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ENERGY and INDUSTRY
STAFF

| Vice President: Vacant |
| Total HL Staff: 230 |

| Energy Department |
| Director: Churchill * |
| Total HL Staff 90 |

| Industry Department |
| Director: Golan |
| Total HL Staff 132 |

Lending Program Managed by EIS	FY81-85 Annual Average	FY86 (est.)	FY86-88(est.) Annual Average
Energy ($million)	726.4	237.1	605.5
Number of loans/credits:	14	6	11
Industry ($million)	1,094.6	1,024.7	1,261.0
Number of loans/credits:	18	15	16

Operations Supervised by EIS

Energy			
Supervision Portfolio ($million)		4,328.6	
Number of loans/credits in Portfolio		91	
Industry			
Supervision Portfolio ($million)		6,912.5	
Number of loans/credits in Portfolio		114	

Attached

1. Overview of EIS functions
2. Major issues in industry
3. Major issues in energy

* As of July 1, 1986.

EIS Overview

The Energy and Industry Staff consists of two Departments -- Energy (EGY) and Industry (IND) -- and is a central project and policy staff which services the six Regional Vice Presidencies in the following areas: (a) development of projects (large and medium-size industries and mines, telecommunications, oil and gas, coal) as agreed for the country lending programs; (b) formulation of Bank strategy and policies in the energy, industry and finance sectors; and (c) functional review of operational activities of the Regional Industrial Development and Finance Divisions and Regional Energy Divisions (which are mainly responsible for power operations and sector work).

Since the Bank has been responding to the fast changing world economic situation, the EIS work program has been reshaped in the following respects to reflect the changing priorities in developing countries and the changing composition of the Bank's operations:

(i) On the industrial side, operations now emphasize improving the productivity, efficiency and financial performance of existing state-owned enterprises (SOEs) through physical rehabilitation and technical assistance rather than lending for new industrial or expansion projects. Most of EIS's current industrial operations stress rehabilitation and improved plant efficiency. At the same time, EIS has started developing, in a small unit, staff capability for new approaches to carrying out thoroughgoing restructuring and/or privatization operations which promote fundamental structural and policy changes in the state enterprises sector. Two examples of this are a Hungary operation which is scheduled for approval this fiscal year and a Turkey project scheduled for FY87. Further, with the assistance of consultants, EIS is developing an operational methodology for the restructuring and the privatization of major SOEs.

(ii) EIS is attempting to increase significantly the catalytic impact of its lending by attracting private capital, particularly, but not only in oil and gas. This would be done primarily through joint venture operations with private industry and parallel financing of infrastructure. A project generation task force was set up in the Energy Department and has identified prospective joint venture operations and established working relationships with international oil companies. The first results are expected in FY1987.

(iii) On policy and sector work EIS has refocused its efforts toward issues of economic adjustment. It has presented policy papers in such areas as financial sector and business environment reform to improve the performance of public and private enterprises. These initiatives, however, are recent and are just beginning to be incorporated in the work of the Regional staff.

A major new challenge is to evaluate the impact of the present oil price decline on our borrowers' investment and other development strategies, and to recommend optimal courses of action. In response to this, EIS is now analyzing potential action plans that would provide guidance to countries attempting to respond to this new situation. It is also beginning a study of the problem of national oil company response to structural changes in the petroleum industry brought on by the price drop.

The objective of EIS policy and operational work program, which is discussed in greater detail in the attached Energy and Industry notes, is to assist the process of structural reform at the enterprise as well as the sectoral level, and help countries find ways to reduce their debt burdens both by attracting non-debt capital flows and by reforming those public enterprises which have seriously contributed to the countries' debt burden and budget deficits. The following are the principal issues which have arisen in connection with EIS efforts to carry out the Bank's program in these areas:

Restructuring operations -- projects involving the restructuring/privatization of large state-owned enterprises are complex and difficult operations in which the Bank has limited experience. While it has traditionally provided a good deal of assistance to improve enterprise operations, it has not -- until now -- addressed major changes in enterprise structure, ownership, decision-making practices, business environment and relationship with governments, which must be addressed if the deep-rooted causes of inefficiency are to be eliminated.

The upcoming EIS-managed restructuring operations have taken time to launch. Part of the problem is in getting a strong government commitment to action in this difficult area. But there are also internal Bank obstacles. In order to design responsive and effective operations, the Bank must be able to take advantage of favorable circumstances -- windows of opportunity -- during which reform can be initiated and implemented with a high probability of success. This may require that decisions by the government and the Bank on restructuring SOEs be taken without the benefit of a full analysis of inter-sectoral and/or broader policy issues, which is the normal Bank approach. Also, the Bank's approach to country issues sometimes impedes a quick response. Responsibility for determining the appropriate country assistance strategy rests with the Regions while EIS is responsible for managing individual operations, this division of labor, while necessary, tends to slow decision-making. Appropriate sensitivity to political issues and the fact that adjustment involves many difficult political choices of which enterprise restructuring is only one, can lead to differences of view on the timeliness of raising with governments the possibility of thoroughgoing restructuring activities that would entail significant modifications (or in some cases elimination) of state enterprises.

Privatization -- in many cases it is essential that government be prepared to consider partial or complete privatization of state-owned enterprises as part of an overall restructuring solution; in the absence of a willingness to consider some privatization, it is likely that many of the fundamental causes of state enterprise inefficiency will not be adequately addressed. While privatization is not a universally applicable remedy, the Bank must be able to identify situations where it should be an essential part of the restructuring formula and be prepared to pursue this sensitive political issue with the government concerned.

Catalytic lending -- Projects in the energy and industry sectors hold much potential for attracting private equity investment as well as debt financing based primarily on the project's creditworthiness. EIS efforts to promote catalytic lending have taken the form of (i) establishing better working relationships and regular contact with international companies, and (ii) designing and structuring projects to facilitate private participation. But, to date, no such operations have been brought to fruition. The requirement of the Bank's Articles that its loans must have a government guarantee necessarily involves the government, and new approaches have to be developed to permit the Bank to support non-government guaranteed private investment. These approaches must be closely coordinated with the Finance complex, the IFC and MIGA.

Staffing -- the type of program outlined above requires a strengthening of staff skills by introducing investment banking and private industry experience. We have been moving in this direction but the reshaping of the staff skills mix is a slow process that can only be accomplished over the medium term.

In summary, EIS has been working in its sectors to develop tools for increasing World Bank support to our borrowers' efforts to resolve their structural problems. The restructuring/privatization approach is likely to be a key element in the success of reform programs, but this will require two important changes in Bank operations: (a) a capacity for quick analysis focusing on critical changes in the institutions and the policy environment capable of bringing early improvements; and (b) a change in the public sector orientation of the Bank, toward a better balance between the public and private sectors, which is rooted in its charter. This is not a matter of ideology, but a matter of adapting to the current environment and requirements of heavily indebted LDCs, which need much greater mobilization of private equity capital, both domestic and foreign.

Industry Department

The Industry Department has two basic functions: (a) responsibility, as a central operating projects department, for direct Bank lending for large industry (e.g., mining, fertilizers, textile and chemical manufacturing industries) and telecommunications projects in all regions; and (b) responsibility, as a central sector policy department, for formulating Bank strategy and policies in industry and finance sectors and for functional review of operational activities of the regional Industrial Development and Finance Divisions.

The key areas receiving particular focus in our current lending and policy work are highlighted below.

A. Industrial Projects

In the past, IND lending focused on large and medium projects aimed at expansion of capacity of individual state-owned enterprises. It has started moving away from this approach toward improving efficiency of existing capacity and tackling of subsector issues. Since EIS was set up in 1983, IND has pursued policy work on the issue of restructuring in response to the fiscal pressure within developing countries. The key challenge facing the Bank in this area is to support the development and implementation of effective restructuring programs for key enterprises, industries, and, in some instances, the entire industrial sector. These programs must necessarily be framed in the context of essential improvements in the policy/institutional framework, the overall business environment and economic policies, to ensure sustained efficiency of industrial enterprises--public and private. EIS has emphasized that issues of reducing the role of governments through direct intervention and excessive regulation be given special attention. In light of their mounting burden on state budgets, central role in the industrial sector and the importance of improving their efficiency in increasing the competitiveness of the entire economy, the restructuring of public enterprises requires priority attention. Options of corporate restructuring, liquidation of non-viable enterprises and privatization wherever feasible, are a very new area for the Bank. Effective actions in these areas can only be based on strong commitment at the highest levels in the countries and prompt and strong support on the part of the Bank. The design of restructuring operations, including the restructuring/privatization of public enterprises, will need to rely on an appropriate mix of policy actions and managerial, physical and financial restructuring of key enterprises.

To give a major impetus to its effort to reorient its operations along the lines discussed above, EIS has established in the Industry Department a special division to concentrate exclusively on developing and testing alternative operational approaches to sector and corporate restructuring and to the sensitive issues relating to privatization. Regional divisions (Industrial Development and Finance, Programs) are also paying increasing attention to this subject; specialized units have been established to address public sector management issues. While some experience has been gained in this area, the Bank is facing a major challenge as to how to evolve customized operational approaches, while ensuring overall consistency across different countries and regions, at a time when a large number of independent Bank units are involved in this new activity, for which the need is almost limitless.

B. Bank's Activities in the Financial Sector

In July 1985, the Board approved a policy paper on Financial Intermediation. The policy paper analyzed the overall poor performance of the majority of the one hundred or so Development Finance Corporations financed by the Bank. The paper highlighted the need for a substantial change in the Bank's objectives and strategy in the financial sector and in the nature of its operations. It emphasized that the Bank must focus not just on the end user of its funds (e.g., the industrial and agriculture sub-borrowers), but rather on the overall operations of the financial system. At this moment the most pressing issues in finance are: (a) to develop restructuring programs for the many Bank-assisted financial institutions and their clients which are effectively bankrupt; (b) to assist countries to mobilize domestically more resources to finance their investment; (c) to help construct a financial system capable of channeling resources to the more productive (private) investments; and (d) to mold programs of financial reform with programs for reform in the productive sectors in a manner that does not destabilize the economy. We are now assisting the Regions in strengthening their implementation of the strategy outlined in this policy paper, and developing new operational approaches. We are in the process of substantially strengthening our staff capabilities in this area.

Energy Department

The Energy Department (EGY) has two principal functions: (a) responsibility as a central operating projects department for direct Bank lending for oil and gas operations including refinery development and rehabilitation (the Regional projects departments are responsible for power projects); and (b) responsibility as the central policy department for the energy sector for formulating Bank strategy and policies in that sector and for functional review of Regional power activities.

The recent dramatic drop in oil prices is the principal issue now confronting the Energy sector and the work of the Energy Department. The present environment is one in which oil prices are likely to be unstable in the short term and may harden somewhat in the longer term. Uncertainty is the main feature facing the sector at the present time. The Department is responding to this situation by refocusing its lending (to favor sectoral adjustment operations) and by devising country policy action plans aimed at assisting countries to benefit from or avoid the negative impacts of the oil-derived developments in the world economy. For oil exporting developing countries, the problem is one of how to maintain growth in the face of falling export revenue, and how to restructure their national oil industries to be better able to cope with the new market requirements and the increased importance of investment and production costs. The issues for oil importing developing countries will be how to take advantage of the opportunities offered by this new price scenario. Importing countries will also need to consider restructuring their energy institutions to make them more productive and less costly, and generally more responsive to competitive forces in an environment of potentially volatile energy prices.

EGY Operational and Policy Initiatives

Substantial Bank oil and gas lending began in 1980 and averaged about 12 operations for $640 million per year through FY1985. In FY1986, lending has dropped to 6 operations, primarily because of uncertainty in the sector. EGY has been reassessing the issues and constraints impeding development of the oil and gas sector in LDCs to define better the catalytic role that the Bank could play in the oil and gas sector and identify potential investment opportunities. New lending guidelines were introduced in 1985, giving greater emphasis to promoting private or joint public-private sector development. In addition, a study has been prepared on specific financing techniques which could be applied in supporting private investment in energy resource (gas) development for domestic use. Finally, EGY is about to begin an evaluation of national oil companies' operations, how to adapt them to a dramatic decline in income and how to improve their efficiency.

On the <u>operational side</u>, in addition to sectoral adjustment, EGY will focus its attention on developing catalytic operations that facilitate private investment in oil and gas development. From a situation of hostility up to 1983, our discussions with private oil companies indicate that they now welcome a role for the Bank. On the <u>policy side</u>, EGY will concentrate on formulating action programs to provide guidance to countries to adapt to the new market situation, and on reviewing energy sector investment programs and providing policy advice for institutional strengthening, restructuring and privatizing of state-owned energy sector enterprises where appropriate. The policy issues that will be of particular importance in energy will be:

Energy Sector efficiency: National Oil and Coal companies that were enjoying high energy prices need to improve performance, and be exposed to competitive pressure. The Bank will seek to assist in this restructuring effort. The Bank intends to continue to help in promoting new institutional frameworks for expanding foreign private investment in the petroleum sector, wherever this is to the long run interest of the LDC.

Interfuel substitution: Power generation investment decisions will be particularly influenced by issues of interfuel substitution. New investment plans will need to be analyzed with a critical eye to more flexibility in primary energy sources, to take account of the uncertainty in prices.

Exploration and development of oil and gas: Lower oil prices will cause both major international oil companies (IOCs) and national oil companies (NOCs) to greatly restrict their outlays for exploration and development, even for good prospects. There will, therefore, be a trend towards more selectivity and lower financial commitments in IOC exploration programs. If the LDCs that have exploration potential wish to avoid a collapse in their exploration programs, they will have to (a) make more attractive areas available to IOCs, (b) negotiate more flexible contracts, providing for better returns during periods of low prices, but allowing the country to recapture a larger share if prices rise dramatically, and (c) allow IOCs more flexibility in their work commitments. World Bank involvement should give IOCs greater confidence in entering into contractual arrangements with LDCs.

Gas utilization and transport: Because of the large initial investment required for gas transport systems lower energy prices have narrowed the scope for new natural gas developments that require long distance transport systems. Gas development will require careful consideration of project timing as well as technical and financial design, and efficient project implementation.

Rural energy (fuelwood): In a large number of developing countries the search for cheap household fuels among growing populations has led to fuelwood shortages and serious deforestation. This requires a dual response - at a scale far greater than has been the case in the past - both to reconstitute and expand fuel wood supplies, and to switch to viable alternate energy sources. Lower commercial fuel prices may provide an opportunity for a breathing space, during which a national fuelwood program could be implemented. EGY has a number of operations in progress addressing both the supply and demand aspects of the fuelwood problem.

In summary, lower oil prices may have, for the immediate future, somewhat reduced the benefit to developing countries of exploiting their national oil, gas, coal and hydro resources. Nevertheless, economic growth and expanding populations will continue to maintain an upward pressure on energy demand which, in energy importing countries, will constitute a continuing drain on foreign exchange. Particularly since oil prices may well harden again, many countries will find it necessary to maintain robust energy investment programs, to expand viable domestic energy resources. To do so most effectively, and with the minimum accrual of further debt, the enterprises responsible for this expansion may often need to be restructured with an increased reliance on private investment (domestic and foreign) as their borrowing capacity, as well as the nation's, will be very limited in the coming years.

April 29, 1986

COFINANCING

COFINANCING (VPCOF)

Role of VPCOF. The Office of the Vice President for Cofinancing (VPCOF) was established in 1983 to increase and strengthen the World Bank's efforts to mobilize additional financing for Bank-assisted projects and programs. Within VPCOF, a Senior Adviser and one adviser for each type of cofinancing (official aid agencies, export credit agencies, and commercial banks) are responsible for overall planning, policy making, advice and monitoring of the Bank's cofinancing program.

FY81-85 Actual, FY86 Estimated World Bank Cofinancing

	FY81	FY82	FY83	FY84	FY85	FY86
Commercial Banks $m:	1,104	968	1,029	1,106	1,064	800-1100
Number of Operations:	18	18	14	11	12	12
Export Credit Agencies $m:	472	1,580	1,894	957	1,321	1300-1700
Number of Operations:	7	21	11	16	20	23
Official Aid Agencies $m:	1,489	2,293	2,375	1,990	2,454	1900-2200
Number of Operations:	69	80	79	85	87	100
Total $m:	3,065	4,841	5,298	4,053	4,839	4000-5000
Total Number of Projects:	73	99	86	99	104	115

Note: The number of operations by source do not add to the total number of projects since projects can be cofinanced by more than one source. Actual Commercial Bank cofinancing reflects possibilities as indicated in financing plans at the time of Board approval.

Cofinancing Tools and Trends.

- Commercial Cofinancing has consisted of:
  - "Traditional" cofinancing in which the private sector extended parallel but unconnected loans to Bank-assisted projects (in the mid-1970's) or cofinanced loans with a formal link to Bank project loans (since the late 1970's). All cofinancing with commercial banks took this form prior to January 1983 when new instruments called the B-loan program were introduced;
  - The B-loan program offers:
    - (i) Direct Financial Participation in which the Bank participates in the later maturities of a commercial loan to encourage banks to extend their own maturities and achieve an overall lengthening of maturities. In loans signed to date, the Bank has directly funded 12 operations totalling almost $1.8 billion;
    - (ii) Partial Guarantees in which the Bank guarantees the later maturities of a loan made by commercial banks. In loans signed to date, the Bank has extended guarantees for 3 operations totalling almost $375 million. In a recent operation in Chile, the Bank guaranteed $150 million against commercial cofinancing of $300 million. This guarantee, however, was a key element in putting together a total rescue package of almost $6 billion in reschedulings, and over $1 billion in new money, for Chile.

(iii) Contingent obligations in which the Bank takes a contingent participation in the final maturity of a commercial loan designed with a fixed level of combined installments of floating interest and variable principal repayments. To date, this option has only been used for a Paraguay Livestock loan for a total of $3.3 million.

Commercial cofinancing with the Bank has hovered around $1 billion per year since 1981 although voluntary commercial bank lending has drastically declined over this period.

- Export Credit Cofinancing fluctuates widely reflecting export credit agencies' (ECAs) coverage of borrowers and the Bank's lending program to these borrowers. A major problem in recent years is that ECAs have been slow to resume coverage for countries which have rescheduled official credits, and the volume of new credits has been kept at very low levels.

- Official Aid Agencies are the largest source of cofinancing for the Bank. About half of all IDA operations are cofinanced with some 40 different agencies. The Bank has signed cofinancing framework agreements with ten donor countries in recent years. These agreements focus primarily on official aid and set a framework for systematic cooperation and coordination of individual cofinancing transactions. Some provide specific targetted amounts for cofinancing with the Bank. In FY85, three donor countries agreed to provide $590 million in concessionary bilateral funds for cofinancing with the Bank. Furthermore, about one-third of the total commitment of $1.5 billion under the Special Facility for Sub-Saharan Africa, established last year, will be provided in the form of special joint financing between the Bank and individual donor countries. Cofinancing with official aid agencies is an important tool for improving effective aid coordination by directing funds to priority purposes.

- Future trends in cofinancing cannot be readily projected because of the array of tools and the variety of borrower and market conditions, but we will continue to promote all potential sources.

- Formal cofinancing data substantially understates the full impact of Bank work in supporting highly indebted countries. For example, a recent $300 million Bank loan to Colombia did not include cofinancing. But this loan helped persuade commercial banks to voluntarily restore trade lines cancelled earlier, and coupled with Bank monitoring and IMF surveillance, enabled Colombia to obtain commitments for $1 billion in medium-term financing from commercial banks. This pattern of assistance, alongside that of the Chile operation mentioned earlier, are expected to continue especially in heavily indebted countries.

LATIN AMERICA
& CARIBBEAN

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May 20, 1986

MEXICO: THE WEAKEST LINK IN THE DEBT CHAIN

Summary and Conclusions

• The oil price decline, while benefiting oil users, is creating grave problems for oil producers, especially financially weak Third World oil-exporting nations. Among those, Mexico is particularly vulnerable. Oil provides close to 30% of its hard currency earnings, much of which services its $97 billion foreign debt.

• The price of Mexican heavy crude has fallen by $14 from last year's average of $25.5/bbl. to just $11.5/bbl. recently. This translates into a $7.7 billion annual loss in export earnings. Moreover, lower prices haven't brought about a surge in demand; on the contrary, soft market conditions coupled with bureaucratic delays have resulted in a decline in the export volume of crude oil. Instead of the projected 1.5 million barrels a day, Mexico was exporting only 1.1 million through the first four months of the year. The combined loss to Mexican exports could be as high as $9.4 billion at annual rates. As a consequence, the Mexican economy could contract 3% to 5% this year, according to government estimates.

• Lower interest rates will bring some relief to Mexico this year, but will pale in comparison to the losses in oil-related export earnings. The total gain will be no higher than $2.3 billion, and the net effect will be a $7.1 billion loss -- ironically, the exact equivalent of the country's 1985 merchandise trade surplus. Plus, the deterioration of Mexico's terms of trade caused by the lower dollar may result in an additional loss of $500 million this year.

• In order to meet its financial obligations this year -- interest payments and short-term debt service -- Mexico will need as much as $10 billion in new money. The banks are ill-prepared to write off, or even write down, their Mexican loans: the <u>total</u> loan loss provisions of the largest U.S.-based Mexican creditors amount to less than one-third of their exposure in Mexico. As a result, they may have to raise the funds to keep Mexico afloat, although it'll be good money thrown after bad, and a temporary relief at best.

• Other short-term solutions, such as austerity measures, may no longer work effectively, since imports have been cut to the bone and exports probably cannot be raised on so short a notice. Other solutions, including the Baker initiative, are long-term. Moreover, they call for sweeping economic reforms, something the Mexican government may not be willing to undertake, especially in view of the general elections coming up in 1988.

• The trump card that Mexico still holds is its U.S. connection. The geographical proximity of that country probably will force the hand of the Administration and the Fed: they won't let it default or fall into political and economic chaos. The Treasury, while maintaining a tight-lipped facade, may well be working behind the scenes on a solution.

As we pointed out in The Four Dramatic Declines -- Winners, But Also Losers (March 20, 1986), the widely touted gains for oil users from the recent oil price decline will be offset, if not overwhelmed, by the losses suffered by the oil producers. Moreover, we pointed out that the risks are on the downside, and that crises among oil producers may trigger a major financial disaster. On the international side, financially weak oil-producing nations are especially at risk. Mexico is particularly vulnerable, since it is one of the world's largest oil producers and the second largest Third World debtor after Brazil, with external debt to banks and public institutions totaling $97 billion. Although Mexico did benefit from the recent decline in interest rates, those gains don't even begin to cover its losses from lower oil prices, so that the country's financial situation is, at best, precarious.

The Indebted Oil Exporter

Mexico's debt, listed in Table I, has grown dramatically in the 1980s, and even though its pace of growth has slowed to a crawl more recently, it is inexorably inching closer toward a massive $100 billion. Although due to rescheduling Mexico is making virtually no repayments on the principal of its long-term loans, debt service on short-term loans and interest charges on the bulk of debt outstanding still consume close to $10 billion a year. Mexico's inability to meet these obligations created a crisis in August 1982, and officially ushered in the Third World debt crisis. Now, due to sharply lower oil revenue, Mexico is once again standing on the brink of financial disaster. This time, the situation is even more ominous.

TABLE I

MEXICO'S DEBT (US $ Billion)

	1980	1981	1982	1983	1984	1985 [1]
Public Sector	$33.7	$42.7	$51.4	$67.5	$69.0	$70.3
Private Sector [2]	7.3	10.2	8.1	14.8	18.5	18.5
Short-Term	16.1	24.9	26.1	10.1	7.4	7.4
Use of IMF Credit	-	-	0.2	1.3	2.4	2.7
TOTAL	$57.1	$77.8	$85.8	$93.7	$97.3	$99.0

SOURCE: The World Bank

[1] Data: 1/85-6/85; [2] Non-Guaranteed

Oil exports provide the bulk of Mexico's hard currency earnings. Last year, it exported 1.4 million barrel per day (mbd) of crude oil, earning $13.0 billion. Together with $1.4 billion from oil products, this provided 68.2% of the country's total export earnings. (See Table II on page 3.) Both oil export volume and earnings suffered declines in 1985 compared to 1984, but they still kept Mexico's trade balance in the black -- despite a considerable jump in imports during the year.

TABLE II

MEXICO'S TRADE BALANCE (US $ Billion)

	1983	1984	1985
Merchandise Exports	$22.3	$24.1	$21.1
Oil (% of total)	$16.0 (71.7%)	$16.6 (68.9%)	$14.4 (68.2%)
of which: Crude (Vol-mbd)	$14.8 (1.54)	$15.0 (1.53)	$13.0 (1.40)
Merchandise Imports	$8.6	$11.3	$14.0
Trade Balance	$13.7	$12.8	$7.1

The Grim New World of Cheaper Oil

Oil prices have declined dramatically since the beginning of the year. The price of Mexican heavy crude went down from $25.5/bbl., its 1985 average, to about $11.5/bbl. recently -- a $14/bbl. loss. Oil prices are bound to swing up and down in response to panics of the markets and never-ending political crises in the Middle East, but the glut in oil production, coupled with economic weakness in the U.S. and other industrial countries, indicates that Mexican crude is unlikely to rebound considerably from the $11.5/bbl. level.

Mexico loses about $550 million a year in export earnings for each $1/bbl. decline in oil prices. Thus, the oil price decline of $14 on a barrel translates into a $7.7 billion loss of revenues on an annualized basis.

Plus, the export target established by Pemex, Mexico's government oil-producing monopoly, calls for exporting 1.5 mbd of crude oil. As seen in Table II, exports fell short of this level last year, to 1.4 mbd of crude, mostly due to sluggish demand for oil and intense competition among cash-strapped oil-exporting countries for market share in the face of weakening prices. These adverse conditions have persisted so far this year and have even been exacerbated, so that lower oil prices haven't been reflected in higher demand. Bureaucratic delays have apparently complicated the problem, and as a result Mexican oil exports fell to below 1.1 mbd in the first four months of 1986. If export volume remains 0.4 mbd below plateau, Mexico will suffer an additional shortfall of $1.7 billion a year with oil at $11.5/bbl.

In total, if oil prices stay at $11.5/bbl. and the export volume of crude continues at 1.1 mbd, the loss to Mexico's export earnings from the combination of the two declines will amount to $9.4 billion. According to Miguel Mancera, governor of Mexico's central bank, this shortfall is expected to result in a contraction of the economy this year of 3% to 5%, compared with last year's expansion of 3%!

Small Change from Lower Interest Rates

We mentioned in The Four Dramatic Declines that the recent fall in interest rates will benefit Third World debtors. London Interbank Offered Rate (LIBOR), on which most interest rates on international loans are based, dropped from 8.3% in mid-December 1985 to 6.9% at the end of April, or 1.4 percentage points. Mexico, with its overall debt just under $100 billion, stands to save close to $1.4 billion a year in interest payments from this decline.

Furthermore, Mexico's bankers charge it approximately seven-eighths of a percentage point above LIBOR; Mexico has been calling for this markup to be abolished, and, unless interest rates fall further, its creditors may be forced to yield. In any case, either from a further decline in rates or a reduction or an abolition of the markup over LIBOR, Mexico may save an additional $873 million a year. Total saving from lower interest rates will then be $2.3 billion annualized.

This, however, doesn't even begin to offset the losses from lower oil prices: the shortfall for Mexico from the combination of a soft oil market, drastic declines in oil prices, and lower interest rates will be $7.1 billion this year -- ironically, just equal to its 1985 merchandise trade surplus. (See Table II.)

The Fallout from the Falling Dollar

Mexico has reason to deplore the recent fall of the U.S. currency, although less so than the Japanese. The bulk of Mexico's export earnings is denominated in dollars. Oil is traded in dollars; tourism, which has brought over $1 billion annually in the past three years, is Mexico's second largest single hard currency earner, and most vacationers come from across the country's Northern border; finally, a large proportion of Mexico's non-oil exports also goes to the U.S. The U.S. also provides the largest portion of Mexico's imports, but over 20% of imports in 1984, the last full year for which data are available, came from Japan and Western Europe. Those countries' currencies have appreciated against the dollar by 30%-40% since last October, causing a deterioration of Mexico's terms of trade.

Mexico reaped benefits in the early 1980s, when the dollar was on the rise, but now the situation has been reversed. Mexico's losses from the lower dollar are smaller than those of such oil importers as Libya or Iran, who get dollars for their oil but buy their imports almost exclusively from Europe and Japan. Still, Mexico may lose as much as $500 million a year in consequence of the dollar's slide. This coming on top of other losses brings the total damage to Mexico to an astounding $7.6 billion in 1986!

Mexico will be hit by other adversities as well, the full effects of which are more difficult to quantify. For instance, when oil prices fall, investor confidence in Mexico suffers. It is already low, if not to say nonexistent, judging by the decline in net foreign investment in the Mexican economy: the inflows of foreign capital into Mexico fell from $2.0 billion a year in the early 1980s to an average of just $500 million in the past three years. Yet foreign investment is still an important source of new hard currency for Mexico, considering that in 1984 banks and international lending authorities provided only $2.5 billion. In its present condition, Mexico certainly can't afford to let this source of financing disappear.

Capital flight is another important problem, one that is also likely to get worse in the aftermath of the oil price decline. Some $53 billion is being kept by Mexicans outside their country, according to a Morgan Guaranty study. In the first quarter, Mexico put a squeeze on credit to businesses, forcing the owners to bring back an estimated $700 million to keep their companies from going under. This was, however, a Sisyphean task, since at the same time the flight of capital accelerated, and in February alone as much as $3 billion may have left Mexico.[1]

Banks in Trouble

The list of those who have lent to Mexico includes some of the biggest names in American banking. As seen in Table III, it's headed by Citibank, the largest U.S. banking institution, whose exposure amounts to $3.1 billion, followed closely by the second largest U.S. bank, BankAmerica, which holds $2.8 billion in Mexican loans. The largest U.S.-based Mexican lenders collectively are responsible for $28.9 billion in loans, or 27.1% of Mexico's overall debt.

TABLE III

COMMERCIAL BANK EXPOSURE TO MEXICAN DEBT

	TOTAL EXPOSURE (BILLION $)	PERCENT OF TOTAL LOANS	MEXICAN DEBT EXPOSURE/ LOSS PROVISIONS
CITIBANK	$3.08	4.04%	2.48
BANKAMERICA	$2.80	3.67%	1.28
MANUFACTURERS HANOVER	$2.05	2.69%	3.30
CHASE MANHATTAN BANK	$1.85	2.42%	7.25
CHEMICAL BANK	$1.68	2.21%	6.00
MORGAN GUARANTY TRUST	$1.40	1.84%	4.18
BANKERS TRUST	$1.03	1.35%	5.87
FIRST NAT'L-CHICAGO	$0.97	1.28%	2.37
CONTINENTAL ILLINOIS	$0.84	1.10%	7.13
WELLS FARGO BANK	$0.72	0.95%	1.94
FIRST INTERSTATE-CA	$0.65	0.86%	1.74
SECURITY PACIFIC	$0.60	0.79%	1.60
CROCKER NATIONAL BANK	$0.58	0.76%	5.25
MELLON	$0.54	0.71%	3.66
EUROPEAN AMERICAN BANK	$0.44	0.58%	7.34
IRVING TRUST COMPANY	$0.40	0.52%	6.26
TEXAS COMMERCE BANK	$0.36	0.48%	1.15
REPUBLIC BANK DALLAS	$0.35	0.46%	3.00
MARINE MIDLAND BANK	$0.34	0.49%	1.69

Many banks have been setting aside funds to cover anticipated losses -- not just from Mexican and other international loans but from their energy, real estate, agricultural, and other lending, where loans are collateralized by tangible assets. In the past year Citibank doubled its loan loss provisions, and BankAmerica raised them by 153%. Houston-based Texas Commerce Bankshares, which also has sizable energy loans in its hands, more than tripled its loan loss provisions.

Yet, as seen in Table III, these measures were not sufficient to cover even a possible default by Mexico, let alone other potential losses, especially if the crises were to hit simultaneously. Mexican debt alone, as seen in the table, exceeds many of those banks' cumulative loan loss provisions by more than threefold.

Even without an outright default by Mexico, the banks' situation is very unpleasant. Mexican debt is traded in swap deals at 55¢-60¢ on the dollar; only Peru's debt has a lower price tag, but Peru of course is technically in default, and banks have been instructed to write off its debt. Recent moves to start converting Mexican debt to securities may backfire: to find buyers, these securities will have to be sold at deep discounts, and the losses written off by the seller will make it harder for other banks to continue carrying Mexican loans on their portfolio at 100¢ on the dollar. Just writing down their Mexican exposure by 40% would more than wipe out many creditors' loan loss provisions.

Can the Crisis Be Solved?

Unfortunately, few realistic solutions to Mexico's desperate financial condition have been voiced either by the creditors or the debtors. Cutting imports and promoting exports may not yield meaningful results anymore, simply because these measures were already taken in the wake of the 1982 debt crisis: imports were cut to the bone while almost everything in sight has been offered for sale abroad.

True, imports did grow in 1985 to $14 billion from $8.6 billion in 1983 (see Table II), but there is little room to cut here: as recently as 1981 Mexican imports were $24 billion, and some of the cuts after the 1982 crisis included spare parts and supplies that are simply indispensable for carrying on the Mexican economy's day-to-day operations.

The share of non-oil exports did rise to over 30% of total exports in 1985, but not because non-oil exports grew in volume. Table II implies that Mexico's oil exports dropped by 13.3%, accounting for 73.3% of the decline in total exports. Non-oil exports also declined, but only by 10.7%.

More money from the foreign banks or official international lenders also is not a realistic solution. Commercial banks do provide a trickle of fresh funds each year, but they do so essentially against their will and against their own best judgment: the banks' steering committee simply sends a letter around notifying Mexico's creditors how much is needed to keep Mexico afloat and what the share of the given creditor is, based on its total exposure. Mexico recently requested

$1 billion in emergency credit from the IMF to supplement scant commercial bank lending. This credit, however is insignificant when compared with an estimated loss of oil revenues this year of over $7 billion. Moreover, concessional lending of this kind is based on Mexico's acceptance of a two-year economic austerity accord with the IMF. Mexico's swelling federal deficit has to date blocked provision of this emergency credit.

Earlier this year, before oil prices slid, Mexico was indicating that it would not need any new money in 1986. Yet, even back then some analysts were suggesting that the financing gap would be anywhere between $2 billion and $4 billion. Now, with the country finding itself some $7.6 billion short, Mexico's new money needs may jump to $10 billion! Its creditors, from the largest to the smallest, are probably opening their morning mail with trembling hands.

Bankers, of course, are aware that they are throwing good money after bad, only postponing the day of reckoning. Moreover, they also fear, not without reason, that what they lend immediately flees the country and winds up in bank accounts in Florida and Texas, or in numbered accounts in Switzerland.

Most proposed solutions to deal with the debt problem, including the Baker initiative, are long-term. Moreover, they involve liberalization of the economy or inflows of new funds, or both. The banks, of course, don't like the idea of new fund inflows. They'd rather see their involvement with Mexico decline, not grow. The Mexican government, on the other hand, doesn't like the idea of economic reform which would probably proceed along the lines of IMF conditionality -- requiring devaluation of the Mexican peso (or possibly a new currency issue), credit ceilings on domestic borrowing, minimum foreign exchange reserves, price liberalization, and restricted public sector expenditures (often in the form of wage controls).

The International Revolutionary Party (PRI), is wedded to a system of patronage to exercise its control over the economy. Not only would these conditions of fiscal austerity place significant restrictions on the populace and Mexican businesses, but might also jeopardize the ability of the PRI to stay in power. Last July's elections, although rigged as usual, showed that the PRI's support is crumbling, especially in the more Americanized, industrialized North. President de la Madrid's administration may want to shore up its popularity before the 1988 presidential elections by handing out a few economic carrots. For this, it would have to expand, not shrink, the public sector deficit, which stood at 7.6% of GNP in 1984.

A Political Solution?

Mexican leaders know that they have in the U.S. a lender of last resort, the implicit co-signer of Mexico's financial obligations. Mexico's unique geographical position vis-a-vis the U.S. is an advantage that other huge international debtors such as Brazil and Argentina do not possess. Mexican officials are quick to mention four reasons why the U.S. should share the burden and the sacrifices of the Mexican debt problem:

1. The threat to the U.S. banking system from Mexico's default. True, Brazil and Argentina can also wreck the U.S. banking system, but of the three big debtors, U.S. banks' involvement with Mexico is the greatest. Fully 37% of Mexico's private banking debt is owed to U.S.-based banks, compared to 32% for Brazil and 31% for Argentina. This obviously worries the Fed, which bailed out Mexico when it was on the brink of financial disaster in 1982.

2. Mexico, because it is highly influential in the region, may be instrumental in the Administration's efforts to isolate Nicaragua in Central America.

3. Financial problems, if allowed to deteriorate further, may culminate in political and economic chaos, and could even result in a takeover by a communist or pro-Soviet regime. The threat of another Nicaragua on the U.S. border is a serious concern for the Administration.

4. The influx of illegal aliens may well create problems in the border states such as Texas, New Mexico, and California. This is especially threatening for the Texans, who are facing problems of their own due to the wholesale collapse of oil-related industries in the state. The number of clashes between illegal aliens and Immigration and Naturalization Service agents is already on the increase, and the level of violence in the border-crossing areas is rising.

Thus, a resolution of the Mexican debt problem involving the U.S. government cannot be ruled out, despite free-market beliefs of the Administration. The U.S. Treasury has been unusually tight-lipped about the problem, but behind the scene it may well be working intently on a solution in one form or another.

Alexei Bayer
Economist

Gilbert F. Benz
Assistant Economist

LATIN AMERICA AND THE CARIBBEAN REGION--FACT SHEET

Vice President: Knox
Total HL Staff: 309
Of which Field: 6

Country Programs I
Director: Steckhan
Total HL Staff: 44

Country Programs II
Director: Gue
Total HL Staff: 55

Projects
Director:van der Meer
Total HL Staff: 196

Number of Field Offices: 4

Regional Overview

Number of Borrowers: 34
Total Population: 369,850 (thousands)

Work Program	FY81-85 Annual Avge.	(Est.) FY86	(Projected) FY86-88 Annual Avge.
Lending--IBRD ($ million):	3,227	4,500	5,300
--IDA ($ million):	38	88	68
Number of Loans/Credits:	44	42	50
Supervision Portfolio--($ million):	-	25,777	
No. of Loans/Credits in Portfolio:	-	363	
Cofinancing Mobilized ($ million):	1,299	1,000	
Number of Operations Cofinanced:	12	10	
No. of Countries with Active Aid Group Meetings Chaired by Region		15	

UD9:facts
UDabbagh:mjb

LATIN AMERICA AND THE CARIBBEAN REGION (LAC)

1. Background on Region

The countries of the LAC region have populations ranging from 130 million in Brazil to 53,000 in St. Christopher/Nevis. The combined GNP of the region is about the same as Germany's ($700 billion) and about 20% more than the developing countries of East Asia. Over the long run growth has been impressive (nearly 6 percent per year from 1960 to 1978) and life expectancy has increased from 50 to 65 years since 1950. Countries have performed very differently, Brazil and Colombia having done better than the rest. The average income in the region is about $1,650, ranging from $320 (Haiti) to about $7,000 (Trinidad and Tobago).

In many respects, Latin America seems closer to the advanced industrial countries than to the developing world: (a) a higher level of per capita income than in other developing countries; (b) highly urbanized, about 70% live in urban areas; (c) a large middle class, probably about 1/3 of the population; and (d) an advanced level of manufacturing output: Brazil, Mexico and Argentina are among the leading industrial producers of the developing countries. However, as indicated below, many of the essential features of the region make it unequivocally part of the developing world.

The region's major problems include debt, economic recession, high inflation, skewed income distribution and unemployment.

Debt. 1973-1981 were years of heavy external borrowing. By the end of 1985 the total external debt of the region is estimated at over $375 billion or 60 percent of GNP. Total interest payments absorb 36 percent of exports, and one-half of domestic savings in some countries. This cripples domestic investment and contributes to fiscal deficits.

Recession. As interest rates increased, commodity prices declined, demand for exports faltered and commercial bankers retrenched, the region went through a deep recession. Since 1982 per capita income has fallen by about 14 percent and imports, investment and consumption have remained low ever since. Only Brazil has managed to recover partially from the slump, while Colombia has managed to avoid a decline. Recession has been aggravated by capital flight.

Inflation. The region has traditionally experienced the world's highest rates of inflation. In spite of many courageous stabilization efforts inflation continues to be high in many countries. The recent monetary reforms of Argentina and Brazil seem to have met with a fair measure of success but it is too soon to tell whether inflation has been "whipped" for good.

Income and Employment. Because of very skewed income distribution as many as one-third of the population (about 125 million) live in conditions of extreme poverty, in spite of expanding clean water and education coverage. Because the labor force is increasing by nearly 3 percent p.a. (about 6 million people), the 1981-86 recession has meant mounting urban unemployment--in most countries without any "safety net"--and the rapid spread of the informal sector. This is creating increasing pressures on governments all but a handful of which are democratic and civilian.

What can be done to achieve resumed growth?

Prospects hinge on developments of the global economy and on continued domestic policy reform. Lower interest rates and oil prices will help growth in the industrialized countries which, in turn, will help the LAC region, with the major exception of oil-exporters. Yet even under optimistic global assumptions the drain on resources due to interest payments on external debt will continue to be heavy. The domestic policy agenda is clear but will be very difficult to implement, especially if debt service continues to depress imports and investment. Resumed growth can be achieved with reduced inflation and improved creditworthiness, if the policy emphasis is on export expansion and greater overall efficiency.

After half a century of discriminating against both traditional and non- traditional exports, policy-makers in LAC are beginning to realize that trade reform is essential to resumed growth. Trade liberalization and export encouragement, especially to manufactured goods, are at the top of the policy reform agenda. But vested interests are solidly entrenched and progress is bound to be slow. Expanded exports would create jobs (directly and indirectly) and help reduce the debt burden.

Reactivation through export growth can only be sustained in the longer run if overall efficiency improves. This means that public sectors must shift from being net users of savings to being net generators; it entails a smaller size of the public sector and realistic pricing; and it means exposing the private sector to greater external competition. A greater savings and investment effort also entails reform of financial institutions designed to improve their efficiency.

The key to inflation-reduction is a continued effort to reduce public sector deficits and to maintain realistic interest and exchange rates, all of which are conducive to improve the state of confidence. In very high-inflation countries monetary reform may be the only solution.

Resumed growth is the best remedy to alleviate widespread poverty, especially since government social programs will be severely constrained in the years ahead. A redirection of social programs to focus more sharply on the poorest groups could help greatly without adding to government expenditure. Export expansion should help alleviate unemployment, since export activities are particularly labor-intensive.

None of these domestic efforts is likely, however, to bring about improved living standards unless the flow of external capital increases substantially from its very small volume, especially in the next 3 to 5 years. As noted, commercial bankers have retrenched; private foreign investment has declined reflecting poor market growth prospects; government export credit agencies operate at moderate levels; only World Bank flows have increased substantially. Overall flows are at a low point reflected in the region's total current account deficit of only around $4 billion in 1985. Efforts are underway to mobilize larger external flows, along the lines envisaged in Secretary Baker's Seoul speech. More on this below.

2. Major Aspects of the Work Program

The Bank has responded to these challenges by reorienting its operations. To help meet the region's huge need for fresh capital, lending has been expanded and reoriented towards more quick disbursing policy loans and towards projects more appropriate to circumstances of constrained growth and funds. Over the last several years, considerable efforts have been expended to help countries design "workout programs" aimed at restoring growth through appropriate policies. Efforts to mobilize additional resources in support of these programs from commercial banks, official aid agencies, and other multilateral sources (IDB and IMF) have led to increased cooperation and new models of cofinancing, although a great deal remains to be done. These changes all have consequences for the staffing and administration of the region.

a. Major Country and Sectoral Distribution of Lending

The Bank currently has lending programs in 27 countries. There is no program in Nicaragua where disbursements have been suspended since September 28, 1984 because the country has not serviced its debt to the Bank since June 1, 1984. Antigua and Suriname are currently not creditworthy. There is also no lending to Trinidad and Tobago which has been "graduated" and Venezuela where until recently, per capita income has been in excess of the Bank's lending cutoff. However, because of the recent fall in Venezuela's per capita income mainly due to the drop in oil prices, we are considering whether to resume lending. Also, under a technical assistance program, financed by the Dutch Government, we have been asked to prepare an economic report for the Netherlands Antilles. Cuba is not a member; and we have never done anything in the French or US dependencies in the Caribbean.

Among the countries to which we currently lend, 6 account for over 60% of the number of loans made and 90% of the money loaned. Indeed, of the $16.3 billion committed to LAC (222 loans) over the last five years, nearly 75% went to three of these: Brazil, Mexico and Colombia. Nevertheless, there have been major shifts, with lending to Peru and Jamaica declining and that to Argentina, Chile, and Ecuador increasing. Under the Bank's graduation policy, we expect that our last loan to the Bahamas will be in fiscal year 1989 and to Barbados in about five years. The Bahamas has accepted this but Barbados has not.

The sectoral distribution of lending over FY82-85 reflected the diversity of the Region--agriculture (23%), industry (20%), energy (22%), infrastructure (22%), social sectors (8%), and non-project (5%). The aggregates disguise the shift of lending over the last few years in response to the economic crises. Quick disbursing policy based loans have grown substantially and are expected to be more than 30% of volume in FY86, while the share of energy and infrastructure is declining. Industry declined initially reflecting the impact of the crisis, but is now recovering with increased lending in support of restructuring, rehabilitation and financial reform. In all sectors, lending has shifted towards sectoral policy operations, although this is particularly true in Agriculture and Industry.

b. Key Issues Being Addressed in Country Economic and Sector Work

The shift in operations has required the expansion of economic analysis to support lending designed to address key policy issues. This trend has been reinforced by the need to support more coordinated resource mobilization efforts from an increasingly skeptical financial community.

The country economic and sector work program focuses on how countries can emerge from the present slump and achieve sustained resumed growth of production, consumption and employment. Work-out papers defining policy agendas to these ends have been prepared for a number of countries and several have already been discussed with the IMF and member governments (e.g., Argentina, Brazil, Colombia and Mexico). Economic reports are focusing on incentive systems (how to improve trade regimes to achieve faster export growth and greater efficiency of resource use), public sector improvements (analysis of public investment programs, institutional improvements) and resource mobilization (financial sector analyses, public enterprise analyses, etc.) A series of country papers is being prepared on the social consequences of the debt crisis to be followed-up by recommendations. Sector reports also focus on re-activation policies in agriculture and industry and on ways to cope with the financial sector crises. The Region produces about 30-35 economic and sector reports per year, which are discussed with governments, in addition to technical notes and internal analyses.

c. Trends in Bank Assistance Strategy

The Baker Initiative implies increasing disbursements in LAC from the current level of about $3.0 billion per year to an average of about $4.5 billion per year over FY86-88. It is possible to do this if:

(a) We increase our lending to about $16 billion in the 3 year period FY86-88 as compared with $10 billion in FY83-85.

(b) We change the structure of lending to increase quick disbursing loans supporting major policy changes from 10% over the last few years to about 30-40% of new loans.

(c) We continue to provide a relatively high share (60-70%) of the costs of projects to relieve the pressure on domestic budgets and speed up execution of projects.

Over the last few years, the Bank has made considerable progress in these directions. Lending increased from $3.0 billion in FY84 to an expected $4.5 billion in FY86. Quick disbursing policy loans are expected to reach 30% of the total in FY86, up from 13% in FY85. Disbursements increased from $2.0 billion in FY82/FY83 to $3.0 billion for FY85/FY86 and we project about $3.7 billion in FY87.

For the future, we plan that some 2/3 of our lending will be in specific projects focusing on rehabilitation and strengthening of productive capacity, supporting export growth and greater efficiency, and ensuring adequate attention to neglected social issues. The remaining 1/3 will be for structural adjustment and sector lending aimed at major policy reforms in support of the policy objectives indicated above.

In addition to our own lending, we are making major efforts to increase resource flows from commercial banks, and official export aid agencies. The aforementioned medium-term workout papers that have been prepared for our major borrowers are expected to provide the intellectual framework for such increased assistance while sector loans and SALs will provide the mechanisms for ensuring that policy agendas are carried out. In developing these agendas, we have been working closely with the IMF. We have also been working to improve our collaboration with the Inter American Development Bank (IDB).

3. Major Issues for the LAC Region in FY87

The increased volume of lending and the shift towards adjustment lending have already stretched the region's resources to the limit. Particularly needed are staff with a deep understanding of both general and sectoral economic policy issues; e.g., agricultural sector policy economists, financial sector specialists, public management specialists, policy oriented general economists and staff with the skills needed to deal effectively with the commercial banks. We are trying to recruit such staff, but these skills are scarce both within the institution and outside.

A great deal more needs to be done to marshall resources from other sources. The $1 billion commercial banking packages worked out in connection with Bank policy lending for Chile and Colombia offer a possible model for commercial cofinancing, as do pilot efforts in several other countries. The reluctance of official export credit agencies to reopen lending to most LAC countries remains a major unresolved issue. Consultative groups offer a possible vehicle for some countries. The Caribbean Group for Cooperation in Economic Development Chaired by the Bank, covers 20 countries and dependencies in the Caribbean.* We also have a Consultative Group for Colombia and are working on such groups for Bolivia and Ecuador. MIGA may also help restore the flow of private investment.

* Antigua and Barbuda, Bahamas, Barbados, Belize, Dominica, Dominican Republic, Grenada, Guyana, Haiti, Jamaica, St. Christopher and Nevis, St. Lucia, St. Vincent and the Grenadines and Suriname which are Bank members, and Anguilla, British Virgin Islands, Cayman Islands, Montserrat, Netherlands Antilles and Turks and Caicos Islands which are dependencies.

April 1986

COUNTRY PROFILE--COLOMBIA

Population (1984)	:	28 million
GNP Per Capita (1984)	:	$1,370
External Debt--M&LT (1985)	:	$10.8b.
Debt Ser. Ratio--M&LT/XGS	:	31.3%
Bank Share of M&LT Debt Service	:	20.7%

Development Experience

Political

1. As one of Latin America's oldest democracies, Colombia has enjoyed stability and continuity in policy-making. The two political parties--the Liberal and Conservative--are drawn largely from the same elite. Private sector participation in public sector and in policy formulation is unusually substantive. A new Administration is expected to take office in August 1986; the majority obtained by the Liberals (the party now in opposition) in the recent Parliamentary elections, is expected to be reinforced by a further victory in the forthcoming Presidential election.

Economic

2. For over three decades, Colombia's economic performance has been solid, with growth averaging 5% p.a. The country has an abundance of natural resources, which has resulted in a diversity of economic activity and of exports--coffee, textiles, coal, and soon, petroleum. The country is close to external markets, the population of nearly 30 million is well educated, and entrepreneurship is well developed. A favorable policy environment has partly offset the constraints posed by topography, security problems, and the country's somewhat inflexible administrative system originally devised to preserve a regional and political balance. During 1967-75, an outward-looking strategy including trade liberalization, a competitive real exchange rate and fiscal discipline resulted in GDP growth of 6% p.a., urban unemployment of about 9%, and a low external debt.

3. However, Colombia's record was adversely affected by the rapidly changing circumstances of the last decade. Following the coffee boom of the 1970s, performance deteriorated in the early 1980s due to both external difficulties and policy weaknesses in the fiscal, trade, and investment areas. During 1982-83, the fiscal deficit as a percent of GDP nearly doubled from the previous decade and growth declined to 1% p.a. Non-coffee exports fell and international reserves were cut in half. Despite Colombia's strict honoring of its external debt service obligations, it began to face increasing resistance from commercial bankers. Clearly a decisive change was needed to avert an economic crisis.

Reaction to Crisis

4. Initially, the Government relied on import controls to staunch the outflow of reserves and on countercyclical expenditure policy to preserve growth. While it emphasized export promotion, exchange rate changes, and fiscal and financial reforms, the policy effort was insufficient. In view of the continuing drain on reserves during 1984, the Government moved to significantly adjust macroeconomic policies.

Short-Term Adjustment

5. The authorities sought to achieve stabilization through fiscal, monetary, and exchange rate policy. With a rapidly accelerated crawling peg,

the real exchange rate at end-1985 was higher than the "equilibrium rate" of the mid-1970s. The fiscal and monetary program included revenue measures and current expenditure cuts to reduce the overall fiscal deficit, and a reduction of Central Bank credit to the public sector to permit an expansion of credit to the private sector.

Structural Measures

6. Structural measures were aimed at making Colombia a more open, competitive and efficient economy. Trade policy included, in addition to exchange rate policy, gradual import liberalization, the removal of export restrictions, tariff reform and rationalization of export incentives. Investment and borrowing programs were based on the criteria of encouraging quick-yielding investments with significant impacts on production, resource mobilization, and the balance of payments. As a result of short-term and structural measures, creditworthiness improved in 1985, non-coffee exports registered a 14% growth, reserves stabilized, and growth reached 3%.

Medium-Term Prospects

7. Colombia's medium-term development strategy would need to address three objectives: (i) revitalize growth to historical levels of about 4.5-6%; (ii) maintain and improve creditworthiness by keeping the debt-service burden within prudent limits; and (iii) reduce unemployment rapidly.

8. A needed policy package would integrate five areas: (i) export growth based primarily on macroeconomic management including exchange rate, import and export policies; (ii) resource mobilization through fiscal and financial management, an improved environment for local and foreign investments, moderate foreign borrowing, and higher savings performance; (iii) sectoral growth centered on improved policies for key economic sectors (agriculture, industry, energy and transport), reduction of market distortions, and efficient public investment and pricing; (iv) employment generation and a basic needs strategy for target groups and areas; and (v) greater public sector efficiency and incentives for private sector participation.

Role of the Bank

Past

9. As Colombia's primary creditor, the Bank has provided significant support in three areas. In external finance mobilization, the Bank organized the first Consultative Group (CG) meeting on behalf of Colombia. In 1983, in response to the changing financial environment, the Bank helped transform these meetings into a CG meeting of the country's major commercial bank creditors--also the first of its kind. Through macroeconomic and sector work, the Bank has often provided the analytical underpinnings for decision-making and reform. The lending program in Colombia has been particularly active, diverse, and rapidly expanding. Between FY81-83 and 84-86, annual lending more than doubled to some US$625 million.

10. In recent years, the Bank has been instrumental in turning the country towards a more outward-oriented growth strategy. Bank support for the economic program for 1985-86, which is in line with the approach proposed by Treasury Secretary Baker, led to the securing of a financing package of about US$1.5 billion in short-term trade lines and US$1 billion in medium-term credits from the commercial banks, on the basis of a monitoring arrangement with the IMF (without a standby) and the Bank. The Bank's catalytic role in this effort was particularly evident given the historically strained relationship between the IMF and Colombia.

11. Future lending would include a mix of policy loans and complementary project lending. The policy loans are being premised on the continuation of an acceptable economic program. The Trade Policy and Export Diversification Loan of 1985 was followed up in 1986 by the Trade and Agricultural Policy Loan, designed to monitor macroeconomic, trade, investment and agricultural policies, incorporating the results of the IMF's monitoring. Additional sector loans would be predicated on appropriate conditions related to resource mobilization and the correction of structural weaknesses. These loans would be reinforced by the more traditional project loans to alleviate bottlenecks and to enable sectors which require special support to benefit from policy changes.

Outstanding Issues

12. The Government has demonstrated its ability to implement courageous economic measures. Its efforts have met with success: Colombia has managed to avert a balance of payments and fiscal crisis and emerged with much higher international prestige. However, the unemployment problem continues, while the financial sector is hampered by a partially non-peforming portfolio. There is concern that the current boom in coffee could lead to a relaxation of the restructuring efforts. Moreover, the deepening adjustment impact of the economic program on specific industries and interest groups raises some questions as to its continuation. On the other hand, there have been sizeable offsetting beneficial impacts on other groups, for instance in the export, resource-based and productive sectors. The adjustment program has also been adopted with bipartisan support, and Government requests regarding our economic work reflect concern with the resource management imperatives resulting from coffee price increases.

13. The degree of Bank involvement has come in for intense public discussion in Colombia, particularly in view of the conditionality associated with policy loans. Within the Bank, the temporarily high Bank exposure projected between 1985 and 1990 (at a roughly 25% Bank share of public debt and debt service) though not particularly excessive relative to the past (27% for public debt outstanding and 33% for debt service in 1975) has caused concern. However, given that the related Bank norm of 20% may be increased temporarily to 30% while country creditworthiness is being restored, and given the country's record of policy responsiveness, it would appear to be appropriate for the Bank to share the risks associated with the Colombian program to ensure a decisive turnaround in the prospects for growth and creditworthiness.

COUNTRY PROFILE--MEXICO

Population (1984)	: 76.9 million
GNP Per Capita (1984)	: $2,060
External Debt--M&LT (1985)	: $89.9b.
Debt Ser. Ratio--M&LT/XGS	: 51.6%
Bank Share of M&LT Debt Service:	4.1%

Development Experience

Political

1. The de la Madrid administration is scheduled to remain in power until December 1988. The cabinet is technically the best-qualified ever, but lacks political skills. Thus, the government seems far-removed from the political fabric of the country and at times indecisive. Increasing pressures for pluralism are challenging the de facto 60-year monopoly of the ruling party, the PRI. Local elections in July will provide a further test. No opposition governor has been elected yet. The main opposition party, the PAN, favors the private sector but its role is expected to remain marginal.

Economic

2. Between 1940 and 1970, Mexico experienced rapid growth based on private sector capital formation supported by public infrastructure investment. Low taxes went hand in hand with high domestic savings. By 1973, manufactured exports accounted for 40% of Mexico's exports. While some sectors were highly successful in exporting (mainly to the US), import substitution was far-advanced by the early 1970s. Since the mid-1970s, oil exports permitted continuation of rapid growth, at a time when import substitution had run out of steam. Oil also brought: (i) a rapid expansion of the public sector; (ii) easy access to borrowing abroad; and (iii) a reversal of export diversification; oil represented about 70% of 1985 exports.

3. The rapid growth in public spending and deficits fueled inflation, and brought the exchange rate under pressure. A surge of borrowing in 1980-81 helped support the peso for a time, but in 1982 the Government forced conversion of dollar deposits into peso assets at an unfavorable exchange rate. Waves of capital flight soon led to currency controls, massive devaluation, and a unilateral moratorium on foreign debt service.

4. Considerable progress had been achieved during the decades of rapid growth: Sixty percent of the population has access to clean water; primary school enrollment is quasi-universal; and health indicators have improved considerably. A strong middle-class has emerged (nearly 30% of families own a car). Yet the country faces enormous problems: income distribution has not improved; rural poverty is still pervasive; and the urbanization rate is 70%. The rate of growth of population has come down but is still 2.6% per year.

Reaction to Crises

Short-Term Adjustment

5. The Government acted quickly when it came to office at the end of 1982. A three-year Extended Fund Facility with the IMF supported drastic reduction of the fiscal deficit, major devaluation and sharply higher domestic interest rates, as well as gradual easing of import controls and reforms in public sector pricing. Commercial banks responded with two multi-year reschedulings. Although much progress was achieved, the adjustment largely focused on short-term stabilization, neglecting deeper structural problems.

Moreover, the stabilization program itself began to get off track toward the end of 1984.

6. By mid-1985, Mexico fell out of compliance with the IMF. The economy was already in grave difficulty when the earthquake struck in September. Subsequently, the collapse in oil prices worsened matters. Mexico's per capita GDP remains about 9% below the level of 1981. Yet further severe stabilization measures are needed.

7. Reducing the fiscal deficit has become essential for restoring economic stability and improving development prospects. A record deficit of 17% of GDP in 1982 was nearly halved in 1983 to 9% of GDP. But since then little progress has been made. The original IMF agreement had called for a deficit of less than 4% of GDP. By 1985, the actual deficit came close to 10%. With an estimated shortfall of $8 billion in oil revenues in 1986 --6% of GDP--drastic changes in public finance will be needed to keep the deficit at 10%. This sized deficit, if not financed from external sources, could lead to increased inflation, capital flight, loss of reserves, and the possibility of non-payment of some external debt.

Structural Measures

8. Since 1983, there has been a shift in the rural/urban balance in favor of agriculture. Agriculture had suffered from overvalued exchange rates and pro-urban price policies. Reduced subsidies and better exchange rates have helped stimulate agricultural production. The government also decided to embark on a medium-term trade liberalization policy. A start was made in mid-1985 when many quantitative import restrictions were replaced by tariffs.

Medium-Term Prospects

9. Mexico's medium-term prospects hinge on progress in the following areas:

- inflation-reduction
- trade liberalization and manufactured exports encouragement
- better public investment screening
- improvements in the tax system favoring savings and investment
- credit market deregulation
- reduction in the size of the public sector
- liberalization of agricultural trade and credit regimes
- encouragement to foreign direct investment

10. GDP will decline further this year and real consumption per capita will fall sharply. This will test Mexico's social and political stability. With vigorous policy efforts in the areas listed above, growth could resume in 1987 and reach 5-6% by 1990, the debt-service ratio could be held constant and the debt-to-export ratio could improve marginally. However, per capita consumption would decline further in 1987 and improve slowly to 3% by 1990.

Role of the Bank

Past

11. Mexico is one of the Bank's major borrowers. Past loans were for specific projects ($760 million per year in FY81-85) with a concentration in the productive sectors, notably agriculture. Lending for infrastructure (about 40% of the total) focused on transport, urban development, water supply and education. FY86 lending will be between $1-1.5 billion, including a $400 million earthquake reconstruction loan. The higher level depends on completing a $500 million Trade Adjustment Loan (see Para. 15). Following the 1982 crisis, we used a variety of techniques to increase disbursements, which have roughly doubled to $860 million in FY86.

12. In 1984, the government agreed to the outlines of a larger multi-year lending program including fast-disbursing policy loans of $400-800 million per year supporting key macro and sectoral adjustments on top of "core" project lending. This approach is in line with the Baker Initiative to encourage accelerated structural change and growth. We identified four major areas--foreign trade, public sector management, agriculture and financial sector reforms--where policy reform is required to bring about sustainable growth and productive employment. A substantial program of analytical work in these areas is being implemented, often jointly with the Mexicans.

Outstanding Issues

13. Policy change in the above four areas is taking longer to start than expected, mainly because Mexico has been slow in coming to grips with its fundamental structural adjustment problems. Strong nationalism, long-standing hostility toward outside advice, complex systems for reaching decisions, and the politically-painful nature of the reforms themselves are the most important factors accounting for this slow response.

14. Since 1985 we have conducted intensive discussions on a three-year program of gradual reductions in tariffs and import restrictions to strengthen the competitiveness of Mexican industry. Toward this purpose, we are currently negotiating a $500 million Trade Adjustment Loan. This loan, together with a new IMF stand-by agreement also being negotiated, is expected to form the centerpiece of $5-7 billion net new foreign financing package for 1986 (the precise magnitude remains to be determined). The package would include loans and refinancing from commercial banks, bilateral agencies and the Inter American Development Bank. Without prompt infusions of new money, foreign exchange reserves would rapidly be depleted, the economy severely disrupted, and/or the Government impelled toward unilateral debt relief measures.

15. While Bank lending to Mexico has been marginal compared to massive lending by commercial banks, we have now become an important source of long-term finance and advice. We play--with the IMF--a catalytic role in mobilizing new financing in support of medium-term adjustment and growth, and in monitoring its efficient use. This is the fourth year of de la Madrid's six-year term, the last in which the President can act unimpeded by the search for a successor. Given proper Mexican policies, the Bank can play a key role with its advice and with annual lending in the US$1.5 billion range.

LAC COUNTRY INDICATORS

	Population 1/ Million	GNP per 1/ Capita US$	Total MLT 2/ Debt US $b.	IBRD 3/ Exposure %	Total MLT 4/ Debt as % of Exports	Level 5/ of Bank Effort—SYs	Perf. 6/ Rating
Members							
1. Antigua & Barbuda	.08	1730	NA	NA	NA	0.3	
2. Argentina	28.8	2030	38.2	1.4	386	14.4	3
3. Bahamas	.22	4060	.21	4.6	16	1.6	3
4. Barbados	.26	3930	.28	8.1	34	5.3	4
5. Belize	.15	1140	.07	3.5		2.2	3
6. Bolivia	6.0	510	3.5	8.6	423	4.4	2
7. Brazil	129.7	1890	87.0	5.3	288	53.5	4
8. Chile	11.7	1870	17.3	1.4	359	12.0	4
9. Colombia	27.5	1410	9.4	19.5	177	32.8	4
10. Costa Rica	2.4	1020	3.7	6.2	296	5.1	3
11. Dominica	.08	970	NA	NA	NA	1.7	4
12. Dominican Republic	5.9	1380	2.5	6.8	185	6.8	2
13. Ecuador	8.2	1430	6.8	4.2	229	11.1	4
14. El Salvador	5.2	710	1.5	9.2	167	2.3	2
15. Grenada	.11	990	.04	0		0.4	2
16. Guatemala	7.9	1120	1.6	11.5	128	6.6	2
17. Guyana	.8	520	.7	13.2		3.2	1
18. Haiti	5.3	320	.5	30.5	159	9.4	2
19. Honduras	4.1	670	2.0	19.8	226	6.3	2
20. Jamaica	2.3	1300	2.3	17.7	166	10.4	3
21. Mexico	75.1	2240	87.5	3.8	271	36.4	3
22. Nicaragua	3.0	900	3.8	5.7	834	1.7	
23. Panama	2.0	2070	3.1	9.3	45	6.0	3
24. Paraguay	3.2	1410	1.4	18.6	155	5.8	3
25. Peru	17.9	1040	11.3	5.4	284	15.0	2
26. St. Christopher (St.Kitts) & Nevis	.05	820	NA			0.3	2
27. St. Lucia	.13	1060	NA			0.3	3
28. St. Vincent & the Grenadines	.10	860	.02	0	NA	0.5	4
29. Suriname	.36	3520	NA			0.1	
30. Trinidad & Tobago	1.1	6900	0.9	4.3	34	2.0	
31. Uruguay	3.0	2490	2.7	4.9	194	6.7	4
32. Venezuela	17.3	4100	23.7	.2	126	1.0	
Others - Members of CGCED							
33. Montserrat	.01	2360	NA			0.2	
34. Neth. Antilles	.26	NA	NA				

1/ 1983, from 1985 World Bank Atlas.
2/ Total Medium & Long Term Debt Outstanding and Disbursed at end 1984—Debt Tables.
3/ IBRD and IDA Outstanding and Disbursed Debt as a percentage of Total MLT Debt: as of end 1984.
4/ Medium & Long Term Debt as % of Exports of Goods and Services 1984.
5/ FY86 Task Budget.
6/ Countries rated on a 1 to 5 scale, (5 high) on their recent economic performance: Bank-wide exercise, November 1985.

RG:RVP3:indicator
April 23, 1986