of them would be more effective, but the two teams were working closely with each other.

6. The Chairman stated that one had to go further with regard to the SAL. The fundamental question lies in the nature of the overall program needed. What are the key areas that need to be addressed, strategically? And what, precisely, would we be looking for in these areas? What was needed for example, in the area of social sector policies? The SAL does not make this clear. Was further work in this area perhaps needed before we would be in a position to answer this? Similarly, what was needed/planned in such areas as financial sector policies, entry/exit barriers, etc.? The Region responded that we do, in fact, have CESW completed or underway which should permit us to address these areas more clearly in the SAL.

The Proposed Policy Conditionality in the SAL II

7. Questions were raised by the Chairman on the adequacy of the policy conditionality proposed in the SAL II. For example, even though the proposed operation duplicated conditionality already covered under other Bank operations, it seemed nevertheless to have dropped completely addressing the issue of Government subsidies. This was an important and contentious issue under the SAL I, where failure to meet the reduction in subsidies condition (by a margin of one-half percentage point of GDP) necessitated a waiver in order for the Second Tranche to be released. Under the SAL I, agreement had been reached (in the Letter of Development Policy) on a multi-year program to reduce subsidies. It would be quite appropriate that the SAL II support the next phase of this process, and it should in particular go beyond the earlier focus on overall subsidy levels to address more specifically the structure of subsidies in the economy. Yet the SAL II seemed to leave out the issue of subsidies altogether, even though the issue must be critical to the transformation of the economy to a market-driven one.

8. The Region responded by stating that the overall level of subsidies would be used as one of the macro indicators that would be used to monitor the overall macro performance of the program. The Chairman indicated this would not be enough; the issue of the structure of the subsidies was of equal (if

not greater) importance. He went on to raise the question of energy subsidies. He noted that if a principal rationale of proceeding with the operation now was to assist Hungary in the face of the increase in oil prices that has resulted from the break-up of the CMEA (and until recently, the effects of the Gulf Crisis), then there could be no basis for Hungary to subsidize still the price of energy. The Region responded by noting that Hungary would be raising energy prices in absolute terms by a greater percentage than had been previously agreed with the Bank in the FY89 Energy Development loan (since the economically efficient level was now higher than had been foreseen before). There had already been substantial increases in the prices charged domestically in recent months, in response to the higher prices Hungary now faced. The Chairman inquired as to what the current level of subsidies to energy use were, but the Region responded that it did not know. The Chairman stated that there should be no subsidies in the current environment.

9. The Chairman stated that he believed there could be a case made for a SAL II, but that the operation, as currently structured, did not make it sufficiently clear. There should, for example, be more in the areas of subsidies, energy prices, financial sector policies, and the social safety net. Urgency was not the overriding concern. Much more important was to take the time required to develop a program fully suitable for Bank support. The Region should not worry if this required a few months. The program should also not duplicate what the Fund is dealing with. Rather, there should be, for example, a focus on structure and composition of expenditures and subsidies, not just the overall levels.

The Proposed Policy Conditionality in the Privatization and Enterprise Restructuring Loan

10. The feasibility of the Government's goals on the pace of privatization was discussed. All agreed (Regional staff as well as Committee members) that the Government's goal of 50% privatization by 1993 was extremely ambitious, and probably unrealistic. It was noted that there would not be specific tranche release conditions on this, and that indeed this particular goal fell beyond the time horizon for this particular operation. A member of the committee noted that the tranche release conditions that would be contained in the proposed operation should not express the benchmarks as some specific percentage of privatization of enterprises achieved, since privatization per se was not the objective, efficiency was. The Region responded that the conditions would be written as some percentage of assets that would be brought only to the point of sale. Privatization would not be forced. The Region also noted that a large share of the State Enterprise sector would remain in state hands for a long time, even under the best of circumstances, so there is a strong focus in the proposed operation on enterprise restructuring, ownership reform (i.e. to joint stock companies, even if still 100% owned by the Government), and the relationship between the enterprises and the Government (e.g. transfers). The Chairman noted that we should be very clear to distinguish the Government's own goals, which might be ambitious, from our own tranche release conditions, which should be conservative and doable. In this context, the Chairman noted that the Second Tranche privatization conditionality should be modest and achievable, and focus on the "small" privatizations and the government "offering for sale" some number of the larger enterprises. He also emphasized that ownership

reform and restructuring was potentially as important as privatization, and should be accordingly reflected in the documentation.

11. The financial resources required for the privatization program were also discussed. These would be massive, if the program was to proceed on anything close to the scale the Government hoped. It was noted that a special privatization fund, as is being set-up, might be of use in this. However, the proposal that such funds would be provided at a preferential rate was counter-productive. The Chairman noted that while credit was needed, under such an approach the funding that would be made available to support the privatization program would in fact be limited. The funds should be provided at a market rate, and we should work to encourage this.

12. A member of the committee inquired whether there was still a problem with the soft budget constraint for enterprises in Hungary. The Region responded that this was no longer a major issue in terms of direct Government transfers to the enterprises. For example, there would be no more investment transfers to the enterprises starting this year. However, there was still some worry over transfers from the banking system. Three new laws (a Bankruptcy Law, an Accounting Law, and a Banking Law) should help to address this, as they will force banks to stop accruing income on bad loans and to provision against them. This will hopefully force the banks to enforce a hard budget constraint in their relationship with the enterprises. The Bank's Financial Modernization Loans in Hungary (both the past one, and the proposed follow-up operation) are also addressing this issue.

13. The Chairman also noted that we must be explicit and clear on the approach of Hungary on foreign private investment. This will be critical to the country's privatization and private sector development goals. He also stated that the issue of liquidation should continue to be addressed in the proposed operation, with benchmarks to monitor the effectiveness of the process. The aim would be to ensure there is a process in place under which liquidations, when they are needed, will be undertaken quickly.

External Financing Plan

14. The Chairman opened this discussion by noting the basic issue was whether the Bank was providing an appropriate share of the overall financing required. The financing plan showed substantial net repayments to the commercial banks, and a large build-up in reserves. The Region responded that one had to take a long-term view to assess the appropriateness of the financing plan. The banks currently held a very large share of Hungary's total debt, and while this share would decline over the first half of the decade, it is projected to increase in the second half (although to a level that would still be well below the current level). More importantly, although there would be net capital repayments to the banks in the early years of the decade, the banks would still be expected to provide new gross disbursements equal to roughly 80% of the gross amount they would be re-paid. The Region and a member of the committee noted that, realistically, even if Hungary forced a rescheduling, they should not expect to receive from it much more than about a 80% roll-over ratio. This member of the committee noted that should Hungary decide to reschedule, they should be strongly encouraged to follow a "pre-1980's" style of rescheduling, rather than the form generally followed in the 1980's. That is, the focus should be on a narrow slice of the

maturities coming due. The Region argued that it would be a mistake for the Bank to recommend at this time that Hungary reschedule its debt, even though a rescheduling would likely eventually be done. Hungary had maintained a good track record in servicing its debt under adverse circumstances, which had enabled it in the past to maintain access to commercial sources of financing. Rescheduling would jeopardize this access, the Region argued, when external financing is especially necessary to finance Hungary's modernization. The flow of direct foreign investment would also be threatened. On the reserves issue, the Region argued that the level of reserves would be modest, equivalent to only 2-3 months of imports (which would now all be on a convertible currency basis). This cannot be viewed as excessive given the uncertainties facing Hungary.

15. Concerns were expressed also over the time phasing proposed for the Bank's financial support. One concern was that the Bank was repeatedly expected in Hungary to provide substantial financial support up-front, in the expectation that the commercial banks would then soon follow. But this expected response of the banks keeps being pushed back. Another concern was over the time profile of the Bank's financial support itself. Two quick-disbursing loans were now being proposed to proceed in parallel, with both fully disbursed by January 1992 under the proposed plans. Yet Hungary's reform program will be underway for much longer; the IMF EFF will last until end-1993, and important actions are not planned until 1992 or 1993. The recommendation was therefore made that the Bank's support for this overall program be stretched-out, and not all focussed on the coming year.

16. The Chairman concluded by noting that the longer-term financing plan should be the main focus, and that if it was realistic to assume the banks would provide financing on a voluntary basis of 80% of the amortization due them over the next couple of years, then substantially more should be expected over the medium term. Otherwise, if this continued, the World Bank funds would just be repaying the banks. But the World Bank should certainly not recommend to Hungary that they reschedule their commercial bank debt this year, if it is realistic to expect they will get a 80% roll-over of this year's maturities. We do not want to be put in a position to be blamed, if a rescheduling turns out to be necessary.

D. Decisions

17. The Chairman directed that the Privatization and Enterprise Restructuring Loan could proceed to Appraisal as planned, taking into account the discussion summarized above. Further work was required, however, on the proposed SAL II, along the lines discussed above. The documentation should be re-done reflecting the re-worked program, and brought back to him and to the Operations Committee for approval, before the operation proceeds to the Appraisal stage.

FJLysy: FJL

March 8, 1991

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

Page 6

DATE: February 5, 1991

TO: Operations Committee

FROM: Enzo Grilli, Director, EAS

EXTENSION: 81938

SUBJECT: HUNGARY - Structural Adjustment Loan (SAL II) and Privatization and Enterprise Restructuring Loan; Initiating Memoranda; Operations Committee Meeting Agenda

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1. The Operations Committee will meet on **Friday, February 8, 1991, at 4:30 p. m. in Room 1243** to consider the Initiating Memoranda for the Structural Adjustment Loan (SAL II), and Privatization and Enterprise Restructuring Loan, for Hungary. One and a half hours have been set-aside for the discussion of these two operations. Note that the February 8 date is a change from the originally scheduled date of Thursday, February 7; at the request of Finance, the Morocco and Hungary OC meeting times have been switched. The following is a proposed agenda for the meeting.

Background

2. The Bank has had a major lending program in Hungary since 1983, with a principal focus on industrial restructuring. The program expanded significantly in scale in 1990, with the fundamental political and economic changes that began that year. The new post-Communist Government is committed to introducing a market-based economic system, and has taken major steps in that direction. The approach taken has differed in important respects from that being followed in Poland. In Poland the emphasis has been on immediate, once-and-for-all, fundamental changes in policies; Hungary, in contrast, has followed a more measured but steady pace.

3. The Region is proposing that the Bank proceed with two quick-disbursing adjustment operations to support the current stage of the transformation program. These would be the fourth and fifth quick-disbursing operations the Bank has provided for Hungary, and based on the current lending program, they would be the last. The SAL II operation was planned, as of last summer, to be a FY93 operation. However, with the on-set of the Gulf Crisis, Regional Management decided to bring it forward to FY91. The previous quick-disbursing operations in Hungary consisted of an Industrial Restructuring Operation in FY86, an Industrial SAL in FY88, and the first regular SAL in FY90. The second tranche of this SAL has just been released, based on policy actions taken with the start of the year. There has also been strong policy content in a number of investment operations approved for Hungary; particularly relevant for the operations being

considered today are the FY90 Financial Systems Modernization Loan, where there were conditions on financial sector policies, and the FY89 Energy Development Loan, where a program to raise energy prices to economic levels was agreed to. In addition, a follow-up Financial Systems Modernization Loan is planned. Finally, Industrial Restructuring Loans II and III (FY87 and FY89) are line of credit operations with funds still available; these funds will be used in part to complement the industrial restructuring plans that will be developed in the context of the proposed Privatization and Enterprise Restructuring Loan being considered today.

4. An IMF program is in place in Hungary. A modest, 12-month, Stand-by of SDR 159 million (30% of quota, or about $215 million), was approved by the Fund's Board on March 14, 1990. All four purchases eligible so far have been made, but despite this, Hungary received a <u>negative</u> $148 million net from the Fund in 1990. This was due to a special repurchase Hungary had to make in the first quarter of the year, as a consequence of earlier mis-reporting to the Fund. A major Fund program is now planned. The Fund's Board is scheduled to discuss on February 20 an EFF for SDR 1,114 million (210% of quota, or about $1.5 billion). In addition, in mid-January the Fund Board approved a CCFF drawing of SDR 226.2 million. There would be a further CCFF drawing in about six months of SDR 121.8 million, if the external conditions warrant.

5. It is suggested that the OC discussion of these two operations be largely integrated. It is proposed that the OC first discuss the specifics of the policy program that is to be supported by the two operations, that the external financing plan to support the program then be reviewed, and that lastly the broader issues of Bank country assistance strategy in Hungary be considered.

ISSUES

The Policy Program Being Supported

6. The program to be supported under the Privatization and Enterprise Restructuring operation would focus on three key areas (see page 23 of the IM for a summary of the key conditionality): Privatization, Ownership Reform, and Enterprise Restructuring (including liquidation). The program is comprehensive, and in each of these areas there is a combination of measures that includes establishing a policy framework, institution building, and the setting of specific targets by which progress can be measured. The Operations Committee might wish to consider the following specific issues:

(a) Agreement on a program for liquidations (with specific targets) is included in the Policy Matrix for the operation (at the very end), with specific actions shown both for Board Presentation and for Second Tranche. These do not appear to be included, however, in the specific legal conditions that will be required

Industrial

Subsidies.

for tranche release. Should they be, given the importance of having an effective liquidation process? What is the question?

(b) The soft budget constraint has been very important in Hungary (and elsewhere in Eastern Europe), at least in the past. The proposed operation does not appear to address this directly. Should it, perhaps with specific targets on the maximum transfers that will be allowed?

(c) Discussion is underway on establishing a special fund that will provide credit for privatization at a preferential interest rate equal to 75% of the rediscount rate of the National Bank of Hungary, plus 4% points for bank margins (para. 23 of the Privatization IM, or para. 32 of the SAL II IM). The current rediscount rate is 22%, so this would work out to be 20.5%. Such a preferential rate would be negative in real terms (producer prices rose by 24% in 1990, while consumer prices rose 30%; however, the IMF program envisages a sharp reduction in this over time). Should the Bank be supporting provision of directed credit at preferential rates for such a purpose? If directed credit is considered warranted, is the particular formula (based on 75% of a basic rate, as opposed to a basic rate minus some percentage points) reasonable in an inflationary environment?

(d) The SAL II includes support for a limited program of anti-trust actions to encourage the development of competitive markets. Since this concern on anti-trust will be central in the proper implementation of the Privatization and Enterprise Restructuring programs, would it be more appropriate for Bank involvement in this area to be centered through the Privatization and Enterprise Restructuring operation, rather than the SAL II?

Seems more germane to Priv Enterp

(e) Should the Privatization and Enterprise Restructuring operation include the standard macro conditions, or rely instead on the parallel SAL II?

Yes.

(f) Are there other specific areas of conditionality that should be included?

7. The key conditions for tranche release of the SAL II are summarized on page 24 of its IM. The coverage of the SAL II program is broad. Aside from the standard macro framework conditions, the program will address the issues of : 1) Privatization and Enterprise Restructuring, 2) Financial Sector Reforms, 3) Energy Prices, 4) Trade Reform, 5) Fiscal Reform, 6) Price Liberalization, and 7) the Social Safety Net. There is, however, strong overlap with specific aspects of the policy program that are being supported more directly through other Bank operations. In particular, it appears that all of the tranche release conditions in the first three areas listed above (Privatization and Enterprise Restructuring, Financial Sector, and Energy Prices), as well as the programs in these three areas more

generally, duplicate conditionality (and agreement on the programs more generally) already required under existing Bank operations (or the proposed Privatization and Enterprise Restructuring operation being considered today).

(a) The Region might be asked to discuss what will be added by the proposed SAL II in these areas.

8. In the Fiscal Reform area, no specific conditionality is being proposed. However, the Government plans to implement significant tax reform measures, as well as changes in the budgetary process.

(a) The Region might be asked what the Bank's involvement in this area is expected to be. Should there be direct Bank support? Is this an appropriate area for specific conditionality?

9. In the area of Trade Reform, the program would reduce QR's on imports from the current 28% of industrial production coverage, to 20% in 1992. Announcement (not implementation?) of the 1992 program would be a condition of Second Tranche release. The SAL I supported the first phase of this trade reform program.

QR's

(a) At 20%, the QR coverage at the time of the second tranche of our second operation in this area, would be higher than has been required in a number of recent Bank operations supporting trade reform (particularly in Latin America). Is this an appropriate target for Hungary?

Global quotas

10. In addition to specific QR's that require licenses for the imports of certain goods, Hungary also enforces a second layer of quantitative restriction, through a global quota on the imports of consumer goods. This second layer of restrictions is not discussed in the IM, although it has been a central element of the Bank's dialogue with Hungary for several years 1/. As reported in the Financial Times of January 30, 1991, this quota has been set at $630 million for consumer goods imports in 1991.

(a) Should there be any conditionality in this area?

11. Initiation of a study of effective protection will be a condition of Board Presentation, and initiation of an action program to implement the recommendations of the study will be a Second Tranche release condition.

(a) The Region might be asked to describe to the Committee what would be the broad parameters on effective protection that the Bank would consider acceptable for Second Tranche release.

1/ See, for example, the 1988 CEM for Hungary, pp. 40-41.

12. On Price Liberalization, there have been major changes in the system from that under the Communist Government. This was supported, in part, under the SAL I. About 90% of consumer prices are now considered to be "free", with the remaining items largely for public utility services, transport, plus milk and white bread. No further conditionality is proposed under the SAL II in this specific area. However, "free" prices are still technically subject to the requirement that they not exceed "equivalent import prices". ?

(a) The Region might be asked who decides whether the prices exceed the equivalent import levels. Is this legal limitation subject to abuse?

13. Viewing the SAL II program in its entirety, it would appear that aside from the standard macro conditions, and eliminating those policy conditions that are already required under existing Bank operations (or the Privatization and Enterprise Restructuring Loan), the following Board Presentation and Second Tranche Release conditions would remain. For Board Presentation: 1) Initiate study on effective protection. For Second Tranche: 1) Anti-trust action program; 2) Announcement of a program under which 1992 import QR's will not exceed 20% of industrial production coverage; 3) Implementation of effective protection study; 4) Submission to Parliament of bills on the public pension system, health care, and funding of social assistance programs. It should also be noted that several important recent policy actions formed the basis for the recent (February 5) release of the $100 million Second Tranche of the SAL I (along with $100 million of Japanese co-financing).

(a) The Operations Committee might wish to discuss whether the SAL II program in its entirety suffices, and warrants a loan of $200 million.

The External Financing Framework

14. The current account was roughly in balance in 1990 (a convertible currency deficit of only $80 million, or 0.25% of GDP). Under the IMF program, a deficit of $550 million had been envisaged initially. A sharp deterioration is expected in 1991, however. In part this is due to the break-up of the CMEA system, and in part this is due to the effects of the Gulf Crisis. The Region is using an estimate that the impact of these changes would lead to a deterioration in the balance of payments of $1.9 to $2.3 billion, if no adjustment measures in response to the shock were undertaken. This estimate uses the IEC oil price projection (of the OPEC average) of $23.8 per barrel. This shock effect is of course difficult to calculate and will never be observed. But relative to it and based on adjustment measures planned, the total current account deficit projected for 1991 is $1.2 billion, or 3.6% of GDP. The result is sensitive to the price of oil assumed. With the recent decline, the price for West Texas Intermediate was $20.65 on February 5, or less than the year ago price of $22.50. Arab

Light (which is a grade that has generally been closer to the OPEC average price that IEC projects, than West Texas Intermediate has been) was $17.45 on February 5, versus $18.15 a year ago. Given oil price volatility, one cannot, of course, ever be sure, but if oil prices were to average $5 per barrel less than the $23.8 projected (for the OPEC average), Hungary would save about $700 million per year on oil and natural gas (whose price is linked to oil, although with a lag).

15. A rapid fall in the current account deficit is projected: from the $1.2 billion in 1991, to $650 million in 1992, and to rough balance thereafter. The financing plan developed with the IMF (and ourselves) envisages high levels of official support, especially early in the period (1990-92). For the full EFF period of 1991-93, plus 1990 actual, gross disbursements from the EC would total $1,128 million, from the G-24 $350 million, and from special Japan EXIM funding $512 million. Over this period (1990-93), net purchases from the IMF would total $1,752 million (although this would be off-set by reserve accumulation required under the Fund program of $1,607 million), while net disbursements from the Bank would total $1,050 million (and $1,485 million gross).

16. In sharp contrast to these high levels of official support, commercial/private (mainly commercial bank) net lending would be highly negative. Over 1990-93, net disbursements from commercial/private sources would total a negative $2,036 million, with roughly a negative $400 million in 1991, a negative $800 million in 1992, and a negative $400 million in 1993. Although high levels of voluntary new funding from the banks will likely be difficult to arrange, it should be noted that in a situation of negative net disbursements the country has a good deal of bargaining leverage; a simple rescheduling would raise the net disbursements up to zero.

(a) The Operations Committee may wish to assess whether the external financing plan is a reasonable one.

17. At the same time, the overall Bank program in Hungary would be a large one, given the population of the country (10.6 million). Based on the Bank lending program proposed, commitments to Hungary would average $40.9 in per capita per annum (pcpa) terms over FY91-93. Of all the lending programs as shown in the MIS, this would be by far the largest for any country whose population exceeds one million. In no other country, are lending commitments planned to be over $30 pcpa. It should also be noted, however, that all of the Bank's exposure ratios are well below guideline levels, and are projected to remain so.

(a) Is IBRD support on the scale proposed warranted, and is the proposed burden sharing between official sources (including the Bank) and commercial/private sources reasonable?

Overall Bank Country Assistance Strategy

18. The last CSP for Hungary was reviewed by the President's Council in July 1989. There have of course been fundamental changes in the country since. As noted above, the proposed Bank lending program is an extremely large one, given the size of the country. And although annual lending levels are fairly steady through time, all the quick-disbursing assistance would end (under the current program) with the two operations being considered today. The plan is that the second tranches of these operations would disburse in early 1992. Yet the "Memorandum of Economic Transformation and Medium-Term Policies" presented by the Government to the Bank and the Fund (Annex 2 in the SAL IM package) lays out a three-year 1991-93 reform program. This three-year program forms the basis for the 1991-93 IMF EFF Arrangement, and important actions are planned for 1992-93. For example, full currency convertability for current account transactions is only planned for 1993, which of course restricts the degree of trade liberalization that can be effected before then.

(a) The Region might be asked to discuss their proposed country assistance strategy and its phasing, and in particular the form through which support will be provided to the carrying-through of the reform program in 1992-93. Will the investment operations planned be suitable vehicles for such support?

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, Burmester/Thahane, Hasan, Nouvel, Sood, Okonjo-Iweala, Thumm, de Melo, Pant, Fostvedt, Parmar, Pfeffermann, Rao, Kavalsky, Sandstrom, Liebenthal, Kilby, Robless, Blanchi, Khanna

FJL

FJLysy:

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: February 8, 1991

TO: Mr. Willi A. Wapenhans, EMNVP

FROM: Larry Summers, DECVP

EXTENSION: 33774

SUBJECT: **HUNGARY - Initiating Memoranda for a Proposed Structural Adjustment Loan (SAL II) and Privatization and Enterprise Restructuring Loan**

1. I broadly support these loans, but I have two concerns.

2. Pace of Privatization. The Government's target of selling off 50 percent of the competitive part of the state enterprise sector by the end of 1993 appears highly optimistic. The text of the Privatization and Restructuring Loan discusses the constraints to the process, and some simple numbers illustrate. The book value of state enterprises in Hungary is roughly equivalent to GDP. By contrast revenues from privatization were equivalent to about 15 percent of one year's GDP in Chile (over 1974-88), 8 percent of GDP in the UK (1981-88) and 3 percent in Mexico (1988-90). Starting positions were very different in these countries: in Chile, public enterprises employed less than 6 percent of the work force in 1973. Hungary's plans are unprecedented from both an administrative and financial perspective. This is expected to take place in the context of a radically altered market environment (implying major economic restructuring) and substantial macroeconomic uncertainties.

3. I think we should be realistic in assessing this program so as not to support inappropriate expectations. I would not question the choice of the Government to privatize through sales, rather than through across-the-board approaches now under consideration in Poland. It is too early to form a view on the relative advantages of the differing approaches. However, a slower pace of privatization implies that the state enterprise sector could be dominant for some time. Much greater weight in the strategy has to be given to the management and restructuring of state enterprises, with the maintenance of hard budget constraints of central importance.

4. Burden-sharing between private and official lenders. The documentation makes clear that Hungary is facing a period of severe external resource constraints in the wake of a large adverse external shock. At the same time commercial creditors receive net repayments of US$1.7 billion in 1991-94, while the Bank puts in almost US$1 billion and other official lenders much more. It is not clear that this represents an appropriate borrowing strategy. I recognize that maintenance of creditworthiness is important, but if Hungary is to face negative net transfers to private banks until 2000, as is implicit in the current projections, the benefits are not clear. Moreover, the scenario for the external accounts seems optimistic, with a rapid turnaround in the current account deficit. In the event of a worse out-turn, the Bank and other official lenders will be less well-placed to help later in the decade if they take such a heavy burden in the next few years.

cc: Messrs. M. Qureshi, W. Thalwitz, E. Jaycox, A. Karaosmanoglu, V. Rajagopalan, I. Shihata, K. Kashiwaya, D. Bock, E. Grilli, P. Isenman, J. Linn, D.C. Rao, E. Lari

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THE WORLD BANK / IFC / MIGA

OFFICE MEMORANDUM

DATE: February 7, 1991

TO: Mr. Moeen A. Qureshi

FROM: Joe Wood, FPRVP

EXTENSION: 80602

SUBJECT: **HUNGARY - SAL II and Privatization Loans**

There will be a Finance Management retreat on Friday and I will not be able to attend the OC discussion on the loans to Hungary. I would like to mention some points of concern on these operations:

1. I am fully aware of Hungary's reluctance to reschedule. However, this position is resulting in unfair burden sharing. Table 2a shows that private banks will be repaid $2.1 billion net over 1990-94 while official creditors put in $5.0 billion net, of which $1.2 billion would be provided by the Bank. I think we all agree that multilateral institutions have a prominent role to play in supporting economic transformation in Eastern Europe at this time, but certainly not in providing resources to make large repayments to banks. This strategy implies a drastic departure from the one agreed in the last CSP (reviewed in June 1989) which contemplated no change in commercial bank exposure over that period. Obviously adjustments have to be made to respond to changing circumstances, but it should be within an agreed strategy framework. Hungary no longer has meaningful voluntary access to private capital markets (as indicated in paragraph 21), and we should think of ways to prevent a generalized bailout of banks by multilateral institutions.

2. This brings me to my second point. Parallel to the $200 million SAL II operation (which is being brought forward from FY92) there is a fast-disbursing $150 million Privatization operation. As I recall, SAL I included conditionality related to privatization. In effect, what is being proposed is a $350 million SAL II, or more if the Privatization loan is increased, as foreshadowed in the covering memorandum for this operation. The burden sharing considerations mentioned above would indicate the need to go in the direction of reducing the amounts of quick-disbursing funds, not increasing them.

3. I am also concerned that the conditionality associated with the Bank loans provides relatively little additionality to the Fund program. For example, of the five conditions for SAL Board presentation, two are presumably covered by the Fund's EFF (macroeconomic performance and energy prices), two do not mean much in terms of actions (initiate study on effective protection; finalize strategy for addressing problems in banks), which leaves only the presentation to Parliament of the prudential banking regulations as genuine conditionality. Some of the SAL's second tranche conditions rely on submission of laws to Parliament rather than on actions (see table 3, page 24), and I wonder if this is the most effective way of ensuring that the

reforms will be implemented. Finally, it would be interesting to know to what extent the reforms in these loans go beyond that agreed in the EFF, since this type of Fund operation usually includes significant conditionality in the area of structural reform.

cc: OC Members
Messrs. Lari, Grilli

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: February 6, 1991

TO: Mr. Moeen A. Qureshi

FROM: Frank J. Lysy, Economic Adviser, EAS FJL
(Through: Enzo Grilli, EG Director, EAS)

EXTENSION: 81945

SUBJECT: HUNGARY - PROPOSED SAL II

1. As is normally done, we will brief you on the Hungary SAL II and Privatization and Enterprise Restructuring Loans, just prior to Friday's OC meeting. However, we thought it would be of use to express to you privately and in written form some concerns we have on the SAL II operation, prior to that briefing.

2. We believe the Privatization and Enterprise Restructuring Loan is a solid operation, that should be approved. It reflects a good deal of work, as well as expertise that has been built-up through work on this area in Hungary over a number of years.

3. The SAL II operation, in contrast, looks more hurried. This should not be surprising. It was originally planned to be a FY93 operation (although with a Board date of March 1992), but was brought forward in response to the Gulf Crisis. As a consequence, the conditionality was largely drawn from areas being covered under other Bank operations. Excluding what the Bank will be dealing with under other operations (usually more directly), there is not much left.

4. We would therefore propose that you consider directing the Region to work further on the preparation of this operation, with a delay in the eventual Board Presentation date of perhaps six to twelve months. The Privatization and Enterprise Restructuring Loan would be made a FY91 operation, and the SAL II a FY92 operation. There would be several advantages to such an approach. These include:

(a) It would allow the Region time to develop a more solid operation.

(b) The urgency of the Gulf Crisis is not so apparent now as it appeared to be last October, when the decision was made to bring this operation forward. Immediate financing requirements are likely to be less, and we should in any case be looking to the commercial banks to be covering some share of what is needed. The current financial plan envisages repaying the commercial banks a net $400 million in 1991 and $800 million in 1992. Negative net disbursements to the banks on such a scale are hard to defend.

(c) Most importantly, our primary concern is that with the SAL II brought up now (and fully disbursed by early 1992), the Bank would have no policy-based instrument to serve as a vehicle for the policy discussion that will need to continue with Hungary for some time. The "Memorandum of Economic Transformation and Medium-Term Policies" and the IMF EFF envisage a three-year program where important measures will be undertaken only in 1992-93. Yet it is not clear that the Bank will have an appropriate instrument to serve as a vehicle for the policy discussion that we will need to continue into that period. Certain investment loans will have strong policy content, but it would be useful to have a quick-disbursing operation available as well. No further adjustment operations are planned after the SAL II, and given the large size of the Bank's program in Hungary, it would be difficult to add a new adjustment operation should the usefulness become clear.

5. To conclude, we would recommend that you consider directing the Region to work further on the SAL II operation, with a view to focussing the operation on the adjustment policies that Hungary will need to introduce in 1992 (and perhaps 1993; perhaps a three-tranche operation should be considered?). The Board date would be postponed by six to twelve months.

FJLysy:

cc: Bock, Okonjo-Iweala

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THE WORLD BANK/IFC/MIGA
OFFICE MEMORANDUM

DATE: January 29, 1991

TO: Mr. Moeen A. Qureshi, OPNSV

FROM: Mr. W. A. Wapenhans, EMNVP

WG.

EXTENSION: 32676

SUBJECT: **HUNGARY: Structural Adjustment Loan - Initiating Memorandum**

1. I attach for OC consideration the Initiating Memorandum for the proposed SAL 2 to Hungary in an amount of $200 million equivalent. This loan would support the Government's revised and accelerated medium term reform program which aims at creating a competitive market economy in Hungary. The Government's medium-term reform program, articulated in its "Memorandum of Transformation and Medium-Term Policies" was distributed to the Board earlier this month and is also attached (Annex 2 of the IM). This operation complements the proposed Privatization and Enterprise Restructuring project, whose Initiating Memorandum will also be distributed to you separately. Subject to your approval, we hope to prepare the two projects in parallel. However, only one of the two projects would be presented to the Board in FY91. Together with the already approved Telecommunication Development project ($150 million) and the proposed Human Resources Development project ($150 million) soon to be negotiated, the proposed FY91 lending program for FY 91 would amount to a maximum of 500 million.

2. As you are aware, the Hungarian Government had requested additional financial assistance from the Bank to alleviate the adverse impact on their balance of payments resulting from the increase in world energy prices and the transformation of CMEA trade to market principles. These changes are expected to have a negative impact on Hungary's balance of payments equivalent to about $1.9-2.3 billion (7 percent of GDP) in 1991. The Hungarian authorities have begun implementing a tough stabilization and structural adjustment program to adjust to this shock and to maintain macroeconomic stability and to accelerate the transformation to a market economy. As a result of the Government's reform program, it is expected that the current account deficit would deteriorate by no more than half of the adverse impact on the balance of payments in 1991. This represents a substantial adjustment effort. However, additional external financing is necessary to finance the current account deficit and to build up reserves to prudent levels, especially in view of possible further disruptions in regional trade. The Government has requested the IMF for an arrangement under the Extended Fund Facility (EFF) for an amount equivalent to SDR 1114 million as well as for purchase under the Contingency and Compensatory Financing Facility (CCFF) for SDR 348 million. The IMF's Board approved the CCFF on January 16, 1991 and is expected to consider the request for EFF in February. A Letter of Intent, which will form the basis for the EFF has been signed by the Government and was distributed to the Board of the IMF. The Government has requested the Bank to support its reform efforts with a SAL 2.

3. The proposed SAL 2 represents an acceleration of the reforms initiated under SAL 1. Implementation of the economic reform program under the SAL 1 was good and with the exception of an insignificant slippage in achieving the subsidy reduction target, all second tranche release conditions were met (Annex 1 of IM). As a result of the good implementation of stabilization measures and structural reforms, there were important favorable results, most notably the significant improvement, equivalent to 5 percent of GDP, in the current account of the balance of payments in convertible currencies. However, real economic activity was much weaker than foreseen at the beginning of the year and GDP is estimated to have declined by 5-6 percent in 1990 (compared to earlier projected decline by 1-2 percent). Despite the larger than anticipated fall in GDP, the debt to GDP ratio fell from 71 percent in 1989 to 62 percent in 1990 mainly because of the outflow of short-term capital by about $1 billion. The main reason for the larger decline in GDP are (i) the larger than anticipated contraction in ruble exports, which fell by 27 percent compared to a planned decline of 20 percent; as a result the volume of total exports fell by 7 percent, despite the increase of convertible currency exports by 10.5 percent; (ii) drought-related losses, which are estimated to account for at least 1.5 percentage points of the fall in GDP; and (iii) a more forceful implementation of industrial restructuring. The rate of inflation is estimated to have accelerated to 30 percent in 1990, significantly above the revised target of 22-23 percent. The higher rate of inflation is due to a combination of external factors (oil prices) and policy measures (devaluation, subsidy reductions and excise tax increases), some of which were implemented in response to the external shocks. The Government recognizes that, in addition to tight fiscal and monetary policies, stabilizing the rate of inflation will require greater competitive pressures in the economy. This is one of the key elements of the Government's reform program, which the SAL 2 would support. The emphasis on private sector development, domestic price liberalization, and enforcement of antitrust legislation will increase competition from domestic producers, and the acceleration of import liberalization and foreign direct investment will intensify competition from foreign producers.

4. The basic thrust of structural reforms is to increase competition and to emphasize the role of markets and the private sector. The role of the state, directly as owner of productive assets, and indirectly through policy interventions in economic activity is to be significantly reduced. The four main components of the Government's structural reforms are: (i) reduction of the role of the state through private sector development and measures to reduce the role of the state budget in redistributing resources through taxes and transfers; (ii) intensification of competition, through strong reliance on further import and domestic price liberalization, promotion of new small- and medium-sized enterprises, and an effective antitrust policy including the break-up of highly concentrated market structures that limit competition; (iii) financial system reform, including further liberalization and improved prudential regulations and supervision, and increased competition; and (iv) the further development of an adequate social safety net. A draft policy matrix summarizing the contents of

the reform program is attached as Annex 3 to the IM. This will be developed more fully during the appraisal mission when we will agree with the Government on specific actions to be taken during implementation of the program. The core conditionality for the proposed SAL 2 are summarized in Table 3 of the IM. These will be finalized during appraisal.

5. The proposed SAL 2 is heavily front-loaded and several key measures have already been implemented. These include: (i) On January 7, 1991, 15 percent devaluation of the forint against the basket of currencies to which it is pegged; (ii) the adoption of a restrictive budget for 1991; (iii) announcement of a substantial liberalization of the import regime (72 percent of industrial production are no longer protected through QRs in 1991 compared to 32 percent in 1990); (iv) further price liberalization (90 percent of consumer prices are free), and price increases for administered prices, including for energy; and (v) elimination of interest rate ceilings, resulting in further liberalization of the financial system.

6. The implications for Bank exposure of the macroeconomic framework and the external financing plan underpinning the proposed SAL 2 are described in para. 23 of the IM. The Bank's share in Hungary's total debt outstanding and disbursed would rise from 7.9 percent in 1990 to 11.5 percent in 1995, then decrease to 9.9 percent by 2000. The debt service to the Bank decreases from 3.2 percent of export earnings in 1990 to 2.4 percent in 1995. The Bank's share of total preferred creditor outstanding debt is projected to decrease from 29.8 percent in 1990 to 25.7 percent in 1995, then rise to 27.4 percent in 2000.

7. Subject to your approval, the appraisal mission for the proposed loan is tentatively scheduled for February 7-22, 1991, with Board presentation on June 4, 1991.

Attachment

Distribution:

Regional: Messrs. Hasan, Dhar, Blanchi (EMNVP)

Country Department: Messrs. Lari, Thumm, Zaidan (EM4DR); Nouvel, Pant, Condon, Rajagopalan, Kessides, Chen, Hinayon (EM4CO); Sood, Fostvedt, de Bruyn Kops, Singh (EM4IE); Apitz (EM4IN); Ringlien (EM4AG); Montfort, Hamilton (EM4EE); Harbison, Boissiere, Schweitzer (EM4HR)

Technical Department: Messrs. Kohli (EMTDR); Hinds, Tarr (EMTTF); Ackerman (EMTEN); Roa (EMTPR)

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For information: Messrs. Wyss (COD); Isenman (PRD); Corbo, Coricelli, Gelb, Sagari, Sheng, Nellis (CEC); Stoutjesdijk, Kilby, Oliveros, (FRS); Kashiwaya, Chaffey (CFSVP); Picciotto (CPB); Gustafson (IFC); Burmester/Thahane (SECGE); Ms. Okonjo-Iweala (OPNSV); Parmar (IFC-CIO); Rao, Diwan (IEC); Kavalsky (FRM); Pfeffermann (IFC-CEI); Liebenthal (PRD); Kilby (FRS); Robless (OPNSV); Sandstrom, Khanna (EXC)

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Annex 1

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: January 22, 1991

TO: Mr. Moeen A. Qureshi, OPNSV

FROM: Mr. W. A. Wapenhans, EMNVP

EXTENSION: 32676

SUBJECT: HUNGARY - Structural Adjustment Loan (SAL) (Loan No. 3228 - Hu) - Second Tranche Release.

1. A Bank mission visited Hungary in December 1990 to review progress in meeting the requirements for release of the second tranche of $100 million of the SAL which was approved in June 1990, and made effective in July, 1990.

2. 1990 was a landmark year in Hungary. After more than 40 years, free multi-party elections were held and a new coalition government took charge in April, 1990. The Government's commitment to creating a competitive market economy in Hungary, reflected in their Letter of Development Policy dated May 25, 1990, was demonstrated by its adherence to the policies underlying the SAL.

3. The economic stabilization and structural adjustment program supported by the SAL is proceeding satisfactorily, as the attached draft memorandum to the Board indicates. Strict implementation of the policy program has had some important favorable results. Despite unfavorable and unforeseen exogenous developments -- including the worst drought experienced by Hungary this century, the unexpected shortfall in Soviet oil imports and higher oil prices on world markets -- the current account in convertible currencies is expected to be close to balance in 1990. This is better than the targeted deficit of $550 million and represents an improvement equivalent to more than 5% of GDP over 1989. The improvement was in part due to the stronger-than-expected growth of real exports to the convertible currency markets

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cl/w&cc: Messrs. Hasan (EMNVP); Lari, Thumm (EM4DR); Nouvel, Condon, Rajagopalan (EM4CO); Al-Jabri (LEG)

cc: Messrs./Mmes. Blanchi, Dhar (EMNVP); Zaidan (EM4DR); Kessides, Hinayon, Chen (EM4CO); Sood, Fostvedt, de Bruyn Kops, Singh, Sumi (EM4IF); Apitz (EM4IN); Montfort, Hamilton (EM4EE); Harbison, Boissiere, Schweitzer (EM4HR); Ringlien (EM4AG); Hinds, Tarr (EMTTF); Ackerman (EMTEN); Roa (EMTPR); Grilli, Lysy, Levy (EAS); Stoutjesdijk, Kilby, Oliveros (FRS); Corbo, Coricelli, Gelb, Sagari, Sheng (CEC); Rao (IEC); Diwan (IECDI); Petit (AGRDR); Pouliquen (INUDR); Churchill (IENDR); Piddington (ENVDR); Hamilton (PHRDR); Fowler (LOAEL); Nellis (CEC); Kashiwaya (CFSVP); Chaffey (CFSCO); Belanger, Boote (IMF)

(10.5 percent compared to 8.5 percent projected earlier), and mainly due to improvement in the travel account as a result of lower spending abroad by Hungarians and record tourist receipts in Hungary, and unrequited transfers.

4. To bring about the dramatic improvement in the current account, the fiscal deficit was sharply reduced. Despite the external shocks referred to above, which threatened revenue shortfalls, the authorities acted promptly to implement corrective measures. As a result of these actions, the targeted surplus of Ft. 10.3 billion in the consolidated state budget balance on a Government Financial Statistics (GFS) basis is projected to be met. This represents an improvement equivalent to 2% of GDP over 1989. The authorities also continue to implement tight monetary policies. The interest rates on treasury bills sold to households were raised in November by 4 - 5 percentage points, to 27 - 30 percent. The refinancing rates of the NBH were raised in mid-October to 22 percent for the basic rate and 28 percent for the liquidity rate, and all short-term refinancing interest rates of the NBH, with the exception of those for export refinance, were raised to 28% in the fourth quarter. Ceilings on interest rates for household deposits were eliminated in December. Adjusted for inflation, real interest rates are positive.[1]

5. The unfavorable developments were the larger than anticipated decline in real output and the higher than projected rate of inflation. Real economic activity was much weaker than foreseen at the beginning of the year and GDP is estimated to have declined by 5-6 percent in 1990 (compared to earlier projected decline by 1-2 percent). The main reasons for the larger decline are (i) the larger-than-anticipated contraction in ruble exports, which fell by 27 percent compared to a planned decline of 20 percent; as a result, the volume of total exports fell by almost 7 percent despite the increase of convertible currency exports volume by 10.5 percent; and (ii) drought-related losses, which are estimated to account for at least 1.5 percentage points of the fall in GDP. The rate of inflation is estimated to have accelerated to 30 percent in 1990, significantly above the target of 22-23 percent. While some of this increase is due to the impact of the external shocks and the necessary corrective measures (subsidy reductions, administered price increases), it is clear that competitive pressures would have to emerge quickly and sufficiently strongly to lower the rate of inflation. For this reason, the government is accelerating its reform program.

6. The implementation of structural reforms is proceeding well, and in some cases has gone further than was envisaged when the loan was approved. Progress in the area of privatization, and foreign trade and price liberalization have gone beyond commitments under the SAL. Adequate progress is being made in forcing insolvent enterprises

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[1]Producer prices are estimated to have increased by 24% in 1990. The consumer price index is projected to increase by 30%, 5% of which is due to the budget measures undertaken during the summer and early November.

to face bankruptcy proceedings, which should result in their restructuring or closure. Satisfactory actions were also taken to improve the social safety net, and a more comprehensive reform is being prepared. The Government's commitment to accelerating structural reforms is outlined in their "Memorandum of Economic Transformation and Medium Term Policies" which was prepared in December 1990 with inputs from the staffs of the Bank and the IMF (see para 10). In this context, agreement was reached on an ambitious medium term macroeconomic framework, requiring substantial adjustment to restore Hungary's creditworthiness and lay the foundations for sustainable growth.

7. One of the conditions for release of the second tranche was that the level of subsidies were to be no more than 9 percent of GDP in 1990. During 1990, the authorities shifted the funds for certain local transport subsidies as well as those for subsidies for first-time homebuyers from the state budget to the discretionary control of the local governments. When the 1990 subsidy target is adjusted for these shifts, the revised subsidy target is 8.6 percent of GDP in 1990. On a comparable basis, the actual ratio of subsidies to GDP is projected to be 9.1 percent, implying a small overrun of 0.5 percent of GDP. The slightly higher ratio of subsidies was due to a lower level of GDP, and also because of over-runs in pre-1989 housing loan subsidies and higher subsidies for agricultural exports to the convertible currency area. The higher housing subsidies were a direct consequence of the decision of the Constitutional Court to reverse government measures to reduce pre-1989 mortgage loan subsidies. The higher subsidies for agricultural exports resulted from efforts to redirect production meant for the CMEA market to the Western markets, after ruble export licenses were cut back in response to shortfalls in imports from the CMEA countries.[2]

8. The subsidy reduction program under the SAL envisaged a further reduction of subsidies by 2 percentage points of GDP in 1991. The 1991 budget proposes subsidies be cut by a further 2.5 percent of GDP, thus bringing the 1991 subsidy target in line with that agreed under the SAL. The proposed subsidy cuts are associated with important structural reforms. Household energy subsidies and subsidies given to holders of pre-1989 mortgage loans are prime targets. The adjustment of consumer energy prices to bring them nearly to the level of economic costs is necessary to induce greater efficiency in energy use, while the reduction in interest subsidies on pre-1989 housing loans eliminates the need to retain ceilings on interest rates paid on household deposits, and thus removes the main constraint to financial sector integration.

9. In view of (i) the substantial (4% of GDP) reduction in subsidies in 1990; (ii) the relatively small deviation from the 1990

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[2]Agricultural exports to the CMEA area did not qualify for convertible currency export subsidies; their subsidization was financed from the Price Equalization Fund which was not included in the subsidy reduction program.

target; (iii) the success in meeting the overall fiscal balance target; and (iv) the attenuating circumstances, such as the lower level of GDP; the higher than planned agricultural export subsidies resulting from the redirection of agricultural exports from the Soviet market to the West; and the Court action reversing government measures to reduce housing subsidies; and (v) the resolve of the government, as reflected in the subsidy proposals for the 1991 budget to reduce subsidies by a further 2.5 percent of GDP, we believe the slight deviation from the subsidy reduction target for 1990 is acceptable.

10. The Hungarian Government is committed to accelerating the reform process which was initiated with the SAL. This commitment is reflected in their "Memorandum of Economic Transformation and Medium Term Policies", which was prepared with inputs from the staffs of the Bank and the IMF, and was distributed to the Board on January 7, 1991. Hungary is in good standing with the IMF in regard to the implementation of the stand-by arrangement which lasts until March, 1991. The Government has requested the IMF to cancel the present stand-by arrangement in favor of a 3-year EFF in support of their medium term reform program, and agreement on a Letter of Intent has been reached with the staff of the IMF. The IMF's Board is expected to consider Hungary's request in February, 1991. The IMF also approved Hungary's purchase under the Compensatory and Contingency Financing Facility for SDR 348 million on January 16, 1991.

11. The staff of the EXIM Bank of Japan, which is cofinancing the SAL, were invited to join the Bank supervision mission, but they were unable to participate due to other commitments. The EXIM Bank has been kept fully informed of our assessment of the implementation of the reform program.

12. The first tranche of $100 million (of the original loan of $200 million) has been fully disbursed. Since we believe that the progress in implementing the program has been good, and all conditions but one have been met fully, we recommend that we consider the slight shortfall in meeting the subsidy target as acceptable and seek approval by the Executive Directors of the release of the second tranche on a no-objection basis, thus waiving the condition of reducing the level of subsidies to no more than 8.6% of GDP in 1990. If you agree with the recommendation, we will distribute the attached memorandum to the Board. In the absence of objections by January 31, 1991 we will advise the Government of Hungary of the availability of the second tranche of $100 million.

Attachment

CPant:ad

THE WORLD BANK/IFC/MIGA
OFFICE MEMORANDUM

DATE: January 31, 1991

TO: Mr. Moeen A. Qureshi, OPNSV

FROM: Ram K. Chopra, Acting Vice President, EMN

EXTENSION: 32707

SUBJECT: HUNGARY: Privatization and Enterprise Restructuring Loan Initiating Memorandum

1. I attach for OC consideration the Initiating Memorandum for the proposed Privatization and Enterprise Restructuring (PER) Loan to Hungary in an amount of US$150 million equivalent. This loan would support the fundamental reform of the dominant state enterprise (SE) sector, thus supporting key aspects of the Government's medium-term reform program, articulated in its "Memorandum of Transformation and Medium-term Policies," which was distributed to the Board earlier this month. This operation complements the proposed SAL 2, the Initiating Memorandum for which is distributed to you separately: The SAL supports the Government's economic stabilization and the development of a positive framework for private sector growth, while the PER loan supports the privatization and restructuring of the present SE sector. The two loans will be processed largely in parallel, but the SAL 2 documents should be presented to the Board prior to or together with the documents for this loan. At present, we expect to propose SAL 2 for approval in FY91, while this loan would be presented in early FY92. During project processing, we will consider whether to increase the loan amount from the US$150 million now proposed. This will depend on the strength and scope of the program that we would support and, of course, on Hungary's balance of payments needs. The Bank's FY91 lending program for Hungary, the country's balance of payments situation and the justification for quick disbursing financing are discussed in the Initiating Memorandum for SAL 2.

2. The Government has requested the Bank's assistance to implement a comprehensive, detailed program for the fundamental reform of the dominant state enterprise (SE) sector, thus addressing in full core issues of Hungary's economic transformation that have partly been addressed under previous operations including SAL I. The Program would address inter-related issues in three broad areas:

* Privatization - in the context of developing the private sector in Hungary and in order to effect the reduction of the share of the SEs to less than 50 percent of the competitive sector over a period of three years; a very ambitious target that will require significant Government policy decisions and the systematic improvement of the Government's privatization machinery;

* <u>Ownership Reform</u> - in order to establish a Government organizational structure for the exercise of ownership over SEs together with the rapid transformation of SEs into company forms. This will introduce the ownership influence over SEs that is now missing, will establish company boards as key organs for strategic decisions and control of management, and place SEs on par with private enterprises;

* <u>Restructuring</u> - in order to establish realistic Government policies and priorities for the selective restructuring of enterprises (in a few cases as a prerequisite for privatization, or of enterprises that would remain for a while or forever in the SE sector), and to encourage the establishment of market-oriented institutions that can play a role in restructuring on commercial terms. This would include technical assistance support for the establishment of a "turn-around" entity with private sector management and investment that would restructure enterprises on a commercial basis for subsequent sales at a profit.

3. In addition to the Program as such, the Bank would work in the context of the proposed loan with up to 12 individual SEs to develop and implement specific restructuring programs. We believe that such direct Bank involvement on a limited scale is important in order to help initiate constructive restructuring in some important enterprises and to develop models that could subsequently be followed by other SEs.

4. In order to support the Program, we recommend a SECAL in the order of US$150 million equivalent, which would substitute for the FY91 restructuring project previously in the lending program. We expect that the Program will require significant technical assistance, which we will seek as much as possible to get financed through bilateral or multilateral grants for Hungary. We have in this respect been coordinating closely in particular with the EC PHOS (ex PHARE, i.e. Poland/Hungary economic restructuring assistance) administration, which has indicated its strong interest in participating with financing, possibly of about 40 million ECU, which could cover on grant basis a substantial portion of the technical assistance requirements as well as the Government's initial equity contribution to the proposed turn-around entity. We are also in close contact with staff of the EBRD, which may become actually involved in some components. We propose to finance additional technical assistance requirements, as well as investment requirements that might be identified in particular under the restructuring component, out of existing Bank lines of credit for Hungary. However, it is possible that in addition we would also require a technical assistance component under the proposed loan. This will be reviewed during appraisal.

5. A draft policy matrix summarizing the contents of the SE adjustment program is attached as Annex 3 to the IM. This will be developed more fully during the appraisal mission, when we will agree with the Government on specific actions to be taken during implementation of the Program. The core conditionalities for the proposed PER loan are summarized in Table 2 to the IM.

6. The Program has been under preparation with the Government for some time. Several components have been completed, such as the initiation of the active privatization programs from the State Property Agency, which was supported by SAL I. A number of other components are under advanced preparation, including preparatory analyses of the enterprises to be included under the proposed restructuring component. The Government has stated its strong interest in the Program, which it sees as urgent for helping accelerate the economic restructuring of the country. We therefore believe that the proposed loan should be appraised now, although a significant amount of work is still required in order to finalize the Program. In particular, delays in preparation have occurred due to a lack of Government coordination of the various activities under the proposed Program. With the recent internal Government changes in Hungary, however, we expect to be able to achieve significant progress in this regard. At appraisal, we would also confirm and quantify the various targets under the Program now indicated in the draft matrix.

7. We believe that tranching will be required for this loan, in view of the necessary lead time required for many of the activities under the Program. At present we think in terms of two equal tranches. Subject to your approval, the appraisal mission for the loan is scheduled to start around mid February 1991. As mentioned in para 1, we expect the loan to be presented to the Board in early FY92.

Attachment

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

Distribution:

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

Country Dept: Messrs. Zaidan, Thumm (EM4DR); Nouvel (EM4CO);
Apitz (EM4IN); Harbison (EM4HR); Montfort (EM4EE); O'Sullivan (EM4AG);
Rajagopalan, Pant, Condon (EM4CO)

Technical Dept: Messrs. Kohli (EMTDR); Wackman (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); Corbo (CEC);
Stoutjeskijk (FRSDR); Picciotto (CPBVP); Gustafson (CEMDR); 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)

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); Al Jabri
(LEGEM); Fowler (LOAEL)

Messrs. de Bruyn Kops, Sumi, Herat, Aghdaey, Singh (EM4IF)

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February 7, 1991

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THE WORLD BANK

OPERATIONS COMMITTEE

Minutes of the Operations Committee to consider
MOROCCO: I.M. for Structural Adjustment Loan (SAL 11)
held on February 7, 1991 in Room A-1243

A. Present		Others	
Messrs.	M. Qureshi, Chairman	Messrs.	A. Hovaguimian, CMEDR
	K. Kashiwaya, CFSVP		K. Dervis, EM2DR
	I. Shihata, LEGVP		S. Burmester, SECGE
	J. Wood, FPRVP		M. Ayub, EM2CO
	D. Bock, OPNSV		W. Grais, EMNVP
	S. Asanuma, ASIVP		E. Forestier, EM2IE
	R. Chopra, EMNVP		M. Walton, DEC
	J. Linn, DECVP	Ms.	N. Okonjo-Iweala, OPNSV
Ms.	K. Marshall, AFRVP		A. Khanna, EXC
	M. Selowsky, LACVP	Ms.	N. Dewitt, LEGEM
			M. Fardi, PRDRA
		Ms.	I. Guerrero, EM2CO
		Ms.	J. Salop, CODOP

B. Issues

1. The Chairman opened the meeting by saying there were three major issues to be discussed. The first had to do with the timing of the proposed operation, especially in view of the lending strategy agreed upon at the time of the President Council's discussion of the CSP -- to proceed cautiously with adjustment lending and link it to the existence of a medium-term Fund program (EFF). The second concerned the choice of the program. Even assuming that a SAL was justified, the program did not have a single focus but a variety of components. This needed explaining. Why not have, for instance, sectoral focus on the financial sector? The third related to the specific conditionality to which the $300 million loan would be tied. The proposed conditionality did not give an immediate picture of what reforms were being sought on a priority basis.

2. The Chairman, before opening the floor for the questions, asked the Region to first address these three issues.

3. At the outset the Region noted that it had proposed two last major adjustment operations for Morocco - the SAL II and the PERL II - when the CSP was discussed in the summer of 1990. Morocco was then moving closer to a situation where it was expected to be able to access again international financial capital. Its macro performance had improved regularly. It was felt that a last adjustment effort was required and that such an effort warranted Bank support. The weak sides of the picture were the social

sectors and basic infrastructure, which had borne the cost of adjustment in the 80s. In this context, a SAL was judged as necessary to elevate the poverty/social sector issues to the general framework of policy reform. A financial sector loan could be an alternative option, and indeed a preferred one by the Moroccans, but the Bank would see its leverage reduced, miss the opportunity to tackle several issues in a coordinated and linked way and to stress at the same time the importance it attached to improvements in social conditions. In addition, addressing adequately the social dimension of adjustment through such lending might not be possible. Secondly, the Region indicated that there had been a substantial economic impact on Morocco from the Gulf crisis, as well as strong internal political pressure on the Government because of its pro-alliance stance. In light of these developments and last December's riots, the IMF and the Government have agreed to delay their talks over a medium-term economic program. Given some of the difficult price increases that the IMF had been insisting on, an EFF had now have become harder to achieve. Both sides might agree to go the route of a stand-by instead. Moreover, macro policy and performance in Morocco have continued to improve steadily. The budget deficit has already been substantially reduced to around 2.6% of GDP. Insisting on the abolition of consumer subsidies in the political and economic conditions now faced by Morocco was not opportune. The past record, combined with the repercussions of the Gulf crisis, called for some flexibility. While a Fund program was clearly a precondition for the Bank proceeding with adjustment lending, the existence of an EFF should not be made a necessary condition. Thirdly, the Region noted that the number of conditions in the IM had to do with the diversity of objectives being pursued. It hoped to get a firm commitment from the Moroccan Government on a number of them in the Letter of Development Policy and to be able to reduce considerably the number of legal conditions. Redundancies with the Fund would also be avoided.

4. The Chairman raised again the question of the justification of the SAL, but from the point of view of the BOP needs of Morocco. The Region responded that the need had been heightened by the sharp shortfall in tourism (probably of the order of 75% this year), which represents 4% of GNP. The Chairman then noted that because of the balance of payments impact of the Gulf crisis, it was important to ensure IMF's support for the short term. It was also desirable to approach the Paris Club for another round of debt rescheduling. The Chairman then opened the floor for questions.

C. Discussion

5. A member of the Committee stressed the need for institution building in Morocco, for example in the financial sector. The development of small financial institutions could be encouraged, he thought, together with joint ventures between foreign and local banks. He also noted the need for cofinancing in the building of basic infrastructure, whose financial burden the government alone could not shoulder. Japan might be interested in cofinancing in Morocco.

6. Another Committee member expressed the view that the social objectives of the proposed loan should be better specified. Some of the proposed social indicators were too indirect, while some could not reflect changes during the life-span of the program. He also noted that the core

conditions of the loan were not easily identifiable (a point reiterated by another member) and that the time schedule of the proposed civil service reform seemed unrealistic. Yet another member expressed the view that the social indicators being proposed were either too output-oriented (e.g. nutrition) or too input-oriented (e.g. government expenditure). Something "in-between" should be devised instead (e.g. books or school feeding programs). On the same issue, another Committee member noted that while he was happy to see emphasis put on social indicators, he believed that more attention should be paid to the institutions that had the responsibility for ensuring measurement of progress in the social areas. He also stressed the importance of transparency in public expenditure programs in Morocco and asked whether much of the expenditure was off-budget and whether budget implementation was monitorable.

7. On the question of Fund involvement, a Committee member underlined the importance of IMF BOP support to Morocco and of sending the Government the right policy signals. Social objectives should not be pursued at the expense of sound macro-management. The difference between EFF and a series of Stand-by operations was not too critical, but a Fund presence was. He also asked whether all the things necessary to create a favorable environment for the private sector were in place and whether IFC was satisfied that this area was well covered.

8. Commenting further on the good macro performance of Morocco, a Committee member noted that rewarding good performance was important. At the same time, he asked whether some aspects of the program that the loan was intended to support, such as commercial banking and civil service reform - notoriously sticky areas of adjustment - had received adequate preparation.

9. The Region addressed the questions raised as follows:

a) Social sector and infrastructural development needs. With regards to the social sectors, it noted that there were several investment operations being prepared or ready, such as the basic rural education project that was scheduled to go to the Board on February 26, 1991. The SAL was raising the profile of the social concerns that we had by bringing them to the attention of the highest echelons of the Government. This was necessary, since when financial crises occur, it's often the social ministries and the social sectors which are hurt first. Morocco was no exception to this "rule". The SAL was bringing the social sectors to the center of attention. As regards infrastructure, PERL II was going to play a very important role as many infrastructure investments in Morocco are carried out by public enterprises. The Region would also attempt to bring the private sector in infrastructure investment. The Moroccans were fully on board on this issue.

b) On budget expenditure and its monitorability. The Region noted that the Moroccan budget is transparent and expenditure is monitorable, except for the Ministry of Interior expenditure (15% of central and local government expenditure).

c) On the social indicators to be monitored. The Region said that it had focussed on some that were simple and available. However, it was prepared to look at others as well. It welcomed suggestions and new ideas in this area.

d) On the preparatory work for sectoral reforms. The Region stated that a considerable amount of work had been done in the areas such as banking sector and trade reform, but less on others, such as the civil service reform. There was, however, still room for adjusting the focus of the proposed reform programs. It also noted that Morocco was capable of moving fast. In the area of trade, for example, complete elimination of QRs should be achieved by 1992, with the exception of a negative list of security items, such as firearms and explosives. The Government had been moving even faster than agreed under SAL I. Non-tariff barriers will only be maintained in the form of: (i) a variable levy for a few basic agricultural commodities; and (ii) a list of products for which reference prices were established in the mid-eighties in dirhams, which have been eroded by inflation since.

e) On the question of macro-management and balance in policy objectives. The Region stressed that long-term economic viability in Morocco required an increase in capital expenditure (especially in infrastructure and the social sectors) even at the cost (in the very short-term) of slightly larger budget disequilibria. As a development institution, the Bank had to strike a balance between encouraging the undertaking of critical investments and the maintenance of complete fiscal stability. If achieved for too long at the cost of impairing growth prospects, macro balance itself would become unsustainable. Consequently, the message that it intended to send to the Government of Morocco would have to be one of continued fiscal orthodoxy, but tempered by the recognition that urgent public investment needs could no longer be postponed.

10. On the issue of Bank/IFC collaboration, the IFC representative stated that the Bank and IFC were jointly preparing a line of credit operation. There was also scope for accelerating reform in the financial sector. In particular, as the existing foreign exchange risk coverage system still leads to below market interest rates, which tend to crowd out IFC lending to Morocco in financial intermediation loans, this area should receive prompt attention. A number of IFC loans had been cancelled because of this problem. He noted, in addition, that the 7-year time frame for eliminating the T-bill purchasing requirement now placed on the banking sector was too long. As for privatization, the Government was moving, if at a slower pace than IFC would have liked to see. The efforts, however, were systematic and in the right direction.

11. The Region was asked by the Chairman to address two of the specific points raised by the IFC representative: a) the speed of the elimination of mandatory Bank's purchases of T-bills at below market rates, and b) the foreign exchange risk system now in existence. On the first point, the Region answered that it would seek elimination of the T-bill purchasing requirement in 5 years. This would be difficult to obtain. A shorter timetable was, however, impossible. On the foreign exchange risk the Region was in agreement with the authorities on the desirability to provide a guarantee scheme for long-term loans for development projects in order to encourage private sector investment, but the system should ensure that the interest rate charged to financial institutions (and to ultimate borrowers)

are market determined. The Region also provided clarification on the level of interest rate subsidies on remaining selective credits (cereals, export and medium-term investment loans). The interest rate subsidy is low and the volume of lending affected is limited. Under the SAL program, it was proposed to restrict subsidized medium-term investment loans to SSIs.

12. The Chairman stated that there was enough evidence that subsidized lending for SSIs gives poor results and that we should try to eliminate it from the program. He then concluded by saying that:

- The Region should make sure that Government authorities in Morocco understand and appreciate the kind of BOP problem that they face and move to obtain adequate help from the IMF.

- The Bank was ready to assist Morocco in this particular BOP juncture, but the IMF should have a primary role. We would go forward with SAL assistance only if there was a Fund program in place. This did not have to be necessarily an EFF, even though an EFF would be preferable from the standpoint of the Bank.

- Broad financial support for Morocco was needed. Bank exposure was high and many of the guidelines were being exceeded. In order to proceed safely in such circumstances we needed a strong adjustment case and broad-based financial support from the IMF, the private sector, the IFC, the Gulf Cooperation Council and other lenders. In this respect, Morocco should be encouraged to go for the second part of the London Club agreement.

- The Region should write a note on the <u>core</u> conditionality that will be sought in the areas on which the program will be focused and circulate it to the OC members. In the <u>financial sector</u> the priority objectives should be the freeing of interest rates, the initiation of key institutional reforms and the achievement of a transparent foreign exchange management system. <u>In the trade sector</u> the priorities should be the elimination of QRs and the rationalization of tariffs. Conditions pertaining to internal commerce (such as the deregulation of transport) were better included in the Letter of Development Policy. Civil service reform should not be included in the program at this stage. Tranches should have yearly limits in order to cover 3 years of the program. The Region should look into the opportunity of a separate adjustment loan in the social sector.

E.Grilli/M.Ayub:eg
2/27/91

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

Is this the right instrument? Fin Sector Trade Sector Conditions about transport

DATE: February 6, 1991

TO: Operations Committee

FROM: EG Enzo Grilli, Director, EAS

EXTENSION: 81938

SUBJECT: MOROCCO: Initiating Memorandum for SAL II Proposed Agenda

1. The Operations Committee will meet on **Thursday, February 7, 1991, at 4.30 p.m. in Room E-1243** (not Friday, February 8, as previously announced) to consider the Initiating Memorandum (IM) for a proposed Second Structural Adjustment Loan (SAL II) in the amount of $300 million. The Committee may wish to take up the following issues for discussion.

Background

2. A number of signs have emerged to show that the economy is responding well to economic reforms: lower inflation and fiscal and current account deficits; real effective depreciation of the exchange rate; a reduced debt service ratio (reflecting the 1990 debt rescheduling); and a promising response of exports to trade liberalization. Against these positive signs, however, are the continuation of depressed social indicators, and deteriorated and inadequate infrastructure (paras. 16-17). Currently there is a Fund Stand-by in effect, covering the period July 1990 to March 1991. A recent review of the Stand-by, the IM states, might lead to an Extended Fund Facility (EFF) for 1991-93.

- The Region might indicate the results of the Fund's review of its program and assess the chances of an EFF materializing.

- Given the picture drawn of the economy, is the SAL the best instrument available to address infrastructure and social problems?

- As domestic investment appears to have been relatively high, why have infrastructure and the social sectors been neglected under the adjustment program started six years ago?

The Operation and the Lending Program

3. Bank lending to Morocco averaged $480 million a year in the four-year period FY87-90. Lending would amount to $441 million in the current year, and is programmed to average $460 million a year in the period FY92-94. Both the operation under review, and another adjustment loan, PERL II (aggregating $525 million) are expected to be taken to the Board in FY92 when lending would amount to $615 million. Already six adjustment operations have been processed for Morocco in the period FY85-89, totalling $1265.4 million, equivalent to over half of the lending program in that period. In June 1990 the OC discussed the CSP for Morocco which was later considered in the President's Council. The OC may wish to consider the following points made by the President in a memorandum dated August 31, 1991 following the PC meeting on the CSP:

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- o Whether the Region is over-optimistic regarding the "last big push" of lending recommended in the CSP and now being followed through in the lending program?

- o The President's instruction that the Region must not move with the SAL or the PERL without an EFF which would consider long-term development issues.

The Objectives of SAL II

4. The course of adjustment lending to Morocco did not follow the usual pattern of sector adjustment operations following economy-wide reforms under an initial series of SALs. Instead, adjustment lending was spearheaded by SECALs in industry and trade, agriculture, education and public enterprises. Conditionality under SAL I, approved in December 1988, and whose second tranche was released in September 1989, covered measures to improve tax administration; public sector investment priorities; improved budgetary management; deregulation and liberalization of imports; and measures to improve external debt management. The present operation has set itself three objectives: (a) financial sector reforms; (b) further trade liberalization; and (c) bolstering the social services through rationalization of public expenditures. In para. 20 the IM states that not all the measures indicated will become legal tranche release conditions and that these will be determined during appraisal.

- o The Region might indicate a preliminary set of core conditions that would guide the appraisal mission.

Public Expenditure Reform and the Social Sectors

5. SAL I minimum levels of public investments were apparently maintained and budgetary procedures improved in the context of a program that aimed at improving investment planning and budgeting. A Public Administration loan also provided added institutional support. Various fiscal reforms helped improve public revenues and further improvements are expected under the forthcoming EFF. The current operation would seek a minimum investment in infrastructure needed to serve private investments; raising the efficiency of the civil service, and rationalizing investment incentives. Investment will be protected for a group of seven core Ministries some of which targeting the social sectors.

- o Are the social indicators in Table 7 to be monitored during implementation (recurrent expenditure per pupil; percentage of births attended; weight/height ratio of children) the most useful and significant? And do we expect the latter two to change during implementation?

- o Are the measures outlined in para. 63 for improving civil service management clear, and the results of the study likely to be implemented?

- Is it essential to put all sectoral investment incentives in one code? ?

- Does having all these studies mean that the content and direction of reform are yet to be known?

The Financial Reforms

6. The financial reforms pursued under SAL II appear to be worthwhile, but the following questions might be asked. Time phased program

- Footnote 8 (page 14) states that regulated interest rates would continue for cereal and export financing and rediscounting medium-term investment loans for small and medium industries. What is the level of present subsidization and how long will it continue?

- Why should it take seven years -- well outside the SAL II perspective -- to remove the mandatory placements of Treasury Bills and substitute them by auction (para. 38)? ?

- What does it mean to "harmonize" tax treatment of all financial instruments (para. 38) and to "harmonize" accounting policies and procedures between banks and financial institutions (para. 41)?

- The new foreign exchange coverage system (paras. 46-7) envisages an intermediation role for the government which assumes the foreign exchange risk and charges a premium to the final user. Why cannot the users assume this risk directly?

- As the reference rate for risk coverage (para. 47) will be related to "the 12-month Treasury bond rate", will the latter rate be market-determined?

The Trade Reforms

7. The trade reform section (paras. 67 ff.) contains a candid description of the restrictions still remaining under the trade regime, and these are clearly extensive (Table 8).

- The Region might explain how reference prices will be determined for oil, meat, sugar, cereals and milk.

- Are the maximum tariffs in para. 76 nominal or effective? And if nominal (see para. 80) are not these rates too high considering previous reforms? And what are the corresponding effective rates of protection being targeted?

Tranching

8. The President's memorandum of August 31, 1991 recommended an extended disbursement period for adjustment operations in Morocco of 3.5 to 4 years.

- Is such extended disbursement appropriate for this operation at this time?

- Is the three-tranche format an adequate substitute for disbursement extension? 3.5

- The Region might indicate the expected timing of all three tranches.

Operations Committee

Messrs. Qureshi, OPNSV; Husain, LACVP; Jaycox, AFRVP; Karaosmanoglu, ASIVP; Chopra, Acting EMNVP; Wapenhans, EMNVP, (o/r); Rajagopalan/Summers, PRE; Shihata, LEGVP; Kashiwaya, CFSVP; Wood, FPRVP; Bock. OPNSV.

cc: Messrs. Wyss, COD; Isenman, PRD; Linn, CEC; Stoutjesdijk, FRS; Picciotto, CPB; Burmester/Thahane, SECGE; Goldberg, LEGOP; Ms. Okonjo-Iweala, OPNSV; El Serafy, EAS; Parmar, IFC-CIO; Rao, IEC; Kavalsky, FRW; Pfeffermann, IFC-CEI; Liebenthal, PRD; Kilby, FRS; Robless, OPNSV; Sandstrom, Khanna, EXC; Hasan, EMNVP; Dervis, Ayub, Ms. Guerrero, Coudol, EM2.

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February 1, 1991

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THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

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P. 7. para 8

DATE : January 30, 1991

TO : Operations Committee

FROM : EG Enzo Grilli, Director, EAS

EXT. : 81935

SUBJECT: RWANDA: Proposed Structural Adjustment Credit
Initiating Memorandum - Agenda

1. The Operations Committee will meet on Friday, February 1, 1991 at 5:00 p.m. in Room E-1243 to consider the Initiating Memorandum for a Structural Adjustment Credit.

2. The proposed credit of $90 million would be disbursed in two unequal tranches, the first one being front-loaded to some $50-55 million. This would be the first adjustment operation in Rwanda, signalling the successful outcome of some three years of negotiations with the Government on exchange rate and price liberalization measures; it is expected to be followed up during the next several years with an expanded lending program including additional adjustment operations. As the first of a series, the coverage of this credit is quite orthodox and encompasses reforms of the exchange rate system, tariffs, domestic price controls and regulations, and public expenditure policies. The Committee might wish to consider the following issues.

3. The continuing war situation makes it difficult to assess the chances of the Government being able to introduce and sustain adjustment measures. Nonetheless, the program defined in the IM assumes a sharp break from past trends. Even though GDP has been falling since 1987, the IM forecasts a jump to nearly 2% this year and to 3.7% in 1992. The corresponding growth assumed for imports (Table 1, Annex II) seems low, especially because of the progressive import liberalization being assumed. The Committee might focus on:

- the financing needs and downside risks. How firm is the commitment from others to help close the financing gap, and what are the implications of the war continuing or escalating?

- the macro-framework being used by the Fund. How restrictive do fiscal and monetary policies have to be to ensure that the recent devaluation is reflected in a substantial real depreciation? Would such restrictive policies be consistent with the growth rates forecast?

4. The proposed program consists principally of a series of measures to eliminate or reduce public interventions designed to influence prices, beginning with the exchange rate. A general issue is whether these

corrective measures would be supplemented by other policies, whether supported through this credit or not, to enhance potential supply responses. Another general issue is the extent to which the Government has a clear vision of where it wants to get to over the medium-term. Some questions are:

* Exchange rate policies. The IM notes the actions already taken by the Government which, if effective, will offset the real appreciation that has occurred during the 1980s. But it is also recognized that a further devaluation may be needed before Open General Licensing (OGL) can be introduced as a condition for second-tranche release. What is the Government's attitude to further exchange rate changes? Does it endorse the idea of a more flexible and systematic exchange rate policy for the future, and if so what kind of rules or triggers might be appropriate?

* Tariff policies. Regarding tariffs, the IM envisages a structure of ten categories, with a 10% minimum and a 60% maximum, to be gradually reached over the medium term. This is much less liberalization than has been aimed for in many other countries (the maximum rate being typically set at 30 to 40%). Should we seek lower levels and greater uniformity?

* Export promotion. The possible need for export promotion policies is not discussed in the IM. Yet there should be a strong case for measures such as duty draw-back schemes or temporary admission regimes in view of the slow speed of tariff reforms and the critical need to increase export earnings to validate the adjustment program.

* Price decontrols. The text describes the objective of "progressive liberalization" of the price system, but the matrix shows a single step in March of this year. Would the Region clarify how much will remain to be done after March and whether the remainder should be a second-tranche condition? Why should petroleum prices be fixed? Why should there be floor prices for the inputs of agro-industries, and if we are going to have them why should they be set at border prices and not lower?

* Supply-side policies. The IM discusses the coffee, mining, and energy sectors under this category of issues and proposes a number of policy changes for coffee and electric power. While the types of changes being considered for coffee, to be defined in detail before second tranche, are likely to be important there is no discussion of policies on inputs (e.g., extension services, fertilizers), quality-control, and external marketing. The Region might elaborate upon the range of supply side measures that should be initiated in these and other sectors to expedite the adjustment process and how they could be supported by our credits.

* Other areas. There are two potentially very important areas of policy reforms that are not mentioned in the IM. These are: (i) the financial sector, which currently is characterized by

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Slow Progress

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Research Agri

Project Extension Agri Services

negative real interest rates; and (ii) foreign direct investments, which are generally discouraged. The Region might explain what the policy priorities are in these areas and how they might best be addressed in our lending program.

Operations Committee Members

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

cc: Messrs. Wyss (COD), Isenman (PRD), Linn (CEC); Stoutjesdijk (FRS), Picciotto (CPB), Burmester/Thahane (SEC), Goldberg (LEGOP), (Ms.) Okonjo-Iweala, Parmar (IFC-CIO), Rao (IEC), Kavalsky (FRM), Pfeffermann (IFC-CEI), Liebenthal (PRD), Kilby (FRS), Robless (OPNSV), Sandstrom (EXC), Khanna (EXC), O'Brien, Aguirre-Sacasa, Gorjestani, Varon, Devaux, AFR.

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Dept of labour — Removal of restrictions on hiring & firing

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: January 25, 1991

TO: Mr. Moeen Qureshi, OPNSV

THROUGH: Mr. Edward V.K. Jaycox, AFRVP

FROM: Francisco Aguirre-Sacasa, Director, AF3 FAS

EXTENSION: 34380

SUBJECT: Rwanda: Initiating Memorandum for a Proposed Structural Adjustment Credit

1. Attached for consideration by the Operations Committee (OC) is an Initiating Memorandum (IM) requesting authorization to appraise a proposed Structural Adjustment Credit (SAL) in the amount of US$90 million in support of the first phase of the Government's reform program.

2. The main objectives of the proposed operation are to help stabilize the Rwandese economy, improve its competitiveness, create an incentive framework for the efficient allocation of resources, and lay the foundations for export-led growth. The special design features of the operation include: (i) up-front implementation of most of the politically difficult key measures prior to Board presentation (e.g., devaluation, abolition of import prohibitions, increases in petroleum product prices); (ii) a limited number of second tranche release conditions which are easy to monitor and which are critical to the success of the adjustment program (e.g., establishment of an Open General Licensing system, liberalization of the coffee sector and agreement on a public expenditure program); and (iii) a satisfactory social safety net to help ease the transitional costs associated with the adjustment process.

3. A draft PFP was prepared with the help of Bank and IMF staff in 1990. During the last Annual Meetings, negotiations of the PFP were completed ad referendum, and agreement was reached between the Government and the IMF on a first year arrangement under the SAF (about US$13 million).

4. The President of Rwanda visited Washington and met with you on October 1 to confirm his personal commitment to the reform program. He also asked for an acceleration of the processing of the proposed SAL. We were about to submit the PFP and an IM to the OC when Rwandese refugees (primarily from the minority Tutsi ethnic group) invaded the country from Uganda in early October. In view of events, we decided to withhold the IM and the PFP, pending clarification of the evolving security situation.

5. The Government was able to reassert its control over the country within a few weeks, with the help of troops from Belgium, France, and Zaire, but there is still occasional low-intensity combat along Rwanda's

north and north-east frontier (fighting took place as recently as January 20-22 when rebels attacked a town in northern Rwanda close to the Ugandan border).

6. Despite the troubled domestic situation, on November 9, the Government announced the implementation of all the up-front measures under the program which had been agreed with the Bank and IMF staff, including a major devaluation (67 percent in local currency vis-à-vis the SDR) of the Rwandese franc and a 75 percent increase in petroleum derivative prices; a gallon of gasoline now sells for about US$4 in Kigali. The Government's decision to move ahead with politically difficult reforms in the midst of a war is an important indication of its commitment to the adjustment process.

7. The Government has also announced political reforms, including a move towards a more democratic multi-party system and measures to lower tensions between the majority (and ruling) Hutus and the Tutsi minority. It has also mounted a regional initiative including a proposed meeting of the Heads of State of neighboring countries to resolve the refugee situation.

8. A joint Bank/Fund mission visited the country in December 1990 to assess the impact of the hostilities on the economy. The mission concluded that the war had an impact on the macroeconomic situation and the short-term outlook, and that some adjustments to the macroeconomic framework would have to be made. The budget deficit and the financing gap are likely to be much higher than had been projected in the draft PFP. The attached IM reflects the findings of the latest mission. Another joint Bank/Fund mission is scheduled for early February to update the PFP in parallel with the appraisal of the proposed SAL. IMF staff will also be updating the Memorandum of policy for the first year SAF program. The revised PFP will be submitted to the OC after the mission.

9. The financing gap, after taking into account disbursements under the proposed SAL and the IMF SAF is estimated at about $170 million during 1991-93. About a quarter ($40 million) of this gap represents additional military expenditures. We have taken the position that the Government should mobilize bilateral financing under special assistance arrangements to cover military expenditures. The remaining gap (about $130 million) should be possible to fill under the SPA, given the positive indications from donors.

10. Rwanda is facing an acute balance of payments crisis. An international effort -- led by the Bank and the IMF -- is urgently needed to give Rwanda's adjustment program a chance to succeed. Assuming that we could reach agreement on a PFP, we plan to propose Rwanda's eligibility for SPA II at the next meeting of donors in April. In the meantime, we have arranged for key donors to participate in the proposed SAL appraisal mission so that they would be ready to disburse balance of payment assistance as soon as the PFP is agreed. Five of them (Belgium, Switzerland, Canada, France and the U.S.) have responded positively to this invitation. We are confident that several of these donors will

provide bridge financing to meet Rwanda's short-term external requirements during the months prior to disbursement of the proposed SAL's first tranche.

Attachment

cc: Messrs./Mmes: E. Jaycox (AFRVP); W. Wapenhans (EMNVP), S. Shahid Husain (LACVP); A. Karaosmanoglu (ASIVP); I. Shihata (LEGVP); V. Rajaagopalan, J. Linn (PRE); K. Kashiwaya (CFSVP) (4 copies); D.J. Wood (FPRP); R. Picciotto (CPB); S. Sandstrom, A. Khanna (EXC); D. Bock, C.L. Robless, Okonjo-Iweala (OPNSVP), D.C. Rao (IEC); H. Wyss (COD); A. Stoutjesdjk, F. Kilby (FRS); E. Grilli, A. Ray, G. Sicat (EAS); P. Isenman, R. Liebenthal, M. Fardi, O.Kalantzopoulos (PRD); S. Burmeister/T. Thahane (SECGE); D. Goldberg (LEGOP); B. Kavalasky (FRM); S. O'Brien, G. Swamy (AFRVP); Serageldin (AFTDR); Holsen (DECVP); J. Parmar (IFC-CIO); G. Pfefferman (IFC-CEI); N. Gorjestani, A. Otten, M. Blanc, M. Sarris, A. Colliou, B. Varon, J. Chevallier, M. Devaux, E. Akpa ,L.Hobeika (AF3); N. Abuzobaa, A. Tahari (IMF)

January 30, 1991

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The World Bank
OPERATIONS COMMITTEE

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Minutes of the Operations Committee to consider
PAKISTAN - Proposed ECO for the Hub Power Company
Held on Wednesday, January 30, 1991 in Room E-1243

A. Present

Committee

Messrs. M. Qureshi (Chairman)
W. Wapenhans (EMNVP)
H. Scott (LEGVP)
L. Summers (DECVP)
K. Kashiwaya (CFSVP)
H. Vergin (AS4DR)
J. Wood (VPFPR)
R. Moscote (LATIE)
M. Martinez (AFRVP)

Others

Messrs./Mmes. S. Babbar (CFSPS)
M. Barrientos (EM1EG)
F. Batzella (EM1EG)
C. Blanchi (EMNVP)
A. Clift (EM1DR)
I. Elwan (CFSPS)
E. Grilli (EASDR)
A. Hamid (LEGEM)
A. Heron (CODOP)
A. Khanna (EXC)
F. Lysy (EAS)
H. Morais (LEGOP)
J. Niehuss (CFSPS)
N. Okonjo-Iweala (OPNSV)
M. Penalver-Quesada (EM1CO)
S. Rajasingham (CFSPC)
A. Stoutjesdijk (FRS
J. Taylor (CFSPC)
M. Walton (DEC)
A. Watkins (PRDPD)
M. Wiehen (EM1DR)
H. Wyss (CODDR)

B. Issues

1. The Committee discussion focused on two main issues: (a) whether the state of the economy in Pakistan and the lack of agreement with the Government on economic management issues warranted postponement of the project; and (b) the advantages of the proposed ECO versus a direct Bank loan.

C. State of the Economy

2. The Chairman opened the discussion with a statement of policy regarding the processing of ECOs in general. These should not be undertaken until policy issues on major economic matters have been satisfactorily resolved with government. In the case of the Hub Power Project ECO, he would expect Pakistan to have an IMF program in place, agreements with the Bank on actions to support an adjustment operation, and the conditions met for release of the second tranche of the Second Energy Sector Loan. Only after the resolution of these policy issues should the Bank proceed to the market with the ECO. The Chairman also directed that in the future, ECO operations should not normally be prepared for IIIb (or worse) countries. The Hub ECO would be an exception due to its advanced state of preparation before guidelines were discussed last fall.

3. Several members asked the reasons for proceeding with arranging financing for the project until the uncertainties in the domestic economy and the Middle-East were resolved. To do so may result in passing the point of no return where the operation may have to proceed even in the absence of a resolution of economic management issues. The Region and CFS advised that if the project does not proceed quickly, the Government will have to take a decision to make additional public sector investments in power generation. At present there is load shedding in Pakistan which will only get worse and which has resulted in use of high cost private generation. The Government's resources are already strained and it wishes to proceed with the Hub Power Project on a priority basis. The colenders are keen to go ahead and it is important to avoid delays as they would raise concerns on the part of investors and lenders regarding the Bank's commitment. CFS noted that in large project financing it is not uncommon for a great deal of preparatory work to be done before the final decision to proceed is made. Furthermore, the work on the ECO would be done on the basis that it could not be effective until the conditions precedent, which would include a satisfactory resolution of the macroeconomic situation, were met. Delay of the initial processing of the ECO to meet these conditions would lead to unacceptable delays from the standpoint of the project. Accordingly, while the Region had intended to postpone final Board approval of the ECO until after the economic issues were satisfactorily resolved, it favored asking the Board to approve negotiations now with the understanding that the Government's action on the economy be a precondition to financial closure. The Chairman recognized that processing delays at this stage involved the risk of losing investors and lenders, but it was one which may have to be taken because it would be more embarrassing to pull out at a later stage if an agreement between GOP and the Bank/Fund on a macroeconomic adjustment program is not reached. Therefore, the Bank should not sell the transaction in the market until the Government of Pakistan accepts the linkage of this project to satisfactory actions on the economy.

D. ECO vs. Direct Bank Loan

4. The advantages of the proposed ECO versus a direct Bank loan were discussed in the context of three issues: (a) the guarantee of 100% of the commercial bank loan principal; (b) the extent to which ECO and the limited recourse financing structure mobilizes cofinancing; and (c) the impact of the ECO agreements on the Bank's preferred creditor status.

Guarantee

5. The Chairman asked why the Bank needed to guarantee 100% of principal on the commercial bank loans, which with the acceleration provisions proposed, would result in exposure for the Bank that approached that of a direct loan. It seemed that the commercial banks and promoters were assuming very little risk. A member amplified this point by observing that while the Bank wanted to promote private sector investment in infrastructure, this project, because of its oil price flow-through to tariffs and its take-or-pay sales contract, involved little risk to promoters and questioned if it constituted a good precedent. One member expressed doubts about the replicability of this structure in other developing countries.

6. CFS responded that the Bank guarantee was partial in that it covered only those risks associated with operations under control of the Government of Pakistan, which are the supply of oil, the payment for power, and the provision of foreign exchange to service the debt. Commercial risks, including cost overruns, performance penalties, equipment failure and operation and maintenance of the power station were borne by the lenders and contractors. It was emphasized that the guarantee by Hub of supplying power at 60% of plant capacity and plant availability of over 80% under the conditions prevailing in Pakistan, posed considerable risk to investor as the penalties for failure to deliver were high. Also, it was noted that it was normal practice in the power utility industry to pass on increases in oil prices to consumers through fuel adjustment clauses in tariffs.

7. One member stated that the 100% guarantee of principal (and in effect interest through the acceleration mechanism) was well in excess of the normally expected 50% guideline for credit enhancement. The Chairman asked what would be the reaction of the commercial banks if something less were offered, such as a 50% guarantee. CFS pointed out that the guideline reference was to 50% of the exposure on total debt service (interest as well as principal) and that the proposed guarantee of the principal would not necessarily result in enhancement in excess of 50%. For example, in the Hungarian ECO the Bank guaranteed 100% of principal and still met the guideline's 50% test on a present value basis. CFS also noted that the proposed guarantee, compared to the total package of limited recourse debt mobilized for the project, is in fact less than 50%. CFS would not be confident of a deal if the Bank guarantee now under discussion with commercial banks was diminished. Another member concurred that the credit enhancement as now structured was driven by the market and was necessary to induce commercial banks to participate in this high risk country.

Mobilization of Cofinancing

8. The Chairman said that the Board has been informed that additional funding for projects would be mobilized through the use of ECOs. For the present operation it is not clear that the Bank's guarantee of the commercial bank loans has been instrumental in inducing non-commercial bank lenders for the project. There seems to be no comfort provided to such other lenders for the project and no linkages between the ECO and the rest of the financing package. If this is the case, the justification for the ECO is weakened considerably.

9. CFS responded that the Bank guarantee and participation in the financing for this project clearly motivated the commercial bank's participation, and additionally, provided comfort to all limited recourse lenders and project investors. Specifically, without the ECO for the commercial

banks and the limited recourse financing mechanism, the ECAs would not participate to the same degree. The reason is that the guarantee cover being structured for the ECO would be duplicated by the ECAs, and furthermore, through the operations of the escrow account all lenders to the project have the same senior lender status. Thus, if the commercial banks loans are called, the ECA guaranteed loans may also be called. In the case of the direct loan alternative the Bank would have a direct claim on the Government and the ECAs would not. Also, the ECAs' are prepared to give longer than normal grace periods and final maturities under the proposed arrangements. CFS believes that the ECO effectively helps to mobilize $800 million of limited recourse financing from ECAs that would not otherwise be available to Pakistan, and advised that the linkages would be made clear in revised Board documents.

Preferred Creditor Status

10. The Chairman asked if the language for the Indemnity Agreement between J-Exim and GOP compromised the Bank's preferred creditor status. The representative from Legal responded that the language that had been agreed to with J-Exim for their indemnity agreement with Pakistan was not in substance different from the pari-passu clause that was customarily used by J-Exim in its loan agreements when cofinancing with the Bank. From a legal standpoint, therefore, he did not believe that the language compromised the Bank's preferred creditor status. He pointed out, however, that the discussions between the Bank and the J-Exim on this matter could have created some expectation that J-Exim would in fact be treated pari-passu with the Bank. The representative from Finance noted that his concern was that there should not be any misunderstanding with the Government of Pakistan on this matter. He felt that although the Bank could not prevent J-Exim and the Government from entering into an indemnity agreement, it might nevertheless be prudent to require a letter from the Government of Pakistan stating that notwithstanding the agreement, the Bank would continue to be serviced on all its debt in a timely manner. The representative from Legal responded that such a letter would be a mistake and would emphasize the issue unnecessarily, since J-Exim had agreed to use a pari-pasu clause similar to the ones used in its confinancing with the Bank. The Chairman agreed.

11. In response to a question from a member, CFS explained that the question of preferred creditor status would only arise after the guarantees of both the Bank and J-Exim had been called. At that time, GOP would be obliged to reimburse the Bank and J-Exim under the separate indemnity agreements with GOP, and the situation then would be the same as in the case of a normal cofinancing, where GOP's obligation to J-Exim (if it could not be paid) would presumably be subject to Paris Club rescheduling.

E. Other Issues

12. Several members observed that the projected returns on equity seemed high and resulted in retained earnings well beyond the need to comply with financial covenants. CFS responded that the 18% return on equity projected for the shareholders was not high given the downside risks involved and the fact that there was no upside potential. CFS pointed out that the project is designed as a private sector venture and as such is expected to compete for equity in the international market. It should therefore provide returns on equity that would attract the required resources with adequate compensation for project and country risks. CFS also advised that the return on WAPDA bonds, which are guaranteed by GOP, is 15%, and that other private investment in Pakistan earns much higher returns on equity. It was also noted that returns to

equity for a similar project in the U.S., with much less risk, would range from 24-34%.

13. The Chairman asked that the issues of oil prices and power demand and their relation to the sequencing of investments in the least-cost power sector investment program be addressed in the revised SAR.

F. Conclusion

14. The Chairman added his appreciation for the staff work on this innovative and complex project to the previous expressions of other members. He asked that the SAR and MOP (a) clearly explain the risk assumed by all parties to the project, in particular the commercial risk borne by the commercial banks, and (b) demonstrate that even though there may be no legal linkages betweens the ECO and other financiers, that in the context of the project in its entirety, the ECO will in effect mobilize cofinancing that would otherwise not be available.

15. Regarding the guarantee, he asked the Region and CFS to explore again with the commercial banks alternatives to the presently contemplated principal acceleration provision with a view to reducing the credit enhancement in the Bank guarantee. He also wished, in light of these discussions, a more precise description of the credit enhancement under the proposed ECO. The objective of both these exercises is to be able to go to the Board with a proposal which is consistent with the ECO guidelines.

16. The Chairman asked that the revised documentation be forwarded to him to review whether the issues identified in paras 14 and 15 have been satisfactorily resolved, following which he would circulate the documentation to the Committee. While preparation of the proposed ECO would continue, active marketing of the transaction should await agreement between the Bank/Fund and GOP on a macroeconomic adjustment program.

AHeron:gms
PC#5\Heron\OCPAK
February 8, 1991

THE WORLD BANK / IFC / MIGA

OFFICE MEMORANDUM

DATE: January 22, 1991

TO: Operations Committee

FROM: Hans Wyss, CODDR

EXTENSION: 82852

SUBJECT: PAKISTAN: Proposed ECO for Hub Power Company
Operations Committee Agenda

1. The Operations Committee will meet on Wednesday, January 30, at 3:30 p.m. in Conference Room E 1243 to discuss a proposed Expanded Cofinancing Operation (ECO) to guarantee a syndicated commercial bank loan of $360 million to the Hub Power Company (HUBCO) in Pakistan. The draft Memorandum of the President and Staff Appraisal Report for the project have been distributed by the Region.

The Project

2. The project is a 1,292 MW oil-fired power station located at the mouth of the Hub River on the Arabian Sea. It is to be constructed and operated by HUBCO, a newly created privately-owned (foreign and local) utility. HUBCO will sell power to the government-owned Water and Power Development Authority (WAPDA) under a take or pay contract at specified prices. Imported fuel will be supplied to HUBCO by the government-owned Pakistan State Oil (PSO). The Contractual obligations of both WAPDA and PSO would be guaranteed by the Government of Pakistan (GOP). The Total financial requirement for the project is $1.5 billion, of which about 20% will be equity and 80% debt. No direct guarantees of the project financing will be provided by the government and the lenders will look to project cash flows to repay loans. To induce foreign commercial banks to participate in the project financing, the Bank and the Export-Import Bank of Japan (JEXIM) would, in the ratio of 2:1, guarantee principal payments on a syndicated loan up to an amount of $360 million if HUBCO fails to make payments due to failure of WAPDA, PSO, and GOP to meet their obligations, or the State Bank of Pakistan fails to make available foreign exchange to HUBCO. The obligations and risks of all parties involved are set forth in a security package (SP) which will comprise a set of agreements for implementation, power purchase, fuel supply, construction, and operations.

Issues

3. Financing Plan. The proposed financing plan for $1.5 billion is complex, involving two groups of offshore and local equity investors, the local Private Sector Energy Development Fund (the recipient of a $150 million Bank loan), local banks, four export credit agencies (ECAs), foreign commercial banks, and other offshore financial institutions. Letters of commitment from all investors and lenders, except for ECAs, are proposed as a condition of Board presentation. All agreements for equity and loans and the security package must be signed as a condition of effectiveness for the ECO. The committee may want to ask the Region to elaborate upon the firmness of the financing plan, and the extent to which it has been affected by the Middle East crisis.

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4. Capacity of Governments to Meet its Commitments. Although the project financing is limited recourse, its success depends on the performance of the economy and the political stability of Pakistan which will determine the Government's capability of meeting its commitments to HUBCO. The events in the Middle East have adversely effected Pakistan's import bill and reduced the flow of remittances of overseas nationals. Pakistan has a new government. In light of these events the Committee may want to discuss:

(a) Should HUBCO wait until the macroeconomic outlook and political environment are more clear before proceeding with the project?

(b) To what extent will the project contribute to Pakistan's medium term economic performance?

5. Project Economics. The project is determined to be part of the power sector's least cost development plan (1989-2010):

At what price of oil, other alternatives become feasible

(a) What is the "cross over" price for oil which would change sequencing of the power sector investment program (i.e., should indigenous coal, gas, and hydropower be accelerated and/or options with lower capacity increments be substituted)?

Pvt Sector

(b) Would higher electricity tariffs themselves reduce electricity demand to the extent where the project would represent an excessively large, and possibly uneconomic, addition to power production capacity?

6. Justification for the ECO. The ECO effectively mobilizes $360 million of commercial bank financing which would otherwise not be available. The Bank/JEXIM will provide guarantees of the full amount of principal as an alternative to provision of a direct loan for the project through the Private Sector Energy Development Fund. The Committee may want the Region to address the following issues:

(a) What is the advantage to Pakistan for using the ECO versus direct borrowing from the Bank?

(b) Does the proposed guarantee conform to the guidelines for ECOs?

7. Limited Recourse Financing vs. Direct Borrowing. The private sector development of the project involves a highly complex interrelated set of agreements and financing arrangements. The advantage claimed for the government is avoidance of public sector expenditure, additionality of external finance, and a cost of power no greater than alternative government generated power. The Region may be asked to explain:

(a) Can it be demonstrated that the limited recourse financing plan fits into the Government's overall borrowing strategy?

(b) Do the performance guarantees of the government, primarily for the payment of power, in fact have an impact on the government's debt service capability and represent a use of its external credit?

8. The proceeds of the loan guaranteed by the Bank under the ECO would be used to finance equipment, materials, and services included in the Turkey Construction Contract. The proceeds of the BAnk loan to PSEDF (Loan 2982-PAK) would be onlent to the Hub Power Company to finance a part of the contract for the turbine-generator, plant and plant engineering. The Committee may wish the Region to provide more information on the procurement arrangements to include:

(a) The competitive process under which the contractor's were selected for components financed under the ECO, and by other lenders (number of contractors short listed, proposals evaluated, actual cost versus estimates).

(b) An evaluation of the effectiveness of the ICB process for selection of the turbine-generator contract and other components financed by the Bank through PSEDF (number of proposals, actual cost versus estimates).

9. Pricing/Cost of ECO. The terms and costs of the commercial bank loan to be guaranteed by the Bank will only be known at the time of financial closure. What is the expected premium over LIBOR and the anticipated guarantee fee?

Distribution

Messrs./Mmes. Qureshi, Bock, Okonjo-Iweala (OPNSV); Jaycox (AFRVP); Karaosmanoglu (ASIVP); Wapenhans (EMNVP); Husain (LACVP); Rajagopalan (PRSVP); Summers (DECVP); Shihata (LEGVP); Kashiwaya (CFSVP); Wood (FRPVP); Grilli, El Serafy (EAS); Isenman (PRD); Linn (CEC); Stoutjesdijk (FRS); Picciotto (CPB); Burmester/Thahane (SECGE); Goldberg (LEGOP);

cc: Messrs./Mmes. Parmar, Pfeffermann (IFC); Rao (IEC); Kavalsky (FRM); Liebenthal (PRD); Kilby (FRS); Robless (OPNSV); Sandstrom, Khanna (EXC); Hasan (EMNVP); Shakow (EXTDR)

m-pakistan:AH:KS:tha/gms

Mr. Wiehen, EM1DR

re: Pakistan: OC Agenda for Hub Power ECO

Attached please find a proposed strategy for responding in the OC Meeting to the questions raised in Mr. Wyss' memorandum of January 22, 1991. This could serve as the basis for your review meeting and any other follow-up meetings by Management that you might deem necessary.

Ibrahim Elwan and Franco Batzella

January 27, 1991

cc: Messrs. Blanchi, Clift, Taylor, Tambe, Rajasingham, Babbar, Baughman, Ghani, Hatano, Shimazaki, Morais, Hamid, Ms. MEBarrientos

Ngozi,
Attached please find the broad strategy for responding during the OC meeting to the issues raised in MR. Wyss' memorandum covering the Agenda for the operations committee.
Ibrahim

3. Financing Plan

The Region may wish to comment on the firmness of the financing plan, and the extent to which it has been affected by the Middle East Crisis.

The financing plan for the Hub Power Complex requires the mobilization of US$1.5 billion in the form of debt and equity. Of this US$1,235 million would be raised as foreign (US$1,131 million) and local (US$104 million) debt, and US$308 million as foreign (US$208 million) and local (US$100 million) equity. Mandates from the Hub Power Group have been issued to all parties involved in raising debt and equity for the financing of the project.

Letters of commitment for debt financing have been received from: (i) a syndicate of foreign commercial banks for an amount of US$360 million equivalent (September 29th, 1990) conditional on satisfactory SP and approval of ECO by the Bank; (ii) NDFC for US$410 million for financing from PSEDF (October 1st, 1990); (iii) CDC of UK for US$19 million (April 4th, 1990); and (iv) Bankers Equity Limited for US$104 million equivalent (Sept.28th 1989), which was reconfirmed to the Hub Group in September, 1990. Letters of commitment have also been received from: (i) the Sponsors for US$128 million of foreign equity (December 20, 1990); (ii) CDC for US$ 8 million of foreign equity (April 4th 1990) and (iii) from Dhabi Trading, the offshore underwriter, for US$100 million equivalent of local equity (January 13th,1991). Letters of interest have been received, between October, 1990 and January, 1991, from various offshore groups for placing equity in a total amount of US$72 million on a best efforts basis. A letter of guarantee from the Sponsors would be obtained before Board presentation to make up any shortfall in the amount of US$72 million of foreign equity in case the placing agents fail in their efforts. Letters of interest from ECAS have been received.

The Middle East crisis could soften the appetite of lenders and equity investors in the project. However, up till now we have had no such indication. A constant dialogue has been kept up with the financiers and they have reiterated their commitment to the financing of the project. However, the crisis, if it were to last up to the time of financial closure, which is foreseen to take place in the next 9 months, would in all probability affect the terms of financing. Also, the currently cautious attitude towards LDC financing in the international capital markets, and the new capital reserve guidelines from the Bank of International Settlements may have affected the international banks, especially Japanese ones, in terms of the required capital reserve ratio. Consequently, the Bank has made arrangements to broaden the membership in the syndicate of commercial banks who would be covered by ECO.

4. Capacity of Government to Meet its Commitments

(a) Should HUBCO wait until the macroeconomic outlook and political environment are more clear before proceeding with the project?

The project is already a year and a half behind schedule during which the cost of the construction has had to be increased. In fact in order to accommodate the pressing needs of Pakistan we had compressed the implementation period for the commissioning of the first unit for the power station from 39 months to 33 months, while the original bid was for 42 months. The preparation of the Hub Power Complex has involved substantial outlays by the sponsors, and the commercial banks to review the Security Package (SP). Further delays in the project would thwart the interest of the investors and lenders to the detriment and probable demise of the project by losing the credibility of the project and increasing the cost. Moreover, as the project is of substantial size relative to the needs of Pakistan, and since it is the first project of this nature to be implemented by the private sector, further delays in launching the project would jeopardize the growth prospects of the economy during the Eighth Plan because of substantial load-shedding. Failure of Hub Power Complex would also dampen the interest of other private sector investors who are awaiting the conclusion of GOP's negotiations with HUBCO before proceeding with their own investments.

As far as the macro-economic outlook is concerned, the project to a large extent is insulated from the economy in that all the resources for its implementation have been earmarked. In this sense, it provides a respite during a period of restructuring, since investments in a major power station would be underway while the economy is being realigned, as all resources needed for the implementation of Hub Power Complex would be outside the public sector outlays. The first debt service payment would not take place until 1995. Delays would be justified only if our projections for the growth of the economy indicate that the current revised projection of an average annual rate of growth of about 4% - 5% is no longer sustainable.

The Hub Power Complex was initiated in 1986, and supported by all Governments since then. The present Government is fully committed to the fast implementation of the Hub Power Complex as reflected in its request, prior to the Gulf war, to the Hub Group to conclude the negotiations by January 21, 1991. As for the Gulf crisis and its impact on the project, substantial support continues to be received by investors in the Gulf region, and the Kuwait Investment Authority and investments houses in Bahrain and Saudi Arabia have requested information on this project.

(b) To what extent will the project contribute to Pakistan's medium-term economic performance?

Under the medium-term macroeconomic program (MAP) for FY88-91 agreed with the IMF and supported by the Bank, public sector investments, including those in the energy sector, were to be reduced given the resource constraints that faced GOP. It was recognized that in order to meet the forecast demand for energy in the country within ;the constraints of the fiscal targets set under MAP, private sector investments would have to fill the gap left by the reduction of public sector outlays. Therefore, in support of the macroeconomic objectives outlined under MAP, a core investment program (CIP) for the energy sector including both public and private investment, for the Seventh Pan period (FY89-93), was agreed by GOP and the Bank under Energy Sector Loan II. CIP for the energy sector amounts to about US$8.6 billion, comprised of US$6.5 billion to be undertaken in the public sector, and US$2.1 billion to be initiated during the Seventh Plan by the private sector. Private sector investments in the power subsector would provide about 2,300 MW of critically needed additional installed capacity. Therefore, Hub Power Complex and the private sector investments to follow once it is approved, are a critical part of the macroeconomic and energy sector adjustment program in Pakistan, and in turn, MAP.

Within this context, the Hub Power Complex would provide almost 1,300 MW of the 2,300 MW planned additional capacity in the power subsector through private sector financing. Approximately half of the total investment for the Hub Complex, estimated at about US$1.5 billion would be invested during the last two years of the Seventh Plan, while the remainder would be during the first two years of the Eighth Plan (FY94-98). The successful implementation of the Hub would serve as a precedent for many other private sector projects in the energy sector which have been proposed and are under preparation, as well as in other sectors. Given the expected continuing resource constraints, these additional private sector investments would serve to further relieve the burden on the public sector in undertaking large capital intensive infrastructure projects in the future.

5. Project Economics

(a) What is the "cross-over" price for oil which would change sequencing of the power sector investment program (i.e., should indigenous coal, gas, and hydropower be accelerated and/or options with lower capacity increments be substituted)?

The issue of cross-over price for oil, which would shift Hub Power Complex, or replacement to coal is not relevant as far as the Seventh and Eighth Plans are concerned, because of the time to prepare, negotiate, and finance the implementation of a new coal-fired power station, including a port facility for handling coal. As for the least cost development plan, the timing for commissioning the Hub Power Complex would remain unaltered, even with substantial increases in oil prices. Pakistan has virtually no alternative for the development of power generation for the following reasons:

(i) Domestic coal Currently proven reserves of domestic coal, if fully exploited and extracted using modern technology, would provide fuel for about 600 MW. The cost of extracting the domestic coal is higher than the imported price (cif Karachi), and given the characteristics of the coal, would require the use of fluidized bed technology, to ensure that there would be no adverse environmental impact. This would result in a capital cost per kWh of US$1,400 per kilowatt, compared with a cost for the Hub Power Complex of US$840 per kilowatt. The difference in the capital cost erodes the advantage of using domestic coal as a substitute for fuel oil;

(ii) As for imported coal, the Bank has recognized the potential for the use of this fuel for power generation as a means for reducing Pakistan's import bill. A feasibility study for the import of coal and its use for power generation was completed in 1990. It proposes the development of a coal handling facility at Kaio Island in Lasbela district of Balochistan, 15 miles west of the site for the Hub Power Complex, on the Arabian Sea. The site would allow for the construction of 3,600 MW of coal-fired power generating facilities. GOP intends the new coal handling facilities and power station to be built according to the formula put in place for Hub, that is BOO. GOP has requested the Bank to clear the request for the submission of proposals. However, in view of the state of negotiations on the Hub, the Bank advised that such an announcement be delayed until final agreement on the Hub, lest it be interpreted that GOP is not following through its negotiations in good faith;

(iii) As for natural gas, although its potential is good, so far the supply has been significantly below the existing and forecast demand. The low-quality gas, which for the past forty years has not been used, would be developed and exploited for power generation by the private sector with financing from PSEDF. Recently, the negotiations between the private sector, the Government of Qatar and Pakistan was concluded for the export of natural gas to Pakistan. This would allow for the possibility of using natural gas supplied at an attractive price which is below the imported price of fuel for the generation of electricity and the manufacture of fertilizer, etc. The feasibility study is expected to take about a year and the implementation about 2-1/2 years. If this potential is viable, it could have a profound impact on the energy supply scheme in Pakistan and would allow for the substitution of natural gas for liquid hydro-carbons including the Hub. It would also eliminate the need for the import of coal and substantially reduce the capital cost for meeting the future demand for electricity.

(iv) As far as hydro is concerned, the Bank has been involved as the executing agency for the feasibility study for the Kalabagh hydro scheme under financing by UNDP. However, at the final stages of project preparation, the issues of water rights and compensation for land used for storage resulted in serious inter-provincial disputes which compelled the federal government to indefinitely postpone the project. Since 1986, the Bank has felt that the concentration on the preparation of a single hydro power site could hinder the future development of this critical resource for Pakistan. Consequently, a hydro ranking study was completed under which the economic viability of each site over 200 MW was assessed and the sites ranked in their order of economic benefits. Basha, with a potential of about 3,600 MW was ranked as the best site after Kalabagh. Consequently, a pre-feasibility study was undertaken for Basha under Canadian financing. GOP, however, has been reluctant to initiate the preparation of a detailed engineering study during the time it was negotiating with the provinces for the development of Kalabagh to avoid having this perceived as an abandonment of the project. To this date, the feasibility and detailed engineering study for Basha had not been launched. The feasibility study for Gazi Ghariala which would provide about 1,000 MW has been initiated and the financing by UNDP with the Bank as executing agency. The study is expected to be completed in early 1992. As a result, despite Pakistan's endowment of hydropower potential estimated at 30,000 MW, the commissioning of a hydropower project of any significant size (500 MW or more) would not take place until towards the end of the century at the earliest. In fact, this is an optimistic timetable given the vast domestic and foreign exchange resources that would have to be mobilized.

Therefore given the time constraint, and the extent of the load shedding experienced at present which is conservatively put at 800 MW, and is expected to reach about 2,400 MW by 1996, given the resource constraints experienced by the public sector, the only option open to Pakistan in the development of its power generation capacity, is to develop the ongoing projects in the public sector and provide the environment necessary for the private sector to fill the gap and the resources required by developing oil-fired power stations which could be converted to operate with imported gas or coal when available.

(b) Would higher electricity tariffs themselves reduce electricity demand to the extent where the project would represent an

excessively large, and possibly uneconomic addition to power production capacity.

The new tariffs for electricity and petroleum products have been used, together with a forecast of the growth in the various sectors in the economy provided by the COD, to ascertain the impact on the forecast demand for electricity for the period 1991-2010. The forecast demand remains virtually unaltered as the long-term price elasticity of demand is estimated at -0.5, while the long term income elasticity of demand is estimated at about 1.2. This, in essence, implies that the income effect on the demand for electricity is much stronger than the price effect. Moreover, as the economy continues to experience severe load-shedding which, in most cases, forces the industrial, commercial and irrigation pumping consumers to install auto-generators to guarantee the supply of electricity at a much higher price than the new tariff for electricity, and the tariffs expected in the future to comply with the Bank's covenant, the tariff for the supply from the national integrated grid is still more economic for consumers than generating their own electricity. This contributes significantly to the inelasticity of response on the part of consumers to higher electricity tariffs.

6. Justification for the ECO.

(a) What is the advantage to Pakistan for using the ECO versus direct borrowing from the Bank?

Fundamental to the use of the ECO as a substitute for the direct Bank loan is the implementation of a long-term strategy for the sector to reduce its dependence on public sector investments and its move gradually towards greater reliance on commercial financing. The Hub Power Complex would provide a blue print for the provisions needed to be put in place in order to safeguard the interest of lenders, investors, and government. The same blue print has been used now for a much more accelerated negotiation with private sector suppliers for additional capacity estimated at about 800 MW. While we are not proposing to use our guarantees for each of these projects, the fact that ECAs have participated in providing financing under limited recourse in a structure that already has been vetted by the international financial community and accepted as a means for providing financing without government guarantees, these would provide an inducement and pressure by the investors and suppliers for the ECAs to use the same approach for financing future projects. We are, at the moment, exploring the possibilities for various governments to participate in a similar guarantee arrangement as that we have reached with Japan under the Hub project which will truly leverage the Bank's guarantee potential and provide additionality in resources channeled to Pakistan's development program.

The ECO is structured to provide partial guarantees mainly to safeguard the interests of the lenders against risks associated with defaults by the public sector entities in their agreements with HUBCO, and in the event of failure by GOP to take the necessary steps to remedy the default by its agencies. This structure has been essential for attracting US$340 million of financing from the export credit agencies. ECAs would not provide direct financing for the Hub Power Complex to cover the cost of goods and services procured in their respective countries. ECAs would provide coverage against a set of agreed risks to commercial banks who would provide the required resources to HUBCO. Consequently, SP under the ECO would serve as the basis for the risks which would be covered by ECAs and those which commercial banks are expected to assume. The guarantee of ECAs would mirror Bank/JEXIM guarantees to ensure that all commercial banks involved in the Hub Power Complex are treated equitably. GOP would not be required to provide any guarantees to the commercial banks covered by the ECAs who are relying on the structure of the SP as well as their treatment as senior lenders in terms of debt service and liquidation, comforted by the fact that PSEDF loan is subordinate to their loans. In the event that the ECO guarantee is replaced by a Bank loan, the ECAs would be unwilling to assume project risks without sovereign guarantee as they would be exposed without the comfort provided by the participation of the Bank/JEXIM in the commercial financing portion of the financing plan. In addition, while JEXIM is prepared to provide a guarantee for a US$120 million in the knowledge that the likelihood that the guarantee would be called is fairly small in view of the strength of the consortium and its past track record, and recognizing that the only risks that need safeguarding are those which are attributable to the failure by the government to live up to its commitment, in the event we elect a direct loan as a substitute for the guarantee, JEXIM has confirmed its unwillingness to participate as it would raise its contribution to the PSEDF fund from US$150 million to US$270 million, representing a significant increase over the contribution of other bilaterals to the PSEDF fund.

(b) Does the proposed guarantee conform to the guidelines for ECOs?

The guidelines for the credit enhancement instrument spelled out the possibility of using this instrument for supporting projects under limited recourse financing. It was explained in the Memorandum to the Executive Directors that in a particular ECO, the Bank's guarantee will not normally exceed the corresponding country exposure incurred by commercial banks or other lenders associated with the transaction, on a present value basis. The question is to consider whether we mean by transaction the actual ECO transaction or the project as a whole. Interpreting the ECO to be the project/transaction in the context of project financing could be meaningless, as it forms part of an integrated and complex financial arrangement. In the context of project financing, the ECO should be regarded as one element of the overall project financing plan. Hence, if we consider the overall financing requirement for the Hub River Project of US$1,543 million, and we deduct from it US$410 million which would be provided by PSEDF under government guarantee, it leaves US$1,133 million which would be financed under limited recourse or with partial guarantees, including the US$360 million covered under the ECO. If we deduct the US$240 million representing the Bank's guarantee, it would mean that US$893 million of financing in both equity and debt have been provided under limited recourse. In essence, therefore, the Bank is providing a guarantee which is part of the overall financing required for the project under limited recourse, representing only 27% of the total financing requirement. In the context of project financing, the use of the Bank guarantee has not, in fact, violated the extent of the coverage approved by the Board. This argument would be reiterated during the OC review meeting and, if approved, would serve as a basis for future project financing under limited recourse where ECO guarantee could be used.

As for the guidelines concerning the country eligibility for the use of the ECO guarantee, Pakistan complied with these and was eligible when the use of ECO was first considered. Since the approval of the ECO program by the Board, however, there has been an agreement between the Operations and Financial Complex that "the use ECOs, even for limited recourse projects, should be restricted to countries judged close to market access". This is a criteria and not a guideline approved by the Board. In that sense it is used to screen candidate countries and, in turn, projects. According to the screening criteria, Pakistan should not qualify for an ECO transaction. The achievements of the medium-term macro-econoomic adjustment program (MAP) would not be possible without the reduction in public investment and the enhanced role for the private sector. In the case of Pakistan, access to the private sector would require the support of an institution such as the Bank to serve as a catalyst in financing infrastructure projects. In fact, so far, financing of infrastructure projects in developing countries by the private sector has not been possible because of the absence of the multinational financial institutions to safeguard investors and lenders against certain risks beyond their control. Only in Thailand, and to a certain extent in Malaysia, has there been success in financing dual-carriage highways by the private sector. Even then local banks with access to sustantial foreign exchange are providing a sort of an ECO to safeguard the lenders, in terms of seniority of debt, recourse and standby facilities in cases of sovereign default.

The argument that the ECO should not be used as a deal-making instrument seems to be inconsistent with the cofinancing nature of our activity where we are seeking to mobilize additional resources by leveraging the Bank's contribution. Aside from the differences between guarantees and Bank loans, both are instruments without which the financing of a critical project in a developing country would not come to fruition. Consequently, the question of the uses of ECO for a country which has not rescheduled over the past five years should be part and parcel of the country assistance program pursued by the Bank. The use of the Bank loan versus the ECO should be dictated by the sectors where ECO could be used, namely, revenue generating sectors and the pricing differential between the two instruments. The adjustment mechanisms being pursued on the policy level would not provide effective change, unless supported tangibly by major transactions, that will demonstrate the effectiveness of shifting from a heavy reliance on public sector to a de-regulated economy where private sector gradually assumes a greater role. If ECOs are to be restricted to countries that are judged to be close to market access then an instrument that could gradually foster and demonstrate a greater reliance on commercial financing would be absent from the Bank support of eligible member countries. We believe that ECO should be used prudently in critical projects in countries undergoing structural change to enhance the role of the private sector and the flow of venture capital.

7. Limited recourse Financing vs. Direct Borrowing

(a) Can it be demonstrated that the limited recourse financing plan fits into the Government's overall borrowing strategy?

As discussed above, under the macroeconomic adjustment program, GOP prepared a core investment program for the energy sector which comprises high priority ongoing and new projects required to meet expected energy demand. Projects were to be undertaken by the public sector only so far as the extent of resources available permitted. The remaining investments were to be undertaken and financed by the private sector. In order to capture the potential additionality through private sector financing, about 45% financed on a limited recourse basis from commercial banks and export credit agencies without a sovereign guarantee from GOP. This greatly alleviates the exposure of GOP in the context of large infrastructure projects which frequently require large up front investment. The approach outlined above for financing PS investment is a central feature of the CIP prepared under ESL II and MAP.

(b) Do the performance guarantees of the government, primarily for the payment of power, in fact have an impact on the government's debt service capability and represent a use of its external credit.

The performance guarantees, as such, are contingent liabilities of GOP and they are included below-the-line when it comes to estimating the debt obligations of a country._ Whether the power project is financed by the public or private sectors, GOP would have the obligation of servicing the debt in the case of public sector, and ensuring that the revenues and the foreign exchange are made available to service debts to lenders in the case of private sector financed projects. The difference between the two approaches revolves around the fact that during the implementation of the private sector project and while the grace period for the commercial loans are in place, GOP guarantee or provisions for debt service would not be tapped.

8. (a) The competitive process under which the contractors were selected for components financed under the ECO, and by other lenders (number of contractors short listed, proposals evaluated, actual cost versus estimates).

Xenel Industries, sponsors of the 600 MW oil-fired project proposal, had initiated selection of a turnkey contractor prior to the award of the letter of intent by GOP. Xenel were assisted in this process by Fosters Wheeler Power Engineering U.K. Ten leading international firms were requested to participate in the project as turnkey contractor. Based on the response, six firms were short-listed and were requested to submit proposals for installation of the 600 MW power plant on a turnkey basis. Four proposals were received of which three complete proposals were evaluated. The evaluation took into consideration factors such as: (i) contract price; (ii) implementation schedule and capability to achieve the schedule; (iii) conformance with specifications; (iv) contribution towards development costs; (v) contractor's organization for implementation of the project; and (vi) previous experience. Based on the above considerations, Xenel Industries selected Mitsui & Co. in May, 1988 as the turnkey contractor to implement the 600 MW plant. Based on GOP's decision to issue a joint letter of intent to Xenel Industries and Hawker Siddeley Power Engineering Ltd., both the sponsors decided to enter in a single contract for the total complex (1200 MW) with Mitsui and Co. After negotiating a reduction in price on account of economics of scale, the prices offered compared favorably with the international prices at the time of selection and the equipment price which formed the basis of the original tariff. Subsequently, two members of the consortium i.e. the civil works contractor and the turbine generator contractor withdrew in January 1990. The civil works contractor was selected from the two contractors who had shown interest in joining the consortium and submitted the proposals to the Hub Power Group. The Hub Power Group resorted to international competitive bidding under World Bank Guidelines for the Turbine Generator island package. However, as GOP is ultimately purchasing electricity, the acid test for competitiveness of the prices is the comparison of electricity price with the long run marginal cost and the avoided cost for WAPDA. The price of electricity from the proposed project would be lower than both, and compares favorably with electricity price of similar projects internationally.

(b) A evaluation of the effectiveness of the ICB process for selection of the turbine-generator contract and other components financed by the Bank through PSEDF (number of proposals, actual cost versus estimates).

In response to the prequalification notice for the Turbine Generator package, seven firms submitted prequalification applications. Out of these, five were finally prequalified and requested to submit proposals against specifications reviewed by the Bank. Three proposals were received of which one was incomplete. The two prequalified bidders who did not submit their bids indicated that uncertainties in Pakistan and other work commitments were the source of many reasons for not submitting proposals. It was mentioned that the bids were opened on September 28, 1990 which was a period of considerable turmoil in the Middle East and uncertainties in Pakistan. As the original contract was on a turnkey basis, there was no separate price indicated for the Turbine Generator package. However, the final contract price of the selected bidder is reasonable compared with similar proposals.

9. What is the expected premium over LIBOR and the anticipated guarantee fee?

CFS is now scheduled to negotiate with commercial banks on the pricing and JEXIM on the guaranteed fee. It is expected that the Bank's involvement in this project will induce the participation of the commercial banks while the market conditions towards LDC financing, including those of project financing have been deteriorating sharply. CFS wishes to advise the most appropriate pricing reflecting the real market appetite after letting commercial banking fully understand the nature of SP, ECO, and the role of the Bank in this project.

January 27, 1991

THE WORLD BANK INTERNATIONAL FINANCE CORPORATION MIGA

Office Memorandum

DATE: **January 22, 1991**

TO: **Mr. M.A. Qureshi, Senior Vice President, Operations**

THROUGH: **W. Wapenhans, EMNVP, and K. Kashiwaya, CFSVP**

FROM: **M. Wiehen, EM1DR, and I. Elwan, CFSPS**

EXT.: **33001, 80811**

SUBJECT: **PAKISTAN: Proposed ECO transaction for Hub Power Complex: Operations Committee Package**

1. Attached please find the Operations Committee Package for the proposed ECO transaction to partially guarantee US$240 million of a US$360 million syndicated commercial bank loan for the Hub Power Company (HUBCO). The remaining US$120 million would be guaranteed by the Japan Export Import Bank (JEXIM). HUBCO is a privately owned company, incorporated in Pakistan, to design, construct, finance, own and operate a 1,292 MW (4 x 323 MW) oil-fired power station, the Hub Power Complex (HPC). HPC would be located at the mouth of the Hub River in the Province of Baluchistan, 35 miles north west of Karachi. When commissioned HPC would account for 15% of the country's installed generating capacity.

2. HPC is part of the national integrated least-cost development plan for the power subsector, which was formulated under the Second Energy Sector Loan (ESL II). HPC is part of the Core Investment Program (FY89-92) agreed with the Government of Pakistan (GOP), which is comprised of ongoing and new investments, to be undertaken by both the public and private sectors. Under the Core Investment Program, the private sector is expected to provide about 2,000 MW of generating capacity, to be initiated in the Seventh Plan and commissioned in the Eighth Plan. The proposed project would contribute over 64% of the planned private sector investments in power generation.

3. Impetus to the creation of HUBCO was provided by GOP's decision to increase private sector involvement in the energy sector as a means for supplementing public sector investment in energy and reducing the burden on the national budget. In support of this decision the Executive Directors' approved, in June 1988, a loan in the amount of US$150 million for the Private Sector Energy Development Project (Loan 2982-PAK), with the objective of assisting GOP in: establishing the institutional and policy framework for attracting, and subsequently sustaining, private sector involvement in energy; and mobilizing resources for co-financing private sector investments. In keeping with these objectives, the necessary institutional framework, including guidelines for facilitating the processing and approval of private sector projects, has been established, and a Private Sector Energy Development Fund (PSEDF), to be administered by the National Development Finance Corporation (NDFC), has been created.

4. PSEDF is designed to finance up to 30% of the debt of eligible private sector investments in energy. Interest rates on PSEDF loans are fixed and are based on the prevailing market rates at the time the loans are made. The interest rates on loans provided by PSEDF would cover GOP's cost of borrowing, including an exchange rate insurance premium that covers the debt portion of the financing, and the cost to NDFC of operating

and administering PSEDF. Repayment terms are structured to reflect the long gestation and amortization periods which are set at up to 23 years including a grace period of up to eight years. Under the terms of Loan Agreement investors may also receive additional financing from PSEDF to enable them to: (i) meet up to 25% of cost overruns, provided that investors are willing to cover at least 25% of such overruns with additional equity; and (ii) continue to meet their debt service payments in the event of delays in the completion of project construction or suspension of operations, resulting from causes beyond the control of investors. GOP has mobilized additional financing in the amount of US$563 million from the Governments of Italy, Germany, France and bilateral agencies, including JEXIM, USAID, ODA of United Kingdom, and the Nordic Investment Bank. Other bilateral agencies have also expressed interest in financing PSEDF.

5. HPC would be a sub-project for financing under the PSEDF, a pre-feasibility study was submitted by the sponsors/investors to GOP and a Letter of Intent (LOI) was issued in April, 1988, outlining the responsibilities of the parties involved, the timing for the preparation of the detailed feasibility study and the parameters to be used in setting the tariff. On the basis of the LOI the sponsors/investors selected a consortium, led by Mitsui Company of Japan, for the implementation of HPC on a fixed price turnkey contract. The consortium comprises IHI of Japan, Campenon-Bernard of France, Ansaldo GE of Italy, and BEI of the United Kingdom. GOP, with the assistance of the Bank and the bilateral agencies, has put in place a security package that safeguards the interests of the lenders, investors, and GOP, and its agencies, without direct sovereign guarantees. The security package comprises agreements and measures that cover: implementation, power purchase, fuel supply, construction, operation and maintenance, shareholders, escrow accounts, and trust deeds.

6. The total cost of HPC, including taxes, duties, project development cost, engineering and coordination costs, O&M costs and initial working capital is estimated at about US$1,083 million, based on the original turnkey contract quotation, the cost of development, and overall engineering coordination, as agreed with GOP on December 23, 1989, and adjusted to account for the changes in the value of the various currencies for financing the project, relative to the US dollar, and for local inflation, whichever applies. These adjustments are in line with the agreement reached between GOP and the consortium.

7. The total financing required for HPC, including interest during construction, contingencies, and other finance-related costs, is estimated at US$1,543 million equivalent. Of the total financing required, US$308 million would be in equity; MIGA is considering coverage of selected foreign equity investors; US$410 million would be provided by PSEDF; US$342 million in the form of suppliers' credits from the export credit agencies of Japan, United Kingdom, France, and Italy; a syndicated loan by commercial banks of US$360 million; US$19 million by the Commonwealth Development Corporation (CDC) of the United Kingdom; and US$104 million of local bank financing. This financing would be provided under limited recourse, which implies that lenders and investors have recourse only to the revenue generated by HUBCO from the sale of electricity to WAPDA, and that the debt (other than that provided through PSEDF) incurred for the construction of HPC would not be guaranteed by GOP.

8. At the time the proposed ECO was reviewed by the EMENA Regional Review Group (RRG) on September 4, 1990, the guarantee proposed was for a syndicated commercial loan of US$274 million, of which the Bank was to guarantee US$183 million, and JEXIM the remaining US$91 million. This was based on a base cost estimate of US$864 million, subject, however, to the outcome of the then ongoing negotiations with the principal subcontractors, and to the adjustments for exchange rate changes and local

inflation provided for under the agreement between GOP and the consortium of December 23, 1989. The estimated base cost of HPC has since been revised and increased by US$218 million, to US$1,083 million, to bring it to January 1, 1991 prices. This adjustment has resulted in a total financing required of US$1,543 million, inclusive of interest during construction, and a US$200 million contingency fund, to be utilized only after the approval of the Bank and Cofinanciers, to cover variation orders by GOP, changes in design attributable to geological conditions, changes in financing costs, etc. This contingency was increased by US$90 million at the request of the commercial lenders from the originally proposed level of US$110 million. In addition, interest during construction has increased by US$30 million. The aggregate increase in total financing requirements of US$338 million will be financed through an increase in equity of US$88 million, export credit financing of US$149 million, PSEDF of US$21 million. Taking into account a US$6 million reduction in the Pakistani banks' commitment to provide local debt financing, this leaves a gap of US$86 million, which will need to be financed by the foreign commercial banks, thereby leading to an increase in the proposed commercial bank loans from US$274 million to US$360 million.

9. The issue of Pakistan's eligibility for ECOs has been discussed with FRSCR who feel that Pakistan does not fully meet the criteria for ECOs discussed by the Board since it is not likely to enjoy voluntary market access in the near future; FRSCR further point out that Pakistan is above the Bank's guidelines for preferred creditor exposure. On the other hand, since (a) Pakistan remains eligible for IBRD lending and the proposed ECO would be accommodated within the approved Bank lending program; (b) the ECO would result in a very significant improvement in the terms of commercial bank lending to Pakistan; (c) the Bank's guarantee is limited to sovereign risk; (d) GOP's exposure to external debt risk is reduced to the extent of the commercial risk assumed by the banks; and (e) the ECO provides the necessary assurance to official export credit agencies to cover substantial amounts of suppliers' credits without sovereign guarantees; we feel that it is justified to recommend the proposed ECO to the Board.

10. The Bank's exposure resulting from extending the ECO will build up over a four-year period from 1991 to 1994 with the disbursement of the proceeds of the syndicated loan. Under the proposed structure, the loan would not be accelerable (except if the project is terminated) during the grace period which coincides with the project construction phase. As a result, the guarantees would not be callable before 1995. We propose to comply with the requirement that the Bank's exposure under an ECO be counted against the Bank's approved lending program by spreading the face value of the operation over the four-year period during which the syndicated loan will be disbursed in equal amounts of $60 million. Alternatively, we would resort to the less desirable option of counting the present value of the Bank's contingent liability (US$176 million, after discounting the face value of the ECO for four years at 8%), against the FY92 program for Pakistan.

11. At present the Bank is not able to release the Second Tranche ($125 million) of the Second Energy Sector Loan pending the implementation of price increases for power and natural gas. We expect these increases to be effected in the near future and well before we would need to seek the approval of the Board to the negotiated ECO. In the meantime, we recommend that we proceed to obtain the Board's mandate to negotiate the terms and conditions of the ECO.

Attachments:

Operations Committee:

Messrs: S. Husain (LACVP), E. Jaycox (AFRVP), A. Karaosmanoğlu (ASIVP), W. Wapenhans (EMNVP), V. Rajagopalan (PRSVP), L. Summers (DECVP), I. Shihata, (LEGVP), K. Kashiwaya (CFSVP), D.J. Wood (FPECP), D. Bock (OPNSV)

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PTHE WORLD BANK INTERNATIONAL FINANCE CORPORATION MIGA

Office Memorandum

DATE: **January 30, 1991**

TO: **Mr. D. Joseph Wood, FPRVP**

FROM: **Michael Wiehen, EM1DR; and Ibrahim I. Elwan, CFSPS** JE.

EXT.: **33300, 80811**

SUBJECT: **PAKISTAN: Hub Power Project ECO**

1. This is in response to the issues raised in your memorandum of January 29, 1991 to the Operations Committee.

Country Eligibility

2. There is a real problem in establishing a cut-off date in applying changing eligibility guidelines to a long lead-time project like Hub Power Complex. Several months ago when the financing plan was being developed, Pakistan met the basic eligibility criteria in effect at that time; namely, all countries which had not rescheduled their debts in the previous five years were eligible for ECO support. Based on this, work was initiated on the proposed ECO and the Finance Complex were kept informed. In light of the changes embodied in the guidelines, it now appears that there is some doubt as to whether Pakistan retains its ECO eligibility. For the reasons set forth below, there is a strong case for proceeding with the ECO under the original eligibility criteria to support the Hub Power Project, and if necessary, agree in this particular instance to some departure from the current eligibility criteria.

3. In any event, the transmittal memo for the OC does not argue that eligibility for a Bank loan automatically implies eligibility for ECOs. On the contrary, it lists five factors why despite the doubtful prospects of Pakistan gaining market access, an ECO is justified for this project.

Justification of ECO versus a Direct Bank Loan

4. The ECO transaction proposed for HUBCO is project specific and may not directly enhance the accessibility of Pakistan to the international capital market. It would, however, provide the comfort to the international lenders in initiating the first utility to be developed by the private sector in Pakistan which would set a precedent for future developments with the aim that, as the institutional framework strengthens and the operations of the private sector in power generation takes root, the support required for mobilizing financing would be phased out. The proposed ECO for the Hub Power Project is dictated by the country assistance program. This is pursued under the Energy Sector Loan II, which constitutes a central piece of the medium-term adjustment program, the private sector investment in power generation is expected to complement the public sector investments which have been curtailed significantly to achieve the structural adjustment objective.

5. The framework for the guarantee and the security package structured under the ECO, served the basis for the Bank's success in mobilizing US$340 million from ECAs who would provide guarantees to a syndicate of commercial banks covering only sovereign risks and mirroring the Bank's guarantee. If we make a direct loan as a substitute for the ECO, it would mean that: (a) GOP would bear both the commercial and sovereign risks

which is clearly less desirable than the current arrangement; (b) leave the financing covered by the ECAs as the only part of the package extended under limited recourse since the ECAs have indicate their unwillingness to stand alone without the comfort of other guarantors in the transactions who would bear similar risks; and (c) the ECAs would require sovereign guarantee for the loans assumed by HUBCO, and in this case, the extent of their exposure would shift from project financing where they were able to go beyond country limits, to a more limited country exposure, thus leaving a gap in the financing. In addition, JEXIM is not prepared to cofinance a direct loan to GOP for HUBCO as its exposure through PSEDF would then increase from the current US$150 million to US$270 million, putting it out of line with the contribution of other cofinanciers to PSEDF.

6. The issue of potentially higher cost of borrowing under the ECO compared to a direct loan is valid. However, the pricing and currency composition of the loan is yet to be negotiated and discussing possible terms is speculative at this stage. In any event, any difference in cost to the government should be regarded as the price paid for securing the US$340 million from ECAs without affecting GOP's access to incremental contributions by the same agencies. Moreover, the proposed arrangement is consistent with the Bank's strategy for the sector of moving it towards greater reliance on the capital market and reflecting the cost of such borrowings in the tariff charged to consumers.

Extent of Credit Enhancement

7. The Bank guideline on the extent of credit enhancement for ECO transactions reads as follows:

> "In a particular ECO, the Bank's guarantee, or other credit enhancement, will not normally exceed the corresponding country exposure incurred by commercial banks, or other lenders associated with that transaction, on a present value basis."

It was further recognized in the Bank's June 1989 memorandum, that depending on the circumstances and requirements of particular transactions, the guideline on credit enhancement should be applied with flexibility. In para 55, it was noted that:

> "In each transaction, of course, the Bank will seek to limit its commitment as much as possible in order to obtain the optimum leverage from its presence in the transaction. But for the program to be effective, it will be necessary for the Bank to retain flexibility in devising the type and extent of its credit enhancement to meet the specific circumstances of the borrower and the financial instrument which is being used to access the needed financial resources."

8. The principle for structuring the Security Package (SP) for the Hub Power Complex, and hence the guarantee under the ECO is to put HUBCO in the same setting as if it was operating in a orderly functioning market for a utility in terms of access to fuel, ability to generate revenue from sales of electricity and ease of transfer of foreign exchange to service debt. The mobilization of debt and equity for project finance without direct sovereign guarantees implies that the providers of financing would have recourse only to the revenues generated from the sale of electricity. These revenues are affected by: (a) the availability of fuel, which HUBCO does not have free access to except through a Government agency, namely PSO; (b) the sale of the contracted power to WAPDA, another Government owned entity, constituting HUBCO's only market for the sale of its electricity; and (c) its ability to operate efficiently and within the parameters agreed with

GOP. In addition, HUBCO's ability to service the debt and pay dividends is dependent on its access to foreign exchange. HUBCO is, in essence, competing for venture capital and debt in the international market and hence the SP has been structured to mitigate risks that normally are not encountered in investments elsewhere for similar projects, e.g., the construction and operation by the private sector of a power utility in the United States, or United Kingdom, etc.

9. Under the Implementation Agreement, GOP agreed to guarantee the performance of its agencies namely , PSO, WAPDA, and State Bank of Pakistan. This guarantee is essential if HUBCO is to access debt and equity financing in the international financial market. In the event of the failure by GOP to fulfill its commitment to remedy any shortfall by its agencies in the respective undertakings to HUBCO, the guarantee from the Bank/JEXIM would be triggered. The triggering mechanism would be spelt out in the Guarantee Agreement administered by the Escrow Agent. The guarantee is not callable in case the revenues are not available to service the debt on account of failure by HUBCO to perform.

10. In the case of project financing an ECO cannot be considered as a self-standing transaction but must be viewed in the context of the entire financing plan. Of the overall financing required for the Hub Power Complex of US$1,543 million, US$410 million would be provided by PSEDF. This leaves US$1,133 million to be financed under limited recourse or with partial guarantees, including the US$360 million from commercial banks partially covered by the ECO. If we further deduct US$240 million, representing the Bank's guarantee, it would mean that US$893 million of finance in both equity and debt have been provided under limited recourse. In essence, therefore, the Bank is providing a guarantee which represents 29% (face value) and 20% (present value) of the limited recourse debt financing required for the project.

11. Under the guarantee proposed for HUBCO, the guarantees of the Bank, JEXIM and the ECAs, only cover sovereign risks. Even if we separate the ECO as a self-standing transaction, which is not practical in the context of project financing, it would be virtually impossible to identify the proportion sovereign risk in the total risk associated with the project. Consequently, we would reiterate that in terms of project financing, ECO guarantees should be part and parcel of the overall financing required for the project. The ECO as proposed, provides only partial coverage of all the risks involved, and, in that sense, we do not believe we have deviated from the spirit of the guidelines.

JEXIM Co-Guarantee

12. We do not believe that the co-guarantee agreement with JEXIM will dilute the Bank's preferred creditor status because of an explicit reference to the World Bank's Indemnity Agreement in the pari passu clause of JEXIM's own Indemnity Agreement with Pakistan. In the typical clause in JEXIM's agreements, the borrower undertakes to accord the loan pari passu treatment with all other external indebtedness (actual or contingent) of the borrower; under such clause, the World Bank Indemnity Agreement would clearly be covered. All that JEXIM has asked (although this was not absolutely necessary) is to clarify explicitly that the World Bank Indemnity Agreement was covered by the term "external indebtedness". As such, the Legal Department has concluded that the arrangement proposed for the Hub River guarantee is not, in substance, different from JEXIM's standard pari passu clause. This clause is included in its direct lending agreements which are regularly used in cofinancing with the World Bank. In short, the co-guarantee arrangements for the Hub River Project are not a significant deviation from arrangements the Bank has found acceptable in the past and should not create any

undesirable precedent. In fact, we were under the impression that the financial complex had no objections to the co-guarantee arrangements as it had cleared the letter on that matter sent to JEXIM.

Accelerability

13. No payments of principal or interest are required until the construction of the project is completed. Therefore, the accelerability of the guarantee as structured will not disrupt the financing of the project. Furthermore, the use of an accelerable guarantee as structured, has allowed the Bank to avoid an additional guarantees on post-completion interest, while meeting the concerns of the commercial banks with respect to the needed cover.

Conclusion

14. The financing of the Hub Power Project is particularly complex, but one that could provide major benefits to Pakistan if successfully completed. Without the ECO, it is unlikely that the project will proceed in its present structure and Pakistan's efforts to provide needed power for its development and to promote private sector infrastructure development will suffer a severe setback.Consequently, we feel that on both country and project considerations, the ECO transaction is fully justified.

Distribution:

Operations Committee Members:

Messrs. M. Qureshi (OPNSV), S. Husain (LACVP)(3), E. Jaycox (AFRVP), Karaosmanoglu (ASIVP), W. Wapenhans (EMNVP), K. Kashiwaya (CFSVP), V. Rajagopalan (PRSVP), L. Summers (DECVP), I. Shihata (LEGVP), D. Bock (OPNSV)

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THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

cc: SES FL

DATE: January 29, 1991

TO: Mr. Larry Summers, DECVP

THROUGH: Robert Liebenthal, Chief, PRDRA

FROM: Alfred J. Watkins, PRDPD and Guenter Reif, PRDRA

A.W.

EXTENSION: 3-1386 / 3-1267

SUBJECT: **Pakistan -- Proposed ECO for Hub River Complex: OC Meeting**

I. Project Description

1. The Hub River Project has been in the gestation stage for at least three years. It now looks as if the project is about to move to the execution phase. The proposed ECO, which is designed to help mobilize a portion of the necessary external financing, is only one component of Bank support for private sector energy projects in Pakistan. As the documentation notes, a project to finance the creation of a Private Sector Energy Development Fund (PSEDF) was approved by the Board in 1988. The fund, which was capitalized by the Bank in concert with several bilateral donors, will offer 23 year, fixed rate, (currently 14%), local currency financing to private sector investors for use in private sector energy projects.

2. This proposed project will have an 80-20 debt equity ratio. A significant share of the foreign equity will be provided by contractors, operators, and equipment suppliers. This is fairly standard practice in a private sector LDC project finance context. The contractors have also committed to raise additional equity from a variety of offshore investors or, if that effort fails, to provide the additional equity themselves. These arrangements are designed to ensure that the multinational contractors, equipment suppliers etc. have a financial stake in the project's long term viability. ECA and MIGA insurance covers losses due to expropriation, transfer risk blockages of dividend and profit remittances, and other governmental actions that can be construed as a breach of contract. The coverage does not guarantee a specific rate of return to any investor.

3. Virtually all of the foreign debt for this project will be supplied or guaranteed in one form or another by public agencies. This includes Bank and bilateral contributions to the PSEDF, ECA guaranteed supplier's credits, commercial bank finance mobilized via the proposed ECO and JEXIM guarantee, and loans from the Commonwealth Development Fund.

4. The government of Pakistan has contracted to sell the necessary fuel to the project at market prices, to purchase energy from the generators at a price designed to cover all project costs and provide an agreed rate of return, assuming the project is operated efficiently, and to sell foreign exchange to the project at the prevailing exchange rate. These are fairly standard clauses for private sector energy projects in

developing countries. They ensure that arbitrary and capricious government actions do not force the project to shut down or prevent the project from earning sufficient local currency to purchase the foreign exchange needed to service its debt. The guarantee under the ECO can be called only if the revenue shortfall is due to this sort of government interference.[1]

5. On the other hand, if the revenue shortfall is caused by the failure to operate the facility in an efficient, commercially viable fashion, the lenders will not have any recourse to the ECO, ECA guarantees, or government of Pakistan. In this sense, Hub River is a typical limited recourse project finance package, similar in structure to revenue bonds issued by US municipalities. In other words, all debt service and dividend payments are to be generated from project revenues. The government in whose jurisdiction the project is located assumes no liability for the normal commercial risks of the project. However, in the US, the sponsors and lenders have access to a variety of legal remedies if the government unlawfully interferes with project operations. The ECO and ECA guarantees are designed to compensate for the absence of credible legal recourse.

II. Financial Analysis

6. Although the limited recourse structure appears to be fairly standard, it might be useful to explore a variety of issues at the OC before deciding to go ahead with this specific guarantee. This remainder of this memo will try to highlight issues that were not explicitly addressed in the COD agenda.

7. Justification. Since the ECO covers 100% of the principal payments on the underlying commercial bank loan, it consumes the same amount of Bank capital as a direct loan. One major difference, however, is that the Bank cannot lend on a limited recourse basis, while ECOs can mitigate the political risks of private non-recourse funds, provided that the Bank receives a suitable counter-guarantee from the host country government. Is this sufficient justification for moving ahead with this ECO instead of providing a direct Bank loan? What specific advantages accrue to the Bank and the borrower (Pakistan) by providing a guarantee rather than a direct loan?

8. Coverage. The documentation stresses that the ECO will only pertain to the 21 semi-annual amortization payments due after the expiration of the grace period. Interest accrued on the commercial bank loans during the four year grace period will be capitalized and put under the ECO umbrella. The capitalization of interest during construction is a fairly standard practice. However, in reality, this means that the Bank's guarantee will cover 100% of the construction cost plus the first

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1/ The guarantees are designed primarily to protect lenders against capricious government interference. However, not every act of interference should be classified as capricious. For example, failure to sell the requisite foreign exchange or import the requisite fuel oil may be due to a general balance of payments crisis. In this case, government actions may be entirely warranted or unavoidable. Nevertheless, the project documentation indicates that they could also trigger a call on the Bank's guarantee.

four or five years of interest. Commercial lenders will be at risk only for interest payments due between years 6 and 14. <u>Should the Bank assume such a large share of the total risk? Does this conform to the ECO program guidelines which specify that the Bank should not assume more than 50% of the total risk on a present value basis?</u>

9. <u>Accelerability</u>. The documentation stresses that the Bank's guarantee cannot be accelerated during the grace period, except in case of termination. <u>What events can trigger project termination, and what is the extent of the Bank's legal liability if an event of termination occurs? How will this limited accelerability affect the Bank's accounting for the guarantee? After the expiration of the grace period, a variety of unspecified events could presumably trigger an accelerated call on the Bank's guarantee. What are these? In particular, would failure to meet one interest payment, or to maintain an adequate balance in the escrow account, be grounds for accelerating the entire loan. If so, doesn't this mean that failure to meet one interest payment would trigger an immediate repayment of the remaining outstanding principal, thereby leaving the commercial lenders exposed to no more than six months of interest? Is the Bank assuming too much liability, or conversely, are commercial lenders assuming too small a share of the overall project risk?</u>

10. <u>Seniority</u>. The project documentation suggests that all foreign lenders will be <u>pari passu</u> and connected via pro rata sharing clauses. Consequently, failure to honor even one principal payment owed to a non-Bank guaranteed lender could trigger a call on the Bank's guarantee. Similarly, failure to honor one interest payment could also trigger a call on the Bank's guarantee if the aggrieved lender accelerates his loan, thereby accelerating the other loans. <u>Should the Bank relinquish its preferred creditor status for this project, especially in view of the fact that it is providing a 100% guarantee of all principal payments?</u>

11. <u>Oil Price Risk</u>. If oil prices rise above a certain level, oil fired generators will no longer be the most economical source of electricity for Pakistan. Nevertheless, the Government is legally obliged to continue importing high priced fuel oil and purchasing electricity at prices that reflect these high petroleum prices. As a result, the government of Pakistan and the local economy are exposed to fairly sizeable oil price risks. <u>Have any steps been taken to reduce these risks, perhaps by entering into long term, fixed price fuel oil purchase contracts or using the available array of financial derivative instruments (commodity swaps) to mitigate some of these oil price risks?</u>

12. <u>Foreign Exchange Risk</u>. The project will borrow in multiple foreign currencies and generate only local currency revenues. This foreign exchange mismatch exposes the project's revenue stream to the risk a Pakistani devaluation as well as relative exchange rate movements among the borrowing currencies. <u>What exchange rate risk mitigation techniques have been applied in this project? If none, is it prudent to issue a guarantee for a project that is exposed to so much cash flow risk?</u>

III. Country Conditions

13. The Gulf War has further intensified Pakistan's domestic political divisions and uncertainties as reflected by the electoral defeat of Mrs. Bhutto in October 1990 and the installation of the Islamic Democratic Alliance (IDA) government under Nawaz Sharif. The country is deeply split about its involvement in the Gulf war on the Allied side. Radical Islamic fundamentalism is rising menacingly threatening the conservative Islamic government itself. In addition, the planned introduction of Islamic Shariat law has further antagonized the country's Shia minority. The cutback of US aid in response to Pakistan's nuclear policies has further hurt the economy and heated up anti-Western emotions.

14. These internal and external political difficulties have added considerably to Pakistan's endemic economic problems. The Gulf crisis raised the balance of payments deficit by over 2 billion. The flow of remittances has been drastically reduced while a large number of impoverished expatriate workers has to reintegrated. Inflation is running at about 25 percent. But little assistance has so far been offered by Arab and Western countries to help Pakistan overcome the crisis. Above all, the growing political difficulties have greatly reduced the government's response, willingness and capability to deal with the economic and financial problems. This affects also Bank operations. For example, the Second Tranche of the Second Energy Sector Loan cannot be released pending the implementation of price increases for power and natural gas (para. 11, cover memo).

15. Moreover, Pakistan is currently rated IIIb by the Bank in terms of creditworthiness. Finance is contemplating a downgrading to IIIc in view of the growing economic difficulties and the apparent inability by the government to respond. This heightens concerns expressed earlier by Finance that Pakistan does not fully meet the criteria for ECOs discussed by the Board since it is not likely to enjoy voluntary market access in the near future (para. 9, cover memo).

16. Given the political and economic difficulties facing the country, the appropriateness of this operation in Pakistan at this time is questionable.

Distribution:

cc: Messrs./Ms. Thalwitz (PRESV), Rajagopalan (PRSVP), Colaco (PREVP), de Tray/Walton (DECVP), Linn (CECDR), Shakow (EXTDR), Isenman (PRDDR), Petit (AGRDR), Pouliquen (INUDR), Corbo (CECMG), Pfeffermann (CEIED), Grilli (EAS), Bock (OPNSV), Kilby (FRSCR), Opper (FRSFP), Piddington (ENVDR), Churchill (IENDR), Rao (IECDR), Hamilton (PHRDR), Sandstrom/Khanna (EXEC), Wapenhans (EMNVP), Wiehen (EM1DR), Penalver-Quesada (EM1CO), McCleary (EM1DR)

THE WORLD BANK INTERNATIONAL FINANCE CORPORATION MIGA

Office Memorandum

DATE: **January 30, 1991**

TO: **Mr. D. Joseph Wood, FPRVP**

FROM: **Michael Wiehen, EM1DR; and Ibrahim I. Elwan, CFSPS**

EXT.: **33300, 80811**

SUBJECT: **PAKISTAN: Hub Power Project ECO**

Country Eligibility

1. The current situation of Pakistan's creditworthiness brings into question the eligibility for ECOs in Pakistan in light of the most recent guidelines for country eligibility. As you note, however, these guidelines were developed after the project was well advanced. Therefore, para 9 of the transmittal memorandum was intended to list the factors that, in these specific circumstances, make us believe that the proposed ECO operation is justified for this project.

Justification of ECO versus a Direct Bank Loan

2. The ECO transaction proposed for HUBCO is project specific and may not directly enhance the access of Pakistan to the international capital market. It would, however, provide the comfort to the international lenders in initiating the first utility to be developed by the private sector in Pakistan which would set a precedent for future developments with the aim that, as the institutional framework strengthens and the operations of the private sector in power generation takes root, the support required for mobilizing financing would be phased out. The proposed ECO for the Hub Power Project is consistent with the country assistance program. This is pursued under the Energy Sector Loan II, which constitutes a central piece of the medium-term adjustment program. Private sector investment in power generation is expected to complement the public sector investments which have been curtailed significantly to achieve the structural adjustment objective.

3. The framework for the guarantee and the security package structured under the ECO, was the basis for the Bank's success in mobilizing US$340 million from ECAs who would provide guarantees to a syndicate of commercial banks and would cover only sovereign risks and mirroring the Bank's guarantee. If we make a direct loan as a substitute for the ECO, it would mean that: (a) GOP would bear both the commercial and sovereign risks which is clearly less desirable than the current arrangement; (b) the financing covered by the ECAs would be the only part of the package extended under limited recourse which will prove unacceptable to the ECAs who have indicated their unwillingness to stand alone without the comfort of other guarantors bearing similar risks; and (c) the ECAs would require sovereign guarantee for the loans assumed by HUBCO, and in this case, the extent of their exposure would shift from project financing where they were able to go beyond country limits, to a more limited country exposure, thus leaving a gap in the financing. In addition, JEXIM is not prepared to cofinance a direct loan to GOP for HUBCO as its exposure through PSEDF would then increase from the current US$150 million to US$270 million, putting it out of line with the contribution of other cofinanciers to PSEDF.

4. The issue of potentially higher cost of borrowing under the ECO compared to a direct loan is valid. However, the pricing and currency composition of the loan is yet to be negotiated and discussing possible terms is speculative at this stage. In any event, the terms would represent a significant improvement over those available without the ECO. Any difference in cost to the government should be regarded as the price paid for securing the US$340 million from ECAs without affecting GOP's access to incremental contributions by the same agencies. Moreover, the proposed arrangement is consistent with the Bank's strategy for the sector of moving it towards greater reliance on the capital market and reflecting the cost of such borrowings in the tariff charged to consumers.

Extent of Credit Enhancement

5. The Bank guideline on the extent of credit enhancement for ECO transactions reads as follows:

> "In a particular ECO, the Bank's guarantee, or other credit enhancement, will not normally exceed the corresponding country exposure incurred by commercial banks, or other lenders associated with that transaction, on a present value basis."

It was further recognized in the Bank's June 1989 memorandum, that depending on the circumstances and requirements of particular transactions, the guideline on credit enhancement should be applied with flexibility. In para 55, it was noted that:

> "In each transaction, of course, the Bank will seek to limit its commitment as much as possible in order to obtain the optimum leverage from its presence in the transaction. But for the program to be effective, it will be necessary for the Bank to retain flexibility in devising the type and extent of its credit enhancement to meet the specific circumstances of the borrower and the financial instrument which is being used to access the needed financial resources."

6. The principle for structuring the Security Package (SP) for the Hub Power Complex, and hence the guarantee under the ECO is to put HUBCO in the same setting as if it was operating in a orderly functioning market for a utility in terms of access to fuel, ability to generate revenue from sales of electricity and ease of transfer of foreign exchange to service debt. The mobilization of debt and equity for project finance without direct sovereign guarantees implies that the providers of financing would have recourse only to the revenues generated from the sale of electricity. These revenues are affected by: (a) the availability of fuel, which HUBCO does not have free access to except through a Government agency, namely PSO; (b) the sale of the contracted power to WAPDA, another Government owned entity, constituting HUBCO's only market for the sale of its electricity; and (c) its ability to operate efficiently and within the parameters agreed with GOP. In addition, HUBCO's ability to service the debt and pay dividends is dependent on its access to foreign exchange. HUBCO is, in essence, competing for venture capital and debt in the international market and hence the SP has been structured to mitigate risks that normally are not encountered in investments elsewhere for similar projects.

7. Under the Implementation Agreement, GOP agreed to guarantee the performance of its agencies namely , PSO, WAPDA, and State Bank of Pakistan. This guarantee is essential if HUBCO is to access debt and equity financing in the international financial market. In the event of the failure by GOP to fulfill its commitment to remedy any shortfall

by its agencies in the respective undertakings to HUBCO, the guarantee from the Bank/JEXIM would be triggered. The triggering mechanism would be spelt out in the Guarantee Agreement administered by the Escrow Agent. The guarantee is not callable in case the revenues are not available to service the debt on account of failure by HUBCO to perform.

8. In the case of project financing an ECO cannot be considered as a self-standing transaction but must be viewed in the context of the entire financing plan. Of the overall financing required for the Hub Power Complex of US$1,543 million, US$410 million would be provided by PSEDF. This leaves US$1,133 million to be financed under limited recourse or with partial guarantees, including the US$360 million from commercial banks partially covered by the ECO. If we further deduct US$240 million, representing the Bank's guarantee, it would mean that US$893 million of finance in both equity and debt have been provided under limited recourse. In essence, therefore, the Bank is providing a guarantee which represents 29% (face value) and 20% (present value) of the limited recourse debt financing required for the project.

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Commercial B.

9. Under the guarantee proposed for HUBCO, the guarantees of the Bank, JEXIM and the ECAs, only cover sovereign risks. Even if we separate the ECO as a self-standing transaction, which is not practical in the context of project financing, it would be virtually impossible to identify the proportion of sovereign risk in the total risk associated with the project. Consequently, we would reiterate that in terms of project financing, ECO guarantees should be part and parcel of the overall financing required for the project. The ECO as proposed, provides only partial coverage of all the risks involved, and, in that sense, we do not believe we have deviated from the spirit of the guidelines.

<u>JEXIM Co-Guarantee</u>

10. The Legal Department has concluded that the arrangement proposed for the Hub River guarantee is not, in substance, different from JEXIM's standard <u>pari passu</u> clause. This clause is included in its direct lending agreements which are regularly used in cofinancing with the World Bank. In short, the co-guarantee arrangements for the Hub River Project are not a significant deviation from arrangements the Bank has found acceptable in the past and should not create any undesirable precedent. In fact, we were under the impression that the financial complex had no objections to the co-guarantee arrangements as it had cleared the letter on that matter sent to JEXIM.

<u>Accelerability</u>

11. No payments of principal or interest are required until the construction of the project is completed. Therefore, the accelerability of the guarantee as structured will not disrupt the financing of the project. Furthermore, the use of an accelerable guarantee as structured, has allowed the Bank to avoid an additional guarantees on post-completion interest, while meeting the concerns of the commercial banks with respect to the needed cover.

<u>Conclusion</u>

12. The financing of the Hub Power Project is particularly complex, but one that could provide major benefits to Pakistan if successfully completed. Without the ECO, it is unlikely that the project will proceed in its present structure and Pakistan's efforts to provide needed power for its development and to promote private sector infrastructure development will suffer a severe setback.Consequently, we feel that on both country and project considerations, the ECO transaction is fully justified.

Distribution:

Operations Committee Members:

Messrs. M. Qureshi (OPNSV), S. Husain (LACVP)(3), E. Jaycox (AFRVP), Karaosmanoglu (ASIVP), W. Wapenhans (EMNVP), K. Kashiwaya (CFSVP), V. Rajagopalan (PRSVP), L. Summers (DECVP), I. Shihata (LEGVP), D. Bock (OPNSV)

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THE WORLD BANK/IFC/MIGA
OFFICE MEMORANDUM

cc: Moeen Qureshi
Gotti

DATE: January 28, 1991

TO: Operations Committee Members

FROM: D. Joseph Wood, FPRVP

EXTENSION: 80600

SUBJECT: **Hub River Project**

1. This note summarizes my major concerns about this proposed operation.

Country Eligibility

2. In the November 21, 1990 OC meeting to review the ECO pilot program, the Chairman noted that the ECO program should be limited to the lower risk, more creditworthy countries judged close to market access, and that he did not wish to see IBRD guarantees being provided in deteriorating country situations. I do not believe that Pakistan's current creditworthiness situation is consistent with these criteria. Since these criteria and guidelines were developed after the Hub River ECO was well advanced, there may be a case for making an exception for it. However, I strongly disagree with the argument implied in para. 9 of the Transmittal Memorandum, namely, that eligibility for a Bank loan should automatically imply eligibility for an ECO.

Extent of Credit Enhancement

3. The proposed ECO contravenes the Board guideline "normally" restricting credit enhancement in an ECO to less than 50%. The Bank and JEXIM provide 100% coverage of both principal and interest on the commercial loan over its entire life. During a 5-year grace period, interest won't be paid but will instead be added to principal and covered by the guarantee. After the grace period, current interest will be covered through an escrow account and the risk of loss of future interest payments will be covered by accelerability of the guarantee.

4. The Transmittal Memo, para 9, defends the proposed coverage on the ground that the ECO spares the government and the guarantors from commercial risks assumed by banks. While commercial banks do assume certain commercial risks, several important risks such as supply and price of major raw material, demand, price of output, realization of sale proceeds, etc. are in fact underwritten by the GOP and the guarantors over 25 years. Construction and operation risks are similarly reduced through turnkey contract and O & M agreements. An additional safety umbrella is accorded by giving the commercial banks seniority over PSEDF and other loans, for which GOP would bear the ultimate payment responsibility. Thus, in reality, the banks are protected against most commercial risks.

Justification of ECO versus a Direct Bank Loan

5. This ECO would likely raise borrowing costs and add variability relative to a direct Bank loan. About $250 MM of the commercial loans under the ECO transaction would carry LIBOR-based interest rates, which would be far more variable than those of a direct Bank loan. Such uncertainty of total cost is particularly undesirable for a power utility.

Moreover, I understand that the commercial loan may be priced around 80 bp over LIBOR. With the Bank's guarantee fee of about 50 bp, the ECO would have a total cost of approximately LIBOR plus 130 bp. This is about 110-130 bp higher than the cost of a comparable direct Bank loan (carrying a margin of 50 bp over the Bank's own funding cost of about LIBOR minus 30-50 bp). Hence, over a 15-year period, the ECO transaction will be more costly than a direct Bank loan, unless short-term rates for the funding of commercial bank loans turn out to be consistently and substantially lower than medium- and long-term rates at which the Bank (mainly) borrows.

Accelerability

6. FINCOM has consistently expressed reservations about the use of accelerable guarantees because of their potential to disrupt the project's financing in the midstream. Commercial lenders desire accelerable guarantees to protect full interest and principal. If commercial lenders are to be given 100% coverage, and accelerability, it would seem more reasonable to proceed with a direct Bank loan partially cofinanced with JEXIM.

JEXIM Co-Guarantee

7. This proposal envisages a co-guarantee arrangement with JEXIM which could dilute the Bank's preferred creditor status. The Bank has been advised that JEXIM will require GOP to reimburse payments under the joint guarantee by JEXIM on a pari passu basis with the Bank. While obviously the Bank cannot prevent the GOP and JEXIM from reaching any such agreement, its participation in a co-guarantee on such terms comes uncomfortably close to (and may be misunderstood as implying) Bank's acceptance of an extension of preferred creditor status to an ECA. I worry about the potential reluctance of ECAs to co-finance without these protections in the future.

Conclusion

8. These shortcomings of the proposed operation are not redeemed by either significant real leverage or by the prospect of improving Pakistan's market access in the foreseeable future. Thus, I do not believe an adequate case has been made for using an ECO in preference to a direct Bank loan.

Operation Committee Members:
Messrs. M. Qureshi (OPNSV), S. Husain (LACVP), E. Jaycox (AFRVP), A. Karaosmanoglu (ASIVP), W. Wapenhans (EMNVP), V. Rajagopalan (PRSVP), L. Summers (DECVP), I. Shihata (LEGVP), K. Kashiwaya (CFSVP), D. Bock (OPNSV).

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January 28, 1991

Mr. Qureshi

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: January 24, 1991

TO: Operations Committee

FROM: EG Enzo Grilli, Director, EAS

EXTENSION: 81934/5

SUBJECT: GHANA: Initiating Memorandum for an Agricultural Sector Adjustment Credit - Agenda

1. The Operations Committee will meet on Monday, January 28, 1991 at 4:30 p.m. in Room E-1243 to discuss the Initiating Memorandum (IM) for the proposed Agricultural Sector Adjustment Credit (AGSAC) in the amount of US$60 million.

Background

2. The recent Country Strategy Paper (CSP) made private sector development the cornerstone in the Bank's assistance strategy. The CSP also stressed the importance of improving the efficiency of public resource use, revitalizing the Government's administrative framework, addressing poverty and protecting the environment. The President's Council discussed the CSP on June 18, 1990 at which time the President endorsed this strategy.

3. The Government's broader adjustment policies are set out in the recently negotiated Policy Framework Paper for 1991-93. The continued economic reform process would be supported by the third annual ESAF arrangement and by the proposed Third Structural Adjustment Credit. The IM for SAC III was discussed by the Committee on October 22, 1990. The appraisal has essentially been completed.

4. The proposed AGSAC would pursue this reform agenda within the agricultural sector. It would expand the role of the private sector through liberalization of agricultural prices, removal of monopsonistic marketing arrangements for inputs and outputs, and divestiture/privatization of production, processing and storage facilities. The credit would seek to redirect public expenditures to areas with higher potential returns (such as agricultural research and small scale irrigation) and to revitalize public administration through regional decentralization of budget and program implementation. In addition to encouraging greater labor absorption in the agricultural sector--and, thus, improve the incomes of the rural poor--the credit would establish a system for monitoring the poverty impact on public expenditures in the sector. Deforestation, soil degradation and erosion are key environmental problems that would be addressed under the AGSAC through the preparation of a land resource management strategy for Ghana. The policy and institutional reforms that would be supported under the AGSAC are based on the comprehensive Medium Term Agricultural Development Strategy prepared by the Government in collaboration with the Bank.

5. The AGSAC would be disbursed in two tranches of US$30 million each. The proceeds of the credit would be used for import of equipment and

material needed by the agricultural sector and identified on a positive list. Retroactive financing of up to $10 million is recommended. The KfW and EEC might cofinance the credit.

Issues

6. Against this background, the Committee might want to discuss the following issues:

* Government commitment to the expanded role for the private sector. Some of the key actions supported by the AGSAC are: (i) demonopolization of cocoa purchasing, marketing of inputs to cocoa producers and fertilizer distribution; and (ii) privatization/divestiture of cocoa, palm oil and cotton processing facilities, cocoa and palm oil plantations and two Farmers Agricultural Supply companies. However, the restructuring and divestiture of public enterprises have in the past been very slow and key government officials have repeatedly made ambivalent statements about the role of the private sector. Thus, the Region might want to explain why it is now confident that the proposed reforms aimed at expanding the role of private entrepreneurs in the agricultural sector will move forward as planned.

* Macro-economic policy environment. The Government's agricultural strategy seeks simultaneously to promote exports of cocoa, coffee and horticulture produce and expand efficient import substituting production of cotton, maize and rice. The exchange rate needs to be kept under active review to ensure international competitiveness--especially in the tree crops sub-sector--and, thus, to achieve the desired supply response in the medium and long term. The inflation rate has been creeping upwards over the last two years and was around 35 percent in 1990. In the short run, agricultural liberalization can be expected to increase inflationary pressures (although the long term effects of increased competition should be the opposite). A lack of price stability is likely to increase uncertainty and limit the farmers' investments in new technology and political pressures might slow down the price reforms. Thus, sound economic management is essential for the success of the AGSAC. Consequently, the Region might want to explain what actions the Government is expected to take in order to ensure a macroeconomic environment that is conducive to accelerated agricultural growth.

* Expected supply response. The AGSAC is designed to elicit two types of supply responses: first, significant investments by private entrepreneurs in input distribution, product marketing and processing; second, area expansion and more intensive input use by farmers in response to more enumerative prices and better access to inputs and product markets. However, because of uncertainties about future policy directions, private investors in Ghana have so far remained rather cautious. Agricultural production has responded rather sluggishly to the economic reform program, growing at 2.2 percent p.a. since 1984. The production and marketing of roots, tubers and plantain--that together account for three-fifths of agricultural GDP--are essentially free from

government interference. The prices of cocoa, cotton, coffee, oil palm, maize and rice--accounting for roughly a quarter of agricultural GDP--are still controlled. The liberalization of the cotton sub-sector can be expected to result in major price increases but for other crops the impact is likely to be rather moderate. Still, the Region projects that the reforms supported by the AGSAC will lead to an acceleration of agricultural growth to around 4 percent. The Region might want to clarify how this supply response is expected to materialize.

* Decentralization. One key action supported under the AGSAC is the decentralization of program planning, budgeting and implementation to the regional level. This is expected to lead to quicker decision making and to the design of development programs that are better adapted to local conditions. The Region might want to (i) describe what additional actions are needed to increase the implementation capacity at the local level; and (ii) assess the financial implications of these reforms.

* Credit amount. The CSP proposed a lending program of US$270 million for FY91, US$225 million for FY92 and FY93 and US$260 million for FY94 and FY95. Most of the adjustment lending would be concentrated in FY91 with US$100 million for SAC III and US$50 million for AGSAC. In his comments to the CSP, the President recommended that the front loading of the lending program with adjustment operations should be reviewed. Subsequently, the increased balance of payment needs due to the Gulf crisis led to an increase in the amount for SAC III to US$120 million. The credit amounts for other operations have also been increased and, at present, the anticipated FY91 lending to Ghana amounts to US$343 million (including a supplement of US$8.3 million for SAC II). This is equivalent to US$24 per capita. In considering the proposed credit amount of US$60 million for the AGSAC, the Committee might want to consider if this amount of lending is justified based on Ghana's balance of payment needs and economic performance.

Check the lending allocation?

OC Members

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

cc: Messrs. Wyss (COD); Isenman (PRD); Linn (CEC); Stoutjesdijk (FRS); Picciotto (CPB); Burmester/Thahane (SECGE); Goldberg (LEGOP); (Ms.) Okonjo-Iweala (OPNSV); Parmar (IFC-CIO); Rao (IEC); Kavalsky (FRM); Pfeffermann (IFC-CEI); Liebenthal (PRD); Kilby (FRS); Robless (OPNSV); Sandstrom, Khanna (EXC); O'Brien, Lim, Seth, Bunyasi, AFR.
Institutional ISC (E-3-200)

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THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: January 16, 1991

TO: Mr. W.A. Wapenhans, Acting Senior Vice President, Operations

THRU: Mr. Stephen M. Denning, Acting Vice President, AFR

FROM: Magdi R. Iskander, Acting Director, AF4

EXTENSION: 34858

SUBJECT: GHANA - Initiating Memorandum for the Agricultural Sector Adjustment Credit (AGSAC)

We are seeking the approval of the Operations Committee to appraise an agricultural sector adjustment credit to Ghana in the amount of US$60 million. AGSAC is designed to support implementation of the policy actions identified in the Medium Term Agricultural Development Strategy (MTADS) developed by the Government in collaboration with the Bank. AGSAC focusses on measures to accelerate sustainable agricultural growth through measures which are designed to increase efficiency in the marketing and pricing framework, improve public sector resource use efficiency, and increase Government's focus on poverty alleviation and the environment. We believe the content of the Government's program fully merits the proposed level of support.

Attachment: 2 copies

Distribution

Operations Committee Members:

Messrs. **Qureshi (o/r), Jaycox (o/r), Summers, Husain, Karaosmanoglu, Rajagopalan, Shihata, Kashiwaya (4), Wood, Bock**

Others

Messrs./Mmes. Wyss, Grilli (2), Isenman (2), Linn (3), Stoutjesdijk, Picciotto, Thahane, Goldberg, Okonjo-Iweala, Chaudhri, Parmar, Rao, Kavalsky, Pfeffermann, Liebenthal, Kilby, Robless, Sandstrom, A. Khanna, O'Brien, Anil Gore, Gruss, M. Martinez, Faruqee, Thalwitz, Barrientos, J. de Merode, Smith, Seth, Iskander, Wright, Petit, Barghouti, Feder, Ismail Serageldin (2), Landell-Mills, Peberdy, Thillairajah, Walters, Christoffersen, C. Cook, Lietard, Corbo, Keatley, Torabi, Weindler, Ijichi, Jones, Leechor, Kanbur, Ton, Bunyasi, Conlin, Ranade, Sherif, Ghana Country Team, AF4AG HL Staff, Capoluongo, Haile-Mariam, Sigrist, Regional ISC, Div-BB

January 25, 1991

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THE WORLD BANK

Operations Committee

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Minutes of the Operations Committee to consider
ZAMBIA: DRAFT PRESIDENT'S REPORT ON AN ECONOMIC RECOVERY CREDIT &
SECOND YEAR POLICY FRAMEWORK PAPER
held on January 25, 1991 in Room A-1243

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A. Present

Committee

Messrs. M.A. Qureshi (Chairman)
I. Shihata (LEGVP)
L. Summers (DECVP)
K. Kashiwaya (CFSVP)
E. Jaycox (AFRVP)
S. Asanuma (AS1DR)
W. Grais (EM2CO)
M. Selowsky (LACCE)
F. Kilby (FRSCR)
C.L. Robless (OPNSV)

Others

Messrs. S. Al Habsy (LEGAF)
R. Armstrong (AFRCE)
F. Chaudhri (EAS)
Ms. M. deNevers (FRS)
S. Denning (AF6DR)
G. Gebhart (AF6CO)
R. Grawe (AF6CO)
E. Grilli (EAS)
Ms. O. Kalantzopoulos (PRD)
Ms. N. Okonjo-Iweala (OPNSV)
P. Patel (AF6CO)
Ms. J. Salop (CODOP)
J. Todd (AF6CO)
M. Walton (AF6CO)

Ms. B. Dillon (IMF)
G.R. Kincaid (ETR/IMF)

B. Issues

The meeting was called to consider the draft President's Report on a proposed $175 million Economic Recovery Credit to Zambia to be disbursed in two tranches and the second year Policy Framework Paper that the Government of Zambia had prepared with the collaboration of the staffs of the Bank and the Fund. The main issues raised in the Economic Advisory Staff agenda of January 23, 1991, especially the macroeconomic adjustment program, its foundations and the risks connected with the proposed lending were the focus of discussion in the meeting.

C. Discussion

In his opening remarks the Regional representative observed that following a disappointing record of adjustment during the 1980s, the Government of Zambia had initiated an adjustment program and had made progress in areas such as exchange rate management; price decontrols; liberalization of agricultural marketing; parastatals restructuring, civil service reform etc. He stressed, however, that implementation capacity remained weak. There were some slippages in some aspects of the program; and new risks in the context of the forthcoming elections. In his judgement the chances of a successful continuation of the program in the foreseeable future were barely better than even. As to the ways to support it, alternatives such as a series of smaller Bank adjustment credits or larger adjustment credits with more drastic measures, that did not work in the past, were not realistic options. He concluded by saying that the proposed financing package, supported by large donor contributions, was still financially tight but manageable.

The Chairman observed that the Regional and Bank management had spent an enormous amount of time in shaping up the financing plan. The need was the clearing of the large arrears to the Bank and the Fund and reconciling their clearing with a sufficient financial support to the program. He suggested that if any member of the Committee had useful views and suggestions on the financing plan then these could be addressed to him directly and copied to the President. This would allow more time for the discussion of the other issues raised by the proposed ERC and by draft PFP than would otherwise be possible. In his judgement the central questions were whether: (a) the adjustment underlying the proposed program was sound, (b) its priorities were right and (c) the pace of program implementation was adequate. The chairman felt that there were serious risks to the program. However, these risks did not emanate from the additional amount of finance that was being made available to Zambia to close the final gap, but from the program itself.

In the ensuing discussion, one Committee member remarked that, in view of the possible enormous advantages to the country, he was not put off by the risks. He felt nevertheless that four general institutional issues should be noted: (i) at variance with present practice, the proposed operation was to be presented to the Board before the Bank arrears were cleared; (ii) there was a very large percentage of retroactive financing proposed in the ERC, far beyond the standard limit; (iii) we ought to avoid the need for a waiver to the negative pledge condition that was being created by the IMF proposal to set-up a fund where copper sale proceeds (above a certain level) would be placed and (iv) we ought not to accept the cross-default clause that the IMF was de facto requesting of the Bank.

The Chairman said that he did not favor the idea of special SDR accounts for reimbursement of IMF debt service. On the question of "cross default assurance" to the Fund, he doubted that this was really being asked and stated that we should give the Fund an understanding that should the program go off track and Zambia suspend debt service to the Fund, the Bank would act in a way that will be consistent with our collaborative approach on arrears. Depending on the circumstances, we will examine whether continued disbursements are justified and suspend new operations if necessary. The Region felt that the risks of the Government of Zambia following the program, but not paying the Fund were remote. On the issue of the presentation of the loan to the Board, the Chairman indicated that the need to clear large arrears justified some deviation from our normal practice. The loan will be presented to the Board, but not signed, until arrears are cleared. Exceptionally large retroactive financing was also a regrettable necessity in this case, to ensure a sufficiently large disbursement of the credit to Zambia, faced with pressing needs after arrears clearing.

As to the program's strength, the Region's assessment was that despite periodic and occasionally significant setbacks in recent years, the program was not back to square one. As stated in the opening remarks, several policy advances have been made, and the Government's political will has strengthened. The Government recognized that the alternatives to adjustment were 'brutal' in economic and social terms. The Region's representative warned that the progress would not be smooth and the program was likely to come off track more than once in the next 4 years. Ultimately, however, the chances of its success were better than 50:50.

The Chairman asked whether the targets relating to savings/investment, fiscal deficits and reduction in inflation etc. were not overly optimistic. Generally speaking the Region felt that while the election could engender shortfalls in certain areas, the authorities have a reasonably good handle on the economic situation. The Region also noted that the target for investment was to move towards the investment/GDP ratio that existed in the mid-1980s. Substantial improvements in decontrolling prices, exchange rate management, interest rates etc. have now set the stage for improvements in the investment behavior and hence it was not optimistic to assume that this objective would be achieved. Even if there were to be some slippages on the investment front, it would not necessarily jeopardize the program in the short run because growth would still derive mainly from greater utilization of the existing excess capacity and efficiency, and the compensating consumption increases would also be welcome.

One Committee member stressed that in a period when austerity measures are to be implemented, budget deficit and imported capital goods are contracting, it would not be possible to achieve a 3 percent-plus growth that the Region had projected. In such circumstances the social acceptability of the program would be called into question. Was it realistic to expect that a government facing elections would stay the course? Wasn't it better to wait for 6 months and, for the newly elected government to be in place before going ahead with the proposed operation?

Another Committee member felt that the ERC conditions were couched too much in general terms and there was a need to state them in a more action-specific fashion. Explicit actions were necessary for monitoring purposes. The program as presented seemed weak on the fiscal side.

According to another Committee member since the Fund was taking out well over $200 million in the program period, the Financing Plan remained inflexible and tight. One of the argument for sequential clearing of arrears was that it would enable the institution that was cleared first to provide additional resources in the event of adverse external developments. Since the Bank was already providing substantial IDA resources upfront, further flexibility could be achieved by moving forward the date at which the Fund arrears would be frozen thereby releasing some resources in 1991. In light of the Chairman's opening remarks with respect to the financing plan, this point was not discussed further.

On the issue of political uncertainty, one Committee member felt that if the Government that would materialize after the election was in tune with the present thinking, then there was no problem. However, if it was of a different orientation, then it would not feel committed to the program, thereby creating difficulties of considerable proportions. The Region's response was that it is highly unlikely that the economic approach of the new Government would be radically different from the current one. The approach is expected to be equally private-sector oriented, as agreement on it is fairly widespread. The Region also felt that a change in the top leadership of the country was unlikely in the current situation.

On the other hand, the dangers in waiting are: (a) the Bank arrears would continue to accumulate, (b) the financing plan would virtually be impossible to keep intact as donors will drift away and (c) the macro management would unravel.

On the question of postponing the proposed operation, the Chairman remarked that the aid-donors coalition has been pulled together with great difficulty. In this particular situation where the Bank arrears are to be cleared and the Fund maintained current by substantial debt relief, additional financial flows and other arrangements, the donors coalitions remained under considerable pressure. While the issue of a new government was significant, the Chairman felt that in the absence of actions now, the coalition may not stay together for another few months and we may have little to negotiate at a later time. It was also possible that the Government may postpone elections. The Government has taken a few important measures already and the donors feel that a further delay in the proposed actions would be tantamount to loosing an excellent opportunity for doing something concrete and meaningful. Given the substantive nature of the program, the Regional representative stressed the need to 'cash-in' on the efforts of all the parties and the donors' present interest. Under the circumstances, he felt the timing of the proposed operation was appropriate.

On the question of realism in projections at the time the economy was being disinflated the Regional staff stated that: (a) unlike the last year, adequate credit would be going to the private sector this year, (b) growth in agriculture would be the driving force, (c) the public sector is expected to be using its resources more efficiently and above all (d) the projection depended on some fundamental policy changes already agreed upon with the Government. In response to a follow-up question as to how the investment in the economy would increase when the tariffs will be rising on the imported capital goods and when their inflows would be decreasing, the Region noted that the level of import that is forecast would be higher than the recent trend and that the inventory was substantial. The Fund representative also stated that a main goal was to make the Zambian economy less import and less capital intensive. This would be achieved by raising tariffs on capital goods and achieving the positive real interest rates. Also the degree of capacity utilization in the economy was low, and a substantial amount of output growth was expected from small scale enterprises and in the agriculture sector, requiring relatively low investments. The Chairman then raised the exchange rate management issue and asked what was preventing the Government from moving rapidly towards simplification and a market clearing rate? The IMF representative informed the Committee that with respect to windows one and two, considerable progress toward unification had been made (with almost 90% of non-mining imports now flowing through the second window). Zambia could move faster than indicated. However, early unification of the two rates would increase monetary expansion but do little to improve resource allocation. The export retention scheme and resulting unofficial inter-bank rate, she said, was not a "neat" solution but the exporters value it highly and the scheme is likely to stay for some more time. In her judgement, the reforms in this area were proceeding well.

In response to the question raised in the agenda on parastal reforms and the role of the private sector, the Regional representative stated that: (a) the first phase restructuring of 18 parastatals has been accomplished, (b) the Bank has in fact advised the Government not to be over ambitious in the first stages of its privatization program and (c) an initial policy statement on the Investment Code, which was overly generous, was being redrafted at the Bank's advice and would be issued shortly.

The Region reaffirmed that the Government is fully committed to removing subsidies on fertilizer by end May 1991 and removing all price controls on maize and maize meal products and ending maize handling subsidies as quickly as possible taking into consideration the supply situation.

In his concluding remarks the Chairman authorized the Region to begin negotiations on the ERC taking into consideration the points raised in the meeting, and to take the next steps in the processing of the PFP. While there was an option to wait for a few more months, he said, on balance the conclusion to process the ERC at this time was justified for the reasons given above. He agreed with the judgement of a Committee member that in 1991, the growth in the economy may be considerably below that projected in the document. He was also of the opinion that during the next period of austerity and consolidation, one should not emphasize too much the investment side of the growth equation. The focus should rather be on efficient use of resources, on improved capacity utilization and on keeping the program of adjustment on track. He also stressed the need to work hard on realizing the potential that agriculture holds in Zambia (which is primarily in the private sector) and on achieving an economically viable diversification of the economy.

FMChaudhri:gs
11-FEB-91

Mr. Qureshi

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

How would this additional $35 million fit in?

2n1

DATE: January 23, 1991

TO: Operations Committee

FROM: Enzo Grilli, Director, EAS EG

EXTENSION: 81938

SUBJECT: ZAMBIA: Draft President's Report on an Economic Recovery Credit (ERC) and Second Year Policy Framework Paper (PFP) - Agenda

The Operations Committee will meet on Friday, January 25, 1991 at 4.30 p.m. in Room E-1243 to consider the above documents. The Members may recall that a meeting of the Committee was held on August 22, 1990 to consider an IM for a proposed $175 million Economic Recovery Credit to Zambia. The agenda and minutes of that meeting are appended for ease of reference. Given the many challenges facing IDA operations, the Region is seeking further guidance from the Committee before starting negotiations with the Government of the Republic of Zambia and prior to the submission of the second year PFP to the Committee of the Whole. The Committee may wish to consider the key macroeconomic adjustment issues discussed in the PFP and some of the ERC-specific issues, focussing on the country's arrears, the financing requirements and burden-sharing arrangements that are foreseen.

i) Macroeconomic Stability and Broader Adjustment Issues [1]

- The macroeconomic program requires a firm government commitment in general and a substantial reduction in spending. Given the spending increase that occurred in 1990, the prospects of heavy pressure on expenditures during the forthcoming elections in 1991 and the Government's past off-and-on postures on adjustment measures, with what confidence does the Region believe that (a) the government is generally able and willing to stick by the current agenda of economic reform and (b) initiate and sustain the necessary spending restraint that the program implies?

Mobilization of domestic savings are critical for the sustaining investment and growth in the economy. This will require substantial progress in achieving positive real interest rates, together with a rapid decline in inflation, and reduced government deficit. The Committee may wish to enquire further into the following questions on the country's adjustment effort to ascertain whether the proposed program presents a coherent, consistent and sustainable scenario.

1/ The PFP is a comprehensive document that contains both macroeconomic and sectoral issues. The key sectoral objectives and proposed policy measures do not give rise to any serious concern on which the OC discussion would be necessary.

- Gross domestic savings would rise from an average of 18.5 percent of GDP during 1985-90 to about 19.5 percent during the program period, 1991-93. Is this the best that can be achieved? Can we expect that the gross domestic investment/GDP ratio will increase by 7 percentage points by 1993, after the big jump that occurred in 1990? Is it desirable?

- The primary fiscal deficit (excluding grants) was reduced from 7.1 percent of GDP in 1988 to 6.1 percent in 1989 and to 4.1 percent in 1990. The last year's achievement, however, was well short of the Fund-monitored program target of 0.4 percent. Given this performance, are the projected budgetary surpluses in 1992 and 1993 feasible?

- Inflation has been reduced from 154 percent in 1989 to about 75-80 percent in 1990 compared with the objective of 50-55 percent. Given that direct deficit financing by monetary means is not likely to be the whole reason behind inflationary pressures still present, what accounts for the high rate of inflation in the Zambian economy? How much is the borrowing by the parastatals contributing to this phenomenon? Is it realistic that inflation will be reduced to 40 percent in 1991 and to 10 percent or less in 1993? To what extent would the proposed contractionary fiscal and monetary policies be consistent with achieving the envisaged GDP growth rates of 3.5 percent per annum?

- Exchange rate management is central to the adjustment effort and substantial progress has been made. However, it still remains a multiple rate system. In one window, the primary source of funds is foreign currency proceeds from copper exports. A second window is fed by foreign exchange earnings from other sources including non-traditional exports, and external loans and grants. Finally, a third channel derives its funds from the 'export-retention' and 'no-funds' schemes. Why can't all these systems be simplified further? Why can't a market clearing equilibrium rate be achieved in all three of these markets in the context of the proposed ERC operation rather than during the next Industrial and Trade Adjustment Credit?

(ii) Parastatal Reform

Parastatals continue to be a dominant component of the Zambian economy. The Bank's Industrial Reorientation Project embarked upon the first phase effort to enhance their efficiency. However, the progress remains unclear. What concrete achievements have been made in this respect and what specific portion of the action agenda is likely to be implemented over the program period? What is the weight and importance of six parastatals that will be offered for sale to the private sector under the proposed ERC?

(iii) Role of the Private Sector

Given the crucial role of the private sector, the Government has already introduced several reform measures. However, the Government's policy statement on how to achieve a liberalized and vigorous private sector is yet to be issued. What strategic factors hinder the progress of the private sector, and how would they be resolved?

(iv) Maize and Fertilizers

The June 1989 price decontrols constituted a major step for obtaining market based prices for farmers. Two important commodities still under government controls are maize and fertilizer. Even in these the price ceilings have been raised several times both to decrease the cost of subsidies, and to give more appropriate incentives to farmers and private traders. Can the Region clarify to what degree these two important commodities were subsidized at the beginning of the adjustment program and how much progress has been made to-date? In view of the above, how likely is it to assume that the market-based prices will be introduced by mid 1991?

(v) Arrears Clearance and Burden-Sharing

As the Region points out, the proposed ERC is a highly risky operation. Moreover, a number of internal and external shocks have made the situation more difficult since the OC meeting on the IM. Nevertheless, the Region believes that this is the last, best opportunity to introduce a viable adjustment program before arrears and the magnitude of Zambia's financial requirements become insurmountable, donor support is eroded, and the country's adjustment effort falters. The Committee may wish to discuss, in this context:

(a) The proposed arrangements for clearing arrears to the international institutions. Although not all aspects of the financing plan have been finalized, it is envisaged that Zambian arrears to the Bank and Fund are to be cleared sequentially. Arrears to the Bank, amounting to \$340 million (less payments received in 1991) would be cleared first, while the Fund would pursue an accumulation-of-"rights" approach, its arrears being cleared at the end of the program period. Financing for the clearance of Bank arrears would consist of a bridge loan of \$200 million, plus \$85 million of donor funds earmarked for that purpose and the balance from Zambia's own resources. Repayment of the bridge loan, to be arranged with the Bank of England, would come from the ERC (\$130 million), IDA reflows credits (\$25 million), IDA investment credits under implementation (\$15 million), and the second tranche of the previous Economic Recovery Credit (\$30 million). The entire first tranche of the ERC and IDA reflows would be disbursed on a retroactive basis. Does the Committee concur in these arrangements? ✓

(b) The implications of these arrangements for burden-sharing. Under these arrangements, the Fund will not directly contribute to financing the program. Indeed, during 1991, net payments to the Fund would total \$273 million, including \$92 million in arrears accumulated during the second half of 1990 in order to freeze arrears at the level of June 30, 1990. Over the next two years, an additional $122 million and $119 million, respectively, will be paid to the Fund to keep Zambia current. During the course of the program, assuming it remains on track, Zambia's remaining arrears to the Fund would be transformed into new obligations on somewhat softer terms. Does the Committee agree that the proposed financial flows to the Bank and Fund during the program period togetherwith their implications for financial exposures are justified in this case? The Region has made a major effort to mobilize bilateral resources in support of the program. Does the Committee agree that the indicated contribution of bilateral donors constitutes adequate burden-sharing? What role, if any, does the Region expect the African Development Bank to play in support of the program?

(c) The IMF has informally asked that language be included in the ERC or the Letter of Development Policy, on the basis of which the Bank could cease disbursing in the event that Zambia fail to remain current in its payments obligations to the Fund. The Region has proposed such language to the Legal Department and recommends that the approach be accepted. Does the Committee concur in this recommendation?

Operations Committee

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

cc: Messrs. Wyss, Isenman, Linn, Stoutjesdijk, Picciotto, Burmester/ Thahane, Goldberg, Ms. Okonjo-Iweala, Chaudhri, Parmar, Rao, Kavalsky, Pfeffermann, Liebenthal, Ms. Kalantzopoulos Kilby, Robless, Sandstrom, Khanna, O'Brien, Denning, Messenger, Todd, Gebhart

FChaudhri/FLevy:gs

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: August 20, 1990

TO: Operations Committee

FROM: EG Enzo Grilli, Director, EAS

EXTENSION: 81934

SUBJECT: ZAMBIA: Economic Recovery Credit: Initiating Memorandum - Agenda

The Operations Committee will meet on **Wednesday, August 22, 1990, at 3:30 p. m. in Room 1243** to consider the Initiating Memorandum for a proposed $175 million Economic Recovery Credit to Zambia. The following represents a proposed agenda for the meeting.

Background

The Zambian economy is dominated by a single commodity - copper. For example, in 1988, copper contributed nearly 85% to total exports, 15% to GDP and a substantial proportion to the budgetary resources. A downward trend in copper production and prices determined an erosion of the country's terms of trade by 80% and real GDP per capita by one-third between 1970 and 1986. In the hope of a recovery in copper export, fiscal policies attempted to maintain consumption levels and living standards which resulted in large budgetary and external deficits, the built-up of external debt and a severe decline in investment in the economy. Additionally, inadequate incentives for non-traditional exports, price controls, subsidies and heavy reliance on exchange and trade restrictions further hindered the process of growth and diversification of the economy.

The Zambian Government supported by the Fund, the Bank and the international community made several attempts at restructuring and adjusting the economy, but none of them were sufficiently broad and deep to bring about and sustain significant structural changes. Weak copper prices and declining output continued to be a drag on the process.

Zambia's economic situation has been deteriorating with virtually no growth of GDP in 1989, very low levels of savings, investment, government revenues and high magnitudes of subsidies and budgetary deficits. Faced with this grim situation, Zambia entered a new phase of policy dialogue with the Bank and the Fund. A Policy Framework Paper, endorsed by the Fund Board and the Bank Committee of the Whole, was adopted in late 1989; a Fund-monitored program was approved in March 1990 and a financing plan has been drawn up to allow for adequate levels of imports and clearance of arrears to the Bank and Fund. Given the seriousness of the situation, the Government started to implement elements of the PFP in the middle of 1989, although it was formally approved in the fall of that year. The Initiating Memorandum lists the measures that the Government introduced over the last several months (IM, paras. 13 to 21).

Track Record of the Adjustment Process

As the IM points out, Zambia has a long and checkered history of adjustment efforts. Several attempts were made in the past to mount ambitious programs that got derailed for internal or external reasons. The IM also recognizes the high risks attached to the proposed operation. The Committee may wish to ascertain what is new in the present situation and the proposed adjustment strategy that would enhance our confidence in the possibilities of success of the adjustment effort at the present time?

Realism and Consistency of Macro-economic Measures

Establishing a stable macro-eocnomic environment calls for both stabilization and structural adjustment measures. Given the past history and performance in this respect:

- Is it realistic to expect that the high and accelerating rate of inflation in 1989 (154%) can be progressively reduced to 15% or less by 1993?

- Can an average annual real growth of GDP of 3.5% be achieved with negative import elasticity over the program period especially when the production process in the past has shown heavy dependence on imported inputs?

- Even though starting from a small base, is it realistic to expect that non-traditional exports would increase by at least 10% per nnum in real terms? What particular exports and markets have the greatest potential? What more can be done to monitor export proceeds from copper and some precious commodities?

- What accounts for a big jump in Government revenues in 1990 (17.7% to 24.5% of GDP) and why the fiscal performance shows no improvement in the subsequent three years?

- In view of the very low and declining level of domestic savings, is there not a need to devise specific targets and measures to enhance domestic savings?

- Is it possible to judge macro performance under the adjustment process for purposes of second tranche release from what happens in the fourth quarter of 1990?

Scope and Coverage of the Proposed Operation

The coverage of the proposed operation envisages actions on macro-economic management and in the areas of the maize and fertilizer marketing distribution systems; trade, tariff and civil source reforms; the parastatal sector and private sector development. Most of these measures are directly or indirectly intertwined with the operational health of the financial sector in the Zambian economy.

- Is it not necessary to include the critical areas of financial sector defficiencies in this operation by bringing forward the proposed review of the financial sector or atleast focusing on key issues in this area?

Funding of the Program and Burden Sharing

The most difficult and delicate centerpiece of the proposed operation is the strategy to meet the gross financing requirements, averaging about $1,573 million a year over the 1990-93 period, but more importantly a huge $3,366 million in 1990. The funding scenario is based on a number of assumptions with respect to the Fund's use of resources, including clearance of arrears; generous rescheduling terms for bilateral debt and deferrals of private debt service and some private inflows.

For 1990, IDA would contribute $200 million. These resources would be made available from front loading of Zambia's IDA-9 allocation, an extraordinary allocation from IDA, use of the IDA reflows program and the drawing down of undisbursed credits. Bank Group's net flows to Zambia will still be negative in that year because of the IBRD debt service and arrears. Beginning FY 91, however, Bank Group's flows are projected to become positive.

The amount of arrears to the Fund, as at June 30, 1990, was about $1,092 million. Although the modalities to use the Fund resources and clearance of arrears are under discussion, the staff proposals envisage the Fund taking large sums out of Zambia during the program period while the Bank and other donors would be contributing substantial sums to the country's financial plan that is already tightly constrained.

The Committee may ask the Region to assess:

- The firmness of the financing plan and the dangers of a financing shortfall that played havoc with the previous adjustment efforts.

- The current Fund approach to the clearance of arrears as applied to Zambia and its implication for burdens sharing during the propram period and subsequently, as well as any issues of cross-conditionality that may arise from Bank lending in the presence of unsettled arrears to the Fund.

- The realism of assumption regarding the rescheduling arrangements with the bilateral donors.

- Finally, the recent developments in the Middle East will entail higher cost and difficult financing arrangements for importing crude oil that Zambia needs. What are the

Region's preliminary thoughts on the implications of these development for the financing plan and the likely effects on the economy's performance? Wouldn't the financing plan need to be revisited in the light of the new oil market situation?

Tranching and Conditionality Issues

The Region proposes to disburse the $175 million Credit in two tranches: the first, at effectiveness, would equal 50% of the Credit amount plus retroactive financing estimated at $45 million. The second tranche is expected to be disbursed by the end of April 1991. With respect to the retroactive financing, the estimated $45 million is to finance expenditures dating back to September 19, 1989, when the Committee of the Whole endorsed the PFP. This takes the cut-off point for retroactive financing beyond the period indicated in the current guidelines.

Since second tranche release conditions in key areas (e.g. agriculture, public sector, parastatals) envisage only agreements with government or adoption of strategies and the first tranche plus the retroactive financing represent about three-fourths of the total credit, is the Region's proposal for retroactive financing justified under the circumstances? And, would the remaining small amount in the second tranche provide adequate leverage to induce actual implementation of the second tranche conditions, as opposed to simply formal compliance?

Operations Commmittee

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

cc: Messrs./Mmes. Wyss, Isenmann, Linn, Stoutjesdijk, Picciotto,
Burmester/Thahane, Goldberg, Okonjo-Iweala, Parmar, Rao,
Kavalsky, Pfeffermann, Liebenthal, Kilby, Robless,
Sandstrom, Khanna, O'Brien, Agarwala, Denning, Messenger,
Gebhart, Grawe, Krumm

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Operations Committee

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Minutes of the Operations Committee to consider
ZAMBIA: Economic Recovery Credit - Initiating Memorandum (IM)
held on August 22, 1990 in Room A-1243

A. Present

Committee		Others	
Messrs.	M.A. Qureshi (Chairman)	Messrs.	D. Bock (OPNSV)
	A. Karaosmanoglu (ASIVP)		S. Burmester (SECGE)
	S. Husain (LACVP)		F. Chaudhri (EAS)
	I. Shihata (LEGVP)		S. Denning (AF6DR)
	S. Fischer (DECVP)	Ms.	M. de Nevers (FRSCR)
	J. Wood (FPRVP)		M. Fardi (PRDRA)
	K. Kashiwaya (CFSVP)		G. Gebhart (AF6CO)
	P. Hasan (EMNVP)		R. Grawe (AF6CO)
	S. O"Brien (AFRCE)		H. Gruss (LEGAF)
			J. Karuga (AF6CO)
			R. Liebenthal (PRDRA)
			N. Martinez (AFRVP)
			G. Nkojo (AF6CO)
		Ms.	J. Salop (COD)
			J. Todd (AF6CO)
		Ms.	K.B. Dillon (IMF)

B. Issues

1. The Operations Committee met on Wednesday, August 22, 1990 to discuss the Initiating Memorandum (IM) for an Economic Recovery Credit in the amount of $175 million. The discussion covered the main points in the agenda prepared by the Economic Advisory Staff, focussing in particular on the package of reform measures; the underlying macroeconomic strategy; the tranche release mechanism and conditions; the burden sharing arrangements and the impact of the oil price increases.

C. Discussion

2. At the outset, the Chairman enquired about the status of the proposed operation: to what extent it has been pre-negotiated and agreed with donors, and what flexibility remained at this stage. He also wondered whether the Region was bending over backwards to assist Zambia and asked whether the Region had confidence in the sustainability of the program. A Committee member also wanted to ascertain the probability of success in view of the past record of adjustment efforts in Zambia.

3. The Region informed the Committee that the package of reforms has been evolving for quite sometime, the donors are familiar with it and in large part it has been agreed with the Government in the context of the

Policy Framework Paper approved in September 1989. The Region further stated that the gist of the program was well-underway - especially actions related to the exchange rate, maize prices, gasoline prices etc. and the track record of the last year or so has been impressive. Despite the many political uncertainties, Zambian policymakers have thus far demonstrated a firmer grip on the management of the economy than during previous adjustment episodes. A comprehensive financing plan has been worked out amongst the Bank, Fund and donor community and was tabled at the recent CG meeting. The Region felt that in view of the remarkable opening-up of the debate on the political system and the progress in the liberalization of the economy, external resources now must flow to support the system with the donors, Fund and Bank playing their respective roles.

4. While agreeing that there was some progress on the macroeconomic front, one Committee member was not convinced that structural aspects were tackled satisfactorily. Even looking ahead, studies and programs were the dominant features and not many actions were required before second tranche release. While admitting that the progress to date with respect to privatization fell short of the desired level, the Region noted that actions to eliminate price controls and to reform agricultural pricing and marketing, etc. were on track. Privatization has been an ideological issue; this has changed, but the government still did not want a 'public splash' on it. In response to the Chairman's query whether the Government can move faster in certain areas, the Region felt the Bank's transport sector report, agricultural sector memorandum and the proposed parastatal study provide the basis for continuing sectoral reforms.

5. One Committee member questioned the underlying macro management strategy and the viability of the program and noted that IDA was putting the bulk of its assistance into the program before major measures were taken. He argued that in light of the big jump in the government revenue/GDP (7 percentage points in 1990 over 1989) and tight fiscal policy; movement towards higher interest rates; devaluation of the currency and compressed import levels, how could investment in 1990 take a quantum jump and GDP grow about 4% compared with less than one percent growth in 1989 and 1990. He also did not find the data on the nominal exchange rates and CPI very meaningful and therefore asked for more information on the real effective exchange rate movements. On the basis of the information presented, he felt the program would not work, as the prospects of Government taking all the tough actions in the face of a worsening economic situation, and after receiving most of the Bank's financial assistance, were not good. The Chairman also added that if the program is in fact implemented, economic growth is likely to slow down and in the event tough actions would look even tougher, thereby engendering opposition to the program.

6. The Fund and the Region's representatives responded that in fact most of the difficult decisions were already taken e.g. devaluing the exchange rate; increasing maize prices; decontrolling all other prices; introducing an OGL system. The Region also enumerated the steps taken to contain inflation, stabilize copper production and recounted the export potential of the agricultural, precious metals and small scale mining

sectors. The Fund representative stated that economic activities at the small scale levels were vibrant and a slow down is not imminent.

7. Several questions were raised on the mechanism for the first tranche release including the retroactive financing; timing of the second tranche and assessment of performance on the basis of the first quarter 1991 outcome; the nature of the additional actions expected between the two tranches and the scope for strengthening it. In particular, the General Counsel stated that the proposed payment to the Special Action (out of the first tranche) cannot be used to service the bridge loan and that other mechanisms, including further retroactive financing, may be considered to enable the borrower to use loan proceeds disbursed against import bills, for the purpose. The Chairman emphasized that a clearly defined set of structural actions must be a part of the second tranche release. He also asked the Region to work out, with the help of the Legal Department, a satisfactory mechanism for tranche releases, retroactive financing, disbursements and special accounts. The agreed note should be sent to his office for review and onward transmission to the OC members. He also felt that presentation of conditions in the policy matrix could be improved by linking more clearly the program actions with the issues and objectives.

8. The Chairman also observed that while he agreed with many remarks to the effect that much needs to be done, two points were worth noting: (i) there was a fairly impressive track record of important stabilization-cum-structural actions in the last year or so and (ii) unlike the previous programs, the current measures were part of the Government's own program. Also, while the difficulties associated with the program were serious, the calculated risks were worth taking.

9. The discussion then turned to the financing plan and the issue of burden sharing. The Chairman recalled that in mid-1990, certain agreements were reached with the donors that if the Fund froze its arrears as of end June 1990, and if the Bank came forward with a substantial lending program based on IDA, extra ordinary allocations etc., then the donors would also contribute substantial amounts, both by rescheduling existing loans and by providing new money, to the financing needs of Zambia. In view of a possible shift in the Fund's interpretation of the agreement to freeze arrears, the Chairman stated that he had talked to Mr. Erb who reported that the Fund Board had directed management to make every possible effort to reduce Fund arrears. He (Mr. Erb) therefore had limited discretion. Nevertheless, in light of the fact that a financing plan premised on Fund arrears being frozen at June 30th levels had been agreed with the Bank and presented to the donors as a basis for action, he promised to review the situation. The Chairman further observed that following the failure of previous attempts, enormous effort has gone into the re-development of the proposed adjustment program. Despite some doubts about the program, all involved needed to give it a chance.

10. The Chairman asked the Regional representatives to assess the impact of the recent oil price increases on the financial, budgetary and growth prospects of Zambia. In response it was stated that depending on the low, medium and high price assumptions in the near future, increased expenses would be about $30 million, $148 million and $280 million over

the current program. The copper price cushion in the current projection could allow Zambia to cope with the situation as long as future oil prices did not hit the level in the high price scenario. The Regional representative went on to re-emphasize that adjustment with growth was the only real option for Zambia. The changes introduced in the exchange rate, relative prices, parastatals, regulatory environment etc. augur well in this respect. Responding to a further query from a Committee member, the IMF representative elaborated the mechanism underlying the Window I and Window II foreign exchange operations that aim at establishing the market clearing rate by mid-1992. The Chairman advised the Region to state more clearly the proportion of imports in the two windows and the exchange rate applicable to them so that one could ascertain how in the aggregate the exchange rate has been progressing towards the targeted marketing clearing level.

11. In his concluding remarks the Chairman reiterated the difficult and risky nature of the proposed operation. While recognizing the many actions taken, he stressed that some important components of the reform package still need to be implemented. He recognized the delicate nature of the financing package and emphasized the need for all parties involved to stick to the commitments made, otherwise the already fragile financing arrangements would unravel to everyone's disadvantage. Subject to the observations and points raised in the meeting, the Region was authorized to appraise the operation.

August 31, 1990
FMChaudhri:gs

Washington, D.C. 20433
U.S.A.

MOEEN A. QURESHI
Senior Vice President, Operations

January 25, 1991

Mr. Wood:

Joe:

Zambia - Economic Recovery Credit

This issue was raised with me yesterday as a matter of urgency when I was in the Board meeting. In the case of the Fund, the staff found it necessary to inform Board members about their position, following extended discussions with us. After discussion with Kim, I informed Erb that we would be prepared to go ahead on the basis that the staff had negotiated. I have also informed Barber.

On the substantive issue, I do not agree that the arrangement with the Fund is not equitable. We should keep in mind that we are getting our "arrears" cleared while the Fund is only getting current debt service. What you suggest would make sense if we too were accumulating "rights". Secondly, I do not think that this arrangement with Zambia sets any precedent. The only other country where we could conceivably get into a similar position is Sudan - but that is a different case in many respects.

With regard to precedent, I am more concerned about some of the Latin American cases where the Fund is in a relatively better position and has, in fact, been able to extract payments without our benefiting from any reduction in arrears.

The basic problem in the case of Zambia is the risk that the program is not sufficiently strong and comprehensive, and the political will to adjust leaves something to be desired. If the program collapses at this time, for whatever reasons, it is not the Fund which will be criticized (because there is no reduction of arrears to the Fund); it is the Bank which will be seen as the culprit. The donors are now increasingly turning on the Bank and saying that we should develop an approach similar to the Fund's "rights" approach. I know this is unfair and short-sighted but even some of our more "understanding" G-7 shareholders are now taking this line.

Moeen

cc: Mr. Jaycox

THE WORLD BANK / IFC / MIGA

OFFICE MEMORANDUM

DATE: January 24, 1991

CONFIDENTIAL

TO: Mr. Moeen A. Qureshi

cc: Messrs Bock, Grilli

FROM: Joe Wood, Vice President, FPR

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EXTENSION: 80602

SUBJECT: ZAMBIA - Economic Recovery Credit

As you know the O.C. will be meeting on Friday to discuss the Economic Recovery Credit for Zambia.

I recognize that an exceptional effort has been made by all parties to develop a financing package that would make the clearance of arrears to the Bank possible, but remain concerned about the manner in which the remaining $70 million financing gap for 1991 has been closed. My understanding is that the current Fund proposal is to defer payments of $35 million from the first quarter of 1991 to later in the year (i.e., no net contribution for 1991). Zambia will provide an extra $35 million from its own reserves and IDA is expected to provide an extra $35 million. I find it difficult to see how this can be characterized as equitable burden-sharing and I am concerned about the precedent this may set for future workouts, or indeed for meeting possible future shortfalls in Zambia.

As you know under the proposed financing plan, Zambia is expected to repay $92 million to the Fund to meet arrears that have accumulated between June and December of 1990. Without this repayment, the 1991 balance of payments would be overfinanced by $22 million. Under the circumstances, I believe that a fair formula would be to link additional IDA contributions to a shift in the date for freezing Fund arrears from June 1991 to September. This would reduce payments to the IMF by $45 million. These arrears could then be financed through the rights accumulation program in 1994 or repaid earlier if additional donor support for this purpose can be found. The balance of $25 million could be met by additional equal contributions from Zambia and IDA of $12.5 million each. If the Fund is unwilling to agree to this reasonable counterproposal, they should accept the responsibility for breaking the deal.

cc: Mr. Jaycox, AFRVP

Joe:

In the case of the Fund, it was necessary for them to inform Board members about their position, and I have informed Erb that we would be prepared to go ahead on this basis. I have also informed Barber.

On the substantive issue, I do not agree that the arrangement with the Fund ~~does~~ is not equitable. You should keep in mind that we are getting our "arrears" cleared while the Fund is only getting current debt ...

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

910117003
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DATE: January 17, 1991

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

FROM: Stephen M. Denning, Acting Vice President, Africa Region

EXTENSION: 34035

SUBJECT: ZAMBIA: Economic Recovery Credit (ERC) and Supplemental IDA Reflows Credit: Negotiation Authorization Package Policy Framework Paper (1991-1993)

1. Authorization is hereby sought from the Operations Committee (OC) for the Region to invite the Government of the Republic of Zambia to negotiate the terms and conditions of a proposed SDR 125 million (US$175 million) Economic Recovery Credit (ERC) and a Supplemental Credit of SDR 19 million (US$25 million) from the IDA Reflows program. A draft President's Report and Letter of Development Policy from the Zambian Government are attached. Also attached is a draft Policy Framework Paper, which has been agreed with the Zambian Government and IMF staff. Authorization is also sought for submitting the PFP to the Committee of the Whole.

2. Zambia has adopted and is pursuing, albeit with occasional lapses, a strong and comprehensive adjustment program. It is a program that we believe will bring about the stabilization, restructuring and eventual recovery of the economy that are its primary objectives. The task ahead is to ensure full and effective implementation of the program and assistance is being provided to the Government in this regard. There are serious risks associated with the program, as explained in the ERC documentation (paras. 70-74), however, we feel that these risks are manageable and acceptable. The program has the strong support of the international donor community, which is contributing substantial financial and technical support to ensure its success.

Clearance of Bank Arrears

3. In addition to supporting the adjustment effort, a major aim of this operation would be to assist Zambia with its cash flow when the arrears to the Bank are cleared. Without this assistance, these arrears would be not settled and the Bank would not be able to resume operations in the country. Assuming that the arrears are cleared in early March, the total payment due at the time will be about US$340 million, minus any payments received in 1991. This would be met by US$200 million from a bridge loan to IDA disbursements, US$85 million from the donor funds specifically allocated for this purpose, and the balance of US$55 million (or less, depending on payments received in 1991) from Zambia's own resources. Zambia paid the Bank US$21 million in 1990, so its total contribution to settling the arrears will be about US$76 million. This is about as much as they will be able to pay without reducing their liquid reserves to dangerously low levels or lowering essential imports.

January 18, 1991

9/02/2005
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THE WORLD BANK
Operations Committee

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Minutes of the Operations Committee to Consider the BOLIVIA - Structural Adjustment Credit; Initiating Memorandum

Held on Friday, January 18, 1991, at 12:00 noon in Room E1243

A. Present

Committee

Messrs. W. A. Wapenhans, Acting Chairman
I. F. I. Shihata, LEGVP
L. Summers, DECVP
K. Kashiwaya, CFSVP
S. S. Husain, LACVP
B. G. Kavalsky, FIN
S. M. Dennings, AFR
F. F. Johansen, ASI

Others

Messrs./Mmes P.-C. Loh, LA3DR
M. Selowsky, LACVP
J. M. Page, LA3C1
D. Morrow, LA3C1
W. Shaw, LA3C1
E. Grilli, EAS
J. A. Carvalho, LEGLA
F. J. Earwaker, PRDRA
J. Salop, CODOP
J. A. Katz, FRM
F. J. Lysy, EAS

B. Issues

1. The Operation Committee met on January 18, 1991, to discuss the Initiating Memorandum for the proposed Bolivia Structural Adjustment Credit (SAC). The discussion focussed on the following sets of issues:

(a) The relative merits of a Quick-Disbursing or a Hybrid form for the operation;

(b) The merits of closing the public development banks operating in Bolivia;

(c) The conditionality and objectives in the Privatization component of the operation;

(d) The balance of payments need for a quick-disbursing operation;

(e) The fundamental causes of slow growth in Bolivia.

C. Discussion

Introductory Comments

2. In their introductory comments, the Region noted that Bolivia has pursued a far-reaching reform program since 1985, with many important measures

implemented in the areas of trade, exchange rate policy, financial sector policies, and other fields. There was now a need for a "wrap-up" policy-based operation which would support a shift in focus from stabilization/adjustment to growth. The Region anticipates this will be the last quick-disbursing operation for Bolivia (there has been only one so far, it was noted, since the start of the present reform program in 1985). The Region noted that although Bolivia's reform program had brought a quick end to the hyperinflation, the recovery of growth has been considered disappointing. Private investment has been very low (4 to 5% of GDP), but the passage of new legislation recently (on the investment code, financial management, and investment in the mining and hydrocarbons sectors, respectively), should encourage a recovery in private investment. This operation is focussed on measures designed to encourage an acceleration in the rate of growth, and will complement the rest of the Bank's program in Bolivia (which includes operations in the infrastructure and social sectors, lending through financial intermediaries, and a possible natural gas pipeline to Brazil as an enclave operation).

Quick-Disbursing or Hybrid Operation

3. A member of the committee asked whether a hybrid, rather than quick-disbursing, form for the credit might be more appropriate. In such a hybrid, a portion of the funds would be quick-disbursing to support the policy changes proposed, but it was suggested a significant portion should also be made available as a financial intermediary operation, for on-lending directly to private business (perhaps to medium and small-scale businesses). This member noted that Bolivia has pursued a strong reform program for five years now, but private investment has remained extremely low. Would not the direct provision of funds for private investment (via a financial intermediary) be more effective in stimulating growth than just the provision of balance of payments assistance? The policy program would be the same, supported by the quick-disbursing portion of the hybrid. Without such an arrangement, he was concerned that loan proceeds would finance mainly consumer goods (mainly luxury items), given the very low investment ratio, the pattern of income distribution in the country, and the low tariff on imports (a 10% ceiling).

4. The Region responded that there is a strong balance of payments need for these quick-disbursing funds (see below for a further discussion of this point), and that these funds should not be cut. The focus here will be on the Government's policies and programs, for which a quick-disbursing, policy-based, credit was appropriate. Furthermore, it would be inappropriate to proceed with a directed credit operation, rather than to focus on the overall operation of the financial system, which this policy-based operation would do. Finally, one must not consider this particular operation in isolation, but as part of the overall IDA program in Bolivia; the remainder of the program provided for a more direct provision of funds for directly productive activities, while this operation focussed on policies. The Region was therefore opposed to converting this operation into a hybrid.

Closure of the Public Development Banks

5. A second tranche release condition would be that the remaining public development banks in Bolivia be closed (with the possible exception of certain non-development bank activities of BANEST). The question was raised whether there was no role in Bolivia for a public development bank. Another member of the committee raised the related issue of whether there should not

be more attention paid to financial institution building, rather than exclusively focus on deregulation and liberalization.

6. The Region responded that the Central Bank of Bolivia effectively acts as a second-tier development bank, through its role in channeling externally provided development credit by means of a well-functioning auction system. Where the Government has been grossly ineffective has been the attempt to provide financial credit directly to final borrowers; commercial banks can do this better. The three development banks at issue have not served their original intended purpose, and they should be shut down. The World Bank is also working with the Government, both through this operation as well as others in our overall Bolivia program, in building up the capacity of the financial system in Bolivia as a whole to provide effectively credit to the private sector, and to particular groups such as small farmers. The agricultural development bank run by the Government of Bolivia was not effective in this (farmers simply felt there was no reason to repay a loan extended by the government); private banks can be.

7. It was also noted that the portfolios of the public development banks to be closed were very weak, and that there was no-one but the Government to absorb these losses when they become recognized. What would be the effect on the Government budget? Could this be absorbed? The Region agreed that it would examine this.

The Privatization Component

8. Several members of the committee noted that the privatization component of the operation contained ambitious objectives. In particular, a second tranche condition would require that 60% of enterprises (weighted by sales) operating in competitive markets (or 40% plus the national airline), be brought to the point of sale. A member of the committee commented that perhaps Bolivia was being pushed too quickly in this area. If rushed, the job might not be done well. Other members questioned whether one should have such a precise target, and more fundamentally whether the focus should not be on the inefficiency of these enterprises rather than on their privatization. The concern was raised that it would be quite possible that there would be no bidders (at any price) for many of these enterprises; what would happen then? Little would have been achieved simply through having brought these enterprises to the point of sale. In addition, if many of these enterprises are sold, there is a strong possibility this would lead to a further concentration of holdings in just a few families. Could anything be done in the design of the process to avoid this?

9. The Region responded that the 60% target was ambitious, but it was the Government's target, which the Region had accepted. However, for the purposes of this operation, the Region agreed (with the approval of the Chairman) not to use a precise quantitative target such as the 60% as a tranche release condition. The realism of the Government's target will be further examined at appraisal. The appraisal mission will also investigate whether mechanisms can be designed to assure that existing public monopolies are not simply converted into private monopolies. The Region agreed there was a risk that there might not be many (or any) bidders for some of the enterprises, although there was some foreign interest in some of the sectors (in particular hydrocarbons and mining). However, an attempt to privatize was reasonable first step. The proposed operation also contained as a second

tranche condition that there would be no further government transfers to these enterprises (except those required for legitimate public services). Therefore, if there was no bidder for some enterprise it would have to operate without government transfers, and would therefore be either efficient enough to be self-sustaining, or would slowly shrink as it used up its existing capital. A member of the committee suggested that the Bank should perhaps consider the creation of an entity that would purchase such enterprises with a mixture of public and private money, but the Region (with the support of the Chairman) rejected this.

Balance of Payments Need

10. It was noted that a clear balance of payments case would have to be made for such a quick-disbursing operation. The Region agreed that the IM may have been too brief on this point, but that there was a clear balance of payments need for such funds in Bolivia, and the President's Report would present this case. It was noted that a substantial amount of co-financing would be associated with the operation, and that the operation was only one part of the overall financial plan for Bolivia. This overall financial plan included support from the IMF (through the third year of an ESAF Arrangement), IDB financing that would be provided in parallel with this operation, bilateral aid, as well as specific bilateral co-financing that might be linked to this operation. A member of the committee stated that the authorities of Japan have indicated they have not yet discussed with the Bank the possibility of co-financing this operation. This member indicated that the Japan ExIm Bank has, however, provided a tentative commitment of $180 million for co-financing of the gas pipeline project.

The Causes of the Low Rate of Growth

11. The possible causes of the low rate of growth in Bolivia, despite the adoption of the far-reaching reform program five years ago, was discussed. As noted above, the stated intention of this operation is to support a shift from a focus on stabilization/adjustment to a focus on growth. A member of the committee noted the high level of dollar interest rates; at such rates one could not expect there to be a sufficient level of private investment in productive activities. There was a need to deal with this directly. Another member noted that in the light of past sluggish growth, the realism of the projected significant improvement in growth over the next three years was questionable.

12. The Region responded by noting that with the possible exception of Chile, there had never been a spurt in growth following soon after the adoption of a far-reaching reform program. The changes required in the economic structure and rules of the game are major, and consequently the disruption, though necessary, is severe. One should not expect a high rate of growth to follow quickly, but given that the reform program had been initiated in 1985, there were some grounds to project that there would now be some improvement in the rate of growth relative to what it has been. The high real interest rates observed in Bolivia are also not a surprise; the same has been observed in other countries in Latin America undergoing adjustment. A fundamental problem is the lack of confidence that the new system will be maintained. Such confidence will take time to develop, and there is not much one can do except sustain the program.

13. Another representative of the Region noted also that, while still high, there has been a significant fall in real interest rates over the last few years (by almost ten percentage points) as the program has been sustained thus far. Real rates remain as high as they are for the three reasons: i) high intermediation costs, ii) lack of confidence in the banking system, and iii) lack of confidence that the overall reform program will be sustained. The World Bank has been working with the Government and the banking system to reduce intermediation costs. The earlier Financial Sector Adjustment Credit (FSAC) (with follow-up measures proposed under the SAC), supported important measures to restore confidence in the banking system. These included quite successful measures to create an effective Superintendency of the Banks as well as other measures in the areas of supervision and prudential regulation. One area where progress had been disappointing under the FSAC was the issue of banking crisis management. A different approach, focussing on clear rules rather than a discretionary process, would be followed under the SAC. Finally, the whole of the Bank/IDA program in Bolivia in its entirety is focussed on sustaining the reform program.

D. Decisions

14. The Chairman authorized the Region to proceed with the processing of this operation, as a quick-disbursing credit. It was noted that two tranches were planned. The Chairman directed that the President's Report should make more clear the balance of payments case for the operation, as discussed above. He also noted that the focus of the privatization component is the efficiency of the enterprises at issue, and that therefore the Region should develop further what course would be followed for those enterprises that are not bought. The precise 60% target (or 40% plus the national airline) for enterprises to be brought to the point of sale, should not be used in the conditionality.

FJLysy:

February 7, 1991

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: January 16, 1991

CORRECTED

TO: Operations Committee

EG

FROM: Enzo Grilli, Director, EAS

EXTENSION: 81938

SUBJECT: BOLIVIA - Structural Adjustment Credit; Initiating Memorandum; Operations Committee Meeting Agenda

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1. The Operations Committee will meet on **Friday, January 18, 1991, at 12:00 noon in Room 1243** to consider the Initiating Memorandum for the proposed Structural Adjustment Credit for Bolivia. The following is a proposed agenda for the meeting.

BACKGROUND

2. The Region is proposing consideration of a $35 million Structural Adjustment Credit (SAC) for Bolivia, which would provide continued Bank support to the country's adjustment program. Bolivia's reform program has now been continuously underway since 1985. It is widely viewed as exceptionally strong, and has been continued under two Governments, representing different political parties. The Bank has provided major support to this program, including through two Reconstruction Import Credits (in FY86 and 87), three Social Fund Credits, one (but only one) quick-disbursing adjustment credit (an FY88 Financial Sector Adjustment Credit), plus a number of regular investment projects and technical assistance credits. The reform program of these two Bolivian Governments has also received strong support from others. There have been generous Paris Club reschedulings (most recently under the Toronto terms), major increases in bilateral grant funding and concessional loans, and other multilateral support (including IMF SAF and ESAF facilities). Bolivia was also a pioneer with its commercial bank debt buy-back program, where its bank debt was bought back at 11 cents per dollar, using grant funding provided by certain bilateral donors.

3. Despite the strong reforms and external support, the growth response of the economy has been viewed as disappointing. The hyperinflation was quickly ended (prices rose at a 28,800% annual rate between January and September, 1985, but then rose at only a 15% annual rate from 1987 on, and perhaps 17-18% recently). But GDP growth has averaged only 2.7% a year over 1987-90. Although the 1980-86 fall in GDP was reversed (GDP fell by a total of 14% cumulative over 1980-86), the recovery since 1986 has been considered weak. The primary goal of the SAL is therefore stated to be to deal with some of the causes of this slow growth.

4. The following is a proposed agenda for the meeting. It is suggested that the Committee first discuss the proposed conditionality, then to address the issue of the financing need for such a quick-disbursing operation, and finally to consider how the operation fits into the broader country assistance strategy for Bolivia.

ISSUES

Proposed Conditionality

5. The original conception of this operation was as a follow-on to the FY88 Financial Sector Adjustment Credit (FSAC), but it was later decided to broaden its scope to make it into a SAC. Not surprisingly, given this history, the most specific conditionality in the operation is in the financial sector component. Several important, and difficult, measures would be supported and required as tranche release conditions. Perhaps the most important is the condition that prior to Board Presentation, there would be an end to all lending by the remaining public sector banks (BAB for agriculture, BAMIN for mining, BANEST for several sectors, and the fund FONEM for export mining), and that prior to second tranche release these institutions would be effectively closed (with the possible exception of certain non-lending functions of BANEST). There will also be certain measures required in the areas of banking supervision, the managing of banking crises, and capital market development.

6. The IM notes that Bolivia has made very major advances in recent years in terms of financial sector reforms, some of which were done in the context of the Bank's FSAC. All interest rates are now fully market determined, for example, and "development credits" (funds provided by external donors for on-lending by the private banking system) are distributed by the Central Bank through an auction mechanism. However, as noted in para. 22 of the IM, the FSAC failed in its objective of restructuring the public sector banks BAB and BANEST. As a second tranche condition of the FSAC, the Government was required to submit a plan of action and implementation schedule for the restructuring of these institutions. Although an acceptable plan was received, it was never implemented fully.

(a) The Region might be asked why it believes conditionality through a policy-based loan will now be effective, and the most appropriate instrument, in achieving these aims with regard to the public sector banks.

7. Another aim of the FSAC was to establish an effective mechanism for the Government to manage banking crises. To this end, a unit called GSF was set-up in the Central Bank to manage bank crises and deal with problem banks. While initially successful, the assessment now is that the GSF has not been effective in this. Measures supported under the SAC will attempt to deal with this difficult area, through

use of a strategy that relies on explicit rules rather than the discretion of some institution.

(a) The Region might be asked why it now believes this approach will be successful. Are there examples of other countries where such an approach has succeeded?

8. Support of a privatization program and public enterprise reform is the second major area of conditionality in the proposed SAC. The Government's efforts in this area (especially privatization) is still at an early stage, and the first tranche conditions are therefore mostly of the nature of establishing a framework. The second tranche conditions are ambitious, however, and include the requirement that the Government will have brought to the point of sale public enterprises accounting for either 60% of total public enterprise sales operating in competitive markets, or the national airline (LAB) plus enterprises accounting for 40% of total public enterprise sales in such markets.

(a) The Region might be asked whether this schedule is realistic. Has work on the privatization program progressed far enough so that it is reasonable to expect that Bolivia will be able by the expected time of the second tranche to bring to the point of sale such a large share of its public enterprises?

9. The other policy components of the proposed SAC are in the areas of trade and registration, the public sector investment program, and the social sectors. There would be no explicit tranche release conditions, but the Letter of Development Policy will state that the Government will undertake certain actions. Specifically, there will be certain procedural reforms on trade (there are already essentially zero QR's on imports in Bolivia, and the tariff structure is a uniform 10% except for 5% for capital goods). There is also a commitment to introduce a duty drawback or temporary admissions system for exporters. In the area of public investment, the commitments will be not to undertake certain "white elephant" projects that have been proposed. In the social sectors, there will be commitments for certain minimum expenditure levels in the areas of health and education, where some of these commitments repeat commitments made in the context of the Bank's FY90 Health project.

(a) The Operations Committee might wish to discuss whether the measures proposed in these areas are sufficient. Is it possible to utilize a more positive approach in the area of the public investment program, perhaps focussing on processes and procedures? Should we expect that even if the current list of "bad" projects are dropped, there will not be other bad projects that advance under the current system next year? And is conditionality in the areas of health and education perhaps best dealt with through the FY90 Health project and the planned Primary Education project?

Financing Need

10. Proceeding with the operation as a quick-disbursing credit requires that there be a clear balance of payments need for such funds. Growth in recent years has perhaps been slow, but it is not clear that this has been due to a lack of sufficient external balance of payments support (as opposed to internal reasons). This is due in part, of course, to the external support provided by the Paris Club reschedulings, the commercial bank debt buy-back financed by grants, and the high levels of development aid received. In addition, there have been the large inflows of drug-related money, whose magnitude could equal the above effects combined. There are also indirect indicators available. For example, the real exchange rate (which is fully market determined) has depreciated somewhat over the last couple of years, but not by a great extent. In addition, lending rates in US dollars are now about 20% in nominal terms; this is down from rates close to 30% a couple of years ago. Given the risk of lending in Bolivia, one should not expect much of a further drop in this interest rate even if substantially more dollars were to become available.

11. In addition, the financing projections assume Bolivia will continue to receive Toronto terms on the rescheduling of its Paris Club debt. Yet it now appears likely that the Paris Club will agree to a substantial improvement in these terms. If, for example, the Paris Club were to adopt the Trinidad Terms proposed by John Major, Bolivia would save roughly a further $30 million in interest each year on Paris Club debt.

(a) In this context, the Region might be asked to discuss the case for using this portion of Bolivia's constrained IDA allocation as a quick-disbursing credit, in preference to a regular investment operation. Is it expected that the additional balance of payments support will help to spur growth?

Country Assistance Strategy

12. The recent OPNSV IDA allocation for Bolivia for the period FY92-94 was SDR 121 million. This was 50% above the Norm allocation level for Bolivia (which would have been SDR 81 million), but was felt appropriate given the strength of Bolivia's reform program. The SDR 121 million allocation is equivalent to $170 million over three years, or $57 million per year. A $35 million SAC would absorb a significant share of this.

13. The basic issue is whether $35 million of this allocation for the proposed SAC would be the best use of Bolivia's scarce IDA resources. Options might include proceeding instead with a financial intermediation loan which could still address the financial sector issues that are at the core of the SAC. The existing auction scheme for Development Credits might be used to distribute the funds. One might also consider a direct loan that would provide more direct support of the privatization and public enterprise reform plans of the

Government. And if funds are available, the Primary Education project (now listed as FY94 in the lending program, for $8.3 million) might be brought forward.

(a) <u>The Region might be asked to present the reasons behind the decision that $35 million of Bolivia's IDA allocation is best used for a quick-disbursing SAC, in preference to the other possibilities</u>.

<u>Operations Committee</u>

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

cc: Messrs./Mmes Loh, Goldberg, Wyss, Isenman, Linn, Stoutjesdijk, Picciotto, Burmester/Thahane, Selowsky, Page, Morrow, Okonjo-Iweala, Shaw, Parmar, Pfeffermann, Rao, Kavalsky, Sandstrom, Liebenthal, Kilby, Robless, Khanna

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THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

9107.011/013

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DATE: January 11, 1991

TO: Mr. Willi A. Wapenhans, Acting SVPOP

FROM: S. Shahid Husain

EXTENSION: 39001

SUBJECT: BOLIVIA - Structural Adjustment Credit

1. Attached for your approval is the Initiating Memorandum for the Bolivia Structural Adjustment Credit. This operation would provide US$35 million to support policy reforms essential to an acceleration of growth.

2. Macroeconomic program. In 1985 the Bolivian Government achieved a remarkable stabilization of the economy and comprehensive liberalization of markets, after the economic crisis of the early 1980s characterized by hyperinflation and declines in output. Despite considerable political opposition, a sharp fall in the terms of trade, and a prolonged drought, the two Bolivian administrations in power since 1985 have maintained the adjustment program. Tight monetary policies, market determination of interest rates and a reduction of the fiscal deficit have kept inflation low and encouraged a substantial inflow of private capital. Successful negotiations with bilateral creditors have reduced Bolivia's substantial debt burden and rescheduled a large share of debt service payments on concessional terms. Significant improvements have been achieved in public sector administration, particularly in management of the investment program, bank supervision and tax administration.

3. Despite the excellence of economic policy, Bolivia is now entering its fifth year of slow growth. Per capita GDP has stagnated since 1986 and per capita consumption has fallen steadily. Private investment remains below 6% of GDP, despite the remarkably improved incentives regime for private sector economic activity. Major reasons for the slow private sector response to the adjustment program have included barriers to entry and excessive regulations, including defects in the legal framework for investment and cumbersome trade and company registration procedures; fragility of the financial system; the large share of economic activity still controlled by the public sector; and lack of labor flexibility owing to depressed social conditions.

4. Adjustment operation. The proposed adjustment operation is designed to serve as a bridge from stabilization to sustained growth, and may well be the final adjustment operation necessary for Bolivia. The goal of the operation would be to increase the level and efficiency of investment through improving incentives for and regulation of private sector economic activity, enhancing the operations of the financial system, reducing the share of production carried out by the public sector, and improving the performance of public sector investment and enterprises. A prerequisite for the success of the adjustment operation has been the passage of the hydrocarbons, mining and investment laws to improve the

incentive framework for private sector investment. The operation would in part recognize the significant achievements of the Government in obtaining passage of these laws, as well as reforms already undertaken to increase the availability of medium- and long-term financing at market rates. Further policy reforms to be supported are the following:

(i) The financial sector component would improve the allocation of savings through the financial system by closing public banks that have incurred substantial losses and misallocated scarce investment funds, by strengthening supervision of the banking system and other financial intermediaries, and by removing various impediments to capital market development.

(ii) The public enterprise component would assist the Government in privatizing public enterprises operating in competitive markets and in improving the administration of enterprises remaining in the public sector.

(iii) Streamlining of trade and registration procedures would facilitate trade and reduce bureaucratic impediments that particularly impair investment by small businesses.

(iv) The public sector investment component would eliminate wasteful investments by the public sector.

(v) Finally, to support long-term growth and to ensure that essential services to the poor are not curtailed as part of the adjustment effort, the social sector expenditures component would support increased targets for expenditures on primary health care and basic education.

5. IMF program. Since mid-1986 the Government's economic program has been supported by arrangements with the IMF, including a three-year Enhanced Structural Adjustment Facility (ESAF) arrangement approved in July 1988, supported in each year by a Policy Framework Paper (PFP). The third year ESAF program will be negotiated in January 1991, during the scheduled appraisal mission. Bank and Fund staff have worked closely together, particularly in the design of the financial sector component, and the PFP will incorporate elements of the SAC policy conditionality. Maintenance of a macroeconomic policy framework satisfactory to the Bank is a condition of Board presentation and of second tranche release, and we will consult with IMF staff in determining whether Bolivia meets this condition.

6. Coordination with donors and cofinancing. We have prepared this operation in conjunction with both multilateral and bilateral donors. The IDB is considering two parallel operations for the financial sector, a sector adjustment loan and a credit line operation, which together may equal US$100 million. Joint IDA/IDB missions developed the financial sector program, and the IDB loans will incorporate the same conditionality as the financial sector component of the SAC. Extensive discussions have been held to coordinate technical assistance activities by USAID, GTZ, the IMF, the IDB and this operation in both the financial sector and the privatization program. We also have discussed cofinancing from the OECF, and they will consider a request for US$50 million in cofinancing for their next fiscal year.

7. <u>Timing.</u> The appraisal mission is tentatively scheduled for mid-January, with negotiations during the fourth quarter of FY91 and Board presentation during the first quarter of FY92. This schedule was adopted to facilitate parallel processing by the IDB while ensuring the availability of sufficient IDA resources.

<u>Distribution</u>

<u>Operations Committee:</u> Qureshi (OPNSV) (o/r); Jaycox (AFRVP); Karaosmanoglu (ASIVP); Rajagopalan, Linn (PRE); Shihata (LEGVP); Kashiwaya (CFSVP); Wood (FPRVP); Bock (OPNSV); Wyss (COD); Grilli, Ray (EAS); Isenman (PRD); Stoutjesdijk (FRS); Picciotto (CPB); Burmester, Thahane (SECGE); Goldberg (LEGOP); Okonjo-Iweala (OPNSV)

<u>For Information:</u> Thalwitz (PRESV); Parmar, Pfeffermann (IFS); Rao (IEC); Kavalsky (FRM); Liebenthal (PRD); Kilby (FRS); Robless (OPNSV); Sandstrom, Khanna (EXC); Selowsky, Fleisig, Quijano, Aiyer, Aguilar, Duer (LACVP); Garcia-Zamor, Vasiliades (LA3DR); Page, Morrow, Shaw, Konishi, Albert, Ardila, DeVan; Segura (LATDR); Collel (LEG); Grothe (LOAEL);

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