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OFFICE MEMORANDUM

TO: Messrs. Kaji, PMD
Clarke, COM
Rohrbacher, OPD
Twining, ADM
Rayfield, CAD

Date: July 23, 1982

FROM: Heinz Vergin, Director, PAB

SUBJECT: Funding of New Initiatives and Policy Changes

1. The staff functions which we collectively represent will be submitting to the Managing Committee and its Sub-Committees during FY83 recommendations on a number of initiatives and policy changes which will result in increases (or decreases) in administrative expenses. Cost implications of these measures will register not only in FY83, but also in FY84 and beyond when the full costs of the changes proposed during FY83 will be incurred.

2. In the context of constrained budgets, it is important that the cost and budget implications of new initiatives be assessed as completely as possible at the time that recommendations are made and decisions taken, and that an overview be maintained of their aggregate impact. It would therefore be helpful if each recommendation to the Committee and Sub-Committees include a review of cost and budget implications. We would request that cost estimates for each recommendation be developed jointly by the initiating department and counterpart staff in the Programming and Budgeting Department. It would also be helpful for each recommendation to include an explicit statement of how budgetary requirements in FY83 are expected to be met. Full year costs in the FY84 budget would also have to be registered and would be assumed to be included in the Department's budget submission for FY84.

cc: Messrs. Paijmans (o/r)
Gabriel (o/r)
Cosgrove
Cole
Humphrey

NN/jem

OFFICE MEMORANDUM

To: Mr. W. Baum (through Mr. van der Meer) — July 22, 1982

From: Miguel Schloss, Acting Director, LAC II

Subject: URUGUAY - Revised Board Memorandum on the Graduation Lending Program

1. The Uruguay graduation memorandum has been revised to incorporate all of Mr. Stern's comments of June 29 (attached).

2. As noted in the graduation memo, the rapid rise in Uruguay's dollar-denominated *per capita* income since 1977 was caused to an important degree by its lagging exchange rate policy. Correction of this lag could result in a decline of Uruguay's estimated dollar-denominated GNP over the next several years. For the present, it has been agreed that the 1981 per capita income estimate, being sent to the Board in August as part of the operational guidelines, will repeat the 1980 figure of US$2,820. Hence, there will be no inconsistency on this score with the graduation memo.

3. Finally, as you may know, an earlier version had already been approved by Mr. Stern as a basis for discussions with the Government and these have taken place (as reported in the paper). No new discussions, therefore, are necessary. Instead, I will send the paper to the Government, give them a few weeks' time for comments, after which we can go to the Board.

Cleared with and cc: Mr. Enrique Lerdau

cc: Operational Vice Presidents
Messrs. Ruisanchez, CLAVP
Vergin, PAB
Waide, OPS
van der Meer, LCP
Assistant Directors, LCP
Division Chiefs, LCP

July , 1982

MEMORANDUM TO THE EXECUTIVE DIRECTORS

Subject: URUGUAY - Graduation from the Bank.

Introduction

1. Pursuant to the Board decision of January 26, 1982 (M82-4 (Rev.)) to fix a figure of US$2,650 *per capita* income in 1980 dollars as a benchmark whereby a country would be considered eligible for graduation, this is to outline the approach to be followed in the case of Uruguay. The proposals contained in this memorandum have been agreed upon with the Uruguayan authorities and their views have been reflected herein.

Recent Economic Developments

2. Uruguay's 1980 *per capita* income exceeded the benchmark established by the Executive Directors by about 6%. However, recent economic developments suggest that the country's *per capita* income may decline in terms of U.S. dollars in the near future both because of exchange rate realignments and because, after a period of strong economic recovery during 1974-80, Uruguay is now experiencing a severe recession. The deterioration in the economy reflects both adverse changes in external demand conditions--particularly in Brazil and Argentina, Uruguay's major trading partners--and severe domestic cost-price distortions associated with the Government's price stabilization policies in effect since late 1978. In this connection, it should be noted that the recent rise in Uruguay's dollar-denominated *per capita* income (by 94% in only three years) was caused to an important degree by its lagging exchange rate policy, a major policy tool employed in the anti-inflation program. Between the end of 1977 and the end of 1981, the peso was devalued by only 114% despite an increase in domestic consumer prices of 394%. Recently, the authorities determined that, in view of distortions in relative prices, adverse external demand for Uruguay's exports, and the consequent unfavorable near-term outlook for domestic growth, the rate of peso depreciation against the US dollar would be accelerated from a 15.2% annual rate during the first quarter of 1982 to a 29.8% annual rate announced for the quarter ending in December 1982. Although expected to accelerate slightly from its current 9% rate, domestic inflation seems likely to remain substantially below the rate of devaluation during 1982, reflecting the depressed aggregate demand conditions and strong competition in the domestic market from imports. In these circumstances, it is quite possible that recalculation of Uruguay's dollar *per capita* income in future years may show that Uruguay has fallen below the above mentioned benchmark and may not recover to that level for some time to come.

3. In view of the uncertainties caused by this situation, agreement was reached with the Government on a flexible approach for phasing down and ultimately ending Bank lending to the country. Initially, a five-year program is proposed, a period considered long enough to permit the

introduction of the policy changes still neded to improve Uruguay's prospects for self-sustained development. However, it was agreed with the Government that, should Uruguay's per capita income fall below the benchmark for a significant period of time (e.g. for two consecutive years), or should the country's access to capital markets be seriously impaired, consideration would be given to extending the graduation period beyond the proposed five years. Appropriate recommendations based on an economic report would, in such an event, be submitted to the Executive Directors.

Economic Background

4. After having become one of the most prosperous countries in Latin America in the first half of the twentieth century, Uruguay's economy deteriorated steadily over the next two decades. A highly literate and predominantly urban population generated increasing demands for well-paid employment, better public services and social benefits. These demands were met through fiscal, exchange rate, pricing, and external trade policies which produced a sustained transfer of income from the resource-rich livestock sector chiefly into consumption by the urban population. Industrialization, strongly stimulated by shortages of consumer goods during World War II, was fostered through a protectionist import substitution policy and an overvalued exchange rate during the immediate post-war era, creating an economic environment that militated against the development of export-oriented production, whether agricultural or industrial. These results were reflected in unfavorable trends in the external sector of the economy. By 1958, the nominal level of Uruguay's total exports was similar to that achieved in the 1940s, while the import level had increased by 159%, and the share of imported inputs in manufacturing output had risen substantially. Thus, far from achieving economic autonomy, the import-substitution strategy increased the dependence of Uruguay, particularly that of its industrial sector, on imports.

5. During the 1920s, when the resources that could be obtained from the livestock sector seemed inexhaustible, Uruguay had instituted comprehensive welfare legislation covering such areas as social security retirement and survivors' pensions, job security, unemployment compensation, free health and education services. Uruguay was thus able to achieve a high level of social progress, as evidenced by an income distribution pattern that compared favorably with that of many developed countries. The redistributive mechanisms were not, however, immune to the effects of economic stagnation and instability. The uncoordinated growth of the social security system placed increasing stress on the country's resources. As the economy continued deteriorating, unemployment and underemployment rose sharply and Government policies aimed at maintaining urban incomes and consumption reinforced the inflationary pressures.

6. During the early 1970s, political and social unrest marked by urban terrorism and labor strife further discouraged savings, investment and initiatives to expand output and exports. These unfavorable developments were also aggravated by the three-fold increase in the price of oil in 1973, substantial increases in manufactured import prices, and the

temporary closure of the European Common Market to meat imports. There ensued a sharp reversal in the balance of payments, a precipitous deterioration of fiscal performance, and an acceleration of domestic inflation.

7. Strengthening the balance of payments and restoring growth were the two major priorities confronting the new economic team appointed in mid-1974. Emphasis was placed on turning away from the inward-looking policies of the past toward a strategy of greater integration with the world economy. Exports were promoted through subsidies, inexpensive state-supported credit, frequent devaluations, and a streamlining of administrative procedures. Domestic investment, supported by large inflows of foreign savings, was stimulated through a gradual reduction of price controls, fiscal incentives, a liberalized foreign investment regime, decontrol of financial and foreign exchange markets, and a gradual reduction in the size of the country's chronic fiscal deficits. During 1974-80, real exports expanded by more than 20% annually, real domestic investment by 14%, and overall output growth by more than 5%, the highest average rate in a quarter of a centry. Unemployment declined from over 12% in the mid-1970s to under 6% in the first half of 1981, international reserves rose to the equivalent of over one year's imports, and the debt service ratio declined from 46% of exports of goods and non-factor services in the early 1970s to 11% in 1980.

8. However, only limited progress was achieved during this period in reducing inflation and raising the international competitiveness of domestic industry. In the late 1970s, policymakers gave added priority to the solution of these problems. In 1978, the maximum global import tariff was lowered from 300% to 150%, and it was announced that this rate would be lowered in annual stages to 35% by January 1, 1985. In an effort to curb inflationary expectations, the quotation of the peso against the U.S. dollar, minimum officially-mandated salary increases, and increases in public utility tariffs were announced 6-9 months in advance, starting in October 1978. The announced rates were well below the prevailing rate of inflation. In 1979, the practice of publicly projecting salary and public tariff increases was discontinued, but preannouncement of the rate of peso depreciation has continued up to the present. The new policy strategy also led to a decision that the Central Bank should desist from active management of the domestic money supply. All open market operations were halted, banking reserve requirements were eliminated, and the remaining interest rate ceilings were removed. It was anticipated that domestic interest rates would converge rapidly to the international rate of interest, adjusted for changes in the valuation of the peso, through the unimpeded arbitrage of international capital flows.

9. The initial impact of the new policies was contrary to expectations. Consumer price inflation nearly doubled from 46% in 1978 to 83% in 1979, propelled by the monetary shock of large-scale inflows of foreign capital attracted by high peso interest yields and by a comparatively low rate of devaluation. Inflation was also fuelled by the one-time liquidity effect of removing all bank reserves requirements, a surge of tourist and real estate investment demand from neighbouring Argentina, a sharp increase in international beef prices reinforced by the

removal of longstanding domestic livestock price controls, and shortfalls in domestic crop production. Although inflation declined rapidly thereafter (to 43% in 1980, 29% in 1981, and 9% on an annual basis during the first 5 months of 1982), it remained substantially above the rate of devaluation until late 1981, generating a severe cost-price squeeze which eroded both the international competitiveness of domestic production and public confidence in the peso. The world recession, rising international interest rates, and the appreciation of the U.S. dollar vis-á-vis the currencies of Uruguay's other major trading partners were additional, exogenous factors which have exacerbated the difficulties of domestic producers in adjusting to sharper competition from imports.

10. As a result, Uruguay now faces a grave economic recession. GDP growth declined steadily from a 4.5% annual rate in 1980 to -0.8% in 1981 and an estimated -5.0% during the first quarter of 1982. Unemployment rose from 5.7% of the active labor force in the first half of 1981 to 10.6% in the first quarter of 1982. Nominal export growth slowed from 34% in 1980 to 15% in 1981, and then declined 21% in the first quarter of 1982. Real peso interest rates rose from -1% in 1979 to 26% in 1980 to 45% by the end of 1981. The non-financial public sector fiscal balance shifted from a surplus of .5% of GDP in 1980 to a deficit of 2.4% in 1981, and to around 11% of GDP during the first 5 months of 1982. And net Central Bank international reserves, after rising by US$122 million in 1980 and US$24 million in 1981, have fallen by an estimated US$300 million during the first five months of 1982.

11. Acknowledging the severity of the domestic economic situation, in May 1982 the Government announced a new package of corrective measures designed to both consolidate the gains achieved in reducing inflation and to reactivate the economy, including: (i) an acceleration in the pre-announced rate of peso depreciation from 1.1% monthly in the first quarter of 1982 to 2.2% monthly during the last four months of the year; (ii) a temporary across-the-board export subsidy of 10% and an equivalent surcharge on imports; (iii) cancellation of plans to grant additional officially-mandated salary increases for the remainder of 1982; (iv) new revenue measures, including increases in value-added and corporate income taxes, the introduction of a new salary withholding tax earmarked for housing construction, and stricter enforcement of existing legislation covering tax evasion; and (v) plans to create a new Development Department in the state-owned Banco Republica to increase the flow of medium and long-term credit to industry and agriculture. The Government also announced that it would begin to negotiate a three-year Extended Facility Agreement with the IMF.

Current Situation, Development Constraints and Bank Role

12. Quite apart from Uruguay's recent economic problems, which are short-term in nature, there are a number of key long-term developments priorities. In the first place, maintaining the momentum of the trade liberalization process and speeding the restructuring and modernization of production facilities along the lines of comparative international advantage will play a central role in efforts to improve the efficiency of recource allocation. The Bank's lending program has provided critical

support for the Government's decisions to lower import barriers and reduce price controls, financing needed infrastructure and furnishing medium to long-term producer credits designed to accelerate the adjustment process. In the current difficult economic situation, the Bank's lending efforts will need to be structured so as to encourage the Government to press forward with complementary reforms along the lines suggested below and resist the strong domestic pressures to reverse the economic opening process.

13. Secondly, the human resource base, though well developed in terms of literacy levels, needs to be further adapted to the requirements of an open economy. One of the central traits of Uruguay's upper and middle management levels--both public and private--is its grounding in academic values that are not always best-suited to the pragmatic, problem-solving needs of a modern society. Bank involvement through technical assistance in various projects and, more recently, through a vocational training and technological development project, has only just begun the task of modernising the educational system.

14. Thirdly, Uruguay has not yet achieved the degree of institutional development required to assure self-sustaining growth, although with the Bank's help some significant progress has been made. Bank-supported power, telecommunications, and ports projects are gradually transforming three of Uruguay's oldest and most poorly managed agencies into modern institutions. Longstanding assistance to the livestock sector gave birth to a high-quality extension service. Two recent industrial credit projects established an independent appraisal unit that is rapidly becoming a model of public sector project evaluation and technical assistance to industry. Bank lending to highways has promoted the development of a transport planning capability that hitherto did not exist in Uruguay. Yet, the fact remains that, in broad terms, the institutional capacity for public sector planning and management, agricultural research and crop support services, and export marketing remain fragmented and ineffective. In fact, the lending program proposed below is chiefly the outcome of the Bank's own economic, sector and operational work over recent years, as the Government has not yet prepared a comprehensive, multi-year public investment program. For this reason, the authorities have requested that the Bank consider providing technical assistance to strengthen project identification and appraisal leading gradually to the formulation of a public investment program with sound economic justification.

15. The proposed lending program derives justification from its strong project linkage to Uruguay's key unmet institutional development needs. Without the proposed Bank involvement, progress toward solving the country's major institutional bottlenecks is likely to be significantly delayed, if not neglected altogether. Breaking these bottlenecks should enhance Uruguay's capacity to sustain satisfactory growth. Processing of the proposed lending program would be predicated on the restoration of consistent macroeconomic policies, particularly with respect to the harmonization of current fiscal, wage, trade and exchange rate policies. Similarly, the lending proposed for each sector will hinge on success in reaching agreement on adoption of the individual sectoral policies outlined below. Developments in these areas will be closely monitored and reviewed

with the authorities in order to assure the continuing appropriateness of the Bank's lending posture.

Criteria for Disengagement and Development Prospects after Graduation

16. It seems likely that Uruguay's future comparative advantage will lie in two major areas: (i) in the primary production and industrialization of agricultural commodities, including livestock (beef, mutton, wool, and milk) and by-products (leather apparel, shoes, etc.) and selected crops (rice, wheat, barley, etc.); and (ii) in the exporting of various services (tourism, banking, transportation, etc.). Promoting these activities will require: (a) greater economic integration internally as well as with neighboring countries in the region, (b) a strengthening of the private sector, particularly in agriculture, industry and services, (c) further reduction in the distortionary effects of exchange rate, tariff, tax, subsidy, and regulatory measures, and (d) a strengthening of those public functions, such as investment in infrastructure and manpower training, which support private sector development.

17. During Uruguay's graduation phase, the Bank's lending effort would focus on maintaining the momentum of the economic opening process. This does not necessarily mean that, once graduated, Uruguay will have achieved levels of institutional or human resource development fully comparable to those attained by earlier Bank graduates from the OECD area. The Government and the Bank have opted to focus on achieving basic institutional development in the sectors of greatest comparative advantage and in the most critical factor resource area--human capital--while acknowledging the risk that Bank lending to Uruguay may end before institutional development becomes self-sustaining.

18. In contemplating the phase-out of the lending program, the Bank would limit its involvement to those areas where: (i) there is good potential for achieving significant institutional or policy improvement through Bank financial and/or technical assistance; and (ii) the targeted sector is instrumental in overcoming the development constraints referred to above. With this in mind, the proposed program envisions limited Bank participation in new sectors and an emphasis on operations consolidating reforms already initiated as part of ongoing projects. Bank efforts would accord priority to agriculture and education. Below, the specific objectives to be sought in each sector are described.

Sectoral Activity and Strategy

19. Agriculture is and will continue to be the mainstay of the Uruguayan economy. Although the contribution of this sector to GDP and employment is relatively modest, its importance as a foreign exchange earner and a supplier of raw materials to domestic industry is fundamental. Whereas the sector generates only around 15% of GDP and directly employs less than 20% of the labor force, agricultural raw materials go into products accounting for more than 85% of export earnings.

20. Policy instability has heightened producer uncertainty, leading to the abandonment of some past improvements in production technology, and a reduction in the near-term potential for major output growth. Until now,

the Bank has concentrated on the livestock sector with a heavy emphasis on strengthening producer incentives and ranch management. Bank involvement was instrumental in setting up a solid extension/appraisal institution and, more recently, in supporting Government efforts to formulate a series of reforms related to the livestock sector. These reforms, announced in August 1978, represented an important initial step toward reducing official intervention in pricing and marketing, and enhancing the role of market forces. However, because of their limited scope, and the cautious way in which they have thus far been implemented, the reforms have not yet had the desired impact on long-term agricultural development.

21. Future agricultural loans would be contingent on obtaining the Government's commitment to broaden the reforms (e.g., by enhancing the role of the private sector in meat export operations) and would be aimed at diversifying output. In the livestock subsector, emphasis would shift downstream to the processing stage where the meatpacking industry continues to suffer from the effects of past government intervention. Investments are needed to meet the sanitary requirements in major consumer markets to which Uruguay has no access at present and to promote Uruguay's reintegration into the major world beef-marketing channels via greater foreign investment in domestic meatpacking. This is an area where both the Bank and the IFC might play constructive roles. To reduce the ranchers' heavy dependence on meat markets, the Bank would promote diversification into dairy products via improvements in the rural feeder road system, the expansion of the power distribution network within major milk producing regions, and the provision of medium-term production credits. Intensified livestock/crop rotation techniques would be promoted through credits, strengthened crop-oriented research services, and comprehensive extension. The proposed projects would, thus, help not only to stabilize producer incomes, but also to enhance productivity and retard soil erosion. Experience derived from an on-going agricultural development loan, including a study being financed by the loan, should throw light on the prospects for intensifying small farmer production.

22. Despite the high literacy rate in Uruguay, the educational system suffers from a number of problems, chief among them being its limited responsiveness to the rapidly evolving manpower needs of a more open, internationally competitive economy. A modest start in addressing this problem is being made through a vocational training and technological development project. However, the problems go beyond this area, involving the entire educational system, particularly at the secondary level. Inadequate curricula, lack of adequately trained teachers, antiquated equipment, and inadequate administrative and financial controls are the principal weaknesses identified in the Bank's recent sectoral review. A secondary education project is proposed to help rectify these problems, provided agreement can be reached on the specific changes that are required. The proposed project would support a recent government decision to establish new secondary training facilities providing for direct placement into the labor market. The Bank is also exploring prospects for the creation of an institute of business administration to increase familiarity with and the use of modern management techniques.

23. Uruguay depends heavily on imported oil, which supplies nearly two-thirds of total energy requirements and accounts for about one-third of

total imports. A key government objective is to speed the replacement of petroleum with hydropower and natural gas through the expansion of transmission and distribution networks in tandem with the hydroelectric projects now coming on stream and with growing Argentine surplusses of exportable gas.

24. A key element for successfully carrying out such a program will be the strengthening of UTE (the country's electric power company). Under the Fifth Power Project, currently in execution, UTE undertook commitments to engage management consultants and accounting advisors, carry-out a tariff study based on marginal cost criteria, start a study on distribution losses, formulate a training program, engage additional professional staff, and review its salary structure. In most of these areas, the results achieved so far are satisfactory, so that the proposed new lending operation would be designed to finance needed physical plant, and follow up on institution-building objectives. A prerequisite for further Bank lending to the power sector has been satisfactory action on tariffs to meet UTE's growing investment requirements, an area where the Government has recently announced new measures still under review within the Bank.

25. Increased attention to the petroleum sector will be necessary in view of Uruguay's heavy dependence on oil imports. ANCAP, the state-owned petroleum company, plays a key role in shaping energy investment and planning. Discussions are now underway between the Bank and the Government concerning the optimal design of a refinery modernization feasibility study being financed by ANCAP. This feasibility study will need to take into account the nation's projected supply and demand of energy in all forms, the potential for inter-fuel substitutability, the role of the petroleum refinery sector, the energy pricing system, and ANCAP's institutional and financial situation. Eventual Bank financing of the project would be conditional upon arriving at a favorable assessment of the possibilities for constructive Bank involvement in the broader issues of petroleum usage and ANCAP planning and management.

26. The Bank has made two loans for <u>industrial development</u>, both designed to help speed the transformation of industry from a predominantly inward-looking and protected sector to an export-oriented one. The second industrial loan was linked with the tariff reduction program enacted in December 1978. It provides for a review and analysis of the progress achieved in reducing tariffs and in promoting a healthy restructuring of industry, thereby assuring that the loan proceeds will have the maximum beneficial impact on the adjustment process. The project includes assistance in establishing mechanisms for project evaluation in the Ministry of Industry and for project preparation and promotion within the banking system. Industrial credit should continue to be provided through a follow-up IDF operation, supporting efforts to (i) achieve import liberalization goals beyond those set out in the December 1978 framework decree and (ii) further the transformation of the domestic banking system into an efficient mechanism for providing medium and long-term industrial credit through actions easing legal and institutional constraints on multi-service banking and improving the functional usefulness of bank reporting systems to savers, borrowers and shareholders. This operation will also need to take into account how effectively sectoral and

macroeconomic policy tools, such as exchange rate management and financial market liberalization, are being used and how they are affecting the industrial adjustment process.

27. It is proposed to present a last highway project to help finance the country's first four-year highway investment program (prepared under an ongoing project). In this operation, the Government and the Bank intend to focus on improvements that will optimize the overall development benefits of the entire road system, including for the first time, the establishment of a national feeder road program. Technical assistance will focus on strengthening the Transport Ministry's institutional capacity to evaluate and prioritize road investments. This evaluation process does not exist now and is unlikely to emerge without Bank involvement. An extensive bridge strengthening program and pre-feasibility work on the operation of an intermodal transport facility are additional elements in the proposed project not dealt with in prior highway projects that will help Uruguay to develop as a regional transport corridor (between Argentina, Paraguay and Brazil), thus increasing the country's integration into the regional economy as an exporter of services as well as goods. Finally, the project will provide technical assistance to the state railway system for the purpose of establishing a cost accounting system. This system could assist railway management in identifying unprofitable rail services and restructuring tariffs so as to reduce heavy system operating losses. In view of the urgent need to rationalize rail services and strengthen the system's investment planning capability, a reserve railway project has been included in the lending program.

Lending Program Magnitudes, Trends and IFC Objectives

28. In constant US dollars, the lending program for FY83-87 is expected to be some 40% below the US$229 million in 1982 dollars actually lent over the past five fiscal years (FY78-82). The level of commitments, after reaching a peak in FY83, is projected to fall significantly thereafter. In constant 1982 prices, the reduction in average loan size is from $32.7 million actual in FY78-82 to a proposed $19.5 million in FY83-87. This implies an increased reliance on cofinancing (possibly halving the share of Bank lending as a proportion of total external financing anticipated in ongoing projects) and on Government contributions for project financing. The Bank will propose cofinancing possibilities for the highways and power projects and, wherever possible, for agricultural projects.

29. Provided that the current problems involving cost-price distortions and excessively high real interest rates can be overcome, the climate for private investments seems likely to improve, and more active IFC involvement in Uruguay could be contemplated. Priority is being given to (i) investment opportunities in export-oriented sectors where the country has demonstrated a strong competitive potential, such as leather, wool, textiles, fishing, agroindustries, banking, and tourism and (ii) technical assistance designed to deepen the capital market through the development of new private sector financial instruments, including leasing, bonds, debentures, new share issues and commercial paper.

Implications for Country Economic and Sector Work (CESW)

30. To provide a more detailed basis for the policy recommendations referred to above, the proposed CESW program for FY82-84 would be relatively extensive. A special study is at present being carried out to examine the existing production and marketing framework for crops, comparable to the study of policy issues already done for the livestock sector. Together, the two will enable the Bank to offer comprehensive policy recommendations and to pursue a fully-integrated agricultural lending strategy. Secondly, the sector-wide assessment of industrial export prospects completed in FY81 will be followed by a micro-firm survey of the corporate adjustment strategies being developed in response to import liberalization. This survey is being financed under the Bank-supported IDF II loan and will be analyzed in a sector memorandum.

31. With respect to the public sector, the Government has instituted a number of accounting and procurement reforms in recent years. However, qualitative deficiencies persist in the way projects are identified, selected, and managed. At the same time, mounting wage costs and social security liabilities have forced a recent series of cuts in public investment expenditures, which, if continued, could leave the country with inadequate infrastructure to support vigorous private sector growth. For these reasons, a study of the role of the public sector and administrative practices and how they affect competition and growth in the private sector is planned for FY83-84. It would support the Government's plans for establishing a preinvestment system designed to permit systematic review of the economic justification of public sector investment proposals.

32. With regard to economic integration, some internal work was done in the Bank in 1979 on the potential for promoting the flow of intermodal transhipments through Uruguay. It also highlighted the urgency of shifting the focus of future investment efforts toward optimization of the economic benefits of the national road network. A survey aimed at formulating more specific recommendations in these two areas will be carried out during this period.

A. W. Clausen
President

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

MB
File with OPSC papers WH 8/17

TO: Mr. William Humphrey, Secretary to the Managing Committee

DATE: July 16, 1982

FROM: Alexander Shakow, Chief, CPDPL
Alex

SUBJECT: Uruguay Graduation

Attached, per request, is the Uruguay graduation package for your background information:

1) February 25, 1982 LC2 paper (received May 25, 1982 in CPD);

2) May 11, 1982 LC2 paper;

3) May 20, 1982 Chernick to Lerdau memo;

4) June 25, 1982 Lerdau to Stern memo and latest LC2 paper; and

5) Stern to Barletta memo dated June 29, 1982.

cc (without attachments): Messrs. Chernick/Edelman

Attachments

AS:ww

FORM NO. 75 (9-78) THE WORLD BANK

ROUTING SLIP

DATE: May 25, 1982

NAME	ROOM NO.
~~Mr. Chernick~~	
(1) File Cont.	
(2) Circulate J.E./R.M/A.S.	

	APPROPRIATE DISPOSITION		NOTE AND RETURN
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	COMMENT		PER YOUR REQUEST
	FOR ACTION		PREPARE REPLY
	INFORMATION		RECOMMENDATION
	INITIAL		SIGNATURE
	NOTE AND FILE		URGENT

REMARKS:

Re: URUGUAY - Graduation

I am attaching, as per our discussion yesterday, the memorandum we have sent to Mr. Stern, together with notes on his reaction.

cc: Mr. Lerdau

FROM: M. Schloss

ROOM NO.: E-913

EXTENSION: 72257

(Lending Policy Uruguay) Mr. Schloss for file

OFFICE MEMORANDUM

TO: Mr. Ernest Stern
(Through Mr. N. Ardito Barletta)

February 25, 1982

FROM: Enrique Lerdau, Director, LC2

SUBJECT: URUGUAY - Graduation from the Bank's Lending Program

This looks like an excellent basis for discussion. I only think that we avoid having all countries graduate in 5 years, Uruguay presents a good case for doing in 4. We cannot note that we might extend it Uruguay falls below the trigger
3/7/82

1. Pursuant to the Board decision to fix a figure of US$2,650 per capita income in 1980 dollars as a benchmark whereby a country would be considered eligible for graduation, this is to propose the approach to be followed in the case of Uruguay. Once we have an agreed position in the Bank, we plan to have discussions with the Uruguayan authorities and reflect those in subsequent paper to you.

Development Constraints, Bank Role and Period of Graduation

2. Uruguay, with a per capita income of US$2,820 exceeds the benchmark by about 6%. It may be noted, however, that the recent rise in Uruguay's dollar-denominated per capita income (by 50% in only two years) was artifically inflated by its lagging exchange rate policy. Between the end of 1978 and the end of 1981, as part of the Government's anti-inflation program, the peso was devalued by only 68% despite an increase in domestic consumer prices of 238%. It is not inconceivable in view of recent recessions experienced by its major trading partners (Brazil and Argentina), and the latter's devaluations, the pressure on relative prices and growth prospects may soon force a major devaluation of the peso against the US dollar and a consequent significant decline in dollar-denominated GDP. I do not propose, however, that we review our lending posture to Uruguay every time the country falls above or below the above-mentioned per capita income benchmark. Instead, I suggest that we plan and initiate discussions toward designing a flexible program for phasing down and ultimately ending Bank lending to the country. As there is considerable likelihood that Uruguay's per capita income will fall below the trigger for a number of years, we should avail ourselves for the time being of the maximum graduation period approved by the Board to meet the objectives outlined below, and keep under periodic review the progress we are making in meeting them.

On April 7 Mr. Barletta informed me that Mr. Stern has agreed to 5 years
2-4-

3. That point aside, while there is little doubt that Uruguay now enjoys favorable access to external capital markets and has improved the level of economic performance since 1974, in other respects Uruguay continues to face serious obstacles to development. In the first place, the economy has only begun the process of restructuring and modernizing production facilities along the lines of comparative international advantage implied by the economic opening. Our lending program has provided critical support in advancing the Government's plans to lower import barriers and to free livestock production and pricing from controls. These plans are now well underway, but face an uncertain future because of international recession, which is affecting Uruguay's main export products, and strong opposition from major interest groups who fear adverse consequences for output and employment. Bank lending to finance needed infrastructure and producer credit have been useful tools to help speed the adjustment process

and encourage the Government to press forward with key complementary reforms intended to consolidate the gains already achieved in the liberalization program and to stem a reversal of economic policies.

4. Secondly, the country's human resource base, though well endowed in terms of literacy levels, is rather ill-prepared by modern standards. One of the central traits of Uruguay's upper and middle management levels--both public and private--is its orientation towards humanistic and academic values that bear heavy signs of outmoded educational shaping. Bank involvement through technical assistance in various projects and, more recently through a vocational training and technological development project, has only just begun a modest effort in modernising the outlook of a small group of Uruguayans.

5. Thirdly, Uruguay has not yet achieved the degree of institutional development required to assure self-sustaining growth, although with the Bank's help some significant progress has been made. Our power, telecommunications, and ports projects are gradually transforming three of Uruguay's oldest and most poorly managed agencies into modern institutions. Our longstanding assistance to the livestock sector gave birth to a fine rural extension service, our two recent industrial credit projects established an independent appraisal unit that is rapidly becoming a model of public sector project evaluation and technical assistance to industry. Our lending to highways is helping establish a sectoral planning capability that has hitherto not existed in Uruguay. Yet, the fact remains that, in broad terms, the institutional capacity for public sector planning and management, agricultural research and crop support services, and export marketing remain fragmented and ineffective. Here, the Bank's role as an outside observer,identifying institutional deficiencies and continually pressing for their resolution, is very valuable. And, despite Uruguay's tradition of collegial decision making, which has oftentimes resulted in a slower than desirable rate of institution building, the Government has been in general receptive to Bank advice in the area, as reflected in the progress mentioned above.

Criteria for Disengagement and Development Prospects after Graduation

6. During Uruguay's graduation phase, our lending effort needs to focus on consolidating and assuring the forward momentum of the gains in recent years. This does not mean that when fully graduated Uruguay is likely to have achieved levels of institutional or human resource development comparable to those attained by earlier Bank graduates from the OECD area. We have opted to focus on achieving basic institutional development in the sectors of greatest comparative advantage and in the most critical factor resource area--human capital (education), recognizing the risk that Bank withdrawal may occur before these institutions have achieved a stage that will assure self-sustaining evolution. Consequently, the matter of possible follow-on Bank assistance will need to be kept under close review, in particular through further sector work and project preparation/appraisal without further commitment of Bank funds.

7. It seems likely that Uruguay's future comparative advantage will lie in two major areas: (i) in the primary production and industrialization of agricultural commodities, including livestock (beef, mutton, wool,

and milk) and by-products (leather apparel, shoes, etc.) and selected crops (rice, citrus, fruits, etc.); and (ii) in the exporting of various services (tourism, banking, transportation, etc.). Promoting these activities will require: (a) greater economic integration internally as well as with neighboring countries in the region, (b) strengthening the private sector, particularly in agriculture and services, and (c) policies aimed at reducing the distortionary effects of present tax, subsidy, and regulatory measures, as well as strengthening those public functions, such as investment in infrastructure and manpower training, which support private sector development. These are the areas where our lending program can continue to provide useful support.

8. When contemplating the phase-out of our program, we will, however, have to limit our involvement to those areas where: (i) there will be reasonable capacity of the sector or institution to continue to develop on a self-sustained basis after Bank disengagement; (ii) there is good potential for Bank financial and/or technical assistance to achieve significant institutional or policy improvement; and (iii) the sector in question will be instrumental in overcoming the constraints referred to above. With this in mind, the program that is proposed here envisions no Bank involvement in new sectors and no further involvement in telecommunications and ports, except for more intensified supervision of the ongoing projects aimed at ensuring adequate follow-up on the agreed provisions concerning institutional development, preparation of future investment programs, and pricing policy improvements. Similarly, only one more operation each is planned for highways, power and IDF over the coming five years. These operations are intended to consolidate reforms started under ongoing projects, making for—one hopes—lasting improvements and increasing further the share of cofinancing in these sectors. Bank efforts would thus concentrate on agriculture, and to a lesser extent, education, where the unfinished job is the greatest. Below, I set out the specific objectives to be sought in each sector. It is axiomatic that, to the extent that we are unable to meet these objectives, such lending would not be realized.

Sectoral Activity and Strategy

9. Agriculture is and will continue to be the mainstay of the Uruguayan economy. Although the contribution of this sector to GDP and employment is relatively modest, its importance as a foreign exchange earner and a supplier of raw materials to domestic industry is quite significant. The sector generates less than 15% of GDP and directly employs just 19% of the labor force; however, agricultural raw materials go into products accounting for more than 85% of export earnings.

10. The Bank has concentrated in the past on the livestock sector with a heavy emphasis on the producer. Bank involvement was instrumental in setting up a solid extension/appraisal institution and, ~~more recently~~, persuading the Government to initiate a policy of reforms related to the livestock sector. These reforms, announced in August 1978, represented an important initial step toward reducing official intervention in pricing and marketing, and enhancing the role of supply and demand forces. However, the piecemeal nature of the reforms and the hesitant way in which they have thus far been implemented have significantly diminished their positive impact on long-term agricultural development. Continued policy instability

has resulted in producer uncertainty and the abandonment of some past improvements in production technology, such as improved pastures, and diminished near-term prospects for major new livestock investment and output growth. Our future agricultural loans will seek to obtain the Government's commitment to enlarge the scope of the reform (e.g. by further reducing official intervention in exports).

11. Future operations in the sector would also be aimed at diversification, thereby initiating a shift in the livestock-oriented tradition of Uruguayan farmers and institutions. First, the livestock subsector emphasis would shift downstream to the processing stage, where the industry continues to suffer from the effects of past government intervention, and where investments are needed to override the sanitary barriers in major consumer markets to which Uruguay has no access at present, and to promote Uruguay's reintegration into the major world beef-marketing channels through greater foreign participation in domestic meat packing. This is an area that could lend itself for a concerted IFC/Bank involvement. Second, to reduce the ranchers' strong present dependence on meat markets, Bank involvement would also help them diversify into dairy products via improvements in the feeder road system, the expansion of the power distribution network in primary milk producing regions, and medium-term production credits. (Deficiencies in the processing of the raw milk, which have hampered its marketability as a final product outside Uruguay, are being addressed directly by an IDB loan). Also directed at diversification would be promotion of more widespread application of livestock/crop rotation techniques through livestock and crop credit, strengthening crop-oriented research and extension. This might not only help stabilize producer incomes, but also enhance productivity and slow erosion. Experience under the on-going agricultural development loan and a study being financed by it should throw light on the possibilities in regard to the diversification of small peasants, and the economic, policy and operational implications of diversification to crops for the sector as a whole will become clear after a forthcoming crop subsector mission.

12. Despite the high literacy rate in Uruguay, the education system suffers from a number of problems, chief among them being its non-responsiveness to the manpower needs of a more open, internationally competitive economy. A modest start in addressing this problem is being made through a vocational training technological development project. However, the problems go beyond this area and affect education in general, particularly at the secondary level: inadequate curricula, lack of adequately trained teachers, antiquated equipment, and weak administrative and financial controls. A Secondary Education Project is included in the Program to help begin actions aimed at rectifying some of these more fundamental problems, particularly in the light of recent government decisions to establish a program that should enable students to go to the labor market without entering the University. The loan also would allow for the preparation of a follow-up operation in the reserve category for possible financing by other parties.

13. Uruguay's tariff reduction program, which introduced into the economy the first large-scale competition from foreign imports since the Depression, has also exposed the serious inefficiencies in both public and private entreprenurial capacity. In order for this policy to meet its

objectives, adjustments in the thinking, work style and planning capacity of managers are required. Uruguayan managers, whose training is for the most part centered on classical and general studies, are notoriously ill-prepared to face rapidly changing demands imposed by the world economy. Accordingly, it is proposed that the Bank assist in financing the establishment of a new institute that would prepare private entrepreneurs and managers as well as public administrators to use modern management techniques.

14. Uruguay depends heavily on imported oil, which supplies nearly two-thirds of total energy requirements and accounts for about one-third of total imports. A key government objective is to speed the substitution of hydropower and natural gas for petroleum through the development of transmission and distribution networks in tandem with the hydroelectric projects now coming on stream and with growing Argentine surplusses of exportable gas.

15. A key element for successfully carrying out such a program will be the strengthening of UTE (the country's electricity company). Under the Fifth Power Project, currently in execution, UTE undertook commitments to engage management consultants and accounting advisors, carry-out a tariff study based on marginal cost criteria, start a study on distribution losses, formulate a training program, engage additional professional staff, and review its salary structure. In most of these areas, the results achieved so far are satisfactory, and the proposed new lending operation would, in addition to financing needed physical plant,aim at following up these programs. A key factor for Bank involvement will be satisfactory action on tariffs to meet the growing investment requirements, an area where the Government has so far failed to take suitable action.

16. For the last two years, the authorities have been discussing a gas pipeline project with Argentina. Provided gas supplies can be contracted on satisfactory terms, the project promises considerable benefits mainly by substituting natural gas for more expensive fuel oil. The Government is also considering a further search for off-shore oil along the coast of the River Plate, if a review currently being undertaken by consultants gives reasonable indications of the prospects of the area, and suitable arrangements can be worked out with foreign oil companies to undertake the exploration works. While Bank financing of the gas pipeline itself may not be desired by the Government, it is possible that such financing may be sought for investments associated with the conversion of major oil users to natural gas (mainly the Government's refinery, gas and power companies). Bank involvement would be geared towards steering project preparation and, if possible, inducing other sources to finance the project. Accordingly, a reserve (rather than a regular) project for oil exploration and gas conversion has been included in the program.

17. The Bank has made two loans for industrial development, both designed to help speed the transformation of industry from a predominantly inward-looking and protected sector to an export-oriented one through the modernization and expansion of production facilities. The second industrial loan was linked with the tariff reduction program enacted in December 1978, and provides for a review and analysis of the progress achieved in reducing tariffs and promoting a healthy restructuring of industry in order to assure that loan proceeds will have the maximum beneficial impact on the

process. The project also includes assistance in establishing a mechanism for project evaluation in the Ministry of Industry and within the banking system. Industrial credit should continue to be provided through a follow-up IDF operation, supporting efforts to achieve import liberalization goals going beyond those set out in the December 1978 framework decree. This operation will also need to take into account the full range of sectoral and macro-policy tools, such as exchange rate management and financial market liberalization, and their impact on the industrial adjustment process. Moreover, this loan could seek policy measures to increase the competitiveness of the banking system, particularly through actions easing legal and institutional constraints on multi-service banking and improvements of functional usefulness of Bank reporting systems to savers, borrowers and shareholders.

18. We propose to present a last highway project to help finance the country's first four-year highway investment program (prepared under the ongoing project). In this operation, we intend to focus on improvements that will optimize the overall development benefits of the entire road system, including for the first time, the establishment of a national feeder road program. Technical assistance will aim at strengthening institutional capacity to evaluate and prioritize road investments. This evaluation process does not exist now, and is unlikely to emerge without Bank's involvement. Finally, a traffic safety program and an extensive bridge strengthening program are elements in the proposed project not dealt with in prior highway projects that, together with a survey for an intermodal facility, will help Uruguay to develop as a regional transport center (between Argentina and Brazil), thus increasing Uruguay's integration into the regional economy as an exporter of services as well as goods.

Lending Program Magnitudes and Trends

19. The lending program that is proposed (annex) is justified on the basis of the strong project links to Uruguay's key unmet institutional development needs. In all cases, without Bank involvement, progress towards the solution of the country's major institutional bottlenecks will be significantly delayed, if not neglected altogether. Satisfactory progress towards resolving these bottlenecks should make it feasible for Uruguay to achieve satisfactory growth. Processing of the proposed lending program would be predicated on continued coherent macroeconomic management, in particular with respect to the internal consistency of fiscal, wage, trade and exchange rate policies. As the Government comes under increasing pressure to counter the effects of recession through greater public spending and less restrained wage policies, developments in these areas will be closely monitored to review the adequacy of our lending posture.

20. Our lending program for FY83-87 is expected to be some 40% below, in constant US dollars, the actual lending over the past five fiscal years (FY78-82). The process of disengagement can be observed in the five-year accumulated level of commitments (last line of attached table), which after reaching a peak in FY83, falls significantly thereafter. From FY84 onwards, the lending program is reduced year by year in real terms from almost \$40 million in FY84 (1982 prices) to \$15 million in FY87. Finally, our average project in FY83-87 will be close to \$22.9 million in nominal terms, compared to an actual of \$29.2 million in FY78-82. In constant 1982 prices the reduction is even more pronounced: from \$32.7 million actual in

FY78-82 to a proposed $19.5 million in FY83-87. This implies an increased reliance on cofinancing (possibly halving the share of Bank lending as a proportion of total external financing estimated in the November 1979 CPP) and on Government contributions for project financing. We will propose cofinancing possibilities for the highways, power project and, wherever possible, for agricultural projects.

Implications for Country Economic and Sector Work (CESW)

21. To provide a more detailed base for the policy recommendations referred to above, the proposed CESW program for FY82-84 represents an extension of our earlier work program. Firstly, a special study is being organized to examine the existing production and marketing framework of crops, vegetables, and fruits, where our understanding of policy impact and requirements lags considerably behind the work already done in livestock. This will complement a just-completed livestock study, enabling the Bank to offer comprehensive policy recommendations and pursue a fully integrated agricultural lending strategy. Secondly, the sector-wide assessment of industrial export prospects completed in FY81 will be followed up by a micro-firm survey of the corporate adjustment strategies being developed in response to import liberalization. This survey is being financed under the Bank's IDF II loan and will be analyzed in a sector memorandum.

22. With respect to the public sector, the Government has instituted a number of accounting and procurement reforms in the investment allocation process since the publication of our last report on that subject. However, qualitative deficiencies persist in the way projects are being identified, selected, and managed. At the same time, mounting wage costs and social security liabilities have forced a recent series of cuts in public investment expenditures, which, if continued, could leave the country with inadequate infrastructure to support vigorous private sector growth. For these reasons, a study of public administration practices and how they affect competition and growth in the private sector is planned for FY83-84.

23. Finally, with regard to economic integration, the Transport Sector Memorandum issued in 1979 highlighted both the potential for converting Uruguay into a "turning plate" for regional transport services as well as the need to shift the focus of future investment efforts toward optimization of the economic benefits of the national road network. A survey aimed at formulating more specific recommendations in these two areas would be carried out during this period.

Reviewed by and cc: Messrs. Doyen/Johanson/Moscote/Newman/Ramasubbu, LCP; Elejalde, EGY; Levy, LC2; Hughes, Acting Chief, LCP; Joshi, Acting Chief, IPD

JHJohnson/AMates/MSchloss:cj

Attachment 1a

Population : 2.9 million (1980)
GNP per capita: $2,820 (1980)
Area : 177,500 sq.kms.
Literacy : 94.0% adult pop.

URUGUAY - ACTUAL AND PROPOSED LENDING PROGRAM THROUGH FY-87

(in Millions of US Dollars)

		Through FY76	Actual FY77	FY78	FY79	FY80	FY81	FY82	Program FY83	FY84	FY85	FY86	FY87	Total FY72-76	Total FY77-81	Total FY82-86	Total FY83-87	Reserve Project
Livestock I	IBRD	7.0																
Livestock II	IBRD	12.7																
Livestock III	IBRD	6.3																
Livestock III Supplemental	IBRD	4.0																
Livestock IV First Stage	IBRD	11.2																
Livestock IV Second Stage	IBRD	13.5																
Livestock V	IBRD	17.0																
Agricultural Development	IBRD					24.0												
Diversification Credit	IBRD												20.0					
Tacuarembo Rivera Regional Development Project	IBRD																	20.0 (
Meat Processing and Dairy Industry	IBRD										20.0							
Power I, II and III	IBRD	64.0																
Power IV	IBRD	18.0																
Power V	IBRD					24.0												
Power VI	IBRD									30.0(a)								
Power Plant Rehabilitation	IBRD																	33.0 (
Interior Distribution and Transmission	IBRD																	15.0 (
Oil Exploration and Gas Conversion	IBRD																	10.0 (
Industrial Development & Export Expansion	IBRD	35.0																
Industrial Credit II	IBRD						30.0											
Industrial Credit III	IBRD											30.0						
Vocational Training & Technological Development	IBRD			9.7														
Secondary Education	IBRD									15.0								
Public & Business Administration	IBRD										5.0							
Highways I	IBRD	18.5																
Highways II	IBRD				26.5													
Highways III	IBRD								40.0									
Montevideo Port	IBRD					50.0												
Telecommunications	IBRD							40.0										
Lending Program	IBRD / No.	207.2 / 13		9.7 / 1	26.5 / 1	98.0 / 3	30.0 / 1	40.0 / 1	40.0 / 1	45.0 / 2	25.0 / 2	30.0 / 1	20.0 / 1	56.0 / 4	164.2 / 6	180.0 / 7	160.0 / 7	
Lending Program in Constant FY82 Commitment Dollars				12.3	32.0	112.3	32.1	40.0	37.5	39.8	20.8	23.6	14.8					
Commitment Delfator (82=100)				79.0	82.9	87.3	93.4	100.0	106.6	113.2	120.0	127.2	134.9					
Standby Projects	IBRD / No.									30.0 / 1								
Accumulated five-year Lending Program								228.7	278.5	270.7	170.2	143.7	131.5					

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Operations Policy Subcommittee (through Mr. Nicolas Ardito Barletta) May 11, 1982

FROM: Enrique Lerdau, Director, LC2

SUBJECT: URUGUAY - Graduation Lending Program

1. Pursuant to Mr. Stern's approval of the proposals outlined in our memorandum to him of February 25 (i.e. prior to the institution of the new procedures for Graduation Papers), Mr. Schloss and I held discussions with the Uruguayan Government on the basis of an edited version of the aforementioned memorandum. The Government subsequently confirmed the substance of our understandings to Mr. Ardito Barletta. The authorities took the view that, given the policy decision adopted on graduation by the Board, the approach, conditions and specific lending program suggested in the paper was generally acceptable. They, however, expressed three areas of concern, to which we responded and propose to handle as described below.

Flexibility of Graduation Period

2. While admitting that, in the interest of evenhanded international comparison, there was no superior option than that of using a base average exchange rate to measure GNP in a common currency, the authorities enquired about the degree of flexibility planned in applying the five-year graduating period. The question was prompted particularly in view of the significant lag in the rate of depreciation of the Uruguayan peso against the U.S. dollar during recent years, which had raised significantly the country's U.S. dollar-denominated per capita income. They pointed out that, in light of international recession (in particular in neighboring Argentina) and the recent Uruguayan decision to accelerate the depreciation of the peso, the country might well fall below the per capita income level that triggers the graduation period in coming years. Furthermore, the authorities expressed concern that increasingly restrictive monetary policies affecting major international capital markets, coupled with the country's own economic management problems, might also constrain Uruguay's access to external sources of finance.

check

true?

measures in time?

i.e. p.c.i below 2650? access difficult

3. I indicated that, should either of these two factors persist for any significant period of time (i.e. for two years or more), consideration could be given at that time to lengthening the graduation period. The Uruguayans agreed that transitory factors should not lead to such a review and that, other things being equal, the five-year graduation period would prevail, even in the eventuality of slippages in processing loan proposals for project reasons. ?

Lending Program Flexibility and Technical Assistance

4. The authorities agreed with the sector and project composition of the lending program, but noted that, in the absence of any Government effort to prepare a systematic public investment program, it was necessarily the product mainly of the Bank's own economic, sectoral and operational work. Furthermore, they noted that with the likely change of Government

anticipated during the coming years, it would be difficult for the current administration to take a definite position on certain projects, particularly during the outer years of the program. Accordingly, they enquired as to the degree of flexibility in substituting projects and about the prospects for Bank technical assistance in project identification, appraisal and formulation of a public investment program.

5. As to the former, I pointed out that projects could be substituted, provided that they satisfied the criteria and constraints on total lending spelled out in the paper. Moreover, we noted that the projects listed in the reserve category already satisfied those conditions in principle. It was agreed that the lending program table would be spelled out in terms of operations for the sectors concerned, without identifying the specific project proposals. Regarding the need to develop a process for project identification and preparation of a public investment program, we agreed that there was an urgent need to enable the Government to pass judgement on the merits of investment proposals--particularly in view of future fiscal constraints. We summarized the kind of technical assistance that has been provided by the Bank in such cases as Paraguay, and suggested that the authorities review the proposals contained in the Bank's public sector report of 1979 and in a subsequent proposal for a preinvestment system outlined by a Bank-financed consultant. We also agreed to continue our support to the IMF work leading towards a possible extended facility financing, and to entertain in that context proposals for appropriate technical assistance for public investment planning. Finally, I confirmed that graduation from the Bank did not imply simultaneous graduation from IFC.

Board Presentation.

6. The authorities inquired about how the proposal for Uruguayan graduation would be conveyed to the Board, with particular reference to the concerns highlighted above. I indicated that, while there were no precedents for this type of presentation, I expected that a paper would be distributed to the Board along the lines of the document discussed with the authorities, suitably amended to incorporate the authorities' views. I promised that the Board paper would be shown to the Government prior to its distribution. I attach the draft paper which, upon the Operation Policy Subcommittee's approval, is proposed to be sent to the Government for final comments and ensuing distribution to the Board.

Distribution

Mr. Stern (Chairman)
Operational Vice Presidents
Mr. Vergin, PAB
Mr. Waide, DPS
Mr. CPD

cc: Messrs. Ruisanchez, Vice President, CLAVP
van der Meer, Director, LCP
Assistant Directors, LCP
Division Chiefs, LCP

MSchloss:cj

May , 1982

MEMORANDUM TO THE EXECUTIVE DIRECTORS

Subject: URUGUAY - Graduation from the Bank.

Introduction

1. Pursuant to the Board decision of January 26, 1982 (M82-4 (Rev.)) to fix a figure of US$2,650 per capita income in 1980 dollars as a benchmark whereby a country would be considered eligible for graduation, this is to outline the approach to be followed in the case of Uruguay. The proposals contained in this memorandum have been agreed upon with the Uruguayan authorities and their views have been reflected herein.

Development Constraints, Bank Role and Period of Graduation

2. Uruguay, with a per capita income of US$2,820 exceeds the benchmark by about 6%. It may be noted, however, that the recent rise in Uruguay's dollar-denominated per capita income (by 50% in only two years) was largely inflated by its lagging exchange rate policy. Between the end of 1978 and the end of 1981, as part of the Government's anti-inflation program, the peso was devalued by only 68% despite an increase in domestic consumer prices of 238%. The authorities consider that, in view of recent recessions experienced by its major trading partners (particularly Brazil and Argentina), the latter's devaluations, and the pressure on relative prices, and growth prospects, the Government has to step up its devaluation pace of the peso against the US dollar and that there will be a consequent significant decline in dollar-denominated GDP. In these circumstances, it is quite possible that the country's income might fall below the above-mentioned per capita benchmark in the near term. Accordingly, the suggested approach involves a flexible program for phasing down and ultimately ending Bank lending to the country in five years. It was agreed with the Government that in the event that Uruguay's per capita income should fall below the trigger for a significant period of time (i.e. for some two years) or the country's access to capital markets be seriously affected, favorable consideration would be given to extending the graduation period beyond the proposed five years to meet the objectives outlined below, and keep under periodic review the progress that is being made in meeting them.

meaning? dependent on external factors or Uruguayan decision?

3. While Uruguay enjoys for the time being favorable access to external capital markets and has improved the level of economic performance since 1974, in other respects the country continues to face serious obstacles to development. In the first place, after decades of economic

stagnation and of inward-looking policies, Uruguay only in 1976 began a process of restructuring and modernizing production facilities along the lines of comparative international advantage. The Bank's lending program has provided critical support in advancing the Government's plans to lower import barriers and to free livestock production and pricing from controls. These plans are now well underway, but face an uncertain future because of the international recession, which is affecting Uruguay's main export products. Bank lending to finance needed infrastructure and producer credit have been useful tools to help speed the adjustment process and encourage the Government to press forward with key complementary reforms intended to consolidate the gains already achieved in the liberalization program and to stem a reversal of economic policies.

4. Secondly, the country's human resource base, though well developed in terms of literacy levels, needs to develop skills through preparation methods that meet modern standards. One of the central traits of Uruguay's upper and middle management levels--both public and private--is its orientation towards humanistic and academic values that bear heavy signs of an outmoded educational system. Bank involvement through technical assistance in various projects and, more recently through a vocational training and technological development project, has only just begun a quite modest effort in modernising the outlook of a small group of Uruguayans.

5. Thirdly, Uruguay has not yet achieved the degree of institutional development required to assure self-sustaining growth, although with the Bank's help some significant progress has been made. Bank-supported power, telecommunications, and ports projects are gradually transforming three of Uruguay's oldest and most poorly managed agencies into modern institutions. Longstanding assistance to the livestock sector gave birth to a fine rural extension service, two recent industrial credit projects established an independent appraisal unit that is rapidly becoming a model of public sector project evaluation and technical assistance to industry. Bank lending to highways is helping establish a sectoral planning capability that has hitherto not existed in Uruguay. Yet, the fact remains that, in broad terms, the institutional capacity for public sector planning and management, agricultural research and crop support services, and export marketing remain fragmented and ineffective. In fact, the lending program proposed below is mostly the outcome of the Bank's economic, sector and operational work over recent years, as the Government has not yet found it possible to prepare a systematic public investment program. The authorities have thus requested that the Bank consider providing technical assistance in project identification, appraisal and formulation of a public investment program, and that in the meantime there be a certain flexibility for substituting projects in the lending program. It is proposed to provide to the Government such assistance, and to allow the substitution of projects, provided that they meet the criteria explained below and that they involve loan amounts not exceeding those outlined in the attachment to this memorandum. In principle, the projects listed in the "reserve" category meet these conditions.

Criteria for Disengagement and Development Prospects after Graduation

6. During Uruguay's graduation phase, the Bank's lending effort needs to focus on consolidating and assuring the forward momentum of the gains in recent years. This does not necessarily mean that when fully graduated Uruguay is likely to have achieved levels of institutional or human resource development fully comparable to those attained by earlier Bank graduates from the OECD area. The Government and the Bank have opted to focus on achieving basic institutional development in the sectors of greatest comparative advantage and in the most critical factor resource area--human capital (education), recognizing the risk that Bank withdrawal may occur before these institutions have achieved a stage that will assure self-sustaining evolution. Consequently, the matter of possible follow-on Bank assistance will be kept under close review, in particular through further sector work and project preparation/appraisal without further commitment of Bank funds.

7. It seems likely that Uruguay's future comparative advantage will lie in two major areas: (i) in the primary production and industrialization of agricultural commodities, including livestock (beef, mutton, wool, and milk) and by-products (leather apparel, shoes, etc.) and selected crops (rice, citrus, fruits, etc.); and (ii) in the exporting of various services (tourism, banking, transportation, etc.). Promoting these activities will require: (a) greater economic integration internally as well as with neighboring countries in the region, (b) strengthening the private sector, particularly in agriculture and services, and (c) policies aimed at reducing the distortionary effects of present tax, subsidy, and regulatory measures, as well as strengthening those public functions, such as investment in infrastructure and manpower training, which support private sector development. These are the areas where our lending program can continue to provide useful support.

8. When contemplating the phase-out of the lending program, the Bank will, however, have to limit its involvement to those areas where: (i) there will be reasonable capacity of the sector or institution to continue to develop on a self-sustained basis after Bank disengagement; (ii) there is good potential for Bank financial and/or technical assistance to achieve significant institutional or policy improvement; and (iii) the sector in question will be instrumental in overcoming the constraints referred to above. With this in mind, the program that is proposed here envisions no Bank participaton in new sectors and no further involvement in telecommunications and ports, except for more intensified supervision of the ongoing projects aimed at ensuring adequate follow-up on the agreed provisions concerning institutional development, preparation of future investment programs, and pricing policy improvements. Similarly, only one more operation each is planned for highways, power and IDF over the coming five years. These operations are intended to consolidate reforms started under ongoing projects, making for, it is hoped, lasting improvements and increasing further the share of cofinancing in these sectors. Bank efforts would thus concentrate on agriculture, and to a lesser extent, education, where the unfinished job is the greatest. Below, the specific objectives to be sought in each sector are set out.

Sectoral Activity and Strategy

9. Agriculture is and will continue to be the mainstay of the Uruguayan economy. Although the contribution of this sector to GDP and employment is relatively modest, its importance as a foreign exchange earner and a supplier of raw materials to domestic industry is quite significant. The sector generates less than 15% of GDP and directly employs just 19% of the labor force; however, agricultural raw materials go into products accounting for more than 85% of export earnings.

10. The Bank has concentrated in the past on the livestock sector with a heavy emphasis on the producer. Bank involvement was instrumental in setting up a solid extension/appraisal institution and, more recently, in supporting Government efforts to formulate a policy of reforms related to the livestock sector. These reforms, announced in August 1978, represented an important initial step toward reducing official intervention in pricing and marketing, and enhancing the role of supply and demand forces. However, the partial nature of the reforms and the cautious way in which they have thus far been implemented have significantly diminished their positive impact on long-term agricultural development. Policy instability has resulted in producer uncertainty and the abandonment of some past improvements in production technology, such as improved pastures, and diminished near-term prospects for major new livestock investment and output growth. Future agricultural loans will be contingent on the Government's commitment to enlarge the scope of the reform (e.g. by further reducing official intervention in exports).

indication of gov't commitment

contingent
meaning?

11. Future operations in the sector would also be aimed at diversification, thereby initiating a shift in the livestock-oriented tradition of Uruguayan farmers and institutions. First, the livestock subsector emphasis would shift downstream to the processing stage, where the industry continues to suffer from the effects of past government intervention, and where investments are needed to override the sanitary barriers in major consumer markets to which Uruguay has no access at present, and to promote Uruguay's reintegration into the major world beef-marketing channels through greater foreign participation in domestic meat packing. This is an area that could lend itself for a concerted IFC/Bank involvement. Second, to reduce the ranchers' strong present dependence on meat markets, Bank involvement would also help them diversify into dairy products via improvements in the feeder road system, the expansion of the power distribution network in primary milk producing regions, and medium-term production credits. (Deficiencies in the processing of the raw milk, which have hampered its marketability as a final product outside Uruguay, are being addressed directly by an IDB loan.) Also directed at diversification would be promotion of more widespread application of livestock/crop rotation techniques through livestock and crop credit, strengthening crop-oriented research and extension. This might not only help stabilize producer incomes, but also enhance productivity and slow down soil erosion. Experience under the on-going agricultural development loan, and a study being financed by it, should throw light on the possibilities of crop diversification for small peasants.

12. Despite the high literacy rate in Uruguay, the education system suffers from a number of problems, chief among them being its non-responsiveness to the manpower needs of a more open, internationally competitive economy. A modest start in addressing this problem is being made through a vocational training and technological development project. However, the problems go beyond this area and affect education in general, particularly at the secondary level: inadequate curricula, lack of adequately trained teachers, antiquated equipment, and weak administrative and financial controls. A secondary education project is included in the program to help begin actions aimed at rectifying some of these more fundamental problems, particularly in the light of recent government decisions to establish a program that should enable students to go to the labor market without entering the University. The loan also would allow for the preparation of a follow-up operation in the reserve category for possible financing by other parties.

in short, IBRD staff need to develop projects for them

13. Uruguay's tariff reduction program, which introduced into the economy the first large-scale competition from foreign imports since the depression of the thirties, has also exposed the serious inefficiencies in both public and private entrepreneurial capacity. In order for this policy to meet its objectives, adjustments in the thinking, work style and planning capacity of managers are required. Uruguayan managers, whose training is for the most part centered on classical and general studies, are not adequately prepared to face rapidly changing demands imposed by the world economy. Accordingly, it is proposed that the Bank assist in financing the establishment of a new institute that would prepare private entrepreneurs and managers as well as public administrators to use modern management techniques.

issue — Stern has not been enthusiastic re this [illegible]

are these institutes? objective?

14. Uruguay depends heavily on imported oil, which supplies nearly two-thirds of total energy requirements and accounts for about one-third of total imports. A key government objective is to speed the substitution of hydropower and natural gas for petroleum through the development of transmission and distribution networks in tandem with the hydroelectric projects now coming on stream and with growing Argentine surplusses of exportable gas.

15. A key element for successfully carrying out such a program will be the strengthening of UTE (the country's electricity company). Under the Fifth Power Project, currently in execution, UTE undertook commitments to engage management consultants and accounting advisors, carry-out a tariff study based on marginal cost criteria, start a study on distribution losses, formulate a training program, engage additional professional staff, and review its salary structure. In most of these areas, the results achieved so far are satisfactory, and the proposed new lending operation would, in addition to financing needed physical plant, aim at following up these programs. A key factor for Bank involvement will be satisfactory action on tariffs to meet the growing investment requirements, an area where the Government has so far failed to take suitable action.

16. For the last two years, the authorities have been discussing a gas pipeline project with Argentina. Provided gas supplies can be contracted on satisfactory terms, the project promises considerable benefits

mainly by substituting natural gas for more expensive fuel oil. The Government is also considering a further search for off-shore oil along the coast of the River Plate, if a review currently being undertaken by consultants gives reasonable indications of the prospects of the area, and suitable arrangements can be worked out with foreign oil companies to undertake the exploration works. While Bank financing of the gas pipeline itself may not be desired by the Government, it is possible that such financing may be sought for investments associated with the conversion of major oil users to natural gas (mainly the Government's refinery, gas and power companies). Bank involvement would be geared towards steering project preparation and, if possible, inducing other sources to finance the project. Accordingly, a reserve (rather than a regular) project for oil exploration and gas conversion has been included in the program.

17. The Bank has made two loans for industrial development, both designed to help speed the transformation of industry from a predominantly inward-looking and protected sector to an export-oriented one through the modernization and expansion of production facilities. The second industrial loan was linked with the tariff reduction program enacted in December 1978, and provides for a review and analysis of the progress achieved in reducing tariffs and promoting a healthy restructuring of industry in order to assure that loan proceeds will have the maximum beneficial impact on the process. The project also includes assistance in establishing a mechanism for project evaluation in the Ministry of Industry and within the banking system. Industrial credit should continue to be provided through a follow-up IDF operation, supporting efforts to achieve import liberalization goals going beyond those set out in the December 1978 framework decree. This operation will also need to take into account the full range of sectoral and macro-policy tools, such as exchange rate management and financial market liberalization, and their impact on the industrial adjustment process. Moreover, this loan could seek policy measures to increase the competitiveness of the banking system, particularly through actions easing legal and institutional constraints on multi-service banking and improvements of functional usefulness of bank reporting systems to savers, borrowers and shareholders.

18. It is proposed to present a last highway project to help finance the country's first four-year highway investment program (prepared under the ongoing project). In this operation, the Government and the Bank intend to focus on improvements that will optimize the overall development benefits of the entire road system, including for the first time, the establishment of a national feeder road program. Technical assistance will aim at strengthening institutional capacity to evaluate and prioritize road investments. This evaluation process does not exist now, and is unlikely to emerge without Bank's involvement. Finally, a traffic safety program and an extensive bridge strengthening program are elements in the proposed project not dealt with in prior highway projects that, together with a survey for an intermodal facility, will help Uruguay to develop as a regional transport center (between Argentina and Brazil), thus increasing Uruguay's integration into the regional economy as an exporter of services as well as goods.

Is it money?
willpower?
T.a.?

Lending Program Magnitudes and Trends

19. The lending program that is proposed (annex) is justified on the basis of the strong project links to Uruguay's key unmet institutional development needs. In all cases, without Bank involvement, progress towards the solution of the country's major institutional bottlenecks will be significantly delayed, if not neglected altogether. Satisfactory progress towards resolving these bottlenecks should make it feasible for Uruguay to achieve satisfactory growth. Processing of the proposed lending program would be predicated on continued coherent macroeconomic management, in particular with respect to the internal consistency of fiscal, wage, trade and exchange rate policies. As the Government will have to deal with increasing pressures to counter the effects of recession through greater public spending and less restrained wage policies, developments in these areas will be closely monitored jointly with the authorities to review the adequacy of the Bank's lending posture.

20. The lending program for FY83-87 is expected to be some 40% below, in constant US dollars, the actual lending over the past five fiscal years (FY78-82). The process of disengagement can be observed in the five-year accumulated level of commitments (last line of attached table), which after reaching a peak in FY83, falls significantly thereafter. The lending program is reduced from almost $40 million in FY84 (1982 prices) to $15 million in FY87. Finally, the average loan size in FY83-87 will be $22.9 million in nominal terms, compared to an actual of $29.2 million in FY78-82. In constant 1982 prices the reduction is even more pronounced: from $32.7 million actual inFY78-82 to a proposed $19.5 million in FY83-87. This implies an increased reliance on cofinancing (possibly halving the share of Bank lending as a proportion of total external financing estimated in ongoing plans) and on Government contributions for project financing. The Bank will propose cofinancing possibilities for the highways and power projects and, wherever possible, for agricultural projects.

Implications for Country Economic and Sector Work (CESW)

21. To provide a more detailed base for the policy recommendations referred to above, the proposed CESW program for FY82-84 would remain quite active. Firstly, a special study is at present being carried out to examine the existing production and marketing framework of crops, vegetables, and fruits, where current understanding of policy impact and requirements lags considerably behind the work already done in livestock. This will complement a just-completed livestock study, enabling the Bank to offer comprehensive policy recommendations and pursue a fully integrated agricultural lending strategy. Secondly, the sector-wide assessment of industrial export prospects completed in FY81 will be followed up by a microfirm survey of the corporate adjustment strategies being developed in response to import liberalization. This survey is being financed under the Bank-supported IDF II loan and would be analyzed in a sector memorandum.

22. With respect to the public sector, the Government has instituted a number of accounting and procurement reforms in the investment allocation process since the publication of the Bank's last report on that subject.

However, qualitative deficiencies persist in the way projects are being identified, selected, and managed. At the same time, mounting wage costs and social security liabilities have forced a recent series of cuts in public investment expenditures, which, if continued, could leave the country with inadequate infrastructure to support vigorous private sector growth. For these reasons, a study of public administration practices and how they affect competition and growth in the private sector is planned for FY83-84, while supporting the Government and the IMF in their current discussions to assist setting up a mechanism to pass judgement on public investment proposals, particularly in view of future fiscal constraints.

23. Finally, with regard to economic integration, a draft Transport Sector Memorandum discussed in 1979 highlighted both the potential for converting Uruguay into a point of convergence and intermodal transhipments for regional transport services as well as the need to shift the focus of future investment efforts toward optimization of the economic benefits of the national road network. A survey aimed at formulating more specific recommendations in these two areas would be carried out during this period.

A. W. Clausen
President

Population : 2.9 million (1980)
GNP per capita: $2,820 (1980)
Area : 94.0% adult pop.

Attachment 1a

URUGUAY - ACTUAL AND PROPOSED LENDING PROGRAM THROUGH FY-87
(In Millions of US Dollars)

		Through	Actual						Program					Total	Total	Total	Total	Reserve
		FY76	FY77	FY78	FY79	FY80	FY81	FY82	FY83	FY84	FY85	FY86	FY87	FY72-76	FY77-81	FY82-86	FY83-87	Projects
Livestock	IBRD	71.7																
Agricultural Diversification and Development	IBRD					24.0					20.0		20.0					20.0(85)
Power	IBRD	82.0				24.0				30.0								33.0(85) 15.0(86)
Energy	IBRD																	10.0(85)
Industrial Development and Export Expansion	IBRD	35.0					30.0					30.0						
Vocational Training, Technological Development and Education	IBRD			9.7						15.0	5.0							
Highways	IBRD	18.5			26.5				40.0									
Port	IBRD					50.0												
Telecommunications	IBRD							40.0										
Lending Program	IBRD	207.2		9.7	26.5	98.0	30.0	40.0	40.0	45.0	25.0	30.0	20.0	56.0	164.2	180.0	160.0	
	No.	13		1	1	3	1	1	1	2	2	1	1	4	6	7	7	
Lending Program in Constant FY82 Commitment Dollars				12.3	32.0	112.3	32.1	40.0	37.5	39.8	20.8	23.6	14.8	125.6	188.7	161.7	136.5	
Commitment Deflator (82=100)				79.0	82.9	87.3	93.4	100.0	106.6	113.2	120.0	127.2	134.9					
Accumulated five-year Lending Program								228.7	253.9	261.7	170.2	161.7	136.5					

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Mr. Enrique Lerdau, Director, LC2 DATE: May 20, 1982

FROM: Sidney E. Chernick, Assistant Director, CPD

SUBJECT: URUGUAY: Graduation Program

1. As agreed during our telephone conversation, we will meet next Monday, May 24, at 4:00 p.m. to discuss the draft memorandum to the Executive Directors on Uruguay's graduation, which you sent to Mr. Stern on May 11, 1982. In preparation for that meeting, here are some of our concerns. E923

2. Analysis of Uruguay's economic situation and prospects. It would be most useful to have a brief and candid assessment of Uruguay's economic situation and prospects, an examination of the government's policy priorities, and the degree of their commitment to correcting basic problems. It might also include a review of the special issues affecting Uruguay's per capita income and their access to capital markets. The latter is, of course, an extremely important part of the graduation timing decision, and if current favorable access is expected to deteriorate, it would be most helpful to have an analysis of whether this is likely to be the result of the failure to take important internal decisions or of external factors beyond Uruguay's control or both.

3. Rationale for a five-year graduation program. A five-year program, according to the graduation guidelines, is not automatic; the graduation time period should reflect individual country circumstances, including (in addition to the items noted in para. 2 above) an "assessment of a government's seriousness in addressing (serious institutional issues) and receptivity to Bank advice at the macro, sector and project levels." (Board paper, para. 12) We believe your proposal could be strengthened by defining more clearly why Uruguay should have a five-year program; what major policy issues do we believe the Bank will be able to influence in this period; how responsive are the Uruguayans to our advice in these areas? It is not very clear what benchmark is to be used to determine whether Uruguay is meeting its performance obligations, and what would happen if their performance was poor in key areas (e.g., para. 10 - what are the implications of the statement "future agricultural loans are contingent on the government's commitment, etc."). The flexibility on project choice suggests, perhaps inadvertently, an apparent commitment to a five-year lending target without reference to policy performance. To support a five-year program rather than, for example, a two-year program, requires some indication of a country's willingness to take on tougher policy decisions. In the same vein, presumably Uruguayan failure to take steps to enhance access to the capital markets, with resulting diminished access, is not grounds for extending the graduation period. Treating these two substantive areas in greater depth in the paper, would provide a better basis for management's consideration of a graduation program. Of course, not all of the discussion need be reproduced in the Board paper but the OPSC should have a candid appraisal of these important issues.

4. There are few other areas where we have questions or suggestions:

i) the tone of the paper, especially paras. 4 and 5, appears to exaggerate the role of the Bank;

ii) the notion of concentration in the lending program is sensible, but the actual project distribution proposed does not demonstrate concentration so clearly: Agriculture ($40 million, 2 projects), Highways ($40 million, 1 project), Power ($30 million, 1 project), Industry ($30 million, 1 project) and Education ($20 million, 2 projects);

iii) the suggestion appears in para. 12 that the Bank help prepare follow-up education operations for possible financing by other parties; if this implies Bank staff technical assistance (which you may not intend), it is an issue which requires further explanation since Mr. Stern has indicated a preference for concentrating scarce resources on poorer countries;

iv) it is surprising that, despite Uruguay's relatively advanced education system, the crucial area identified for Bank focus over the last five years of its lending program is in education; and

v) some discussion of the IFC role - present and proposed - would be useful, as would any further suggestions for the links during the post-graduation period.

5. As we noted during our conversation, this is one of the first graduation program papers to be considered. And we are all learning how best to design and present graduation programs. In this regard, you will be interested in a paper prepared by EMENA on Yugoslavia's graduation which illustrates another approach. A copy of this paper has been sent to Mr. Schloss.

AShakow/SEChernick:ag

cc: Messrs. Waide, E.B.
Kavalsky, B.
Shakow, A.
Edelman, J.
Moran o/r

cc: Mr. Schloss

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

Mr. Shakow

OFFICE MEMORANDUM

To: Mr. Ernest Stern

June 25, 1982

From: Enrique Lerdau, Acting RVP, LAC

Subject: URUGUAY - Revised Board Memorandum on the Graduation Lending Program

1. You will find as attachment A the revised Uruguay graduation memorandum, reflecting comments received on the earlier version sent to the Operations Policy Subcommittee. New language has been incorporated regarding the per capita income benchmark, Uruguay's development background and near-term economic outlook, and the implications of the country's current economic difficulties for management of the graduation process (see, especially, paras. 2-11, 15, and 35). We have also added to the lending program a reserve project for railway modernization (see para. 29).

2. As explained in my memo of May 11 to the Operations Policy Subcommittee (attachment B), it was agreed that, prior to distribution of this memo to the Board, it would be shown to the Government for final comment. Your approval of this revised version is, therefore, requested, so that it may be discussed with the authorities at our earliest opportunity.

cc: Operational Vice Presidents
Messrs. Mr. Vergin, PAB
Mr. Waide, OPS
Ruisanchez, Vice President, CLAVP
van der Meer, Director, LCP
Assistant Directors, LCP
Division Chiefs, LCP

June , 1982

MEMORANDUM TO THE EXECUTIVE DIRECTORS

Subject: URUGUAY - Graduation from the Bank.

Introduction

1. Pursuant to the Board decision of January 26, 1982 (M82-4 (Rev.)) to fix a figure of US$2,650 per capita income in 1980 dollars as a benchmark whereby a country would be considered eligible for graduation, this is to outline the approach to be followed in the case of Uruguay. The proposals contained in this memorandum have been agreed upon with the Uruguayan authorities and their views have been reflected herein.

Recent Economic Developments

2. Uruguay's 1980 per capita income exceeded the benchmark established by the Executive Directors by about 6%. However, recent economic developments suggest that the country's per capita income may decline in terms of U.S. dollars in the near future both because of exchange rate realignments and because, after a period of strong economic recovery during 1974-80, Uruguay is now experiencing a severe recession. The deterioration in the economy reflects both adverse changes in external demand conditions--particularly in Brazil and Argentina, Uruguay's major trading partners--and severe domestic cost-price distortions associated with the Government's price stabilization policies in effect since late 1978. In this connection, it should be noted that the recent rise in Uruguay's dollar-denominated per capita income (by 94% in only three years) was caused to an important degree by its lagging exchange rate policy, a major policy tool employed in the anti-inflation program. Between the end of 1977 and the end of 1981, the peso was devalued by only 114% despite an increase in domestic consumer prices of 394%. Recently, the authorities determined that, in view of distortions in relative prices, adverse external demand for Uruguay's exports, and the consequent unfavorable near-term outlook for domestic growth, the rate of peso depreciation against the US dollar would be accelerated from a 15.2% annual rate during the first quarter of 1982 to a 28.3% annual rate announced for the quarter ending in October 1982. Although expected to accelerate slightly from its current 9% rate, domestic inflation seems likely to remain substantially below the rate of devaluation during 1982, reflecting the depressed aggregate demand conditions and strong competition in the domestic market from imports. In these circumstances, it is quite possible that recalculation of Uruguay's dollar per capita income in future years may show that Uruguay has fallen below the above mentioned benchmark and may not recover to that level for some time to come.

3. In view of the uncertainties caused by this situation, agreement was reached with the Government on a flexible approach for phasing down and ultimately ending Bank lending to the country. Initially, a five year program is proposed, a period considered long enough to permit the

introduction of the policy changes still neded to improve Uruguay's prospects for self-sustained development. However, it was agreed with the Government that, should Uruguay's per capita income fall below the benchmark for a significant period of time (e.g. for two consecutive years), or should the country's access to capital markets be seriously impaired, consideration would be given to extending the graduation period beyond the proposed five years. Appropriate recommendations based on an economic report would, in such an event, be submitted to the Executive Directors.

Economic Background

4. After having become one of the most prosperous countries in Latin America in the first half of the twentieth century, Uruguay's economy deteriorated steadily over the next two decades. A highly literate and predominantly urban population generated increasing demands for well-paid employment, better public services and social benefits. These demands were met through fiscal, exchange rate, pricing, and external trade policies which produced a sustained transfer of income from the resource-rich crop and livestock sub-sectors chiefly into consumption by the urban population. Industrial sector development, strongly stimulated by shortages of consumer goods during World War II, was fostered through a protectionist import substitution policy and an overvalued exchange rate during the immediate post-war era, creating an economic environment that militated against the development of export-oriented production, whether agricultural or industrial. These results were reflected in unfavorable trends in the external sector of the economy. By 1958, the nominal level of Uruguay's total exports was similar to that achieved in the 1940s, while the import level had increased by 159%, and the share of imported inputs in manufacturing output had risen substantially. Thus, far from achieving economic autonomy, the import-substitution strategy increased the dependence of Uruguay, particularly that of its industrial sector, on imports.

5. During the 1920s, when the resources that could be obtained from the livestock sector seemed inexhaustible, Uruguay had instituted comprehensive welfare legislation covering such areas as social security retirement and survivors' pensions, job security, unemployment compensation, free health and education services. Uruguay was thus able to achieve a high level of social progress, as evidenced by an income distribution pattern that compared favorably with that of many developed countries. The redistributive mechanisms were not, however, immune to the effects of economic stagnation and instability. The uncoordinated growth of the social security system placed increasing stress on the country's resources. As the economy continued deteriorating, unemployment and underemployment rose sharply and Government policies aimed at maintaining urban incomes and consumption levels reinforced the inflationary pressures.

6. During the early 1970s, political and social unrest marked by urban terrorism and labor strife further discouraged savings, investment and initiatives to expand output and exports. These unfavorable developments were also aggravated by the threefold increase in the price of oil in 1973, substantial increases in manufactured import prices, and the

temporary closure of the European Common Market to meat imports. There ensued a sharp reversal in the balance of payments, a precipitous deterioration of fiscal performance, and an acceleration of domestic inflation.

7. Strengthening the balance of payments and restoring growth were the two major priorities confronting the new economic team appointed in mid-1974. Emphasis was placed on turning away from the inward-looking policies of the past toward a strategy of greater integration with the world economy. Exports were promoted through subsidies, inexpensive state-supported credit, frequent devaluations, and a streamlining of administrative procedures. Domestic investment, supported by large inflows of foreign savings, was stimulated through a gradual reduction of price controls, fiscal incentives, a liberalized foreign investment regime, decontrol of financial and foreign exchange markets, and a gradual reduction in the size of the country's chronic fiscal deficits. During 1974-80, real exports expanded by more than 20% annually, real domestic investment by 14%, and overall output growth by more than 5%, the highest average rate in a quarter of a centry. Unemployment declined from over 12% in the mid-1970s to under 6% in the first half of 1981, international reserves rose to the equivalent of over one year's imports, and the debt service ratio declined from 46% of exports of goods and non-factor services in the early 1970s to 11% in 1980.

8. However, only limited progress was achieved during this period in reducing inflation and raising the international competitiveness of domestic industry. In the late 1970s, policymakers gave added priority to the solution of these problems. In 1978, the maximum global import tariff was lowered from 300% to 150%, and it was announced that this rate would be lowered in annual stages to 35% by January 1, 1985. In an effort to curb inflationary expectations, the quotation of the peso against the U.S. dollar, minimum officially-mandated salary increases, and increases in public utility tariffs were announced 6-9 months in advance, starting in October 1978. The announced rates were well below the prevailing rate of inflation. In 1979, the practice of publicly projecting salary and public tariff increases was discontinued, but preannouncement of the rate of peso depreciation has continued up to the present. The new policy strategy also led to a decision that the Central Bank should desist from active management of the domestic money supply. All open market operations were halted, banking reserve requirements were eliminated, and the remaining interest rate ceilings were removed. It was anticipated that domestic interest rates would converge rapidly to the international rate of interest, adjusted for changes in the valuation of the peso, through the unimpeded arbitrage of international capital flows.

9. The initial impact of the new policies was contrary to expectations. Consumer price inflation nearly doubled from 46% in 1978 to 83% in 1979, propelled by the monetary shock of large-scale inflows of foreign capital attracted by high peso interest yields and by a comparatively low rate of devaluation. Inflation was also fuelled by the one-time liquidity effect of removing all bank reserves requirements, a surge of tourist and real estate investment demand from neighbouring Argentina, a sharp increase in international beef prices reinforced by the

removal of longstanding domestic livestock price controls, and shortfalls in domestic crop production. Although inflation declined rapidly thereafter (to 43% in 1980, 29% in 1981, and 9% on an annual basis during the first 5 months of 1982), it remained substantially above the rate of devaluation until late 1981, generating a severe cost-price squeeze which eroded both the international competitiveness of domestic production and public confidence in the peso. The world recession, rising international interest rates, and the appreciation of the U.S. dollar vis-à-vis the currencies of Uruguay's other major trading partners were additional, exogenous factors which have exacerbated the difficulties of domestic producers in adjusting to sharper competition from imports.

10. As a result, Uruguay now faces a grave economic recession. GDP growth declined steadily from a 4,5% annual rate in 1980 to -0.8% in 1981 and an estimated -5.0% during the first quarter of 1982. Unemployment rose from 5.7% of the active labor force in the first half of 1981 to 10.6% in the first quarter of 1982. Nominal export growth slowed from 34% in 1980 to 15% in 1981, and then declined 21% in the first quarter of 1982. Real peso interest rates rose from -1% in 1979 to 26% in 1980 to 45% by the end of 1981. The non-financial public sector fiscal balance shifted from a surplus of .5% of GDP in 1980 to a deficit of 2.4% in 1981, and to around 11% of GDP during the first 5 months of 1982. And net Central Bank international reserves, after rising by US$122 million in 1980 and US$24 million in 1981, have fallen by an estimated US$300 million during the first five months of 1982.

11. Acknowledging the severity of the domestic economic situation, in May 1982 the Government announced a new package of corrective measures designed to both consolidate the gains achieved in reducing inflation and to reactivate the economy, including: (i) an acceleration in the pre-announced rate of peso depreciation from 1.1% monthly in the first quarter of 1982 to 2.2% monthly by next September-October; (ii) a temporary across-the-board export subsidy of 10% and an equivalent surcharge on imports; (iii) cancellation of plans to grant additional officially-mandated salary increases for the remainder of 1982; (iv) new revenue measures, including increases in value-added and corporate income taxes, the introduction of a new salary withholding tax earmarked for housing construction, and stricter enforcement of existing legislation covering tax evasion; and (v) plans to create a new Development Department in the state-owned Banco Republica to increase the flow of medium and long-term credit to industry and agriculture. The Government also announced that it would begin to negotiate a three-year Extended Facility Agreement with the IMF.

Current Situation, Development Constraints and Bank Role

12. Quite apart from Uruguay's recent economic problems, which are short-term in nature, there are a number of key long-term developments priorities. In the first place, maintaining the momentum of the trade liberalization process and speeding the restructuring and modernization of production facilities along the lines of comparative international advantage will play a central role in efforts to improve the efficiency of recource allocation. The Bank's lending program has provided critical

support for the Government's decisions to lower import barriers and reduce price controls, financing needed infrastructure and furnishing medium to long-term producer credits designed to accelerate the adjustment process. In the current difficult economic situation, the Bank's lending efforts will need to be structured so as to encourage the Government to press forward with complementary reforms along the lines suggested below and resist the strong domestic pressures to reverse the economic opening process.

13. Secondly, the human resource base, though well developed in terms of literacy levels, needs to be further adapted to the requirements of an open economy. One of the central traits of Uruguay's upper and middle management levels--both public and private--is its grounding in academic values that are not always best-suited to the pragmatic, problem-solving needs of a modern society. Bank involvement through technical assistance in various projects and, more recently, through a vocational training and technological development project, has only just begun the task of modernising the educational system.

14. Thirdly, Uruguay has not yet achieved the degree of institutional development required to assure self-sustaining growth, although with the Bank's help some significant progress has been made. Bank-supported power, telecommunications, and ports projects are gradually transforming three of Uruguay's oldest and most poorly managed agencies into modern institutions. Longstanding assistance to the livestock sector gave birth to a high-quality extension service. Two recent industrial credit projects established an independent appraisal unit that is rapidly becoming a model of public sector project evaluation and technical assistance to industry. Bank lending to highways has promoted the development of a transport planning capability that hitherto did not exist in Uruguay. Yet, the fact remains that, in broad terms, the institutional capacity for public sector planning and management, agricultural research and crop support services, and export marketing remain fragmented and ineffective. In fact, the lending program proposed below is chiefly the outcome of the Bank's own economic, sector and operational work over recent years, as the Government has not yet prepared a comprehensive, multi-year public investment program. For this reason, the authorities have requested that the Bank consider providing technical assistance to strengthen project identification and appraisal leading gradually to the formulation of a public investment program with sound economic justification. Pending a clearer definition of the Government's own development priorities, the authorities have also requested that a certain flexibility be incorporated into the Bank's own lending program, allowing for future substitution of certain projects. It is proposed to provide the Government with such assistance and to allow for some project substitution, provided that any new projects emerging from our dialogue meet the criteria explained below and that the loan amounts involved not exceed those outlined in the attachment to this memorandum. In principle, the projects listed in the "reserve" category would meet these conditions.[1/]

1/ Projects are classified as either "regular" or "reserve". The latter are projects which would only become part of the lending program if any of the "regular" projects had to be dropped.

15. The proposed lending program (annex) derives justification from its strong project linkage to Uruguay's key unmet institutional development needs. Without the proposed Bank involvement, progress toward solving the country's major institutional bottlenecks is likely to be significantly delayed, if not neglected altogether. Breaking these bottlenecks should enhance Uruguay's capacity to sustain satisfactory growth. Processing of the proposed lending program would be predicated on the restoration of consistent macroeconomic policies, particularly with respect to the harmonization of current fiscal, wage, trade and exchange rate policies. Similarly, the lending proposed for each sector will hinge on success in reaching agreement on adoption of the individual sectoral policies outlined below. Developments in these areas will be closely monitored and reviewed regularly with the authorities in order to assure the continuing appropriateness of the Bank's lending posture.

Criteria for Disengagement and Development Prospects after Graduation

16. It seems likely that Uruguay's future comparative advantage will lie in two major areas: (i) in the primary production and industrialization of agricultural commodities, including livestock (beef, mutton, wool, and milk) and by-products (leather apparel, shoes, etc.) and selected crops (rice, wheat, barley, etc.); and (ii) in the exporting of various services (tourism, banking, transportation, etc.). Promoting these activities will require: (a) greater economic integration internally as well as with neighboring countries in the region, (b) a strengthening of the private sector, particularly in agriculture, industry and services, (c) further reduction in the distortionary effects of exchange rate, tariff, tax, subsidy, and regulatory measures, and (d) a strengthening of those public functions, such as investment in infrastructure and manpower training, which support private sector development. These are the areas in which Bank lending can continue to provide useful support.

17. During Uruguay's graduation phase, the Bank's lending effort would focus on maintaining the momentum of the economic opening process. This does not necessarily mean that, once graduated, Uruguay will have achieved levels of institutional or human resource development fully comparable to those attained by earlier Bank graduates from the OECD area. The Government and the Bank have opted to focus on achieving basic institutional development in the sectors of greatest comparative advantage and in the most critical factor resource area--human capital--while acknowledging the risk that Bank lending to Uruguay may end before institutional development becomes self-sustaining. Consequently, the option of furnishing follow-on Bank assistance will be kept alive, chiefly through further sector and project preparation work.

18. In contemplating the phase-out of the lending program, the Bank would limit its involvement to those areas where: (i) there ~~is~~ reasonable potential for the sector or institution to develop on a self-sustained basis after Bank disengagement; (ii) there is good potential for achieving significant institutional or policy improvement through Bank financial and/or technical assistance; and (iii) the targeted sector is instrumental in overcoming the development constraints referred to above. With this in

mind, the program that is proposed here envisions limited Bank participation in new sectors and no further involvement in telecommunications and ports (other than intensifying project supervision, so as to ensure adequate follow through on institutional development, the preparation of future investment programs, and pricing policy improvements.) Similarly, only one more operation is programmed for highways, power, and IDF, respectively, over the coming five years. These operations are intended to consolidate reforms already initiated as part of ongoing projects and increase the share of cofinancing in these sectors. Bank efforts would accord priority to agriculture and education. However, overcoming institutional constraints in education could prove to be a major task. Below, the specific objectives to be sought in each sector are described.

Sectoral Activity and Strategy

19. Agriculture is and will continue to be the mainstay of the Uruguayan economy. Although the contribution of this sector to GDP and employment is relatively modest, its importance as a foreign exchange earner and a supplier of raw materials to domestic industry is fundamental. Whereas the sector generates only around 15% of GDP and directly employs less than 20% of the labor force, agricultural raw materials go into products accounting for more than 85% of export earnings.

20. Policy instability has heightened producer uncertainty, leading to the abandonment of some past improvements in production technology, and a reduction in the near-term potential for major output growth. Until now, the Bank has concentrated on the livestock sector with a heavy emphasis on strengthening producer incentives and ranch management. Bank involvement was instrumental in setting up a solid extension/appraisal institution and, more recently, in supporting Government efforts to formulate a series of reforms related to the livestock sector. These reforms, announced in August 1978, represented an important initial step toward reducing official intervention in pricing and marketing, and enhancing the role of market forces. However, because of their limited scope, and the cautious way in which they have thus far been implemented, the reforms have not yet had the desired impact on long-term agricultural development.

21. Future agricultural loans would be contingent on obtaining the Government's commitment to broaden the reforms (e.g., by enhancing the role of the private sector in meat export operations) and would be aimed at diversifying output. In the livestock subsector, emphasis would shift downstream to the processing stage where the meatpacking industry continues to suffer from the effects of past government intervention. Investments are needed to override the sanitary barriers in major consumer markets to which Uruguay has no access at present and to promote Uruguay's reintegration into the major world beef-marketing channels via greater foreign investment in domestic meatpacking. This is an area where both the Bank and the IFC might play constructive roles. To reduce the ranchers' heavy dependence on meat markets, the Bank would promote diversification into dairy products via improvements in the rural feeder road system, the expansion of the power distribution network within major milk producing regions, and the provision of medium-term production credits. Intensified livestock/crop rotation techniques would be promoted through credits,

strengthened crop-oriented research services, and comprehensive extension. The proposed projects would, thus, help not only to stabilize producer incomes, but also to enhance productivity and retard soil erosion. Experience derived from an on-going agricultural development loan, including a study being financed by the loan, should throw light on the prospects for intensifying small farmer production.

22. Despite the high literacy rate in Uruguay, the educational system suffers from a number of problems, chief among them being its limited responsiveness to the rapidly evolving manpower needs of a more open, internationally competitive economy. A modest start in addressing this problem is being made through a vocational training and technological development project. However, the problems go beyond this area, involving the entire educational system, particularly at the secondary level. Inadequate curricula, lack of adequately trained teachers, antiquated equipment, and inadequate administrative and financial controls are the principal weaknesses identified in the Bank's recent sectoral review. A secondary education project is proposed to help rectify these problems, provided agreement can be reached on the specific changes that are required. The proposed project would support a recent government decision to establish new secondary training facilities providing for direct placement into the labor market.

23. Uruguay's tariff reduction program has introduced large-scale competition from foreign imports into the economy for the first time since the 1930s. In the process, serious deficiencies in private entrepreneurial capacity have become evident. Adjustments in managerial thinking, working styles, and planning will, therefore, be necessary. Managers, whose training has heretofore centered on classical and general studies, are not fully equipped to seize upon rapidly changing opportunities generated by the world economy. Accordingly, it is proposed that the Bank assist in financing the establishment of a new institute that would train private entrepreneurs and managers in the use of modern techniques of business administration.

24. Uruguay depends heavily on imported oil, which supplies nearly two-thirds of total energy requirements and accounts for about one-third of total imports. A key government objective is to speed the replacement of petroleum with hydropower and natural gas through the expansion of transmission and distribution networks in tandem with the hydroelectric projects now coming on stream and with growing Argentine surplusses of exportable gas.

25. A key element for successfully carrying out such a program will be the strengthening of UTE (the country's electricpower company). Under the Fifth Power Project, currently in execution, UTE undertook commitments to engage management consultants and accounting advisors, carry-out a tariff study based on marginal cost criteria, start a study on distribution losses, formulate a training program, engage additional professional staff, and review its salary structure. In most of these areas, the results achieved so far are satisfactory, so that the proposed new lending operation would be designed to finance needed physical plant, and follow up on institution-building objectives. A prerequisite for further Bank

lending to the power sector will be satisfactory action on tariffs to meet UTE's growing investment requirements, an area where the Government has so far failed to take suitable action.

26. For the last two years, the authorities have been discussing a gas pipeline project with Argentina. Provided gas supplies can be contracted on satisfactory terms, the project promises considerable benefits mainly by substituting natural gas for more expensive fuel oil. The Government is also considering a further search for off-shore oil along the coast of the River Plate, provided that a review of seismic data now underway gives reasonable indications of favorable prospects in the area, and assuming that suitable arrangements can be worked out with foreign oil companies to undertake the exploration. While Bank financing of the gas pipeline itself may not be called for, financing for investments needed to convert major oil users to natural gas (mainly the Government's refinery, gas and power companies) may be in order. Initial Bank involvement would be geared toward strengthening the project preparation and, if possible, inducing other parties to finance the project. Accordingly, a reserve energy project for oil exploration and gas conversion has been included in the program.

27. Increased attention to the petroleum sector will also be necessary in view not only of the heavy dependence on oil imports, but also the key role of ANCAP, the state-owned petroleum company, in shaping energy investment and planning, and the distortionary effects of current petroleum pricing policies on the pattern of domestic energy demand. Discussions are now underway between the Bank and the Government concerning the optimal design of a refinery modernization feasibility study being financed by ANCAP. This feasibility study will need to take into account the nation's projected supply and demand of energy in all forms, the potential for inter-fuel substitutability, the role of the petroleum refinery sector, the energy pricing system, and ANCAP's institutional and financial situation. The aforementioned energy reserve project might, therefore, include a refinery modernization component. Eventual Bank financing of this component would be conditional upon arriving at a favorable assessment of the possibilities for constructive Bank involvement in the broader issues of petroleum usage and ANCAP planning and management.

28. The Bank has made two loans for industrial development, both designed to help speed the transformation of industry from a predominantly inward-looking and protected sector to an export-oriented one. The second industrial loan was linked with the tariff reduction program enacted in December 1978. It provides for a review and analysis of the progress achieved in reducing tariffs and in promoting a healthy restructuring of industry, thereby assuring that the loan proceeds will have the maximum beneficial impact on the adjustment process. The project includes assistance in establishing mechanisms for project evaluation in the Ministry of Industry and for project preparation and promotion within the banking system. Industrial credit should continue to be provided through a follow-up IDF operation, supporting efforts (i) to achieve import liberalization goals beyond those set out in the December 1978 framework decree and (ii) further the transformation of the domestic banking system into an efficient mechanism for providing medium and long-term industrial

credit through actions easing legal and institutional constraints on multi-service banking and improving the functional usefulness of bank reporting systems to savers, borrowers and shareholders. This operation will also need to take into account how effectively sectoral and macroeconomic policy tools, such as exchange rate management and financial market liberalization, are being used and how they are affecting the industrial adjustment process.

29. It is proposed to present a last highway project to help finance the country's first four-year highway investment program (prepared under an ongoing project). In this operation, the Government and the Bank intend to focus on improvements that will optimize the overall development benefits of the entire road system, including for the first time, the establishment of a national feeder road program. Technical assistance will focus on strengthening the Transport Ministry's institutional capacity to evaluate and prioritize road investments. This evaluation process does not exist now and is unlikely to emerge without Bank involvement. An extensive bridge strengthening program and pre-feasibility work on the operation of an intermodal transport facility are additional elements in the proposed project not dealt with in prior highway projects that will help Uruguay to develop as a regional transport corridor (between Argentina, Paraguay and Brazil), thus increasing the country's integration into the regional economy as an exporter of services as well as goods. Finally, the project will provide technical assistance to the state railway system for the purpose of establishing a cost accounting system. This system could assist railway management in identifying unprofitable rail services and restructuring tariffs so as to reduce heavy system operating losses. In view of the urgent need to rationalize rail services and strengthen the system's investment planning capability, a reserve railway project has been included in the lending program.

Lending Program Magnitudes, Trends and IFC Objectives

30. In constant US dollars, the lending program for FY83-87 is expected to be some 40% below the actual lending over the past five fiscal years (FY78-82). The process of disengagement can be observed in the five-year accumulated level of commitments (last line of attached table) which, after reaching a peak in FY83, falls significantly thereafter. The lending program is reduced from almost $40 million in FY84 (1982 prices) to $15 million in FY87. Finally, the proposed average loan size in FY83-87 will be $22.9 million in nominal terms, compared to an actual average of $29.2 million in FY78-82. In constant 1982 prices, the reduction is even more pronounced: from $32.7 million actual in FY78-82 to a proposed $19.5 million in FY83-87. This implies an increased reliance on cofinancing (possibly halving the share of Bank lending as a proportion of total external financing anticipated in ongoing projects) and on Government contributions for project financing. The Bank will propose cofinancing possibilities for the highways and power projects and, wherever possible, for agricultural projects.

31. Provided that the current problems involving cost-price distortions and excessively high real interest rates can be overcome, the climate for private investments seems likely to improve, and more active

IFC involvement in Uruguay could be contemplated. Priority will be given to investment opportunities in export-oriented sectors where the country has demonstrated a strong competitive potential, such as leather, wool, textiles, fishing, agroindustries, and services such as banking and tourism.

Implications for Country Economic and Sector Work (CESW)

32. To provide a more detailed basis for the policy recommendations referred to above, the proposed CESW program for FY82-84 would be relatively extensive. A special study is at present being carried out to examine the existing production and marketing framework for crops, comparable to the study of policy issues already done for the livestock sector. Together, the two will enable the Bank to offer comprehensive policy recommendations and to pursue a fully-integrated agricultural lending strategy. Secondly, the sector-wide assessment of industrial export prospects completed in FY81 will be followed by a micro-firm survey of the corporate adjustment strategies being developed in response to import liberalization. This survey is being financed under the Bank-supported IDF II loan and will be analyzed in a sector memorandum.

33. With respect to the public sector, the Government has instituted a number of accounting and procurement reforms in recent years. However, qualitative deficiencies persist in the way projects are identified, selected, and managed. At the same time, mounting wage costs and social security liabilities have forced a recent series of cuts in public investment expenditures, which, if continued, could leave the country with inadequate infrastructure to support vigorous private sector growth. For these reasons, a study of the role of the public sector and administrative practices and how they affect competition and growth in the private sector is planned for FY83-84. It should eventually support the Government and the IMF in their current discussions about establishing a preinvestment system designed to pass judgment on the economic justification of public investment proposals.

34. With regard to economic integration, some internal work was done in the Bank in 1979 on the potential for converting Uruguay into a corridor for intermodal transhipments. It also highlighted the urgency of shifting the focus of future investment efforts toward optimization of the economic benefits of the national road network. A survey aimed at formulating more specific recommendations in these two areas will be carried out during this period.

35. Finally, in light of the recent sharp deterioration in Uruguay's economic situation (see paras. 7-10 above), there is a need for close monitoring of short-term developments. We propose to achieve this through economic missions in close coordination with the IMF. Two such missions have already been undertaken in the current calendar year.

A. W. Clausen
President

opulation : 2.9 million (1980)
NP per capita: $2,820 (1980)
lteracy : 94.0% adult pop.

URUGUAY - ACTUAL AND PROPOSED LENDING PROGRAM THROUGH FY-87
(In Millions of US Dollars)

		Through	Actual						Program					Total	Total	Total	Total	Reserve
		FY76	FY77	FY78	FY79	FY80	FY81	FY82	FY83	FY84	FY85	FY86	FY87	FY72-76	FY77-81	FY82-86	FY83-87	Projects
griculture and Livestock	IBRD	71.7				24.0					20.0		20.0					20.0(85)
ower and Energy	IBRD	82.0				24.0				30.0								58.0(85-86)
ndustrial Development and Export Expansion	IBRD	35.0					30.0					30.0						
ocational Training, Technological Development and Education	IBRD			9.7						15.0	5.0							
ransport	IBRD	18.5			26.5	50.0			40.0									30.0(87)
elecommunications	IBRD							40.0										
ending Program	IBRD	207.2		9.7	26.5	98.0	30.0	40.0	40.0	45.0	25.0	30.0	20.0	56.0	164.2	180.0	160.0	
	No.	13		1	1	3	1	1	1	2	2	1	1	4	6	7	7	
ending Program in Constant FY82 Commitment Dollars				12.3	32.0	112.3	32.1	40.0	37.5	39.8	20.8	23.6	14.8	125.6	188.7	161.7	136.5	
ommitment Deflator (82=100)				79.0	82.9	87.3	93.4	100.0	106.6	113.2	120.0	127.2	134.9					
ccumulated five-year Lending Program								228.7	253.9	261.7	170.2	161.7	136.5					

Attachment B

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Operations Policy Subcommittee (through Mr. Nicolas Ardito Barletta)

May 11, 1982

FROM: Enrique Lerdau, Director, LC2

SUBJECT: URUGUAY - Graduation Lending Program

1. Pursuant to Mr. Stern's approval of the proposals outlined in our memorandum to him of February 25 (i.e. prior to the institution of the new procedures for Graduation Papers), Mr. Schloss and I held discussions with the Uruguayan Government on the basis of an edited version of the aforementioned memorandum. The Government subsequently confirmed the substance of our understandings to Mr. Ardito Barletta. The authorities took the view that, given the policy decision adopted on graduation by the Board, the approach, conditions and specific lending program suggested in the paper was generally acceptable. They, however, expressed three areas of concern, to which we responded and propose to handle as described below.

Flexibility of Graduation Period

2. While admitting that, in the interest of evenhanded international comparison, there was no superior option than that of using a base average exchange rate to measure GNP in a common currency, the authorities enquired about the degree of flexibility planned in applying the five-year graduating period. The question was prompted particularly in view of the significant lag in the rate of depreciation of the Uruguayan peso against the U.S. dollar during recent years, which had raised significantly the country's U.S. dollar-denominated per capita income. They pointed out that, in light of international recession (in particular in neighboring Argentina) and the recent Uruguayan decision to accelerate the depreciation of the peso, the country might well fall below the per capita income level that triggers the graduation period in coming years. Furthermore, the authorities expressed concern that increasingly restrictive monetary policies affecting major international capital markets, coupled with the country's own economic management problems, might also constrain Uruguay's access to external sources of finance.

3. I indicated that, should either of these two factors persist for any significant period of time (i.e. for two years or more), consideration could be given at that time to lengthening the graduation period. The Uruguayans agreed that transitory factors should not lead to such a review and that, other things being equal, the five-year graduation period would prevail, even in the eventuality of slippages in processing loan proposals for project reasons.

Lending Program Flexibility and Technical Assistance

4. The authorities agreed with the sector and project composition of the lending program, but noted that, in the absence of any Government effort to prepare a systematic public investment program, it was necessarily the product mainly of the Bank's own economic, sectoral and operational work. Furthermore, they noted that with the likely change of Government

anticipated during the coming years, it would be difficult for the current administration to take a definite position on certain projects, particularly during the outer years of the program. Accordingly, they enquired as to the degree of flexibility in substituting projects and about the prospects for Bank technical assistance in project identification, appraisal and formulation of a public investment program.

5. As to the former, I pointed out that projects could be substituted, provided that they satisfied the criteria and constraints on total lending spelled out in the paper. Moreover, we noted that the projects listed in the reserve category already satisfied those conditions in principle. It was agreed that the lending program table would be spelled out in terms of operations for the sectors concerned, without identifying the specific project proposals. Regarding the need to develop a process for project identification and preparation of a public investment program, we agreed that there was an urgent need to enable the Government to pass judgement on the merits of investment proposals--particularly in view of future fiscal constraints. We summarized the kind of technical assistance that has been provided by the Bank in such cases as Paraguay, and suggested that the authorities review the proposals contained in the Bank's public sector report of 1979 and in a subsequent proposal for a preinvestment system outlined by a Bank-financed consultant. We also agreed to continue our support to the IMF work leading towards a possible extended facility financing, and to entertain in that context proposals for appropriate technical assistance for public investment planning. Finally, I confirmed that graduation from the Bank did not imply simultaneous graduation from IFC.

Board Presentation.

6. The authorities inquired about how the proposal for Uruguayan graduation would be conveyed to the Board, with particular reference to the concerns highlighted above. I indicated that, while there were no precedents for this type of presentation, I expected that a paper would be distributed to the Board along the lines of the document discussed with the authorities, suitably amended to incorporate the authorities' views. I promised that the Board paper would be shown to the Government prior to its distribution. I attach the draft paper which, upon the Operation Policy Subcommittee's approval, is proposed to be sent to the Government for final comments and ensuing distribution to the Board.

Distribution

Mr. Stern (Chairman)
Operational Vice Presidents
Mr. Vergin, PAB
Mr. Waide, DPS

cc: Messrs. Ruisanchez, Vice President, CLAVP
van der Meer, Director, LCP
Assistant Directors, LCP
Division Chiefs, LCP

MSchloss:cj

cc: SC
dE
AS

Mr. Nicolas Ardito-Barletta, LCNVP June 29, 1982

Ernest Stern, SVPOP

Graduation Paper on URUGUAY

I have no problem with the basic approach in this paper and think it is suitable for discussion with the Government. However, as a Board paper it seems to me to provide excessive detail and would have to be slimmed down but this can be done after discussions with the Uruguayan Authorities.

Specifically, those post-discussion changes should include:

a) The deletion of the last portion of para 14 because it is unnecessary to obtain Board approval of the specific project composition and we therefore do not need to alert the Board to the fact that there may be project changes.

b) I do not believe it useful to show the lending Annex which is referred to in para 15.

c) Paras 16-18 sound as if we were just starting operations in Uruguay instead of finishing them. In particular, I do not believe we should stress self-sustaining institutional development since nobody knows what that means, and institutional development may be described by many factors over which we would have no control in any event. The last sentence of para 17 should be deleted.

d) The project detail in para 18 is excessive and the penultimate sentence in the last para seems to lay the basis for continuing lending which cannot be the intention.

e) In para 21, in the third sentence, I suppose it should say "investments are needed to meet the sanitary requirements etc".

f) Para 23 is astonishing. This generalised indictment of all managers cannot be true, and if it is, the establishment of an institute of business administration will not help any time soon. This subject it seems to me could be profitably deleted.

g) There is too much project detail in paras 26 and 27.

h) There would seem to be no reason why we should finance an oil exploration project. Moreover, the reference to inappropriate pricing policies quite understates a major problem.

i) The third and fourth sentences in para 30 should be deleted.

j) The discussion of the potential IFC role in Uruguay is very weak.

k) Para 33 - it is unclear how a study in 1983-84 can support current discussion between the Government and the IMF.

l) Para 34 - lets find other language for "converting Uruguay".

m) Para 35 - I have long suspected that there is too much staff time being spent on monitoring all short-term development even in countries which hardly qualify as major borrowers. Rather then advertise a continuation of this practice, we should stop it.

cc: Mr. Lerdau
Mr. Waide

(Dictated by Mr. Stern over telephone from airport)

m. Humphrey

OPS File

wrt 7/16

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Members of the Operations Policy Subcommittee

DATE: July 15, 1982

FROM: Sidney E. Chernick, CPD

SUBJECT: Higher Education in Developing Countries: Initiating Brief

The Operations Policy Subcommittee will meet on Wednesday, July 28 at 9:30 a.m. in Room E-1208 to consider the attached paper prepared by the Education Department.

Attachment

cc: Ms. Pratt
Messrs. van der Tak
Aklilu
Waide

HIGHER EDUCATION IN DEVELOPING COUNTRIES
INITIATING BRIEF

Background

1. Since it began operations in the Education Sector two decades ago, the Bank Group has provided loans and credits for higher education [1/] of about US$1.2 billion for projects costing close to US$3.0 billion. This amounts to almost 40 percent of total Bank Group lending in the Education Sector.

2. While all Bank Group lending to higher education has been justified on the basis of country needs for high level manpower - teachers, professionals and higher technicians - the Bank Group has explicitly supported the broader objectives of higher education in research and in the international transfer of technology. Some of the more recent examples are the education projects in China and Korea. The acceptance of broader objectives for lending for higher education is an implicit recognition of the increasingly important and varied role which higher education plays in economic and social development.

3. The increased participation by institutions of higher education in development over the past two decades has done much to change the ivory tower image with which they had been identified in the past. This increased participation has been due to efforts on the part of the countries to integrate the universities more into the search for solutions to national development problems, as well as to the efforts of the universities themselves to become more "relevant" to the societies which they serve. In addition to producing highly trained manpower, the universities have become increasingly involved in research in agriculture, industry, socio-economic issues, management and questions of the environment and appropriate technology. This involvement in turn helps to promote the external efficiency of their programs of education and training. They have established increasingly close links with other universities within and outside their countries in the exchange of scholars and knowledge and in cooperative research efforts, thus enhancing their ability to undertake their expanding responsibilities in development.

The Need for a Subsector Paper

4. The attention which the Bank has given to higher education policy has been less than would be expected, given the volume of our lending and the interests of borrowers in the subsector. Moreover, in explicit recognition of the widening role of higher education in development, the subsector is featuring more prominently in development plans and, in a few countries such as China, Korea and Nigeria, has a very high priority.

1/ The term "higher education" is defined in a broad sense to include all formal post-secondary education and training.

5. Under conditions where both country and Bank resources are becoming increasingly scarce and competing claims are mounting, there is a need to be more explicit about Bank policy toward this subsector. This need is amplified by the recent shift in relative priorities both within the Bank and among some donors in favor of primary and basic education in support of a variety of development strategies, but most prominently those emphasizing equity, rural development and the alleviation of poverty. However, there bas been insufficient appreciation of the key contributions which universities can make in support of these strategies.

6. The need for clarification of Bank policy is also underscored by the relative unit costs of higher education as opposed to other levels of the system. Typically, unit costs of higher education are 100-150 times the unit costs of basic education and investments in higher education must therefore show correspondingly higher economic and social benefits. However, a substantial and growing part of the actual and potential benefits of higher education are in forms not easily captured in economic analysis. Clear guidelines are required on how these might be taken into account to assure an appropriate balance in the development of education systems as a whole.

7. The Bank is not in as strong a position as it should be to conduct thorough policy dialogues with borrowers on higher education. The normal contacts of Bank staff in operations are with ministries of education which, normally, are not responsible for universities. As a consequence, there is less familiarity on the part of Bank staff with the problems and needs of higher education. Some elaboration of Bank policy, the identification of common problems and issues and the provision of broad guidelines would assist Bank staff in their work.

8. In a variety of ways, all Bank activities have implications for higher education. A large proportion of projects finance overseas fellowships and technical assistance to help remedy shortages of high level manpower, raising the question of whether governments and communities at large are making full use of higher education resources or whether these resources have been fully developed. The stronger the intellectual capital available within the country the more informed and effective the Bank/country dialogue on economic and sector work would be and the greater the role which can be played by borrowers in all phases of the Bank's lending operations. Our borrowers vary widely in the range and depth of the intellectual capital that they have at their disposal and these variations stem, in part, from the scale and patterns of development of their higher education systems. Within many of these systems exist individuals and teams of exceptional ability by any standards whose expert knowledge of their own countries is a resource which should be tapped by development institutions. In some sectors in some countries such a resource is not available and in these cases well designed programs to help institutions of higher education to improve their capability and to be involved where possible in training, research and consultancies in development activities would be useful. Guidelines are required

for Bank staff that will promote the use and development of university-based resources by both the Bank and its borrowers; these guidelines should reflect the diversity of conditions found in higher education among our borrowers.

9. There is a widespread feeling that some countries have overinvested in higher education while others have underinvested or have designed their higher education programs in ways which do not contribute substantially to development needs.

10. Over the past twenty years, the Bank has accumulated significant experience in the design and implementation of higher education projects particularly on matters of curriculum development and staff upgrading. It is now appropriate to assess the Bank's past experience and, on the basis of "lessons learned", to articulate more precisely Bank policies and strategies for the future.

Objectives of the Paper

12. The proposed paper has the following objectives:

(a) to provide an overview of the development of higher education in less developed countries during the last two decades and the expanding role which it plays in the development process;

(b) to identify the major issues which have attended the growth and expanding role of higher education institutions in development. These issues fall into several categories:

(i) institutional and informal arrangements designed to promote and facilitate relationships with other institutions of higher education and with the public and private sectors in pursuit of development goals whether through training or research or other outreach activities;

(ii) external efficiency in meeting national high level manpower requirements; the scope, scale and content of higher education appropriate to this goal;

(iii) internal efficiency; the cost-effectiveness of higher education programs;

(iv) national priorities; balance between education and other sectors, balance between levels of the education system itself;

(v) finance; the burden on governments and the community, and means of financing, including cost-recovery schemes; and

(vi) access and equity; the relative benefits accruing to different socio-economic groups and to the society and economy as a whole from higher education, and

(c) on the basis of an analysis of issues and the Bank's experience, to suggest a strategy and guidelines for the Bank's future role and assistance in the sub-sector.

Scope and Organization

13. The paper will contain three sections:

a) the first section will provide a global perspective on the development of higher education during the last two decades and set the scene for the subsequent discussion of policy issues. The section will highlight the growing importance within less developed countries of the efforts to harness the resources of universities to help in providing services to national communities not only in education and training but also in research and consultancies and as links with the latest developments in their respective disciplines. It will also contain a short overview highlighting the diversity and range of the institutions, enrollment patterns and trends, resources allocated to the sub-sector (staff, students, budgetary allocations), etc.

b) The second section will analyse the most important issues which have emerged in the development of higher education in developing countries. These issues include the relationships between higher education, on the one hand, and government industry and the community, on the other hand; managaement and governance; cost-effectiveness; financing, and access and external efficiency.

(i) The Framework for Cooperation. Major trends in university development include greater roles in addressing national problems through programs of research and training. Institutional arrangements are needed to promote the interaction between the university and the outside world and among the universities themselves; organizational arrangments internal to the university are needed to ensure that the internal (teaching and research) and external (advisory and consulting) functions are complementary rather than competitive. A second issue concerns the funding and support needed to promote these arrangements and to initiate and sustain some of the research and outreach activities.

(ii) Management and Governance. Managing institutions of higher education has become increasingly difficult because of their large size, but also because of the increasing number of their functions and the growing complexity of their relationships with international and national institutions. University administrators and managers must provide an improved accountability, usually to governments, for public resources which are committed to them, in the face of growing politicization of their institutions and a need to protect traditions of academic freedom.

(iii) The Cost-Effectiveness of Higher Education. There is considerable need and, often, considerable scope for reducing the costs of university programs. The need is made urgent by the scarcity of financial resources and the opportunity costs of higher education, particularly when measured in terms of the development of other parts of the education system. Some of the specific issues are the teaching loads; adequacy, utilization and maintenance of physical plant; appropriateness or inadequacy of investments in libraries and information retrieval systems, and the planning capabilities within the institutions of higher education. The paper will discuss possibilities of more efficient use of staff and facilities and educational technologies and of better management and planning.

(iv) Financing. The paper will outline experience and trends in the total and unit costs of higher education and set these findings in the context of the ability of countries to finance them. Further, the paper will review experience with respect to alternative schemes for financing higher education, including student loan schemes and other cost recovery methods and identify the more important issues which have arisen.

(v) Access and External Efficiency. While many systems of higher education have become far more open and inclusive in terms of access through admissions policies, extension programs and "open university" schemes, serious questions continue to be raised about the equity of the distribution of opportunities for higher education among different social and income groups. Part of the equity issue is its costs. Greater inclusiveness often means lower standards, expensive remedial work at the university level and lower internal efficiency because of high repeating rates. Using new data and analysis derived from recent research, including a major Bank-sponsored study, the paper will attempt to shed light on this controversial issue.

(vi) Higher education systems are responsible for the education and training of the professional manpower required in every sector of the economy. The supply of trained manpower is influenced by a complex set of factors such as the wage structure, the "brain drain" and the quality of training. It is commonly agreed that in many countries, higher education systems are now producing more graduates in the humanities and some social sciences that can be absorbed into appropriate employment. Conversely, many countries claim that there are severe shortages of manpower in the science and mathematics based professions. Given these and other employment and manpower considerations, there are differences of expert opinion on the appropriate scale of higher education in poor countries and the balance which should be sought between different levels of the education system. The proposed paper will summarize the most current research findings on these issues and their policy implications.

c) Based upon the discussion and analysis in the first two sections of the paper, the final section will be concerned with guidelines for Bank staff in dealing with the subsector and Bank policy, specifying objectives and the means by which the objectives are to be achieved.

Work Completed and Additional Staff-Time Requirements

14. A series of "in-depth" studies on selected issues (namely, cost benefit, financing, selectivity, and internal efficiency) have been prepared. The proposed sub-sector paper will draw on the principal findings of these studies. Shorter papers focusing on specific topics are planned to fill existing gaps (e.g., on the role of private universities in Latin America and the Arab World, assessment of developing countries' experience with cost-recovery strategies).

15. The Department plans to allocate 25 staff weeks to the formulation of the paper in FY 83. A preliminary draft is expected by April 15, 1983 for staff level review.

16. The consultations undertaken with outside experts and professional bodies during the preparation of the education sector policy paper proved to be extremely useful. Similar consultations will be undertaken for this paper with selected experts and higher education institutions in developing as well as developed countries.

Education Department
June 28, 1982

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

Mr Humphrey
File w/Att 6/14

TO: Members of the Operations Policy Subcommittee DATE: June 14, 1982

FROM: Sidney E. Chernick, Assistant Director, CPD

SUBJECT: Agenda for June 16 OPSC Meeting - Review of Training in Bank-Financed Projects

Attached is an agenda of issues for discussion at the June 16 OPSC meeting.

Attachment

cc: Ms. Pratt
Messrs. Habte
Waide

OPERATIONS POLICY SUBCOMMITTEE

June 16, 1982

Agenda

Management Comments on OED Review of Training in Bank-Financed Projects

A. General Comments

1. Does the OPSC agree on the general approach taken by the Education Department's response - that with the few reservations noted, the OED Review findings "substantially accord with the findings of the Bank", that regional and OPS reactions have "generally been positive", and that the report "gives support to many of the developments in policies and procedures which Bank management has been pursuing?"

2. The OED Review recommendations, illustrated by many of the individual project examples OED describes in detail, criticize the continuing inadequate attention given training components during all stages of project development and implementation. While noting improvements, OED suggests the Bank gives far too little emphasis to the "human factor" (e.g. para. 28 (i)). Sound guidelines and policies exist in many areas but are not, apparently, consistently carried out - in some cases due to staff constraints, in others to staff and managerial neglect. (e.g. OED Review, Section VI, pp. 49-60)

   (a) If the OPSC agrees that the Review presents an accurate picture, are the measures contained in the recommendations and response adequate to correct the situation?

   (b) Should senior regional managers review this Review's findings and recommendations directly with regional staff to help assure increased priority is given to the issues raised?

B. Selected Specific Issues

1. Human Resource Development in CESW. OED suggests (para. 26 (a)) more intensive attention to human resource constraints in development of country strategies. For example, the OED Review states that "economic reports emphasize economic performance without sufficient acknowledgement of the urgency of removing human resource constraints upon national development" (para. 6.06). Should management's response be more explicit in acknowledging these weaknesses and emphasize our intention to correct it by more forceful management follow-up?

2. Organization and Staffing. OED recommends (para. 26 (d)) that the regional education divisions be brought more into operations which involve training, while maintaining a central operational support unit. The EDC response (para. 3.16) notes the three major staffing alternatives discussed in the past several years: (i) using education divisions to deal with training, (ii) placing training in each projects division, and (iii) strengthening the Central Training Unit in OPS/EDC. The response states that a substantial role for the Training Unit will be needed "at least in the near future" while building up regional staffs; in this connection, OPS supports OED's recommendation for increased use of education divisions rather than adding training staff to projects divisions. Does the OPSC agree? Are specific

regional reviews of the adequacy of staff resources devoted to training needed?

3. Fellowships. OED recommends (para. 26 (i)) much greater use of fellowships; the proposed response is more cautious based on "general Bank experience" (para. 3.07). What is the basis for these different perceptions? Should the response explain management's reservations more precisely to help staff understand when fellowship programs are most appropriate? Are existing guidelines and management attention adequate to achieve the desired increase - albeit selectively - in fellowship use?

4. Appraisal and Supervision Reports. Does the response (paras. 3.09 - .13) reflect OPSC consensus on the need to strengthen specific attention to training in these reports? In this section, the response emphasizes the need to treat human resource issues "adequately and appropriately", to exercise "selectivity", and to interpret and apply the guidelines in a "practical manner"; are there too many qualifications?

June 11, 1982

OFFICE MEMORANDUM

WHT 7/9

TO: Members of the OPSC

DATE: July 1, 1982

FROM: Sidney E. Chernick, S.E.C. Assistant Director, CPD

SUBJECT: Comparative Analysis: Operations Organization Models

The Operations Policy Subcommittee will meet on Wednesday, July 7 at 9:30 a.m. in Room E-1208 to consider the attached paper prepared by the Organization Planning Department.

Attachment

cc: Ms. Pratt
Messrs. van der Tak
Rohrbacher
Waide
J.P. Evans

June 30, 1982

Comparative Analysis: Operations Organization Models

1. Some time ago, Mr. Stern asked the Organization Planning Department (OPD) to inventory the various initiatives that had been undertaken within the Operations complex relative to organization and methods and to suggest how the development emanating from them might be evaluated and utilized. In response, OPD has produced the attached paper which Mr. Stern has reviewed. He has asked that it now be circulated for discussion by the Operations Policy Sub-Committee.

2. In the paper OPD has identified, as a result of preliminary discussions with Program Coordinators and other staff, that there are some 35 initiatives being taken by different organizational units of the Bank which are likely to have an impact on organization structure, processes and procedures, staffing levels and allocations. OPD has therefore proposed a project to:

- monitor the ongoing and new Operations-wide and regional initiatives and to provide assistance as appropriate;

- analyze and examine the completed studies, or work in progress for long-term studies individually and collectively, and to assess whether or not they offer any approaches that are fundamentally better for accomplishing Operations work; and,

- develop approaches for capturing experience and disseminating "lessons learned" to other interested parties.

3. OPD stresses that it does not see itself in any way in a control role nor does the Department have the staff to provide substantive support to each and every project even if it were invited to do so.

4. The objective in putting the paper before the Operations Policy Sub-Committee is to gain acceptance of and support for the project and, more importantly, the agreement of the members that they are prepared to share their experience with other units of Operations and the Bank. This sharing of experience must lead in many cases to improvements in the organization structure, processes and procedures and the use of staff resources.

June 16, 1982

OPD 115: COMPARATIVE ANALYSIS - OPERATIONS ORGANIZATION AND PROCESSES MODELS

PROJECT BRIEF

A. Background

1. Over the past year, OPD staff have become increasingly aware, as a result of various contacts with Operations staff, of the Operations staff concerns over the continued appropriateness of existing organization structures and processes for carrying out operations work. Following a discussion of this between Messrs. Stern and Rohrbacher, OPD conducted a brief, limited survey of the level of regional and Operations Policy Staff activity on these matters. The survey identified some 35 studies (or improvement projects) currently active in the Operations complex (see Annex 1). All of these studies have either process and procedural, organizational, staffing, or management information implications.

2. A first assessment shows that some ten of these studies could have an Operations-wide impact. The balance are more limited in scope and potential although discussions with Regional Program Coordinators and others indicate that even these could be of broader interest to staff outside the initiating region.

3. The 35 studies fall into a number of categories:

- organizational studies which are aimed at modifying organizational units within the existing basic overall Operations structure to improve the way in which the current work methods and programs are carried out;1/

- reviews of processes and procedures, again of the way in which the current work methods and programs are carried out, with the objective of improving productivity and quality;

- more fundamental studies, which question either the current organizational arrangements or basic processes and procedures or both. These studies review the overall work programs in the light of changing plans in terms of volume and product mix;

- studies which attempt to address the more nebulous concepts of "communication" and "coordination".

1/ And in some areas to take account of reduced work programs and staffing levels.

All these studies are likely to lead to some modification of the processes and/or the organization structure of units within which they are being conducted.

B. Problem

4. These initiatives should be viewed positively since they show the increasing interest of regional and OPS management in making changes to improve productivity and to enhance quality. But there are two concerns:

- There is no Operations-wide mechanism for evaluating the costs, benefits, and implications of these proposed changes and selecting solutions from among them that might be replicated elsewhere; and

- The process of identifying and exchanging information on worthwhile structural or process improvements needs to be improved.*

C. The Project

5. The proposed project will have three objectives:

- to monitor the ongoing and new Operations-wide and regional initiatives and to provide assistance as appropriate;

- to analyze and examine the completed studies, or work in progress for long-term studies individually and collectively, and to assess whether or not they offer any approaches (i.e., organization and/or process and procedures "models") that are fundamentally better than present arrangements for accomplishing Operations work; and

- to develop approaches for capturing experience and disseminating "lessons learned" to other interested parties.

These three objectives are interlinked. We believe OPD has a comparative advantage particularly on the second objective, where we can bring to bear an independent perspective on organization and process analyses.

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* One element is in place: the OVP meeting and its wide circulation of minutes; but these, by themselves, are insufficient to determine applicability of an initiative throughout the Operations complex.

6. As a first stage, OPD will carry out a more comprehensive diagnostic review of ongoing and planned activities and, at the same time, will develop a suitable method for evaluating the content and potential impact of particular studies. Based on this analysis, projects will be categorized as follows:

- projects with potential high-impact on an Operations-wide basis;

- projects with limited impact, but likely to be of interest Operations-wide;

- projects with potential high impact in the specific Region, or OPS, but of limited impact elsewhere;

7. For those projects with a potentially high impact on an Operations-wide basis, where OPD does not yet have a project, OPD will determine, with the lead organization involved, the most appropriate way to assess the project's broader implications. This may entail direct project participation, e.g., on a Task Force or Steering Committee.

8. This close involvement on the key projects, as well as a broader analysis and review of the remainder, should enable OPD to identify one or more preferred approaches for organization structure and process improvements and their rationale as well as the conditions and prerequisites (and the potential dangers) of making possible changes. This in turn should help facilitate senior management decision-making on organization and procedural changes and provide an overall framework for and assessment of certain organization and process models.

9. It must be stressed that the intention of the study is not to provide a new, outside control mechanism; this already generally exists in other ways. The underlying theme is to identify the most usable, generally applicable, and cost beneficial approaches from among the many initiatives under way and to ensure their dissemination through a more formal review and transfer process.

D. Timing and Approach

10. This effort would initially cover the first six months of FY83. At the end of that time, end products would be:

(a) a proposed methodology for regularly monitoring, reviewing, and disseminating key themes and outcomes of Operations change/improvement efforts;

(b) a survey of the results of work to date in the current round of "open" Operations projects and an identification and analysis of key innovations and developments that should receive wider dissemination/discussion in the Operations Complex;

(c) a proposal on further work in the project (if at that time viewed as appropriate) during the remainder of FY83.

11. The project would be led in OPD by John Evans. Both Richard Lynn and Bruce Rohrbacher will provide overall departmental supervision. We would expect to use other OPD consultants from time to time for analytic duties as well as liaison with the various Operational units and managers. At a minimum, we would ask for an SVPOP office counterpart for continuity and a coordinating point of contact in each vice presidency, perhaps the Program Coordinator or equivalent.

JPEvans/RBLynn/BWRohrbacher:hb

Notes

Each identified project has been given a title designed to indicate briefly its content. The client or originator of the work is given below with a measure of OPD's involvement as follows:

**:	Indicates that OPD is relatively heavily involved.
*:	Indicates that OPD has an advisory role and that OPD's involvement is unlikely to exceed a few staff days.
OPD/S.C.:	Indicates that OPD is on the Steering Committee.
-	Indicates that at present OPD has no involvement.

The date given in the right hand side of the box shows the expected completion date.

OPD 115 - PRELIMINARY PROJECT LIST
Updated to June 1982

GENERAL: OPERATIONS-WIDE

REGION - WIDE					
Location of Railway Staff Baum/ Stern 6/82 *	Location of Power Engineers PMD On hold OPD/TAS	Improvements in Project Processing - Project Implementation Review Stern Adler(PAS) 6/82 -	Review of Support for Field Offices Stern (Paijmans) On-going *	Update Loan Officers Handbook Stern In abeyance *	Restructuring Economist Positions 1/ Stern 6/82 **
Cofinancing Org. & Processes Stern Essentially complete **	Operations Org. Stern 6/82 **	Role of Legal Department in Project Cycle Golsong 6/82 **	Division Chiefs' Information System Stern 6/82 *		

1/ Operations-wide - Restructuring Economist Positions.

Report on country economic and sector work in Eastern Africa submitted to SVPOP in May 1982 and subsequently discussed with RVP AEN.

OPD 115 - PRELIMINARY PROJECT LIST
Updated to June 1982

OPS	EASTERN AFRICA	WESTERN AFRICA	EMENA	LAC	EAST ASIA & PACIFIC	SOUTH ASIA
Organization and Management Review of PHN Evans In abeyance; planned for restart *	Use of Country Teams Wapenhans (?) Task Force	Reorg. of Transportation Division on country basis Knox 6/82 - OPD/TAS	Reorg. of Agr. & Transportation Divisions Picciotto 7/82 - OPD/TAS	Programs/Projects Relationship Ardito-Barletta 6/82 LAC T.F. OPD/TAS	Role of Asst. Projects Directors Husain 12/82 T.F. *	Mgt. Structure and Procedures - Overall Review[4] Hopper 8/82 ASA T.F. *
	Review of Resident Mission Zaire Wapenhans 6/82 *	Cofinancing Regime Study Knox 9/82 OPD/TAS	Review of Appraisal Procedures - Agr. 3 Ritchie (?) -	Lending Process Review Ardito-Bartletta (?) LAC T.F.	Role of Projects Director[1] 12/82 -	New Delhi Office Review Hopper New rev. likely to follow Mgt.Str. Review *
	Review of all Field Offices Wapenhans (?) -		Organizing for Cofinancing Chaufournier Not Sch. -	Front Office Mgt. Systems Ardito-Bartletta (?) LAC T.F.	Realignment of the Role of RMB Husain Program Coord. Imple. OPD/TAS	Organization for Cofinancing Hopper (?) -
	Review of Country Eco. & Sector Work Wapenhans Imple. -			Economic and Sector Work Ardito-Bartletta (?) LAC T.F.	Mgt. Info. Systems - DIVINFO[2] Husain Imple. -	
				Review of Circulation Lists Ardito-Bartletta Perez (?)	Establish an Economic Data Base[3] Imple.	
				Design and Content of Reports Ardito-Bartletta Wessels (?)		
	Review of Role of ADS and APMU Wapenhans/Knox 8/82 OPD/SC					

Notes

1/ East Asia and Pacific - Role of the Projects Director.

This is not as yet a study but is likely to become an issue when the role of the Assistant Projects Directors is reviewed in the Fall 1982.

2/ East Asia and Pacific - Management Information Systems.

This is largely a training exercise for a system already established in the IDF Division.

3/ East Asia and Pacific - Establishing an Economic Data Base.

Further details will be sought when the Program Coordinator returns from leave.

4/ South Asia - Management Structure and Processes.

This blanket project masks many smaller organizational issues which the region is addressing. These include the number of agriculture divisions, the future of the Education and Agricultural Institutions Division, a split of the Energy and Water Supply Division with Water Supply going to the Urban Division.

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

MB
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OPS sub-committee
papers
[illegible]
6/29

TO: Members of the OPSC

DATE: June 28, 1982

FROM: Sidney E. Chernick, Assistant Director, CPD

SUBJECT: Science, Technology and the World Bank of the 1980s

Attached is an agenda for the June 30 OPSC discussion of this subject. Also attached for your information are minutes of a May 13 staff review of a previous draft.

Attachments

June 28, 1982

DRAFT AGENDA

OPSC Meeting - June 30, 1982

on

Science, Technology and the World Bank of the 1980s

1. The PAS paper notes many Bank accomplishments in science and technology; it states that the current activities are modest, however compared to the potential, and urges a "long-term expansion of current efforts" and "an explicit policy concerning science and technology" (para. 2.29).

- Do OPSC members agree that scientific and technological development should be a higher priority objective and have a more prominent place in Bank work?

- To what extent is this feasible given existing staff constraints? What are the prospects for adopting the paper's recommendations selectively, depending on regional, country and sectoral priorities, and still remaining within existing staff allocations?

2. The paper suggests that the Bank should do more toward establishing a science and technology base in borrowing countries (para. xxii ff). This links to previous OPSC discussions (e.g. re: OED's training report) on the need for more systematic attention to human resource development in Bank-supported programs.

- How can efforts in these two areas most effectively reinforce each other?

3. The paper suggests increased lending for research, development and pilot tests, and increased attention to the choice of technology and to the building of local capability at all phases of the project cycle (para. xxii).

- Does the OPSC agree? What opportunities do members see in this regard?

4. The paper proposes that the Bank make research grants in science and technology (para. xxix - xxx).

- Does the OPSC agree that this is desirable? Does it see a need to support global research systems? Should a separate research budget be set up for science and technology, or should it be integrated with the existing (economic) research budget, possibly expanded for this purpose?

5. The paper proposes greater attention to science and technology in Bank public relations (para. xxx-iv).

- Do OPSC members agree? Is there a danger of raising expectations excessively?

6. If the OPSC agrees with the broad thrust of the paper, what should be the next steps?

OFFICE MEMORANDUM

TO: Files

DATE: June 25, 1982

FROM: Alexander Shakow, CPD

AS

SUBJECT: Minutes of May 13, 1982 Staff Review of PAS Paper: Science and Technology and the World Bank of the 1980s

Participants: Messrs. van der Tak (Chairman), Rajagopalan (PAS), Weiss (PAS), Andersen (WAP), Bronfman (EAP), Brown (IND), Donaldson (AGR), Drysdale (AEP), Fouad (IFC), Glaessner (LCP), Habte (EDC), Hartigan (IFC), Hennin (PAS), Hultin (EDC), Imam (PAB), Khanna (IND), Nishimizu (DRD), O'Brien (AEA), Van Holst Pellekaan (AEP), Perram (IND), Pritchard (ASP), Schrenk (AEN), Shakow (CPD), Sheehan (EGY), Ms. Stitt (IPA), Messrs. Stewart (EMP), Waide (CPD), Willoughby (TWD).

1. The Chairman opened the session by suggesting that discussion focus on the substance of the paper - on its general assessment of science and technology issues and its broad recommendations (summarized in the front of the paper) rather than arguing over the staff and budgetary implications. The latter would have to be confronted but at a later stage. The PAS authors emphasized that the intention of the paper was to establish a long-term framework for increased Bank activity in science and technology, expanding upon the considerable amount of productive and effective work already underway albeit in a rather cautious and unsystematic fashion.

2. Given the wide ranging coverage of the paper, the different interpretations of science and technology, and the specialties of many of the participants, the focus of the comments (most of which were quite supportive of the paper and its objectives) tended to vary widely. There appeared to be consensus on the following major points:

i) Increased attention to advances in science and technology (however interpreted) is extremely important to both borrowers and the Bank itself. While LDC resources were scarce, this should not be used as an excuse to do less - a case could be made that proper attention to science and technology could enhance the use of scarce resources.

ii) While much important work is going on in the Bank already - some of it described very well in the PAS paper - there is a good deal more that could be done, in many cases at low cost in both staff and financial terms. Finding those appropriate steps in each sector is an important objective.

iii) Bank staff creativity is often limited by failure to take advantage of new advances in science and technology; many staff are not aware of even the knowledge and progress described in the PAS paper and need to be brought up-to-date. Staff tend to use old technologies too often without exploring alternatives.

iv) The paper focuses on two distinct aspects of Bank work - most critical is the need to help borrowers establish indigenous capacity to know about, adapt and apply scientific and technological advances. LDCs want access to new developments - even though they may not be prepared to borrow for the necessary infrastructure - and if the Bank's investments in development are to be sustained, strengthening of the human resource capacity of the borrowers is required. This reinforces the need to pursue not only the establishment of agricultural research institutes, for example, but more attention to national science policies and training in basic sciences and other human resource fields (including the social sciences) which ultimately permit countries to benefit from scientific and technological advances on their own.

v) Despite agreement on point iv), most speakers noted that Bank project and sector work attention to human resources and science and technology took second or third place to other priorities. For example, support for agricultural research as components of projects tended to receive little supervision and attention as they were often small parts of larger projects.

vi) Bank sector missions and reports offered the best opportunity to introduce increased attention to science and technology issues in a specific context, thereby helping to formulate programs of the type described in the PAS paper. (Economic sector work was considered to be less effective for this purpose given the need for sectoral expertise.) It was agreed that especially broadly gauged and able people were required, however, to do this work and that they were not in plentiful supply.

3. Thus, there was general enthusiasm at this review for the importance of the subject and the value of the PAS paper. There were also areas of concern, as follows:

i) Despite the Chairman's opening constraint on discussion of budget and staff limitations, some speakers (and memoranda received after the meeting) stressed that to the extent this paper called for an increase in staff time to be devoted to another set of topics ("a new activity"), it could not come at a worse time given staff reductions and administrative budget constraints. To the extent that the proposed approach could be considered selectively as an extension and adjustment of existing work - as the authors and others suggested - there might be ways to move ahead on science and technology more quickly (as had already occurred in some areas). How much time there was for a systematic approach now - however desirable as a long-term goal - was questioned.

ii) There were mixed reactions to the idea of setting aside a special fund of money for research and special projects for science and technology.

iii) The authors were urged to strengthen the science parts of the paper, as many thought it received less emphasis than the technology issues.

iv) Questions were raised as to whether a special science and technology program might not skew scarce Bank resources to countries at the upper end of the income spectrum, as poorer countries were less able to take advantage of new advances given resource and institutional constraints. It was suggested that country economists might be asked to identify bottlenecks to country growth prospects to test this hypothesis. The authors indicated their belief that innovative technologies and adaptations were essential in poor countries as well.

v) The role of the small science and technology advisor's office in PAS was praised for its world view, but several speakers also urged increased in-depth assistance on new technological advances in several sectors - especially energy and industry.

4. The Chairman indicated the paper would be revised in light of the comments at this session and then sent on for review by the Operations Policy Sub-Committee.

Cleared by: Messrs. van der Tak
Weiss

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

OPS/MC82-22

TO: Files

DATE: June 24, 1982

A Shakow

FROM: Alexander Shakow, CPD

SUBJECT: Minutes of Operations Policy Subcommittee Meeting of June 16, 1982

Present:

Members: Messrs. Stern (Chairman), Ardito-Barletta, Chaufournier, Goldberg, Husain, Knox, Kraske, van der Tak, Vergin, Wiehen, Wright

Others: Ms. Pratt, Messrs. Habte, Swahn, Chernick, Kopp, Horsley, Shakow

Review of Training in Bank-Financed Projects - Comments on OED Report No. 3834, March 1, 1982

1. OPSC members generally found the OED Review a balanced and constructive commentary on the treatment of training and human resource issues in Bank projects, and EDC noted that many of the OED recommendations were now being implemented. The Chairman indicated that he found training components often to be the least well-prepared parts of projects and that they were seldom placed in a broad enough sectoral or long-term context. Several members commented that regional attention to training issues had increased recently and improvements in design and implementation of training components had occurred, but members agreed that more emphasis was needed along the lines contained in OED's recommendations and the EDC response.

2. OPSC members endorsed OED's emphasis on the importance of more systematic planning of Bank training programs as part of a careful examination of the borrower's human resources situation. Country Program Papers (CPPs) should give greater attention to this subject in designing overall Bank assistance strategies, but sector strategy papers provided an even better vehicle for this purpose as they could cover the subject in more depth.

3. In discussing staff and organizational issues, the OPSC agreed that the Training Unit in EDC would continue to be required, but a prime objective should be to strengthen regional capability to provide support for training components in projects. If new staff were assigned to this function they would be placed in the regions. While regional education divisions would be expected to undertake significantly increased support services, members agreed that ultimate responsibility for design and implementation of training components in Bank projects will remain with the appropriate project divisions.

4. The Chairman asked PAB to assure that the training support function be explicitly reviewed during the next budget cycle. One possible way to assure adequate attention to training components in project preparation and supervision might be to transfer to the budgets of the

education division and/or the EDC Training Unit the number of staff weeks needed for this purpose. It was also noted that education officers may naturally tend to focus more on design of education projects than support for training components in other projects, despite the importance of training and the significant share of Bank lending it represents. Proper balance in deployment of staff should be part of the budget review.

5. The Chairman suggested that each region prepare a brief statement on how the training support function would be organized in the future to assure it receives greater attention. This should include developing, with EDC, strategies on where resources should be concentrated given our inability to cover all areas simultaneously. Enhanced capacity in agricultural training was considered by some to be the highest priority, but priority areas should be determined by regional management in light of lending program plans.

6. It was agreed that in addition to the steps noted above, the OED Review, the EDC response (revised as necessary to reflect the OPSC discussion), and the OPSC minutes should be used as the basis for regional staff meetings to stress the importance attached to the careful design and implementation of human resources and training programs.

Cleared by: Messrs. Chernick
Swahn

AShakow/ww

Mr. Humphrey
OPS/MC 82-21

OFFICE MEMORANDUM

TO: Files

DATE: June 21, 1982

FROM: Alexander Shakow, CPD

SUBJECT: Minutes of Operations Policy Subcommittee Meeting of June 9, 1982

Present:

Members: Messrs. Stern (Chairman), Chaufournier, Goldberg, Kirmani, Knox van der Meer, van der Tak, Vergin, Wapenhans, Wiehen, Wright

Others: Mrs. Hughes, Messrs. Yudelman, Waide, Chernick, Duncan, Scandizzo, Horsley, Kopp, Ms. Pratt, Mr. Shakow

Bank Group Financing of Tea, Coffee and Cocoa

1. The OPSC reviewed a memo which proposed an interim procedure for lending decisions on tea, coffee and cocoa while awaiting the design and testing of a new approach which would include global cost-benefit analysis at an early stage of project identification. (This proposal emerged from discussions between EPD, AGR and others in the Bank in response to the July 15, 1981 OVP decision to restrict lending for these commodities.)

2. The OPSC agreed that the proposed Interim Guidelines should be modified so that they can serve as a statement of current policy. First, to simplify the cocoa conditions, the guidelines will read:

> "8. The Bank will finance projects involving production of cocoa only if they will not lead to increases in exports. Exceptions will be made for projects meeting normal Bank criteria only - i) in countries where the output level is much below historical levels due to major disruptions in production patterns, or ii) in low-income (i.e. IDA-eligible) countries without economically viable alternatives."

(This eliminates a provision in the draft which required that exceptions meet normal Bank economic rate of return criteria "even after discounting the projected world price by 50 percent", a condition OPSC members thought was unnecessarily arbitrary.)

3. Second, the members clarified the proposed panel review system and agreed that appraisal missions for projects involving these crops should not leave until there is agreement between the relevant project department, EPD and AGR that the project meets the interim lending guidelines. This agreement, achieved as early in the project cycle as possible, should be reflected in the final project brief before appraisal. The attached Interim Guidelines reflect these OPSC decisions.

4. AGR, in consultation with EPD, is preparing a new methodology to extend existing economic rate of return analysis to allow for the impact of Bank-financed projects on the real income of producers and consumers in other developing countries. While the OPSC agreed that the proposed study of a new methodology should proceed, members expressed skepticism as to the ultimate feasibility and usefulness of this approach. Members were especially concerned about the implications for other commodities - e.g. iron ore - also facing inelastic demand: where would the line be drawn once an explicit methodology was used to measure impact on other countries of Bank projects? Members were thus unsure that such an approach, even if the data and technical aspects proved manageable, would help significantly in making project decisions. In addition, it was noted that indirect Bank assistance to these crops in the form of road or water projects would not be judged using this methodology.

On the other hand, AGR and others noted the possibility that the methodology, once prepared and tested, could be helpful to project decisions - and only when a proposal had been prepared could a judgment be made. It was also pointed out that such a methodology could help Bank policy advice on prices, tariffs, etc. and increase the consistency between Bank lending and policy advice.

5. In summary, it was agreed a) that the attached guidelines (Annex A) would serve as a restatement of existing Bank policy on the three commodities, and b) that AGR, in consultation with EPD, ERS and the regions would prepare and test the methodology for global cost-benefit analysis for tea, coffee and cocoa; when it was ready (estimated to be within the next 6 months) it would be sent through the normal review process for consideration by the OPSC. At that time, any proposed changes in policy and procedure would be considered.

Attachment

Cleared by: Mr. Stern

AShakow/ww

ANNEX A: LENDING GUIDELINES FOR BANK GROUP FINANCING OF TEA, COFFEE AND COCOA PROJECTS

1. This note sets out the procedure to be followed for all projects, including comprehensive rural development projects, which include significant production of tea, coffee or cocoa. Before appraisal teams leave Washington, AGR EPDCE and the relevant Projects department will agree (and reflect in the project brief) that the project adheres to these lending guidelines.

Tea

2. Consistent with existing Bank guidelines,[1/] the Bank Group will not finance projects involving production and processing of tea, except for:

i) increases in output in countries with no investment alternatives yielding an acceptable rate of return; and

ii) rehabilitation involving no increase in output (this implies a reduction in acreage and encouragement to diversification).

Projects for diversification out of tea production will be encouraged where economically feasible, particularly in countries with large shares of the market. If an effective International Tea Agreement is negotiated, financing of increased production can take place within the framework of the Agreement.

Coffee

3. The Bank Group should normally not lend for coffee projects, except:

i) for crop diversification out of coffee and for rehabilitation of plantings affected by sudden and recent damage by disease or weather, for quality improvements or for new plantings which replace output from other areas; and

ii) such projects should be undertaken only if they do not lead to increases in total production in the borrowing country in excess of projected increases in (a) domestic consumption plus (b) International Coffee Organization (ICO) quota exports plus (c) exports to non-ICO countries.

4. Almost all coffee-producing countries are members of the International Coffee Agreement and are therefore subject to export quotas. For small coffee-producing countries (i.e. producing less than 400,000 bags of 60 kg. annually), the rate of expansion of their export quota is specified in the Agreement. For other countries, export quotas are set annually by the International Coffee Organization, but their long-term expansion is determined by the growth in world import demand.

1/ Bank Group Financing of Tea, Board Paper, August 17, 1973; reaffirmed in Bank Financing of Tea: A Reappraisal, February, 1979.

5. Application of the above guidelines would mean that domestic consumption and export growth must be forecast for each potential borrowing country, with exports including those to non-ICO countries as well as to ICO-importing members. It also means forecasting the future growth of production in each potential borrowing country, to determine if future production is likely to be in harmony with expected total demand. Such forecasts are already provided by EPDCE.

6. According to the most recent Bank analysis of the coffee market (reported in the Technical Annex to the draft Policy Paper) 1/, world production of coffee cannot grow on average faster than about 1.3% per annum for the next 10 years if the intervention "floor" price is to be maintained at its present level in real terms. For the time being, this should be the norm against which the expected production of each potential borrower is assessed, with appropriate allowances made for ICO export quota allocations, for export growth to non-ICO countries and for potential growth in domestic consumption.

Cocoa

7. There are no export quotas within the International Cocoa Agreement (ICA). The ICA seeks to stabilize prices by buffer stock purchases and sales. Unlike the Coffee Agreement, the ICA does not cover all significant producing and exporting countries.

8. The Bank will finance projects involving production of cocoa only if they will not lead to increases in exports. Exceptions will be made for projects meeting normal Bank criteria only i) in countries where the output level is much below historical levels due to major disruptions in production patterns or ii) in low-income (i.e. IDA-eligible) countries without economically viable alternatives.

June 21, 1982

1/ T. Akiyama and R. Duncan, Analysis of the World Coffee Market, EPDCE, November, 1981, annexed to World Bank Group Financing of Tea, Coffee, and Cocoa, EPDCE, February, 1982.