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The World Bank
OPERATIONS COMMITTEE

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Minutes of the Operations Committee Meeting to Consider SUDAN - Economic Recovery Credit, held on April 13, 1988, in Mr. Qureshi's Conference Room, E-1243

A. Present

Committee		Others	
Messrs.	M. Qureshi (Chairman)	Messrs.	T. Allen, AF2
	E. Barandiaran, LACVP		K. Amoako, AF2
	S. Fischer, VPDEC		T. Baudon, SVPOP
	H. Fleisig, ASIVP		V. Dubey, EASDR
	D. C. Rao, FRSDR		S. El Serafy, EAS
	S. Sandstrom, AFRVP		H. J. Gruss, LEGAF
	I. Shihata, VPLEG		K. Lateef, AF2
	W. Thalwitz, EMNVP		C. Madavo, AF2
	H. Vergin, SVPOP	Ms.	C. Mann, VPDEC
			R. Nooter, AF2CO
			C. Obidegwu, SPRPA
			S. O'Brien, AFRVP
			O. Rahkonen, SEC
			C. Robless, OPNMS
			W. Schwermer, CODOP
			M. Yaqub, IMF

B. Issues

1. The Operations Committee met on April 13, 1988 to consider the Initiating Memorandum (IM) for an economic recovery credit to Sudan approximately in the amount of $150 million. The discussion followed the agenda prepared by the Economic Advisory Staff. The issues raised included skepticism about the success of the new program in the light of the poor implementation record of past operations in Sudan; the status and realism of the medium term program and its likely financing; the role of the exchange rate; savings and investment; parastatal reform; and the regulatory framework.

C. The Discussion

2. The Chairman asked the Region to explain the basis for the proposed operation, considering the past unsatisfactory record of adjustment programs in Sudan and the very large size of the external gap. The Region stated that they had very carefully weighed the considerations

for and against this obviously risky operation. For about three years lending had been confined to a core program in the absence of a satisfactory macroeconomic framework. This had to await the development of a short term action program for 1987/88 which took shape last year with Fund advice, while the Bank helped with a medium term program. The medium term program has now been agreed in principle, but has yet to get formal Cabinet approval. A PFP and a 1988/89 action program are in the making. A Heads of Delegation meeting was held in December 1987, but commitments fell somewhat short of requirements. A Consultative Group meeting is planned for May 1988, by which time progress will have been made on the medium term framework. Although the case is fragile, the Region sees the current situation as offering a good opportunity for long-awaited policy changes. However, there is a costly war in the south, and an enormous debt and debt service arrear problem. The Economic Recovery Program measures would be incorporated in the next budget, and the Region has taken care to front-load the operation in view of the risks involved so that commitments on the Bank's part would be closely linked to satisfactory actions on the Government's side at each step in the process.

3. On the implementation of past operations, the Region said that the record was not altogether a bad one in the period 1979-84 when Sudan had a number of agreements with the IMF, which had a mixed record of implementation. Sudan also had access to two IDA adjustment credits, in 1980 and 1983, which had a good record, as the exchange rate was adjusted and some improvement occurred in pricing and payments systems so that the production of export crops rose to levels that had been achieved in the seventies. Sudan had a setback, however, during the last two years of the Numeiri regime, which was a period of overall economic deterioration.

4. The IMF representative added that the Fund was equally concerned about the program, its feasibility, Government commitment, and the mobilization of foreign assistance in its support. All of these issues were the subject of a Fund Board discussion the day before. One difficulty with Sudan is that agreements reached in principle are not always easy to translate into agreements on specifics. There were risks in not taking action, and there were risks in taking action, but the IMF has decided that it will continue to support the Government's program so long as progress is satisfactory.

5. The Chairman asked the meeting to focus on the exchange rate policy and sources of finance other than the Bank that are necessary to fill the remaining gap. He was particularly concerned that the Bank should not be "going it alone" without financial support from other donors. The Region said that it planned to ascertain donors' attitudes, both in regard to aid and the IMF arrears, when the medium term program has been finalized. However, some $750 million in aid is expected to be disbursed in FY1988, whereas about $400 million, apart from debt repayments, is required. The Chairman reiterated his concern about the clarification of the role of others, and how much of their pledges covered arrears due to them and how much would be in the form of new money.

6. On macroeconomic policy and the exchange rate, the Region said it was working closely with the IMF. The Fund concentrated on the annual programs within the medium term framework worked out with the Bank. Thus

the Fund is addressing exchange rate issues as well as demand management concerns including budgetary and monetary targets. Its forthcoming mission will work on the 1988/89 program as well as the PFP which is expected to incorporate the medium term program.

7. The Chairman enquired if pegging the Sudanese pound at a high level was not impeding the liberalization process being sought. In answer, the IMF representative said there was no doubt the pound was overvalued, but the question is by how much. Adjusting the exchange rate was a sine qua non for proper demand management; so was improving the fiscal balance. Experience in Sudan shows that agreed targets on such things as tax/GDP ratios turn out to be disappointing in retrospect. He did not know what the exchange rate level should be since results of a study on this subject are not yet ready. However, the Fund has already begun to estimate the production cost of major exports as a threshold to determine an exchange rate consistent with export competitiveness; and also to follow the implications of an adjusted rate for the cost of imports and the impact of that on the budget, credit, etc. The subject was of course very sensitive, but in any event no specific level of exchange rate can be indicated before more is known. It would be counterproductive, he added, to effect a significant devaluation of the exchange rate prior to some progress on decontrolling domestic prices, and said that both the Region and the IMF should continue to work closely on appropriate macroeconomic policies, including the exchange rate.

8. A member questioned the optimism built into the export projections, and asked if the whole program was in fact feasible since failure would make matters worse. He asked about the sources of funding for technical assistance and for redressing the social cost of adjustment. The Region replied that export growth was starting from a depressed base, and that the growth projected was certainly possible, albeit optimistic in the light of recent performance. However, the important thing is to assure that appropriate policies are put in place in order to move the economy in the right direction. Other sources besides this credit would be tapped to finance technical assistance and the social cost of adjustment, but what is coming from the proposed credit would be fully disbursed over its life.

9. Another member had difficulty with understanding the relative importance of goods whose prices are to be exempted from decontrol. He also questioned the impact on the projected revenues of the tax measures proposed, considering that some of them would be difficult to enforce and had not yet been agreed with the Fund. The Region responded that the revenue projections were only indicative of the tax change; that a dialogue was already taking place on these issues with the Government; and that the two missions would be seeking Government agreement on specific revenue and expenditure measures. The Chairman intervened to say that his understanding was that the Region was proposing agreement with the Government on a broad tax design, but that the specific measures would be left until December 1988. What was promised by June was a broad outline of the reforms. He hoped that before Board presentation the operation would have addressed issues of cost recovery, such as land and water charges on

the irrigated schemes and of public utilities. The Region responded that cost recovery conditionality was included under other credits such as ARP-III and the parastatal reform program. As to tax changes, the Region's projections did not reflect estimates of returns from each, but were indications of the tax performance required to meet the budgetary and revenue objectives.

10. A member queried the wisdom of going ahead with this credit before a PFP and a financing plan, considering also that the debt problem was substantial. The Region said it expected the PFP to be in place before the operation goes to the Board, and that work was progressing with the IMF and other parts of the Bank to delineate options for an attack on the arrears problem. The same member emphasized that if we went ahead and no complementary financing materialized, there was a grave risk that Government resolve to implement the adjustment program might be dissipated. He also urged the Region to develop to the extent possible the linkage between the proposed policy changes and the numerical outcomes in the projections for 1988/89 and beyond, especially if finance did not materialize. The Region said that we should not be mesmerized into inaction by the problem of arrears; plans were already in hand to engage donors' support, and the Region was fairly certain that something would work out which would at least meet the financing needs of the economy.

D. Other Issues and Decisions

11. By way of conclusion the Chairman turned to parastatal reform saying that what was being proposed in this regard should be clearly spelled out. The issue of parastatal pricing was critical, and the whole approach to this should be made clear. As to imports, he thought that there was very little liberalization planned, and he had put that down to the lack of movement on the exchange rate. He wanted to see spelled out the degree of liberalization sought, with indication of the relative importance of the various imports affected. He thought that the proposed retroactive financing of 10% of credit proceeds should have very clear justification or else it should be dropped. Finally, the Chairman directed that the operation should proceed to appraisal subject to the points mentioned above.

April 25, 1988

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: April 11, 1988

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS V Dubey

EXTENSION: 78051

SUBJECT: <u>SUDAN - Initiating Memorandum for an Economic Recovery Credit</u>

1. The Operations Committee will meet on Wednesday April 13 at 2.30 p.m. (not 3.00 p.m. as previously announced) in Room E-1243 to consider the Initiating Memorandum (IM) for a proposed IDA Credit for about $150 million in support of an Economic Recovery Program. The Committee may wish to take up the issues identified below as an agenda for the meeting.

<u>Background</u>

2. When the present coalition government assumed office in May 1986 the economy was in total disarray. GDP had hardly grown during the previous decade. Drought, civil war and economic mismanagement had led to low investment, a decaying infrastructure, high inflation, budget deficits and substantial parastatals losses. Severe shortages of inputs and consumer goods became standard occurrences. The foreign debt mounted, and so did debt service arrears. It took the government seventeen months to announce in October 1987 an action program for fiscal 1987/88, worked out with Bank-Fund assistance. This has included fiscal and monetary adjustment, and a depreciation of 44%. A medium term program for "Salvation, Recovery and Development" is being worked out. This, the Region would support by annual economic recovery credits of which the present operation would be the first. The Bank and the Fund have been active in Sudan during the past decade, and the Bank's own lending program on IDA terms has been replete with "rehabilitation" credits. However, as the IM states (para. 12) "the record of unsuccessful attempts to achieve economic adjustment in the past has made donors skeptical of Sudan's ability to sustain a major reform effort."

- <u>The Region might review the fairly unsuccessful record of rehabilitation and recovery for IDA projects since 1980 in order to dispel a lingering skepticism that the new program might meet with the same fate as previous reform attempts.</u>

What is the basis for thinking this is new & a solid beginning

- <u>Would the Region throw more light on the lack of implementation of measures previously agreed under agricultural rehabilitation credits, which, however, are indicated as necessary in the future medium term program?</u>

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The Medium-Term Framework

3. A draft medium term program is said to be already available with a four-pronged approach aiming at strong demand management; stimulating supply responses from existing investments; drawing underground activities into the formal economy; and revitalizing private savings and investment. A detailed 5-year program (1988/89-1992/93) is outlined in the IMF March Staff Report for Article IV Consultation. Provided a set of optimistic assumptions holds (including absence of severe drought and substantial foreign aid) the economy would grow at 4.5% a year; inflation would reduce from 37% to 12%; the current account deficit would decline from 10% to 6% of GDP; and with ICOR at 2.8, investment would increase from 10% to 17% of GDP over the projection period. The role of the private sector in all this would be crucial and therefore a convincing liberalization policy is necessary to revive confidence and induce efficient allocation of scarce resources. Also needed is a major shake-up of the parastatal system which is overstaffed, inefficient, and subject to stifling regulations and faulty pricing signals. A Policy Framework Paper is foreshadowed, and a mission to discuss it in the field may coincide with the appraisal mission for this operation.

- The Region might elaborate on the chances of such a program being adopted and, if adopted, implemented, given the political constraints.

- What level of outside financing was promised at the Consultative Group Meeting in December 1987; and can this be raised? What levels of aid are required for the medium-term program, and what can realistically be expected?

Exchange Rate Policy

4. The inadequacy of the exchange rate policy pursued during the past decade or more, has contributed to the rise of the very complex regulatory measures that have characterized the economic system of Sudan. The parallel market is said to value the US dollar at 9.5 Sudanese pounds, whereas a major devaluation in October 1987 had set the rate at $1=4.5 Sudanese pounds. The IM is a little inconsistent on the exchange rate, maintaining simultaneously that the pound "remains significantly overvalued" (para. 13) and that the new official rate has "ensured price incentives for the principal export crops without explicit or implicit subsidies" (para. 23). The claim that Government is reiterating its intent under the "Salvation, Recovery and Development Program" to "continue to review the exchange rate in a flexible manner to assure export competitiveness" rings hollow, considering that the rate is now neither flexible nor at an adequate level. A radical change of government position on this would be a clear signal of its commitment to the program and in fact might make it easier to accelerate the liberalization process without getting the Bank entangled in monitoring detailed regulatory changes.

- o In view of the considerable benefits that can accrue to Sudan from a truly flexible exchange rate policy, what can we and the Fund expect by way of movement on the exchange rate over the medium term?

- o And what exactly is expected by way of Government commitment on this issue as a condition of Board presentation as set out in the Policy Matrix in Annex A?

Savings and Investments

5. Very clearly the level of savings and investment are low and they need to be raised substantially. The IM shows savings in terms of national and not domestic savings. National savings are said to be -0.4% of GDP [(compounded according to the IMF Report of -9.1% government and +8.7% private (together with "public enterprises.")] Under the program private national savings would at a minimum be maintained, while the government's deficit would be turned to a surplus of 1% of GDP by 1990/91 (para. 17).

- o Would the Region indicate the sources and levels of domestic savings and their projected development over the next few years? Savings

- o Is the programmed domestic improvement of public savings between now and 1990/91 realistic? How much improvement

- o How much improvement in the savings-investment climate can be expected from reforming the financial intermediation system along lines yet to be determined (para. 21) if no movement is forthcoming on the exchange rate? Can realistically be expected

Parastatal Reform

6. The parastatal sector plays a most important role in Sudan's production, marketing and exports. Making it a "leaner and more effective" sector naturally provides a major objective for the program which is described as a "balanced mixture between rehabilitation and divestiture of enterprises" (para. 35). Bank support for program implementation, the IM states, would be through the medium of IDA projects for specific parastatals, as well as this and subsequent economic recovery credits. Reforms being sought include a freeze on establishing new parastatals; classifying by purpose existing parastatals in order to identify commercial and strategically important entities; discontinuation of their tax and credit preferences; giving them greater autonomy; and rationalizing their staffing and operations.

- Considering the very large number of parastatals in existence, is the individual entity approach practicable?

- As to the blanket approach to reforming parastatals, would the Region explain why the Public Enterprise Economic Management project, approved in FY1987, has not become effective yet?

- And since several projects involved with parastatals are at various stages of implementation, or more accurately, lack of implementation, would it not be wise to reiterate their conditionality under this operation in order to accelerate reform? [Compare in this regard the reference in para. 34 to agricultural price conditionality being already included in ARP III and therefore need not be covered here.]

In view of lack of performance, what is our approach

Regulation of Exports, Imports, Investment and Other Conditionality

7. Exports are heavily regulated, and the proposed set of deregulatory measures, all to be implemented before Board presentation, are praiseworthy. However, concerning the simplification and streamlining procedures and information requirements for registration of exporters, should not all registration of exporters be done away with? In the same vein, what is the rationale of maintaining a list of permissible imports under own-resources scheme? Why cannot all imports be allowed if the importers provide their own financing? Such a policy would bring in needed imports at times of scarcity, and would encourage workers' remittances. Furthermore, can the "extensive red tape" now governing investment approval be eliminated sooner than the second tranche as proposed? As to the various fiscal reforms contemplated, have these been discussed with the IMF? [The IMF Report (p. 19) indicates otherwise.] Can any commitment be obtained on reforming the civil service which is demoralized by low pay and dulled incentives? And lastly, can some assessment be made, however interim, of the social cost of this far-reaching adjustment program--far reaching, that is, if it is implemented? In other words, would not the enormous social cost involved reduce the chances of program implementation?

cc: Messrs. Lee, COD; Shakow, Liebenthal, SPR; Holsen, CEC; Rao, Steer, FRS; Burmester/Thahane, SEC; Baudon, SVPOP; O'Brien, Madavo, Amoako, Allen, AFR; El Serafy, EAS.

For Information Only

Messrs. Hopper, SVPPR; Bock, DFSDR; Goldberg, VPLEG; Frank, IFC(CFP); Parmar, IFC(CIO); Pfeffermann, IFC(CEI); Baneth, IECDR; (Ms.) Haug, EXC; Robless, OPNMS; Agarwala, AFRCE.

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April 1, 1988

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The World Bank
OPERATIONS COMMITTEE

CONFIDENTIAL

Minutes of the Operations Committee to consider NIGERIA: Trade and Investment Policy Loan (TIPL)- Green Cover President's Report on April 1, 1988 in Room E-1243

A. Present

Committee	Others
Messrs. M.A. Qureshi (Chairman)	Messrs. M. Alizai (CA2DR)
C. Quijano (LACVP)	T. Baudon (SVPOP)
S. Sandstrom (AF6DR)	F.M. Chaudhri (EAS)
M. Wiehen (ASIVP)	F. Earwaker (SPRPA)
P. Hasan (EMNVP)	E. Grilli (EAS)
H. Scott (VPLEG)	R. Harris (CODOP)
J. Wood (VPFPR)	J. Ijichi (AF4CO)
J. Holsen (CECDR)	C. Koch-Weser (AF4DR)
	S. O'Brien AFRCE)
	G. Pfeffermann (CEI)
	O.Rakhonen (SEC)
	A. Rigo (LEGAF)
	Ms. J. Salop (AF4CO)
	L. Squire (AF4CO)
	T. Swayze (AF4CO)

B. Issues

1. The meeting was called to discuss the Green Cover package of the proposed Trade and Investment Policy Loan (TIPL) to Nigeria. The discussion covered the main issues raised in the EAS memorandum of March 29, 1988 and focussed on the macro policy context of the proposed operation, exchange rate and the auction mechanism, tariff adjustment and the protection regime, private investment and industrial regulations, conditions of second tranche release, social impact of the adjustment program and Bank strategy vis-a-vis donors and the financing package.

C. Opening Statement by the Region

2. At the invitation of the Chairman, the Region informed the Committee that the Government of Nigeria remained strongly committed to the adjustment process. A decision had been taken by the Council of Ministers to phase out the petroleum subsidy but no announcement had been made as yet; nor was it clear when the decision would be implemented. On the domestic political front the Region felt that there was less friction in the military and, compared to the early January when the 1988 budget was announced, the concern about labor unrest has now subsided. The weekening of the oil price, however, had deterred the Government from coming out with a strong budget as expected earlier. The foreign exchange inter-bank rate had also increased relative to the auction rate in recent weeks.

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3. The Region indicated that Bank staff has continued to work closely with IMF staff, but given the difficult IMF-country relations, the Bank remains in the forefront of the macroeconomic policy dialogue. Broadly speaking, the Bank and the Fund agreed on most of the necessary macro economic policy adjustments. Two areas in which the two institutions remain somewhat apart are: the level of funding for the auction market and the size of the uncovered financing gap. The Region also informed the Committee about the status of discussions with the commercial banks on the financing package for 1988, indicating prospects for lengthy and difficult negotiations ahead.

D. Discussion

4. The Chairman followed the agenda prepared by EAS. The first question he raised was with respect to the major effort needed to correct the budgetary imbalance. The Region responded by saying that the Nigerians saw the need for budgetary corrections, although they were thinking of somewhat smaller cuts than the Bank. The Fund and the Bank were in broad agreement on the magnitude and composition of the required budgetary cuts. In the Region's judgement, the major areas for cuts would be in the public expenditures program because the scope for revenue increase remained limited, except in the area of petroleum pricing. The Region also felt that the size of the actual budgetary cut remains sensitive to the magnitude of the financing package.

5. The Chairman expressed concern about the low level of real investment relative to GDP (which was perhaps just sufficient to maintain the capital stock) and on the severity of reduction in per capita consumption in recent years, and wondered whether the scenario presented was viable. He felt that securing a drastic reduction in the budget would not be easy, especially because the rising rate of inflation and narrowness of the auction market have made the system delicately balanced and vulnerable. Some other speakers also stated that given the foreign exchange rate is adjusting upward and debt service rising and the budget deficit is deteriorating, the effect on other expenditure must be severe. Also, given the relatively low level of public investment there must be severe pressure on the Government not to cut expenditures to the degree suggested in the program documents. The Region addressed these concerns by saying (i) the low investment-to-GDP ratio in constant terms was in part due to the greatly over-valued exchange rate in the base year and (ii) the investment-to-GDP ratio in current prices was typically twice the level in the constant price projections. In the Grey Cover, the Region would present the forecast using a post reform year as the base. The Chairman concluded the discussion by reiterating the importance he attached to the viability of the savings and investment scenarios underlying a program's projections and the articulation of the budgetary and financial policies needed to bring them to fruition.

6. Turning to the question of the exchange rate policy and auction mechanism, the Chairman asked why could the size of the market not be further expanded in tandem with the desired depreciation of the currency. The Region explained that initially the auction system had been restricted to private sector imports and approved capital transactions, but recently the Government had decided to channel public sector imports through the

auction. Therefore, the coverage of the auction market had already expanded; although there was some scope for further expansion.

7. The Chairman referred to para. 30 in the draft President's Report and drew the Region's attention to the discussion of the chronology of the changes in the protection regime. He suggested that it be revised to highlight: (i) what had been the cumulative net effect of changes in the protection regime since the beginning of the reform process and (ii) what additional measures can realistically be introduced to further improve the protection mechanism.

8. On the question of private investment and industrial regulations the Region stated that as a first step, the Government's agreement to liberalize the Nigerian Enterprise Promotion Decree, which governs foreign investment, and to establish the Industrial Development Coordination Committee (IDCC) as a "one-stop shop" to investment approvals were important measures to facilitate investment and reduce the severe drag of the regulatory mechanism. To further reinforce the process, the Bank is including satisfactory operation of the IDCC as a condition of Second Tranche release.

9. There was considerable discussion on the nature of the second tranche release conditions which, according to the Chairman, required greater specificity, if not explicit performance criteria. In its response the Region stated that leaving conditions in somewhat general terms had proved helpful in the Trade Policy and Export Development Loan (TPED). The Region wanted to follow the same approach in the proposed operation. One speaker suggested that the Bank's intentions with respect to some second tranche release conditions could be specified, e.g., by making clear that we would be monitoring the real exchange rate. The Chairman concluded by saying that the Region could retain some flexibility in the conditions, but that these should still be made more specific, and the objectives the Bank is seeking to achieve should be spelled out more clearly in the text.

10. In light of the prospects of accelerated inflation, budgetary cuts, and recent sharp decline in the per capita consumption, the Chairman pointed out the need for further discussion of the social cost of the adjustment program. The Region explained that the brunt of the Program's adverse effects was being borne by the urban middle class as they had been the beneficiaries of the over-valued exchange rate. The Region agreed to expand that section of the report to reflect its full findings and indicate the steps needed to minimize the social costs.

11. The Chairman asked what precise strategy the Region aimed to follow vis-a-vis the other creditors. The Region explained that assuming the Nigerians could reach policy agreement with the Bank and the Fund, its proposal was to go ahead even without agreement in principle with the banks. Hopefully, the Fund would also be able to go to its Board for approval in principle, which would open the way for the Paris Club. The Region is prepared to play an active role with the London Club, but it did not feel that much progress could be achieved in the next few months. One Committee member felt that the proposed operation was predicated on the availability of foreign financing and that it could not achieve its objectives unless it is accompanied by a volume of external financing

broadly in line with what is assumed in the Initiating Memorandum. The member noted that there is still significant uncertainty about how much external financing can realistically be mobilized. He urged that a strong effort be made to firm up a financing plan before the Bank commits its own resources. The Region agreed on the critical importance of the financing plan as a condition of Bank support, and argued that this was implicit in the Board presentation condition of policy agreement with the Fund. However, actual agreement with the creditors would take longer, although, with the endorsement of both the Bank and the Fund, it was likely to be forthcoming. To the question "why not hold up the proposed operation until some agreement with other donors was forthcoming", the Region answered that such an approach would be very risky; it could well mean that the Nigerians might not take the difficult decisions they need to take, and the adjustment process now underway could be jeopardized. The Chairman emphasized that there was a need in this case to carefully balance the urgency of going ahead and sustaining the desirable shifts in policies in Nigeria with making sure that adequate progress was simultaneously being made on the financing package. The Chairman concluded that the Region could take the next step in the processing of the proposed operation but at the same time it must also reinforce its effort to help Nigeria obtain the necessary agreements with the London and Paris Clubs as soon as possible. He emphasized that in any event, the release of the second tranche must be made contingent upon a satisfactory agreement with other creditors.

12. Responding to the Chairman's query on the IFC role in Nigeria, the IFC representative informed the Committee that an IFC office has been opened in Lagos but the problems of exchange rate risk were hindering the Corporation's operations. The Corporation was working on a case-by-case basis and hoped to establish a few credit lines with some merchant banks. Under the Bank's proposed apex loan for small industries in Nigeria, large amounts would become available to the banking sector without the borrowers assuming the exchange risk. The Bank and IFC have been working closely together to reduce the areas of overlap between such lines and the IFC lines of credit and are also coordinating closely with respect of the financing of two large projects (Mobil's Oil condensate and NNPC's petrochemical projects) where joint financing from the two institutions is being sought.

May 9, 1988
FMChaudhri:gs

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

Date: March 29, 1988

To: Operations Committee

From: Enzo Grilli, EG Acting Director, EAS

Extn: 78061

Subj: NIGERIA: Proposed Trade and Investment Policy Loan (TIPL) Green Cover President's Report - Agenda

1. The Operations Committee will meet on Friday, April 1, 1988 at 3.00 p.m. in Mr. Qureshi's Conference Room (E-1244) to discuss the draft President's Report on the proposed Trade and Investment Policy Loan for US$500 million to Nigeria. The Initiating Memorandum (IM) for the proposed operation was submitted to the Loan Committee on May 11, 1987; there was no meeting but the Region was advised to proceed with the appraisal of the proposed TIPL on the basis of the IM. Overall, the Region has added more items to the proposed operation's action list than those deleted from its IM. The proposed operation would cover policy issues in five major areas: maintenance of a realistic exchange rate policy; further reform of protection regime; export incentive measures; stimulation of private investment; and rationalization of capital budgeting process and the public expenditure program.

2. The Committee might like to discuss the following key issues:

(a) macroeconomic policy content. The trade and investment framework is clearly affected by, and is closely linked to, the domestic macro balances (savings, budget, etc). If the main domestic imbalances are not corrected, the program of trade adjustment, exchange rate correction and investment cannot go far. How far the Region is confident that a large budgetary correction, amounting to 30% of projected federal budget revenue and 5% of projected GDP would actually materialize? (Do the Bank and the Fund agree on the magnitude of this and other macro corrections?) What is the process through which the budgetary and other macro corrections will be monitored in the context of the proposed operation, particularly because the signing of the Letter of Intent with the IMF does not necessarily ensure compliance with the agreed macro targets.

But 82-85 per capita consumption dropped by 30% Current Ac/deficit 8% GDP

Supply Response

(b) Exchange Rate Policy and Auction Mechanism. The basis of allocating foreign exchange for funding the auction mechanism is not clear. While the proposed reduction of funding from US$120 million to US$100 million per fortnight is compatible with the need to depreciate the exchange rate to N5 = US$1.0, it would also narrow the scope and coverage of the auction market. Would it not be desirable to gradually increase foreign exchange allocations and expand the list of commodities

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eligible for imports under the system in such a way that would lead to the desired exchange rate without necessarily shrinking the auction market?

(c) Protection Regime. Given the complex system of tariffs and bans, it is not clear whether the actions taken so far and those intended for implementation, would significantly reduce the degree of protection and/or the level of industrial restrictions.

(d) Private Investment and Industrial Regulations. A resumption of investment activity is critical to the adjustment process. How far is the Region satisfied that the forthcoming Industrial Policy Statement would significantly reduce the damaging effects of industrial regulations and investment licensing and how would it ensure the effective and efficient implementation of the policy?

(e) Conditions for Second Tranche. Most of the conditions for the release of second tranche are couched in broad and general terms, e.g., expecting satisfactory review, agreement, progress or operation of different schemes and undertakings. Would it not be desirable to make them both specific and concrete?

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(f) Social Impact of the Adjustment Program. A number of steps have been included - budgetary corrections, tariff changes and the like - which will affect certain subsectors and groups of population more than others. The estimates show that inflation will rise to about 20% and 'a worsening of the unemployment situation is inevitable'. Under these circumstances, is it not necessary to analyze which sectors of the economy and parts of the population would gain and which would lose and what is being done to safeguard the vulnerable groups?

(g) Exposure Situation. According to the Region's calculation, the IBRD share in total external debt would continue to rise, reaching 20% by 1995. The IBRD debt service ratio would also rise from 4% in 1987 to 7% in 1990 and 9% in 1995. How far the exposure level and burden sharing are likely to become issues in the 1990s.

Debt Strategy

(h) Conditions for and Date of Effectiveness. Given the number of conditions for effectiveness, and the time required to process the proposed loan from the IM to the Green cover stage, is it realistic to plan date of effectiveness in May 1988?

No Reform chances

3. Broader Considerations. Besides presenting the proposed loan, the Region has also sought in the last paragraph of the cover memo the Committee's endorsement of a Bank lending program of $3.0 - 3.8 billion

Social aspects of the program

Public Consumption Annex p.8

Social

External Gap

during FY88-90, and the support the Bank should provide the Government in its debt rescheduling and the money inflows from the commercial banks. The Committee might like to address these points as well.

cc: Messrs. Lee (COD), Shakow (SPR), Holsen (CEC), Rao (FRS), Baneth (IEC), Thahane, Burmester (SEC), Liebenthal (SPR), Steer (FRS), Baudon (SVPOP), Bock (DFA), Frank, Parmar (IFC), Hopper (PPR), Goldberg (VPLEG), Robless (OPNMS), Agarwala (AFRCE), O'Brien (AFRCE), Koch-Weser (AF4DR), Humphrey (AF4CO), Ms. Haug (EXC)

FMChaudhri:gs

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: March 25, 1988

TO: Mr. Moeen A. Qureshi, Senior Vice President, Operations
Through: Mr. Edward K. Jaycox, Vice President, Africa Region
FROM: Caio Koch-Weser, Director, AF4

EXTENSION: 34858

SUBJECT: NIGERIA -- Proposed Trade and Investment Policy Loan (TIPL) Green Cover President's Report

1. The Operations Committee is requested to consider the attached draft presenting the Region's recommendation for a US$500 million Trade and Investment Policy Loan to the Federal Government of Nigeria. The Initiating Memorandum was submitted to the Loan Committee on May 11, 1987; there was no meeting. This memorandum (i) summarizes the status of the Nigerian Structural Adjustment Program, the continuation of which the proposed loan would support, and highlights the critical decisions now facing the Nigerian Government; (ii) puts the proposed operation in the broader context of Bank strategy towards Nigeria; and (iii) presents the main issues for negotiations and timing considerations. It concludes with recommendations for Bank actions for which we seek your support.

I. The Reform Program

2. Background. The Nigerian economic reform program was introduced in mid-1986, supported by a US$452 million Trade Policy and Export Development (TPED) Loan from the Bank. There was also an SDR 650 million stand-by arrangement with the Fund, although the Nigerians made clear at the outset their intention not to draw under it. The centerpiece of the program was the introduction of a market-determined exchange rate system and the elimination of import licensing. These steps constituted a radical break with the previous policy framework, which had relied on administrative controls and had fostered corruption and rent-seeking behavior at the expense of productive activity. The program included initial steps to reform tariff and export policies. The inefficient agriculture commodity boards were abolished, thereby substantially raising incentives for the production of export crops. And the Government announced its intention to commercialize and privatize the large parastatal sector. In order to forestall excessive pressure on the exchange rate and prices, monetary and fiscal restraint played an important role in the program's design. Financing for the large foreign exchange gap in 1986-87, which resulted from the steep drop in oil revenues in 1986 and large debt service obligations and outstanding arrears, was to be provided from the TPED loan and reschedulings and new money from the London and Paris Clubs. In the event, with the exception of disbursements under TPED, no new money inflows materialized.

3. Implementation of Structural Measures. Implementation of the essential structural measures supported by TPED has been satisfactory. Prior to the introduction of the second-tier foreign exchange market (SFEM) in September 1986, the allocation of foreign exchange had been

subject to stringent but arbitrary quantity rationing, as demand for foreign exchange at the official exchange rate far outstripped supply. With the introduction of SFEM -- encompassing an auction and an interbank market -- this process was replaced by a floating exchange rate system for the allocation of foreign exchange across competing uses. The new system has proved an effective vehicle for securing the long resisted depreciation of the naira, and the auction rate has averaged US$1 = ₦4.0 since its inception, compared with US$1 = ₦1.2 in the preceding 12 months. The official first-tier rate was unified with the auction rate as scheduled in mid-1987, and in the 1988 budget the auction's scope was widened to include foreign exchange purchases by parastatals and Government ministries. The interbank market is functioning well, funded by private sector inflows from non-oil exports and capital transactions. Auction funds, derived from oil exports and official sources, cannot be resold on the interbank market, and the differential between the auction rate and the interbank rate has hovered around ₦0.5 per US$.

4. <u>Macroeconomic Developments</u>. Performance on implementing macroeconomic policy has been weak. Overspending by the public sector last year, in both local currency and foreign exchange, depleted foreign currency reserves and left a legacy of excess liquidity in the economy. It also contributed to a breaching of the Fund's performance criteria early in 1987, and the first review under the stand-by was never completed. The overruns put pressure on the exchange rate, which the authorities were reluctant to see depreciate significantly below ₦4 = US$1 for domestic political reasons. However, the impact on domestic output and prices for most of the year was small, with inflation estimated at 10 percent and activity levels in the non-oil, non-agricultural sector staging a very modest recovery. This was accompanied by labor shedding in the manufacturing sector, which, in the context of 3 percent labor force growth, contributed to a further rise in the unemployment rate. The 1988 budget, announced in early January, was decidedly reflationary, and the exchange rate has depreciated to ₦4.3 = US$1. But more recently, as the weakness in world oil markets has persisted and as domestic inflation has shown signs of picking up, the authorities have begun to rethink their fiscal strategy and have given indications of their intention to adopt a more restrained stance.

5. <u>Impact</u>. With the new exchange rate policy, the gross overvaluation of the Naira has been eliminated. As a result, domestic currency prices for exports have risen sharply, and capital flight has been largely arrested. Access to foreign exchange by the productive sectors of the economy has become easier and more certain, and raw materials and capital goods now account for a significantly larger share of visible imports compared with the pre-SFEM period. The replacement of the import licensing system and foreign exchange controls with a system of protection based on a market-determined exchange rate and tariffs has further rationalized incentives. Reflecting these changes, major signs of adjustment are evident throughout the economy. Tree crop cultivation has witnessed a resurgence, and manufacturers are seeking

opportunities to exploit the new relative price structure. Output, investment, and employment in the export sector have picked up, and producers in all sectors are looking for ways to economize on imported inputs and to source their input needs locally. The shift in relative prices is also changing consumer demand patterns.

6. Assessment. The reform program has taken root and produced fundamental changes in the economic environment. Moreover, the experience of the past 18 months bears out our previous expectations that the dynamic and entrepreneurial spirit of the Nigerian people would respond well to the shift to a more market-oriented incentive framework. But while commitment to the program at the highest levels of Government remains strong, the political coalition that supports reform is fragile, and there is increasing pressure for an economic upswing and a reduction in unemployment. The recent weakening of oil prices has made the task of delivering on these goals that much harder, as the Government's ability to maintain funding of the foreign exchange auction at levels consistent with a sustained recovery has been severely compromised. The further depreciation of the exchange rate that will accompany reduced auction funding will weaken political support for the reform program and strengthen the hand of those who have already been arguing for unilateral reductions in external debt service payments. But the macroeconomic policy package that would stabilize the exchange rate with available auction funding could push the economy into a deep recession. Pressures to abandon the program and to reject conditionality imposed by the international community will undoubtedly intensify, and could succeed in achieving those ends, unless sufficient external resources can be mobilized to ensure a reasonable level of foreign exchange inflows, commensurate with the additional adjustment effort the Nigerians are going to have to make. In this increasingly difficult political and economic climate, the role of the Bank has become even more critical.

II. Bank Strategy

7. Overview. The Bank's primary objective is to help Nigeria increase growth in per capita income and consumption. This implies action on two broad fronts: first, to help maintain and deepen the reform program and provide the enabling environment that would allow it to generate an adequate supply response; and second, to help put together the external financing that is essential to keep the economy and the reform program moving forward. In current circumstances, there is also the critical short-run dimension, to maintain the viability of the program and to keep Nigeria's relations with its foreign creditors intact. These objectives are being addressed through our lending program and dialogue, both with the Government and the international financial community. The Bank's general strategy is briefly described in the following paragraphs. The particular role to be played by TIPL is discussed in section III.

8. Lending Program. The Bank's lending program, totalling $3.0-3.8 billion over the next 3 years, is designed to strengthen the supply side foundation necessary to achieve sustained growth. The proposed follow-up policy loan to TIPL, the Financial Sector and Development loan, accounts for about one-half of our lending in FY90 and would support measures to promote efficient resource intermediation through financial intermediaries and the federal budget. The level of future quick disbursing instruments, one per year, would gradually taper off as the Nigerians' reform program matures. These adjustment lending operations would be complemented by a broad program of sector activities, where we have established a very effective dialogue and have been able to pursue sectoral policy reforms. The ultimate objective of this traditional lending would be to facilitate growth in the productive sectors in line with long run comparative advantage; and the macroeconomic forecast provided below is predicated on a degree of success in these endeavors. A portfolio of seven to eight projects a year is foreseen, with agriculture, infrastructure, and energy accounting for the bulk of our sectoral lending. We are also providing assistance in the social sectors where we have renewed our policy dialogue and lending in education and are developing major interventions in population planning and the health sector. Project assistance would help ease the constraints to growth created by infrastructural bottlenecks, in many cases arising from years of inadequate maintenance. Institutional strengthening and rationalization, aimed at a greater degree of public sector cost effectiveness and cost recovery, would be integral parts of these operations. ?

9. Medium-Term Prospects. Although import levels are now substantially lower than assumed in the Initiating Memorandum, reflecting downward revisions in projected oil prices and export volumes, growth prospects beyond 1988 are reasonably good. Real import growth is now projected to average over 4 1/2 percent during 1989-95, compared with 4 percent in the Initiating Memorandum. However, this reflects the projected compression of imports in 1988 to US$5.6 billion -- representing a 6 percent decline in real terms from 1987's already low levels -- compared with US$6.3 billion projected in the Initiating Memorandum. On this basis, real GDP growth should average 4 percent over the period and per capita income should rise modestly. However, income levels are projected to remain low, with GNP per capita staying below US$300 throughout the period. ?

10. Creditworthiness. One of the objectives of the program was a restoration of commercial creditworthiness, which was to be achieved through selective external borrowing and some growth in debt, albeit at a slower rate than projected export growth, with the result that creditworthiness would be restored over time. This remains the basic approach; however, the time frame over which creditworthiness is projected to be restored has lengthened since the submission of the Initiating Memorandum. External debt in 1995 is now projected at almost US$37 billion, compared with US$29 billion previously. For the most part this reflects worsening conditions in and less favorable 37 billion

projections of future prospects for world oil markets, with oil exports in 1995 now projected at US$11 billion compared with previous estimates of US$13 billion. Even with reduced import levels, the economy's financing requirements have increased. The major sources of this financing are: (i) very favorable rescheduling terms for the promissory notes -- 22 years, 3 years grace -- agreed to in January which have added US$4 billion to the 1995 debt stock; (ii) an assumed rerescheduling of the Paris Club trade arrears, which provides an additional US$2 billion; and (iii) an assumed rerescheduling of the London Club letters of credit (LCs). Based on present forecasts, which have debt beginning to be paid down in 1995, we now expect a resumption of full commercial creditworthiness by 2006. This is based on the criterion of equality between external debt and exports of goods and non-factor services, which should yield a pre-rescheduling, steady state debt service ratio of 20-30 percent, depending on the interest rate and debt maturity structure.

What does this mean

full comm credit worthiness by 2006

?

11. <u>Exposure</u>. An important part of our country assistance strategy involves mobilizing external support from other creditors, through cofinancing, reschedulings, new money, and concessional aid, both to improve the foundations for growth and to ensure burden sharing. Assuming we go ahead with TIPL, and other creditors reschedule maturities and provide new money in the amounts assumed in our work-outs (para 13), IBRD exposure would rise from US$2.9 billion at end-1987 to US$3.6 billion at end-1988. This would raise the IBRD share in total external debt from 11 percent to 12 percent, even as the London Club share rises from 19 percent to 20 percent. Offsetting these increases are small declines in the exposure shares of the Paris Club and the promissory notes. With an annual lending program of US$1-1.3 billion, IBRD exposure would continue to rise through 1995, reaching 20 percent of the total debt stock in 1995. The London Club share in total debt would remain broadly unchanged over the period, reflecting assumed new money inflows after 1988 broadly equivalent to interest due on medium and long-term debt (MLT). On these assumptions, the IBRD debt service ratio would rise from 4 percent in 1987 to 7 percent in 1990, reaching almost 9 percent in 1995. As a percentage of total debt service, IBRD debt service would rise from 21 percent in 1987 to 22 percent in 1990 and 1995, and total preferred creditor debt service from 21 percent in 1987 to 24 percent in 1990, and 27 percent in 1995.

-9 2 90
7 2 -1995
21-22
24-27

III. <u>Trade and Investment Policy Loan</u>

12. The basic objective of the reform program is to influence the productive structure of the economy over time by addressing the underlying determinants of investment decision-making, because it is largely through investment that structural adjustment takes place. To this end, the proposed loan is designed: to encourage investment by improving the administrative climate, especially for foreign investment; to streamline and reallocate the public investment program to ensure that it supports growth, and to ensure that foreign financing sources are fully and efficiently tapped; and to ensure that the price signals

that inform investment decision-making are in line with Nigeria's long run comparative advantage. The policy agenda for TIPL (as was proposed in the Initiating Memorandum) thus covers five broad areas: (1) exchange rate and related budget policy; (2) further reform of the protection regime; (3) implementation of export promotion measures; (4) stimulation of private investment; and (5) rationalization of the capital budgeting process and the public investment program. The main issues and measures are outlined below:

(a) Foreign Exchange Market. The keystone to the reform program and the most important element in the loan's policy package is the maintenance of a sustainable market-determined exchange rate system. On the basis of the projected cash flow and macroeconomic program described below, the exchange rate will need to depreciate to perhaps ₦5 = US$1 before the end of the year. And while the Nigerian economic management team favors complete flexibility in the exchange rate, there are groups of strong opposition, which perceive their interests as served by a more appreciated rate. We will thus need from the highest levels of Government a reaffirmation of the commitment to let the exchange rate depreciate to whatever level is necessary to clear the market. TIPL will also require flanking actions on foreign exchange cash management and macroeconomic policy. Explain

(i) Cash Flow: Assuming full payment of arrears and post-rescheduling debt service obligations, auction funding will need to be reduced from its present level of US$120 million per fortnight to ensure its financial sustainability. If further financing of US$243 million -- beyond that assumed in our work-outs (see attached table) -- can be arranged, auction funding of US$100 million per fortnight could be sustained. This would imply a 6 percent drop in import volumes from 1987. Without such additional funding, or if oil prices average below US$16 per barrel, the auction size will have to be reduced. Our proposed strategy is to require an immediate reduction to US$100 million per fortnight and to keep the situation under close review as we redouble our efforts to secure additional funding. Further reductions could be introduced later in the year if necessary. strategy on auction funding

(ii) Macroeconomic Policy: Macroeconomic policy will have to be set in a manner that reconciles the size of the auction with the degree of movement in the exchange rate that is felt to be politically sustainable, taking into account the implications for real growth and inflation. On our assessment, this will require a budgetary correction amounting to more than 5 percent of projected GDP. Institutional mechanisms for generating substantial revenues from tax increases are lacking, and the budget for current expenditures is already lean, hence our efforts will concentrate on securing large cuts in capital expenditures (where our work on the public investment program suggest there is considerable scope), measures to ensure that parastatals do not require large budgetary transfers to cover operating losses, and a sharp rise in domestic petroleum prices. In view of the large overruns on programmed expenditures last year and the threat that a repeat of such slippages would pose to the program, the Bank will need to closely monitor adherence to the agreed budgetary undertakings.

Contraction in budget needed to keep Exp check in check

(iii) Implications. On our forecast, the results of the proposed policy package would be an inflation rate of 20 percent and overall real growth of 4 percent, led by the projected recovery of the agricultural sector from the weather-induced contraction last year. The manufacturing sector, while suffering from the further cutbacks in imports and the stance of policy, should benefit from the assumed depreciation of the real exchange rate; on balance, it is projected to expand marginally. However, a worsening of the unemployment situation is inevitable as job growth lags behind projected increases in the labor force.

20% is high!

(b) Protection Regime. The proposed loan supports continued reform of the tariff structure and lays the groundwork for introducing a consumption tax.

(i) Tariffs. The new structure narrows the range of rates and results in moderate -- less than 30 percent -- levels of net nominal protection. It has also introduced a number of changes that remove arbitrary aspects of the previous protection structure. It terminated the system of concessionary rates of duty on selected imports, unified customs duty rates throughout the country, and curtailed discretionary duty exemptions. In addition, the Government has taken important steps to strengthen customs procedures which had resulted in significant under-collections of import revenues. As these improved procedural measures bear fruit, the Government expects to be able to lower duty rates and replace the remaining import prohibitions with appropriate tariffs. The new duty schedule provides more protection than we had recommended, although the level of protection is substantially lower than the effective levels prevailing before the reform program. The Government is establishing a Tariff Review Board, and under the loan we would seek agreement that the Board would review the structure of protection in order to address anomalies in the new schedule and to provide the basis for discussions with the Bank of changes. In the meantime, as a condition of Board presentation, we will seek agreement on correcting certain "technical" anomalies which should not require further study.

(ii) Bans. In 1986, the Government removed a substantial number of import prohibitions. As a condition of Board presentation we are seeking the further removal of selected bans. We would seek agreement that the Tariff Review Board examine the remaining bans in light of their effectiveness and economic cost and make proposals for replacing them with appropriate tariffs. We should recognize, however, that some of the bans are politically highly sensitive and it may take time to eliminate all of them.

(iii) Consumption Tax. The reforms supported by TIPL go well beyond trade liberalization and represent the first steps in a restructuring of the system of indirect taxation. In introducing a landing charge on imports equal to the excise on domestic production, the authorities have laid the foundation for, and accepted the principle of, a consumption tax. Further development of this initiative will be pursued under subsequent loans.

(c) Export Promotion. The Government has taken initial steps to help promote non-oil exports. The program supported by TIPL will follow-up on two important areas: the strengthening of the Nigeria Export Council and the effective implementation of a revised duty drawback scheme for exports.

(d) Private Investment. The Government has initiated a number of measures to improve the overall investment climate. These are being spelled out in a Statement of Industrial Policy, promulgation of which would be a condition of effectiveness of the proposed loan. Among other measures, the program would streamline the regulatory environment for new investments by establishing the Industrial Development Coordinating Committee as a one-stop agency for all initial investment approvals. The rules for foreign investment are also being liberalized.

(e) Public Investment Program. The proposed loan would support reforms in federal capital budgetary procedures, the implementation of a revised capital budget for 1988, and reforms in the parastatal sector.

(i) Capital Budgetary Procedures. We will seek a series of reforms in budgetary procedures to introduce: economic criteria for project priorities, a funding strategy for individual projects, effective monitoring and review mechanisms, and clearly delineated institutional responsibilities for the various participating federal ministries.

(ii) Size and Composition of the Public Investment Program. The Bank has been working closely with the Government for several years to rationalize and strengthen the public investment program and to ensure that new projects do not preempt expenditures for maintenance and rehabilitation. Under the proposed loan, we would seek agreement on the size and sectoral allocation of the 1988 budget in the context of the overall macroeconomic framework. On present estimates, this will mean reducing capital expenditures by 26 percent from projected levels. Such reductions can be made without major harm to the economy, provided the Government is willing to reconsider all capital spending -- i.e., including general administration and defense -- and that contribution to economic growth is the principal criterion for retention in the revised spending plans. We have given particular attention to the petrochemical and steel subsectors, where we would agree on specific multi-year subsectoral investment programs. Pending the outcome of a Bank-financed study which is to be completed in September, we would seek agreement that expenditures on steel be held to a modest level (₦400 million), primarily for working capital for Delta Steelworks and the rolling mills, which are both efficient and starved of funds. Such a cap was agreed to under the TPED loan, but it was substantially exceeded, after the incurrence of arrears and payments from oil dedication accounts for the Ajaokuta project are taken into account. The lobby for larger expenditures includes the French Government, which has guaranteed, through COFACE, work on Ajaokuta, and the Soviet Union, which also has a strong presence there. Steel

(iii) Parastatal Reform. Public sector pricing issues are being resolved in the context of a broader program of parastatal reform, which should contribute to the targeted reduction in the federal budget deficit. Tariffs for Nigerian Airways and the Nigerian Railways were raised last year, and tariffs for overseas telephone calls were increased by 300 percent earlier this year. Commercialization of Nigeria's National Electric Power Authority (NEPA) and Telecommunications Authority (NITEL) has been approved in principle, which we would follow-up through other Bank lending operations. Implementation of these reforms will permit long overdue increases in domestic telephone and electricity tariffs, which in turn will substantially reduce the need for federal subsidies. Last week, the Nigerian National Petroleum Corporation (NNPC) was fully commercialized to operate as an international oil company. It is now empowered to set domestic petroleum prices in line with those prevailing on world markets. A formula for such pricing has been adopted, which, when fully implemented, will eliminate the implicit subsidy on such products and permit changes in world oil prices and the exchange rate to be automatically passed through to domestic prices. Our budgetary calculations assume elimination of the subsidy in a series of price increases at the beginning of April, June, and October 1988 and January 1989.

13. <u>Program Financing</u>. In going forward with TIPL and the associated enlargement of our exposure, the Bank must press the London and Paris Clubs to do their respective shares. This will involve the following issues:

(a) <u>London Club</u>. The Nigerians have requested from the London Club Steering Committee the rescheduling over 25 years of MLT maturities falling due during 1988-91, the rerescheduling of the LCs, which were rescheduled in 1986-87, and the capitalization of the late interest on the LCs, i.e., the equivalent of US$385 million in new money. They also requested that the deadline for meeting the requirements for the release of the US$320 million new money package from 1986-87 -- i.e., Fund Board approval of a new stand-by -- be extended. Securing agreement on the Nigerians' request will be exceedingly difficult, and it now seems inevitable that the banks will jettison the 1986-87 new money package. We propose to support the Nigerians' total new money request -- and indeed have assumed in our own work-outs new money in the amount of interest due and unpaid as at end-March, i.e., some US$816 million.

(b) <u>Paris Club</u>. We estimate that even after conventional reschedulings, Nigeria would be making payments to the Paris Club of over US$800 million this year, partly offset by US$200 million from the Japanese in untied cofinancing for TIPL. However, in view of the strained foreign exchange situation, the Nigerians intend to request the rerescheduling of the insured LCs, paralleling the request to the London Club with respect to the uninsured LCs. The Paris Club will resist this, but agreement may be facilitated by the recognition of Nigeria's new status as a low income country and which our calculations suggest is technically IDA eligible. We propose to support this request, and, as a further gap filling measure, to encourage the Paris Club to provide exceptional rescheduling terms with respect to the large interest payments due.

(How much is this in relation to interest due)

14. <u>Loan Conditions</u>. As a condition of <u>negotiations</u>, we are requiring a large up-front increase in domestic petroleum prices as an

urgent revenue measure. We propose to make <u>Board presentation</u> conditional on two major measures: agreement on the funding levels of the foreign exchange market and the size and composition of a revised federal budget. We will also, at negotiations, seek agreement on the removal of selected import bans. In addition, Board presentation would be conditional on the Government's agreement on a Letter of Intent with the IMF. <u>Effectiveness</u> of TIPL would be tied to agreement that the Tariff Review Board would review certain anomalies in the new tariff regime and undertake to prepare recommendations for a phased removal of the remaining import bans. In addition we would seek the satisfactory implementation of a revised duty drawback scheme, approval of the guidelines for processing the capital budget, the statement of Industrial Policy, and the strengthening of the Nigeria Export Council. The effectiveness of the proposed loan would trigger the release of substantial funds from Japan and the African Development Bank -- all of which are urgently needed to meet minimum ongoing foreign exchange requirements. However, because of the likelihood of protracted delays in the London Club negotiations, and the urgent need for the Bank's and associated funds to maintain the auction in the short-term, we do not propose to make either Board presentation or effectiveness conditional on Nigeria's reaching an agreement with the commercial banks. <u>Second tranche release</u> of the loan -- the timing of which is estimated for the fall -- would be conditional on agreement in principle reached with the London and Paris Clubs, as well as, our assessment that Nigeria is funding the auction at realistic levels and making satisfactory progress on key reform measures.

No payment until then

15. <u>Links to IMF and London and Paris Clubs</u>. An orderly reform program is critically dependent on agreement with the IMF and in turn, on support from the London and Paris Clubs. Hence, the proposed loan must be orchestrated in the context of the larger financial assistance program, even as we respond quickly, by providing badly needed foreign exchange in the near term, once the up-front policy decisions and actions are taken by the Government. Assuming that the IMF letter can be signed at the end of April, the IMF Board could consider the stand-by in June. However, the previous stand-by was presented for conditional Board approval only after the term sheet for the 1986-87 London Club rescheduling had been issued, with full approval dependent on the critical mass of banks' agreeing to the terms. Realistically, we do not expect the term sheet for the 1988 rescheduling to be agreed by June, and negotiations could well continue into the fall. Unless there is a change in either IMF or Paris Club policy, this would delay the Paris Club rescheduling. However, cover should reopen following the signing of the Fund letter.

No payments then too.

IV. <u>Conclusions and Recommendations</u>

16. Although fundamental adjustment is well underway, the Government faces an acute short-run problem. The fall in oil prices has sharply reduced growth prospects at a time when ensuring continued domestic political support for the program is critical. Without the

Bank's help, the reduced availability of foreign exchange could cause the authorities either to return to foreign exchange rationing, as the exchange rate that would clear the market would be politically intolerable, or to suspend debt service payments. Both of these situations would be a major setback to the Bank's assistance strategy in Nigeria, as well as for all of Africa. In our view, provided the Nigerians are prepared to do their part in adjusting to the new and more difficult external environment, the Bank should both go ahead with TIPL and launch a special effort to secure exceptional financing and rescheduling terms from the London and Paris Clubs. We should also be prepared to provide credit enhancement so as to enlarge the new money inflows from the commercial banks. We have already begun working on possible instruments for achieving credit enhancement and hope to come forward with specific proposals before the next London Club Steering Committee meeting at end-April. Finally, the Bank should press ahead with the adjustment and sectoral lending program outlined above, in order to ensure the basis for a robust supply-side response. Yes.

17. In summary, we recommend the following Bank actions:

(a) Approve the invitation to negotiate the proposed Trade and Investment Policy Loan, after the announcement of a substantial increase in petroleum prices.

(b) Present the proposed loan to the Executive Board, after the IMF Letter of Intent has been agreed to; second tranche release would be linked to agreement being reached between the Government and the London and Paris Clubs.

(c) Support the Government's request -- although not the specific terms -- to the London Club for the extension of the 1986-87 "old new" money package, the rescheduling of MLT maturities, and the rerescheduling of the LCs; press for "new new" money in an amount equal to interest payments due from April through December, net of any disbursements on the "old new" money package; and continue our work to develop instruments for providing credit enhancement to enlarge the new money inflows from the commercial banks. What does this mean

(d) Support the Government's request to the Paris Club to reschedule the insured LCs, and, acknowledging the low income status of Nigeria and its substantial debt burden, help mobilize concessional assistance.

(e) Endorse a Bank lending program of $3.0-3.8 billion during FY88-90, assuming adequate performance on the implementation of the reform program. Yes consistent with allocations?

Attachment

Distribution:

Messrs./Mss. D. Hopper (SVPPR), E. Stern (SVPFI), S. Husain (LACVP), A. Karaosmanoglu (ASIVP), W. Thalwitz (EMEVP), V. Rajagopalan (VPPRE), I. Shihata (VPLEG), D. J. Wood (VPFPR), S. Fischer (2) (VPDEC), A. Ouattara (IMF), V. Dubey (EASDR), D. Lee (CODDR), H. Vergin (SVPOP), A. Shakow (SPRDR), J. Holsen (CECDR), D. C. Rao (FRSDR), J. Baneth (IECDR), Burmester/Thahane (SECGE), S. Obrien (AFRCE), R. Liebenthal (SPRPA), A. Steer (FRS), T. Baudeon (SVPOP), D. Bock (DFS), Aguirre-Sacasa (EXTDR), R. Frank (CFPVP), J. Parmar (CIOVP), M. Haug (EXC), D. Goldberg (VPLEG), R. Agarwala (AFRCE), C. Robless (OPNMS), K. Awunyo (LEG), Wiratunga/Abrahams (LOAAF), C. Ohri (AFRVP), L. Christoffersen (AFTEN), F. Chaudhri (EAS), J. Barrientos (AF4DR), W. Humphrey (AF4CO), L. Squire (AF4CO), A. Pellegrini (AF4IN), J. de Merode (AF4PH), A. Seth (AF4IN), S. Aiyer (AF4EN), M. Allen (IMF), T. Swayze (AF4CO), J. Salop (AF4CO).

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March 30, 1988

The World Bank
OPERATIONS COMMITTEE

Minutes of the Operations Committee Meeting to Consider ARGENTINA - Trade Policy and Industry Deregulation Loan Initiating Memorandum

Held on March 30, 1988 in Room E-1244

A. Present

Committee	Others
Messrs. M.A. Qureshi (Chairman)	Messrs. P. Bottelier (LAC)
S. Husain (LACVP)	P. Eigen (LAC)
D.J. Wood (VPFPR)	P. Scherer (LAC)
S. Fischer (VPDEC)	M. Selowsky (LACVP)
H. Scott (VPLEG)	D. Mc Carthy (LAC)
E. Lari (EMNVP)	L. Moreau (LAC)
S. Asanuma (ASIVP)	D. Bock (DFS)
R. Westebbe (AFRVP)	O. Rahkonen (SEC)
H. Vergin (SVPOP)	K. Jay (SPRPA)
	T. Hill (LEG)
	S. Ettinger (CODOP)
	Ms. C. Mann (VPDEC)
	E. Grilli (EAS)
	U. Thumm (EAS)
	C. Collyns (IMF)

B. Issues

1. The meeting was called on the IM for a proposed Trade Policy and Industry Deregulation Loan to Argentina in an amount of up to $400 million. The discussion mostly followed the agenda prepared by the Economic Advisory Staff. The central issues were (a) adequacy of the macroeconomic framework and supply response, and (b) the importance of the deregulation component in connection with the loan amount.

Macroeconomic Framework and Supply Response

2. The Region commented extensively on the seriousness of the current macroeconomic difficulties faced by Argentina, where run-away inflation, stagnating or even declining GDP, depressed investment, high real interest rates, and lack of private sector confidence are aggravated by a difficult political situation. Medium to longer-term export and general economic growth prospects were assessed as still being relatively favorable. The crucial question is how to get out of the current downward spiral and generate an increase in savings and investment capable of supporting future growth. A consistent medium-term macroeconomic framework, continued structural reforms, and a medium-term external financing package were considered indispensable to firm up investors' expectations and eventually restore their confidence in the future. It was stressed that the feasibility and success of reviving investments depended, among other

things, on the possibility of lowering real interest rates, which in turn depended on the success of macro-stabilization. As investments are not viable at real interest rates of 30-40 percent per annum in the absence of fiscal subsidies, the possibility of getting rid of the existing special tax incentives was also related to the success that macro-stabilization (and especially public sector deficit reduction) would have in reducing real interest rates.

3. The Region explained that work on a medium-term framework and Bank strategy was at an advanced stage of preparation. It was also pointed out that in the past the Bank essentially relied on the macro-economic framework elaborated by country authorities and the IMF. Based on recent experience, the Region felt that the Bank had to define its own framework of minimum conditions in terms of macro-economic and sector achievements that would allow the Bank to pursue an assistance strategy having reasonable prospects of success. It was considered necessary to reach, by the time the proposed operation would be negotiated, a clear understanding with the government on the medium-term macroeconomic framework and with all other concerned parties on a financing package sufficient to support the proposed policy framework.

Deregulation and Loan Amount

4. The discussion went on to clarify the nature and relative importance of individual loan components, particularly in the deregulation area and their bearing on the size of the loan. The Region explained that the loan would support the completion of the trade liberalization process by dismantling the remaining QRs and establishing a more rational tariff structure with a lower average level, and that the most important step was to complement trade liberalization with domestic deregulation in order to achieve the necessary flexibility for structural shifts and the supply response needed to sustain growth in the medium term. Two elements were considered essential: (i) the dismantling of special promotion schemes to free up market entry; and (ii) the reduction and rationalization of fiscal incentives that are onerous to the budget and result in perverse factor allocation (including location of industry).

5. The Region pointed out that initially there was great government resistance to the deregulation component of the package, particularly since it was felt that accelerated trade liberalization would require on its own substantial financial support from the Bank to be implemented successfully. Since legislation is required for almost any change of the existing regulatory framework, it could not be ascertained at this stage how far the government was really able to go.

C. Decisions

6. The Chairman decided that: (i) the Region could go ahead with the appraisal of the proposed operation (without commitment to a specific loan amount); (ii) deregulation should be made the centerpiece of the operation (its strength would determine the loan amount); and (iii) to assist in the evaluation of the proposed operation, the Region would prepare a medium-term framework paper which should be ready by the time the green-cover package is reviewed.

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April 4, 1988

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Mr. Qureshi

The World Bank
OPERATIONS COMMITTEE

Minutes of the Operations Committee Meeting to Consider ARGENTINA - Trade Policy and Industry Deregulation Loan Initiating Memorandum

Held on March 30, 1988 in Room E-1244

A. Present

Committee

Messrs. M.A. Qureshi (Chairman)
S. Husain (LACVP)
D.J. Wood (VPFPR)
S. Fischer (VPDEC)
H. Scott (VPLEG)
E. Lari (EMNVP)
S. Asanuma (ASIVP)
R. Westebbe (AFRVP)
H. Vergin (SVPOP)

Others

Messrs. P. Bottelier (LAC)
P. Eigen (LAC)
P. Scherer (LAC)
M. Selowsky (LACVP)
D. Mc Carthy (LAC)
L. Moreau (LAC)
D. Bock (DFS)
O. Rahkonen (SEC)
K. Jay (SPRPA)
T. Hill (LEG)
S. Ettinger (CODOP)
Ms. C. Mann (VPDEC)
E. Grilli (EAS)
U. Thumm (EAS)
C. Collyns (IMF)

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April 4, 1988

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION 88132500l
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Mr. Qureshi

OFFICE MEMORANDUM

DATE: March 24, 1988

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

EXT: 78074

SUBJECT: ARGENTINA - Proposed $300-400 million Trade Policy and Industry Deregulation Loan, Initiating Memorandum - Agenda

1. The Operations Committee will meet on Wednesday, March 30, 1988 at 3:30 p.m. in Room E-1244 to discuss the Initiating Memorandum for the proposed $300-400 million Trade Policy and Industry Deregulation Loan (TIL) to Argentina. The Operations Committee may wish to discuss the issues as set out in paragraphs 3 to 7.

Background

2. The proposed loan would support a continuation of the trade liberalization and deregulation process, initiated in 1986, which is expected to bring about structural changes to stimulate economic growth through a better integration of Argentina into the world economy based on comparative advantage and more efficient resource use. The proposed loan, together with other forthcoming Bank loans, would also contribute to closing a major external financing gap in 1988 which is estimated to be on the order of $3 billion. Several questions arise as to the adequacy of the proposed TIL to meet the stated objectives, given (i) the current macro-economic environment and medium-term outlook and (ii) some of the specific features of the operation.

Macroeconomic Environment and Medium-Term Program

3. The current macroeconomic situation in Argentina is marked by great uncertainty, with high inflation and inflationary expectations fueled by a protracted public sector deficit. In spite of encouraging structural reform initiatives, the macroeconomic uncertainties have thus far constituted a major impediment to new investment. Indeed, investment for years has remained at a level barely sufficient to maintain the current capital stock. The Region could be asked to present its assessment of the current economic situation and medium-term outlook. The following aspects are of particular importance:

(i) what are the macro-economic adjustments needed over the medium term that would be likely to bring about the expected supply responses to the proposed course of structural adjustments? How likely is it that the current standby-arrangement with the Fund will be complied with and actually prepare the ground for the needed adjustment over the medium-term?

Person about the macro structure light at the end of the tunnel

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(ii) how are the prospects for closing the external financing gaps in 1988 and beyond? Do the Bank's financial contributions stand a chance to actually finance additional investment rather than just debt-service payments to other creditors? and

How we finance investment or debt exposure

(iii) how does the Region assess the medium to longer-term implications of the current lending strategy for Bank exposure in view of the likely medium to longer-term development of Argentina's credit-worthiness?

Government Commitment, Strength of Program, and Loan Amount

4. The trade component of the proposed TIL would support a continuing process in which the Government has shown its commitment through actions beyond prior commitments and additional upfront measures. However, the region expresses doubts with regard to the deregulation component and the Government's ability and willingness to undertake the desirable reforms. It seems that a more thorough assessment of current reform proposals and possible alternatives would be needed to get a clearer picture. At this stage, can the Region define what it would consider the bare minimum requirements regarding industrial deregulation to make the program meaningful and worthy of being supported by a loan at the lower end of the $300-400 million range? How could Government commitment be strengthened? Would public announcement of the essential elements of the reform package and the general direction of future reforms help?

Previous over performance but now doubts re deregulation

Specific TIL Features

5. Trade. On the trade side, the Government has advanced more than expected under the previous trade policy loan and is expected to take more upfront action before Board presentation and loan effectiveness. While the process has been encouraging, a few questions remain:

(i) have QRs really been reduced and will they be further reduced to the levels suggested in paragraph 36 (i)? Does "fully automatic import approval" mean total absence of government action and discretion?

(ii) will the proposed tariff reductions (para. 36 (2)) apply to tariffs or to surcharges? and

(iii) the reduction in protection resulting from the elimination of QRs can be compensated by the introduction of temporary surcharges. If surcharges are needed and granted at all, is it realistic to expect their total elimination prior to second tranche release?

6. Deregulation. The proposed trade and deregulation package essentially concentrates on the liberalization of product markets. Are there any serious impediments in factor markets that would have to be addressed to make the proposed reforms effective?

7. The proposed reforms of the current tax incentives schemes would go a long way towards fiscal cost reduction and rationalization. The question remains, however, whether the maintenance of specific incentives (even in the form of general tax credits (para 38 (2)(iv)) rather than the lowering of the (corporate) income tax would not retain certain distortions, particularly an anti-labor bias if the incentive is linked to capital investment?

cc: Messrs. Grilli, EAS (o/r); Lee, CODDR; Shakow, Liebenthal, SPR; Holsen, CEC; Rao, Steer, FRS; Baneth, IEC; Burmester/Thahane, SEC; Baudon, SVPOP; Selowsky, Bottelier, Rowat, Eigen, Tyler, Scherer, Gerken, LAC.

For Information Only

cc: Messrs. Hopper, VPPPR; Fischer, VPDEC; Bock, DFA; Frank, Parmar, IFC; (Ms.) Haug, EXC; Goldberg, VPLEG; Robless, SVPOP.

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March 16, 1988

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The World Bank
OPERATIONS COMMITTEE

CONFIDENTIAL

Minutes of the Operations Committee to consider BRAZIL - Country Strategy Paper held on March 16, 1988 in Room E-1244

A. Present

Committee

Messrs. M.A. Qureshi (Chairman)
A. Karaosmanoglu (ASIVP)
D. Goldberg (VPLEG)
S. O'Brien (AFRCE)
P. Hasan (EMNVP)
J. Holsen (CECDR)
D.C. Rao (FRS)

Others

Messrs. S. Husain (LACVP)
A. Choksi (LA1DR)
V. Dubey (EAS)
H. Vergin (SVPOP)
T. Baudon (SVPOP)
Ms. N. Birdsall (LA1HR)
F. Earwaker (SPRPA)
A. Harth (CODOP)
S. Mitra (FRS)
M. Munasinghe (LA1IE)
G. Nankani (LA1CO)
D. Papageorgiou (LA1TF)
N. Paul (DFS)
O. Rakhonen (SECGE)
S. Rajapatirana (EAS)
A. Steer (FRS)
J. Tanaka (EXC)
J. Wijnand (LA1AG)

B. Issues

The Operations Committee met on Wednesday, March 16, 1988 to discuss the Brazil Country Strategy Paper.

The Chairman identified the principal issues for discussion as those relating to macroeconomic and fiscal adjustment, the Bank's lending strategy and risk management for Brazil and the role of the Bank in assisting resource mobilization and debt management. With respect to macroeconomic and fiscal adjustment, the key question was the prospect of the Government adopting an early and a viable macroeconomic policy framework to address the large fiscal imbalances.

The Region explained that the prospects for an early addressing of the fiscal imbalances were mixed given the political situation. An early program of stabilization would require strong political commitment to take control of fiscal expenditures. While political uncertainties are present, there are some positive signs especially with the appointment of the new Minister of Finance. According to the Region the Minister seems strongly committed to a stabilization program with primary emphasis on cutting fiscal expenditures and restoring credibility to macroeconomic management by eschewing earlier, unsuccessful price and wage freezes. Indications are

that Brazil's economic managers have the desire and the ability to put a program in place. They need help from the Bank in identifying the elements of a viable macroeconomic program. Brazil is currently having preliminary discussions with the IMF on a stabilization program. The prospects for a viable macroeconomic policy framework will become clearer after the current political processes are completed within a year and the roles of the different institutions and interest groups become more clearly defined.

The Chairman asked the Region to elaborate on the linkage between domestic demand management and the external sector. The Region explained that the present situation of a trade surplus of $1.0 billion a month could not be sustained with the current inflation rate (16% in January), although the inflation rate has declined in February 1988. High inflation will lead to high real interest rates, stifling investment including that in the tradeable sector. If inflation persists the trade surplus will begin to decline rapidly. Basically, the country needs a credible stabilization program that can reverse the current inflation expectations. Earlier stabilization attempts failed because of the inconsistency between the fiscal component of the stabilization program and the degree of wage/price restraints that were adopted. In this connection, a committee member raised the issue of why the trade balance remained the same in the first two economic scenarios, although in the first of these there was a substantial macroeconomic imbalance. The Region explained that the first economic scenario was unsustainable precisely because of this inconsistency beyond the near term. Large fiscal deficits in the presence of difficult external financing prospects would fuel a high rate of inflation that would lead to a rapid depreciation of the exchange rate due to indexation which in turn would feed back on the domestic inflation. In the second and third economic scenarios, both imports and exports are higher compared to the first economic scenario because those two scenarios imply progressively stronger domestic stabilization measures, trade liberalization, and other incentive improving reforms.

Referring to expenditure restraints required to bring about macroeconomic balance one committee member pointed out that the recent measures to freeze state government expenditures could be evaded by the entities increasing their arrears and that could still lead to an expansionary effect. The Region explained that while previously state banks had financed deficits, the Federal Government had since passed legislation to bring them under its control and restructure them before handing them back to the state governments. The Region did not rule out the possibility that financial control could fail even after restructuring the state banks.

The Chairman turned to the issue of Bank lending strategy towards Brazil and raised the issue as to how much of macroeconomic adjustment constituted a threshold for the Bank to move from investment operations in the economic and social sectors to macroeconomic adjustment lending. The Region indicated that even under the investment operations they would expect to pursue important sectoral policy concerns. They also stated that they would look at a number of performance benchmarks in order to determine when to move to adjustment operations. These included progress not only on the macroeconomic front relating to the level and intensity of fiscal and monetary actions introduced to control inflation but also policy consistency, progress in institutional reforms such as the clear definition of the role of the Central Bank, the relationships between state governments and the federal government, and in general a viable and satisfactory overall macroeconomic adjustment program. Progress in implementation of the program would be examined on a six-month basis, including the impact on the economy of the measures undertaken and the prospects for improvement in a medium term perspective. The Region also reported on the prospects of an agreement with the IMF.

The Region noted that the strategies articulated under the Low, Intermediate and High lending scenarios were sequenced and graduated to respond to meet different levels of progress in policy reforms. For example, under the Low lending scenario the Region would address policy reforms in such areas as cost recovery and domestic subsidies. Under the Intermediate Lending scenario, more fundamental policy reforms are expected through trade, finance and power sector adjustment loans. The Region's economic and sector program is designed to underpin the different strategies proposed. In trade, the Region has identified import liberalization to be achieved through the replacement of quantitative restrictions by tariffs as a primary goal. In power, reform of the state power utilities is a major priority. In the financial sector wide ranging reform measures have been identified and some already agreed upon with the Government. In agriculture the Region has held up a second tranche release due to lack of progress on trade liberalization in that sector. Social sector issues have been analyzed in a recent report indicating specific measures and their sequences. The Region emphasized that these wide ranging performance benchmarks, would be applied using judgement.

A committee member raised two related issues with respect to the need for clear benchmarks for movement from the Low to the Intermediate lending scenario and the appropriateness of the use of the net disbursement concept in the paper. With relation to the issue of the benchmark for movement from the Low lending scenario to the Intermediate lending scenarios the Region mentioned that there was no presumption that they would move abruptly from one lending scenario to another. The overall lending strategy has to be viewed as a continuum. At each stage the Region will evaluate progress before moving to the next stage. The Region pointed out that there were many indicators, and many alternate combinations of indicators that would be used to evaluate progress. Furthermore, no smooth transition in policy reform was to be expected, but change would be discontinuous. Consequently, the Bank should remain ready to reduce or increase lending with different levels of progress in policy reforms.

On the issue of using net disbursements to delineate scenarios, the Region explained that they were not using the concept to analyze exposure under different scenarios. Rather the levels of net disbursements differentiated the outcomes of the three lending levels. The low lending scenario is also designed to ensure that the Bank assist Brazil with its major development priorities in infrastructure, agriculture and human resources. A positive cash flow would occur only in the high lending scenario with a strong and credible macroeconomic adjustment program. Bank lending under those circumstances could help to increase the country's creditworthiness.

The Chairman summarized the lending strategies articulated in the paper as follows: the Bank is facing a large structural adjustment program in Brazil. To start such a program a strong stabilization effort was needed. With such an effort, the Bank could help the country to undertake wide ranging reforms relating to trade, finance and distortions in other areas. Whether there is adequate progress on the macroeconomic and incentive reforms will be judged each year. If there is progress the Bank would be prepared to increase its lending. If not, the Bank would cut back lending to the low level scenario which does not entail any major adjustment operations but maintains the Bank's presence in a few sectors and incentive related areas. The Chairman commented that the objective of keeping net disbursement equal to zero was not a general rule to be applied to all countries. Instead, it was to be viewed as an approach for maintaining the Bank's lending capability in Brazil while facilitating a dialogue and it was also to be viewed as an element of prudent risk management.

A committee member raised the question of the differentiation between the Low Lending scenario and the other two lending scenarios. He noted that if the difference between the former and the later was only adjustment lending he would not be very concerned as each operation would be reviewed by the Committee. However, there were also differences between the investment loans across scenarios, this had implications for risk management. The Chairman indicated that all major operations, not only adjustment operations, were subject to scrutiny by the Operations Committee. The Chairman also noted that excessive dependence on adjustment loans was not always warranted. He felt that more attention should be paid to the direction of overall policies in a country - whether the policies are in the right direction or not - rather than the particular instrument the Bank uses to engage the Government in a policy dialogue.

On issues relating to resource mobilization and debt management the Region reported that Brazil's negotiations with the commercial banks were well advanced. The amounts and terms of rescheduling existing loans were agreed upon and certain details are being worked out on the links of debt negotiations with the IMF and the Bank. While progress is thus being made on this front, the Bank's own role has to be clearly defined to assure that the momentum of these negotiations is maintained. The Bank's own inputs into these negotiations were important for the country and for its risk management.

The Chairman noted that the Country Strategy paper was to be discussed at the Policy Committee shortly.

March 25, 1988
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Qureshi

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: March 11, 1988

TO: Operations Committee

FROM: John Holsen

SUBJECT: Guidelines for Bank Lending For State Owned Enterprise Reform Proposed Agenda

Background

The Operations Committee will meet on Wednesday, March 16, 1988, at 3:00 p.m. to discuss the Guidelines for Bank Lending for State Owned Enterprise Reform.

These guidelines are intended for staff working on the reform of state enterprises as a group or sector, rather than individual firms. It briefly summarizes the nature and volume of Bank lending in this area, then analyzes policy issues related to state enterprises in the areas of pricing, labor, commercial and financial policy. The need for governments to reassess the role and scope of the state owned sector is stressed, as is the task of classifying individual firms and setting their objectives on the basis of that exercise. The paper analyzes the use of corporate plans and performance contracts as a way of clarifying enterprise objectives and discusses the difficulties of taking account of noncommercial objectives without damaging commercial performance. It also explores measures to increase the autonomy of state enterprise managers through holding companies, stronger boards of directors and other institutional arrangements, and efforts to upgrade managerial capacity through training, better compensation, merit oriented and more transparent selection and the like. Accountability, and in particular the experience with Bank sponsored performance evaluation systems, is assessed, as is divestiture. Finally the paper discusses issues specific to the Bank-- such as diagnostic studies as a basis for operations, phasing of reforms, the choice of lending instruments, building country commitment and the implications of the increasing emphasis on these broad sector-wide reforms for staffing.

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Items for Discussion

Treatment of the Guidelines. These guidelines are expected to be the first in a series of PPR guidelines designed to inform staff about cross country experience and state of the art in key areas. Do members of the committee find the contents generally consistent with their views of the appropriate Bank approach to state enterprise reform? How should these guidelines feed into the operational cycle?

Choice of Lending Instruments. The paper deals with reforms of state enterprises as groups or sectors which is the subject of over 100 operations. The rationale for this approach is that enterprise-by-enterprise reforms through traditional projects may serve to create islands of excellence but do not affect the wider environment in which SOEs operate. Comprehensive reforms, however, have the disadvantage of being complex and cumbersome to implement and may lack the pragmatic realism of changes based on an appreciation of individual enterprises. Another problem is that fast disbursing adjustment operations, which are the usual instrument for comprehensive reform, are not well synchronized with the slow pace of institutional reforms. The early experience with hybrid operations (such as the public enterprise rehabilitation loans, or PERL as in Morocco), which combine fast disbursing components with slow disbursing technical assistance and comprehensive reforms with support to individual enterprises, shows these complex operations place a heavy burden on staff and government. The paper recommends that the policy framework for state enterprises be tackled first through a SAL or, if policy distortions are not acute, with a public enterprises rehabilitation loan. Freestanding technical assistance loans (not associated with a SAL) or sector adjustment loans would be used once the basic policy framework is agreed. The committee may wish to discuss how best to assure the appropriate combination of instruments, tailored to each country's circumstances.

Too rigid.

The Bank's Approach to Divestiture. Some 40 Bank operations contain components addressed at selling, leasing, liquidating or contracting the management of state enterprises. In some cases, divestiture is a condition of disbursement. Sales of SOEs, in particular, have proved slower and more difficult to implement than expected and there are instances where a government has offered protection and special privileges in order to attract private buyers. The widespread use of this component contrasts with its inherent difficulty and the lack of progress so far. The Guidelines recommend more attention be given to curbing new public investment, contracting out activities to the private sector and liquidation than to sales. What is the best way to assure a balanced treatment of this issue?

Institutional Implications. Sector wide state enterprise reform is staff intensive and slow. The Africa and EMENA regions have assigned specialized staff in the technical departments to work on the subject and CECPS provides operational support and training Bank-wide. Have adequate resources been assigned to this activity? How best to extend support to other regions?

Future Directions. The guidelines suggest areas for future work, notably: case studies of divestiture and the lessons learned, investigations of ways to increase domestic competition through deregulation and other reforms, review of the experience with performance contracts, a study of appropriate compensation and incentive systems for SOE management, and a review of the experience in implementing efficiency targets for natural monopolies. Are there other areas that should be studied?

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

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OFFICE OF THE SVPOP

Date: March 7, 1988

To: Operations Committee

From: Vinod Dubey, Director, EAS

Extn: 78051

Subj: BRAZIL - Country Strategy Paper - Agenda

1. The Operations Committee will meet on ~~Thursday~~ Wednesday, March 16, 1988 at 4.00 p.m. in Room E-1244 (Mr. Qureshi's Conference Room) to discuss the Brazil Country Strategy Paper (CSP). The Committee may wish to take up the issues identified in this agenda as meriting discussion.

Background

2. Following the economic reforms of the mid sixties and up to the debt crisis in 1982, Brazil has had very strong economic growth. This growth, exceeding 8% per year over the period, and accompanied by a comfortable external payments position was achieved through large investments in industry, energy and in related infrastructure, and extensive factor use rather than efficiency improvement. There was relatively little investment in the social sectors. Consequently, while incomes at all levels improved with growth, income disparities widened. Social indicators for the Northeast of Brazil for example are low even compared to countries with a third of Brazil's per capita income.

3. In the 1970s, with its rapid growth, large resource base and excellent export potential, on the one hand, and availability of foreign loans at historically low interest rates, on the other, Brazil was able to borrow heavily from commercial banks to maintain its investment rate without adjusting to the oil shocks. At the beginning of the debt crisis in 1982, Brazil found itself with the largest foreign debt for any developing country and a macroeconomic situation that required a substantial adjustment effort. In 1983 and 1984, Brazil undertook a strong stabilization effort which involved reduced investment, compressed imports and negative output growth. It was able to resume growth with significantly improved external accounts in 1984-86. However, the country could not achieve the necessary internal adjustment to bring national savings into line with investments because of the large and growing fiscal deficit.

4. Two stabilization attempts through heterodox policies (the Crusado Plan (February 1986) and the Macroeconomic Control Plan (June 1987)) failed. Inflation resumed and reached 16.5% a month in January 1988. However, Brazil's external payments position strengthened considerably with a trade surplus exceeding $11.0 billion in 1987. The moratorium declared on interest payments to non-preferred creditors on February 1, 1987 was lifted on February 1, 1988. The on-going negotiations with commercial banks have reached a stage that a re-scheduling of $67 billion of the debt is considered imminent.

5. Adding to the economic difficulties, there is the continuing state of uncertainty as to the next stage in Brazil's political evolution with the impending finalization of the Constitution and the determination of the election schedule. The preoccupation of Brazil's leaders with political concerns has been a major impediment to the adoption of a consistent economic strategy.

Macroeconomic and Fiscal Adjustments

6. The fundamental macroeconomic problem facing Brazil today is to stabilize the economy through the control of the growing fiscal deficits that are being financed through money creation. The dimensions of the problem can be appreciated by the fact that to achieve an external transfer of 3-5% GDP in debt service requires the affecting of a sizable internal fiscal transfer. Some 20% of the Government expenditures is needed to finance interest payments. The stabilization task itself is complicated by a host of factors; the need to raise key public sector prices and tariffs to reduce the deficit while the indexing mechanisms can set off a new round of inflation; the high interest rates needed to induce the Brazilian private sector to lend to the public sector not only raise the size of the deficit but cause financial distress in public and private sector businesses; the real exchange rate depreciation needed to generate an export surplus also leads to a higher debt burden in domestic currency, not to mention the impetus it gives to a new round of wage increases. Yet, reducing the fiscal deficit is fundamental and the earlier stabilization attempts failed mainly because of the inability to bring the fiscal deficit under control.

- The Region proposes to engage in an extensive policy dialogue with the Government on stabilization and macroeconomic management issues. What advice does the Region offer to the Government to restore credibility to a fiscal consolidation policy that has failed twice? And how is the deficit of the state and local governments to be controlled?

- What are the elements of a consistent stabilization program that can lay the basis for sustained high growth in the medium term and what trade off's exist in reaching these two objectives?

- What are the political implications of cutting domestic absorption to service foreign debt and restore investment while a large part of the population remains poor and expects quick economic benefits from the democratization process?

The Incentive Structure and Sectoral Issues

7. As described in the CSP, the Government's proclivity to use administrative controls such as quotas and licenses instead of price measures, and the presence of captive sources of funds to provide low cost finance for Government determined priority investments have contributed to a highly distorted incentive structure. Strong incentive improving policies are clearly needed to raise efficiency to offset the declining

investment resources and opportunities to grow primarily through increased factor supplies.

- In agriculture a wide agenda is proposed to improve efficiency, relating to rural credit, marketing, pricing, trade and taxation. What are the priorities within the sector, and how are the reforms within agriculture to be implemented in the light of past experience? Are there competent implementing agencies that can undertake these activities across state lines?

- Given that reforms in agriculture, industry and energy are closely related through their effects on the movement of resources, how are the competing claims coordinated and reconciled within the central government and in relation to a state governments? What measures are contemplated to build in a sustained addressing of issues relating to coordinating and reconciling competing claims across sectors?

Poverty and Human Development

8. Brazil's income distribution is recognized to be significantly skewed compared to other countries at its per capita income level. Income disparities have persisted and indicators relating to infant mortality and educational enrollment in Northeast Brazil are below countries with less than a third of Brazil's per capita income. High growth emphasizing resource based industries with initial inequal endowments and intensive in capital have led to a highly skewed income distribution. In addition, a large part of the public expenditure on social sectors has been captured by the middle and high income groups so that while expenditures in social sectors are not low they do not reach the poor.

- How are the expenditures on social sectors to be targeted to poor, and how will the middle and high income beneficiaries be weaned of the large subsidies they have come to enjoy?

- Given the substantial macroeconomic imbalances and the significant departure of domestic prices from international prices, stabilization and adjustment must lead to large changes in relative prices. What kind of a safety net is needed to protect the poor from these changes?

- What is the impact of public sector employment and wage policies on income distribution? Is this an area of concern?

Banks Lending Strategy and Risk Management

9. The Region's proposed lending strategy to Brazil is cognizant of the political and economic uncertainties prevalent in the country, the external environment faced by Brazil and the implications of different lending levels for the Bank own risk management. The strategy proposed is described as a "graduated response" to policy and institutional changes in Brazil. A fundamental feature of the strategy is that the actual volume of lending to Brazil in any given year will depend on the comprehensiveness and credibility of the Government's stabilization and adjustment efforts.

Three lending scenarios - a low, intermediate and high scenario - are articulated that relate to three economic policy scenarios.

The scenarios are subject to a number of caveats. The low and intermediate scenarios are more probable in the near term than the high scenario. The economy policy scenarios assume a given state for the world economy, and entail different risks including the extent of policy efforts, inflation and the ability to restrain the fiscal deficit. They also imply different GDP growth rates, consumption paths, and different outcomes in terms of debt indicators and external financing requirements.

- What are the benchmarks for policy progress under the different scenarios? And what will constitute satisfactory progress on macroeconomic adjustment?

- Over what period is progress to be measured, and how are sustainable policy stances distinguished from transitional improvements?

- Given that the actual outcome could be worse than what is described in the first economic policy scenario ("characterized by instability and repeated crisis") is a level of lending of \$1.0 billion to \$1.4 billion as described in the Low Lending scenario justified in terms of comparability with other Bank borrowers and in relation to the risk to the Bank's portfolio?

3)

Bank's Role in Resource Mobilization and Debt Negotiations

Brazil has recently indicated a stronger desire to normalize its relations with its creditors, as evidenced by the lifting of the moratoriam on interest payments and the recent progress achieved toward rescheduling a part of its debt reportedly at terms similar to that of Mexico's most recent renegotiation.

Although macroeconomic adjustment and restoration of growth with new money must remain the centerpiece of the strategy towards resolving Brazil's debt problems, opportunities to explore different means to reduce the debt burden may present themselves. The CSP proposes that the Bank play an active role as a "honest broker" and as a cofinancing catalyst .

- In addition to good macroeconomic performance what considerations will guide the Region's decisions to play a more active role in the future as a catalyst for new money?

- What are the relative risks and returns to providing comfort arrangements as against reductions in lending? In otherwords how will the Region evaluate the marginal dollar of providing comfort arrangements vis-a-vis lending on the risk to the Bank?

- Why is it that under the Low lending scenario, (with less satisfactory economic performance) commercial banks are the overwhelming source of funds? Is defensive lending of this scale credible? Also why should commercial banks have a lower share of lending under the Intermediate Scenario when strong adjustment policies are followed?

- Under the assumption that a Fund program is put in place in the First Scenario, Fund's new flows just equal the required the repurchases. A Fund program could lead to Paris Club rescheduling and additional new flows of bilateral supplier credit. But the Bank share under the first scenario is not changed. Why do the benefits of IMF participation accrue to others and not to the Bank? (Table 3.2 on page 20).

March 7, 1988
SRajapatirana:gs

March 10, 1988

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The World Bank
OPERATIONS COMMITTEE

CONFIDENTIAL

Minutes of the Operations Committee to consider MALAWI - Policy Framework Paper held on March 10, 1988 in Room E-1244

A. Present

Committee	Others
Messrs. M.A. Qureshi (Chairman)	Messrs. E. Jaycox (LACVP)
I. Shihata (VPLEG)	V. Dubey (EAS)
W. Thalwitz (EMNVP)	H. Vergin (SVPOP)
A. Karaosmanoglu (ASIVP)	S. Sandstrom (AF6DR)
D.C. Rao (FRS)	R. Armstrong (AFRCE)
R. Liebenthal (SPRPA)	T. Baudon (SVPOP)
P. Bottelier (LA4DR)	M. Edo (IMF)
	M. Fardi (SPRPA)
	R. Grawe (AF6CO)
	F. King (AF6CO)
	Ms. K. Krumm (AF6CO)
	H. Messenger (AF6CO)
	O. Rakhonen (SECGE)
	S. Rajapatirana (EAS)
	R. Scobey (AF6CO)
	W. Scwermer (CODOP)
	A. Zerabruk (LEGAF)

B. Issues

1. The Operations Committee met on Thursday, March 10, 1988 to discuss the Malawi Policy Framework paper. The discussion broadly followed the agenda for the meeting prepared by the EAS.

2. The Chairman noted that macroeconomic adjustment was a principal issue particularly on the public expenditure side. The Region agreed that this was the case and explained that the adjustment measures already taken included a reduction of the fiscal deficit from last year, a reduction in domestic financing, and the payment of import related arrears. The Region was satisfied with the pace of adjustment. The huge external shocks faced by the country were duly noted: the thirty percent increase in transport costs due to the closing of traditional transport routes; the substantial adverse terms of trade; and the burden of accommodating some five to seven hundred thousand refugees from Mozambique. These continuing adverse external circumstances required further domestic adjustment.

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The Chairman indicated that the basic issue of Bank strategy towards Malawi was how to ensure that Malawi is able to restore a viable policy framework on a sustainable basis rather than respond in an ad hoc way each time it faced adverse circumstances. He noted that the country's policies had departed from its liberal policy framework of the past in the face of adverse external shocks. The Region indicated that the Government had not responded quickly to the adverse shocks as it felt that these shocks were transitory. However, at present the Government was making genuine progress and it was committed to develop a policy framework that could maintain macroeconomic balance and adequate incentives over time. This commitment was reflected in its progress in liberalizing the trade regime and small holder marketing while the earlier actions in price liberalization and public enterprise reform were sustained.

The main adjustment needed to restore a more permanent and viable policy framework was to restore fiscal balance. This required a basic restructuring of the expenditure system. The Region explained that the main objective of expenditure reforms was to restructure investments away from the public sector towards the private sector while protecting those current expenditures needed to prevent a deterioration of the welfare of the people. A Committee member raised the issue of expenditures - particularly in relation to Press Holding, and ADMARC. The Region indicated that Press holdings were restructured and that a Board of trustees managed its day-to-day operations. The Region assured the Committee that both in its financial performance and its relationships with the Government, Press Holdings have shown satisfactory progress in the last few years. The Region indicated that ADMARC has also been restructured and its monopolistic position in marketing significantly reduced. Meanwhile its main function of managing the strategic grain reserve on behalf of the Government has been strengthened. At present ADMARC is re-examing its other functions.

Two Committee members raised the issue of future sources of growth in the Malawi economy. The Region indicated that there was potential in agriculture, particularly in small holder maize production that presently had very low productivity compared to the other countries in low income Africa. However, these increases in production could only be expected in the medium-term. There were no obvious large projects that could be cut to prune down expenditures. The success in improving agriculture will also help the poor as the majority of the poor live in rural areas. It was noted that high transport costs limit the expansion of cash crops while Malawi remains competitive in several cash crops. There were also to be some efficiency gains in reallocating expenditures towards improving human capital which will have longer term pay-offs.

The Chairman drew attention to the scenarios presented in the paper. The two scenarios were a base scenario which continued the present reforms and an alternative with expanded reforms that indicated a higher GDP growth rate and increased external assistance over the base scenario. He requested that the scenarios be clearly spelt out indicating the policy contents of the base and alternative scenarios and showing the relationships between policies and the outcomes under the two scenarios.

Commenting on the policy regimes under the two scenarios, the Region explained that they felt that the alternative scenario was necessary to lift Malawi out of the present slow growth and vulnerable external position to one of higher and sustained growth compared to the base case. The base case was more favored by the IMF. Under the alternative scenario, private sector opportunities will be expanded more and the incentive structure improved over and above what was contemplated under on-going programs such as the Industry and Trade Policy Adjustment Credit. Towards improving incentives in the agricultural sector, the Region is preparing an Agriculture Adjustment Credit which will aim at further liberalization of marketing, reforming the land tenure system and generally improving the small holders access to inputs.

The Chairman raised the issue of poverty alleviation and the social impact of the adjustment program. The Region indicated that it was involved in the design of strategies to deal with social impact. A food security unit has been established in the office of the President and Cabinet and a work program is being developed to examine issues regarding nutrition and strategic grain reserves. The Region's economic and sector work program is taking an integrated approach to the examination of issues relating to poverty alleviation, food security and the social impact of adjustment. The next country economic memorandum will focus on questions of poverty alleviation and the social sectors.

In summarizing the discussion, the Chairman instructed that the paper be revised in the light of the Committee discussion to (a) give policy content to the scenarios, indicate more clearly the pay offs to the alternative policies, explain the financing gaps and specify the burden sharing arrangements to meet these gaps (b) strengthen the sections of the paper on poverty alleviation, food security and social costs of adjustment drawing together the implications and issues relating to these areas and linking these issues to the policy framework.

March 17, 1988
SRajapatirana:gs

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

Date: March 7, 1988

To: Operations Committee

From: Vinod Dubey, Director, EAS

Extn: 78051

Subj: MALAWI - Policy Framework Paper (PFP) - Agenda

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1. There will be a meeting of the Operations Committee on Thursday, March 10, 1988 at 3.00 p.m. in Room E-1244 (Mr. Qureshi's Conference Room) to discuss the Malawi PFP. The Committee may wish to take up the issues identified in this Agenda as meriting discussion.

2. Background

Until the late 1970s, Malawi was able to achieve high income growth (3% per capita income per year), with external balance as a result of sound macroeconomic policies and a price oriented incentive system. However, after 1978 the Malawi economy deteriorated with slowed output growth, large payments imbalances and inflation. This poor economic performance was the result of strong external shocks, and poor macroeconomic management and policies that led to departures from price based incentive structures towards greater administrative controls. The parastatals took on an increasing role in marketing and distribution. 1978 1982-84 3 SALs

3. In the early 1980s, the Government undertook a strong adjustment program to restore macroeconomic stability and improve incentives to return to the high growth path of the earlier period supported by successive Stand-by arrangements with the Fund and three SALs from the Bank. Under these programs a domestic price liberalization was initiated, aggregate demand and supply imbalances that led to external imbalances were rectified and a reform of the parastatals were undertaken. With these reforms output growth recovered and per capita income growth turned positive during the 1982-84 period. 1985 1987 fragile

4. However, after 1984, the Malawi economy again began to perform poorly due to a combination of a rapid decline in terms of trade, closure of traditional transport routes through Mozambique and domestic policy failures which led to large fiscal deficits (12.5% of GDP in 1986/87). In response to these external shocks, the Government introduced quantitative restrictions and foreign exchange controls, departing from the liberal economic policies of the 1970s. Meanwhile the payments situation worsened with import payments arrears reaching SDR 44 million in 1985. Inflation surged and output growth fell. The growing influx of displaced persons from Mozambique caused a run down of grain reserves and placed an additional burden on the Government budget. The Government again undertook measures to arrest the deteriorating situation beginning in August 1987. It reduced the fiscal deficit and raised domestic interest rates. However, the economic situation remained very fragile in 1987 when inflation surged

to 26%, external payments imbalances widened, import payments remained suspended and per capita income growth turned negative. In January 1988 the Malawi Kwacha was devalued by 15%.

Macroeconomic Adjustments

5. From the experience of the last decade it can be seen that Malawi's economy has been subject to inordinate external shocks that have been exacerbated by expansionary fiscal policies and adverse microeconomic policies such as quantitative restrictions, price controls and monopoly practices. These policy failures have moved the economy away from its former growth path.

Emphasis on sustain-ability

- 1. How does the Government propose to bring about **sustained** fiscal adjustments over the medium term to restore macroeconomic balances?

- a) Given that the public revenues generated are already high compared to other countries, what are the prospects for reducing public expenditures and re-directing them to priority areas so to raise efficiency and improve the welfare of the poor?

- b) What are the elements of the public expenditure review now under completion that will assist in the re-direction of the expenditure? Is the Government open to advice on expenditure allocations?

Restructuring of Public Sector, etc.

IMF or IBRD
Are we helping or hurting by adding to the debt & propping up Consumption

- c) Why are the medium term macroeconomic projections specially on the fiscal side between the base and alternative scenarios dependent mainly on the availability of external assistance rather than on policy improvement?

Good Question
ADMARC

Incentive Structure

6. During the 1980 many controls were introduced that led to a significant departure from the Government's liberal economic policy stance of the 1970s.

Are we dealing with a Government that has any commitment to sustained reforms or just opportunism?

- Given that a recent Industry and Trade Adjustment credit is addressing incentives within the industrial sector, how does the Government propose to restore incentives in a time frame that will arrest the further decline in efficiency outside industrial sector?

- (a) What advice does the Region propose to give the Government on the pace of restoring incentives in the foreign trade sector and domestic agriculture sector.

Agriculture and Small Farming

7. Agricultural productivity in Malawi among the small farmers is significantly low compared to neighboring countries such as Kenya. A combination of land pressure, backward technology and limited access to

inputs and research act as major constraints to increasing agricultural productivity. Low agriculture productivity is the main cause of pervasive rural poverty in Malawi. The goal of raising agricultural productivity must contain the elements described in paragraph 25 - development of appropriate maize-based technologies, improvements of research and extension linkages and increased expansion of credit.

- What specific measures are contemplated to reach the above goals in terms of changed policies and institutional reforms to induce farmers to adopt such technology and provide access to inputs?

- What elements of design in policies and institutions are contemplated to bring about sustained reform of incentives on agriculture?

Commitment and Implementation capacity

8. The reform effort has to be closely coordinated for its success. However reforms recommended range wide from reform of the fiscal system to the exchange rate and trade regimes and to specific areas such as those described above for agriculture.

- Does the country have the commitment and the implementation capacity to undertake such a wide ranging program?

- Should not the principal effort be concentrated in key areas and sectors such as fiscal and exchange rate reforms and in major sectors as agriculture and social sectors so as to sustain the effort?

Poverty Alleviation and Social Impact

9. Malawi has serious poverty problems and its social indicators remain below low income Africa in general.

- Should not Bank strategy be directed at improving social sector performance particularly in relation to nutrition, health and infant mortality?

- Because the necessary price adjustments will raise food prices and could lead to further reductions in the already low nutrition levels of the poor, should not food security issues be frontolly addressed in Bank dialogue with the Government?

March 7, 1988
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M. Qureshi

The World Bank
OPERATIONS COMMITTEE

CONFIDENTIAL

Minutes of the Operations Committee Meeting to Consider a Draft Board Paper on Policy Framework Papers - A First Review of Experience in the World Bank

Held on March 7, 1988 in Conference Room E-1244

A. Present

Committee	Others
Messrs. M.A. Qureshi (Chairman)	Messrs. V. Dubey (EAS)
S. Husain (LACVP)	E. Grilli (EAS)
E. Jaycox (AFRVP)	U. Thumm (EAS)
R. Cheetham (ASIVP)	R. Liebenthal (SPRPA)
A. El Maaroufi (EMNVP)	T. Baudon (SVPOP)
I. Shihata (VPLEG)	O. Rahkonen (SEC)
H. Vergin (SVPOP)	Ms. C. Mann (VPDEC)
D.C. Rao (FRS)	
S. Fischer (VPDEC)	

B. Issues

1. A meeting of the Operations Committee (OC) was held to review the draft Board paper on the Bank experience with PFPs, prepared by the Economic Advisory Staff. The agenda highlighted four issues, which were discussed by OC Members.

C. Discussion

2. On the first item placed in the agenda, several OC members stressed the considerable difficulties that Bank-Fund collaboration on PFPs posed to the Bank, because of: (a) excessive focus of PFPs on short-term, macro-stabilization issues (as opposed to longer-term development issues); (b) too heavy reliance on "available" external financing (as opposed to financing "necessary" to achieve minimum growth); (c) too strict linkage with Fund cycle (as opposed to Bank or country policy cycle); and (d) the high costs for the Bank generated by the PFP process (relative to its direct benefits). One member expressed the view that PFPs should be considered as a prime instrument of dialogue with the country and the IMF and as such should be "taken over" by the Bank.

3. On the second item, members of the OC who spoke on the subject were nearly unanimous in their views that PFPs and Bank adjustment lending should not be formally tied. One member summed up this consensus view when he said that we should expect PFP (or the equivalent) to be in place before

the Bank goes on with policy-based lending, but as a matter of substance, not of form. OC members clearly indicated their preference that PFPs remain framework papers, broad in character and focused on policies (global as well as sector). There was again broad consensus on the possibility of using PFPs more extensively than in the past in aid coordination and mobilization for SAF-eligible countries.

4. On the third item, one member expressed the view that the recently issued guidelines went as far as one could hope in stressing the need to focus PFPs more than they have been in the past on longer-term developmental issues (e.g. population, health, sector constraints). Without a lengthening of the three-year time horizon of these papers, not much more could be tagged on them. Another member stressed the need not to overload the PFP process with too many objectives and too many changes in content from the current model. There was no problem raised with the notion that the Bank should take a more visible, and at times leading, role in PFP missions than in the past. OC members, however, pointed out that more "joint" missions were possible, but formal Bank mission leadership was difficult, because of the link between PFP and SAF (and now ESAF) operations. Fund missions do in fact negotiate SAF agreements concurrently with PFPs.

5. On the fourth item, one member expressed the view that the paper should point out more specifically to the history of the compromise on Board rules for PFPs and to the clear and recognized fact that there is no consensus among Board members on how to conduct country reviews.

6. The Chairman summed up the discussions; he asked EAS staff to separate clearly, in the revised version of the draft, the issues of content from those of process that were raised and discussed by the OC, and to reflect in the draft paper the conclusions of the OC discussions on the four points raised by the agenda.

March 14, 1988

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

Mr. Qureshi

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DATE: March 3, 1988

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS   VDubey

EXT: 78051

SUBJECT: Draft Board Paper on Policy Framework Papers - A First Review of Experience in the World Bank

The Operations Committee will meet on Monday, March 7, 1988 at 10:00 a.m. in E1244 (Mr. Qureshi's conference room) to discuss the draft Board paper entitled: Policy Framework Papers: A First Review of Experience in the World Bank. The paper was distributed to the OC members on Friday, February 26, 1988.

Background

A brief report to the Board on the procedures to be followed for the discussion of PFPs had been promised by Mr. Stern in the Fall of 1986. In February 1987, IMF management sent to its Board a staff paper reviewing Fund experience with the SAF. The IMF Board Review took place in June 1987. Several Bank Directors then asked for a parallel review of our experience with the PFP/SAF process. Because of the endorsement at the Venice Summit meeting of the IMF proposal to enlarge SAF, the completion of our review paper was delayed until the outcome of the Fund discussions with donor countries would become clear. In January 1988, the enlarged SAF (ESAF) was approved by the IMF Board. Since then EAS staff, in close consultation with regional staff, have completed the above-mentioned draft. A pre-OC review was held on February 18 and was attended by Operations, PPR and Finance staff. The paper, once cleared by the OC, will go to the Policy Committee. We plan to distribute it to the Board in time for discussion on March 31, 1988.

Items for Discussion:

1. The paper reviews first the Bank's own experience with the SAF/PFP process in the context of Bank-Fund collaboration. The basic problem here was the adjustment of Bank schedules and work cycles to an "outside" requirement, part and parcel of a process initiated and driven by the IMF (SAF). Do the Committee members feel that the rather positive judgment of the Bank-Fund interaction is justified (despite its costs and the initial implementation difficulties)?

2. The second issue relates to the role that PFPs can take in the Bank's own operations. Here the range of possibilities is very wide: from pure and simple support to an IMF based process (SAF and now ESAF), to a formal link between the existence of a PFP and Bank-group lending to SAF-eligible countries, to the transformation of the PFP into a document that directly supports Bank group adjustment lending.

(a) Somewhere between the middle and the upper boundary of this set of possibilities lies the proposal made by Secretary Baker in September 1987 to "integrate policy-based loans from the World Bank into Policy Frameworks as closely as loans from the IMF's SAF". The paper takes a negative view of a possible formal link between PFPs and Bank group adjustment lending, arguing that de facto Bank lending to SAF-eligible countries is already closely associated to the tripartite policy process out of which PFPs emanate and that the additional costs of a formal link would outweigh its marginal benefits. Is this an appropriate and defensible tack?

(b) The paper takes a more positive and flexible view on the other possible uses of PFPs in Bank work, especially in the policy dialogue with SAF-eligible countries and in the dialogue with bilateral aid donors over support of adjustment programs in low income countries. Does the draft paper go far enough in highlighting the possible new uses of PFPs?

3. The third set of issues has to do with the visibility and weight of the Bank participation in the formulation of the PFPs. The paper stresses the recent changes in the guidelines for the preparation of PFPs distributed to the staff on September 8, 1987. Is this sufficient to deal with a second aspect of the US proposal: joint missions (Bank leadership)?

4. Finally, on the section concerning Board Procedures, are members of the committee comfortable with the rather neutral treatment of the options open to the Board for the discussion of PFPs (in isolation or in conjunction with Bank lending operations). Should the Board wish to continue with the present review system, is the suggestion that the Directors be sent "second" (and then "third") year PFPs, to be considered accepted on a "no-objection" basis, a feasible and useful one (to reduce Board and staff review time and burden)?

cc: Messrs. Lee, Shakow, Holsen, Rao, Baneth, Burmester/Thahane, Liebenthal, Steer, Baudon

For Information:

Messrs. Hopper, Fischer, Bock, Frank, Parmar, Goldberg, Robless,
Ms. Haug

March 3, 1988

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The World Bank
OPERATIONS COMMITTEE

CONFIDENTIAL

Minutes of the Operations Committee to consider TURKEY - Second Financial Sector Adjustment Loan, held on March 3, 1988, in Mr. Qureshi's Conference Room, E-1244.

A. Present

Committee		Others	
Messrs.	M. A. Qureshi (Chairman)	Messrs.	R. Al-Jabri (LEGEM)
	E. Barandiaran (LACVP)	Ms.	R. Anand (EM1CO)
	S. Fischer (VPDEC)		J. Balkind (EM1CO)
	E. Jaycox (AFRVP)		S. Banerji (EM1D)
	A. Karaosmanoglu (ASIVP)		T. Baudon (SVPOP)
	H. E. Kopp (EMNVP)		D. Bock (DFA)
	D. C. Rao (VPFPR)		S. Dhar (EM1CO)
	H. Vergin (SVPOP)		V. Dubey (EAS)
			A. El Maaroufi (EMNVP)
			S. El Serafy (EAS)
		Ms.	S. Hadler (FRS)
			P. Hasan (EMNVP)
			R. Liebenthal (SPRPA)
			V. Polizatto (CECFP)
			O. Rahkonen (SEC)
			E. Segura (EM1)
			K. Siraj (COD)
			T. Tsui (EM1CO)
			J. Reitmaier (IMF)
		Ms.	D. Ripley (IMF)
			D. Robinson (IMF)

B. Issues

The Operations Committee met on March 3, 1988 to consider the Initiating Memorandum (IM) for a Second Financial Sector Adjustment Loan to Turkey in the amount of $400 million. The discussion followed broadly the agenda prepared by the Economic Advisory Staff. The issues raised included the state of the macroeconomic program and the role of the IMF; the progress achieved under the First Financial Sector Adjustment Loan; the design and conditionality of the proposed operation; Bank exposure; and loan size and tranching.

C. The Discussion

The Region summarized the adjustment process initiated in Turkey some eight years ago with Bank support, and related how five SALs were followed by a series of sector adjustment operations. As adjustment moved into sectors, the Region stressed, it became clear that, in the absence of the Fund's active involvement, some macroeconomic umbrella was needed. Hence was born the concept of a Government letter spelling out its commitment to a macroeconomic program. The dialogue with the Turks over macroeconomic policy intensified as inflation and the fiscal deficit worsened, but Turkey had been understandably reluctant before the recent elections to commit itself on paper. The Region felt all along that this operation could not be taken to the Board without a letter containing a macroeconomic program that was both plausible and feasible, and the Government has now accepted this. Once the November 1987 elections were over, a set of measures was put in place, including increases in State Economic Enterprise prices (20-40%) and various rises in prices of transport, energy, medical and education services. Since February 1988 taxes have been raised on tobacco, alcohol and fuel. Up to 30% of the revenue flowing into extra-budgetary funds could now be used within the budget. New public sector investment could not be initiated. Interest paid by the Central Bank on commercial banks' foreign exchange reserve requirements has been lowered. Interest rates on deposits and on preferred credit have been raised. And the scheme for foreign exchange retention by exporters has been abolished. The Region stated that it was not yet in a position to assess properly the entire macroeconomic situation, but the picture should be clearer on the return of the two imminent missions: for appraisal of the FSAL-II, and for the Country Economic Memorandum (CEM). The Region would then be able to assess the impact and realism of the projected 1988 program, which entails a 5% economic growth rate, fiscal deficit reduction by 2.7% of GDP, and inflation decline to 33% a year. The Region intended to come back to the Operations Committee before negotiations, with an assessment of the macroeconomic situation. In any case satisfactory macroeconomic progress would certainly be a condition of second tranche release. At that time, additional measures would be considered as necessary.

The Region added that the Government remained adamant against seeking a Fund Program on the grounds that that would indicate economic weakness and undermine its position as a borrower in the capital markets, but regular Article IV Consultations had continued, with Bank staff participation. Fund staff are also participating in the FSAL-II appraisal mission and the CEM mission. Turkey's record on servicing its foreign debt, the Region noted, had been excellent. A hump in debt service has developed as a result of rescheduling undertaken eight years ago, causing stress to the balance of payments. Major efforts have been made to elicit capital flows from other sources, but Bank exposure remained high, and would increase because of past lending even if all fresh lending were to stop. The Japanese Ex-Im Bank is prepared to support FSAL-II with $400 million, and possible Japanese commercial bank support might also materialize later in the calendar year. Another $300 million could be forthcoming from Japan (OECF) for quick disbursing operations in agriculture and the social sectors. After Japan Mr. Thalwitz was also visiting Germany for the same purpose of exploring burden-sharing. The Region rounded up its initial presentation by saying that all conditions of FSAL-I had been met, and that FSAL-II would build on the first operation in order to secure transparency and discipline in the financial sector.

A member noted that Turkey clearly needed Bank money as well as funds from other sources, encouraged by Bank involvement. He was afraid that processing this operation in the absence of the Fund, and under conditions of fiscal imbalance and inflation, might give financial sector adjustment a bad name. The Chairman then called upon the IMF representatives to comment. The Fund staff said that borrowers in general tended to come to the IMF only if they needed access to capital markets. In Turkey the Fund was not engaged in enhanced surveillance, but in Article IV Consultations, for which a mission would visit Turkey in April/May. They, therefore, were not in a position yet to assess the proposed macroeconomic program. If a financial gap developed, for which Turkey needed Fund support, they would favorably respond as Turkey had a good track record, but they could not push their services on Turkey. However, the Fund was closely cooperating with the Bank in analysing the macroeconomic situation. The Chairman then enquired if IMF staff could effect the monitoring necessary for the monetary and fiscal aspects of the macroeconomic program, once agreed, and the IMF staff stressed that they were not doing enhanced surveillance.

To the assertion by the same member who had urged IMF presence that Turkey's situation was sufficiently bad to warrant a Fund program, the Chairman thought that overall the indicators signalled a strong macroeconomic position, albeit with a liquidity problem. The progress so far achieved looked impressive, with rapid economic growth and expansion of exports, though with some retrogression on account of the elections.

Another member said that while sympathizing with the notion that a Fund program was necessary, he thought the quality of the macroeconomic work carried out by the Bank was such that he had no difficulty in endorsing continued Bank support for Turkey's longer term adjustment. He thought, however, that the issues raised by this operation indicated that this was truly a SAL, dressed up as a SECAL. He questioned the wisdom of stopping the number of SALs at five. The reforms proposed in the banking system did not appear to him to be substantial enough for this large loan. A SAL would address the macroeconomy, and perhaps a smaller loan could finance the banking reforms. The Region again emphasized the importance of the reforms being sought in the financial sector. They aimed at creating a proper incentive and regulatory framework to strengthen financial discipline, increase transparency and change managerial behavior in the banking system. Proposed measures included audit and evaluation of banks' portfolios, changes in loan classification and provisioning for non-performing assets, reducing loan concentration exposures and restructuring interest rates. This operation would also build the institutional mechanisms necessary to deal with the existing stock of non-performing assets and facilitate the restructuring of insolvent banks. Such reforms would affect both the stock of problems inherited from the past, as well as improve future practices in line with international standards. The Region elaborated the reasons it saw behind high interest rates, and described how the operation sought to reduce these and also to support an action program for improving the efficiency of State banks.

The Chairman concurred with the Region on the significance of the reform program proposed, which covered not only comprehensive improvements of the banking sector institutions, but also restructuring interest rates, and strengthening the equity and bond capital markets besides.

A member said, however, that he was unimpressed by the policy matrix appended to the IM. The banking regulatory reforms were not structural in nature, but conformed to what a central bank should routinely do anyway. He saw the interest rate issue primarily as a fiscal problem that should be handled through macroeconomic adjustment. Only one item on the program appeared structural to him, and that was phasing out preferential credit. To his question how important that was, the Region said preferential credit was constrained by lack of funds, had limited applicability, and amounted to only 15-20% of total credit. A member said he saw no need for preferential credit in Turkey, this having been got rid of in Korea by the second SAL.

The Chairman stated that the limit of five SALs was not preordained, but that we should not worry about form, and focus instead on the substance. Did we have an adequate macroeconomic framework? The answer was clearly no; but a program was forming, which we and the Fund would assess and then monitor at implementation. He would be reluctant to have a SAL unless the Fund was formally in the picture. On the other hand he had no desire to push Turkey to accept the Fund against its will. We could use our influence to persuade Turkey to have a Fund operation, but not as a condition, since this might be counterproductive for the dialogue with both the Fund and the Bank. He observed that while some of the features of the program were indeed appropriate to a SAL, it had enough substance for a financial sector loan. In any case he felt that an adequate macroeconomic framework must be a precondition for this operation.

A speaker said that, besides the Government's prohibition against starting new public sector investment projects, he would have favored a cap on extra-budgetary financing of municipal projects. The Region responded by saying that the Government had decided to transfer a third of revenues accruing in extra-budgetary funds to the budget, but they were not yet in a position to assess the implication of this proposal. The Region agreed that macroeconomic conditionality might cover this aspect of fiscal policy. A member returned to the size of the loan as being in excess of what it would cost Turkey to institute the reforms. The Chairman said that many factors contributed to setting the size of such a loan, including the scale of reforms, the state of the balance of payments and Bank-borrower transfers. As net resource transfers are reaching negative levels, and Turkey was experiencing a debt-service hump, he thought the proposed size of the loan was not excessive.

D. Decision

The Chairman summed up the discussion as follows. The Region would come back to the OC with an assessment of the macroeconomic situation before negotiations. Once a viable macroeconomic program was adopted and significant actions taken, he urged the Region to develop the program in three main areas: (a) to make sure that the structure of interest rates is more in line with the system we would want to see (he had in mind specifically interest rates on credit to State Enterprises); (b) to move forward from the area of banking regulation to actual restructuring of institutions in financial difficulties (creating a regulatory framework might not be enough without identifying and assisting the entities under stress); and (c) to expand further the notion of developing capital markets (inflation tended to be particularly damaging to capital market development, and inhibited foreign capital inflows). As to the size of the loan, the Chairman thought that $400 million could be considered only if the operation was organized over three tranches, including one at the end based on a well defined program for restructuring and recapitalization of institutions in difficulty.

March 9, 1988

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SESerafy/lcu

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: February 26, 1988

TO: Operations Committee

SALoan

V Dubey

FROM: Vinod Dubey, Director, EAS

EXTN: 78051

SUBJECT: TURKEY - Second Financial Sector Adjustment Loan Initiating Memorandum

1. The Committee will meet on Thursday, March 3, at 3.15 p.m. in Room E-1244 to consider the Initiating Memorandum (IM) of the Second Financial Sector Adjustment Loan for Turkey. The Committee may wish to take up as an agenda for the meeting, the issues here identified.

Background

2. Since March 1980 Turkey has availed itself of five SAL operations, aggregating $1,556.3 million and, subsequently, of three sector loans: for agricultural adjustment in FY86 ($300 million), for Financial Sector Adjustment, also in FY86 ($300 million plus two B-loans aggregating $52.9 million), and for energy sector adjustment in FY87 ($325 million). Total adjustment lending to Turkey so far has been $2,534.2 million, and the Region is proposing this second financial adjustment operation ($400 million), which would take total adjustment lending to Turkey up to a record of nearly $3 billion.

The Macroeconomic Framework

3. Adjustment lending which began in 1980 has sought to put in place for Turkey a macroeconomic framework that would ensure that growth would proceed at adequate rates in conditions of stability and without undue stress on the external balance. The achievements have on the whole been remarkable, with growth averaging 5% a year (nearly 7% in 1987), and a general easing of inflation and narrowing of the current account deficit which was only 1.4% of GNP in 1987. There was, however, a marked deterioration of performance in 1987, coinciding with parliamentary elections. Annual inflation rose to 49% (against 25% a year earlier); public sector deficit increased to 9-10% of GNP; and money supply was up 36%. These are significant danger signs indicating macroeconomic imbalance, and it is doubtful whether financial sector adjustment, as proposed, can be fruitfully pursued in the current economic setting. This is recognized in the IM sufficiently for the Region to propose delaying Board presentation until a satisfactory agreement had been reached with the Government on a sound macroeconomic framework. A Government letter on policy is said to be expected in the Spring covering the macroeconomic program for 1988 and 1989, which the Region would monitor in terms of GDP growth, inflation, public sector deficit etc.

fiscal

- Since a satisfactory macroeconomic framework was always either an explicit or implicit condition of previous adjustment operations in Turkey, what is the value of another policy letter, even as a condition of effectiveness?

- The Committee may wish to enquire about the role of the IMF, if any, in devising and monitoring such a program. Would it not be more effective if the program was to be undertaken in the context of a Fund operation? Besides, might it not be to the advantage of financial adjustment, and perhaps also Turkey's creditworthiness, if the Fund was seen to be playing a more active role at present than enhanced surveillance as it has been doing in Turkey for some time?

Financial Sector Adjustment Loan I

4. The first Financial Sector Adjustment Loan (FSAL-I), approved in May 1986, sought to support the Government's financial sector adjustment program during 1986-88. Its stated aim was to establish an efficient and flexible system of resource mobilization and allocation, offering a variety of financial instruments to borrowers and savers. The program included reduction of credit subsidies, maintenance of positive interest rates on preferential credit; standardization of financial institutions' accounts; external auditing of commercial banks; and external auditing of corporations as a means to a regulatory framework leading to development of a capital market. At the time of second tranche release in March 1987, Management reported to the Board that the standardized accounting system was now in place, and that that enabled the Central Bank to monitor the financial situation of the commercial banks accurately. An inter-bank money market had apparently been established and was growing in importance as a source of short term liquidity for the commercial banks. Open market operations began in February 1987, and trading of securities on the stock exchange was growing in volume and variety. Of eight conditions listed for tranche release of FSAL-I six were said to be fulfilled, while two were not: [(i) introduction of external audit of corporations offering securities by public issue, and (ii) nomination of the membership of a board of financial advisers]. The Government had given assurances that these would be met "no later than January 1, 1988" (SecM27-278, dated March 19, 1987, p. 4).

- The Region might wish to update the story of FSAL-I implementation, indicating if these two conditions have now been met.

Loan Design and Conditionality

5. The proposed loan is said to have four major objectives: (a) improving fiscal policy and its impact on the financial system; (b) strengthening the banking system *inter alia* by regulating loan classification, interest suspension and provisioning, reducing loan concentration, and setting up a mechanism for rehabilitating insolvent banks and for restructuring State-owned banks; (c) reducing the excessively high interest rates on non-preferential credits and improving rate structure; and (d) developing a capital market for equity and bonds.

Several Bank studies have identified the Government's fiscal deficit as the main force behind the high interest rates reflecting the Government's high borrowings which crowd out the private sector from credit and capital markets. High reserve requirements (reduced under FSAL-I, but crept up again), taxes on transactions and lack of competition at Treasury auctions as well as banking institution inefficiencies have also contributed to elevated rates. The operation seeks to reform interest rate structure and set in motion a process of institutional reforms that would be highly beneficial for the financial sector. Reform int rates

6. The Fiscal Deficit. The IM proposes (para. 1.16) that the fiscal deficit and its financing, as well as the demand for base money be monitored semi-annually by the Region in order to ensure compliance with agreed targets and to shape any necessary policy adjustments.

- o The Committee might question the likely effectiveness of such monitoring for curbing the fiscal deficit. Can monitoring, by itself, be sufficient for deficit control? Again, would not the Fund be better placed to play an effective role in this area? Yes.

Interest Rates. Apart from reducing the fiscal deficit and hence public sector borrowing requirements, the operation seeks to reduce interest rates through improvements in primary and secondary markets for Government securities, decreasing taxes on transactions, and raising preferential interest rates to positive levels in real terms. A set of conditions is proposed for these reforms, and highlighted in Annex 3 to apply at tranche release.

- o In view of the central place of interest rates in financial sector adjustment, can the appraisal mission explore the possibility of advancing in time some of the proposed changes for reducing the spread between deposit and lending rates?

Institutional Reforms. The operation covers various institutional reforms focusing on financial entities, which would eventually produce healthy banks, setting up monitoring procedures to ensure their viability and solvency. Much of the difficulties of the financial institutions, however, stem from the weak financial position of their corporate and individual clients in the real sectors of industry, agriculture and trade.

- o Could the Region throw light on the difficulties encountered by the real sectors, and assess the impact of these difficulties on the financial institutions? Can anything be done directly to improve their lot in an attempt to ease pressures on the financial institutions?

Bank Exposure

7. The Region projects a Country Strategy Paper to be available for consideration by the Operations Committee in June 1988. Meanwhile the IM highlights the problem of Bank exposure in Turkey: the share of the Bank's lending to Turkey in MLT would rise from 21.5% at end-1987 to 24% by 1992 and its share in the total debt service of Turkey would rise from 16% to

23% over the same period. The Bank already absorbs as debt service 5% of Turkey's export proceeds, and this ratio is projected to prevail through 1992. Total debt service ratio is quite high (37-38% in each of 1987 and 1988) though this is projected later to ease.

- o <u>The Committee might question the assumptions under which these ratios are being projected: what is the role of other creditors? and what are the level and composition of Bank lending in terms of projects and quick disbursing operations?</u>

future lending

<u>Loan Amount and Tranching</u>

7. The IM proposes a $400 million loan to be disbursed over two tranches of $150 million each, in addition to $100 million to be available on effectiveness specifically for recapitalizing insolvent financial institutions. The IM contains no justification for setting the recapitalization fund at that level, and the covering memorandum (p. 3, para. 6) admits that "neither the Government nor we know the extent of non-performing assets in the banking system." The covering memorandum states that the $100 million would help "initiate" a process which has to be accomplished under a subsequent FSAL. The fund would be disbursed only if a mechanism for restructuring the insolvent banks had become operational. For such a mechanism to be operational several conditions must be satisfied including asset classification, provisioning, interest accrual etc., and of course auditing of the institutions concerned. An effective Deposit Insurance Fund must also be in place to rule, on a case by case basis, on whether a bank should be liquidated or rehabilitated. Paras 1.32 and 1.33 detail further provisions to make such a Fund effective, and these include going to Parliament to amend the Banking Law, besides various institution-building measures.

- o <u>In view of the fact that the conditions that have to be satisfied for release of the $100 million for bank recapitalization may prove unattainable during the course of this "quick-disbursing" operation, and also since no adequate explanation has been given for the size of this component, the Committee may wish to consider that loan disbursement be divided over three tranches, rather than two, while extending the life of the loan and guiding the recapitalization drive by adequate conditionality at critical stages of implementation</u>.

Yes

cc: Messrs. Lee, COD; Shakow, SPR; Holsen, CEC; Rao, FRS; Baneth, IEC; Thahane, Burmester, SEC; Liebenthal, SPR; Steer, FRS; Baudon, SVPOP; El Maaroufi, Hasan, EMNVP; Kopp, EM1DR; Cohen, EM1CO; Banerjee, C52D1, El Serafy, EAS.

<u>For Information Only</u>:

Messrs. Bock, DFA; Fischer, VPDEC; Frank, Parmar, IFC; Hopper, SVPPR; Robless, SVPOP; Goldberg, VPLEG, Ms. Haug, EXC.

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The World Bank
OPERATIONS COMMITTEE

CONFIDENTIAL

Minutes of the Operations Committee Meeting to Consider
Dominican Republic - Framework for Cooperation

Held on March 3, 1988 in Conference Room E-1244

A. Present

Committee

Messrs. M.A. Qureshi (Chairman)
H. Vergin (SVPOP)
O. Yenal (ASIVP)
R. Armstrong (AFRVP)
H. Scott (LEGVP)
P. Hasan (EMENAVP)
D.C. Rao (FRS)

Others

Messrs. P. Loh (LA3DR)
A. Ray (EAS)
S. Voyadzis (LA3C2)
J. Sokol (LA3C2)
R. Ground (LA3C2)
Ms. S. Ono (LA3C2)
G. Pfeffermann (CEC)
T. Baudon (SVPOP)
A. Harth (CODOP)
R. Incer (IMF)
E. Williams (IMF)
M. Molares (LEGLA)
F. Kilby (CDD)

B. Issues

1. The Committee considered the paper "Framework for Cooperation" that was drafted in advance of a Bank mission to discuss the basis for a resumption of lending to the Dominican Republic. The discussion broadly covered the issues raised in the agenda prepared by the EAS, in particular the lending program options presented by the Region.

C. The Discussion

2. In an opening statement the Region stated that the Bank's strategy for the country has not been discussed comprehensively since 1981, that no new loans have been committed since 1985, that prior to 1985 the annual lending program was below average for similar countries, and that in recent years we have had considerable difficulty obtaining repayments of our loans. In the meantime the economic and social situation deteriorated appreciably. Even though the new Government has taken some positive steps on exchange rates and on public finance, much remains to be done and a stable economic team has not emerged yet due to frequent ministerial changes. A strong recovery was achieved in 1987, but the economy became seriously "overheated." The Chairman commented that he had requested a new look at our relations with the countries in that part of the Region to see if we could reestablish a positive development role instead of remaining a net recipient of their funds; the basic issue was whether there was a reasonable prospect of the Government implementing the proposed reforms. He also asked why the increase in the lending volume envisaged for complete implementation of the policy package would be as low as the proposed $80 million.

3. In the ensuing discussion, the main questions concerned the design of the adjustment programs and the management of net disbursements. One member of the Committee asked what the minimum adjustment program would be like and whether it would be achievable through only project-lending. Another member suggested that if achieving zero net disbursements were the aim, then the method represented by the proposed project pipeline was not the most efficient method--it would be better to consider quick disbursing loans early on from that point of view in addition to the possibility of restructuring undisbursed loans. He also questioned the Bank exposure figures presented in the paper. Another member suggested that the Bank might restrict its involvement in a very limited number of sectors--the most challenging being health, nutrition and education, that the reestablishment of a relationship with the IMF be considered a necessary condition for policy lending, and that the paper be revised to conform to the PFP format if it were to be signed by the Government. On the net disbursement issue, the Region's position was strongly endorsed by another member who said it would be extremely unfortunate if the country slipped into non-accrual status.

4. The Region responded to these questions and remarks at various stages. It stressed the importance of presenting a comprehensive and coherent medium-term program to the Government. It also said that economic management and performance in the country had not been worse than in other comparable countries which have active Bank programs, that the negative net disbursement situation could not be sustained, and that the minimum, or "core," program would merely help restore Bank lending towards normal levels. However, while the Central Bank Governor was on our side there was considerable uncertainty concerning the Government's receptivity to the proposed initiative, especially given that it had not yet been discussed with President Balaguer. It was because of this uncertainty that the Region was being conservative in proposing only two policy-based loans at this point. It further stressed that the objective behind the initiative was broader than that of attaining zero net disbursements per se. On the IMF, it stated that the Fund staff at the working level had endorsed the proposals, and while the Government did not want to borrow from the IMF it did seek an enhanced surveillance program. The IMF representative supported this statement, although he added that the country did not meet the criteria for the enhanced surveillance status.

D. Decisions

5. The Chairman said that he did not want this to be an exercise in merely preventing negative net disbursements. The point rather was that we had not had a meaningful dialogue with the Government for sometime. Our strategy should be to establish an effective dialogue and rebuild our image in the country. We should involve ourselves selectively in a few sectors which unambiguously contribute to growth and development. He would suggest proceeding experimentally with the proposed low program, subject to a review next year. He also would not rule out quick-disbursing policy-based components for the sectoral operations, but he would not envisage general adjustment lending at this stage unless we could be completely satisfied with the feasibility of the overall macroeconomic program. He ruled out the use of IDA resources.

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THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

RECEIVED
88 MAR -1 PM 5:01
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DATE: March 1, 1988

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

EXT: 78051/2

SUBJECT: DOMINICAN REPUBLIC - Framework for Cooperation - Agenda

1. The Operations Committee will meet on Thursday, March 3, 1988 at 10:00 a.m. (instead of 11:00 a.m.) in Room E-1244 (Mr. Qureshi's Conference Room) to discuss the above-mentioned paper. Since the paper is to be discussed with the Government, a longish cover memorandum has been provided to assist the Committee's discussion. Both documents propose a resumption of lending after a hiatus of nearly three years--the last loan was in July 1985. In addition the cover memorandum provides a brief update of the last Economic Report--issued in grey in January, 1987--which developed the various policy recommendations contained in these documents.

2. Over the long haul the growth performance of this country has been quite satisfactory; it is only during 1985 and 1986 that per capita incomes declined but 1987 was apparently a year of strong growth. The current difficulties stem essentially from the sharp deterioration in the country's external terms of trade in the early 1980s, failure of domestic savings to keep pace with investments, and the lags in adjusting the incentive framework that introduced serious distortions in the allocation of resources. The current administration has already taken some important remedial steps, especially in the areas of exchange rate and fiscal policies. The "high-case" scenario presented by the Region reflects good medium-term prospects, even if not as good as those presented in last year's Economic Report.

Two options
521 — 60

3. The Region has presented two strategic options as possible guides to its impending discussions with the Government. The first option is that of regular project lending. With the objective of keeping net disbursements positive, the Region proposes a lending program of $521 million during FY88-92. The second option would expand this program by $80 million to accommodate two policy-based quick disbursing operations. The basic question is whether the Region has correctly described the conditions under which either of these lending programs would be justified.

4. The Expanded Program. The conditions under which the full program will be proposed are basically (i) an agreement with the Paris Club to reschedule arrears, and (ii) full acceptance of the various measures described in the Policy Matrix (see also paragraph 55). The base-case scenario corresponding to the acceptance of the full reform package is the "high-case" scenario. The Committee might wish to consider the following issues:

(a) the Government's attitude towards external agencies and donors--its cancellation of IDB loans, its refusal to use IMF resources, attitude towards IMF & Bank

and the threat of default on IBRD loans unless positive net transfers can be assured;

(b) the Region's current judgment regarding how and by whom the financing gaps would be filled, and the minimum contributions from others that we would expect if we are to proceed with the proposed program; is it reasonable to assume that the Paris Club will agree to reschedulings even if there is no IMF involvement in any form;

(c) the Region's assumptions regarding burden-sharing in the event of adverse developments. This is particularly relevant to this country given its dependence on export goods subject to large world price fluctuations;

(d) the Government's attitude to the policy reform program. Is there a presumption at this point that the Government might fully endorse the reform program? Is a firm and credible commitment likely or feasible?

(e) would it be appropriate to propose policy-based lending even if the full policy reform package is not accepted? Where should we be flexible?

(f) the composition of the lending program in terms of the share of policy-based loans. The reforms being asked for in taxes, expenditures, public enterprise policies, and in banking and finance could also provide the basis for additional policy loans. A policy loan dealing with public finance issues may in any case be more helpful than the proposed sugar sub-sector loan. The reform priorities in agriculture--as described in the 1987 Economic Report--could also be incorporated in a policy loan that is broader and more potent than the proposed sugar sub-sector loan. Increasing the lending program by only $80 million over a 5-year period for only two policy loans may not be seen to be an adequate response to the radical changes we are seeking in the policy regime. It can also be misleading to signal to the Government and to others that one-shot policy operations are sufficient to support the process of policy changes in such areas as trade and industry;

Should we give a Public finance Loan instead of a Sugar sub-Sect. Loan.

Is $80 mill policy program sufficient

(g) as proposed, the bulk of the program would involve projects. But is this wise in a situation of extremely difficult balance of payments problems that could adversely affect the quality of the project cycle? Will there be enough lead time to identify and prepare the projects in the best possible way? An extrapolation of the past record would suggest considerable implementation problems. What institutional and policy changes are being planned to increase absorptive capacity and improve project-cycle management?

(h) is the Government likely to commit itself to the particular projects in the pipeline, especially in the social sectors? Is there a case for IDA financing of those social sector projects, taking into account the fact that the country's per capita income is way above the effective IDA cut-off point and that the country does not fall under the "small-country exception" rule. No

5. The Regular Program. In addition to the project lending issues already mentioned above, the Committee might review the macroeconomic requirements of proposing the project only lending program to the Government. In particular, the Region might comment on the extent to which the policy reform program will be a pre-condition to this lending program. If we assume no significant progress beyond the 1987 policy measures, we would get the so-called "status-quo" scenario. However, this is not a viable scenario, having been constructed solely to highlight the need for further changes. The Region might clarify what the appropriate macroeconomic framework should be to justify this lending program. The Region might also clarify the implications in terms of financing gaps, sources of finance and alternatives, if any, to Paris Club actions.

6. Strategy Paper Procedure. The Region has sought the Committee's permission to treat these documents as a substitute for the Country Strategy Paper due later this fiscal year. In the opinion of the EAS, this would not be appropriate for two reasons: (a) the documents do not convey fully and coherently all the information required in a CSP; and (b) too little is known about the Government's responses to the proposals at this stage. While the proposed approaches may be endorsed in principle, any strategic commitments at this point would be rather speculative. The Committee might consider the alternative of requiring a CSP as scheduled on the basis of the next round of discussions with the Government.

cc: Messrs. Lee, CODDR; Shakow, Liebenthal, SPR; Holsen, CEC; Rao, Steer, FRS; Baneth, IEC; Burmester/Thahane, SEC; Baudon, SVPOP; Selowsky, LACVP; Loh, LA3DR; Voyadzis, Sokol, (Ms.) Ono, Lynn-Ground, LA3C2.

For Information Only

cc: Messrs. Hopper, VPPPR; Fischer, VPDEC; Bock, DFA; Aguirre-Sacasa, VPEXT; Frank, Parmar, IFC; (Ms.) Haug, EXC; Goldberg, VPLEG; Robless, SVPOP.

ARay:vlw

- External debt impact rather unavailability of resources.

Is there need for a smaller Program

Our Posture: No program with the IMF

Consultation Group

Debt -

Send to the Policy Committee.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: February 19, 1988

CONFIDENTIAL

TO: Mr. Moeen Qureshi

FROM: Pieter P. Bottelier, ~~Acting~~ Regional Vice President, LAC P.B

EXTENSION: 69378

SUBJECT: DOMINICAN REPUBLIC - Framework for Cooperation

1. Please find attached for review by the Operations Committee (OC) the above referenced document. I would greatly appreciate it if the meeting could be organized during the week of February 29 at the latest. We intend to send the translated document to the authorities on March 4 and field a mission to discuss it on March 10. We propose an OC review because of the reasons mentioned in paragraph 3 below.

Background

2. The last Country Program Paper (CPP) on the Dominican Republic was reviewed by management in November 30, 1981 and was in general quite pessimistic about the future prospects for economic and social developments because of a proliferation of policy-induced price distortions, stagnation, a deteriorating balance of payments, and falling domestic savings. The meeting likewise expressed considerable doubt about the Government's ability to adopt warranted corrective measures, and thus proposed a minimal lending program during the Government's first year in office, but left the door open for a possible SAL if appropriate structural adjustment policies and an IMF Stand-by Arrangement were adopted. In the event, no policy-based lending occurred, albeit two IMF programs were pursued.

3. A new Country Strategy Paper (CSP) is scheduled for management review in the fourth quarter of this fiscal year. We propose that this memorandum, together with the attached Framework for Economic Cooperation Paper prepared by the Bank for the Dominican authorities, be considered as a substitute for the CSP. This memorandum will discuss some of the issues that cannot be explained in the attached paper.

Government-Bank Relationship

4. Bank relations with the Dominican Republic (DR) have always been difficult. Insufficient policy dialogue on key economic and social issues, institutional weaknesses in the public administration, disappointing performance in project execution, almost total lack of policy coordination and continuous policy interventions by the Government have been the norm rather than the exception since the country became a Bank member in 1948. On August 16, 1986, President Joaquin Balaguer assumed office. A staunch fiscal conservative, President Balaguer prefers to minimize borrowing from abroad. The focus of his efforts is to reactivate the economy through a public works program, create new jobs, provide basic infrastructure and services to lower income groups and support private sector led growth. At the same time, concerned by the deteriorating foreign exchange situation, President Balaguer has adopted a very strong stance vis-a-vis external sources of financing, pressing for net transfers and concessional lending from external donors.

fiscal conservative?

5. Until April 1987 our relations with the DR were characterized by: strenuous efforts from the Region and the Executive Director to ensure that debt service payments to the Bank would be made in the 60th-75th day range (we have even accepted about a year ago a payment in two installments); efforts from both sides--sometimes successful--to improve the implementation of projects and hence disbursements (averaging about US$19 million per annum); unsuccessful efforts to put in place a relatively firm pipeline of projects; and serious Government threats to stop servicing its debt to us (the Bank's DOD as of the end of 1987 was US$241 million) unless net flows became positive. Net transfers were negative by US$5 million in 1985, US$11 million in 1986 and about US$20 million in 1987, and for the first time, in 1987, net disbursements became negative by about US$3.5 million. Finally, the DR accumulated external debt servicing arrears with bilaterals and Paris Club which reached about US$238 million in 1987, up from US$142 million in 1986. Arrears

Recent Bank Initiatives

6. Against this background, a first mission in early September 1987 proposed to the authorities from the outset a new approach according to which, without any promises or false expectations, both the Government and the Bank would agree on a framework for cooperation which would clearly indicate how and under which conditions support from the Bank could be expected. The mission indicated that if the Government were to implement the measures needed to restore an appropriate macroeconomic framework we could consider quick disbursing policy based lending; alternatively, we would limit our involvement to project lending. With regard to net disbursements the mission indicated that new projects had to be identified and that the burden for proposing such projects for Bank financing was with the Government. The authorities agreed with the above approach. The mission returned with ten proposals for possible projects, in addition to the Power I Project (FY88), which was confirmed to be of the highest priority. All operations are indicated in the annexed table and discussed in detail in the attached paper.

7. Subsequent discussions during the Annual Meetings and in Santo Domingo confirmed the above approach. Our economic mission took place in late October 1987. Three additional factors have helped our strategy. First, in late September 1987, hurricane Emily damaged crops; this provided us with the opportunity to amend the Coffee and Cocoa I Project and agree to provide emergency relief of US$6 million for fertilizer imports which should be disbursed soon. Second, the appointment of a technocrat, Mr. Saladin, as Governor of the Central Bank; he previously held the Finance portfolio. Finally, revenue generating measures undertaken since November 1987--estimated to yield income equivalent to 5% of GDP--as well as the new exchange rate regime, may be indicative of the Government's intentions to begin taking some bold measures to improve the macroeconomic environment. Better environment

Economic Developments

8. To better understand recent changes in economic management, I believe there is need to present it in an historical perspective. Economic management in the DR has been traditionally characterized by a lack of policy coordination. During most of the 1970s the economy performed impressively--real GDP grew at about 8% per year on average during 1970-78

--reflecting an improvement in the terms of trade and adequate macroeconomic policies. Economic conditions deteriorated during the early 1980s, due to a worsening of the terms of trade and an inadequate domestic policy response. This situation declined further as the Government adopted lax fiscal and monetary policies, permitted the exchange rate to appreciate and adopted a dual exchange regime. The economy stagnated, rising fiscal and external deficits became common, and the country accumulated external arrears. During 1983-84 the Government, under an IMF program, introduced a number of fiscal and monetary measures in an attempt to adjust the economy. However, the authorities did not move far enough on the policy front. The measures were not successful and economic conditions continued to worsen. In January 1985, the Government, again under an IMF program, unified the exchange markets under a freely floating exchange regime which included a major devaluation of the Peso and a tightening of monetary and fiscal policies, with significant price and tariff adjustments by public enterprises. As a consequence, the consumer price index increased by almost 40% on average for the year. Widespread riots ensued, causing over 100 deaths.

9. In 1986 the outgoing administration changed its policy stance and adopted expansionary demand management policies; fiscal and monetary indicators continued to deteriorate. The opposition party under the leadership of Mr. Joaquin Balaguer assumed office on August 16, 1986 and initially maintained the overall policy thrust. Nevertheless, President Balaguer's traditional pro-private sector position, together with an improvement in the terms of trade and a strong public works program, stimulated increased private sector confidence and investment, and the economy began to recover. By March 1987, the expansionary demand management policies were exerting increasing pressures on domestic prices, imports, the country's foreign exchange reserves, and the free market exchange rate. By June 1987 the economy was expanding at an annual rate of 11% in real terms while inflation was rising at an annualized rate of 35%. Instead of tightening its policy stance, the Government suspended the free market float, successively appreciated the exchange rate, and introduced a dual exchange rate regime and exchange controls. By October 1987 the economic situation became unsustainable. After significant public discussion on economic issues and policies, the President replaced the Governor of the Central Bank. Mr. Saladin reestablished the free market exchange rate system, eliminated exchange controls and accompanied these actions with a number of monetary and fiscal measures to reduce excess liquidity and stabilize the economy. The results have been mixed. In particular, the economy remains overheated: initial estimates indicate that real economic growth reached 7.9% in 1987 (final estimates, however, may show growth closer to 10%). Moreover, inflation, which averaged 12% for the year, was 24% at end 1987.

10. The above macroeconomic policies constitute steps in the right direction. Despite the Government's commendable fiscal efforts, however, demand pressures have continued. These have been reflected by a parallel exchange rate which is now 8% above the official end of 1987 level and by a fall of gross international reserves to US$50 million, considerably less than the equivalent of a month of imports. Clearly, a tightening of Central Government expenditures and further fiscal adjustments in the decentralized public sector are still required to eliminate the public sector's domestic financing gap and in this way reduce excess liquidity in

the economy. This is needed in order to avoid recourse to Central Bank borrowing, bring inflation down to lower levels and stabilize the sharp exchange rate fluctuations.

Development Issues

11. The country is facing some critical development issues: (i) a severe structural unemployment problem; (ii) the domestic savings effort needs to be stepped-up; (iii) the domestic financial gap needs to be eliminated; (iv) fiscal and monetary policies need to be coordinated; (v) the balance of payments needs to be strengthened; and (vi) both the external debt as a percentage of GDP and the external debt service ratio need to be reduced. These issues are discussed in the attached paper.

Bank Group Strategy

12. The Bank's strategic objectives at this time should be to use our analytical work and lending operations in support of the Government's efforts to reactivate the economy through export-led growth, increase the availability of foreign exchange and stabilize the economy. As a first step, we would focus our efforts on redressing the problems we have had in the past by establishing a much closer country dialogue, providing our analytical support in the adoption of a viable medium-term framework, and testing and supporting the Government's ability to address simple and complex issues as we move on with our ESW and lending operations. The attached paper, which was prepared as the Government's paper, comes at the right time. It will constitute a test of the Government's intentions to consolidate and undertake further change; it will require consensus which is not going to be easy. The program is front-loaded but the record so far with the DR as well as its severe external resource constraint require such an approach.

13. In our lending operations, we initially propose to maintain a core program consisting of investment projects to buttress the Government's efforts to address its sectoral issues, and through improved project performance, influence macroeconomic developments. The core program would be sufficiently large so as to maintain positive net disbursements over the FY88-92 period. The objectives, proposed strategy and proposed lending for each sector are discussed in Section III of the attached paper. The specific criteria for these lending operations would have to be developed in each proposed project. Yearly commitments would average about $100 million during FY88-92 with disbursements at about US$50 million per year on average. The net disbursements are estimated to be positive by about US$15 million and US$12 million in FY88 and FY89 respectively, and average US$42 million per year during FY90-92. Net transfers, however, are projected to be negative during FY88-89 and positive during FY90-92. Our current efforts to increase disbursements under ongoing operations and process as quickly as possible the proposed new projects would have to continue. This, however, may prove difficult essentially for two reasons. First, because of the authorities' poor track record in implementing ongoing projects; and second, President Balaguer's reported uneasiness to increase borrowing from external sources, including the Bank. We would recommend holding a Consultative Group (CG) meeting for the Dominican Republic in the context of the Caribbean Group for Cooperation in Economic Development (CGCED)--it would be the first one for the DR since June 1981--

with the objective to help the Government identify the needed public investment financing for year one of the program. Finally, since the Dominican Republic's 1986 GNP per capita was US$710, the country is now eligible for IDA resources. We would like to seek management's approval for using IDA resources, starting in FY89, for projects in the social sectors.

14. Should the Government agree to implement the macro economic measures indicated in the attached paper we would propose to proceed with the preparation of quick disbursing policy based lending (Sugar Subsector - US$30 million - possibly in FY89; and Trade Sector Adjustment Loan - US$50 million - possibly in FY90) -- the specific conditionality would have to be developed in each loan; and organize a special subgroup meeting within the context of the CGCED to help close the three-years financing gaps. Prior to that meeting we would mount, together with the authorities, a financing tour to visit several European capitals (including in particular Madrid), USA and Japan. Preliminary indications from the few donors contacted (including Japan) seem to support such an approach. To what extent the Government, using the attached document and the CG results, will be able to obtain Paris Club rescheduling in the absence of an agreement with the IMF (see para 18) would have to be tested. About 70% of the DR's debt to the Paris Club is owed to the United States. The latter has been extending BOP support until very recently. If the US agrees with our strategy the chances of Paris Club rescheduling might improve. We would not recommend presenting to the Board the two quick disbursing policy based operations until Paris Club rescheduling has been obtained.

Consultative Group

15. The proposed lending program would support the country's efforts to enhance its international competitiveness, improve resource allocation, increase domestic resource mobilization, buttress the operations of the public enterprises and public sector pricing, alleviate the external disequilibrium, strengthen the social infrastructure, targeting the poor, identify the key issues and policies needed to protect the environment, and possibly reform the sugar industry, trade regime and the financial sector. Because of the formidable list of tasks, however, we have identified priorities. Also, all economic and sector work would necessarily be preceded by demonstrated Government interest and concrete evidence that our analyses can form the basis for future lending. Our ESW would initially focus on assisting the Government in the preparation of a medium-term public investment program and financing plan (FY88), and on assessing the policy framework for agricultural and industrial development, with emphasis on exports (FY89). This work would in turn be expected to lead to new lending to raise agricultural and industrial productivity and export capacity. Subsequently, our ESW would promote multi-year investment planning, project evaluation and monitoring (FY89); develop a more comprehensive long-term examination of energy alternatives (FY89/90); and forge an adequate framework for environmental protection (FY90).

Country Risk Management

16. The country's external debt increased by almost three times during 1980-86 following the deterioration in the terms of trade, the fall in domestic savings, the continuing rise in imports and the maintenance of high expenditure levels in real terms. External debt (public and publicly guaranteed), including non-guaranteed private and short-term, stood at

about US$3.3 billion (59% of GDP) at the end of 1986; of this amount, public sector debt accounted for about 96%. Of the total debt, multilateral institutions accounted for US$0.6 billion (18%); bilaterals, US$1.2 billion (37%); private creditors US$0.8 billion (24%); IMF US$0.3 billion (9%); short term US$0.3 billion (9%); and private nonguaranteed, US$0.1 billion (3%). External debt service, comprised almost equally by interest and amortization payments, was estimated at 27% of goods and nonfactor exports, and the debt service to GDP ratio, about 6% in 1987. In May 1985 and in February 1986, the Government obtained Paris Club and commercial banks' reschedulings, respectively. The worsening balance of payments situation, however, has made it impossible to service the Paris Club reschedulings and the country has accumulated arrears on them. The country is facing an external liquidity crisis. If the Government were to adopt the measures we are proposing, it would be in a position to carry out all of its payment obligations. However, the Dominican Republic would need to reschedule its Paris Club debt and to continue to need annual reschedulings covering nearly all of the preceding years' commercial banks' payment obligations. Debt service payments to multilateral organizations have been delayed to the maximum payment period. Moreover, the gravity of the country's debt payment situation has been compounded by the dwindling net flows from all creditors. Net capital inflows in 1987 amounted to US$26 million; this was, however, made possible by building up arrears in external payments to about US$238 million.

17. While the proposed program both with and without quick disbursing policy based lending would mean a considerable increase in the Bank's lending to the country, our exposure and risk are expected to remain at reasonable levels. The Dominican Republic's debt service ratio as of 1986 was about 28%, the total debt service represented 5.5% of GDP, and the Preferred Creditors' debt outstanding and disbursed (DOD) was about 28% of the country's total DOD. The Bank's exposure has been small: our share of total DOD was 5.4% and the Bank's share of the Preferred Creditors' DOD was 19%. The debt service to the Bank represented 9% of the country's total debt service, and about 3% of exports of goods and nonfactor services. As projected in the attached paper, under the appropriate policies scenario, the country's projected debt service ratio is projected to decline to 23% in 1992 although total debt service would remain at 5.5% of GDP. The Bank's share of total DOD is projected to be 9.4% in 1992 and the Bank's share of the Preferred Creditors is projected to remain below 30%. The debt service to the Bank is projected to increase to around 13% of the country's total debt service without quick disbursing policy based lending and 14% with such lending. The debt service to the Bank as share of total exports is projected to remain at about 3% with or without quick disbursing policy based lending.

Relations with the IMF

18. IMF staff have participated in the working level review of the attached paper and supported it at the meeting. IMF staff is concerned, as we are, of the fragility of the Government's program in the absence of additional fiscal and monetary measures required for economic recovery and stabilization. Nevertheless, we have assumed that there will be no program with the IMF. The 1985 events mentioned above, together with President Balaguer's statements during the election campaign, seem to preclude it. The Government initially seemed to wish an enhanced surveillance which the

No Program with IMF [illegible]

IMF does not seem to be willing to extend. More recently, Mr. Kafka (IMF Executive Director) visited the Dominican Republic and was unsuccessful in persuading President Balaguer to accept an IMF standby even under a different name. Our last reading of the situation is that Governor Saladin would present the attached paper to President Balaguer as the Government's medium-term economic program. If it were to be accepted by the President, Mr. Saladin would in turn present it to the IMF to receive its public endorsement. At this point it does not appear to be possible to reschedule the Paris Club debt without an IMF agreement (see para 14 for our suggestions). Discussions on the rescheduling of commercial bank debt are ongoing. Although the banks have been requesting an IMF agreement, in practice they have been rescheduling the country's debt de facto.

Conclusions

19. The proposed program is comprehensive. This is the first time we attempt such an approach in the Dominican Republic. We do not know if the Government will accept it. Even if we were not to succeed in full at the outset, we believe the core program should be maintained in order to support the progress that has been made and foster policy reforms. We propose pursuing the investments included in the attached paper so long as the macroeconomic policy framework does not induce serious distortions in the economy.

Attachments

Cleared with and cc: Messrs. Loh (LA3DR), Selowsky (LACVP),
Voyadzis, Sokol (LA3C2)
cc: Messrs. Jaycox (AFR), Karaosmanoglu (ASI),Thalwitz (EMENA),
Rajagopalan (VPPRE), Shihata (VPLEG), Wood (VPFPR),
Vergin (VPTRE), Lee (CODDR), Dubey (EAS), Shakow (SPRDR),
Holsen (CECDR), Rao ((FRS), Baneth (IECDR),
Thahane/Burmester (SECGE), Liebenthal (SPRPA), Steer (FRS),
Baudon (SVPOP), Fischer (VPDEC), Bock (DFA), Stanton (VPEXT),
Frank (CFPVP), Parmar (CIOVP), Hopper (SVPPR),
Goldberg (VPLEG), Agarwala (AFRVP),
Flood (LA3), Forno (LA3AG), Page (LA3TF), Moscote (LA3IE),
Drysdale (LA3HF)
Ms. Haug (EXC)

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The World Bank
OPERATIONS COMMITTEE

Minutes of the Operations Committee to Consider
HUNGARY - Industrial Sector Adjustment Loan;
Initiating Memorandum

Held on March 3, 1988 in Conference Room E-1244

A. Present

Committee		Others	
Messrs.	M. A. Qureshi (Chairman)	Messrs.	R. Al-Jabri (LEGEM)
	E. Barandiaran (LACVP)		T. Baudon (SVPOP)
	F. Colaco (VPPRE)		D. Bock (DFS)
	E. Jaycox (AFRVP)		T. Condon (EM4)
	A. Karaosmanoglu (ASIVP)		A. Deshpande (EM4)
	H. E. Kopp (EMNVP)		V. Dubey (EAS)
	D. C. Rao (VPFPR)		A. El Maaroufi (EMNVP)
	H. Vergin (SVPOP)		S. El Serafy (EAS)
			J. Harrison (EM4)
			P. Hasan (EMNVP)
			K. Jay (SPRPA)
			E. Lari (EM4)
			S. Mitra (FRS)
			P. Nouvel (EM4)
			O. Rahkonen (SECGE)
			V. N. Rajagopalan (EM4)
			K. Siraj (CODOP)
			A. Sood (EM4)
			J. Proust (IMF)

B. Issues

1. The Operations Committee met on March 3, 1988 to discuss the Initiating Memorandum for a first Industrial Sector Adjustment Loan to Hungary in the amount of $200 million. The discussion followed broadly the agenda prepared by the Economic Advisory Staff. The Chairman and other speakers also added the issue of the investment program in the industrial sector.

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C. Discussion

2. The Region stated that the Stabilization/Restructuring process in Hungary had moved slowly in 1985-1986 but was given a new impetus in 1987 with the implementation of major policy reforms as well as progress in reversing negative trends in the budget and current account deficits. The proposed program of stabilization and structural adjustment, particularly in the industrial sector, represented a heavily front-loaded program to continue progress between 1988 and 1990 on both the macro-economic and structural reform elements. The planned support of the Bank and the IMF was needed to maintain the present momentum and strengthen it in the coming years. The program was considered by the staff of both institutions to be a well-designed step toward fostering sustainable economic growth and a viable external position. Implementation of the program was not free of some uncertainty and risk related to political factors, CMEA relations, the external environment, effective implementation of reform elements, and particularly, the time necessary to induce changes in the behavior of enterprises and government agencies. In the past, the Government and the Bank had underestimated the time necessary to induce such changes. The Government was well aware of the risks and has committed itself to accelerate and deepen policy actions should the necessary supply response not materialize adequately in 1988. The Region also noted that the proposed program was fully consistent with past Bank strategy in Hungary in its emphasis on promoting reforms of the economy within an appropriate macro-economic environment. In response to developments in 1985-1986 the past "hybrid" Industrial Restructuring Operations have increasingly emphasized appropriate macro-economic policies along with the focus on the reform program. The strong pressure exerted for action to curtail growing fiscal and current account deficits in the context of the second Industrial Restructuring Loan supported the Government's efforts in this direction in the later part of 1987.

3. The Chairman drew attention to selected items raised in the agenda and focused specifically on the following issues: (i) the apparent gap between legislative actions and their implementation, (ii) changes in the regulations which appear not to have resulted in real action and the desired supply response, and (iii) apparent macro-economic inconsistencies in the projections, particularly with regard to the puzzling decline in the share of the exports and imports as a share of GDP, while seeking progress towards a more open economy.

4. The Region explained that: (i) a number of fundamental changes had been implemented as part of the reform program and provided an illustrative list of salient actions; these changes included measures such as the Law of Association which increases the scope of private sector activities in Hungary as well as major reforms of the financial system and the tax system; (ii) there has indeed been a lag between these actions and the desired supply response for a number of reasons explained in the Initiating Memorandum; and (iii) the macro-economic scenario was based on the need for a sharp compression in imports in the short run and explained some factors which make this feasible. In the medium and long term imports were expected to remain approximately constant as a share of GDP while exports to convertible currency areas would grow in real terms as a percent of GDP.

5. The IMF representative explained the salient elements of the standby program scheduled to be presented to the Fund Board on March 28. In response to a query by the Chairman , he added that the underlying tight fiscal and monetary policies have in fact begun to be implemented in mid 1987 and have resulted in a reduction in the fiscal and current account deficits as well as improved economic performance in the second half of 1987.

6. The Chairman drew attention to the chart in the initiating Memorandum showing the IMF and Bank programs and queried the "additionality" of the Bank program. The Region explained that there was, in fact, a single program of stabilization and structural reform which both institutions were supporting. Hence, substantial commonality was to be expected. At the same time the appraisal mission would seek to deepen the program in the outer years, i.e. 1989-90. Also, there were a number of additional actions reflected in the attached matrix which had not been included in the summary chart. The Chairman queried the impact of the program, for example, on breaking up monopolies in the industrial sector in Hungary. The Region explained that substantial progress in this specific area has been made and further action was included specifically in the matrix. The Chairman emphasized the importance of a clear and transparent list of the measures included in the program and how they were to be monitored.

7. A speaker noted that the Bank program, as presented, looked much like a Fund program and the separate role of the Bank did not emerge clearly. He emphasized the need for a focus on the composition of investment, particularly in the industrial sector. Another speaker added that the implied capital output ratios appeared very high. The Region indicated that the focus on the macro-economic program had evolved in time. The Bank has increasingly urged the Hungarian authorities to strengthen macro-economic management, had encouraged the recall of the IMF, and had worked closely with the Fund in developing complementary conditionality.

8. The Chairman and another speaker queried whether the Hungarian authorities and Bank staff had a clear vision about the ultimate changes in the economic system and the expertise to manage/guide this change. The Region pointed out that the vision was not a completely clear one and noted that in view of the overall situation, the option for waiting for a clear vision to emerge was not feasible. Furthermore, the overall goals of the reform were clear to both Government and Bank Staff, with the uncertainty affecting the process of getting there and the ultimate system that would emerge. Staff were satisfied, however, that a satisfactory process of reform towards agreed objectives was underway.

9. The Committee discussed the lack of the specific inclusion of the investment program in the operation. The Region explained that the Bank had carried out a detailed investment review in 1985. Subsequently, in preparing the 1988-1990 program, the Hungarians had undertaken an intensive revision of the remainder of their 5 year plan. Much of the industrial investment was in the enterprise sector which would now be subject to tighter financial discipline, improved price policies, reduced subsidies, and a more effective

commercial banking system. The Chairman emphasized the importance of including a qualitative assessment of the program as part of the proposed loan. He also noted that subsequent operations should include quantitative objectives and a consultation and monitoring system at least with respect to the core program in the industrial sector.

10. The Chairman reiterated the importance of reflecting, in the program, the objectives and specifics of the actions in the different policy areas.

11. A speaker noted that the Initiating Memorandum, while generally emphasizing reduced subsidies, also mentioned the increase in subsidies that would result from social programs directed at the poorer segment of the population. He also queried the effects of the rebate of the VAT on investment. The Region explained that the 1988 program did reflect a sharp decrease in overall subsidies and a better targetting of the remaining ones. The justification for the VAT rebate on investment was also explained.

D. Conclusion

The Region was authorized to proceed along the lines proposed in the Initiating Memorandum with a loan of $200 million subject to the discussion summarized above. With regard to the proposed front-loading of the loan disbursement, the Chairman recommended that the loan be disbursed in two equal tranches. In concluding, the Chairman reiterated the need for clarity and specificity in the reform program.

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THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: February 18, 1988

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

EXT: 78051/2

SUBJECT: HUNGARY - Proposed $200 Million loan for an Industrial Sector Adjustment Operation - Initiating Memorandum - Agenda

1. The Operations Committee will meet on Thursday, March 3, 1988 at 2:30 p.m. in Room E-1244 to consider the Initiating Memorandum on a proposed Industrial Sector Adjustment loan to Hungary for $200 million. The loan continues support for a program of industrial restructuring and policy and institutional reform. Two hybrid restructuring loans were approved in FY86 and FY87; investment loans for agro-processing modernization and industrial enterprise restructuring are scheduled for FY88 and FY89 respectively.

2. The Operations Committee may wish to discuss the following issues:

3. Implementation of the Adjustment Program. The industrial restructuring program combines reforms of the economic management system, especially industrial sector policy, with support for specific restructuring investments. (These elements were combined in the previous loan which incorporated both a quick disbursing (policy) and a slow disbursing (investment) component). The Letter of Development Policy enshrined the government's commitments to: (i) implement a comprehensive program of reform around three themes: tightening of financial discipline, enhancement of competition, and improvement of resource mobility; and (ii) maintain a supportive macro-economic policy environment through high demand management, flexible exchange rate and reduction of budgetary support to inefficient enterprises. As the Region notes, "the implementation of the reform, and consequently its results have clearly fallen short, especially during 1985-87" (para 27), i.e., particularly during the period of our operations.

4. Weak macroeconomic management was a major shortcoming. From a surplus in 1984, and a deficit of 1.1% of GDP in 1985 the budget deficit increased to 4.3% of GDP in 1986. The rate of expansion of domestic credit (4.0% in 1988) accelerated to 7.7% in 1985 and 15.2% in 1986. Consequently, per capita consumption increased by about 9% during 1985-87 when per capita GDY increased by only less than 2%.

5. A second area of failure was the tightening of financial discipline. While the legal framework for liquidation of inefficient enterprises was introduced in September 1986 it has been applied to only about a dozen enterprises so far and has been associated with large scale support to chronically loss making enterprises outside the liquidation

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framework. Total budgetary support to loss making enterprise increased significantly, strengthening the perception that despite legal changes the situation was essentially one of business as usual.

6. There was a similar gap in the general area of enhancement of competition, between changes in the legal system in support of reform and actual actions which undercut the reform. It is stated that import competition has not developed because of the difficult balance of payments situation. At the same time "the import regime has been maintained free of formal quantitative restrictions except for a quota for the import consumer goods" (Emphasis added). Obviously nonformal (and nonmarket) systems of control were at work in restricting imports.

7. Is it correct to conclude, therefore, that while there has been significant progress in modifying the legal framework and the philosophical basis of the traditional centrally controlled planned economy substantive progress is much more limited and questionable? What are the implications for structural change and increased efficiency?

Compliant change [illegible] mostly not substantive change [illegible]

8. Program Design. The present loan is designed essentially to carry on the program as designed in earlier operations. The focus still appears to be on supporting changes in the legal framework (e.g., the new Law of Association will enable individualists to form limited liability companies and hold shares, with the objective of increasing domestic competition and market orientation) and stopping the "leakages" which developed around the implementation of previously enacted laws (e.g, measures are included to eliminate and control state support for loss making enterprises outside the liquidation/refloatation framework). Is this the most appropriate approach given the experience with the implementation so far?

Is this emphasis on laws [illegible]

(i) The macroeconomic framework. An agreed macro-economic framework for 1988 is expected to be the basis of an IMF Standby agreement. Per capita consumption is to fall by 2.3% while per capita GDY will increase by 1.3%. The state budget deficit would decline to 1% of GDP and the current account deficit in convertible currencies to $500 million. There are some questions on this framework. First, the current account projections assume a decline in convertible currency imports of 6.4% which appears to be optimistic particularly since investment is to grow at the same rate as GDP and consumption (which is to decline) has a low import content. Import restrictions to achieve this reduction are ruled out by the core conditionality in the import area. Second, the projected decline in consumption also appears to be on the optimistic side. The 15% increase in prices appears to be more a result of the adoption of VAT than because of the likely reduction in subsidies. Further, the proposed agreement on wage policy is still couched in terms of a constant total wage bill and has an escape clause for efficient, creditworthy and competitive enterprises. Third, there is an important issue about the long run directions of reform implicit in the macro projections. Imports as a share of GDP are projected to decline to 27.2% in 1995 from a level of 37-38% in the early 1980s when

?

Inconsistency

imports were restricted. These projections do not appear realistic. It is also puzzling that the share of exports is also projected to decline to 29.3% of GDP by 1995 compared to 38-40% in the early 1980s. Are we working towards a less open economy than before reform?

(ii) The Enhancement of Competition. Domestic competition is to be enhanced by (a) the entry of new enterprises since individuals will be allowed to form limited liability companies; incentives for small enterprises are to be maintained; (b) reform of wage policy; and (c) the reduction of remaining pricing regulations. External competition is to be increased by the "selective use of imports to promote competition" (Mr. Thalwitz memo para. 11 (ii)). A number of questions need to be clarified in this area. First, as pointed out in para. 21 of the IM the introduction of the VAT does not eliminate fiscal distortions since "some enterprise taxes which should have been removed... are being retained" (para. 21). Second, the wage reform which is envisaged to grant enterprises "genuine independence" in managing their labor costs is expected to be implemented over the next two to three years. Further, genuine independence means that enterprises will be "free to determine individual earnings subject to an overall ceiling on their wage bill, related to performance"--allowing great scope for arbitrariness. Third, the IM states (para 23) that since March 1987 the only restriction on the pricing of most producer goods is a ceiling based on import prices. In fact, producer goods prices in practice are not constrained by import prices except for standardized products. Given differences in specifications, durability, variability of product characteristics; packaging and so on, a price scheme based on import prices is a practical impossibility (see e.g., Balassa, "The New Growth Path in Hungary," December, 1985). It appears that the gap between the legal and philosophical framework and the actual working of the enterprise sector is likely to continue to be large, inhibiting the benefits of reform.

Gap

(iii) Tightening of Financial Discipline. The Region rightly stresses the importance of measures in this area. The "curtailment of budgetary support to "crisis" industrial sectors and enterprises is regarded as the single most important element in inducing financial discipline..." (para. 45). Action plans for the resolution of problems of crisis subsectors are to be agreed. A phased reduction of producer and consumer subsidies is to be negotiated. The Region may wish to elaborate on the quantitative objectives in this area and how their implementation is to be monitored. Further, should not attention be given to preventing the emergence of extra-budgetary approaches to supporting enterprise financial indiscipline, as is well known from experience in neighboring socialist economies?

(iv) It is stated in para. 56 that the progress of the reform will be studied prior to release of the second tranche. Among the criteria for judging progress would be "the actual performance of the industrial sector in terms of growth and exports, indicators of overall competitiveness and productivity such as DRC and IFP analysis, as well as less quantifiable evidence..." (para. 56). These criteria are very different from those listed in the tranche release conditions listed in para. 53. What is the relationship between these two elements for monitoring progress?

Relationship Between Proposed ISAL and IMF Facility

9. In response to the Government's request an IMF mission visited Hungary and completed negotiations for a one-year Standby arrangement of SDR 265.35 million (about $365 million). This agreed package includes a number of macro-economic stabilization and medium-term reform measures also included in the proposed ISAL. (Figure 1 of IM indicated that 15 out of 24 measures covered by the proposed ISAL are included in the IMF package). Recognizing the overlap between reforms agreed with the IMF and those proposed under ISAL, the IM provides two justifications for the proposed Bank assistance. First, the Region hopes "that the complementary support of two multilateral institutions would ensure that the medium-term program adequately addresses the priorities for longer-term development and structural change as well as the urgent requirement for short-term stabilization". Second, such a support "would be critical to ease the country's access to the international financial markets to rollover current account balance". In addition, the IM points out that while IMF's program focusses on short-term stabilization measures and on key reforms in 1988, the Bank's program has a more medium-term horizon. Nonetheless, the Committee may want to discuss if the Bank's program is broad and deep enough to justify a quick-disbursing loan of $200 million, particularly in view of the fact that the Bank's share of disbursed and outstanding debt of Hungary is projected to rise from 4.6% in 1987 to 11.6% in 1990 and its share in debt service would rise from 2.2% to 8.6% in the same period. Also, the Committee may want to review if in light of the apparently very limited additional conditionality the front loading of the first tranche ($125 million out of $200 million) is justified. No

cc: Messrs. Lee, CODDR; Shakow, Liebenthal, SPR; Holsen, CEC; Rao, Steer, FRS; Baneth, IEC; Burmester/Thahane, SEC; Baudon, SVPOP; Hasan, Lari, Nouvel, Siraj, EMENA.

For Information Only

cc: Messrs. Hopper, SVPPR; Fischer, VPDEC; Goldberg, VPLEG; Bock, DFA; Frank, Parmar, IFC; El Maaroufi, EMNVP; Ms. Haug, EXC.

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

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DATE: February 5, 1988

TO: Mr. Moeen A. Qureshi, SVPOP

FROM: Wilfried P. Thalwitz, EMNVP

EXT: 32676

SUBJECT: HUNGARY: Industrial Sector Adjustment Loan - Initiating Memorandum

1. I attach for your approval the Initiating Memorandum for the proposed ISAL to Hungary in the amount of $200 million equivalent. The loan continues support to industrial sector restructuring and the underlying reform program which has been the centerpiece of the Bank's strategy for lending to Hungary. The two prior loans for industrial restructuring approved in FY 86 and FY 87 incorporated a hybrid design to provide support to both the reform program and enterprise specific restructuring measures. The proposed sector adjustment loan represents an evolution of this pattern and is expected to serve as the major vehicle for continuing our policy dialogue. It would be complemented by an investment loan in support of enterprise restructuring in early FY 89. A proposed loan for agro-processing modernization in FY 88 would support the restructuring of enterprises in the agro-processing sector.

2. A preappraisal mission visited Hungary from October 14, 1987 to November 5, 1987. The mission met and discussed the adjustment program with Hungarian counterparts headed by Mr. Miklos Pulai, Deputy President of the National Planning Office, Mr. Andras Patko, Deputy Minister for Finance, and Mr. Ede Bako, Managing Director, National Bank of Hungary. The mission was in the field concurrently with an IMF mission in Hungary for Article IV consultations which laid the basis for a standby arrangement. We have fully coordinated our work and ensured consistency of the Bank and Fund positions on the Government's medium term program for macroeconomic management, which

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Attachment

Distribution:

Members of the Operations Committee:

Messrs. Shihata (VPLEG); Jaycox (AFRVP); Karaosmanoglu (ASIVP); Husain (LACVP); Wood (VPFPR); Rajagopalan (VPPRE); Vergin (COD). Wapenhans (SVPEAA)

Cleared with and cc: Mr. Lari (EM4)

cc: Messrs./Mdms. Dubey, Pohl (EAS); Baneth (IEC); Picciotto (PBD); Holsen (CEC); Rao, Hadler (FRS); Bock (DFS); Lee (COD); Shakow, Liebenthal (SPR); Churchill, Barry, Nagaoka (IEN); Hasan, El-Maaroufi (EMNVP); Zaidan(o/r), Nouvel, Sood, Ramasubbu, Harrison, Rajagopalan, Condon, de Bruyn Kops, Nulty, Sumi (EM4), Bouhaouala, Chaparro, Amin, Turnham (EMT); Hassan, Al-Jabri (LEG); Naseem, Sehgal (CEN).

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would be the framework for implementation of the industrial sector adjustment program. The Bank mission developed a policy matrix which is attached as Annex 1 to the Memorandum. The matrix is front-loaded with most of the actions to be taken during 1988-89. During appraisal, we will agree with the Government on specific actions to be taken during the implementation of the proposed loan, and on a letter of Sector Development Policies to which the matrix will be attached. The core conditionality for the loan is spelled out in paras. 51-53 of the Memorandum.

Recent Economic Developments

3. After a successful stabilization of the economy, supported by two Standby Agreements with the Fund in 1982-84, the economy's performance in 1985-1986 has been poor. GDP declined in 1985, and grew only 1.5% in 1986. Exports to convertible currency markets declined in 1986, and imports have continued to rise. The convertible currency current account turned from a surplus of $329 million in 1984 to deficits of $0.5 billion in 1985,and $1.4 billion in 1986. While a part of this deterioration resulted from adverse terms of trade and from removal of quantitative import restrictions in 1984, weak demand management contributed significantly to the poor performance. The State budget turned from a surplus of Ft26.3 billion in 1984 (2.7% of GDP) to a deficit of Ft11.6 billion (1.1% of GDP) and Ft46.9 billion (4.3% of GDP) in 1985 and 1986, respectively. At the Bank's insistence in connection with the Second Industrial Restructuring Loan, the Government took corrective measures during 1987 to reduce the budget deficit from a mid-year projection substantially exceeding the planned Ft44.0 billion to Ft30-35 billion. Together with other demand control measures, this helped to achieve a partial turnaround in 1987: The GDP grew by 2.0%, industrial production by 4.2%, and the volume of convertible currency exports by 5.5%. The current account deficit decreased from $1.4 billion in 1986 to $910 million.

4. The current account deficits of 1985-86 were financed by heavy external borrowing. The external debt in convertible currencies increased from $8.8 billion at the end of 1984 to $15.1 billion at the end of 1986, of which $1.9 billion was due to exchange rate changes. The convertible currency debt service ratio increased from 44% to 49% excluding prepayments over the same period. However, since Hungary took advantage of its favorable access to international markets in 1985-1986 to restructure its debt maturities, the debt service ratio is expected to decline to 50% in 1987 and to average about 40% until 1990.

The Government's Medium-term Program

5. Instead of using the opportunity provided by improved access to capital markets to strengthen and accelerate the restructuring of the economy, the weak demand management policies followed during 1985-86 undermined the restructuring effort. Recognizing that the continuation of weak economic management would lead to unsustainable levels of debt, quick exhaustion of borrowing headroom, and probably to debt rescheduling, the Government prepared a medium term program of stabilization and recovery aimed at restricting the growth of external debt, restoring external and internal equilibrium by 1990, and promoting structural change through acceleration of the economic reform

program. The Parliament approved the 1988 program in September 1987. The program envisages a modest growth of only 1.5% and a reduction in domestic demand of 1.25%, essentially through reduction of consumption by 2.0%. Real wages would decline by 10%, and prices would increase by at least 15% mainly due to elimination of some consumer subsidies. The current account deficit is expected to be $500 million, and the budget deficit Ft 10 billion. This represents a major policy shift as household consumption has not fallen in over thirty years. To minimize the impact of adjustment on the weaker sections of the population, details of the Government's safety net program would be agreed during appraisal.

6. The Government has also reached agreement with the IMF at the staff level on a one-year standby of SDR 265 million, with an understanding with an understanding that the staff and management of the IMF would be prepared to consider a subsequent arrangement in support of its reform program so long as the 1988 arrangement is implemented as agreed and appropriate policies are in place for the period covered by any new arrangement. The agreement with the IMF would ensure the observance of tight demand management policies contemplated under the program. Monitorable targets established for macro management under the IMF program, would be incorporated in the Bank's conditionality, and would establish an appropriate macroeconomic framework within which the reform program could be implemented effectively.

Rationale of the Proposed Loan

7. The overall framework and direction of the reform program, as reflected in the Government's Letter of Sector Policies written to the Bank in conjunction with the First Industrial Restructuring Loan (Loan No. 2700-HU), is intrinsically sound and remains adequate in the current economic environment. The Government has fulfilled its commitments within this framework as agreed under the two approved industrial restructuring loans. The lack of an adequate supply response is attributable partly to external factors and the time necessary for fundamental changes in enterprise behavior to take place, but also substantially to: (i) lax demand management policies; and, (ii) not all the elements of the program (e.g., tax reform) being in place, as well as weak enforcement of some of the enacted measures, particularly those designed to induce stringent financial discipline within enterprises.

8. With this background, and given the present Government's strongly stated commitment - with IMF support - to tough macroeconomic policies while accelerating the reform program, the proposed operation is designed as a sectoral adjustment loan in an amount of $200 million. This would enable more visible and stronger support to the reform at a stage where most of the reform elements are coming in place. The reform is sought to be accelerated in an adverse economic environment under lively internal criticism, and visible Bank support is critical to maintain its momentum. Because of its high external debt, and lack of borrowing headroom, Bank support, coupled with an agreement with the Fund, would be critical to facilitate the country's access to the international financial markets to roll over its maturing debt.

9. Assuming Bank commitments at about $300-320 million per year in FY 88-90, which corresponds to the level reached in FY 1987, the Bank's share of disbursed and outstanding debt of Hungary is projected to rise from 4.6% in

1987 to 11.6% in 1990, and its share of debt service would rise from 2.2% in 1987 to 8.6% in 1990. The share of preferred creditors in the total debt outstanding would change from 15.5% in 1987 to 21.6% in 1990 Hungary's reserves at the end of 1987 are projected to equal 5 months of imports, down from 8.3 months in 1986. Assuming (i) a reversion to the pre 1987 commitment level of $250 million annually during 1990-95, and (ii) continuation of IMF support at 1988 level upto 1990, the Bank's share of disbursed and outstanding debt of Hungary as well as the share of preferred creditors in total debt outstanding would be 17.3% by 1995.

Core Conditionality

10. Besides agreements on targets for the current account and budget deficits, (paragraphs 6-7) salient agreements to be sought during appraisal on the policy reform program are outlined below:

11. The Policy Reform Program. Coordinated actions across all the eleven policy areas set out in the matrix will be covered, with priority given to those areas which are most likely to have an immediate impact on macroeconomic problems, and on realization of the main reform objectives. These are:

(i) Limiting Support to Inefficient Enterprises. The Government would eliminate in 1988: (i) Government assistance to loss making/inefficient enterprises outside the liquidation and refloatation framework, and (ii) Government guarantees of loans and bonds for the Refloatation Organization, to curtail its borrowing capacity. This commitment would be complemented by: (i) limiting the 1988 budgetary allocation to the Refloatation Organization below the nominal 1987 level; (ii) setting strict limits on, and a timetable for elimination of, all other forms of support to inefficient enterprises, such as tax and debt forgiveness and equity allocations; and, (iii) implementing action plans to resolve the problems of chronic loss-making enterprises and crisis subsectors (coal and metallurgy), including bankruptcy procedures. Agreement would be reached on a program with monitorable targets for reduction of producer and consumer subsidies in the economy.

(ii) International Trade. Measures would be agreed to improve exporters' access to foreign exchange for imported inputs from convertible currency areas, and to make the granting of foreign trade rights automatic. Selective use of imports to promote competition will be agreed. Modification of regulations on CMEA trade to increase the relative incentives for exports to the convertible currency markets as compared to the CMEA will be sought.

(iii) Entry of Enterprises. A new law of association would be enacted and implemented by January 1, 1989 which would enable individuals to form limited liability associations and the state enterprises to convert themselves into shareholding companies, with individuals permitted to hold shares in them. In order to further improve the conditions for small scale business ventures, measures would be introduced to exempt enterpreneurs from the payment of VAT on investment goods, the Entrepreneurs Tax and the Countervalue Tax and to increase the maximum number of employees permitted from 15 to 30.

(iv) Pricing, Wage and Tax Reform. A comprehensive tax reform based on the introduction of value added and personal taxes has been implemented effective January 1, 1988. In addition to accompanying changes in prices and wage levels, overall price and wage reform will also be implemented in the course of the year. The current requirement for all firms to report price increases in advance will be discontinued from April 1, 1988. The share of consumer prices subject to administrative controls and regulations will be significantly reduced from April 1, 1988 The mandatory upper limit on wage scales will be abolished.

(v) Financial Sector Reform. Regulations permitting the sale of non-voting profit-sharing coupons by enterprises to their employees would be issued. New accounting and auditing regulations to make enterprise accounts more transparent and in conformity with international standards would also be issued by January 1988. Commercial banks would be required to complete a review of their loan portfolios by end of June 1988, and to make required provisions for doubtful loans, and to undertake annual independent audits of financial statements. A program for the full integration of the enterprise and household banking systems, including the integration of the interest rate structures for the two sectors by January 1, 1989, would be agreed.

(vi) Alleviation of the Social Cost. Specific measures to minimize the impact of the stabilization and restructuring program, focussed on the vulnerable segments of society and retraining of workers who might become redundant will be agreed.

Processing Schedule

12. IMF approval of the proposed Standby Agreement is expected towards the end of March 1988. With this timetable in view, and subject to Operations Committee approval, the appraisal mission for the loan is scheduled for mid February 1988, leading to Board presentation in early June 1988.

Listed below are the principal measures taken by the Government since the November 29 elections:

- SEE prices increased by 20% to 40%. could possibly add another 1 percent of GNP

- Value-added tax (VAT) increases: +1% of GNP

  Basic food products from zero to 3%.
  Medicine and health, education and training services from 5% to 8%.
  A wide range of luxury items from 12% to 15%.
  The general VAT rate kept at 12%.

- Up to 30% of the revenues of extrabudgetary funds authorized to be transferred for use in the budget at the discretion of the Prime Minister.

- New public investment projects not being initiated. The initial estimate for public investment growth in 1988 is 4.8% in real terms.

- A 5% withholding tax imposed on interest earned on Treasury securities (later withdrawn) and foreign exchange deposits.

- The financial transactions tax raised from 3% to 5% for 1988. The rate is to revert back to 3% in 1989.

- Reserve requirements raised from 12% to 14% in December and from 14% to 16% in February. The liquidity requirement (which can largely be met by holding treasury securities) was raised from 23% to 27% in February.

- Interest paid by the Central Bank to commercial banks on foreign exchange reserve requirements lowered from 7% to 5.5% on dollars, from 3.3% to 2% on DM and similarly for other hard currencies.

- Ceilings on deposit interest rates on TL raised as follows:

	July 1, 1987	February 4, 1988
1 month	28	40
3 month	35	45
6 month	38	52
12 month	Liberalized	65

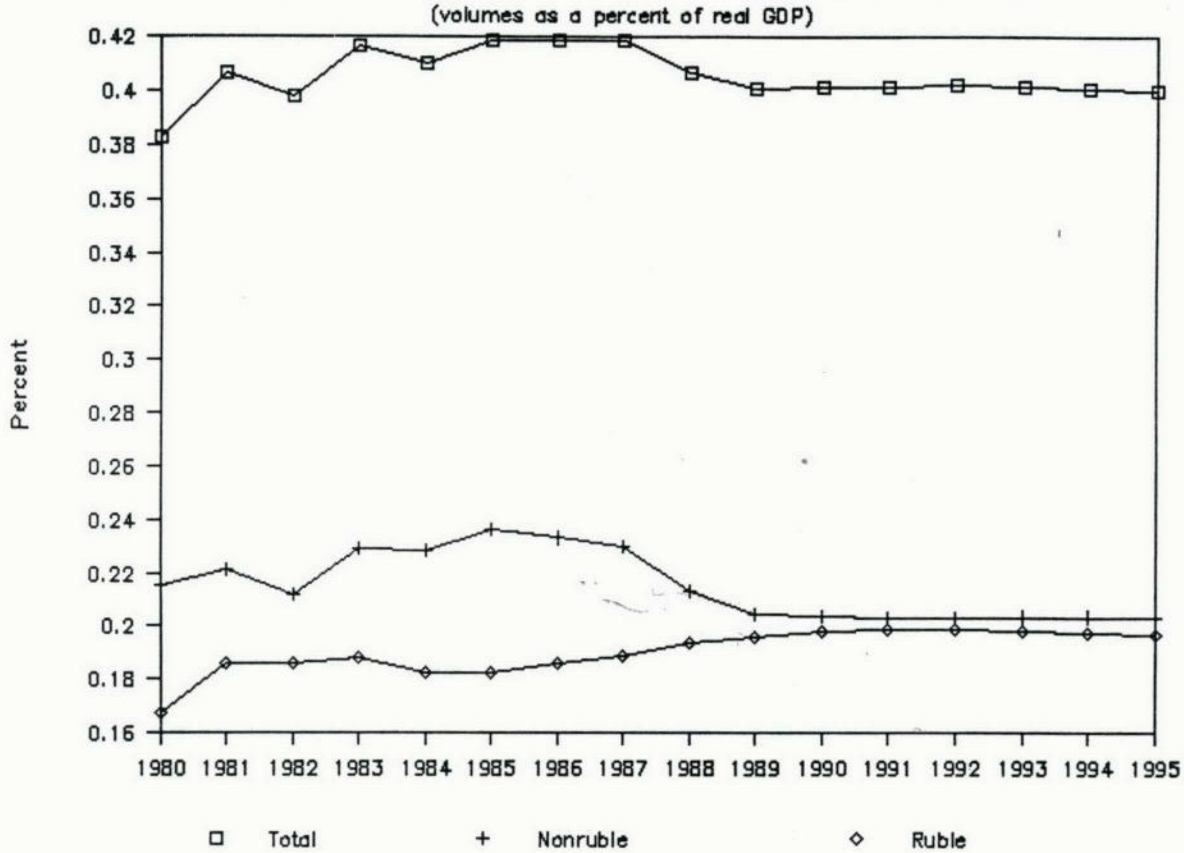
- Interest rates on a wide variety of preferential credits and on Central Bank rediscounts have been raised in real terms. 1/

- Deposit requirement for imports raised from 7% to 15%, to be reduced stepwise from March 1 back to 7% by May 1.

- Exporters now have to convert all their foreign exchange earnings into TL, whereas previously they could retain 20% in foreign exchange. Also, incentives and penalties designed to persuade exporters to repatriate their earnings sooner.

1/ Using the Government's inflation target. To the extent that expected inflation is higher than the official inflation target, the real interest rate on these loans may not have increased.

HUNGARY: IMPORTS IN RELATION TO GDP



March 2, 1988

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The World Bank
OPERATIONS COMMITTEE

CONFIDENTIAL

Minutes of the Operations Committee to Consider
CAR - Country Strategy Paper cum Initiating Memorandum
for a Proposed Second Structural Adjustment Credit

Held on March 2, 1988 in Conference Room E-1244

A. Present

Committee		Others	
Messrs.	M. A. Qureshi (Chairman)	Messrs.	V. Dubey (EAS)
	D. Goldberg (VPLEG)		F. Earwaker (SPRPA)
	J. Holsen (VPDEC)		R. Fares (AF1CO)
	E. Jaycox (AFRVP)		P. Landel-Mills (AF1CO)
	C. Michalopoulos (EMNVP)		T. Mpoy-Kamulayi (LEGAF)
	C. Quijano (LACVP)		S. O'Brien (AFRVP)
	D.C. Rao (VPFPR)		O. Rahkonen (SECGE)
	H. Vergin (SVPOP)		I. Serageldin (AF1DR)
	M. Wiehen (ASIVP)		D. Singh (AF1DR)
			G. Taplin (IMF)
			R. Westebbe (AF1DR)

B. Issues

1. The meeting was called on the Country Strategy Paper cum Initiating Memorandum for a proposed Second Structural Adjustment Credit in the amount of US$ 30 million equivalent. The discussions largely followed the agenda prepared by the Economic Advisory Staff, concentrating first on the strategy and then on the proposed structural adjustment operation. The main issues raised were:

(a) Feasibility of the medium-term scenario and the country's performance;

(b) Proposed lending volume, and burden-and-cost sharing; and in the context of the proposed Structural Adjustment Credit;

(c) Fiscal management, export subsidies, agricultural reform and progress monitoring.

C. Discussion

2. Clarification was sought regarding what the Government had already done to reduce salaries/wages and current expenditures. The Region explained that wages and salaries in CAR had been frozen for over 5 years,

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and were currently among the lowest in West Africa. In order to tackle the wage bill, audits of the civil service had been conducted, department by department, under IDA-financed technical assistance, and a new civil service structure prepared for the major ministries. The Government had already eliminated "non-existing" as well as non-performing civil servants. Surplus staff would be moved to a Personnel Bank, from where they would be induced to move into other economic activities, helped by financial and training incentives. However since opportunities to absorb them into the rest of the economy were becoming very limited, resistance to this program was growing, and the Government needed to proceed at a cautious pace in its implementation.

3. A question was then raised about the lack of growth potential of the country, the size of the projected gap and the medium-to long term sustainability of the large support required, as proposed in the CSP. The proposed IDA allocation is relatively high and could not be justified through the application of normal allocation criteria. This also raised the question of burden sharing. The speaker said that, given the severe lack of competitiveness of the economy under present exchange rate conditions, there may possibly be no other solution but to cut down further on salaries and other expenditures. The question of inclusion of the CAR among the "debt-distressed" countries was also raised.

4. The Region stated that further compression of salaries and wages, given their decline in real terms over the past 5 years, would not be feasible. Reducing other prices would drive the economy in the wrong direction. In agriculture for instance an increase in producer prices had resulted in a positive supply response. To reverse this now would provoke a major setback and risk driving the economy back towards subsistence. The scope for further reduction of other budgetary expenditures was limited and would reduce the ability of the economy to survive and grow.

5. With respect to the proposed level of IDA assistance, the Region stated that, due to historic reasons, there were currently only a few donors to the CAR. Nonetheless the proposed IDA assistance would cover about 20 percent of the country's financing requirements. The French are providing a significantly larger share. IDA was closely associated with structural adjustment, which should not be allowed to fail for lack of adequate funding. The Region submitted that until the CAR can be included in the "debt-distressed" group, we may have to skew IDA allocations to take into consideration situations like the CAR, particularly where performance is good. The Region added that it recognized that the proposed program was basically a "holding" one. However this was the first case in which the Region has used EPD's CFAF exchange rate projections, of CFAF 253, 233, 259 per US $ for 1988, 1989 and 1990 respectively. This may be too pessimistic. If a higher rate were used for the 1988-90 period in other cases, this would imply higher growth rates for the economy.

6. A question was raised about the country's performance under its reform program. The Region responded that slippages had occurred, mainly in two areas: in public finance and in civil service reform. In the area of public finance, IMF performance targets had not been met, largely due to a decline in revenues owing to adverse trends in international prices, and to some unexpected expenditures. With respect to the civil service reform,

the program was very ambitious and initial progress had been slower than anticipated, mainly due to bureaucratic resistance. However, the reform was now moving forward; the audit of the key ministries had been completed and the "Banque de Personnel" was being put in place. The parastatal reform was proceeding satisfactorily; diagnostic studies are being completed and they are being followed by decisions and actions plans for privatization, liquidation or restructuring. As to cross-debts, the main problem had been to enumerate them. This has now largely been done, and an action program for their settlement is being developed.

7. The meeting requested an update on the relations between the IMF and the CAR. The IMF representative stated that the end-December 1987 performance criteria under the ongoing Stand-by [and the SAF-credit ($ 23 million over 3 years)] were not fully met. There have been no purchases since June 1987. The revenue situation was below the initial assumptions and thus the performance targets under the program have not been met in September and December. An IMF mission was currently in the field, and another one is scheduled for April to prepare the second year of the program. In response to a question from the chairman, the IMF representative indicated that the Fund envisaged SAF financing of $ 23 million for the 3-year period. The Chairman indicated that the level of Fund support should be further addressed between Bank and Fund staff.

8. Finally, a question on the amount and fiscal impact of the export crop subsidy element built into the long term perspectives was raised. The Region said that the net budget loss on coffee was about CFAF 1.7 billion and about CFAF 3-5 billion on cotton. These totalled about 5 percent of total expenditures. The coffee losses were anyway projected to persist for only 2 to 3 years.

D. Decisions on the CSP

9. The recommendations of the Region and the proposed lending program were approved subject to the following:

(a) While IDA funds could be used for a holding strategy in the short term, such an approach cannot be justified nor sustained for a long time.

(b) Other donors should be actively encouraged to take up a larger share of the financing burden. The IMF $ 23 million SAF assistance over 3 years was deemed low, and Region staff were asked to examine this further with the IMF including ESAF eligibility.

(c) The proposed level of IDA assistance was appropriate as long as CAR continues to show a high level of performance. In assessing this performance the exchange rate factor will be taken into consideration.

(d) The low cost-sharing level (IDA to finance 95 percent of project costs) is accepted as an exception but should not be considered as the norm.

E. Discussing the Second Structural Adjustment Credit

The meeting then moved on to discuss the proposed Second Structural Adjustment Operation.

10. In answer to a question about the fiscal management elements of the proposed SAL II, the Region stated that these measures would be in agreement with the IMF. They would be part of the new PFP, a joint IMF/Bank paper, finalization of which would precede presentation of the proposed SAL II to the Board. The next draft documentation on this operation would reflect this fact.

11. In response to a question on the type and scope of export subsidies proposed under this operation, the Region said that essentially these were not new subsidies but new arrangements for defining and for paying the current implied subsidies more expeditiously.

12. A question was raised as to the adequacy of tackling issues related to the agricultural sector under this operation rather than under sector adjustment operations. The Region felt that it would have more leverage if it tackled the institutional reform aspects of the sector under the proposed SAL, and indicated that detailed implementation would be followed up in the proposed Research and Extension and other programmed projects.

13. Finally the Region stated that during appraisal, attempts would be made to streamline the system of monitoring the program and to prioritize the actions to be taken.

E. Decision on the Second Structural Adjustment Credit

14. The Region was authorized to proceed with the appraisal of the SAL II operation as proposed.

March 10, 1988

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cc: A. Vegin.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: March 14, 1988

TO: Members, Policy Committee

FROM: Barber B. Conable

EXTENSION: 72001

SUBJECT: ITF Chargeback and End-User Support

Based on the IMTPC recommendations and in light of the discussion at our March 9, 1988, meeting, I wish to confirm the following:

(a) The phasing and scope of the decentralization of end-user support will take place along the lines of Mr. Wapenhans' note of February 26, 1988.

(b) The dollar budget resources to fund the costs of regular and non-regular staff to be decentralized to units (i.e. 2 staff to Finance by July 1988 and 23 staff to Operations by January 1989) will be transferred from the Administration budget to the budgets of the respective end-user complexes.

(c) PBD will also transfer the positions needed for decentralized end-user support from ADM to the respective end-user complexes. Unauthorized T positions for five of the staff to be transferred to Operations will be regularized in the context of the FY89 budget cycle.

(d) The projected chargeback overrecovery of $4.7 million will be translated into user rate reductions and equivalent reductions of user's budgets. These arrangements (including the continuation of micro-computer support on chargeback) will ensure budget neutrality of past decisions including those related to the conversion of certain chargeback services to the institutional account.

Barber Conable

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Mr. Dubey
Rescheduled 3/2
12 noon
Public Investment Program

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION
OFFICE MEMORANDUM

DATE: February 10, 1988

TO: Operations Committee

FROM: ~~Vinod~~ Dubey, Director, EAS V. Dubey

EXT: 78051

SUBJECT: CAR - Country Strategy Paper cum Initiating Memorandum for a Proposed $30 Million Second Structural Adjustment Credit - Agenda

1. The Operations Committee will meet on Friday, ~~February 12~~, 1988 at 3:00 p.m. in Room E-1244 to discuss the CSP for the Central African Republic and the IM for the second SAC for $30 million. The Operations Committee may wish to discuss the CSP related issues raised in paragraphs 4-6 and those specifically related to the proposed SAC in paragraphs 8-13.

Country Strategy

2. Background. After years of serious economic mismanagement and subsequent attempts of economic recovery, the government of CAR embarked on a structural adjustment process in 1986, supported by SAC I and a Fund arrangement (Standby and SAF). Although a wide array of reforms has been undertaken, results to date have been modest, mainly (but not exclusively) because of a deterioration of the external environment, i.e., falling commodity prices and the decline of the US dollar. As a result of these exogenous events, none of CAR's exports is competitive and the balance of payments and fiscal situation deteriorated significantly in 1987, with a build-up of external arrears. Performance criteria under the IMF standby arrangement for September and December 1987 were not met, and the arrangement became inoperative.

3. Against this background, the Region proposes a five-year strategy which aims at re-establishing per-capita income growth over the medium term through a process of major structural change and increased investment (mainly in the public sector). Growth is expected to be led by agriculture and forestry. To support this process, a FY88-92 lending program of $265 million is proposed of which 37 percent is allocated to fast-disbursing policy loans (including the FY88 $15 million[1] cotton sector credit already approved) and the remainder to agriculture/forestry (26 percent), human resources (14 percent), infrastructure (13 percent), small enterprises (6 percent), and SAC related technical assistance (4 percent). While the proposed strategy and lending program adequately address the country's needs, questions may be raised with regard to the feasibility of the medium-term scenario and the proposed lending volume and cost sharing.

4. Medium-Term Scenario. The CSP presents projections up to 1995 built around average annual GDP growth of 3.2 percent through 1990 and an acceleration to 4 percent thereafter, led by agricultural growth of 4.5

1/ Including SFA resources, the credit is actually for about $23.5 million.

percent per year throughout the period. Although para 19 states that at the current exchange rate (about CFAF 280 = $1) CAR's exports are not competitive and the exchange rate is projected to hover around 250 through 1990, the CSP/IM assumes that somehow (through export subsidies and additional external resources) the economy can be kept viable till the proposed structural reforms will result in greater efficiency (lower production costs, particularly for cotton and coffee) and the exchange rate will again become more favorable reaching CFAF 300-350 per dollar during 1991-95. As for other UMOA countries, but particularly for CAR which is at an additional competitive disadvantage (land-locked, neighboring Zaire with a more competitive exchange rate), the key question is whether the proposed strategy will produce the expected results and whether IDA should be a major contributor of external resources (about 30 percent of projected gross disbursements) during the assumed "holding period."

5. Lending Volume and Cost Sharing. The proposed FY88-92 lending program amounts to $265 million or about SDR 200 million which is about twice the IDA norm. Moreover, cost sharing up to 95 percent of total project cost is proposed for project lending. Several questions arise in this connection:

(a) The Region's recommendations are based on CAR's "debt-distressedness." Since the debt-service in relation to exports does not quite reach the standard mark of 30 percent, the case is made on fiscal grounds, with debt-service amounting to more than 30 percent of government revenues (excluding grants). The Region could be asked to provide some additional information, comparing CAR to other marginal cases of debt-distressedness, and the Committee may wish to reconsider the lending volume in the context of overall IDA allocations.

(b) CAR's fiscal situation is weak and will continue to be fragile even after the successful implementation of the revenue measures proposed under SAC II. However, 95 percent cost sharing, although applied in CAR before, is very high and does not provide enough of an incentive for domestic savings. The Committee may wish to consider the appropriateness of the proposed cost sharing, given the OMS 1.22 requirement of local contributions of not less than 10 percent and recent treatment of countries in similar conditions like Burkina Faso and Guinea Bissau.

6. Structural of Lending Program. Overall, the structure of the proposed lending program seems to respond adequately to CAR's priority needs. However, many measures to strengthen the institutional framework for agricultural support services are expected to be implemented under SAC II, while a research and extension project is proposed only for FY90. The Region could be asked to explain and perhaps reconsider the timing of that operation.

Structural Adjustment Credit II

7. Objectives. The main objectives of SAC II are to provide an adequate macroeconomic and incentives framework for resumed growth, led by agriculture and forestry. This requires major improvements in fiscal

management (revenue measures, expenditure control, rationalization of the public enterprise sector), changes of the incentives system (including producer price liberalization), and strong external financial support. Given the Region's own assessment of the exchange rate problem and the lack of export competitiveness, as well as other pervasive weaknesses of a structural nature, the SAC objectives are somewhat surrealistic, and the SAC can at best be seen as a holding action till the exchange rate will indeed be corrected and the economy can adjust accordingly. But even within the constraints of the proposed operation, several questions could be raised.

8. <u>Fiscal Management</u>. While exogenous factors had a major impact on CAR's public finances, weak fiscal management was also a very important factor in the unsatisfactory fiscal performance which led to the build up of arrears and non-compliance with the standby arrangement. The different elements are well summarized in paragraph 30 of the paper. While the proposed expenditure control measures are fairly specif~~y~~ic and monitorable, the revenue enhancement measures are relatively vague. Moreover, higher customs revenues may not be easy to achieve through better administration given that perhaps 60 percent of imports or more are multilaterally or bilaterally financed and tax exempt. <u>The Region could be asked to add specificity to the proposed revenue measures, and an additional condition for second tranche release could be included which would refer to satisfactory overall macroeconomic management, with particular emphasis on fiscal performance (perhaps even with a quantitative target)</u>.

9. In this same context, <u>the Region could also be asked to explain the design, administration, and financing of the proposed export subsidies and whether major private sector involvement in the administration of the Coffee Fund is really advisable (para. 45). Moreover, the establishment of export subsidies (e.g. through the Coffee Fund) could also be retained as a condition for Board presentation</u>.

10. <u>Agricultural Reforms</u>. Substantial institutional reforms in agricultural support services are proposed as part of SAC II (para. 44). Results are not going to be quick which raises again the question as to how realistic the growth assumptions are. Moreover one could ask <u>whether the SACII is the appropriate vehicle to bring about the proposed reforms or whether the research and extension project should not be used instead and brought forward from FY90</u>.

11. <u>Social Impact</u>. The treatment of the social implications of adjustment is fairly extensive. However, in a country as poor as CAR, with stagnating per-capita income, and with the need for a substantial increase in domestic savings (mostly through taxation), not much can be done to avoid that additional sacrifices will also have to be made by the poor as there is not enough of an urban, high-income tax basis. <u>The Region could be asked to elaborate, put the discussion in the green-cover package into a somewhat broader perspective, and to give a better feeling for government commitment and policies as opposed to Bank sponsored actions</u>.

12. Priority Action and Monitoring Arrangements. The policy matrix (annex I) lists 94 measures as part of the SAC II supported program. Page 9 of annex I lists 14 measures which presumably are of highest priority. The Region could be asked to instill a clear priority ranking to ease monitoring and to add the Board and Tranche conditions discussed in paragraphs 8 and 9.

13. With regard to monitoring (paras. 55-56), there are different committees with different responsibilities. There is a risk of "overmonitoring" and focusing on trivial aspects. The question arises whether one should not simplify these monitoring arrangements by having just one committee concentrate on high priority areas (including macrofinancial conditions to be negotiated under the envisaged SAF arrangement) to ensure satisfactory progress.

3 Committees lack of [illegible] Can it be rationalized

cc: Messrs. Lee, COD; Shakow, Liebenthal, SPR; Holsen, CEC; Rao, Steer, FRS; Baneth, IEC; Burmester/Thahane, SEC; Baudon, SVPOP; Serageldin, O'Brien, Landell-Mills, Westebbe, Alba/de Wulf, Fares, AFR.

For Information Only

cc: Messrs. Hopper, SVPPR; Fischer, VPDEC; Goldberg, VPLEG; Bock, DFA; Stanton, VPEXT; Frank, Parmar, IFC; Agarwala, AFRVP; Ms. Haug, EXC.

UT
UThumm:vlw

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: February 17, 1988

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

EXT: 78051

SUBJECT: CAR: Country Strategy Paper cum Initiating Memorandum for a Proposed $30 Million Second Structural Adjustment Credit

The Operations Committee meeting has been rescheduled for Wednesday, March 2 at 12 noon in Room E-1244 to discuss CAR's Country Strategy Paper cum Initiating Memorandum.

cc: Messrs. Lee, Shakow, Holsen, Rao, Baneth, Burmester/Thahane, Liebenthal, Steer, Baudon, Serageldin, O'Brien, Landell-Mills, Westebbe, Alba/de Wulf, Fares, Hopper, Fischer, Bock, Frank, Parmar, Goldberg.

P-1867

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

RECEIVED

88 MAR -2 AM 11: 11

880302005

2.

DATE: March 1, 1988

TO: Mr. Moeen Qureshi, SVPOP

THRU Edward V.K. Jaycox, Vice President, Africa Region

FROM: Ismail Serageldin, Director, AF1 for

EXTENSION: 34501

SUBJECT: GABON - Operations Committee Review of Green Cover Package for a Proposed US$40 million SAL

1. With reference to Mr. Earwaker's memorandum on the Gabon SAL package dated February 24, we have the following comments:

A. Compliance with Senior Management decisions:

(i) A first tranche of US$20 million is proposed in the light of the very substantial up-front action by the Gabonese Authorities (e.g. reduction in public salaries; budget cuts; measures to tackle public enterprise issues; abolishing extra-budgetary expenditures; substantial expansion of the PE audit program to cover 35 out of the 50 PEs, representing 97% of the sector's value added; substantial tightening of financial controls over PEs, etc.); it will send a very negative signal of Bank support for the program and substantially reduce our leverage if our first tranche is as small as US$10-15 million compared to their financing needs of US$695 million in 1988.

(ii) The three year public investment program was reviewed and agreed with the appraisal mission. This will be made clear in the Gray Cover.

(iii) The issue of the minimum wage and public sector salaries is dealt with in paragraphs 5 and 6 of Mr. Singh's covering memorandum dated February 24. The reduction in the public sector wage bill is very substantial and involves the Government in considerable political risk.

Minimum

(iv) The draft PR addresses the environmental issues in paragraph 72. The DDS deals with the issue in paragraph 2.4.2. The Authorities fully share our concern to ensure adequate measures are taken to protect the environment. A master plan is to be prepared for forestry development which will fully address the environmental issues and include an action plan. A Working Group has already been established to start work on this, and the action matrix provides for consultants to be hired to develop the master plan before second tranche release.

(v) With regard to sector reforms, the action matrix adopted by the Government includes measures in the agriculture, forestry, small-scale enterprises, transport and human resource sectors. A number of these measures have already been taken by the Government. Satisfactory progress on the remaining measures is part of the general progress condition for second tranche release.

B. Eligibility for Bank Lending

Mr. Conable has already agreed to the resumption of Bank lending to Gabon, as recorded in his memorandum to Mr. Qureshi dated November 25, 1987. Our most recent data indicates that Gabon's GNP per capita in 1986 was US$2715, well below the graduation level of UD$3010, and in constant terms is unlikely to exceed the graduation level until well into the 1990s. Our projections indicate that Gabon will need non-project external financing at least until 1990, and we would expect to see a Bank policy dialogue and lending program over the next five years.

C. Exchange Rate

The action matrix includes measures to raise import duties and reduce export taxes as a first step towards a "second best solution" for the overvalued CFAF. More sector work is needed before the next step can be designed. Recent experience elsewhere in the franc zone suggest prudence in introducing export subsidies financed through an import tariff surcharge.

D. Reserve Fund

The Government has accepted the principle of establishing a Reserve Fund for Future Generations (paragraph 2.2.1 of the DDS). The precise modalities and rules of its management, however, have still to be elaborated. The basic concept is to create a financial resource to replace the oil resources as they are depleted which would generate a permanent flow of revenue in subsequent years. The way the funds resources are to be invested has yet to be decided. It should be noted that amounts to be set aside in the initial years are relatively small and only grow substantially in the 1990s once oil revenues have grown significantly.

E. Public Sector Reform

It is agreed that the public sector reforms will take several years and we would hope to continue to monitor and support it through future lending.

F. Retroactive Financing

The proposed 20 per cent retroactive financing is consistent with current guidelines and is needed to facilitate rapid disbursement to help ease the current liquidity squeeze and enable the immediate implementation of urgent SAL measures.

cc: Messrs. Fischer, Rajagopalan, Holsen, Shakow, Dubey, Liebenthal, Earwacker

THE WORLD BANK

Office of the President

March 1, 1988

To Messrs. Vergin, Dubey, Jaycox & Serageldin

Re: GABON - Proposed Structural Adjustment Operation

The documentation does not fully reflect Mr. Conable's requests contained in the attached memo. Would you please follow up and let me know how this is being handled.

Marianne Haug

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: February 29, 1988

TO: Mr. John Holsen, ~~Director~~, CEC

FROM: Frank Earwaker Frank Earwaker
(thru Robert Liebenthal, Chief, SPRPA

EXTENSION: 34688

SUBJECT: GABON - Operations Committee Review of a Green-Cover Package for a Proposed $40 Million SAL

1. The Operations Committee is scheduled to review this green-cover package on Wednesday, March 2, 1988 at 12:40 pm in Room E-1244.

2. The Initiating Memorandum for this operation was reviewed by the Operations Committee and by the Policy Committee in November, 1987. After the Policy Committee meeting, Mr. Conable issued a memorandum (attached for your information) indicating how he wished the Region to proceed with the operation.

ISSUES

Compliance with Senior Management Decisions

3. A summary comparison of the tranching and conditionality requested by Mr. Conable with the proposals contained in the draft President's Report (PR) is also attached. The Region should be asked to explain the following differences:

(i) Mr. Conable asked that the first tranche be restricted to no more than $10-15 million.
The draft PR proposes a first tranche of $20 million.

(ii) Mr. Conable asked for agreement on a 3 year public investment program.
The draft PR states that a program for 1988-90 has been prepared but does not say whether it is acceptable to the Bank

(iii) Mr. Conable calls for implementation of initial measures on price and wage reform.
The draft PR includes measures on price decontrol but not on wages other than a reduction in civil service salaries.
What happened to the proposal to abolish the minimum wage?

(iv) Mr. Conable asked that environmental issues be addressed in the context of the second tranche release
The draft PR does not address this issue.

(v) Mr. Conable asked for substantial progress towards comprehensive sectoral reforms as a second tranche condition.
The only sectoral condition included in the second tranche relates to forestry exports.

Eligibility for Bank Lending

4. Gabon was graduated from Bank lending in 1977. In the OM guidelines issued in January 1988, the per capita income cited for Gabon ($3030 in 1986) is still slightly above the $3010 graduation level. It appears from the text of the draft President's Report (PR) that GNP has declined since 1986 but is projected to rise again over the next few years. It does not seem that Gabon will stay below the graduation threshold for very long. This raises two questions:

(i) Is it worth opening up a lending relationship with a country when it is clear from the outset that our "window of opportunity" will be quite small and there will be limited scope for follow-up action. How much of lasting value can be achieved?

(ii) When income levels rebound again (as they are expected to do soon when new oil discoveries come on stream) can we reasonably expect the Government to continue with a politically costly adjustment effort?

5. Discussion of the graduation issue in the PR is skimpy. Figures of actual and projected GDP/GNP in the text are not consistent with the methodology used in Bank graduation guidelines so it is difficult to tell just how much of a "window of opportunity" we have to work with. The Region should be asked to provide a more explicit treatment of this issue.

Exchange Rate

6. Gabon, like other countries of the franc zone, is handicapped by an overvalued currency. In the Initiating Memorandum for this operation a tariff and export subsidy scheme was recommended to compensate for the overvalued currency. The PR makes no mention of this recommendation. The Region should be asked what other measures are contemplated to reestablish the competitiveness of the non-oil sector.

Financial Reserve Fund

7. It is proposed that any future large scale increase in petroleum revenues will be set aside in a fund that will generate a stream of income that will become available as and when oil production declines in the next century. The fund will be untouchable until the year 2000, at which time access will be limited to investment income only to supplement public investment resources.

8. In the absence of any details concerning "some form of trusteeship" to manage the fund, it is not clear how the Government can be prevented from dipping in at will. More fundamentally, is it not at all clear clear that sterilizing financial resources until the (arbitrary) date of 2000 is justifiable under any reasonable assumption concerning the discounted rate of time preference. Nor is there any reason to suppose that a government in the year 2000 will be better prepared or better disposed to use the resources wisely. The Region should be asked to explain why sterilizing resources in this way is considered preferable to using them to finance real income generating assets.

Public Sector Reform

9. This is obviously a long term proposition. Some important first steps (such as a review of the civil service management and organization) will not start until November, 1988. The Region should be asked how it proposes to keep track of this process after the second and final tranche of the SAL is disbursed within six months of loan effectiveness.

Retroactive financing

10. The Region is asking for retroactive financing of up to 20% of the loan amount. The Region should be asked to justify this request.

Attachments

cc. Messrs. Fischer, Rajagopalan, Shakow, Dubey, Serageldin, Landell-Mills, Ms. Haug

FEarwaker

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

1) FC 2) BL O/R 3) [illegible] 2) WDH - Urgent Int

DATE: November 25, 1987

COPY (FYI) to: 1) Shakow 2) Holsen 3) Boneth

TO: Mr. Moeen Qureshi

87 NOV 25 PM 1:03 -009

FROM: Barber Conable BBC

EXTENSION: 72001

SUBJECT: GABON - Country Strategy Paper and SAL Initiating Memorandum

1. As I agreed with President Bongo of Gabon in August, we will initiate lending to Gabon with the preparation of a Structural Adjustment Loan.

2. Following the review of the Gabon-CSP and the SAL initiating memorandum, I would like you to proceed along the following lines:

(a) I agree to a loan size of US $40 million. The size of the first tranche should reflect the upfront macro-economic and sectoral policy reforms to be achieved over and above the IMF reforms linked to standby programs, i.e., should not exceed $10-15 million under present conditions.

(b) the loan conditionality and policy matrix to be developed is to include:

- as upfront action and condition of first tranche release: agreement on a 3-year public investment program and implementation of initial measures on tariff, price/wage and parapublic enterprise reforms.

- for release of the second tranche: substantial progress toward comprehensive price, tariff, parapublic enterprise and sub-sectoral reforms. Environmental issues and problems of disbursement control should also be addressed.

3. I suggest that you limit, in the coming months, staff input to the preparation and supervision of the proposed SAL. If appraisal, negotiations and first tranche release proceed satisfactorily, I would like to review with you again the size and composition of the FY89/90 lending program and its relation to continued progress under the SAL.

cc: Policy Committee Members
Mr. Jaycox

ATTACHMENT

Comparison of conditionality requested by
Mr. Conable with Proposals of Draft President's Report

	Requested by Mr. Conable	Draft President's Report
Tranches		
(i)	First tranche not to exceed $10-15 million.	First tranche of $20 million proposed.
First tranche release conditions		
(i)	Agreement on three year public investment program.	Preparation of three year investment plan for 1988-90 (already completed).
(ii)	Implementation of initial tariff reforms.	Agreement on import taxes that will replace QRs by June, 1988.
(iii)	Implementation of initial	a) Agreement on a list of goods for which commercial margins and price price controls are to be eliminated by April 1988. b) Decree abolishing indicative prices for agricultural products.
(iv)	Implementation of initial parapublic enterprise reforms	a) Closure/liquidation/privatization of nine poorly performing PEs (already completed). b) Government commitment not to start new PEs over the next 5 years. c) Action plan for settlement of arrears between state and PEs.
Second tranche release conditions		
(i)	Substantial progress towards comprehensive price reform.	Removal of price controls on locally produced goods, except for a limited number of socially important goods.
(ii)	Substantial progress towards comprehensive tariff reform.	Removal of commercial margins on imported goods.
(iii)	Substantial progress towards parapublic enterprise reform.	a) Government adoption of programs and action plans to reform at least 22 PEs. b) Settlement during 1988 of 20% of cross debts between state and PEs.
(iv)	Substantial progress towards sectoral reforms.	Adoption of measures to improve competitiveness of timber exports.
(v)	Enviromental issues to be addressed.	None

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: February 29, 1988

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

VDubey

EXT: 78051

SUBJECT: GABON: Structural Adjustment Lending - Green Cover

RECEIVED

88 FEB 29 PM 4:59

880229017 #2

The Operations Committee meeting will meet on Wednesday, March 2 at 12:40 p.m. in Room E-1244 to discuss the draft loan package for a proposed structural adjustment loan of $40 million for Gabon. A Country Strategy Paper cum Initiating Memorandum for the operation was discussed by the Committee on November 6, 1987. The Minutes of that meeting are attached. The covering memorandum from Mr. Singh to Mr. Qureshi (February 24) indicates the major changes in the operation from the IM, providing a basis for the Operations Committee discussion.

Attachment

cc: Messrs. Lee, Shakow, Holsen, Rao, Baneth, Burmester/Thahane, Liebenthal, Steer, Baudon, Hopper, Fischer, Bock, Frank, Parmar, Goldberg, O'Brien, Serageldin, Westebbe, Landell-Mills, Singh, Sherbiny

P-1867

The World Bank
OPERATIONS COMMITTEE

Minutes of the Operations Committee to Consider
Gabon - Country Strategy Paper cum Initiating
Memorandum for a Proposed Structural Adjustment Loan

Held on November 6, 1987 in Conference Room E-1244

A. Present

Committee	Others
Messrs. M. Qureshi	Messrs. I. Serageldin (AFR)
E. Jaycox (AFRVP)	R. Skillings (AF1)
A. Karaosmanoglu (ASIVP)	P. Alba (AF1)
V. Rajagopalan (VPPRE)	F. Vakil (AF1)
W. Thalwitz (EMNVP)	T. Baudon (SVPOP)
J. Wood (FPBVP)	A. Steer (FRS)
C. Quijano (LACVP)	V. Dubey (EAS)
H. Scott (VPL)	U. Thumm (EAS)
	R. Harris (COD)
	F. Earwaker (SPR)
	Ms. C. Morin (LEG)

B. Issues

1. The meeting was called on the Country Strategy Paper cum Initiating Memorandum for a Structural Adjustment Loan to Gabon in the amount of $35 million. The discussions mostly followed the agenda prepared by the Economic Advisory Staff. The issues raised were (a) IBRD eligibility and size of lending program, (b) government commitment and timing of adjustment program, (c) trade policy, (d) sector policies, and (e) government expenditures.

C. The Discussion

IBRD Eligibility and Size of Lending Program

2. The Region made an opening statement on Bank-country relations and recent economic developments in Gabon. It was pointed out that the sharp drop in oil prices resulted in a steep decline of Gabon's GDP and financial difficulties. In response to the crisis, Gabon's external debt was rescheduled and an IMF standby arrangement was put in place. Moreover, the government asked for Bank support which was agreed in principle in Mr. Conable's meeting with President Bongo. The Region also reported on new oil contracts and gave an overview of the ongoing adjustment program which was considered so important as to open a window of opportunity for major structural changes during the next three to four years thus constituting the basis for the proposed SAL and other lending activities.

3. Questions were raised regarding the lending program and continued government commitment to adjustment in light of improved oil prospects and access to commercial bank lending. The Region stressed that the whole lending

program would be conditioned on the successful completion of the SAL and that manpower allocations to other lending operations would be managed cautiously. The Region also emphasized the need for broader Bank involvement to stimulate supply responses in different sectors. It felt strongly that the preparation of additional operations should be left to Regional Management's judgment. Regarding Gabon's future GDP per capita and IBRD eligibility, the Region stood by its projections which showed future per-capita GDP to be below the graduation level while at the same time suggesting continued creditworthiness.

Timing of Adjustment Program

4. While agreeing in principle that the SAL should be frontloaded to the extent possible to maximize government commitment, the Region particularly mentioned how complex and difficult it was to set up the proposed oil fund and to establish meaningful operating rules. In this context, the question was also raised whether the Bank had a new general policy of recommending stabilization funds. The Chairman replied that there was no general policy but that in countries with strong dependence on one commodity a prima facie case could be made for the establishment of some stabilization mechanism. The design and operation could obviously vary from country to country.

5. Regarding the proposed Technical Assistance project, the Region mentioned that a UNDP financed project is currently underway, with the Bank acting as executing agency, and that therefore no additional support was needed for several years.

Trade Policy

6. Regarding the anti-export bias created by high tariffs, the Region stressed that its first priority was to eliminate QRs and to provide free-trade status for exports. The Region also pointed out that most exports would be resource based and that therefore tariffs for manufactured products were less important for the overall incentives structure. The Region was asked to focus essentially on the adequacy of incentives for exports and on the stimulation of supply responses in different sectors through direct promotion measures.

Sector Policies

7. There was general agreement as to the importance of good sector policies for adequate supply responses, and the Region promised to try hard to get the government to prepare policy statements for key sectors as soon as possible. At the same time, a speaker cautioned against too high expectations regarding the development of different sectors outside oil and timber.

Government Expenditures

8. There was general agreement that limiting government spending to high priority activities was crucial for the success of Gabon's adjustment process. The Region agreed to condition the release of the second tranche on the satisfactory implementation of the three-year investment program to be agreed with the government and its extension on a rolling basis.

Decisions

9. Subject to minor modifications as recorded, the Region was authorized to go ahead with the preparation of the proposed SAL. The loan amount was increased to $50 million as requested by the Region.

10. The Chairman decided that the CSP cum IM should also be reviewed by the Policy Committee.

November 10, 1987

UThumm:vlw

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: February 24, 1988

TO: Mr. Moeen Qureshi, SVPOP

Through : Edward V.K. Jaycox, AFRVP

FROM: Dhan D. Singh, Acting Director, AFI

EXTENSION: 34508

SUBJECT: GABON - Proposed Structural Adjustment Operation (SAL)

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2.

1. The Committee is requested to consider the attached drafts of the President's Report and Loan Agreement for this operation for which an IBRD loan of US$ 40 million equivalent is recommended. The documents have been cleared by the departments concerned. The draft PR contains the latest formulation of the conditions proposed under this operation. Consequently the draft Loan Agreement will be amended later.

2. The proposed loan would be the first lending operation to Gabon since 1977 when Gabon's per capita income made it ineligible for Bank financing. It would support the first phase of the government's medium-term adjustment program. In preparing this operation close coordination was maintained with the IMF and with key donors, mainly the African Development Bank, France and the FED.

Recent Developments in Policy Dialogue

3. Since the Operations Committee review meeting on the Country Strategy Paper for Gabon and SAL Initiating Memorandum, two bank missions and one IMF mission have visited Gabon, and a Government delegation visited the Bank in December while in Washington for finalisation of discussions with the IMF regarding the Second Tranche of the on-going Standby. Appraisal was completed and the second Bank mission to Gabon was joined by an AfDB mission, who are considering cofinancing this operation in an amount of about US$ 50 million equivalent. All these missions were able to ascertain and reconfirm the Government's full commitment to structural adjustment as evidenced by the number of reform measures already implemented and still being implemented, some of which go beyond the proposals of the IM (e.g. budgetary discipline; diagnostic audits for the entire PE sector; tighter controls on PE's; reduction in PE subsidies and in transfers to households). Further evidence of this commitment are the quality and the medium-to-long term horizon of the policy dialogue, and the relative speed of the decision-making process Gabon has demonstrated in this context. The key Government officials are convinced that they need to take full advantage of the crisis years (1987-92) to be able to implement all the necessary reforms, and that they thus must proceed as expeditiously as possible.

4. The agreed program, as laid out in the draft Declaration of Development Strategy (DDS) and the matrix of proposed SAL measures, both annexed to the draft PR, correspond closely to the proposals set out in the Initiating Memorandum. To the extent changes to these initial proposals have been made, those are mainly in degree, presentation or timing and have been redesigned to better achieve the objectives while ensuring their social and political acceptability. The main changes are summarized below.

Wages and Salaries

5. The IM proposed to reduce the minimum guaranteed industrial wage (SMIG) and to create a lower minimum guaranteed agricultural wage. As both these measures inherently bear social and political risks, we agreed with the Government that it will instead issue a new Labor Code which would specifically encourage remuneration related to output across the whole economy, an already widely used practice. At present few entreprises are constrained by the minimum wage legislation, which in any event is not being applied, so there is no reason to make the SMIG an issue.

6. The IM proposed a 12 percent reduction in civil service salaries in 1988, in addition to the 45 percent reduction in indemnities (equivalent to 10 percent salary reduction) effected in 1987. The Government feels strongly that any reduction in 1988 would very likely give rise to social unrest. After reviewing the 1988 budget and the 1989 financial forecasts, the Government proposed, and is now already implementing additional reductions in the civil service wage bill to bring the total reduction since 1987 to 15 percent. Together with the IMF we believe the Government has gone as far as it could at this point and we recommend that the Bank accept the Government's proposal. Future reductions will be achieved through the envisaged reform of the civil service and through streamlining and increased efficiency. With respect to public entreprises (PE) a freeze on new hiring is now in effect, and salaries are being reduced to achieve by end 1988 a 15 percent reduction from the end-1986 level, equal to the reduction in the civil service.

Only 5% reduction instead of 10%

16.4

Parapublic Sector

7. Management audits for the bulk of the PE's have started and the Government has committed itself clearly in the DDS to liquidate, rehabilitate or restructure the entreprises concerned in line with the conclusions of each individual audit, and in consultation with the Bank. Agreement now to privatize or liquidate PE's prior to finalization of their audits would not only be infeasible, but would also present a serious risk of the Government being accused of predetermining such issues, and would thus invalidate the effectiveness of these audits as the basis for the decisions to be made. Nine entreprises have already been closed, liquidated or privatized, and audits are scheduled to be completed in time to enable Government to decide by November 1988 on the fate and action plans for at least another 13 PE's (including SNBG and OCTRA). This is a second tranche disbursement condition.

or implement

Agriculture

8. The IM proposed the elimination of the "Mercuriales" system as a Board condition. The Government recognizes in its DDS the inadequacy of this system and is fully committed to its change. A study on the marketing aspects of foodcrops to be completed by October 1988 will specifically address the "mercuriales" issue, and will provide the basis for a rational government decision on this matter prior to disbursement of the second tranche.

— auction system

Another step postponed

9. The IM further proposed the abolition of the Cocoa and Coffee Stabilization Funds. The Government's DDS recognizes the constraint these

by whom

Funds place on the development of cocoa and coffee production. A final decision on these matters, and on the alternative structure to be adopted, awaits completion of an agricultural marketing study now under way, which will define an action plan by November 1988.

Program Management

10. The "Commission de Gestion de l'Economie" has overall responsibility for design, coordination, implementation and supervision of the structural adjustment program of Gabon. It is co-chaired by the Ministers of Planning and Finance and has direct access to the President for key decisions when required. It comprises highly competent officials of all ministries concerned. Although not formally created until a few weeks ago, this Commission, and its technical committee, have been operating informally since October 1987. During that period of time it has demonstrated its ability to deal with all the issues of structural adjustment in a highly professional and expeditious manner. Under its management we are confident that the structural adjustment program of Gabon will be implemented as agreed, and that Phase Two of the program, already under preparation, will follow in a timely fashion.

11. Overall the adjustment program is solid and includes a number of measures initially not envisaged either by the Government, or by the Bank. Specifically the most important of those measures relate to : new Investment and (state) Participation Codes; a new comprehensive Labor Code; promotion of SME's; reform of the civil service; forestry master plan; emergency road rehabilitation and maintenance. In addition, measures to minimize the social costs of the adjustment are now part of the program. ?

small manufacturing

Substitute for not lowering minimum wage

CC: Messrs./Mmes

Shihata (2)
Husain
Karaosmanoglu
Thalwitz
Rajagopalan
Fischer
Wood
Dubey
Vergin
Lee
Shakow
Holsen
Rao
Baneth
Thahane/Burmester
Liebenthal
Steer
Thumm
Baudon
R. Frank (IFC)
J. Parmar (IFC)
Serageldin
D. Bock
O'Brien
Wyss
Haug
Landell-Mills
Westebbe
Goldbery
M. Alexander
Denning
Rigo
AF1 Division Chiefs
Gabon Country Team

Mr. Qureshi

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

RECEIVED
88 FEB 29 PM 1:38
880229016 #2

DATE: February 29, 1988

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS V. Dubey

EXT: 78051/2

SUBJECT: GUYANA - Policy Framework Paper - Agenda

1. The Operations Committee will meet to discuss this paper on Wednesday, March 2, 1988 at 2:30 p.m. in Room E-1244. This first PFP is intended to pave the way for an Enhanced SAF for the equivalent of US$133 million, and a Structural Adjustment Credit of US$60 million (with three tranches).

2. The economic performance of Guyana since the early 1970s has been dismal. It is in non-accrual status with the Bank; the arrears, all to IBRD, will be $21.5 million by the end of this month. The proposed program is intended to help Guyana to clear its arrears to the Bank, the IMF and the CDB, obtain additional concessional finance from various sources, and set a new direction for the economy. The Committee might wish to consider the following issues.

3. External Finance. Given the record during the last 15 years, and given the time-lags between policy actions and results, the projections in Table 1 may be somewhat optimistic; the finance gap may have been underestimated. Would the Region explain:

* the key assumptions underlying the projections, and the sensitivity of the results to alternative values of the main parameters,

* the basis for assuming that the estimated financial requirements would be forthcoming; how much is known about the intentions of the other donors? What are the minimum levels of debt relief and debt forgiveness that would be required from other donors before the Bank would commit itself to a SAC?

4. Program Content and Feasibility. The proposed structural adjustment program covers a broad range of issues; its adoption would represent a radical turn-around by the government. While many of the proposed policy measures are yet to be defined concretely, it is clear that the political and social limits need to be checked. The key questions are: what constitutes the minimum satisfactory program, what is its feasibility, and what are the relative priorities of the various components within the program. The Region might address these questions with special reference to the following areas.

* Exchange rates and trade restrictions. While the proposals call for exchange rate unification and periodic adjustments, the Region might explain the interdependence between these policies and the policies on trade restrictions and domestic demand management. In addition, the Region might explain why it wants to continue with the import licensing system (even in the modified form described in para. 24)? Regarding export incentives, the foreign exchange retention scheme does not amount to much, being purely temporary and restricted to a few industries. How strongly should we push for exempting all exports from import duties and domestic excise taxes on inputs--should not this PFP contain a very clear statement on export incentives? ?

* Domestic pricing policies and competition. The relaxation of direct and indirect controls on prices and the promotion of domestic competition would be extremely important to the redirection of policies. Would the Region explain (i) the feasibility of the public sector pricing reforms, especially as they relate to the need for frequent rate adjustments?, and (ii) the feasibility of abolishing "at the start of the program any existing monopoly of public enterprises in the production, exportation, importation and distribution of commodities"? It is to be presumed that the abolition of monopolies call not only for free entry by the private sector but also the cessation of special subsidies to public sector units. The latter might require, inter alia, changes in accounting procedures and in institutional structures.

* Public finance and wages. The objective is to reduce the overall non-financial deficit of the whole public sector from 43% of GDP in 1987 to 23% in 1990; if interest obligations are excluded, this would mean an overall surplus of 11% of GDP by 1990. A range of measures for raising revenues and for cutting recurrent expenditures are mentioned in paras. 42-44; changes are proposed, inter alia, in corporate taxes, excise taxes, property taxes, import duties and in social sector cost recoveries. Public sector wages are to be controlled; there will be cut-backs in public employment. Typically these types of changes require a great deal of commitment and preparatory work on the part of the government. The Region might comment on the realism of expecting all these changes during the next few years.

* Rice sector policy. In the past, the rice sector had been severely penalized by the activities of the Guyana Rice Marketing Board, leading to declines in both the quality of the rice marketed and in production and exports. The Region might explain the institutional changes that have been made and results attained in terms of the quantity and quality of outputs. In that context

the Region might explain the potential for export growth given world market price forecasts and the economics of the controversial Mahaica-Mahaicany-Abany and Black Bush Polder projects which are to absorb about 30% of public investment resources during the next three years.

cc: Messrs. Lee, CODDR; Shakow, Liebenthal, SPR; Holsen, CEC; Rao, Steer, FRS; Baneth, IEC; Burmester/Thahane, SEC; Baudon, SVPOP; Loh, LA3DR; Voyadzis, Sokol, Taylor-Lewis, Sackey, LA3C2.

For Information Only

cc: Messrs. Hopper, VPPPR; Fischer, VPDEC; Bock, DFA; Frank, Parmar, IFC; (Ms.) Haug, EXC; Goldberg, VPLEG; Robless, SVPOP.

ARay:cmc:vlw

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

RECEIVED
88 FEB 23 PM 4:50
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2.

DATE: February 23, 1988

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

V Dubey

EXT: 78051/2

SUBJECT: GUYANA - Policy Framework Paper

The attached Policy Framework Paper for Guyana will be discussed at an Operations Committee meeting on Wednesday, March 2, 1988 at 2:30 p.m. in Room E-1244. An agenda for the meeting will be issued shortly.

Attachment

cc: Messrs. Lee, CODDR; Shakow, Liebenthal, SPR; Holsen, CEC; Rao, Steer, FRS; Baneth, IEC; Burmester/Thahane, SEC; Baudon, SVPOP; Selowsky, LACVP; Loh, LA3DR; Voyadzis, Sokol, Taylor-Lewis, Sackey, LA3C2.

For Information Only

cc: Messrs. Hopper, VPPPR; Fischer, VPDEC; Bock, DFA; Frank, Parmar, IFC; (Ms.) Haug, EXC; Goldberg, VPLEG; Robless, SVPOP.

February 29, 1988

880314005
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Mr. Qureshi

The World Bank
OPERATIONS COMMITTEE

CONFIDENTIAL

Minutes of the Operations Committee to consider INDONESIA - Second Trade Policy Adjustment Loan held on February 29, 1988 in Room E-1244

A. Present

Committee

Messrs. M.A. Qureshi (Chairman)
S. Husain (LACVP)
E. Jaycox (AFRVP)
H. Scott (LEGVP)
C. Michalopoulos (EMENA)
D.C. Rao (FRS)
H. Vergin (SVPOP)
R. Liebenthal (SPRPA)

Others

Messrs. A. Karaosmanoglu (ASIVP)
R. Cheetham (AS5DR)
V. Dubey (EAS)
A. Golan (ASTDR)
M. Wiehen (ASIVP)
O. Yenal (ASIVP)
R. Calderisi (AS5CO)
N. Hope (AS5IE)
A. Bhattacharya (AS5CO)
T. Baudon (SVPOP)
D. Mead (LEGAS)
K. Siraj (CODOP)
S. Rajapatirana (EAS)

B. Issues

The meeting was called to discuss the Draft President's report on a proposed Second Trade Policy Adjustment Loan (TPAL II) to Indonesia. The main issues discussed at the meeting related to the absence of tranching, the pace of reforms, particularly trade and investment reforms, and debt management and burden sharing.

C. The Discussion
The Absence of Tranching

The Region explained that the rationale for the absence of tranching in TPAL II to Indonesia was that actions had been agreed with, and taken by the Government as part of an on-going policy dialogue. The loan therefore had to be viewed as financing a time slice of a continuing agreed program of reforms. The TPAL II would support this dialogue, including the effective implementation of agreed policies together with future actions. Because these loans were seen as support for this on-going process and were unusual in that they were not tranched, they were relatively small compared to the overall financial needs of the program.

The Committee agreed with the basic rationale for the loan and accepted the revisions that were to be introduced in the Letter of Development Policy (see below) as the means of specifying more clearly the intended future actions and their time frame.

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SVPOP

The Pace of Reforms

The Region was satisfied with the pace of reforms to date particularly in the trade area and indicated that the Government was committed to undertake further reforms.

As a result of the tariff reforms undertaken to date, the average nominal tariff rate in Indonesia was now only 23% with a ceiling of 60%, while the effective rates of protection varied between 14% - 49%. This is in contrast to much higher levels and greater dispersion in effective rates of protection before 1985. The Government also intended to reduce the extent of manufacturing production that was protected by import licencing. After the 1987 reforms, import restrictions applied to about 34% of manufacturing production. A further 10% reduction in the proportion of production subject to import restrictions is expected during the coming year. These reductions are expected in iron, steel and chemical production. In this connection, a committee member raised the issue as to why import elasticity was less than 1.0 in the balance of payments projections given that the trade regime was being liberalized. The Region explained that the significant depreciation of the Rupiah and the reduction in public expenditures contributed to the slowing down of imports. Public sector imports could continue to be restrained for at least another year or so due to the fiscal restraint. However, raw material and intermediate goods imports especially for exports were expected to rise in response to liberalization measures. The net effect would be a slow increase in imports.

A committee member raised the issue of the de-regulation of domestic investment and noted the importance of undertaking such reforms pari passu with the reform of the trade regime. The Region agreed that the further simplification and rationalization of the domestic investment regulations was an important component of the reform agenda. Beginning in 1986, areas open to private investment have been expanded and specified more clearly. Investment approval procedures were also simplified. In 1987 further steps were taken to relax investment licencing through the broad-branding of product categories. A series of measures were taken to reform policies toward foreign private investment which attempt to reduce the differences in treatment between domestic and foreign private investment. Investment licenses were presently restricted in such areas as cement, fertilizer and automotive industries. In all some 40 out of the 620 areas remain closed for new investments. The government intends to open additional areas in the coming year to domestic and foreign private investment.

Results of the trade reforms and the rationalization of the licensing system have been encouraging. As a result of the reduction of the bias against exports, non-oil exports grew from $550 million a month in 1986 to almost $1.0 billion a month at present. Applications for investments in the private sector have increased (following slowed down investment since 1983) of which 60-70% were in export industries.

Further reforms are expected in the coming year as indicated in the amended Letter of Development Policy. These related to further liberalization of imports, simplification of investment licensing procedures and a reform of the public enterprises. The Government has chosen not to be too explicit on the planned liberalization of imports of commodity groups so as to avoid speculation and lobbying efforts that could forestall the reform.

Debt Management and Burden Sharing

The principal issues raised in these areas related to the means available to meet the foreign exchange requirements in the coming 5 years, the implications of debt management on World Bank's exposure and burden sharing.

The Region explained that Indonesia would need to depend more on official sources in the future to meet its foreign exchange requirements compared to the past and consequently depend less on commercial bank borrowing. Indonesia's debt service ratio is expected to peak at about 38% in 1988 and then decline rapidly given the earlier bunching of service payments. This was consistent with the Region's advice to Indonesia to reduce supplier's and buyer's credits as an element of prudent debt management. However, Indonesia will continue to borrow about $500 million a year from financial markets. A borrowing at that level was consistent with the goal of reducing outstanding debt due to the financial markets for 1-2 years at least, after which borrowing from financial markets would rise again.

During the current period of adjustment which is expected to last for another year or two, Indonesia will require special external finance in the order of $1.5 billion per year. This would be provided largely by Japanese financing, the World Bank and the Asian Development Bank. However the Region has advised the Government to renew its stand-by lines of credit with the commercial banks amounting to about $1.5 billion to maintain some cushion against adverse external developments.

A Committee member pointed out that the Region has projected an absolute decline in commercial bank exposure to Indonesia, with the Bank accounting for a very high share of net external financing. As it was likely that Indonesia could access adequate commercial borrowing, to maintain current levels of commercial debt, the projected increase in reliance on the Bank was considered excessive in his view. He felt that an emphasis on fast disbursing loans in the near term would inevitably mean negative net transfers starting in a few years. The Indonesian authorities should be advised of this.

As regards Bank's exposure, its share of debt service in Indonesia's total debt service was around 20% and the debt service to the Bank was about 6% of exports. The present situation regarding Bank exposure was comfortable but future exposure depends on the lending program and adequate burden sharing. However, Bank's share in total debt service should not be allowed to increase significantly above the present levels.

The Region indicated that there was the possibility that given current levels of commitments, Indonesia would be in a negative transfer position vis-a-vis the Bank in the next five years. Current Bank commitments were around $1.1 billion a year of which net disbursements was around $600-700 million a year.

On the general issue of debt management the Chairman endorsed the Region's position that the level of commercial bank debt outstanding could be reduced in the near term without unduly raising the World Bank exposure. This implied the need for reasonable burden sharing between the Bank and other official sources. On the issue of the balance between adjustment and investment lending, the committee felt that this depended on the net resource transfer position and on the felt need for fast disbursing funds at a given point in time.

Summarizing the discussion the Chairman made the following points. First, Indonesia has had a very good macroeconomic adjustment program the results of which were already seen in the growth of exports and in good supply responses. The Bank should continue to encourage the maintenance of a sound macroeconomic environment. Second, given that the loan itself is not tranched there is a legitimate question whether the actions taken are sufficiently justified to warrant such a position. Although the Chairman felt that this was the case there has to be greater transparency in the justification of this approach specially in comparison to other countries and their circumstances. Third, there has also to be clear statement, specially in presenting the loan to the Board what the country intends to do in the future to sustain the reforms and what we believe is necessary to do so. The amendments to the Letter of Development Policy go a certain distance in giving more specificity to the proposed future actions. The Bank needs to make it very clear that the loan supports actions already taken and not mere promises to take action. Finally, in setting the date of effectiveness for the loan, the Region should look into the balance of payments situation of the country and establish the need for disbursements at a given time.

March 10, 1988
SRajapatirana:gs

Reschedule

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

Date: February 23, 1988

To: Operations Committee

From: Vinod Dubey, Director, EAS Dubey

Extn: 87051

Subj: INDONESIA: Proposed Second Trade Policy Adjustment Loan - Agenda

1. The Operations Committee will meet on Wednesday, February 24, 1988 at 5.00 p.m. in Room E-1244 to discuss the draft President's Report on the proposed Second Trade Policy Adjustment Loan for $300 million to Indonesia. The draft President Report is in lieu of an initiating memorandum.

2. Following the sharp decline in oil revenues since 1983, the Government of Indonesia has been undertaking a program of reforms to develop the non-oil sector of the economy within the context of an eminently successful stabilization program. The macroeconomic stabilization measures have included large cutbacks in public expenditures, restrictive monetary policies and a substantial devaluation of the Rupiah. Because of these strong stabilization efforts, the country has been able to reduce the current account deficit in the balance of payments from 5.6% of GNP in 1983 to 2.9% of GNP in 1987, domestic inflation has been kept at less than 10% while the budget deficit has not exceeded 3% of GNP in the last two years.

3. The successful short term macroeconomic management has permitted the GOI to undertake a number of policy reforms to improve the incentive structure, ranging from the reform of the trade regime, the investment licensing system to the financial sector. These reforms have been supported by Bank's advice and financial assistance based on a successful policy dialogue with the Government. The trade reforms have included the replacing of a majority of the quantitative restrictions with tariffs while reducing the levels of effective protection and their variance. In addition, all the existing export bans have been removed, export licenses simplified and free trade status has been provided to a large proportion of raw materials imports. Moreover several currency devaluations have provided increasing incentives to the tradeable sectors. A similar reform program, though on a slower pace is being implemented in the area of investment licensing. Significant among these reforms were the simplifying of procedures for obtaining industrial licences, giving equal treatment to foreign investors as to domestic investors, relaxing of local content (deletion programs) in the automotive industry and widening the range for capacity expansion beyond which a license was required. Reforms in the financial sector have included the removal of interest rate controls on state bank deposits, elimination of credit ceilings for all banks and reduction of the size of programs eligible for Bank Indonesia's subsidized discounts.

P-186

4. The First Trade Policy Adjustment loan for $302 million was presented to the Board in December 1986. That loan supported the trade adjustments undertaken by the Government during 1986, assisted the recovery and enabled the Bank to maintain the policy dialogue on further reforms to increase efficiency and longer term viability of the economy. The present loan supports the reforms undertaken in 1987 which expanded and deepened the reform measures under way. (See Policy Framework Matrix). Bank's adjustment lending to Indonesia has followed a pattern of endorsing policy actions already taken and as such these loans are not tranched.

The Committee could discuss the following issues:

The Pace of Reforms

5. While Indonesia has had a very successful macroeconomic stabilization program responding quickly to emerging imbalances, its incentive reforms have been slower and less forthcoming. Given that the country faces a formidable task in developing the non-oil sector to restore output growth, provide employment opportunities to some eight million people entering the labor force in the next 5 years and has to expand non-oil exports to finance increasing imports, the pace of reform of the incentive structure becomes an important issue.

- How does the Region propose to utilize the present loan to increase the pace of reform in these areas? If the pace of reform were to slacken in the future given the impending change of some key policy makers, could the Region consider tranching future adjustment operations to speed up the reform process?

- Could the Region clarify its strategy and the priorities to address the remaining distortions in the economy that include quantitative restrictions on 34% of manufactured production, (and restrictions on the import of fertilizer, wheat and rice) a positive bias against exports arising from import tariffs and remaining quantitative restrictions and restrictions on licensing capacity expansion?

Coordination of the Reform Program

6. The success of the incentive reforms to bring about more neutral incentives depend on the success achieved in reducing several related distortions in the economy.

- How does the Region propose to expand the ambit of reforms to include such areas as reform of the state banks which dominate the banking system and contribute to the continuing inefficiencies in financial intermediation?

- How does the Region propose to address several monopolies that have continued to exist despite the reforms such as that of the automotive industry?

External Capital Flows and Debt Management

7. The macroeconomic projections indicate that Indonesia's foreign exchange requirements would be substantial arising from lower oil prices and effects of exchange rate changes on external debt payments (Paragraph 44).

- How does the Region visualize viable burden sharing given that borrowing from the private sector is to be limited, and a substantial part of the foreign exchange requirements is expected from disbursements on project aid from official sources? What are the implications for World Bank exposure of the contemplated levels of lending, in the event lending from other official and bilateral sources turn out to be lower than what is visualized?

- Why is the exchange rate adjustment on total debt to be met by the private sector alone (See Annex I Table on external financing and MLT debt).

cc: Messrs. Lee (CODDR), Shakow (SPRDR), Holsen (CECDR), Rao (FRSDR), Baneth (IECDR, Thahane/Burmester (SEC), Liebenthal (SPRPA), Steer (FRSDR), Baudon (SVPOP), Hopper (SVPPR), Fischer (VPDEC), Bock (DFSDR), Frank (CFPVP), Parmar (CIOVP), Goldberg (VPLEG), Ms. Haug (EXC)

SRajapatirana:gs

February 24, 1988

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The World Bank
OPERATIONS COMMITTEE

CONFIDENTIAL

Minutes of the Operations Committee to consider
MALI - Public Enterprise Sector Adjustment Credit
and Public Enterprise Institutional Development Credit
Held on February 24, 1988 in Room E-1244

A. Present

Committee:

Messrs. E.V.K. Jaycox (Chairman)
S. Husain (LACVP)
H. Vergin (SVPDR)
A. Golan (Acting, ASIVP)
P. Hasan (EMNVP)
H. Scott (LEGVP)
J.A. Holsen (FPDEC)
D.C. Rao (FPRVP)

Others:

Messrs. M. Gillette (AF5DR)
J.F. Bauer (AF5IE)
T. Ahlers (AF5CO)
R. Armstrong (AFRVP)
C. Azi (AF5IE)
S. Samen (AF5IE)
Z. Ebrahim-Zadeh (IMF)
M. de Zamaroczy (IMF)
V. Dubey (EASDR)
K. Siraj (CODOP)
C. Vuylsteke (LEGAF)
G.D. Spota (LEGAF)
F. Earwaker (SPRPA)

B. Issues

1. The meeting was called to discuss the draft President's Report on a proposed Public Enterprise Sector Adjustment Credit to Mali and Memorandum of the President on a proposed Public Enterprise Institutional Development Credit to Mali. The discussion covered the main issues raised in EAS's memorandum of February 11, 1988 and some additional issues. The discussion focussed on the Malian Government's commitment to the reform process and its recent economic performance, its relationship with the IMF, the design of the adjustment program, conditionality of the proposed operations, private sector's role and disbursement issues.

C. The Discussion

The Country's Commitment to Reform Process and Recent Performance

2. The Region briefly reviewed the history of the proposed operation and stated that the negotiations for the original Public Enterprise Reform Project could not be completed because of the Government's inability to agree to certain conditions at that time. The situation, however, changed in 1987 when the Prime Minister requested the Region to revive the project. The discussions with the Government convinced the Region of the

Government's commitment to implement the structural economic reforms, both at the macroeconomic and public enterprise sector level. In order to test the Government's commitment to these reforms, the Region decided to change the original project into an adjustment credit by expanding the scope of the project to include, among other aspects, the restructuring of BDM. The Region has advised the Government that an agreement between the Government and IMF on a SAF would be a necessary condition for Board presentation of the proposed credit. The Committee agreed with this approach.

3. The Region described the various economic reform measures taken by the Government in recent years in respect of public investment programming, reduction in government budget deficits, price decontrol, and abolition of and reduction of overstaffing in the civil service. It was, however, pointed out that most of these reforms were implemented in the 1982-86 period, after which there was a weakening of the progress of reform for a period. It was, therefore, necessary that conditionality on the proposed credit be formulated in such a way that it will ensure that effective actions be taken, preferably before credit effectiveness.

The Credit Conditionality

4. The proposed conditionality for the credit was discussed next. The Region pointed out that the Government had already met all the effectiveness conditions of the original PE reform project, with the notable exception of divestiture strategies for 13 enterprises. The Region stated that a number of new conditions have been added to those associated with the original project and that the Government was making good progress in complying with these conditions. In response to a member's question, the Region also indicated that this compliance involved real corrective actions rather than just agreement about actions to be taken. The committee decided that satisfactory continued progress on compliance with effectiveness conditions should constitute a condition for release of the second tranche.

Design of Adjustment Program

5. A member raised a question about the actions contemplated to improve the structure of incentives. Two aspects - price decontrol and tariff and import policy - were discussed. The Region explained that the original project objective of price decontrol has since been achieved for all except 42 products, including 36 products subject to margin control. The Region's objective is to reduce the number of products subject to price controls from 42 to 28 as a condition of the second tranche. On tariff and import policy, the Region confirmed that these issues would be covered under a SAL for Mali, which would only be undertaken if the proposed Public Enterprise Sector Adjustment Credit is being successfully implemented. A question was raised whether the proposed size of the credit and SFA were not too large considering that the proposed credit is a test of the

Government's commitment to the reform process. The Region replied that the Mali Government has implemented a bigger package of reforms without any credit support from the Association than those being supported by the Association in respect of some other African countries. It, therefore, considered the size of assistance as appropriate.

Private Sector's Role

6. In response to a question about the private sector's ability to absorb the proposed public sector divestiture program, the Region explained that knowledge of the Malian private sector was extremely limited, and hence, that the amount of local private capital that could be mobilized for divestiture of public enterprises was unknown. The Region indicated, however, that expatriate firms would be involved in the divestiture of a number of enterprises.

Disbursements

7. The Committee agreed to the proposed retroactive financing of up to 20% of the total proposed credit covering imports up to four months before credit signing.

Concluding Remarks

8. The Chairman concluded that subject to the Committee's observations noted above, the Africa Region is authorized to proceed with credit negotiations.

KSiraj:mda

March 4, 1988

Siraj/PC#6/AD1

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

RECEIVED
88 FEB 11 PM 5:30

DATE: February 11, 1988

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

V. Dubey

EXT: 78051

SUBJECT: MALI: Public Enterprise Sector Adjustment Credit
Public Enterprise Institutional Development Credit

1. The Operations Committee will meet on Tuesday, February 16 at 3:30 p.m. in Room E-1244 to discuss the proposed credit for a public enterprise sector adjustment program to Mali which is ready to be negotiated. The credit is for $36 million (IDA $15 million and the Special Facility for Africa $21 million). Cofinancing from Japan, Saudi Arabia and the African Development Bank is expected for an additional $70.2 million. There is a parallel Institutional Development Project for $12.5 million to provide technical assistance in the implementation of the reform.

Background

2. The country has had an erratic economic performance: Real GDP growth has averaged about 0.9 percent per year during 1980-87, though mainly due to good weather GDP increased by 10 percent in 1986 and 4% in 1987. The Government initiated adjustment efforts in 1982 with Fund support. Cereal markets were liberalized, ubiquitous price controls reduced, public tariffs raised and export monopolies and most import monopolies abolished. However, efforts slackened in 1986 and the last two drawings under the IMF's third standby could not be made. The resultant worsening of the macro-economic situation has resulted in a recent renewal in the Government's interest in proceeding with reform. The Government has requested a SAF program and a mission to prepare and agree on a Policy Framework Paper is expected to be mounted in March. As Mr. Gillette's memo (January 21) states "it was decided to proceed with a PE sector adjustment credit, as a test of the Government's commitment for reform, to be followed rapidly by a broader structural adjustment program supported by a SAL" (para. 2). The basic objectives of the project "remain unchanged, namely to improve the performance of the sector and to reduce its burden on public finances".

3. The Operations Committee may wish to discuss the following issues:

4. Government commitment: The Public Enterprise project has had a long and chequered history. It has been under preparation for about six years. Negotiations were held in July 1986 and while "agreement was reached on most matters, further clarifications (were) required" (Mr. Alisbah to Mr. Stern, August 19, 1986). The Region envisaged a Board date in November 1986. However, a mission in October 1986 reported that

"no progress was made in fulfilling the conditions for Board presentation and there were serious doubts about the firmness of Government's commitment to the PE reform". Board presentation was moved to March 1987 and then later again to May 1987. The worsening economic and financial situation has stimulated the Government's interest in pursuing the reform. However, the ebb and flow of Government commitment raises serious questions about the longer run viability of the reform process. The concern is strengthened by the fact that a number of decisions, e.g. on liquidation of Air Mali, which were reported in earlier documentation as having been made were never implemented. They remain conditions for Board in the proposed credit.

5. Design of Adjustment Program: The project objectives are to be achieved by action in four key areas: (a) reform of key economic policies concerning public resource management and the structure of economic incentives; (b) financial sector reforms, including restructuring the state-owned development bank (BDM); (c) institutional and legal reforms redefining relations between government and public enterprises; and (d) rationalization of PE sector through restructuring and divestiture. However, the balance between various elements of the program and the pace of reform raise several questions.

6. While the need for a comprehensive financial restructuring of BDM is imperative, the Committee may wish to be informed about the alternative options that are being explored to this end between the Government and external donors. What steps are being taken to ensure a fair burden-sharing by the BCEAO and the concerned bilateral donors? Can the Region comment on the use of IDA resources for this purpose.

What is the Pricing re BDM
What are we in for?

7. The program appears to have a rather modest focus on incentive policies. In particular the existing price policy is likely to inhibit the progress towards a more healthy and efficient public enterprise sector and an active private sector. Forty-two "essential" products still remain controlled of which six (which? how important?) remain subject to fixed prices and the remaining 36 to a regime of cost plus fixed margins with 18 requiring prior Government approval for changes. Reduction of the number of products subject to price control is a condition only for the second tranche. Could not some action be required earlier? How many commodities are we aiming to free from control?

Can PE reform be done without price control

Why not earlier action on price controls?

8. The Government's tariff and import policy is not discussed in the President's Report and, therefore, one does not get a clear picture of what trade policy reforms (protection, QRs, import controls) are needed, if any, to support better economic performance of PEs including those slated for being transferred to the private sector.

9. The Government's policy on public utility tariffs needs to be clarified. It is reported (para. 52) that significant increases in water and electricity tariffs were effected in 1985. Have these been adjusted since then? Under what criteria? Any program for the rehabilitation of the six enterprises the Government intends to retain under its ownership must require a reasonable policy understanding on tariff setting.

What are PE tariffs

What understanding re tariff reform for 6 PE's retained by Govt

Given the relative importance of PE's — Prices liberalized as ? of total
PE's " " " " "

10. The program relies heavily on the participation of the private sector. BDM is planned to be privatized by reducing Government ownership to not more than 20%, Similarly, ownership of fifteen PEs is to be transferred to private sector in the first phase of rationalization of the PE Sector. In the second phase an additional 22 PEs would be considered for possible divestiture. Does the private sector have the management skills, competence and willingness to absorb such a large divestiture program?

fund – what is the program of privatization

11. While adoption of the 1988 investment budget is a condition for Board presentation and of the 1989 budget for the release of the second tranche (Annex 7) it would be useful to clarify the size and quality of the project content of the public investment program including ongoing projects. Para. 28 of the President's Report is tantalizingly vague on the subject.

Public investment program – what is its quality

12. The program calls for the Government to prepare, as a condition of the release of second tranche, a plan of action to address financial sector policy issues of: (a) credit allocation, (b) allocation of global credit ceiling among banks, (c) bank supervision procedures, (d) legal procedures for enforcing loan guarantees, and (e) application of sales tax to interest rates. Will the Region like to spell out in more concrete terms what would be the thrust and direction of reforms in each of these areas? Moreover, in the transition period preceding the proposed reforms, will the financial sector be in a position to lend its support to the proposed PE divestiture program, in the form of financing that may be needed by prospective new owners of PEs?

Credit program linkage with PE divestiture program?

13. Effects of the Adjustment Program: The reform program is expected to improve the policy environment but the Region correctly points out that the extent of supply response is uncertain. The scenarios presented without details (paras. 62-64) presumably assume a continuation and extension of the reform process particularly in price policy, trade policy and financial sector. It seems unlikely that the reform of the Public Enterprise sector by itself and as in this project could raise the GDP growth rate from 2.5% to 3.5% "in the early 1990s". The social costs of adjustment are expected to be small and relate primarily to the reduction of overstaffing in key enterprises. It is proposed to establish a reconversion fund to cover severance pay obligations and additional financing to facilitate entry into the private sector. The Committee may wish to be informed as to how this fund is going to work and the preliminary results of ongoing experimental approaches to integrate former public employees into the private sector.

14. Implementation of the Program: An interministerial commission chaired by the Prime Minister and comprising six cabinet ministers is responsible for implementation. However, it is correctly pointed out among the risks that the proposed reforms affect institutions and ministries which have a vested interest in the status quo (para. 67). The stop-go history of reform in Mali supports this concern. In this context the proposal to disburse the credit in three equal tranches is desirable. However, a number of the tranche release conditions are stated in vague terms, e.g. "satisfactory progress in privatization programs" (Annex IV,

page 2, column 4). During negotiations it is important to develop and agree on the objective criteria on the basis of which satisfactory progress will be judged. What are the monitorable criterion to be used to determine satisfactory progress in this and other areas where "satisfactory progress" is the condition for tranche release. Import

15. Disbursement, Counterpart Funds and Retroactive Financing: The credit is to be disbursed against eligible general imports (negative list). Both private and public sector imports would be eligible for financing. Is there a case for setting a ceiling on the share of public sector imports? The counterpart funds generated are to be devoted to financing "general development expenditures". It is expected that they will be used essentially to finance Government obligations in the financial restructuring of the enterprises and BDM, including items like severance pay of redundant employees. The macro-economic implications of these development (?) expenditures would need to be carefully considered. It is proposed that retroactive financing of up to 20% of the total credits and covering imports up to four months before credit signing should be permitted. The case for this appears to be simply "to ensure a rapid drawdown of the credit proceeds". Is that a sufficient argument? The 20% proviso would mean that about $7.5 million of the $12 million of the first tranche would be disbursed in retroactive financing. Is there a case for a periodically replenished fund to be considered as an alternative to retroactive financing?

No retroactive financing

Documentation of Credit Package

16. The draft President's Report has many blanks which prevents us from getting a clear picture of quantitative targets and important dates. Apparently it is a draft prepared for negotiations and the Board; it would be more useful for the Committee if it were written for Bank management stating clearly what is expected to be achieved and by when.

cc: Messrs. Lee, Shakow, Holsen, Rao, Baneth, Burmester/Thahane, Liebenthal, Steer, Baudon, Gillette, Hinkle, Siraji, Hopper, Fischer, Bock, Frank, Parmar, Goldberg, Agarwala and Ms. Haug

K.Siraj/V.Dubey:eg

Important
write a cover note
indicating what you

Pts for Conclusion

(1) sharpen up the monitorable conditions - implementation of PE's etc instead of satisfactory progress of Privatization

(2) ~~Obj [illegible]~~ Program
Price Controls, Clarify, what is intended
Tariffs of PE's
Tariff + Import Policy

(3) Clarify ~~[illegible]~~ position re arrears - we are not being used to finance repayments to BCEAO

February 17, 1988

FORM NO. 75
(9-78)

THE WORLD BANK

ROUTING SLIP	DATE: February 16, 1988

NAME	ROOM NO.
Mr. ~~Baudon~~	E-1241
Mr Qureshi	

	APPROPRIATE DISPOSITION		NOTE AND RETURN
	APPROVAL		NOTE AND SEND ON
	CLEARANCE		PER OUR CONVERSATION
	COMMENT		PER YOUR REQUEST
	FOR ACTION		PREPARE REPLY
	INFORMATION		RECOMMENDATION
	INITIAL		SIGNATURE
	NOTE AND FILE		URGENT

REMARKS:

Thierry: I believe that MAQ would like to see this stimulating (provocative?) note.

FROM:	ROOM NO.:	EXTENSION:
Vinod		

Pakistan: Finance Environmental project
Trade
Education
Population

Fiscal deficit - 4-5 years
reduction 5% Paul
Stanley
Current Acct Deficit 2.8% Attila

Progress on tax reform Heinz
9.6
Budget 7.6
deficit

Med term strategy Focusing
&
Sequencing

Why has growth rate been high.
Growth rate has been [illegible]

Foreign borrowing

Zero net foreign borrowing

Is there a possibility of substantial
export led growth.

Do not reduce foreign borrowing.

DC
2

2.8

Fiscal Adjustment.

Geoffrey.

Financing Plan
Financing Plan
Country
Ratios – understandable

---

directly involved with the
policy-formulation – own work

---

clear bench marks –

Say something on Macro Policy framework.

Price Reform – try right adjust on an
experimental basis.

Grain Subsidies

World Bank WORLD BANK / INTERNATIONAL FINANCE CORPORATION

Paul
PAUL
~~DCRav~~,

Economic & Sectoral
Collaboration Strategy

Feasible & attainable

Relationship of the rhythm change
Front load.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

cc. SES

DATE: February 10, 1988

TO: Mr. F. Stephen O'Brien, Chief Economist, AFRVP

FROM: Akbar Noman, AFRVP

EXTENSION: 34590

SUBJECT: **Pakistan - CSP & PFP**

The Pakistan economy has (according to official statistics which understate growth) grown at an annual rate of 6-7% over the past decade. GDP growth has accelerated to close to 8% a year during 1984/5 - 86/7. At the same time, inflation has decelerated to an annual rate of 5% in recent years and we are told the balance of payments is "satisfactory" (current account deficit as a proportion of GDP has declined from 3.5% in 1980/81 and 5.3% in 1984/85 to 2.1% in 1986/87). Exports grew at 20% in 1985/86 and 19% in 1986/87. However, the fiscal deficit has increased from around 6% of GDP in the early 1980s to 8.8% in 86/87 and the social sectors and infrastructure have lagged behind.

The proposed Bank strategy is to get the government to adopt a medium-term agenda of macroeconomic and structural reform to sustain a lower annual growth of 5.5% for FY89-91. Lower not only than in the past but also than in the "no reform" case when growth is projected to be 6% over those 3 years. For whatever such projections are worth, the supposed positive effects of reforms are projected to materialize in the 1990s. If a satisfactory reform program is adopted Bank lending would increase from $650 million to $800 million a year, if not it would shrink to $400 - $500 million. The policy package in broad terms is the standard one, indistinguishable from the prescriptions for a country like the Sudan which has experienced a prolonged drop in per capita income: trade policy (QRs, tariffs), industrial regulations, agricultural pricing, public sector, financial sector, etc., are all on the agenda with familiar type of policy conditionality.

It behoves the Bank as a development institution as distinct from a conventional banker, overly concerned with fiscal/financial/stabilization issues, to address the question of why it is necessary for a developing economy with a trend growth rate of close to 7% accelerating to nearly 8% in recent years, with modest and declining inflation and BOP deficits, to adopt macroeconomic policies which will reduce the growth rate to 5.5% over the medium term. This question is not really faced head on. The implicit or tangential answers which one can extract from the CSP are not very satisfactory.

It is not clear that the fiscal problem warrants such a squeeze (see below). One argument for some slowdown in growth is the fall-off in workers remittances but exports have picked up to grow at 20% a year. The other argument is that infrastructural constraints are becoming more serious. For longer-term development and poverty alleviation, more emphasis is needed on the social sectors. Should the Bank strategy then be of concentrating on traditional projects in infrastructure and quick-disbursing sector operations in the social sectors?

As for the package of proposed "reforms" which are supposed to improve efficiency and promote exports, one is tempted to ask: Why not leave well enough alone? Pakistan has had an ICOR of 2 and a booming economy for some time and booming exports in the past two years. From the litany of needed reforms - tariff rationalization, reduction of QRs etc - one wonders how the economic performance of the past has been managed. Indeed the question that arises is what are the implications of Pakistan's development experience for our "reform" package? While distortions can destroy development (vide: parts of Africa), is more liberalization always better? What are the lessons of not only Pakistan and Thailand but also Japan and Korea concerning the optimum mix of liberalization and intervention and of the trade-off between static efficiency and dynamic growth considerations? Are our policy packages sufficiently informed by the lessons of development?

By far the strongest case for macroeconomic conditionality is on account of the growing fiscal deficit but are the concerns and proposed remedies exaggerated? Inflation and BOP deficits are modest and declining, private investment has boomed while public investment has shrunk so that the crowding out and confidence of the private sector have not been serious problems. The fact the deficit has not had the adverse consequences which the CSP is concerned about, may well have to do with and the manner of its financing and exaggeration of its size.

The deficit has been financed mostly from non-bank borrowing rather than monetary expansion. The borrowing through attractive financial instruments, has arguably brought "black" money from hiding into more productive uses and possibly increased private savings. There are complex issues about changes in asset preferences, about the economic costs of raising taxes versus those of non-bank borrowing and the speed with which the deficit should be reduced. Pakistan's national accounts underestimate the size and growth of GDP and on plausible assumptions the deficit/GDP ratio shrinks from 8.8% to around 6 1/2% in 1986/87 and 5 1/2% in the new budget projections.

Is there a danger that our increasing concern with the adjustment/macroeconomic/financial syndrome and close collaboration with the IMF are turning us into a bank rather than the Bank so that despite our rhetoric and our intentions we are letting real or imagined financial tails wag the development dog?

cc: Messrs. Agarwala, Armstrong, Ms. Swamy

ANoman:nt:General:Pakistan.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

Mr. Qureshi
Resource impact & budget managing
1)
2) Base case
Realistic case
budget 4.8%

Date: February 12, 1988

To: Operations Committee

From: Vinod Dubey, Director, EAS V. Dubey

Extn: 78051

Subj: PAKISTAN: Country Strategy Paper (CSP)
Policy Framework Paper (PFP)

1. There will be a meeting of the Operations Committee on Wednesday, February 17, 1988 at 3.00 p.m. in Room E-1244 to discuss the above-mentioned papers.

Background

Pakistan has shown impressive growth performance (6-7% p.a.) with relative price stability. The country's pursuit of sound exchange rate management policies, deregulation measures, encouragement of private sector initiates, containment of the public sector role and a recent tilt towards social sectors are in the right direction and deserve commendation. Notwithstanding these achievements, the country continues to confront a number of difficult problems: large and growing fiscal deficits; weak domestic, especially public sector, savings and growing reliance on external borrowings; excessive dependence on a few exports and worker's remittances; growing debt service payments and vulnerable balance of payments position. The objectives of the Bank's assistance strategy is to encourage the Government to adopt macro-economic and structural reforms to sustain growth at a level (5-6% p.a.) that is reasonably above the high population growth rates (about 3.2% p.a.) both to enhance per capita income and realize the key social sector goals.

Bank Assistance Strategy

In response to improved economic management and performance in recent years, the Managing Committee in January 1985 decided to increase lending from an average of US$306 million for FY82-84 (IBRD $116 and IDA $190 million) to a level of US$650 million. Subject to certain improvements in budget targets and the medium-term policy framework, the Region expects total lending amounting to $620 million in FY88. Bank's lending level beyond FY88 will depend on the quality of the adjustment program adopted by the Government and its implementation - $800 million (including upto two quick-disbursing loans per year) if scenerio B, discussed below, is followed or will drop to $400-500 million range of a core program if only a constrained adjustment effort is forthcoming, as in scenerio A. The overall level is close to the country norm of around US$700 million.

?

The Two Scenarios and Two Broader Questions

Scenario A represents the status quo or what the Region describes as "muddling through". This scenario envisages minimal adjustment and resource mobilization effort and high budget deficit - 8-9% of GDP, slow and uneven pace of deregulation and correction of sector distortions, limited import liberalization but reasonably strong export promotion, and a continued heavy reliance on foreign savings to maintain growth at close to 6% per annum. While this scenario is feasible over the next 2-3 years, the Region feels it is not sustainable because debt service problems will become serious with negative impact on interest rates, credit availability and inflation, and the Government's development expenditures.

Scenario B, preferred by the Region, provides for a sustainable fiscal deficit, incorporating a realist trade-off among growth, price stability and debt accumulation objectives - the budget deficit dropping from 7.8% of GDP in FY88 to a sustainable level of 4.8% in three years; reduction of the current account deficit from 2.8% of GDP to 2.4% of GDP, with substantial improvement in resource mobilization and curtailment in the growth of current expenditures.

It would be surprising if the country will either remain anchored with the 'muddle through', status quo, situation or jump on the policy and reform-intensive scenario B. Realistically speaking, the country may combine elements of the both scenarios. In that case what would be the Region's strategy both in terms of the total lending volume and its allocative thrust amongst the various sectors?

The CSP is devoted predominantly to the discussion of the budgetary, resource mobilization and balance of payments issues. The discussion on the real sector is short and somewhat cryptic. From this discussion it is not entirely clear how the level and composition of Bank lending is linked to the resolution of the most important long-term development and critical issues in the real sectors.

Clarification of Issues and Development Policy Agenda

- In the past the debt service ratio has been increasing rapidly, reflecting in part the build-up of short-term external debt. Is the rising share of short-term debt in total still an issue; if so, what is being done about it?

- In the 6th Plan, development expenditure were predominantly financed by borrowed funds. Is the 7th Plan likely to be substantially different in this respect? What should be the target for foreign funding of development expenditures in the next plan?

Development Constraints

- The development policy section of the CSP mentions internal and external constraints in an ad hoc fashion. Would the Region indicate three or four key constraints in each of the two areas - internal and external - and discuss whether the Government and Bank agree on their being the most severe constraints? And is the Region satisfied with the Government approach to dealing with those constraints?

Resource Mobilization

- Increased resource mobilization is by far the most important issue now. Reform of Federal-Provincial financial relations is mentioned as an important point in the overall resource mobilization effort (para. 26). In what sense is it likely to lead to larger amounts of resources and are there some new provincial taxes which have been identified; if so, what would be their revenue implication? Elimination of the present exemption of agricultural incomes is, indeed, an important part of the improved resource mobilization effort. What are the chances of it being finally approved for implementation?

- The CSP mentions the FY89 budget as being "the last opportunity for this Government to propose major tax reform before elections in 1990". How realistic is this? Are there examples where hefty tax increases have been introduced just before a Government faces elections?

Control of Budget Deficit

- Is there some specific evidence to show that the large public sector borrowing requirements are actually 'crowding out' private investment. A lot depends on the flow of resources into the financial system, demand for investment funds by the private sector and other factors.

- The proposed strategy to reduce the consolidated fiscal deficits to about 4.8% of GDP has several components. One component is a revision of central/provincial revenue sharing arrangements. This can reduce the consolidated fiscal deficit if the federal share of revenue to provinces goes down and/or the provincial share of own revenue in total goes up. What is the feasibility of this happening in the case of the poorer provinces.

- The CSP recommends reduction in the growth of current expenditures, including subsidies and a streamlining and coordination of investment. It is not, however, entirely clear what particular areas - other than subsidies - are good candidates for curtailing the growth of current expenditures in the preferred scenario and how much savings can be achieved in this respect.

- The CSP recommends "continued real growth in economic and social infrastructure expenditures (capital and current)". Is it not inconsistent with the need to reduce the consolidated fiscal deficit? In which particular areas expenditure savings can be achieved and would that amount of savings actually support the ambitious targets and a continued real growth in economic and social infrastructure?

- It is not clear how 'a substantial improvement in the financing pattern' would contribute to the reduction of the consolidated fiscal deficit. Further, more attention to operations and maintenance will in the short run lead to increased expenditures and not to reduced fiscal deficit as the CSP asserts.

- In short, the section on Control of Budget Deficit does not clearly identify revenue raising and expenditure reducing measures for reducing the consolidated fiscal deficits to 4-5% of GDP.

Trade Policy Reform

- It is not clear what would be the net balance of payments impact of most of the trade/balance of payments elements mentioned in para. 29. Is it not likely that these measures may actually worsen the situation in the medium-term?

Poverty Alleviation and The Prime Minister's Five Point Program

- The Prime Minister's Five-Point Program to benefit the poor is commendable. Could the Region elaborate whether it is being implemented expeditiously and whether the program is large and stable enough to make a serious dent on the problem.

Management of Natural Resources

- The CSP talks about "widespread environmental degradation throughout the country". It is not clear at all what strategy the Government and Bank propose to follow to first contain and then reduce the dimension of this problem?

Population and Family Planning

The CSP says that many in the Government consider family planning of a high priority but it is not in the Prime Minister's program. Given the sensitivity of the issue, the Region proposes a less direct approach. Could the Region explain the broad elements of the indirect approach and indicate whether it would in fact match with the overall magnitude of the problem.

Burden Sharing and Bank Exposure

The IBRD share in total DOD and debt service will rise dramatically over the next few years. Pakistan would break through the IBRD portfolio exposure guideline limits by 1991. The Operations Committee might like to discuss this issue in the context of the proposed Bank's Assistance Strategy.

Employment Challenge

With rapid population growth, the labor force will expand by about 950,000 new enterants a year over the coming decade. The Middle-East is no more a safety valve -- in fact a net return migration is already an issue. In addition, the problem of absorbing the "educated unemployed" is becoming acute. <u>The Region may explain what strategy the Government proposes to follow to meet the employment challenge and how is the Bank going to support that strategy?</u>

cc: Messrs. D. Lee (CODDR), A. Shakow (SPRDR), J. Holsen (CECDR),
D.C. Rao, A. Steer (FRS), J. Baneth (IECDR),
Thahane, Burmester (SECGE), R. Liebenthal (SPRPA),
Baudon (Asst. to Mr. Qureshi), S. Fischer (VPDEC),
D. Bock (DFA), J.W. Stanton (EXC), R. Frank (CFPVP),
J. Parmar (CIOVP), D. Hopper (SVPPR), D. Goldberg (VPLEG),
R. Agarwala (AFRVP), P. Hasan (EMNVP), H. Kopp (EM1DR),
M. Cohen (EM1CO), Mss. Haug (EXC), M. Nishimizu (EM1CO)

FMChaudhri:gs

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

Macro Policy

DATE : February 12, 1988

RECEIVED

88 FEB 12 PM 5:33

TO : Operations Committee

V. Dubey

FROM : Vinod Dubey, Director, EAS

SUBJECT: China: Rural Sector Adjustment Loan - Initiating Memorandum - OC Meeting Agenda.

1. The Operations Committee will meet on Wednesday, February 17 at 4:00 p.m. in Room E-1244 to discuss the Initiating Memorandum on a proposed Rural Sector Adjustment Loan (RSAL) to China for a total amount of $300 million, of which $100 million equivalent would be from IDA.

2. The proposed operation would be in support of further reform measures in the rural economy, including increased scope of market transactions, reduction in reliance on administered pricing, clarification of land use rights, development of rural industry, devolution of responsibility for rural infrastructure investment, and further development of rural financial institutions. This would be the first adjustment operation in China. Policy-based operations to assist with the restructuring of other economic sectors are now also under discussion.

3. The Committee may wish to discuss the following:

a) While the rural economic reform program to be supported by the proposed operation is comprehensive, the policy matrix remains vague with respect to measures to be taken, e.g. "further reduce interprovincial marketing restrictions" or "begin to phase out contract grain purchases". Very few specific and monitorable performance targets are given. In the absence of specific "monitorable" measures, how does the Region propose to monitor "progress"?

b) The lack of a viable macro-economic framework is probably the greatest risk for the proposed reform program. Low (virtually zero) inflation is seen by the Party and the public as one of the most important achievements of the past thirty years. But during the past four years the government has been unable to limit credit expansion to a rate that is consistent with low price inflation (credit expansion has averaged 30% p.a. for the past four years). Rather than condoning double-digit inflation rates, the government has recently rolled back already announced price reform measures (grain and edible oil) that are closely related to the success of the proposed rural economic reform program.

How can the program succeed without a stronger commitment by the government to bring down credit expansion?

c) Grain subsidies. About 30% of the state budget (or 8% of GDP) is now allocated to subsidize the difference between grain sales and procurement prices. These massive subsidies are one of the most important obstacles to further grain objectives

marketization of the economy and fiscal reform. Could the program be strengthened to include quantitative objectives to reduce grain subsidies?

d) Loan Amount/Tranching. The Region proposes a total loan/credit amount of $300 million, that may be increased to $350 million to respond to the Government's request of $400 million. The lower loan amount has apparently been adopted to avoid tranching which in turn is closely related to the absence of specific and monitorable program targets.

Can such a large loan amount be justified without tranching?

cc: D. Lee, COD; A. Shakow, SPR; J. Holsen, CEC; D.C. Rao, FRS; J. Baneth, IEC; Thahane, Burmester, SEC; R. Liebenthal, SPR; A. Steer, FRS; T. Baudon, SVPOP; O. Yenal, ASIVP; S.J. Burki, AS3DR; J. Goldberg, R. Burcroff, AS3AG; B. Merghoub, G. Tidrick, AS3CO.

For Information Only:

D. Bock, DFA; S. Fischer, VPDEC; R. Frank, J. Parmar, IFC; D. Hopper, PPR; M. Haug, EXC; D. Goldberg, VPLEG;

GPohl:pl

February 12, 1988

Mr. Qureshi E1241

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: February 10, 1988

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS V. Dubey

EXT: 78051

SUBJECT: CAR - Country Strategy Paper cum Initiating Memorandum for a Proposed $30 Million Second Structural Adjustment Credit - Agenda

1. The Operations Committee will meet on Friday, February 12, 1988 at 3:00 p.m. in Room E-1244 to discuss the CSP for the Central African Republic and the IM for the second SAC for $30 million. The Operations Committee may wish to discuss the CSP related issues raised in paragraphs 4-6 and those specifically related to the proposed SAC in paragraphs 8-13.

Country Strategy

2. Background. After years of serious economic mismanagement and subsequent attempts of economic recovery, the government of CAR embarked on a structural adjustment process in 1986, supported by SAC I and a Fund arrangement (Standby and SAF). Although a wide array of reforms has been undertaken, results to date have been modest, mainly (but not exclusively) because of a deterioration of the external environment, i.e., falling commodity prices and the decline of the US dollar. As a result of these exogenous events, none of CAR's exports is competitive and the balance of payments and fiscal situation deteriorated significantly in 1987, with a build-up of external arrears. Performance criteria under the IMF standby arrangement for September and December 1987 were not met, and the arrangement became inoperative.

3. Against this background, the Region proposes a five-year strategy which aims at re-establishing per-capita income growth over the medium term through a process of major structural change and increased investment (mainly in the public sector). Growth is expected to be led by agriculture and forestry. To support this process, a FY88-92 lending program of $265 million is proposed of which 37 percent is allocated to fast-disbursing policy loans (including the FY88 $15 million[1] cotton sector credit already approved) and the remainder to agriculture/forestry (26 percent), human resources (14 percent), infrastructure (13 percent), small enterprises (6 percent), and SAC related technical assistance (4 percent). While the proposed strategy and lending program adequately address the country's needs, questions may be raised with regard to the feasibility of the medium-term scenario and the proposed lending volume and cost sharing.

4. Medium-Term Scenario. The CSP presents projections up to 1995 built around average annual GDP growth of 3.2 percent through 1990 and an acceleration to 4 percent thereafter, led by agricultural growth of 4.5

1/ Including SFA resources, the credit is actually for about $23.5 million.

percent per year throughout the period. Although para 19 states that at the current exchange rate (about CFAF 280 = $1) CAR's exports are not competitive and the exchange rate is projected to hover around 250 through 1990, the CSP/IM assumes that somehow (through export subsidies and additional external resources) the economy can be kept viable till the proposed structural reforms will result in greater efficiency (lower production costs, particularly for cotton and coffee) and the exchange rate will again become more favorable reaching CFAF 300-350 per dollar during 1991-95. As for other UMOA countries, but particularly for CAR which is at an additional competitive disadvantage (land-locked, neighboring Zaire with a more competitive exchange rate), the key question is whether the proposed strategy will produce the expected results and whether IDA should be a major contributor of external resources (about 30 percent of projected gross disbursements) during the assumed "holding period."

5. Lending Volume and Cost Sharing. The proposed FY88-92 lending program amounts to $265 million or about SDR 200 million which is about twice the IDA norm. Moreover, cost sharing up to 95 percent of total project cost is proposed for project lending. Several questions arise in this connection:

(a) The Region's recommendations are based on CAR's "debt-distressedness." Since the debt-service in relation to exports does not quite reach the standard mark of 30 percent, the case is made on fiscal grounds, with debt-service amounting to more than 30 percent of government revenues (excluding grants). The Region could be asked to provide some additional information, comparing CAR to other marginal cases of debt-distressedness, and the Committee may wish to reconsider the lending volume in the context of overall IDA allocations.

(b) CAR's fiscal situation is weak and will continue to be fragile even after the successful implementation of the revenue measures proposed under SAC II. However, 95 percent cost sharing, although applied in CAR before, is very high and does not provide enough of an incentive for domestic savings. The Committee may wish to consider the appropriateness of the proposed cost sharing, given the OMS 1.22 requirement of local contributions of not less than 10 percent and recent treatment of countries in similar conditions like Burkina Faso and Guinea Bissau.

6. Structure of Lending Program. Overall, the structure of the proposed lending program seems to respond adequately to CAR's priority needs. However, many measures to strengthen the institutional framework for agricultural support services are expected to be implemented under SAC II, while a research and extension project is proposed only for FY90. The Region could be asked to explain and perhaps reconsider the timing of that operation.

Structural Adjustment Credit II

7. Objectives. The main objectives of SAC II are to provide an adequate macroeconomic and incentives framework for resumed growth, led by agriculture and forestry. This requires major improvements in fiscal

management (revenue measures, expenditure control, rationalization of the public enterprise sector), changes of the incentives system (including producer price liberalization), and strong external financial support. Given the Region's own assessment of the exchange rate problem and the lack of export competitiveness, as well as other pervasive weaknesses of a structural nature, the SAC objectives are somewhat surrealistic, and the SAC can at best be seen as a holding action till the exchange rate will indeed be corrected and the economy can adjust accordingly. But even within the constraints of the proposed operation, several questions could be raised.

8. Fiscal Management. While exogenous factors had a major impact on CAR's public finances, weak fiscal management was also a very important factor in the unsatisfactory fiscal performance which led to the build up of arrears and non-compliance with the standby arrangement. The different elements are well summarized in paragraph 30 of the paper. While the proposed expenditure control measures are fairly specify and monitorable, the revenue enhancement measures are relatively vague. Moreover, higher customs revenues may not be easy to achieve through better administration given that perhaps 60 percent of imports or more are multilaterally or bilaterally financed and tax exempt. The Region could be asked to add specificity to the proposed revenue measures, and an additional condition for second tranche release could be included which would refer to satisfactory overall macroeconomic management, with particular emphasis on fiscal performance (perhaps even with a quantitative target).

9. In this same context, the Region could also be asked to explain the design, administration, and financing of the proposed export subsidies and whether major private sector involvement in the administration of the Coffee Fund is really advisable (para. 45). Moreover, the establishment of export subsidies (e.g. through the Coffee Fund) could also be retained as a condition for Board presentation.

10. Agricultural Reforms. Substantial institutional reforms in agricultural support services are proposed as part of SAC II (para. 44). Results are not going to be quick which raises again the question as to how realistic the growth assumptions are. Moreover one could ask whether the SACII is the appropriate vehicle to bring about the proposed reforms or whether the research and extension project should not be used instead and brought forward from FY90.

11. Social Impact. The treatment of the social implications of adjustment is fairly extensive. However, in a country as poor as CAR, with stagnating per-capita income, and with the need for a substantial increase in domestic savings (mostly through taxation), not much can be done to avoid that additional sacrifices will also have to be made by the poor as there is not enough of an urban, high-income tax basis. The Region could be asked to elaborate, put the discussion in the green-cover package into a somewhat broader perspective, and to give a better feeling for government commitment and policies as opposed to Bank sponsored actions.

12. Priority Action and Monitoring Arrangements. The policy matrix (annex I) lists 94 measures as part of the SAC II supported program. Page 9 of annex I lists 14 measures which presumably are of highest priority. The Region could be asked to instill a clear priority ranking to ease monitoring and to add the Board and Tranche conditions discussed in paragraphs 8 and 9.

13. With regard to monitoring (paras. 55-56), there are different committees with different responsibilities. There is a risk of "overmonitoring" and focusing on trivial aspects. The question arises whether one should not simplify these monitoring arrangements by having just one committee concentrate on high priority areas (including macrofinancial conditions to be negotiated under the envisaged SAF arrangement) to ensure satisfactory progress.

cc: Messrs. Lee, COD; Shakow, Liebenthal, SPR; Holsen, CEC; Rao, Steer, FRS; Baneth, IEC; Burmester/Thahane, SEC; Baudon, SVPOP; Serageldin, O'Brien, Landell-Mills, Westebbe, Alba/de Wulf, Fares, AFR.

For Information Only

cc: Messrs. Hopper, SVPPR; Fischer, VPDEC; Goldberg, VPLEG; Bock, DFA; Stanton, VPEXT; Frank, Parmar, IFC; Agarwala, AFRVP; Ms. Haug, EXC.

UT

UThumm:vlw

February 12, 1988

Moheen:

My concern about the minimum price we are willing to pay for continuing dialogue was raised by the word "imperative" in para 57.

If we're indeed useful, the Kenyans should find us useful too, and our presence would therefore be wanted by them. The clearer it becomes that we're willing to pay large amounts to be involved, the more we will have to pay to get any policy changes.

Stan.

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

I have a blank spot.

What is the first name of

? Goldberg

Marcello. Selowsky

Population — Donor Countries

3.6

Vaird

Employment

Doubling Italian from 4, 2 %

2/3 rd of the employment from

[illegible]

Privatization

- Fund Stand-by
- Structural Reform need to be done
- Set up Working Group for structural reform
- (Treasury will have to be quarter back)
- Get Commercial banks

Heinz

Land Tenure !

Goldberg

Self limiting lending.

Price lending we are preparing to pay $400.

Merrill

Stanley

Stephens

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

Operational Cuts.

Land Tenure.

SAL 1 & SAL 2

DC Rao, Goldberg / Wilfried

Do what extent are Gov Spend involved

Financing Plan — Hesse

Stanley 180 Brunch Bdg

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

Overextended the implementation -

Kenya by comparison

Grain Marketing:

Brian Kennymore / 83

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

RECEIVED
88 FEB -9 AM 9:22
25178
1.

DATE: February 8, 1988

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

EXTN: 78051

SUBJECT: TUNISIA: Proposed First SAL - Initiating Memorandum

1. The Operations Committee will meet on Wednesday February 10, 1988 at 12.00 noon in Room E-1244 to consider the Initiating Memorandum (IM) for a proposed Structural Adjustment Loan to Tunisia in the amount of $150 million.

2. In FY87 Tunisia availed itself of two sector adjustment loans, each for $150 million, for Agricultural Sector Adjustment and for Industry and Trade Policy Adjustment (ITPAL). Implementation of these loans appears to be progressing satisfactorily.

The Macroeconomy

3. Tunisia's rapid growth in the seventies owed its origins to adequate policy performance, significant workers' remittances, and the contribution of its oil sector with its improved terms of trade. By 1981 petroleum accounted for 38% of exports by value and 19% of government revenues. Things deteriorated in the eighties with the decline in all these factors, and the near depletion of Tunisia's petroleum, aggravated by political uncertainty surrounding Bourguiba's autocratic and prevaricating interventions. Two droughts hit agriculture. The good record of growth had also been marred by capital intensive and sometimes wasteful investments (ICOR rising to 11 in the 1982-86 period); rapid increases in real wages and consumption; low employment creation and almost certainly (notwithstanding the assertion made in para. 2.4 about a real depreciation) by an overvalued exchange rate propped up by receipts which could not be sustained. The social indicators showed persistent improvements, however. Tunisia meanwhile resorted to heavy external borrowing, and by 1986 external debt had reached 60% of GDP.

4. The improvement of the political climate since November 1987, together with the provisions of the Seventh Five-Year Plan (1987-91) which has emphasized an outward looking strategy, augur well for a major drive for policy improvement which this SAL and a projected later SAL (in FY89) would support. GDP is projected under the Plan to grow annually at 4% a year, and exports at 5%, but imports would likely grow much faster than projected (income elasticity of 0.3), while unemployment is expected to remain high. The impact of trade liberalization and the decline of the oil sector would result in pressures that would develop on public revenues, and the balance of payments might worsen also if agriculture failed to grow as projected. Adjusted plan projections yield a slightly different set of outcomes which are presented in Table 1, p. 5.

- The Region may wish to assess the realism of agriculture's projected adjusted annual growth of 4.5% and non-petroleum exports of over 7%. What would these exports be and are there markets to receive them? And is the exchange rate adequate for this high growth?

- What would the impact of slower growth be on the debt service ratio, estimated at 27% in 1990?

- Would creditworthiness for IBRD lending be affected if such a deterioration occurred?

The Adjustment Program

5. Three sets of government instruments are crucial for the program to be supported by the proposed SAL: (a) constrained real wages and civil service employment; (b) better balance between government revenue and expenditure; and (c) an appropriate real effective exchange rate. The exact levels of these variables under the program would be determined at the time of appraisal, and would eventually shape conditionality.

6. Price Decontrols. The SAL would aim specifically at liberalizing the commodity and service markets through reforming the trade and price regimes; introducing new financial instruments to develop and expand the financial markets; and supporting comprehensive fiscal reforms. As of August 1987 46% of the goods (by weight in the CPI) had their prices fixed or determined by the enterprises on a marked-up cost basis. While the SAL would support (with exceptions) the elimination of price controls at the production stage by end-1991, and pursue further liberalization as initiated under ITPAL, it sets a 60% percent liberalization (as compared with 54% in August 1987) as a condition of Board presentation, but it seeks only government commitment to extend the liberalization to the distribution stage.

- The Committee might consider the merit of freeing prices at the production stage while they remain controlled at distribution. Cannot the SAL pursue liberalization at the all-important marketing stage as well?

7. Trade Reforms. The SAL builds constructively on the trade liberalization provisions of ITPAL. It will include a reconfirmation of the commitment to contain tariffs in the 15-41% range by end-1988, and define steps for a gradual reduction of the maximum tariff to 40% by the second tranche and 35% by 1991.

- The Region may wish to explain the significance of the "limitation of the minimum tariff to 15% (para. 3.11) given the fact that the intention is to confine tariffs to the 15-41% range? It might also assess the conditions in which the program as proposed may be difficult to implement, and the chances that the program would remain on course after second tranche release and not be reversed afterwards.

8. Under ITPAL quantitative restrictions would be eliminated on all imports of semi-finished and capital goods by end-1988. The SAL program would attempt to extend this process to consumer goods with the exception of staples subject to the fixed price regime, while setting in motion studies that would reveal concentration in their domestic production, prior to synchronizing price liberalization with QR removal, beginning with the most concentrated items.

- The Committee may wish to question this elaborate procedure. Would it not be possible to seek the gradual removal of QRs on consumer goods without studies? Similarly, is the anti-dumping study proposed necessary?

9. Financial Markets and Fiscal Changes. Ambitious changes are being sought under the program for money market development, reforming the structure of interest rates, the foreign exchange risk of borrowers, and Central Bank supervision of the banking system, as well as long-term savings instruments. These are all worthy objectives, but the Region may wish to explain whether one operation with a limited time-span is capable of bearing the weight of all these improvements. What exactly is to be accomplished in this area before release of the Second Tranche? On the fiscal front, various changes are being proposed, including the introduction of a value added tax.

- Has the fiscal program been agreed with the Fund? And is it realistic to expect by Board presentation (end-June, 1988 or thereabouts) "submission of the draft VAT to parliament? (para. 3.27)?

Social Cost of Adjustment

10. The IM falls short of indicating any social cost to be incurred as a result of implementing the proposed adjustment program. It proposes instead to address such social costs merely by launching two studies: one on the incidence of subsidy reduction and another on the labor markets and employment.

- The Committee might consider if these two studies constitute adequate treatment of this important aspect of the program.

Bank Exposure

11. Present strategy envisages Bank commitments of $290 million a year to Tunisia of which $170 million in adjustment lending (para. 4.4). This is bound to increase Bank exposure in relation to total debt further: to 20% by 1989 rising to 24% by 1991, with preferred creditors' exposure of 29% and 32% respectively. The IM states that such percentages may err on the conservative side, and would probably be lower with greater aid mobilization efforts so that Bank exposure might remain at about 22% in the early nineties.

- The Committee might consider whether such levels of exposure are acceptable.

cc: Messrs. D. Lee, COD; A. Shakow, SPR; J. Holsen, CEC; D. C. Rao, FRS; J. Baneth, IEC; Thahane, Burmester, SEC; R. Liebenthal, SPR; A. Steer, FRS; T. Baudon, SVPOP; D. Hopper, SVPPR; S. Fischer, VPDEC; Bock, DFA; R. Frank, J. Parmar, IFC; M. Haug, EXC; D. Goldberg, VPLEG; Agarwala, AFRVP; P. Hasan, EMNVP; K. Dervis; J. Shilling; W. Grais, EM2.

SESerafy/lcu

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

RECEIVED
88 FEB -9 AM 9:22
25179
1.

DATE: February 8, 1988

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

EXTN: 78051

SUBJECT: KENYA: Country Strategy Paper - Agenda

1. The Operations Committee will meet on Wednesday, February 10, 1988 at 2.30 p.m. in Room C-1006 to consider the Country Strategy Paper (CSP) for Kenya. The Committee may wish to take up the issues identified in this agenda as meriting of discussion.

Background

2. Kenya has had an impressive record of growth over the longer term, and continues to meet its external debt servicing obligations without recourse to rescheduling. It maintains a flexible exchange rate policy which has earned the commendation of the Fund, together with positive interest rates. The first half of the eighties represented a period of stabilization necessitated largely by deteriorating terms of trade as well as drought conditions. The hitherto excellent growth record had then to give way to more urgent considerations. The stabilization process itself suffered paradoxically from the 1986 improvement in the terms of trade, particularly the boom in coffee prices, which led to GDP growth of 6.5% in that year. This temporary respite encouraged a marked deterioration in financial discipline, and the cash deficit of the central government, excluding grants, increased by 4 percentage points to 10.5% of GDP in 1986/87. There was also a parallel deterioration in the current account of the balance of payments. While Kenya's overall economic situation appears still to be manageable, there are structural danger-signs, including an annual population growth rate of 4%, as well as medium-term constraints indicated by the limited success achieved under SALs I and II (respectively in FY80 and FY83) reflecting a certain lack of commitment to policy reform. At a Fund Board Meeting on February 1, at which the Kenya authorities expressed their wish to convert the Standby/SAF proposed arrangements into an Extended Structural Adjustment Facility operation, the Fund Board, though sympathetic, was reluctant to do so for the time-being owing to the feeling that structural adjustment was not being pursued with sufficient rigor.

The Macroeconomy

3. Two scenarios are envisaged: one yielding a 5% annual growth based on policy reforms which would improve resource mobilization and deployment and raise the efficiency of investment, and another which would bring about growth lower than the population increase, thus inhibiting concessional aid and forcing Kenya to seek commercial borrowing which would keep its debt service ratio at 24% by 1995. The latter scenario is said to be "untenable" (para. 41). Much of the source of the high scenario growth would come from projected agricultural growth of 4-4.5% a year.

- The Committee may wish to enquire whether:

  (a) The high growth of GDP and of agriculture as projected is realistic?

  (b) It is too optimistic to project the debt service ratio which was 35% in 1987, at 24% in 1995 in the lower scenario? In other words, does the Region see no danger in a debt service problem developing?

The Proposed Lending Program

4. The CSP proposes a lending program averaging $175 million a year in the period 1988-92, entirely on IDA terms, equivalent to the resources expected to be available for Kenya from IDA and the Special Facility for Africa. No lending on IBRD terms is proposed, essentially because of Bank exposure considerations. The strategy would blend adjustment lending in equal parts with projects, with an average of four operations a year, one of which would be for sector adjustment (e.g., agriculture, industry, education, public sector rationalization). The paper describes the modest success of the two SALs previously mentioned, and attributes this to lack of political consensus and the limited absorptive capacity for policy based lending of Kenya's institutions. The Policy Framework Paper proposals have already been endorsed by the Government (Covering Memorandum para. iv), and there are repeated statements in the CSP to the effect that the dialogue has immensely improved of late. However, there are more than hints that the sectoral reforms that would make up the heart of the proposed Bank strategy may not prove acceptable, in which case lending would be confined to a core program of project financing only -- i.e. at half the level proposed.

- The Region might shed further light on government commitment to policy reforms. As the PFP has recently been endorsed by the Government, and as lack of response to sectoral policy changes would result in loss of IDA money to Kenya, how does the Region assess the relative chances of the two scenarios occurring? Are the higher and downside scenarios of equal probability?

- Is there room for lending on IBRD terms if the higher scenario should materialize?

Longer Term Development Issues

5. The Covering Memorandum identifies longer term issues "critical to the sustainability of development such as poverty, institutional reforms, human capital development, population control and the environment." The CSP's description of the problems in these areas indicates very dim prospects: high pressure of population on resources, shrinking forested land, unemployment, and growing stress on the social services. The CSP does not seem to give commensurate weight to these long term concerns, nor elaborate a convincing strategy that would address these concerns over the next two decades. The population problem by itself deserves a more concerted approach than it receives, with detailed projections of mortality and fertility rates, the labor force, and participation rates as these might respond to a program specifically geared to address them.

- Would the Region sketch a program of studies, technical assistance and lending, intended in the next quinquenium to address these troubled aspects of Kenya's development and indicate steps to be taken in later periods? Could the Region elaborate a little on the focus of the social sector reforms in para. 32 and the likelihood that such reforms would yield tangible results, say by the year 2000?

The Industrial Sector Adjustment Credit

6. The industrial sector of Kenya has rapidly grown, is diversified, but is said to suffer from over protection. It has been highly import-substitution oriented, and, despite a favorable exchange rate, finds it difficult to export. The incentive structure offers better opportunities in the domestic market and penalizes exports. The sector has experienced reduced investments, and the maltreatment of the Asian-Kenyans has also been disruptive. The Region is preparing an Industrial Sector Adjustment Credit for $77 million in the current fiscal for that purpose year, and had circulated an Initiating Memorandum which the OC discussed in early January. The focus of the reforms being pursued under this operation is on trade liberalization and tariff reform, price decontrol, tax changes, and economic access by exporters to duty free inputs.

- In view of the fact that this sector adjustment operation pursues trade liberalization along lines already explored under SAL I and SAL II, the Region may wish to indicate:

  (a) If it expects this operation to be more successful than the earlier efforts;

  (b) Changes from the IM as a result of the appraisal mission that visited Kenya in mid-January, 1988;

  (c) Any update of the cofinancing arrangements (Japan, Netherlands, EEC, UK and West Germany) that were envisaged earlier.

Cost Sharing

7. The Region proposes (Covering Memorandum) that IDA finance up to 80% of all project costs "given the good domestic resource mobilization record, and the overall resource constraints facing Kenya." At the last review (by the OPSC in April 1985) the maximum share of the Bank Group in total project cost in Kenya was set at 75%, and at 85% with cofinancing.

- The Committee may wish to consider the 80% limit, and perhaps modify it if the policy response should prove inadequate for the higher lending scenario.

cc: Messrs. Lee, COD; Shakow, Liebenthal, SPR; Holsen, CEC; Rao, Steer, FRS; Baneth, IEC; Thahane/Burmester, SEC; Baudon, SVPOP; O'Brien, AFRVP; Madavo, Amoako, Lateef, AF2.

For Information Only

cc: Messrs. Stanton, VPEXT; Frank, Parmar, Pfeffermann, IFC; Hopper, SVPPR; Goldberg, VPLEG; Bock, DFA; Agarwala, AFRVP; (Ms.) Haug, EXC.

SESerafy/lcu

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

RECEIVED
88 FEB -9 PM 2:53
25786
1.

Date: February 9, 1988

To: Operations Committee

From: Vinod Dubey, Director, EAS VDubey

Extn: 78051

Subj: GHANA: Financial Sector Adjustment Credit (FSAC)

1. There will be a meeting of the Operations Committee on Wednesday, February 10, 1988 at 3.30 p.m. in Room C-1006 to discuss the Initiating Memorandum-cum-President's Report dated February 3, 1988, on a proposed Financial Sector Adjustment Credit (FSAC) to Ghana for an IDA credit of US$80.0 million. The credit would be in support of a comprehensive program to strengthen and enhance the efficiency of Ghana's financial system, currently handicapped by significant institutional weaknesses in the banking, money and security markets, limited mobilization of financial resources, and deficiences in credit allocation mechanism. The Bank has supported the ongoing adjustment program with a number of adjustment operations, the most recent being the Structural Adjustment Credit approved on April 14, 1987. The adjustment program is broadly on track.

2. The proposed operation has two components: (i) US$75 million equivalent would be in support of ongoing and new policy and institutional reforms, the objectives of which are to (a) improve resource mobilization and allocation; (b) enhance the soundness of banking institutions and (c) restructure financially distressed banks, and (ii) $5 million to finance a comprehensive program of technical assistance to the Bank of Ghana and Consolidated Discount House, training programs, and assessment of the potential for capital market and some studies. Cofinancing of US$100 million is being sought under this project. The Swiss and Japanese Government, and the African Development Bank, are reported to have shown interest, while EIB and the Australian Government are also considering cofinancing in the proposed credit. The credit would be disbursed in three tranches.

3. The Committee may wish to discuss the following:

(a) Objectives and Scope of the Program. At this stage there are a number of priority policy and institutional reforms necessary to overcome the key constraints and major imperfections in Ghana's financial system. Thus the proposed operation envisages measures which aim at (i) enhancing the soundness of banking institutions; (ii) improving deposit mobilization and efficiency in credit allocation; (iii) developing money and secutiry markets and (iv) improving the mechanism for rural financing. This in turn will require remedial actions to change the banking laws and regulations, establish new procedures, adopt improved audit and accounting systems, provide technical assistance to a number of institutions, determine modus operandi and operational framework of many institutions, undertake restructuring of banking institution and through them begin a nationwide program for corporate restructuring. <u>All of these are important and worthwhile measures but how far is this overwhelming array of measures feasible in administrative term and what sequencing is appropriate in terms of achieving the stated objectives of the proposed package.</u>

(b) <u>Macro-economic Context of the Proposed Operation</u>. Issues in the monetary and fiscal area have a direct and significant impact on the working of the financial system. The IMF Board has recently approved the request by the Government of Ghana for a three year extended arrangement (SDR 245.5 million) and a three year structural adjustment arrangement (SDR 129.9 million). Yet the projections (Annex I-1) show that the Government Budget Deficit/GDP ratio will rise from about 4.0 in 1984-87 to about 5.7 in 1988-90. <u>To what extent these large deficit would continue to impinge on the money market, banking system and credit for the private sector and is the Region satisfied that the management of the macro issues will not jeopardize the proposed credit and its intended achievements? Also, how realistic is it to project almost 50% increase in the investment/GDP and Domestic Savings/GDP ratios in three years?</u>

(c) <u>Links between the Informal and Formal Financial Sectors</u>. The proposed operations' main focus is on the formal financial sector. It is, however, clear from the document that formal intermediation in Ghana is low and that in the recent past many firms and individuals reacted to developments in the formal sector by re-channelling their financial resources into the unregulated, informal financial sector. <u>How far does the Region feel confident that a complete isolation of the informal sector from reforms in the financial sector will not make steps in the latter somewhat ineffective especially in light of the recent evidence of strong linkages between the two segments?</u>

(d) <u>The Efficiency of Banking Operations.</u> There are a number of thoughtful components of the proposed reform measures both in the policy and institutional areas which are likely to foster the development of a strong, efficient and responsive financial sector. <u>While there are no significant barriers in the banking law to entry of new banks, is the Region satisfied that there are also no administrative and procedural barriers to entry of new banks and/or smooth exit of those which cannot perform and have to go under</u>.

(e) The IM discusses the fundamental importance of achieving and maintaining the confidence of the public in the financial institutions. In this context it refers to the need for the maintence of secrecy in respect of customer's account, public relations campaign, improving customer services etc. <u>Are these measures strong enough to boost the confidence? Would it not be desirable to study the role of a Deposit Insurance Scheme to</u>

further restore public confidence and improve deposit mobilization?

(f) There are quite a few conditions for effectiveness, some of which like amendments to the Banking Act and other relevant regulations, might take long time and delay disbursements. Could the Region have another critical look on conditions for effectiveness and determine if some of these could be linked to Board presentation.

(g) The financing plan assumes a substantial contribution of the private sector (US$40 million) could the Region explain the method of obtaining these funds and also the link between the financing plan as a whole and the financing needs arising from the restructuring of the banking system?

cc: Messrs. D. Lee (COD), A. Shakow (SPR), J. Holsen (CEC),
D.C. Rao (FRS), J. Baneth (IEC), Thahane/Burmester (SEC),
R. Liebenthal (SPR), A. Steer (FRS), T. Baudon (SVPOP),
D. Hopper (SVPPR), S. Fischer (VPDEC), D. Bock (DFA),
R. Frank, J. Parmar (IFC), D. Goldberg (VPLEG),
R. Agarwala (AFRVP), Koch-Weser (AF4DR), S. Aiyer (AF4IE),
J. Toureille (AF4IE)
Ms. M. Haug (EXC)

FMChaudhri:gs

February 8, 1988

The World Bank
OPERATIONS COMMITTEE

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Minutes of the Operations Committee to consider the draft of the Status Report on the Bank's Support for Poverty Alleviation.

Held on February 8, 1988 in Conference Room E 1244

A. Present

Committee	Others
Messrs. M. Qureshi (Chairman)	A. Shakow (SPR)
V. Rajagopalan (VPPRE)	A. Ray (EAS)
S. Husain (LACVP)	S. Choi (VPS)
C. Koch-Weser (AFRVP)	O. Yenal (AS1VP)
A. Karaosmanoglu (AS1VP)	K. Jay (SPRPA)
I. Shihata (VPLEG)	I. Bannon (AF2CO)
P. Hasan (EMNVP)	Ms. E. Makonnen (SPRPA)
D.C. Rao (FRS)	E. Ribe (AS1CO)
H. Vergin (SVPDR)	T. Baudon (SVPOP)
	H. Scott (VPLEG)
	T. Thahane (SECGE)

B. Issues

1. The Operations Committee met on February 8, 1988 to discuss the draft of the Status Report on the Bank's Support of Poverty Alleviation. The discussion broadly followed the draft agenda prepared by SPR. The main issues included: whether to forward the report to the Board, the general tone and themes of the paper, the treatment of the linkage of growth and poverty alleviation, the relationship of this paper to the forthcoming reports of the Operational Task Force on Poverty Alleviation and on Food Security in Africa, the inclusion of the interim report of the Husain Poverty Task Force and the treatment of the resource costs which would result from an increased emphasis on poverty alleviation programs.

C. Discussion

2. Regarding the relationship between this status report and the work of the Operational Task Forces there was general agreement that this status report did not conflict or create problems. The Committee accepted this report as a useful backdrop to the work of the Operational Task Forces. There was also agreement that the Interim Report of the Poverty Task Force--the Husain report--should be included as an annex to this paper since it provides many useful insights and recommendations and has not to date been provided to the Board.

3. The Committee also felt that greater stress should be placed on the importance of economic growth to the efforts to alleviate poverty; without growth countries will find it extremely difficult to mobilize the fiscal resources on a sustained basis for poverty-alleviation measures. With Sub-Saharan Africa facing many years of limited or no increase in per capita incomes, reducing poverty there will be an especially difficult task.

4. Several members had suggestions on the tone of the paper. Specifically, there was some concern that the paper did not adequately highlight the limits to our knowledge of the poor, of the problems and constraints they face and of ways to effectively improve their standard of living. As a result, the paper might inadvertently raise excessive expectations about what can be done in the near term to alleviate poverty. The Committee suggested that these limitations should be more clearly brought out in the paper, reflecting greater caution and "humility".

5. The Committee also noted that poverty alleviation programs generally require significant Bank resources for ESW, project preparation and project supervision. The paper should avoid any impression that the Bank can significantly increase its poverty alleviation programs without additional staff resources.

6. Several members suggested that the conclusion was too abrupt and needed expanding, and that it might be used to highlight some of the questions which remain concerning poverty alleviation and the Bank's role.

Conclusion

7. The Chairman recommended that the paper, revised in light of this discussion, be forwarded to the Policy Committee and the Board as an interim status report.

KJay/ARay:bmd:vlw
February 17, 1988

The World Bank
OPERATIONS COMMITTEE

CONFIDENTIAL

Minutes of the Operations Committee to consider TANZANIA - Proposed Industrial Rehabilitation and Trade Adjustment Credit held on February 8, 1988 in Room E-1244

A. Present

Committee	Others
Messrs. M.A. Qureshi (Chairman)	Messrs S. Sandstrom (AF6DR)
S. Husain (LACVP)	H. Messenger (AF6CO)
A. Karaosmanoglu (ASIVP)	R. Grawe (AF6CO)
P. Hasan (EMNVP)	D. Kaufman (AF6CO)
V. Rajagopalan (VPPRE)	M. Stevens (AF6CO)
H. Vergin (SVPOP)	F. Chaudhri (EAS)
C. Koch-Weser (AF4DR)	J. Artus (IMF)
H. Scott (VPLEG)	

The discussion of the Proposed Industrial Rehabilitation and Trade Adjustment Credit (IRTAC) centered on six topics: (i) the performance of the economy; (ii) the pace of adjustment; (iii) strategy for the industrial sector; (iv) trade liberalization and the macro-economic framework; (v) the design of the project; and (vi) implications for the financial sector.

Performance of the Economy.

1. The Region reported on economic performance under the Economic Recovery Program (ERP). Tanzania had adhered to macroeconomic and sector policy targets agreed with the Bank and the Fund, and output was increasing, led by a strong supply response in agriculture. However, transport and crop processing bottlenecks and inadequacies in the existing marketing system for food and export crops were constraining the gains from increased production and causing serious strain in the financial sector. In turn, this had caused credit ceilings to be exceeded, preventing a recent Fund mission from completing the third and final review of the standby. The Government recognized the seriousness of these problems and had asked the Bank to assist in defining a phased program of agricultural marketing reform, and would shortly be asking the Fund and the Bank to assist in a financial sector review.

Pace and Nature of Adjustment.

2. The meeting discussed the pace of adjustment. The Chairman suggested that the approach of the Government was rather gentle and incremental given the magnitude of the adjustment required. There is a need for faster and

decisive action to address structural constraints. Several measures and proposed actions (e.g. OGL, tariffs, etc.) need more specificity. However, the Region noted that the Government was now open in recognizing structural problems in industry and agriculture, and believed the leadership was committed to the reform program. In contrast to the past, the Government was now willing to consider a wide range of options and to do this in cooperation with the Bank.

Industrial Sector Strategy.

3. Comments were made on the high prevalence of negative value added firms in the industrial sector and the need to improve resource allocation either by more vigorous action on prices and distribution decontrol, or, if that were not feasible, by improving the administrative allocation system. It was pointed out, however, that since the launching of the ERP significant changes in price signals had occurred. While still far from optimal, levels of effective protection were falling and the differences between the official and parallel market exchange rates and prices were much reduced. Resources were no longer being allocated to inefficient firms on the scale that had occurred earlier, and negative value added firms were being forced to retrench or become more efficient. This process was expected to be intensified during the IRTAC period, as further significant exchange rate movement occurred and facilitated the broadening of the internal and external trade liberalization process. The Chairman pointed out that if inflation remains around 30%, then it would necessitate moving faster on exchange rates. Another speaker pointed out that design and implementation of certain components of the administrative system, e.g. in duty drawback mechanism, could also be improved.

Trade Liberalization and the Macroeconomic Framework.

4. There was agreement on the need to move forward with trade liberalization at a pace that was consistent with the macroeconomic framework changes and requirements. The interdependence between the two was stressed. The Region's expectation was that preparation for an ESAF would be substantially advanced by the time IRTAC was presented to the Board, and that this would provide the required macroeconomic framework for the project to succeed. The Region said it would not present IRTAC to the Board unless ESAF preparations were well in hand, and that successful implementation of a monetary and financial program consistent with the maintenance of appropriate exchange rate movement and fiscal targets. The parallel effort on agricultural marketing reforms would make a crucial contribution to a sound macroeconomic framework. One speaker stressed the need for spelling out other conditions of second tranche release.

Financial Sector.

5. The Committee discussed the implications of industrial restructuring for the financial sector. Concern was expressed by the Fund representative that, following the strains caused by marketing boards, the banking system would find it difficult to withhold funds from industrial firms under stress, and this would further jeopardize credit limits. The Committee endorsed the Region's determination to integrate the restructuring of the industrial sector with work on the financial sector. There was consensus that the role of the

financial sector in the adjustment process was a Bank-wide issue to which more attention should be paid in the design of programs. The linkages between the financial sector and agricultural, trade and industrial restructuring should be a component in the PPR work program.

Project Design.

6. With regard to the design of the project, the Committee felt that in the absence of substantial increases to the conditions of effectiveness, the proposal to front-end load the first tranche was not justified. The Chairman emphasized that not only should there be a clear understanding of conditions but they should be over and above what there is already in place. The pace of reform should be justified more fully and provide a clear view of the long term objectives and the steps necessary to reach it. It was agreed that the policy matrix would show greater specificity and would be re-submitted to the Operations Committee.

February 25, 1988
MStevens and FChaudhri

Decisive.

Strong supply side response

Credit ceilings ~~will~~ have been exceeded

DC Rao:

- Statistical report should be included
- Annex V
- Tone more humility — Greater caution: Growth — poverty — prospects hazards

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Ibrahim: Abdla Helmi

- Use Policy based lending for Human Resource Development.
- Should not downplay the budgetary implications:

1. Reasonable report
2. Since McNamara, we forgot about Poverty. This was understandable. There were other priorities – adjustment. But in Latin America, there is increase in malnutrition; (Brazil) access to education

1

Shihata

We should not make the work of the task force more difficult.

- Put Questions in the "Conclusions"
- We must provide the kind of education which makes a difference to employment e.g technical education
- Questions can be raised about the use of local counterpart for poverty alleviation
- Does not clearly ~~[illegible]~~ show the effect of adjustment lending on poverty areas

Paper for all seasons

Pannex -

Your commitment to this objective is Growth-poverty link very clear
- Why not mention it

Attila:

We are using some surrogates + proxies for Poverty which are not quite right -

Certain aspects such as the above, could be handled better

- We shall soon have to discuss what kind of instruments are feasible

- How can certain poverty-type projects be prepared

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

Anand.

Positive Note –

~~Cairo~~

African Education.

No conflict

Poverty. Other than adjustment lending

Local Currency.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

Mr. Qureshi

Date: February 4, 1988

To: Operations Committee

V. Dubey

From: Vinod Dubey, Director, EAS

Extn: 78051

Subj: TANZANIA: Industrial Rehabilitation and Trade Adjustment Credit - Initiating Memorandum

1. The Operations Committee will meet on Monday, February 8, 1988 at 4.00 p.m. in Room E-1244 to consider the Initiating Memorandum (IM) for a proposed credit to Tanzania for $105 million.

Background

2. The proposed Industrial Rehabilitation and Trade Adjustment Credit (IRTAC) would build upon the progress achieved under the Government's Economic Recovery Program (ERP) initiated in early 1986 and follow the World Bank's Multisector Rehabilitation Credit (MRC) which was approved by the Board on November 30, 1986. A supplementary credit was also approved by the Board in January 1988. Under the ERP several important policy measures were undertaken including adjustments in the exchange rate and interest rates, producer prices for agricultural exports and a program to decontrol domestic prices was initiated. An IMF standby program supported by a Structural Adjustment Facility will end during this month. Under the MRC, the Government initiated important reforms in agriculture such as expanding the participation of cooperatives and other large scale producers in the marketing of export crops, partial liberalizing of the importation and distribution of agricultural inputs, and the raising prices of some agricultural products.

The IRTAC proposes to address allocation issues in the industrial sector as well as a number of economy-wide issues building on the MRC. On trade, the IRTAC covers the gradual liberalization of the foreign exchange allocation system, continuing the domestic price reforms, tax and tariff changes and a reform of export incentives. At a more subsector level, the IRTAC will initiate a process of industrial restructuring and rehabilitation beginning with the textile and leather industries.

Since the launching of the ERP, Tanzania has been able to raise GDP growth to 4% per year compared to 0.6% per year in 1980-85 period, when per GDP capita declined. Agricultural output and exports have also increased substantially due to good weather and improved incentives. However, despite these improvements, the underlyings policy framework is still weak. Inflation although stable remains at about 30% per year, the overall budget deficit is estimated at 8% of GDP, and many price and employment freezes remain in effect. The Government encountered difficulties in implementing the IMF standby program in 1987 when net domestic assets ceilings were breached. While the increase in credit reflects in part success achieved in agricultural production, macroeconomic stability is a concern in the near and medium term.

Macroeconomic Stability

Macroeconomic stability is an important ingredient of the reform program relevant not only for the success of the IRTAC but the entire reform effort.

- How does the Region propose to ensure that the macroeconomic situation is kept under review, since the current IMF standby is to end in February 1988?
- Will the Region consider the Government's agreement to another IMF SAF before Board presentation of IRTAC? If not will it include macro-economic conditionality in this operation?

Will IMF stay
Is that a precondition?

The Exchange Rate Regime

Despite the reforms undertaken under the ERP and further refinements made under the MRC, which included on-going exchange rate adjustments and provision of some own funded imports, the substantial part of the exchange rate allocation is administratively determined based on a priority list.

- Given that the inflation rate has remained at 30% per year, and could possibly accelerate should not the equilibrium rate that is to be achieved by mid 1988 be raised to reflect inflation and the reform of the trade regime?
- Should not the Government aim at an exchange rate system in which the administratively determined allocations are replaced by a faster opening up of the Open General License window than what is presently visualized?

Can we not move more carefully on macro policy changes.

The Restructuring Strategy

Based on detailed and high quality analytical work done by the Region, inefficient industries and firms have been identified for restructuring.

- Is such a firm by firm approach to restructuring the industrial sector feasible beyond a few operations?
- Could the Region consider greater reliance on price signals to induce shifts in resource uses rather than depend on fine tuned re-adjustment and restructuring efforts?

Are we spending a lot of time on small pickings.

Implementation:

The IRTAC recognizes that the many elements of the overall reform program must be present for the credit to achieve its goals. These elements include the proper coordination of macroeconomic policies with the reforms of the incentive system including the sequencing of exchange rate, tariffs and domestic price reforms. ✓

- Does the Government have the commitment and capacity to implement such a multi-phased and multi-sector adjustment effort without jeopardizing some important components of the program?

Conditionality and Tranching

Various actions are stipulated to be undertaken before Board presentation and the release of the second tranche (See paragraphs 30, 35, 38).

- Could the Region consider establishing specific conditionality to speed up the OGL window to a higher proportion of untied imports?

- Would the Region consider equal tranching to achieve more actions on the exchange rate and price decontrols in the first phase of the credit rather than front load the tranche releases.?

cc: Messrs. Koch-Weser, Sandstrom, Messenger, Kaufmann, Lee, Shakow,
Holsen, Rao, Baneth, Thahane/Burmester, Liebenthal, Steer,
Boudon, Fischer, Hopper, Bock, Parmar, Frank, Goldberg
Ms. Haug

SRajapatirana:gs

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: February 5, 1988

TO: Mr. Moeen A. Qureshi

THROUGH: Mr. Vinod Dubey, Director, EAS

FROM: Anandarup Ray, Adviser, EAS

EXT: 78073

SUBJECT: Draft Status Report on the Bank's Support for Poverty Alleviation

1. This is a well-written paper intended to describe the lessons and directions of the Bank's experience with efforts to alleviate poverty. There are plenty of caveats and qualifications. Paragraph 12 makes it clear that it is only an interim report pending the reports of the Jaycox and Karaosmanoglu task forces.

Nonetheless the following general issues might deserve further consideration:

- can we bring out in a more emphatic manner the weak empirical basis for saying anything very much on this subject? Very little is known as a matter of fact. Even in a statistically sophisticated and allegedly poverty-oriented country like India, there is no reliable empirical measurements of poverty trends. When it comes to the fluctuations of the 1980's in the HICs we have to be even more modest about generalizations. This means that (a) we need to err on the side of humility in our casual empiricism; and (b) we should push harder to institute poverty monitoring;

- the linkage between poverty and growth is very lightly treated. This question is not one of long-run "trickle down" etc. The link between growth and equity (food security) is immediate in the sense that without growth the countries are not going to get the fiscal resources to devote to poverty-alleviation measures on a sustained basis;

- in that context we could have said more about the role of external resources in Sub-Saharan Africa. It is difficult to contemplate any significant progress against poverty in that Region as long as expected per capita income growth remains close to zero or negative.

ARay:vlw

Mr. Qureshi

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: February 3, 1987

TO: Operations Committee

FROM: Alexander Shakow, Director, SPR

EXTENSION: 34697

SUBJECT: Status Report on Poverty Alleviation -- Proposed Agenda

The Operations Committee will meet on Monday, February 8, 1988, at 5:00 p.m. to discuss the Status Report on the Bank's Support for Poverty Alleviation.

Background

This report was originally designed as an expansion of an interim report, prepared last April, by the Poverty Task Force chaired by Mr. Shahid Husain. Mr. Husain's report was never sent to the Board, but a report was promised Executive Directors by Mr. Conable. It soon became evident, however, that views on poverty were too varied for PPR to simply "complete" the Task Force's work. As a result, this document has become a "status" report which builds on the work of the Task Force and other background material. The formation in November of two new operationally-oriented task forces on poverty and food security further strengthened the need to make this a status report. It is now described in Section II as one in a series of Bank reports on poverty dating back to the early 1980s and as a stepping stone to the forthcoming reports of the Karaosmanoglu and Jaycox Task Forces.

Items for Discussion

1) Many Board members seem to be seeking a definitive statement on poverty. This paper was never intended to do this, although it summarizes much of what has been learned in many aspects of the Bank's work. The report is selective in the issues it highlights, in part as a follow-through to the priority areas established by the Husain Task Force (generally highlighted in Section IV). Other areas could, of course, have been selected. Do members of the committee find the contents generally consistent with key elements of the Bank's role in poverty alleviation?

2) As noted above, the report is intended as a stepping stone to the forthcoming reports of the Poverty and Food Security Task Forces. Do the comments and suggestions in this report create any potential conflicts or are they likely to be complementary, as intended? Is a stronger link to the Poverty Task Force needed -- e.g., by including its terms of reference as a background document?

3) The paper includes as Annex 4 the interim report by the Husain Task Force. This report contains many useful insights and recommendations which have not previously been provided to the Board. It also contains a candid critique of the Bank's program and refers to several suggestions which are not currently contemplated (e.g., $25-30 million annually for NGO programs). Are there any problems in including this letter in the report?

4) Intensifying the Bank's poverty alleviation efforts at a time of severe resource constraints means that budgetary trade offs may have to be made and other important Bank activities receive a lower priority. The paper does not specifically address this budgetary question as we do not believe it can be answered in a global fashion; presumably there will need to be many hard choices by managers. The Board may ask where the Bank sees trade-offs being made, and this may come up more overtly with the forthcoming operationally focused reports on poverty and food security. How should this question be addressed if it arises?

5) The paper notes the important role which NGO's and the private sector can play in the Bank's poverty alleviation efforts as well as the efforts being made by the Bank to work more closely with the NGO's. Some have argued that the potential for using NGO's in the Bank's poverty alleviation efforts is limited and often overstated. Does this version present the opportunities in a balanced fashion?

6) Is the "regional differences in poverty" section (Annex 1) a fair, albeit brief, summary?

KJ/mcb

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: February 1, 1988

TO: Operations Committee Members

FROM: Alexander Shakow, Director, SPR

EXTENSION: 34697

SUBJECT: Draft Status Report on the Bank's Support for Poverty Alleviation

RECEIVED

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25067

1

The attached draft will be reviewed on February 8, 1988, at 5:00 p.m. It is currently scheduled for Board consideration on March 3.

This report was originally designed to be an expansion of an interim report, prepared last April, by the Poverty Task Force chaired by Mr. Shahid Husain. Mr. Husain's report was never sent to the Board, but a report was promised Executive Directors by Mr. Conable. It soon became evident, however, that views on poverty were too varied for PPR to simply "complete" the Task Force's work. As a result, this document has become "a status" report which builds on the work of the Task Force and other background material. The formation in November of two new operationally-oriented task forces on poverty and food security further strengthened the need to make this a status report rather than a Task Force report. It is now described in Section II as one in a series of Bank reports on poverty dating back to the early 1980s and as a stepping stone to the forthcoming reports of the Karaosmanoglu and Jaycox Task Forces.

This report has benefitted from useful suggestions by various staff, including members of the old and new Poverty Task Forces. As it stands, it provides reference material on previous Bank reports on poverty, records experience in various sectors and functional areas, and indicates changes that are underway in Bank policy and practice.

Attachment

P-1866

February 3, 1988

Hinkle:

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

Technical Assistance Projects

Cotton Sector Rehab Credit

BLETC

Mozambique

I have a mental gap —

What is the name of

Attila's Chief Economist.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

RECEIVED
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1.

DATE: January 29, 1988

TO: Operations Committee t-for pull

FROM: for Vinod Dubey, Director, EAS

EXTENSION: 78051

SUBJECT: Chad - Financial Rehabilitation Credit (FRC); Initiating Memorandum - OC Meeting Agenda.

1. The Operations Committee will meet on Wednesday, February 3, at 3:00 p.m. in Room E-1244 in order to discuss the above-referenced document which was circulated on January 20, 1988 under separate cover. The amount proposed in support of the FRC is US$ 42 million: US$ 32 million from the Special Facility for Africa and US$ 10 million from IDA. It is likely that the Region will recommend an increase in the IDA amount by US$20 million. The African Development Bank (AfDB) may provide up to an additional SDR 30 million in cofinancing.

Background

2. Over the better part of two decades, Chad has experienced serious economic and financial difficulties, largely attributable to successive droughts and intermittent warfare. The armed conflict which took place during 1979-82 had a major and enduring impact on the country's economy which has a weak and narrow productive base: real GDP declined by almost 20 percent; most industries cut back or halted production; and a large part of the economic and social infrastructure was destroyed or deteriorated for lack of maintenance. Since 1983, considerable progress has been achieved in rebuilding the economy despite a severe drought in 1984-85 and falling prices for cotton, Chad's most important export commodity, in 1985-86. However, both the long and short-term outlooks for the economy remain difficult. Real GDP growth in 1987 amounted to less than one percent and large internal and external imbalances continue in evidence. The Government is responding to these economic problems through a medium-term adjustment program which was outlined in Chad's Policy Framework Paper for 1987-90, circulated to the Board in May 1987. An IMF Structural Adjustment Facility in support of the Government's program was approved in October 1987.

Longer-Term Prospects and Bank Country Strategy

3. The IM notes the extreme poverty of Chad (a per capita income of US$ 160) as well as several important structural constraints to future economic growth (paras. 10-16). Although not specifically mentioned in the IM, an increasing population growth rate and emerging environmental problems would also appear to be important constraints.

> In light of the formidable constraints to sustained growth in Chad, the Region may wish to brief the Committee on its longer-term country strategy, particularly on the complementarities

between the FRC and other ongoing and proposed operations. Is it intended that the FRC would be followed by a more comprehensive adjustment operation? If so, what would be the proposed timing and content of such a follow-up operation?

Public Investment Program

4. The IM reports that considerable progress has been made in the past two years regarding the formulation of a public investment program (PIP), and concludes that the 1988 program is "basically sound and meets the Government's stated development policies" (para. 23). It is also mentions that a few projects do not support official development policies or are questionable in financial or economic terms.

How large a proportion of the PIP do the questionable projects constitute? Is the deletion of these projects from the PIP a condition of the FRC? How would resources freed by the deletion of these projects be reallocated?

According to the recent CEM, it would appear that many existing investments urgently require rehabilitation and maintenance. Given this fact, why did the Region opt for a financial rehabilitation credit rather than a RIC or similar type operation? Are resources from the FRC to be allocated to rehabilitation and maintenance? If so, what are the amounts and sectoral priorities?

Cotton

5. Pricing issues. In para. 34, the IM states that the long-term objective of the reform program is to introduce a pricing formula linking producer prices of cotton to the world price. It is not clear, however, what is planned to be achieved in this area through the FRC. Also, the relationship of cotton pricing to the pricing of other agricultural products, and the probable effects of a new cotton price policy on production decisions and cropping patterns is not discussed. Para. 35 points out that the increase in ~~import~~ input prices is reducing the incentives for cotton production, but recommends maintaining producer prices at current levels for the 1988-89 season. A convincing rationale for this is not presented. In light of the above, the Region may wish to brief the Committee on:

(a) the pricing mechanism, or alternatives, considered to be satisfactory to IDA;

(b) the linkages between price structures and policies for the main crops competing with cotton for land and/or labor; and

(c) the analytical support for the expected production and financial impact of the proposal to leave cotton producer prices unchanged for the 1988-89 season.

6. Arrears of COTONTCHAD. Arrears, mainly to the Central Bank (BEAC), currently total about US$ 146 million. This issue is portrayed in the IM as one of Chad's most serious financial problems (paras. 39-40).

However, the strategy for dealing with this problem appears somewhat vague: no financial workout is provided showing the proposed contribution of the FRC, other donors, possible debt rescheduling/forgiveness on the part of the BEAC, and any remaining gap. While various scenarios involving rescheduling/debt forgiveness on the part of the Central Bank are discussed at the beginning of para. 40, the reader is later informed that all such approaches would require a special decision by the Heads of State of member countries which might be difficult to obtain. The solution to the arrears problem thus will likely depend on the willingness of donors to refinance this outstanding debt on highly concessional terms.

> The Region may wish to brief the Committee on its current short and longer-term strategies for dealing with the arrears problem, including the status of negotiations with other possible donors. If donor support is found to be weak, up to what amount is the Region willing fill the gap with funds from the FRC? Does the Region consider the proposed French contribution of CFAF 12 billion to be reasonable given the proposed large IDA and AfDB contributions?

Social Dimensions of Adjustment

7. The IM points out (para. 44) that per capita income is likely to decline slightly during the FRC implementation period. The proposed way to mitigate this problem is through supporting the operating expenditures of key ministries and through various socioeconomic studies (paras. 44 and 45). No mention is made of any attempts to redirect public services toward the poor.

> What is the state of knowledge on the extent to which the poor have access to basic public services in Chad? Are programs particularly directed to the needs of the poor to be given preference when allocating FRC funds in support of Government operating expenditures?

Procurement

8. Procurement is only briefly touched upon in para. 47. The Region recommends retroactive financing up to 20% of the credit amount for imports during the four months preceding credit signing. This is within current IDA guidelines. However, the Region might wish to explain:

(a) who is responsible for procurement;

(b) whether existing procurement practices are satisfactory; and, if not,

(c) whether any reforms are being proposed as part of the FRC.

cc: D. Lee, COD; V. Dubey, EAS; A. Shakow, SPR; J. Holsen, CEC; D.C. Rao, FRS; J. Baneth, IEC; Thahane, Burmester, SEC; R. Liebenthal, SPR; A. Steer, FRS; T. Baudon, SVPOP; D. Bock, DFA; R. Frank, J. Parmar, IFC; D. Hopper, PPR; M. Haug, EXC; D. Goldberg, VPLEG; R. Agarwala, VPAFR; M. Gillete, AF5DR; L. Hinkle, F. Laporte, R. Bendokat, E. Goldstein, P. Annez, AF5CO; S. O'Brien, AFRVP; McLoughlin/Briffaux, IMF

DMahar:pl

MR. Qureshi

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

RECEIVED

88 JAN 29 PM 12:41 25021

DATE: January 29, 1988

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

V. Dubey

EXT: 78051

SUBJECT: GUINEA - Country Strategy Paper cum Initiating Memorandum for a Proposed $60 million Second Structural Credit - Agenda

1. The Operations Committee will meet on Wednesday, February 3, 1988 at 4:00 p.m. in Room E-1244 to discuss the CSP for Guinea and the IM for the second SAC for $60 million. The Operations Committee may wish to discuss the CSP related issues raised in paragraphs 3-9 and those specifically related to the proposed Second SAC raised in paragraphs 7-9.

Country Strategy

2. Background. During the past several years, Guinea has made remarkable progress in adjusting its economy from a highly interventionist to a more flexible and market-oriented system. Changes have been far-reaching and difficult, and initial results are encouraging. The Region proposes a balanced assistance strategy that builds on the initial success of the adjustment program and would support the continuation, consolidation, and broadening of the process, while at the same time aiming at accelerated growth through increased investment in critical sectors. It proposes a $519 million lending program for FY88-91, with about 22 percent allocated to fast disbursing policy-based credits and the rest in support of agriculture (20 percent), infrastructure (32 percent), industry and energy (12 percent), human resources (10 percent), and policy-oriented technical assistance (4 percent). The proposed strategy and lending program address the country's needs in an adequate and balanced way. However, questions may be raised with regard to the medium-term scenario and the proposed lending volume.

3. Medium-Term Scenario. The CSP presents projections up to 1991 built around GDP growth averaging 3.8 percent p.a., heavily relying on agricultural recovery and a major increase in public and private investment. It identifies as a major weakness Guinea's heavy dependence on bauxite and alumina exports which are projected to stagnate. As a consequence, overall government revenues (excluding grants) are projected to decline relative to GDP, from 15.4 percent in 1987 to 14.1 percent in 1991. Several questions arise in this connection, which might caution against a too ambitious strategy and lending program::

(a) given this fiscal constraint (which already factors in a substantial increase in non-mining taxation), the Region could be asked to reassess the proposed increase in government capital spending from 9.9 percent of GDP in 1987 to 14.4 percent in 1991 (average real increase on the order of 14 percent p.a.) particularly since this will also result in increased current expenditures in the future;

(b) given the proposed increase in government capital expenditure, the Region should explain the assumptions underlying the projected increase in current expenditures which is modest, e.g., outlays for goods and services would increase by only 5.6 percent p.a., at current prices, with an actual 2-3 percent decline in real terms; and

(c) it seems that as a result of the 1986 rescheduling the debt-service burden increases towards the end of the projection period. The Region could be asked to present projections beyond 1991 to present a clearer perspective which would also allow to better assess the impact of increased government spending over the next several years.

4. Size and Structure of the Lending Program. The proposed structure of the lending program is balanced and addresses the priority development needs of Guinea adequately. A question could be raised whether it would not be feasible and appropriate to advance the proposed FY91 $35 million rural infrastructure project in light of the weaknesses identified in the CSP and the high priority of agricultural development and greater equity.

5. The more important question, however, refers to the proposed FY88-92 lending volume of $519 million (about SDR 379 million) or about 70 percent above the IDA country norm. Considering that Guinea is a debt-distressed low-income country, there seems to be a case to support the Region's submission. The Committee may wish to postpone a final decision on the proposed lending volume for reconsideration in the context of overall IDA allocations.

Initiating Memorandum

6. Objectives of the Proposed SAC II. The proposed SAC would support the continuation and consolidation of Guinea's adjustment process focusing on: (i) the improvement of public finance; (ii) the further rationalization of the civil service; (iii) the incentives framework; and (iv) some complementary areas, particularly the social dimension of adjustment. Several questions arise with regard to the macroeconomic framework and the scope and timing of specific actions.

7. Macroeconomic Framework. The CSP cum IM correctly emphasizes the importance of public finance management (in its various dimensions), with particular attention being given to revenue enhancement and expenditure control. However, the revenue measures discussed in the paper lack specificity and may not be strong enough to attain the targets suggested in the projections. Moreover, the overall macroeconomic stance is not spelled out clearly in the paper. Could the Region:

(a) elaborate on the revenue measures, assess the feasibility of the introduction of additional measures (including new taxes), and possibly set a specific revenue target (or a range) in the conditions for second tranche release?

(b) explain its views on exchange and interest rates (adequacy of levels and management). The Region should also comment on the use and timing of the PFP process to ensure a joint Bank-Fund view on the macroeconomic framework.

8. Risks. The Region spells out a number of serious political and economic risks that may threaten the success of the adjustment process. Against this background, is it realistic to assume a further reduction of the civil service to 47,500 from the current number of about 74,000 (at the end of 1987) as a condition for second tranche release?

9. Tightening of Actions. With regard to the actions summarized on p. 27, some screening and strengthening may be appropriate:

(a) Is a study on interest and exchange rate policy needed before agreeing on any action and, if so, could one not expect concrete action for second tranche release rather than just agreement on an action program?

(b) In the area of public enterprises, could some of the envisaged actions be advanced to allow a progress review for second tranche release rather than only agreement on future actions?

(c) In the area of government revenues, could additional measures be identified and implemented to reach the revenue projections and make those a specific target for tranche release (see 7a)?

cc: Messrs. Lee, COD; Shakow, Liebenthal, SPR; Holsen, CEC; Rao, Steer, FRS; Baneth, IEC; Thahane/Burmester, SEC; Baudon, SVPOP; Serageldin, O'Brien, Landell-Mills, Westebbe, Atinc, AFR.

For Information Only

cc: Messrs. Stanton, VPEXT; Frank, Parmar, IFC; Hopper, SVPPR; Goldberg, VPLEG; Bock, DFA; Agarwala, AFRVP; (Ms.) Haug, EXC.

UThumm:vlw