Folder Title:	Mr. Moeen Qureshi - Operations Committee Files - Meeting Files
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Series:	Operations Committee records of the Chairman (Moeen Qureshi)
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M. QURESHI'S
OPERATIONS CMTE

October - November 9, 1988

November 9, 1988

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Operations Committee

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Minutes of the Operations Committee Meeting (Continuation) to consider the Brazil: Proposed Financial Adjustment Loan I held on November 11, 1988 at 10.00 a.m. in Room E-1243

A. Present

Committee		Others	
Messrs.	M. Qureshi (Chairman)	Messrs.	E. Abbott (LEGLA)
	K. Jaycox (AFRVP)		A. Choksi (LA1DR)
	H. Scott (VPLEG)		V. Dubey (EAS)
	O. Yenal (ASIVP)		K. Ebiri (CL2DR)
	W. Thalwitz (EMNVP)		F. Earwaker (SPRPA)
	V. Corbo (CECMG)		V. Garcia (LA1TF)
	H. Vergin (SVPOP)	Ms.	V. Garcia-Zamor (LACVP)
	A. Steer (FRS)		R. Lamdany (DFS)
			R. Mosse (LA1TF)
			S. Mitra (FRS)
			M. Munasinghe (LA1IE)
			C. Michalopoulos (EMNVP)
			S. Rajapatirana (EAS)
			S. Weissman (LA1DR)

The Chairman noted that this was a continuation of the meeting that was held on November 9, 1988 to discuss the Brazil financial sector loan. The Regional staff had briefed the Committee on the macroeconomic situation at that meeting. The discussion that was resumed centered around the lending strategy, macroeconomic stability, the interest rate structure, financial market distortions and the timing of the operation.

Lending Strategy

In response to the issue raised by a Committee member whether this loan would put the Bank's lending program in the upper range described in the Brazil Country Strategy paper, the Regional staff replied that it would not do so. The level of lending consistent with the financial sector adjustment loan I and the second power sector loan would put Bank's total lending to Brazil in the lower range of the approved lending strategy. The upper range strategy entailed a lending level of $2.8 billion a year.

Macroeconomic Stability

The Committee raised the issue of macroeconomic stability which would be a prerequisite for a viable financial reform package. Moreover, since Brazil had failures in its recent stabilization efforts, there was a need to go beyond the announcement of a stabilization program to undertake the loan. The Regional staff agreed that macroeconomic stability was crucial to this operation and as described in the Country Strategy Paper they would go ahead only after measures are undertaken and not merely when they were announced.

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Besides, the region would assess the adequacy of the stabilization package before bringing the loan to the Board. Furthermore, the presence of a IMF standby was a pre-condition for the loan to go ahead.

The Regional staff would consider an adequate macroeconomic package as one which included elements such as the reduction of the operation deficit to 2% of GNP, a declining inflation rate to about 10% per month. However, the Regional staff also felt that there were elements in the loan that would contribute to the stabilization effort. These were the reduction and convergence of required reserves that will bring greater stability of the money stock (by making the money multiplier stable) restraining directed credit that will reduce the fiscal deficit by some 900 million dollars a year and the move towards market interest rates. On the other hand, there were measures in the loan that were neutral as to their impact on macroeconomic stability, such as free entry into the banking system and provisions for deposit insurance. As an aside, the Chairman introduced a note of caution on deposit insurance. It was not feasible without proper bank supervision.

Interest Rate Structure

The Committee queried the loan's proposed lending rate for directed credit which was to be 6% over the OTN (a monetary correction index). The Regional staff responded that it was equivalent to the deposit interest rate and constituted a floor to which all official lending rates was pegged. At present it is at 6%. This rate was arrived at as a second best and an interim measure on a path towards market oriented interest rates. There are no market determined long-term rates in Brazil at present. The saving deposit rate appeared a logical anchor, as it implied the cost of funds to the Government. There were many other rates in the directed programs that were negative in real terms and a positive 6% constituted a movement to more realistic interest rates.

The Chairman pointed to the possibility that given effective stabilization measures that would lead to a decline in inflation rates, real interest rates could rise quickly due to indexation. The Regional staff explained that since the OTN rate was changed monthly, high real rates may not persist and in any event, they will investigate the possibility of an appropriate de-indexation measure.

Financial Market distortions

A Committee member raised a question regarding the loan's priorities in addressing the various financial market distortions. The wide range of required reserve and interest rate controls were significant distortions. But there were other distortions that appear to be more important than the ones addressed in this loan. How was one to assess the priority given to reducing one set of distortions rather than others? The Regional staff indicated that other distortions were related to the state banks (those of nine states have been taken over by the Central Bank recently), a large number of directed credit programs, official credit lines from the development banks and a major problem is housing finance. This particular set of distortions (i.e.

required reserves, directed credits and partial interest rate reforms) were being addressed first, because they would help with the stabilization effort and because politically it was difficult for the Government to address them. The Region proposes to tackle the remaining distortions in a subsequent loan.

Timing of the Operation

A number of Committee members raised the question of timing of the operation. This was clearly related to the macroeconomic situation. Was it feasible to make a loan in mid 1989 without taking into account the progress Brazil would have made in stabilizing the economy? The Regional staff stated that uncertainty in the macroeconomic situation was a fact of life in working on Brazil. Consequently they have adopted a parallel track, to prepare projects and to go ahead only when a satisfactory macroeconomic program as the one described above is in effect.

The Committee also wanted to know the yardstick that the region would use to measure macroeconomic progress. The Chairman raised the issue of what will trigger the operation? Two scenarios were described by the Regional staff. A strong program of zero operational budget deficit, inflation of 5-10% a month by the middle of 1989, strong monetary measures and the adoption of a viable de-indexation formula. The less strong but an adequate package would be a 2% operational budget deficit, a stable inflation rate of around 10% a month, with strong monetary policies and a change in indexation rules. The Region would be willing to go ahead with the latter package if it were acceptable to the IMF.

A Committee member suggested that depending on the progress on the stabilization program the Region may want to reconsider the various elements in the project in so far as they interacted with the stabilization program. The Regional staff agreed that this could indeed be the case.

In summarizing the discussion the Chairman made the following suggestions:

(i) The Region may proceed broadly on the lines indicated at the meeting, provided that there is an adequate macroeconomic package in place.

(ii) If the macroeconomic situation is adequate but the Region finds that some of the design element needs to be changed at the margin, the Region could do so but inform the Committee as to these changes.

(iii) But, if there is a change in the structure and content of the loan, the Region will need to come back to the Committee to have the loan discussed further.

(iv) The Region could go ahead with the amounts indicated as this is consistent with the lower range described in the Country Strategy Paper. We should not lose sight of some positive elements in the picture such as the large trade surplus and that hyper-inflation has been avoided.

(v) In the specification of the loan the Region should bring out more clearly the purpose and rationale for the loan, what distortions are being addressed now, what were to be addressed later and the loan's contribution to macroeconomic stability.

November 22, 1988
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The World Bank

Operations Committee

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Minutes of the Operations Committee to consider BRAZIL: Proposed Financial Sector Adjustment Loan and the discussion of the Brazil Second Power Sector Loan held on November 9, 1988 in Room E-1243

A. Present

Committee		Others
Messrs. M. Qureshi (Chairman)	Messrs.	E. Abbott (LEGLA)
K. Jaycox (AFRVP)		A. Choksi (LA1DR)
I. Shihata (VPLEG)		F. Colaco (VPPRE)
J. Wood (VPFPR)		V. Dubey (EAS)
O. Yenal (ASIVP)		F. Earwaker (SPRPA)
C. Michalopoulos (EMNVP)	Ms.	M. Garcia-Zamor (LACVP)
V. Corbo (CECMG)		V. Garcia (LA1TF)
H. Vergin (SVPOP)		A. Heron (COD)
		F. Kilby (FRS)
	Ms.	M. Koch-Weser (LA1CO)
		R. Lamdany (DFS)
		R. Mosse (LA1TF)
		S. Mitra (FRS)
		M. Munasinghe (LA1IE)
		G. Nankani (LA1CO)
		D. Papageorgiou (LA1TF)
		K. Piddington (ENVDR)
		S. Rajapatirana (EAS)
		K. Siraj (COD)
		J. Taylor (DFS)
		T. Thahane (SECGE)

At the start of the meeting the Chairman invited comments on the Brazil Second Power Sector Loan and indicated that the Committee could discuss the macroeconomic situation which was germane for both operations before considering the initiating memorandum for the Brazil Financial Sector Adjustment Loan I.

The discussion of the Second Power Sector Loan centered on five principal topics: (i) the loan's history and features; (ii) economic and financial issues; (iii) environmental issues; (iv) conditionality (v) macroeconomic situation.

(i) The Second Power Sector Loan: Its history and features

The proposed loan had been approved for negotiations by the former Loan Committee in February 1987 and the first round of negotiations took place in May 1987. There has been a hiatus in the discussion due to the major macroeconomic changes in Brazil such as the Cruzado and Bresser Plan. But technical discussions on the sector continued which had strengthened the original project design. The principal purpose of the loan is the rehabilitation of the power

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sector. This is to be achieved through a power sector rehabilitation program. Under the loan, tariffs would be increased from 90% of marginal costs (prevailing today) to full realization of marginal costs by the end of 1989. The loan also contained an environment action program, that followed up on progress achieved under the Environmental Master Plan study initiated by the First Power Sector Loan (in 1986).

About 6-8 weeks ago the Government of Brazil unilaterally and suddenly gave the ELECTROBAS/FURNAS the responsibility for nuclear projects. The Bank has not had any involvement in the nuclear sub-sector before. Given the change, the Bank wants to make sure that the nuclear program is consistent with the financial, economic and environmental safety objectives of the proposed loan, and proposes to reach agreement with the Government on the main issues that are relevant for the nuclear program. Under the proposed loan conditions, the Government will agree to a moratorium on the construction of ANGRA III nuclear plant of which about 5% has been already constructed. Second tranche release will be subject to the completion of a detailed study on the economic feasibility of the plant, and a firm decision on resumption or indefinite postponement of further construction based on the findings of the study. Additional conditions concerning the financial and environmental/safety aspects are also proposed.

(ii) <u>Economic and Financial Issues</u>

A committee member raised issues relating to the size of the investment program, in relation to demand, the absence of thermal generation in the least cost solution and delays in the start up of the ANGRA I nuclear plant.

The Regional staff indicated that demand growth had been high in the past (around 9-10% per year), and was scaled down to a conservative value of 6% for the future. There was also a catch-up factor involved due to past under-investment in the sector, and some new capacity creation (low plant factor) has to take into account the seasonal nature of hydro-power generation. The main reason for building hydro-electric power capacity rather than thermal capacity was that the former was relatively cheap while natural gas was scarce and used by higher value users and would not be available in sufficient volumes for thermal power generation until 2000. ANGRA I was delayed because of technical difficulties with the plant rather than due to implementation weakness in Brazil. The Region assured the Committee that the costs and rates of return estimates for the investment program had been carefully estimated taking into account various options and that the least cost solution that was presented was analytically robust.

Another member of the Committee raised the question of subsidies to the sector, to the extent that the Bank financed equity in the power authority to enable it to meet financial covenants which would not otherwise be met due to the addition of nuclear plants. The Region responded that no economic subsidies would be involved when 100% of the marginal costs are being recovered. However, to the extent that no utility attempts 100% of self-financing, some equity financing would continue.

(iii) Environmental Issues

A number of Committee members raised issues relating to the environment. These issues were concerned with the Bank's involvement in a nuclear sub-sector for the first time in any country, the absence of expertise in the Bank to evaluate the technical feasibility of nuclear plants, the high risks of operations in the nuclear sector and the ability of the Brazilian authorities to implement an environmentally sound program both in respect of the nuclear and the non-nuclear power sectors. The member also asked whether providing a loan to a sector which involves nuclear plants begs the underlying policy issue which is still under discussion and noted that if the loans would finance a negative list, that the latter should exclude any imports related to the nuclear sub-sector unless the general policy issue is resolved positively by then.

The Regional staff indicated that the loan was not directly financing the nuclear program, but that a least cost solution for the whole sector had to take into account the presence of the nuclear plants. The economic feasibility study of these plants was relevant for Bank operations in the power sector, as they are now included within the sector. While the Bank did not have the technical expertise to evaluate feasibility of nuclear plants and their safety standards, the regional staff assured the Committee that they will hire outside expertise to evaluate the feasibility and safety of the nuclear plants to conform to highest international standards. They would get assistance from the International Atomic Energy Commission for the purpose. The Regional staff agreed with the view expressed by a Committee member that an outside (independent) review of regulatory practices and safety standards relating to nuclear power in Brazil was required. The Region shared the concern of the Committee regarding the implementation capability of the Brazilians institutions to carry out an environmentally sound program. However, there is a new and genuine concern for the environment among the high echelons of the Brazilian Government. The loan itself would ensure that the institutions charged with the responsibility for environmental safety will be strengthened. Recently the authorities hired some two hundred new environmental personnel into power sector institutions.

(iv) Conditionality

A Committee member raised the issue of conditionality in the proposed loan. He felt that there could be inconsistencies in the conditions stipulated in the first and the second power loans. In particular the second loan appeared to have more stringent conditions. The Regional staff indicated that this was the case and they would work closely with the legal department to avoid inconsistencies. However, the conditions of the second power loan would be more stringent than the first given the size of the loan, the variety of actions that the Government had to undertake to rehabilitate the sector and to do this in an environmentally sound way. The Regional staff also indicated that since the power loan was a link loan, failure on the part of the Brazilian Government to meet the conditions under the loan would also adversely affect the commercial bank package.

The Chairman made the following observations on the loan. The Committee authorized the Region to start negotiations noting that there has been progress under the earlier loan and a history of on-going negotiations of the present loan since March 1987. Introducing completely new elements into an existing work-out at this stage may neither be feasible nor appropriate. The Committee placed very high priority on environmental issues. He noted that in other countries where there were nuclear plants, the Bank had maintained a neutral stance as these plants were outside the purview of the power sector. This was not the case in Brazil since nuclear plants have been recently transferred to the power sector. It thus presented the Bank with the opportunity to make sure that the nuclear program is economically feasible and environmentally sound.

The Chairman invited the Environment Department in the PPR to work closely with the Region to ensure that an environmentally sound power sector program is developed in Brazil.

(iv) Macroeconomic Situation

The Regional staff briefed the Committee on the present macroeconomic situation. Inflation has increased to 30% in September. There has been a discernible movement away from money to real assets. Due to the upsurge in inflation, one of the five targets in the Fund standby program - relating to a nominal target for the public sector borrowing has been breached. In order to avert a situation of hyper-inflation the Government has negotiated a social pact in early November 1988 to contain wage and price increases to 23% per 30 day period in the next 60 days. The Government will present a fiscal and monetary package on November 20, 1988 (after the November 15 municipal elections). If the 60 day restraint on price and wage increases were to work well, the Government would revise the de-indexation formula. The social pact has averted the immediate prospect of hyper-inflation.

A new program to stabilize the economy has been under consideration by the economic team. They aim to reduce the Budget's operational deficit to zero, the monthly inflation rate to 9% by the middle 1989 and to 3% by the end of 1989. In the meantime, they are also considering a more active market oriented interest rate policy and a de-indexation formula that stretches the period for wage adjustment to reduce the inertial component of inflation. Subsidies for wheat and some export activities are to be reduced. Other measures under consideration to stabilize the economy include de-indexation of outstanding payments, substitution of surcharges for quantitative restrictions on imports and to increase the pace of liberalization imports.

The Regional staff believes that a stabilization program that reduces price increases between 100% to 200% a year but on a declining path, a reduction of the operation deficit in the budget to 2% of GNP and a price-wage de-indexation formula consistent with the fiscal deficit and inflation target would constitute an adequate program of stabilization.

The Region indicated that whether the Bank would go ahead on the Power Sector and the Financial Sector loans was contingent on the macroeconomic situation and continuation of the IMF standby program. The IMF will be reacting to a package of measures to be announced by the Government on November 20. If the package is acceptable to the IMF, it will give a waiver on the existing conditions under the standby. However, if the IMF standby program is to be discontinued because it finds the measures inadequate, the Region will not go ahead with either of the loans, as macroeconomic stability is essential for the success of both loans. The Regional staff indicated that such an eventuality would also imply a breakdown of the existing commercial bank package as well.

November 22, 1988
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Mr Qureshi

The World Bank
OPERATIONS COMMITTEE

Minutes of the Operations Committee Meeting on Progress Reports on MEXICO - Industrial Sector Adjustment Loan, Public Enterprise Adjustment Loan, and Structural Adjustment Loan

Held on Wednesday, November 9, 1988 in Room E-1243.

A. Present

Committee	Others
Messrs. M. Qureshi (Chairman)	Messrs. V. Dubey (EAS)
A. Choksi (LACVP)	A. Ray (EAS)
V. Corbo (VPDEC)	S. Rajapatirana (EAS)
E. Jaycox (AFRVP)	R. Steckhan (LA2DR)
C. Michalopoulos (EMNVP)	M. Selowsky (LACVP)
I. Shihata (VPLEG)	H. Scott (VPLEG)
H. Vergin (SVPOP)	E. Segura (LACVP)
J. Wood (VPFPR)	P. Knotter (LA2TF)
O. Yenal (ASIVP)	M. Martinez (LA2CO)
	S. van Wijnbergen (LA2)
	T. Thahane (SECGE)
	R. Lamdany (DFS)
	J. Taylor (DFS)
	T. Hutcheson (SPRPA)
	Ms. N. Manley (LEGLA)

B. Discussion

1. The OC met on November 9, 1988, to discuss the progress made by the recent missions to Mexico in preparing the above-mentioned loans. The discussion was based on draft papers on the three Adjustment Loans and the policy matrices circulated by the Region (plus a draft memorandum from R. Steckhan to B. Conable on Mexico: Proposed Adjustment Operations - Interim Briefing, November 8, 1988).

2. In his opening remarks, the Chairman noted the amount of substantive and impressive work that has been done by the missions. He felt, however, that the programs described in the documents were far too comprehensive and ambitious at this point, and there was a need to focus on the key policy changes that we should seek in these operations. The Region provided a brief summary of the background to these loans and the current situation in Mexico, commenting, inter alia, on the uncertainty due to the new political balance of power, the overwhelming importance of generating some growth after six years of stagnation, the strikingly good performance in controlling the budget deficit and in reducing inflation, and the continuing concerns with high real interest rates, an appreciating real exchange rate, large increases in imports, and sluggish private investments. There are signs that confidence is waning and that expectations of exchange rate depreciation are building up.

3. In response to questions, the Region further stated that since foreign direct investments are critical to filling the external finance gap it would be important to induce higher levels. It further stated that the liberalization of price ceilings during the transition from the Pacto would need to be gradual in order to avoid a sharp jump in prices. A Committee member expressed reservations about several aspects: the possibility that the proposed conditionalities will duplicate or replace old ones, relations with IMF and commercial banks, disbursement procedures, and the possible need for new laws by the Mexican Congress to carry out the proposed reforms. In response, the Region explained that the purpose of this meeting was to provide an interim briefing. The documents circulated were only drafts, but even so no duplication with existing conditionalities was in fact involved. Bank staff had been working closely with Fund staff who had been kept fully briefed. In response to a question, the Region said that it would prefer positive lists for disbursing the sector adjustment loans. Regarding the need for new laws, the Region said that most of the necessary changes could be brought about through administrative devices alone.

4. The Chairman added that we were proceeding with an accelerated schedule at the request of the present GOM which had indicated willingness to undertake important reforms prior to leaving office if adequate support from the Bank were available. While the kind of reforms the GOM wants to undertake before leaving office seemed difficult, the good dialogue that the Bank and the Fund have had with the GOM enables us to provide the intellectual underpinning to the changes being sought. Although this case is clearly unusual, if not unique, no corners will be cut as far as the substance of the adjustment program is concerned. He also said that it is essential to work closely with the IMF. The GOM wants to maintain its present excellent dialogue with the Fund, but political circumstances prevent GOM from negotiating an IMF-supported program at this time.

5. A speaker suggested that the current situation in Mexico seemed fragile; the objective ought to be survival rather than growth. Another speaker welcomed the tone of the briefing and supported the identification of the priority areas of action. He felt however that emphasis at present should be on the consolidation of stabilization and that a financial package for the next 5 to 6 years in support of the reforms should be worked out now to restore confidence; for this purpose the Bank would need to take the lead in putting together the full medium-term financing package. Questions were also raised by a Committee member regarding the credit to be given for past performance and the consistency of the Pacto with existing adjustment loans. The Region said in response that the high quality of past performance, especially in trade, needs emphasis. It also noted the linkages between the Pacto and any new policy package that might be worked out. The provisions of existing adjustment loans will need to be cleared up prior to making new adjustment loans. It also suggested that short and longer-term issues cannot be separated as the resumption of growth is likely to be critical to the sustainability of stabilization measures.

6. The Chairman said in conclusion that the three missions need to be more selective in developing the reform measures that we can support. In the case of the SAL we should propose measures to further strengthen the budget, smooth the transition from the Pacto, seek further progress in trade and price decontrols, liberalize the financial sector and reduce transfers and subsidies. Regarding the industrial sector loan he proposed special emphasis on the relaxation of restrictions on direct foreign investments and industrial deregulations that complement the trade reforms. The public enterprise loan ought to emphasize the definition of an overall policy, specific elements of the divestiture program that they will undertake next year, and measures to foster competition and efficiency of the public enterprises to be retained in the public sector.

ARay:vlw
November 10, 1988

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

Date: November 8, 1988

To: Mr. W. David Hopper, Senior Vice President, PPR

Thru: Francis X. Colaco, Acting Vice President, PRE

From: K. Piddington, Director, ENV

Ext.: 3-3202

Subject: Brazil - Proposed Second Electricity Power Sector Loan

1. I understand that this loan will be considered by the Operations Committee tomorrow afternoon and I have prepared the following comments, based on a review of the Green Cover version of the loan and my recent discussions with you and with the Regional Environmental Unit on the substantive issue which it raises.

(i) This is a sector loan which is being negotiated against the background of considerable pressure on the balance of payments in the borrowing country; this has made it very difficult to give the environmental aspects the sort of treatment which is in my view required, given the extensive environmental implications of power development in Brazil.

(ii) This in turn forces the Bank to accept undertakings in the environmental area which are short of performance commitments and/or design modification and rely in effect on the integrity of the institutional structure in Brazil. Given the recorded weaknesses of that structure, most particularly in the area of Indian policy and in the recent erosion of SEMA's effectiveness I am unable to conclude that the Bank has obtained the necessary safeguards.

(iii) The existence of the environmental master plan, as noted in the documentation, is clearly a positive element which applies across the whole sector and which therefore has a potential beyond the immediate loan proposal. I accept this and have indeed argued publicly both in Berlin and elsewhere for the leverage which it provides to the Bank. I do not however accept that this is an argument to support endorsement of the loan, given the fact that the Master Plan is already in place and does not obtain any special reinforcement from this loan.

(iv) The inclusion of the nuclear power program within the sector created a new situation in the middle of the negotiations over this loan. You are aware of the policy issues on nuclear energy which need to be resolved by the Bank in a separate context. On the environmental evidence, I see no grounds for the Bank to change its previous stance (i.e. not to support nuclear energy development). Even if it did, there are a number of aspects of the documentation which are inconsistent and which are therefore unsatisfactory from an environmental standpoint. This can be summarized as follows:

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(a) for the reasons stated in para 12 of Annex 12 the Bank has not assessed (and cannot assess) the adequacy or otherwise of the environmental safeguards in the nuclear sector;

(b) the handling of long term nuclear waste is an issue for which no solution is identified;

(c) the various reviews which are proposed, e.g. to establish whether the regulatory authority (CNEN) is equipped to handle the regulation of the industry demonstrate a wish for further guarantees (and yet they also fall in the area where the Bank cannot venture to make judgments).

I am therefore at a loss to understand how in para 86 of the report it is possible to state as the views of the Bank that the program is based on an "adequate regulatory framework". What are the "recognized international standards", e.g. waste disposal? The document demonstrates to me that unless it is made clear that the nuclear industry is outside the competence of the Bank (and specifically of this department) we will rapidly become enmeshed in a sequence of judgments about the acceptability of the nuclear plants in question. I have no evidence on which to base such and the non-operability of Angra I over the last six years reinforces me in the view that the evidence is actually lacking in two vital respects:

(i) whether the Brazilian authorities can operate the plants technically,

(ii) whether they can operate them within acceptable levels of risk.

No safety expert would accept a regulatory check as a substitute for operational risk reduction and hazard containment procedures, and my advice is not to view the Brazilian plants as a proving ground for IAEA's ability to move beyond the role of inspectors and become operational managers in the area of risk.

(v) The view of the Department on this aspect is reinforced by the analysis carried out by LATEN on the nuclear power program in Brazil and by IEN on the economic aspects of nuclear energy. I attach Mr. Daly's most recent note which makes it clear that these plants would not in a greenfield situation have qualified for Bank support.

(vi) The final inconsistency in the report is the suggestion that if the additional costs of nuclear are subsidized by the Government, this makes the plants acceptable within sector policy. In the context of the Bank's approach to macroeconomic policy however it is stated that the objective is to reduce such subsidies and create transparency in the sector.

2. To sum up, the sequence of events leading up to consideration of a loan in this particular form has made me uneasy about the policy process within the Bank. I appreciate that you await resolution by Senior Management of the nuclear power issue in general. Although I am new to the negotiating process between the Bank and its borrowers I must realistically assume that the framework laid out in the Green Cover version will be eroded in the course of future negotiation. Given my reservations on the institutional capacity in Brazil (see (ii) above), I conclude that the final package is likely to be unsatisfactory in terms of the Bank's environmental policy.

3. If Angra III were cancelled along with the rest of the nuclear energy program, if everything else in the document were to stand and if the Bank were able to decide on a reaffirmation on its policy on nuclear power I would however agree with LATEN that the outcome might be accepted. I would still maintain the reservations stated above, but accept that the special circumstances of the loan made such an accommodation necessary.

KPiddington/rcr
Attachment
cc: Messrs. Qureshi (SVPOP), Choksi (LA1DR), Wessels (LATDR), Churchill (IENDR), Goodland (LATEN), Daly (LATEN)

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: October 31,1988

TO: Mr. E. Wessels, LATDR

FROM: H. Daly, LATEN HED

EXTENSION: 39267

Cf ^ Manual
(1) full costs
(2) sunk costs

SUBJECT: Brazil: Power Sector II:Economic Analysis of Nuclear Power Program

1. For Angra III the conclusion is very clear as stated in paragraph 30. Angra III is uneconomic. According to figure 2 the NPV of incremental costs of Angra III are above those of the hydro alternative for all discount rates shown (from 0% to 25%). Paragraph 30 speaks of a reasonable range of discount rates that is somewhat narrower, from 2% to 20%.

2. Angra II is much more difficult. According to the analysis it is uneconomic at discount rates below 6.3%, which falls within the range considered "reasonable"in consideration of Angra III. The discount used was is 10% which is referred to as the estimated opportunity cost of capital for Brazil. The reader is referred to Annexes 3, 4, and 5 presumably for the estimate, but I am unable to find any estimate of OCC in these Annexes. Some justification should be offered for the 10% discount rate. Some evidence that the actual realized rate of return (not expected rate) on capital in Brazil is closer to 10% than to 6% should be presented.

3. Paragraph 14 states that energy conservation programs (investments in end use efficiency?) were not considered feasible alternatives to expansion of generating capacity, but that they were incorporated in the demand forecast, as a complement to existing sector expansion plans. The document should clarify if the demand forecast assumed that investment in energy efficiency would be made ahead of investments in generating capacity whenever it was cheaper to save a kilowatt than to generate a kilowatt.

4. Normal radiation release is treated as having zero costs. This seems contrary to the accepted view that there is no threshold below which radiation effects are zero. Statistical estimates of the number of expected cancers resulting from low level radiation increase are normally made, and should be included even if small.

5. Since Angra II would not be remotely economic unless enormous sunk costs (70%) are ignored, it is clear that it must be the <u>last</u> nuclear plant built, until such time as there is a massive change in technology or relative prices. Therefore the entire social cost of regulating the nuclear power electric sector must be attributed to Angra II alone during its lifetime beyond the life of Angra I , which judging from their respective start up dates would be on the order of 11 years. Paragraph 18-ii dismisses these costs as small relative to the nuclear regulatory costs of health and military uses of nuclear energy. This may be true (no figures are cited), but it is not entirely revelant, even if it is assumed that the military will bear the cost of monitoring Angra II. Regardless of who bears the costs they should be counted and reflected in the analysis. What is

relevant is their absolute magnitude, not their size relative to the military sector. If we merge the military and civilian nuclear programs in the analysis of joint costs, then we should also look at joint military-civilian "benefits", which do not figure in the present analysis.

6. No cost is counted for uninsured risk beyond the limited insurance provided. The amount of liability insurance provided should be specified and some discussion offered of the magnitude of uninsured risk.

7. Safety expenses (incremental nuclear related) for Angra II are assumed to be the same as for Angra I even though the latter is twice the size of the former. This needs clarification.

8. It is to the credit of those preparing the study that assumptions are spelled out clearly thereby facilitating identification of issues on which differences in judgment are likely to arise.

cleared by and cc: Robert Goodland
cc. Messrs. Munasinghe, Weissman, Veliz, Piddington, Arrhenius, Schramm.
LAC Files

HDaly

FORM NO. 75
(6–83)

THE WORLD BANK/IFC

CONFIDENTIAL

ROUTING SLIP	DATE: Nov. 3, 1988
NAME	**ROOM NO.**
Mr. M. A. Qureshi	E-1241

	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:

I would like to brief you on the attached and on the status of the Power Sector and Financial Sector Loan prior to the Operations Committee meeting on the 9th.

Attachment

FROM:	ROOM NO.:	EXTENSION:
Armeane M. Choksi	I7015	31811

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: October 24, 1988

CONFIDENTIAL

DECLASSIFIED
AUG 0 2 2013
WBG ARCHIVES

TO: Mr. Armeane M. Choksi

FROM: Gobind T. Nankani, Division Chief, LA1CO

EXTENSION: 31851

SUBJECT: BRAZIL - Macroeconomic Technical Assistance Mission, October 11-20, 1988

1. At Minister Mailson's request, and as approved by you, I visited Brasilia on a macroeconomic technical assistance mission. During this period, I was in frequent contact with you. This note describes: (a) the current macroeconomic situation; (b) the thrust of Government thinking and of my advice to Ministers Mailson and Abreu, and the technical staff; (c) the prognosis; and (d) next steps.

The Current Macroeconomic Situation

2. The current macroeconomic situation is characterized by:

- accelerating inflation--from 26% in September to an expected level of 30% in October and 33+% in November;
- continuing record export earnings and low imports--making certain a trade surplus of $17-18 billion for 1988;
- GDP growth expected at 1% for 1988 based on moderately high industrial production in the second semester, expectation of a good agricultural crop, and low unemployment;
- an operational budget deficit at end-September at below the IMF target, but with last quarter trends highly uncertain, and with an expected operational deficit of anywhere between 4.5 and 5.5% of GDP, depending upon a number of downside risks (wage developments, real interest rate increases and public enterprise pricing); and
- a very volatile and nervous capital market, with very large movements out of currency and Treasury bills to dollars, gold, real estate and stocks, particularly in the last week.

The Government's Thinking

3. The Government is in the process of working out a new macroeconomic package to deal with the currently untenable situation. Mailson's orthodox "rice and beans" strategy is seen as a failure, and some combination of a fundamentals-and-deindexation package is planned for sometime after November 15th (see below). However, after the inexplicable jump to 50% of the implicit monthly overnight Treasury bill rate on October 13th, the financial market went into a panic and remains unsettled. A leak about the details of the Government's deindexation package on October 19th caused another panic. In the last week, the parallel exchange rate and gold

10/31-13

prices have risen by about 15% each. There is a very high risk that high inflation will skid into hyperinflation even before the elections. The Government is preparing an emergency package based on drastic fiscal and monetary measures to put into effect if the market does not settle down shortly. There is also a risk that one or both of Ministers Mailson and Abreu will leave their positions if the situation continues to worsen.

4. The central package under preparation (Package 1) is yet to be fully defined, but it has the makings of a good package. It is better on the fundamentals than on the deindexation aspects. The team is also preparing a fall-back Package 2 which is more of a damage-minimization plan for the next two to three months, to be followed by Package 1 in early 1989. Finally, there is the Emergency package, to be implemented should hyperinfation set in before either of the other packages are worked out and negotiated with industry and labor through the newly formalized Social Pact.

5. Package 1. The thrust of the proposed package, subject to Presidential and Congressional approval, is:

- An operational fiscal surplus of about 1% in 1989 based largely on expenditure measures and residually on revenue measures.
- A tight monetary program, with no ceilings on interest rates, consistent with expected GDP growth, inflation and rapid remonetization, with no financing for any government deficit; it will also necessarily include an underlying structural modification of policies towards directed credit, reserve accumulation and debt conversions/relending.
- An exchange rate and tariff policy, yet to be defined, consistent with some degree of import liberalization, removal of fiscal incentives for exporters and some transfer of importers' rents to the Treasury.
- A social pact aimed at realigning real wages to make them consistent with macroeconomic stability.
- A gradual forward-looking deindexation system for the labor and goods markets (i.e., wages and prices), with safety valves; as a fall back, a similar scheme extended also to the tradeables and financial markets (i.e., the exchange rate and financial assets), but with considerable overshooting of the exchange and interest rates and corresponding safety valves.

6. Package 2. This is a fall-back package with a less than ideal set of fundamental policies (an operational deficit of 1-2%, restrictions on interest rate policy, etc.). Analogously, the deindexation scheme is modified and is more risk-averse: it is backward-looking, and involves an initial wage-price freeze.

7. Emergency Package. This would be implemented only if the run on financial assets gets out of control before either Package 1 or 2 can be implemented. As is well known from historical experience and from theory, once hyperinflation sets in, a major redistribution of wealth results, and

all that is needed to bring inflation under control is a strong set of orthodox policies. Deindexation is automatic, and needs no specific design. This was most recently used in Bolivia (1985) and historically in Germany (1923), France (1924), etc. The essence of this policy is to:

- require government expenditure to equal revenue, on a quasi-daily basis;
- have zero borrowing from the Central Bank;
- overshoot the exchange rate and then temporarily freeze it; and
- allow for major remonetization in the initial phase as stabilization succeeds, while also permitting a very high real interest rate to induce excess supplies, and assist with capital inflows.

8. Such a package causes severe short-run dislocations, but stops inflation quickly and is superior to allowing hyperinflation to continue.

The Prognosis

9. There are four possibilities, and their probabilities (based on my judgment) are indicated below:

(i) Successful Stabilization. The Government implements the ideal Package 1, and succeeds in reducing annual inflation to about 100% in 1989, with a monthly rate of about 2-3% by October 1989 (probability: 20%);

(ii) Muddling Through Towards Gradual Stabilization. The Government implements Package 2, avoids hyperinflation, but does not succeed in overcoming the chronic inflation problem in 1989 (the Argentina Model) (probability: 50%);

(iii) Hyperinflation and Successful Immediate Stabilization. Hyperinflation sets in the next few weeks, and an emergency package permits a total deindexation of the economy and inflation is reduced to an annual rate of 25-50% (probability: 10%); and

(iv) Muddling Through Towards An Extreme Political Intervention. The financial asset panic results in a hyperinflation before end-1988, and a number of unsuccessful attempts are made to deal with it during 1989, and this leads to an extreme right or left presidential choice or a military intervention in 1989 (probability: 20%).

Next Steps

10. Ministers Mailson and Abreu were highly appreciative of my involvement in providing the framework for and helping to flesh out the three policy packages described above. They requested me to return on October 31st. Between now and then I shall be in frequent telephone contact with the coordinators of the technical groups. The weakest links

in the analytical chain are the choice of deindexation mechanism, the design of consistent safety valves, and formulation of a credible monetary program. (Upon your suggestion, I offered, and they accepted, Jeffrey Shepherd's assistance to their working group on Trade Policy.) I propose to analyze these weak links as best as I can before my return, using COD staff as necessary, on a need-to-know basis. By October 31st, the working groups would have completed their work. A consistent macroeconomic program and the corresponding policies can then begin to be defined in detail.

11. Mr. Mailson also raised the issue of Bank support for the program (Package 1) in the form of a high value of disbursements within 30 days of its announcement. He would want to announce such support with the program. I explained that there were three options (not mutually exclusive):

- o a general statement of support, as discussed with you and Mr. Husain in Berlin;
- o a Letter of Development Policy a la Argentina, as suggested by you, with a statement of their actual and intended actions and our actual and intended loans; and
- o a specific action program to accelerate disbursements in the first 30 days after the announcement of their program; this latter would depend on complementary actions by us and by the Brazilians, and I would indicate to them when I returned, what we could do and what they needed to do.

12. You indicated to me that you would organize the preparation of a first draft of a Letter of Development Policy for the reaction of the Brazilians upon your return from India on November 1 or 2. I have already given the Brazilians a copy of the Argentina Letter. I am initiating work in the Department on the scope for rapid disbursements, and shall give the Brazilians preliminary views when I return next week. Indications are that we could, with some extra efforts, disburse about $400 million in December 1988, if the Brazilians undertake the required complementary actions.

Conclusion

13. Brazil is in need of Bank support at a critical juncture. We should continue to offer them all our support, i.e., technical, financial and public support. The financial support we actually deliver will depend upon the ultimate package they implement. In my view, there is a high risk that the present stabilization attempt will fall short of an ideal package because the underlying political basis is yet non-existent. However, the threat of hyperinflation could rapidly bring this political basis into existence. The payoff, in case of a success, would be very high. A high risk-high payoff strategy is, therefore, very worthwhile. If it succeeds, we would have provided support at a crucial juncture. If it fails, we would have burnt a few bridges when a new economic team arrives, but we should recover quickly from that. The critical condition is that we provide technical assistance support unconditionally, and financial and public support conditional upon a fully credible program.

GTNankani:nev

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: October 24, 1988

TO: Mr. Ping-Cheung Loh, Acting Vice President, LAC

FROM: Mr. Mohan Munasinghe, Acting Director, LA1

EXTENSION: 39320

SUBJECT: BRAZIL - Proposed Second Electric Power Sector Loan

1. Please find attached for your approval and subsequent distribution to the Operations Committee (OC) the revised version of the draft Report and Recommendation of the President and drafts of the Loan, Shareholder and Project Agreements for the Second Electric Power Sector Loan, for which a US$500 million loan to the Federal Government of Brazil is recommended.

2. A loan package (dated August 25, 1988) was submitted to and cleared by the Regional Loan Committee on September 7, 1988. However a recent development in Brazil (as described below in paragraph 3) required the preparation of a revised loan package.

3. On August 31, 1988 the Government of Brazil decided to transfer from NUCLEBRAS to the power sector (ELETROBRAS/FURNAS), the responsibilities for construction, management and financing of the nuclear power program (Angra II and III). Therefore, the new loan package reflects not only the comments of the Regional Loan Committee meeting of September 7, 1988 relating to non-nuclear issues, but also specific changes arising from the above shift of nuclear power responsibilities. In view of the clearance of the earlier Loan Committee package, we are resubmitting for your review mainly the substantive changes made as a result of nuclear power related aspects. These changes relate to the: (i) financial (para. 84), economic (para. 85), and environmental and safety (para. 112) aspects of the loan; and (ii) corresponding undertakings to be carried out by the Government to address effectively the issues arising from the transfer of the nuclear power program. The proposed changes on environmental and safety aspects reflect the substances of and comments received on a paper entitled "Environmental and Safety Issues Relating to the Nuclear Power Program" that was issued by me on October 12, 1987 and circulated widely within the Bank.

4. The six-week delay caused by the need to assess the nuclear power program, enabled Bank staff to also: (a) confirm the increase of the cofinancing participation by the Export-Import Bank of Japan (JEX) from US$300 million up to US$450 million (see para. 8); and (b) change the report format of the proposed operation from an SAR to the standard SECAL style, i.e., Report and Recommendation of the President. More details of the JEX cofinancing will be set forth in the Grey-cover version of the Report and Recommendation of the President.

5. As agreed with Mr. Husain, the following tight timetable will need to be followed if the proposed loan is to be processed for Board Presentation in early December 1988 (tentatively December 6, 1988) -- to ensure sufficient time for Brazilian compliance with the conditions of

disbursement of the second tranche of commercial bank new money and enable disbursement of the first tranche by December 31, 1988.

Documents to RVP	October 21, 1988
Documents to SVP	October 25, 1988
Authorization to Negotiate	October 27, 1988
Start Negotiations	October 31, 1988
End Negotiation	November 4, 1988
Grey Package to Director	November 8, 1988
Grey Package to RVP	November 9, 1988
Grey Package to SVP	November 10, 1988
Documents to ED	November 11, 1988
Board Presentation	December 6, 1988

Detailed below are some considerations relating to the processing of the above operation.

Conditions for Negotiations and Board Presentation

6. During a power-related mission of the Brazilian Government to the Bank in early October 1988, Bank staff reviewed the progress made by the Government/ ELETROBRAS in meeting the following conditions for negotiations and Board presentation:

(i) Negotiations: The Government/ELETROBRAS should submit: (a) a satisfactory program of tariff increases, including a monitoring procedure to assess the increases; (b) a satisfactory Power Sector Rehabilitation Plan (PSRP), plus evidence of initiation of official procedures to provide a final PSRP; (c) evidence of the initiation of legal procedures to capitalize "Avisos" (bridge loans received by the power sector) to cover the shortfall of equity contributions in 1987; (d) evidence that the state utilities are complying with payments to RENCOR ("Reserva Nacional de Compensacao de Remuneracao" - the new mechanism for revenue sharing in the sector); and (e) a detailed record of all safety checks and special studies and repairs carried out since the 1985 Operational Safety Review (OSAR) performed by the International Atomic Energy Agency (IAEA). These conditions are expected to be met by October 25, 1988.

(ii) Board Presentation: The Government/ELETROBRAS should submit: (a) evidence of official endorsement of the final PSRP; (b) evidence of continuing implementation of the tariff-increase program sufficient to achieve the 1988 financial targets of the final PSRP; (c) Presidential authorization to hire 36 specialists for ELETROBRAS and other environmental agencies; (d) letters of commitment from sector utilities expressing agreement to comply with the Environmental Master Plan (EMP); and (e) an assessment by the "Blue Ribbon Committee" of the EMP, revised as of June 1988; and (f) appointment of two nuclear environmental safety experts of international standing to the "Blue Ribbon Committee".

Confirmation of JEX Participation (Tentatively indicated in earlier Loan Committee package)

7. Emerging constitutional changes in 1988 are leading to a greater measure of autonomy on the part of the states and their respective utilities in their relations with the Federal Government and ELETROBRAS. These developments, the current weak financial situation of CEEE (the power utility of the state of Rio Grande do Sul) and other factors have required the addition of CEEE as a recipient of a Government equity contribution amounting to US$150 million in connection with the proposed loan.

8. The sources of this contribution would be the proposed Bank loan (US$30 million, part of the second tranche, US$250 million and US$120 million of the proposed JEX co-financing (US$450 million). With the full support of the Bank, the Government sought an untied co-financing package of US$450 million from JEX. The second tranche of the proposed Bank loan would be conditioned to presentation to the Bank of adequate assurances of the availability of at least US$120 million of JEX cofinancing and to the initial implementation by CEEE of a rehabilitation plan satisfactory to the Bank. Disbursement of US$120 million of the JEX loan would be conditioned to the submission of evidence showing that CEEE was implementing its rehabilitation plan satisfactorily.

Nuclear Program

9. We will seek to reach agreement with the Government during negotiations that the implementation of the nuclear power program would be consistent with the financial, economic and environmental objectives of the proposed loan. Concerning the economic justification of the nuclear power program, there appear to be sufficient economic grounds for accepting completion of Angra II. However, there is no justification for constructing Angra III on the basis of present evidence. Accordingly, the Bank will seek the agreement of the Government to: (i) complete a satisfactory, detailed economic analysis of both Angra II and Angra III; (ii) refrain from making further expenditures or new commitments relating to Angra III until the above studies are completed; and (iii) discontinue construction of Angra III (if above study confirms that this plant to be economically unfeasible) and abstain from initiating the construction of new nuclear plants without Bank concurrence. A firm and unequivocal decision on Angra III, based on economic technical and financial criteria satisfactory to the Bank, will be a condition for second tranche disbursement. Concerning the financing of the nuclear power program, the Bank will seek the agreement of the Government to reimburse the sector fully for any additional costs beyond the least-cost expansion program. Concerning nuclear safety and environmental issues, the Bank will seek the agreement of the Brazilian Government to incorporate a number of measures in the Environmental Master Plan (EMP) to address nuclear safety and environmental issues.

Macroeconomic Situation

10. The macroeconomic situation in Brazil presents a mixed and rapidly changing picture. Available data indicate that the operational deficit target for end-September is expected to be met, and the trade surplus is expected to exceed the $13 billion target for 1988 by $4 to $5 billion

(ending up at $17 to $18 billion). However, inflation has been far higher than had been planned, and consequently the nominal ceiling on public sector borrowing in the IMF program is expected to be exceeded. The IMF will need to approve a waiver to allow the second disbursement under the current stand-by program. Our own Macroeconomic Assessment report, currently being finalized, concludes that unless the Government undertakes significant policy measures in the interim, the end-December picture will involve an inflation rate in the 30% monthly range, and a higher operational deficit than the targeted 4%. The contribution of the power sector (federal and state power utilities but excluding Itaipu Binational which has been managed for the Government outside of the power sector) to the public sector deficit in 1987 amounted to about US$4.6 billion or 56% of the total. As a result of the PSRP agreed under the proposed loan, by 1991 the power sector contribution to the public sector deficit is expected to have declined to about US$2.0 billion or less than one half of the 1987 estimate.

11. In mid-October, inflationary developments and related indicators such as the price of gold, the dollar market premium and activity in the real estate and stock markets appear to have precipitated a move on the part of the Government to put together a new and fundamental package of policy measures involving a "fiscal shock" and deindexation scheme to address the serious risk of further inflation. Such a package, if undertaken, is expected to be put in place sometime after the municipal elections on November 15th. We would need to review the macroeconomic situation and the commitment of the government to undertake further stabilization measures, very closely throughout the period between now and Board presentation.

Attachments:

- Revised Yellow Cover Report of the President
- Draft Legal Documents
- Draft Notice of Invitation to Negotiate

Distribution:

Messrs. S. Husain o/r, E. Segura, C. Quijano, M. Selowsky, M. Linder, G. Dolenc, (LACVP); A. Choksi o/r, S. Weissman, (LA1DR); G. Nankani, D. Klaus, P. Knight, R. Schneider, (LA1CO); J. Wijnand, (LA1AG); D. Papageorgiou, (LA1TF); R. Bates, J. Vietti, J. Larrieu, C. Velez, A. Waldrop, (LA1IE); E. Wessels, (LATDR); R. Moscote, C. Khelil, (LATIE); S. Davies, R. Goodland, (LATEN); R. Barahona, (LOAEL); J. Collell, E. Abbott, R. Cucullu, (LEGLA); LACIC

Mmes. N. Birdsall, (LA1HR); M. Koch-Weser, (LA1CO)

JLVietti/JALarrieu/ACWaldrop:rb

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: October 25, 1988

TO: Mr. Wilfred P. Thalwitz, Acting Senior Vice President, Operations

FROM: Mr. Ping-Cheung Loh, Acting Vice President, LAC

EXTENSION: 39001

SUBJECT: BRAZIL - Proposed Second Electric Power Sector Loan

1. Attached you will find the revised green cover version of the above sector adjustment loan for US$500 million. The tentative Board date is December 6, 1988. As explained in the memo from Mr. Munasinghe to me, the Bank is operating on a very tight timetable to complete processing of the above loan to ensure sufficient time for Brazilian compliance with disbursement conditions of the second tranche of commercial-bank new money.

2. An earlier version of this loan package was cleared in early September 1988 by the Regional Loan Committee. The same package was also reviewed by Mr. Qureshi, shortly afterwards. The present green cover documents are within the parameters approved by the Regional Loan Committee and the SVP. Progress on this operation was also reviewed by the Operations Committee, on March 16, 1988. The loan was originally appraised in February 1987 based on the parameters proposed in the FEPS of February 11, 1987, which was approved by the SVP on February 19, 1987. Negotiations commenced in May 1987 and are scheduled to be concluded by November 5, 1988. Several post-appraisal missions have been undertaken to update the project documents throughout this period.

3. In addition to the most recent delay resulting from the August 31, 1988 transfer of the Brazilian nuclear power program into the power sector, macroeconomic problems and emerging constitutional changes have held up processing of this loan over the past twenty months. These factors have also led to some modifications in the sector financial targets and the specific recipients of the Government equity contribution in the proposed operation, as compared with the operation originally authorized by the Loan Committee in January 1987. Nevertheless, the proposed operation is based on a satisfactory investment program and corresponding financing plan. It also incorporates sound environmental objectives, specific actions, and institutional developments, as included in the Environmental Master Plan. Besides the changes among the equity recipients and a redistribution of the Government equity contributions, there has been an increase of US$150 million in the original US$300 million of proposed co-financing from the Export-Import Bank of Japan (JEX). Of the total of $450 cofinancing from JEX, US$120 million would help finance the equity contribution to CEEE, one of the new recipients.

4. The Brazilian Government has not raised objections to any of the major issues proposed for negotiations by the Bank. Disbursement of the first and second tranche of the proposed loan is conditioned to actions related to the financial, economic, and environmental objectives of the proposed operation. The major risk to this operation relates to the current macro economic problems of the country, as described in the attached memorandum by Mr. Munasinghe.

Distribution:

Messrs. M. A. Qureshi, o/r, (SVPOP); S. S. Husain, o/r, E. Segura, (LACVP); E. Jaycox (AFRVP), A. Karaosmanoglu (ASIVP); V. Rajagopaplan (VPPRE); S. Fischer (VPDEC); I. Shihata (VPLEG); D. J. Wood (VPFPR); H. Vergin (SVPOP), A. Choksi, o/r, (LA1DR); M. Munasinghe, J. L. Vietti, J. A. Larrieu, A. C. Waldrop (LA1IE); LACIC
Ms. M. Garcia-Zamor,

MMunasinghe:rb

cc: Mr Vergin

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: November 1, 1988

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS VDubey

EXTENSION: 78051/2

SUBJECT: MEXICO - Notice of Meeting

An Operations Committee meeting will be held on Wednesday, November 9, 1988 at 9:30 a.m. in Room E-1243 to discuss the proposed Mexico Industrial Sector Adjustment Loan, Public Enterprise Adjustment Loan, and Structural Adjustment Loan. Mr. Rainer Steckhan and selected members of his Team will brief the OC members on the progress of the discussions with the Government and seek guidance on emerging issues.

cc: Messrs. Lee, COD; Shakow, SPR; Holsen, CEC; Rao, FRS; Burmester/Thahane, SEC; Liebenthal, SPRPA; Steer, FRS; Baudon, SVPOP; Selowsky, Steckhan, Segura, Martinez, Knotter, LAC.

For Information Only

cc: Messrs. Hopper, SVPPR; Bock, DFS; Goldberg, VPLEG; Frank, Parmar, IFC; Pfeffermann, IFC; Baneth, IEC; Tanaka, (Ms.) Haug, EXC; Robless, OPNMS.

VDubey:vlw

S8608024 1.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: November 8, 1988 E- 1241

TO: Messrs. Qureshi, J. Wood, Jaycox, Hopper, Shihata, Corbo, Karaosmanoglu Thalwitz, Rajagopalan

FROM: Paul F. Knotter, LA2TF

EXTENSION: 38771

SUBJECT: MEXICO - Proposed Industrial Sector Policy Loan (Draft)

Attached please find a draft report for a proposed Industrial Sector Policy Loan in Mexico as background information for tomorrow's Operations Committee meeting.

cc: Mr. Steckhan, LA2DR

Attachment

Para 16. Program over the next 3 years

Para 19 on subsector programs

Main objectives

Remove Price Controls & Subsidies

Domestic [illegible]. Entry & ~~[illegible]~~ controls.

Sub Sector Program [illegible], subsidies

[illegible] services,

transport

Telecom [illegible]

MXC - PROPOSED SAL - DRAFT POLICY MATRIX

PROBLEM	OBJECTIVES	ACTIONS TAKEN/TO BE TAKEN BEFORE BOARD PRESENTATION	MONITORABLE POLICY ACTIONS
1. MACROECONOMIC CONSISTENCY			
* In order to ensure a stable macroeconomic environment in 1989, the projected operational deficit and the sources of domestic public sector financing should be consistent with the expected inflation, GDP growth and possible foreign borrowing.	* A macroeconomic environment for 1989 with low inflation and minimum uncertainty about the main thrust of the economic policy.	* A non-oil primary (non-interest) balance amounting at least to the equivalent of ____% of GDP in the 1989 Budget submission to Congress. * Agreement that credit to the public sector will not exceed _____ in 1989 and that government financing through new domestic debt will not exceed ____ in 1989.	* Approval by Congress of the 1989 Budget with a non-oil primary surplus amounting at least ____% of GDP. * Budget implementation during 1989 consistent with the macroeconomic objectives. * Quarterly monitoring of domestic credit to the public sector and on issuing of new domestic debt. ? X * Mid-year (July 1989), assessment of the macroeconomic program and agreement on the necessary policy actions to ensure the consistency of objectives and a stable
2. PUBLIC SECTOR PLANNING AND BUDGETING			
* Improvements in investment efficiency are hampered by weak planning and budgeting systems.	* Within the overall objective of recovering economic growth via revived investments, the Government needs to achieve greater efficiency in planning, preparing and implementing public investments.		* Strengthen investment planning and evaluation by issuing guidelines for economic, financial eligibility criteria for public investments; elaborating a program for investment evaluation in commercial and development banks and by carrying out a study with a view to create decentralized preinvestment fund and a central investment/budget control unit. * Strengthen budgeting procedures by introducing multi-year budgeting; and launching a technical cooperation program to strengthen planning and budgeting at state and municipal levels. * Improve externally funded investment implementation by introducing budgeting incentives and establishing a central monitoring unit. * Promote investment evaluation techniques by formulating a public sector training program and initiating its implementation; and promote the complementary role of the private sector by preparing terms of reference of a study of the status and needs of Mexican consulting industry and its potential contributions to the public sector, contracting the study and initiating a program to contract out preinvestment work to private consultants according to a plan of action to be prepared on the basis of the study's recommendations.

Subsidy (?)

Chosen Criterion Key areas

1. Soft landing of Pact.

2. Strengthening of the budgetary schedule — Fiscal [illegible] Primary Surplus, Retention [illegible]

3. Based on [illegible] Fin sector [illegible] by commercial banks, [illegible]

4. Removing remaining restrictions [illegible]

5. Targeted food subsidies

2+6 Reduction of Transfers to [illegible] Parastatal [illegible] of subsidies

7.

MXC - PROPOSED SAL - DRAFT POLICY MATRIX

PROBLEM	OBJECTIVES	ACTIONS TAKEN/TO BE TAKEN. BEFORE BOARD PRESENTATION	MONITORABLE POLICY ACTIONS
3. TAX REVENUES			
* In General, high vulnerability of public sector revenue to the vagaries of international oil prices, connected to a very low tax ration.	* To act on the ultimate causes of this situation in order to raise tax revenue so as to make the system less dependent of oil revenue.		* Analysis of tax base erosions in each of the main taxes.
* In Particular: * "Corporate Income Tax". (i) Need to stop or limit present erosions in the business income tax base, as generated by the special tax treatment of favored economic activities ([illegible]lture, t[illegible]tation and ot[illegible]). (ii) Taxation of corporate dividends is partially eroded through the capital gains loopholes availables for the transaction of corporate shares, (iii) Substantial compliance and administrative costs are present in the accounting methods for taxable profits and, in the system for advance monthly tax payments.	* Direct taxes should pursue tax neutrality and a comprehensive taxable income with vertical and horizontal equity goals.		* Tax policies should be developed for a gradual change of tax rules applicable to selected activities (BET cases). * Repeal the present tax exemption available for capital gains obtained in the transaction of shares, in order to ennace the correct taxation of dividends. * Accelerate the phasing-in of the new-based-system for corporations. * Simply in part the tax accounting methologies and the monthly system of advance tax payments.

PROBLEM	OBJECTIVES	ACTIONS TAKEN/TO BE TAKEN BEFORE BOARD PRESENTATION	MONITORABLE POLICY ACTIONS
* "Taxation of Corporate Direct Foreign Investment". (DFI). Presently, DFI in Mexico is subject to double taxation burden in dividends remitted abroad.	* Enhance the position of Mexico as an internationally competitive host for direct foreign investment.		* Recommend a tax change of the withholding tax rate on dividends from the present 50 to 35 percent.
* "Personal Income Tax". Highly eroded tax base due to a very complex system of exemptions, implicit tax preferences, multiplicity of simplified and ad-hoc systems of compliance and unnecessarily high marginal rates.	* To reduce unnecessary and costly "incentives" and preferential treatments of the personal income tax, to broaden its base so that some room is generated to reduce marginal rates, the combined effect should be an increase in revenue of this tax.	major tax erosion exemption special treatment	* Select most obvious cases of base erosion as candidates for immediate action: - Label related benefits - Interest income - Insurance benefits - Capital gains - Income from sale of shares of stock
* "Value Added Tax". Multiplicity of rates breaks the chain of control of VAT and provides a handle for evasion. Imprecise definition of goods and services that may cause evasion through ad-hoc classifications in lower rates.	* Reduction of the number of rates and refining of the objective classifications of goods and services for tax purposes.		* Study a revenue neutral reaccommodation of tax rates, using the 15 percent rate as the benchmark element.
* "Tax Administration". Lack of an efficient system of enforcement and control of taxes and the adequate equipments.	* To enhance the managerial possibilities of current tax administration by simplifying procedural and operational law and reviewing administrative practice.		* Study current procedural code and administrative practices to prepare legislative and operational proposals to simplify and make more expedite and safe the tax process. * Make available the necessary computer equipment to the tax administration in order to allow an adequate evolution of the decentralization process.

PROBLEM	OBJECTIVES	ACTIONS TAKEN/TO BE TAKEN BEFORE BOARD PRESENTATION	MONITORABLE POLICY ACTIONS
4. PARASTATAL FINANCES			
* Drain of Transfers to Parastatals	* Reduce reliance of parastatals on federal resources to cover operating expenses and investment.	* Transfers to parastatals reduced from 5% of GDP in 1983 to 2.4% in 1988 through major real price increases, cuts in real wages, and reductions in investment.	* Prepare a plan of action for the gradual increase of real parastatal prices and start implementation.
5. STATE AND LOCAL FINANCES			
* Fall in the state governments' own tax revenues, particularly property taxes.	* Improvement in own tax raising effects.	* Tax reforms in 1987-88 have increased incentives for states and municipalities to tighten collections.	* Revision to the revenue sharing formula to give added weight to efforts by states to increase own resources and to introduce similar incentives for their municipal governments. * Preparation of an action plan to gradually eliminate non-matching grants for investment and regional development in those states and municipalities able to service Banobras credits on non-subsidized terms.
* Substantial Budget Transfer to the Federal District.	* Very serious deterioration in user charges and property taxes in the Federal District, requiring mounting transfers to cover services.		* Revisions to the Financial restructuring Agreement with the Federal District to require it to accelerate its program of installing and repairing water meters and privatizing the reading and collection of bills due, together with tariff increases (the Pact permitting) and tightened property tax collections sufficient to raise real own resources by at least 20% in 1989.

PROBLEM	OBJECTIVES	ACTIONS TAKEN/TO BE TAKEN BEFORE BOARD PRESENTATION	MONITORABLE POLICY ACTIONS
6. FINANCIAL SECTOR			
* Private sector has extremely limited access to banking sector funds.	* Support the government's objective of having the commercial banks respond only to market forces.	* Some bankers acceptances are exempt from the forced lending requirements.	* Eliminate forced lending to the government (31% and excesses over Dec. 1987 limits.) Government could issue more bonds which could be voluntarily held by banks or public. * If these changes widen the budget deficit excessively, reduce the interest paid on required reserves.
* Misallocated credit.	* To ensure that the most productive investments are financed.	* All lending by development banks and trust funds are at least at commercial bank cost of funds (except small farmers, etc.)	* Eliminate other forced commercial bank lending (10% to development banks, 7.8% to housing, etc., 16.2% for development).
* Reduced bank competition and deposit mobilization.	* To foster greater competion between banks thereby raising efficiency, and to mobilize more deposits.	* Commercial banks are allowed to pay market rates on funds raised through trust funds.	* Let each bank set its own deposit interest rates.
* Inefficient financial intermediation.	* To reduce the costs of intermediation.		* Increase scope of brokers' activities. * Allow modernization, perhaps via joint ventures between brokers and foreign institutions.
* Role of development banks and trust funds unclear. Subsidies inadequately controlled.	* To improve administrative efficiency and ensure that subsidies are well targeted and controlled.	* Government's new policy is to lend to development banks and trusts at CETES supplemented with subsidies through budget.	* The role of each trust fund and development bank to be defined, and overlaps eliminated. * Re-examine role of transactions between trusts, development banks and public enterprises; eliminate conflicts of interest. * Centralized monitoring of all subsidies through various development banks and trusts. * Reduce and better target subsidies.
* Inadequate supervision and prudential regulations.	* To safeguard the solvency of the banking system and brokers.		* Classify banks' loan portfolios according to default risk. * More stringent provisioning for loan losses and interest accruals. * Disclose the state of each bank's financial state in detail to the public. * Improve and enforce supervision of brokers (e.g. margin loans).

BLEM	OBJECTIVES	ACTIONS TAKEN/TO BE TAKEN BEFORE BOARD PRESENTATION	MONITORABLE POLICY ACTIONS
7. AGRICULTURAL SECTOR			
* Reduce distortions in producer prices.	* For all commodities except [[sugar]], coffee, tobacco and milk maintain producer prices in relation to international producer prices within 100 to 120% of international prices. Producer prices (except for beans and maize) had been agreed under AGSAL to be within 90 to 125% of international prices.	* Price adjustments during 1988, have reduced the gap between domestic and international prices.	* Gradual elimination of remaining export tariffs (except beef), reference prices and elimination of export permits (licenses) for agricultural and fisheries products. * Reduction of export tariffs on beef from 20 to 10 percent and eliminate producer price controls on fish.
* Nontransparent allocation of quotas in foreign markets for sugar, coffee and tobacco.	* Make allocation of quotas more transparent and increase government revenue. A comprehensive study of sugar pricing has been agreed under AGSAL.	* Sales of sugar factories in 1988, over and above the goals set in the AGSAL.	* Actions on sugar sector to depend on results of study. * Auctioning off of coffee quota to the international coffee agreement. * Study of TABAMEX and tobacco price and trade policy.
* Controlled consumer prices which lead to large general food subsidies (transfers to CONASUPO) and misallocation of resources.	* Eliminate all consumer price controls.		* Gradual elimination of consumer price controls according to an agreed time table.
* Reemergence of general food subsidies	* Complete replacement of general food subsidies by targeted food subsidies. * Compensate low income consumers for food price rises. * Comprehensive evaluation of food subsidy and nutrition programs as agreed under AGSAL.	* Expansion of targeted food subsidies LICONSA, CONASUPO/RURAL to US$350 millions in 1988.	* Agreement on an action plan to extend the tortibono program in urban areas and to create a rural food entitlements program for low income groups. * Expansion of budget for targeted food subsidies to $??? million in 1989.

MXC - PROPOSED SAL - DRAFT POLICY MATRIX

PROBLEM	OBJECTIVES	ACTIONS TAKEN/TO BE TAKEN BEFORE BOARD PRESENTATION	MONITORABLE POLICY ACTIONS
* Excessive transfers to BANRURAL and ANAGSA.	* Reduce transfers to BANRURAL to 50% of 1988 transfers (US$1384 million). * Convert ANAGSA into a self-sustaining reinsurance agency to reduce transfers from their 1988 level of US$510 million.	* BANRURAL has increased recovery of its portfolio to ??%. * Interest rates have been raised to at least 100 % of CPP for commercial producers and to 95 % of CPP for small farmers and ejidatarios.	* Further improvements in collections of overdues by ??? % percent. * Classify commercial ejidatarios as such and treat them like commercial farmers in all aspects of credit regulations. * Abandon paternalistic credit practices such as the release of credit in kind and in numerous small installments. * Abolish differences among credit lines which differ only slightly in interest rates. * Increase the share of credit channeled through unions of ejidos, credit unions and non-governmental organizations. * Provide credit subsidies to small poor farmers in the form of transparent upfront grants rather than via interest rates. * Reduce transfers to ANAGSA by 50 percent of 1988 level. * Implement reorganization plan for ANAGSA. * Eliminate compulsory insurance requirements for obtaining agricultural credit.
* Subsidies to fertilizers (of US$ 103 million), electricity (US$ 353 million) and O&M costs of irrigation districts.	* Set fertilizer prices at international levels. * Raise electricity charges for irrigation water to recover full cost. * Turn responsibility for operation and maintenance of all irrigation districts to users associations.	* Increase in fertilizer prices in 1989 by ??? percent as part of the fertilizer sector loan.	* Prices to be adjusted during 1989 and 1990 following the rules agreed in the fertilizer sector loan. By 1990 domestic prices should be liberalized. * Time table for the reduction in the gap in electricity tariffs and start of implementation. * Time table for the turning over of the operation and maintenance of six irrigation districts to users and start of implementation.

MXC - PROPOSED SAL - DRAFT POLICY MATRIX

PROBLEM	OBJECTIVES	ACTIONS TAKEN/TO BE TAKEN BEFORE BOARD PRESENTATION	MONITORABLE POLICY ACTIONS
* Insufficient public investment in agricultural infrastructure and land improvement.	* Enlarge public investment for fishing projects, restore maintainance and expand program for rainfed agriculture, especially drainage. * Add 810 thousand hectares of irrigation and 2.4 million hectares of improved rainfed land.	* a) It has been agreed on terms of reference for water pricing studies and of investment cost recovery in irrigation, b) Increase UW$200 million over 1988 budget as condition for second tranche release of AGSAL, and c) GOM will provide timetable for full recovery of O&M expenses.	* Raise agricultural investment budget for 1989 to US$505 million.
* Inadequate research and extension.	* Transform the public research system (INIFAP) into a decentralized public organization which will recover 50% of its operation expenses from producers. * Expand research in the rainfed south. * Reform the agricultural extension service; relieve extension agents from functions not related to technology transfer. * Provide vehicles and operating expenses and improve quality of staff.	* PROCATI pilot project in operation.	* Change legal status on INIFAP by first tranche release so as to allow it to charge farmers for research. * Expand research budget for 1989 from 76 mm pesos to 150 mmp (1988 pesos). * Redefine role of extension agents and create separate agricultural statistical service by second tranche release. * Expand budget for agricultural extension by 40% in 1989.
* Better seed supply.	* Increased participation of private sector in seed production. * Sell PRONASE assets in advanced agricultural regions to private sector.	* Timetable for the liberalization of seed imports. * Timetable for the selling of PRONASE assets.	* Complete liberalization of seed imports. * Restructuring of PRONASE.

MXC - PROPOSED SAL - DRAFT POLICY MATRIX

PROBLEM	OBJECTIVES	ACTIONS TAKEN/TO BE TAKEN BEFORE BOARD PRESENTATION	MONITORABLE POLICY ACTIONS
B. TRADE POLICY			
* Policy Intentions	* Enhance credibility and sustainability of reform.	* Announce and publish Trade Policy Statement with Medium-term goals and next steps.	
* NTBs	* Further reduction of NTBs to lower protection, increase transparency and limit discretion. Current coverage 23% of tradable production (1986 weights).	* Maintain progress. Start studies to inform further reductions.	* Reduce QR coverage (excluding those on oil and derivatives) to less than 10% of tradables production (1986 weights).
* Tariffs	* Reduce tariffs to lower level and variability of protection. Current tariff range 0-20%.	* Maintain progress.	* Reduce maximum tariff to 15%.
* Anti-dumping	* Consistency with trade liberalization program.		* Review experience and consider improvements.
* Export Controls.	* Promote exports. Current coverage 25% tradable production.	* Maintain progress.	* Reduce production coverage by 10 percentage points to have less than 15%.
* Institution Building.	* Support reform process.	* Launch studies of customs procedures.	* Review experience. Action plan to improve automaticity, transparency and access.
		* Consider establishing a trade transparency agency. Review international experience.	* Action plan for simplification and modernization of importing and exporting procedures.

PROBLEM	OBJECTIVES	ACTIONS TAKEN/TO BE TAKEN BEFORE BOARD PRESENTATION	MONITORABLE POLICY ACTIONS
9. SOCIAL SECTORS			
* Insufficient coverage of, and inefficiencies in social service delivery systems (SSDS) at the States level and limited capability at the central level for planning, monitoring and supporting the decentralization (or deconcentration) programs for the SSDS.	* To prepare sectoral programs for the consolidation of the SSDS. * Begin implementation of sectoral programs, given priorities that would benefit the poorest and those presently unserved.	* To provide budget funds for the preparation of the sectoral programs in the 1989 budget. * To develop TORs for "Programas Sectoriales 1989-94" by agreement between the "globalizadoras" and the "cabeza de sector". * To provide funds in 1989 for financing the implementation of the sectoral programs during 1989. At a minimum funding should be provided for expanding targeted food subsidy and food supplementation programs: pre and postnatal maternal and child care and rural and periurban education, water supply and sanitation. Also, to support key institutional developments.	* Approval and implementation of the "Programas Sectorales".

October 20, 1988

88103102/ 1.

The World Bank
OPERATIONS COMMITTEE

CONFIDENTIAL

Minutes of the Operations Committee Meeting to Consider URUGUAY - Second Structural Adjustment Loan Initiating Memorandum

Held on October 20, 1988 in Room E-1243

A. Present

Committee

Messrs. W. Thalwitz (Chairman)
O. Yenal (ASIVP)
J. Holsen (VPDEC)
H. Scott (VPLEG)
D.C. Rao (VPFPR)

Others

Messrs. V. Dubey (EAS)
U. Thumm (EAS)
T. Baudon (SVPOP)
P. Bottelier (LA4DR)
D. Bock (DFS)
M. Rowat (LA4DR)
S. Bery (LA4CO)
J. Giral-Bosca (LA4CO)
K. Jay (SPRPA)
A. Thorne (CECFP)
A. Harth (CODOP)
A. De Juan (CECFP)
Ms. M. Karanja (LEGLA)
S. Mitra (FRS)

B. Issues

1. The meeting was called on the IM for a proposed second Structural Adjustment Loan (SAL) to Uruguay in an amount of $140 million. (The discussion broadly followed the agenda prepared by the Economic Advisory Staff.) The central issues of the discussion were (i) the content of the proposed SAL and (ii) its amount and disbursement profile.

SAL Content

2. The Chairman opened the meeting by seeking a judgement on the adequacy and strength of the SAL components other than those related to the financial sector, while at the same time recognizing that there would be some deepening of reform efforts in public enterprises, civil service compensation, and social security. Other speakers additionally questioned the adequacy of the projected domestic savings effort, the need for (quick-disbursing) balance of payments support given the projected improvement of Uruguay's net reserve position, and the adequacy of the proposed financial sector reforms given the seriousness of current problems and distortions. As an additional thought, the question was raised whether debt-equity swaps could be considered as part of the proposed solution to recapitalizing the three commercial banks in critical condition.

3. The Region stressed Uruguay's good performance in the past and the risk of backsliding if Bank support was not forthcoming, the soundness of the macroeconomic framework, and the importance of the new reform efforts in the financial sector, the social security system, public enterprises and salary structures of the public sector. It was particularly noted that, in spite of the good performance and the government's commitment to continued reforms, the situation was fragile and there were still serious impediments to returning to a normal economic and financial situation. The LAC representative remarked that the projected improvement in savings rested on the hypothesis of sensitivity of savings to incentives stemming from the financial reform. On the other hand, it was also pointed out that substantial repayments to the IMF over the medium term should be considered as part of the financial normalization process and return to creditworthiness.

Financial Sector Issues

4. On Uruguay's financial sector and the adequacy of the proposed reforms, at the request of the Region, Mr. de Juan, CECFP (who has been involved in advising the Government of Uruguay on these matters) gave a brief account of the grave problems and distortions facing the sector. The Sector is characterized by a large state bank (Banco Republica or BROU) monopoly with about 70-80 percent of the market (including assets assumed from three failed banks) and incurring losses to the tune of $10 million per month (starting from a stock of accumulated losses on the order of $200 million). At the same time BROU receives subsidies equivalent to about $25-30 million per year. He also noted the shortcomings of current prudential regulations which allowed banks to hide actual losses. In summary, he concluded that there was a need for major reforms, including a major clean-up of the portfolio.

5. Summing up this portion of the discussion, the Chairman felt that the proposed loan would adequately address the question of financial sector regulation and capitalization but that the discussion had raised additional issues as to the overall policy framework, within which the commercial bank restructuring would take place, culminating in the question of financial sector subsidies with ramifications to trade and fiscal policies. While he was supportive of the SAL's maintenance character in the macro field, he expressed doubts regarding the adequacy of the proposed financial sector reforms and the readiness for appraisal. The Region responded that Mr. de Juan's confidential work for the Government, which has provided the basis for the financial sector aspects of the loan, would be supplemented by more detailed portfolio analysis during appraisal. The appraisal mission was being staffed to address this issue and the issue of the financial sector as a whole. It was also pointed out that the action plan under the matrix BROU's noncommercial activities would be separated from its banking business to provide a proper basis to measure performance; also that privatization of the recapitalized banks in order to restore competition to the domestic banking system was an integral part of the proposed reform.

Loan Amount and Disbursement Profile

6. The Chairman, supported by several speakers, felt that the country's financial situation and the nature of the macro policy agreements

did not by themselves warrant a quick-disbursing loan in an amount as large as $140 million. He also queried the need for three tranches. If this large amount was needed for balance of payments support, this would argue for use of IMF resources rather than enhanced surveillance although he accepted the region's general principle that quick disbursing bank loans were compatible with a reduction in IMF exposure in a well-performing country. Several speakers supported a reduction of the loan amount and a possible restructuring of the proposed loan so as to disburse directly about half the loan for the actual recapitalization of the banks (which would require foreign exchange resources because of the particular composition of the portfolio) against monitorable progress in the restructuring of the banks.

7. The Region stressed that a significant reduction of the loan amount could send the wrong signal to the very sensitive financial market in Uruguay as expectations had been created based on earlier conversations between the Government and Bank management. It was also noted that the financial restructuring was the last major problem to be addressed in order to pave the ground towards financial normalization.

C. Decisions

8. The Chairman decided that the SAL amount should be limited to $100 million to be disbursed in two tranches. With strengthened financial sector conditionality and a " quasi-projectization" of the financial restructuring program, a slightly higher loan amount of about $120 million might be justified. The Chairman also said that the Region could reopen the question of the amount and structure of the loan with Mr. Qureshi upon his return.

UThumm:vlw
October 20, 1988

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

881018009 1.

OFFICE MEMORANDUM

DATE: October 18, 1988

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

V Dubey

EXTENSION: 78051

SUBJECT: URUGUAY - Proposed $140 million Second SAL, Initiating Memorandum, Agenda

1. The Operations Committee will meet on October 20, 1988 at 2:30 p.m. in Room E-1243 to discuss the Initiating Memorandum for the proposed $140 million Second Structural Adjustment Loan (SAL) to Uruguay. The Operations Committee may wish to discuss the issues as set out in paragraphs 3-6.

Background

2. The proposed loan would support the continuation of the structural adjustment process in Uruguay, initiated in part during the 1970s and early 1980s and stepped up by the present government since 1985. The Bank supported this process through SAL I (approved in June 1987) which concentrated on three broad areas: trade policy, public sector management (with emphasis on social security, the most important public enterprises, and public investment planning), and financial sector reform. Building on solid ground (of policy performance and results), the proposed SAL II would continue to support reform measures in these areas to help Uruguay sustain economic growth of about 4.5 percent a year over the medium term while maintaining financial viability, with a further gradual reduction of inflation. The specific program supported by SAL II would give highest priority to the completion of the reform of the financial system, while also putting in place an adequate regulatory environment for private sector activities and continuing public sector management reforms, particularly in the social security system. Several questions arise as to (i) the orientation and design of the proposed loan and (ii) the overall financing program and burden sharing between the Bank and other external creditors.

Orientation and Design of the SAL

3. The most recent CPP was prepared in June 1986. While the then proposed Bank assistance strategy emphasized the need for support of sound macroeconomic policies and structural reforms, Bank lending (at a higher than the historically observed level) was planned to be concentrated (over 80 percent) on traditional investment projects. SAL II was then listed as a reverse operation for $80 million. Since a CSP has not yet been prepared for OC review, the Region could be asked to put the proposed operation into the broader context of the planned assistance strategy over the next five years and to focus particularly on the importance of the reforms (to be supported by SAL II) and the merit of their support through a quick-disbursing loan within Uruguay's overall medium-term investment and financing requirements.

4. The IM gives a good account of the Government's reform initiatives in the past and thus puts the policy measures to be supported by the proposed loan into a longer-term perspective. However, one gets the impression that the proposed loan would basically just support the continuation or completion of ongoing reforms without embarking on important new initiatives. One is particularly struck by the absence of any new measures in trade policy and the slow pace of further progress in reducing the public sector deficit (now mainly originating in the Central Bank) and inflation. The Region could be asked to comment on the feasibility of and scope for further and more energetic actions in the above areas.

5. The IM stresses the need for vigorous action in the financial sector and justifies external financial support with the need to preserve private sector access to Uruguay's limited domestic financial resources. However, in the absence of a monetary program, the IM fails to make the case for the use of quick-disbursing foreign exchange for the recapitalization of government owned banks, the proposed loan amount, and the related front-loading of disbursements. The Region could be asked to discuss possible financial alternatives of refloating the commercial banks in question and also comment on the feasibility of a less skewed disbursement profile.

Overall Financing Program and Burden Sharing

6. The IM projects a current account deficit in the balance of payments of about 1.5 percent of GDP over the medium term. Through 1992, Uruguay's gross financing requirements are kept at a relatively low level as a result of the 1988-92 MYRA with commercial bank creditors. However, the IMF is projected to receive net repayments amounting to $377 million during 1988-92, which leaves the Bank, the IDB (possibly with over-optimistic assumptions) and some (not clearly identified) "other" creditors as the main sources of financing (table 4, p. 15). This would have a major impact on the Bank's exposure in Uruguay: the debt service to the Bank in relation the country's exports is projected to rise from 2.7 percent in 1987 to over 4 percent in the 1990s (attachment 3-C). The Region could be asked to shed some light on the feasibility of financial flows from "other" sources of external financing to meet Uruguay's requirements (which may be even slightly under-estimated as reserves are projected to remain constant at the end 1988 level). Moreover, the Committee may also wish to discuss the role of the IMF, which would be limited to enhanced surveillance, without use of Fund resources.

cc: Messrs. Lee, COD; Shakow, Liebenthal, SPR; Holsen, CEC; Rao, Steer, FRS; Burmester/Thahane, SEC; Baudon, SVPOP; Selowsky, LACVP; Bottelier, LA4DR; Bery, Giral, LA4CO;

For Information

cc: Messrs. Hopper, SVPPR; Bock, DFS; Goldberg, VPLEG; Frank, Parmar, Pfeffermann, IFC: Baneth, IEC; Tanaka, (Ms.) Haug, EXC; Robless, OPNMS

UT
UThumm:cpf

[redacted] WORLD BANK/INTERNATIONAL FINANCE CORPORATION

881014012 1.

OFFICE MEMORANDUM

DATE: October 13, 1988

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

THROUGH: S. Shahid Husain, RVP, LAC

FROM: Pieter Bottelier, Director, LA4 P.B

EXTENSION: 39378

SUBJECT: URUGUAY-Second Structural Adjustment Loan Initiating Memorandum

1. Attached for consideration by the Operations Committee is the Initiating Memorandum for a proposed Second Structural Adjustment Loan (SAL II) to the Republic of Uruguay. Subject to the guidance and approval of the Committee, we plan to have an appraisal mission in the field in late October.

2. On July 25, 1988, Uruguay's Minister of Economy and Finance, Mr. Zerbino, met with you to request Bank assistance for financial sector reforms, preferably under the umbrella of SAL II which was already under preparation at that time. The Minister requested that we double the loan amount from the originally planned $80 million to $160 million in line with the financial needs generated by the expanded coverage of the reform program. Because of the urgency of the country's financial sector problems and the upcoming Presidential elections (November 1989), Mr. Zerbino asked the Bank to accelerate the processing of the requested loan as much as possible. He hoped that we could aim at Board presentation not later than January 1989. You agreed to consider in principle the integration within SAL II of a financial sector reform program provided adequate sector knowledge existed in the Bank, but you expressed reservations about the amount of the loan (too large for a single Bank loan to a country of Uruguay's size). Following this exchange with Mr. Zerbino, our staff continued the preparatory work for an expanded operation based on the considerable financial sector knowledge that had been developed by Mr. de Juan (PPR) in the course of a special technical assistance mission to Uruguay on financial restructuring in late April 1988.

3. The Initiating Memorandum reflects preparatory work up to now. We expect to be more specific about some details of the program (e.g., performance targets) in the loan documentation after appraisal. It should be noted that this is not a new adjustment operation but a continuation of Bank support for a macroeconomic framework and structural reforms established under a highly successful SAL I. SAL II places particular emphasis on tackling a persistent problem in the banking sector, which requires major institutional surgery, supported by an adequate injection of resources. We envisage that SAL II will be the end of our SAL program in Uruguay.

Region is asking to have an O.C. meeting on this during your absence. Do you agree?

Yes. If they believe it is necessary. E

4. The proposed loan amount of US$140 million, though less that requested by the Government is, of course, still high for a small country like Uruguay. I nonetheless feel that this relatively high amount is justified in this case for the following reasons:

(a) Our financial sector work shows that an effective financial sector reform program for Uruguay requires an equity injection into the relevant banks of at least US$200 million equivalent. If we reduce the loan amount below US$140 million, there is a real risk that the Government may not be able to mobilize sufficient long-term funds for this purpose.

(b) Uruguay has underborrowed from the Bank in the past (US$37 million on average per annum from FY81-86); present exposure is relatively modest.

(c) Uruguay is one of the best performing economies in LAC and responsive to Bank advice. We see the need for serious financial sector restructuring as the most important remaining economic policy task for the Sanguinetti Government. The authorities agree and this was the basis for Mr. Zerbino's request to you in July. The Bank should be willing to provide a loan that is sufficient in size to permit speedy implementation of the reforms.

5. Under the current arrangements with the IMF (enhanced surveillance), Uruguay is expected to repay substantially the short-term assistance received from the Fund under previous Stand-by programs. This is a positive development and a required step for Uruguay to regain full creditworthiness and unrestricted access to commercial bank financing in the early 1990s. It is also consistent with the agreements reached with the commercial banks in the MYRA and the Power Sector cofinancing operation (B-loan) with the Bank. One inevitable implication of this scenario is that quick disbursing funds under the proposed SAL II would be made available while the country is repaying the IMF. This may seem as a problem by some but, given Uruguay's strong recovery, I believe that it is a problem in appearance only, not in substance.

Attachments

JGiral-Bosca/PBottelier:rm/cj

Distribution:

Operations Committee

Messrs. Jaycox (AFRVP); Karaosmanoglu (ASIVP); Thalwitz (EMNVP); Wood (VPFPR); Shihata (VPLEG); Rajagopalan (VPPRE); Fischer (VPDEC); Vergin (SVPOP).

	Outside Region	Inside Region
cc: Messrs./Mesdames	Lee (COD)	Selowsky (LACVP)
	Dubey (EAS) (2)	Segura (LACVP)
	Shakow (SPR)	Quijano (LACVP)
	Holsen (CEC) (3)	Choksi (LA1DR)
	Rao (FRS)	Steckhan (LA2DR)
	Burmester/Thanane (SEC)	Loh (LA3DR)
	Liebenthal (SPRPA)	Bottelier (LA4DR)
	Steer (FRS)	Bery (LA4CO)
	Baudon (SVPOP)	Tyler (LA4CO)
	Hopper (SVPPR)	Scherer (LA4TF)
	Stern (SVPFI)	Joyce (LA4AG)
	Bock (DFS)	Thys (LA4IE)
	Goldberg (VPLEG)	Nissenbaum (LA4CO)
	Collell (LEG)	Giral (LA4CO)
	Cucullu (LEG)	Psacharopoulos (LATTF)
	Frank (CFP)	Iskander (LATTF)
	Parmar (CIO)	Larrain (LATTF)
	Pfeffermann (IFC/CEI)	De Juan (CECFP)
	Baneth (IEC)	Flannery (DFS)
	Haug (EXC)	Thumm (EAS)
	Tanaka (EXC)	
	Robless (OPNMS)	
	Gelb (CECFP)	
	Grothe (LOA)	
	Inakage (VPCOF)	
	Lachman (IMF)	

LAC Information Center

October 17, 1988

881031022 1.

The World Bank

Operations Committee

CONFIDENTIAL

Minutes of Operations Committee to consider
INDIA - Agricultural Extension Development Program
Held on October 17, 1988 in Conference Room E 1243

A. Present

Committee

Messrs. M. Qureshi (Chairman)
A. Karaosmanoglu (ASIVP)
P. Loh (LACVP)
S. O'Brien (AFRVP)
V. Rajagopalan (VPPRE)
I. Shihata (VPLEG)
W. Thalwitz (EMNVP)
J. Wood (VPFPR)

Others

Messrs. T. Baudon (SVPOP)
V. Dubey (EAS)
M. Gopal (LEGAS)
D. Green (AS4DR)
R.G. Grimshaw (ASTAG)
F. Kilby (FRS)
D. Lee (COD)
D. Mahar (EAS)
D.C. Rao (FRS)
G. Reif (SPRPA)
W. Schwermer (COD)
N. Sharma (AS4AG)
M. Wiehen (ASIVP)
O. Yenal (ASIVP)

B. Issues

1. The meeting was called to discuss the Final Executive Project Summary of the proposed India Agricultural Extension Development Program. The discussion covered the main issues raised in the COD memorandum of September 9, 1988 and focussed mainly on the design of the proposed operation and its fit with existing lending instruments of the Bank.

C. The Discussion

2. The Region highlighted the importance that extension plays in agricultural sector growth in India, and emphasized the need for (a) institutional reforms in the extension services of the four project states, and (b) the Bank's continuing involvement in the subsector. The Region pointed out the difficulties of designing a suitable project in a situation where additional investments or foreign exchange were not

required, and where no incremental recurrent costs were being incurred. It had therefore formulated the operation with a strong institutional reform content, while the disbursement of Bank funds would be made against agricultural imports. The additional finance provided by the Bank would help ensure that adequate budgetary resources would be made available to the four project states for investments in agriculture. The Region indicated that if the Committee were to request a significant departure from the proposed project design, particularly a change from its present focus on extension, then the Region would wish to reconsider the project concept.

3. The Chairman, while supporting the Region's emphasis on extension, pointed out that the operation would need to be consistent with the general policy framework of the Bank. In this context he expressed concern that by delinking the use of credit proceeds from the purpose of the project, the operation would provide balance of payments support and would have to be justified on the basis of macro-economic needs. Also, with regard to future policy-based lending in India, by providing resources in the manner proposed, this may set an undesirable precedent. He further pointed out that institution-building is a common theme in many investment operations, and that it was not clear why the operation could not be changed into a sector investment project with the institutional reforms in the extension service being a major element, but without financing recurrent costs which should be borne by the Government.

4. Several Committee members agreed with the views expressed by the Chairman. There was general support for what the Region was trying to achieve in the extension area; but the packaging of the operation, especially the financing of general imports, was not considered to be an appropriate funding mechanism for the project. Instead, it was suggested that the project might directly finance part of the agricultural investment program in the project states while keeping the proposed conditionality on extension intact. Such a shift in the operation transforming it into a sector investment project or another more traditional investment project was considered to be particularly suitable in this case, where the Region was already proposing that the Bank (a) would review the agricultural investment program in the four project states, and (b) reach an agreement with GOI and the states on areas of agricultural investments to be supported and on the criteria to be used in their evaluation.

5. The Region expressed some concern that such a shift in the operation might distract from its extension focus. However, the Chairman and other Committee members emphasized that a change in project design would not have to entail a diminution of the efforts proposed to be made by the project in improving extension services. Rather, the project would provide the Bank with the necessary leverage to ensure that the desirable changes would be made. There should however be a proper linkage between the Bank's financing and the usage of the funds. It was also emphasized

that restructuring the operation to a sector investment project would not require the Bank to appraise each project in the investment program, but that such appraisal could be carried out by Indian authorities in accordance with agreed criteria. In addition to providing the Bank with leverage for improving extension, the restructured operation would assist in strengthening the Bank's dialogue with GOI and the states on agricultural development programs.

6. The Region indicated that, in light of the discussions, appraisal of the operation would be postponed and a decision would be taken on how to proceed. The Chairman concluded that a radical departure from the present project concept was probably not required, but that there should be a clear linkage between the credit proceeds and what the Bank is trying to accomplish. He suggested that some of the Committee members and EAS assist the Region in developing a suitable design of the project.

WSchwermer/mh
October 27, 1988
PC#2:WS2:MIN:AR5

MR. QURESHI

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION
OFFICE MEMORANDUM

DATE: October 13, 1988

TO: Operations Committee

THROUGH: Mr. Attila Karaosmanoglu, Regional Vice President AK.

FROM: David Greene, Acting Director, AS4 DG.

SUBJECT: **INDIA - Agricultural Extension Development Program**

1. To clarify concerns regarding the above operation, we submit the following comments on the questions outlined in the agenda, dated September 9, 1988, for the Operations Committee discussion on October 17.

General

2. We consider institution development at the state level to be a key element for promoting agricultural growth. The government maintains, and we concur, that a strong research and extension program is a necessary condition for the states to increase productivity, to intensify agriculture, and to promote agricultural diversification and resource conservation. Experience in the states shows that technological measures have increased productivity, changed cropping patterns and encouraged conservation measures.

3. We have had an active agricultural sector work program in India and an intensive dialogue on agricultural strategy, especially in rainfed areas, where poverty is more acute and environmental deterioration more severe. The Government, partly as a result of this, and partly as a result of its own parallel investigations, has been shifting its strategy for these areas, emphasizing watershed development and soil and moisture conservation. A broadening of extension activities to encompass soil and moisture conservation, animal husbandry, fodder and agro-forestry is essential if this approach is to be successful.

4. The proposed operation is an effective way of achieving our objective of making extension more efficient, flexible and cost effective in keeping with the changing conditions in agriculture. We agree that a state sector approach to agricultural lending in India would be desirable. We intend to head in that direction but we feel the time is not ripe for such an intervention. As a first step, we have chosen four of the more advanced and responsive states and are concentrating, for the time being, on reforms of the extension service, plus agricultural strategy and the orientation and composition of their investment programs. We hope that over time, as our relationship matures, we will be able to broaden the approach into full-fledged sector lending in these states and, perhaps beginning in the same fairly modest manner, into other states as well.

Agenda Items

Items 4(a), (b) and (c): Reference to quick disbursing operation and justification in a macro-context.

5. The proposed credit would be a slow disbursing operation (3 to 4 years), supporting institutional reforms at the state level for promoting agricultural growth.

6. The focus of the operation is on institution building. The proposed institutional, administrative and policy reforms are directed at "efficiency enhancing" adjustments to improve public sector management of extension services and to make extension more efficient, flexible and cost effective. The operation will also be instrumental in getting the concerned state governments to prepare their medium and long-term strategy for agricultural development, with clearly defined priorities, and to strengthen state and district planning for agricultural development.

7. While the operation does not deal with macroeconomic management issues, it is consistent with para 37 of the recent "Report on Adjustment Lending", dated August 8, 1988. The operation will offer the borrower reasonable assurance of continuing Bank support for difficult, but important, institutional reforms to strengthen extension over a number of years, notwithstanding that the reforms are not closely linked to the medium term resolution of macroeconomic imbalances.

Item 5(a): Is a $200 m loan justified? How significant are these further reforms and on what basis was the loan amount determined?

8. The proposed operation will generate the need for additional capital. By broadbasing and expanding the coverage of extension in irrigated and rainfed areas, the demand for fertilizer, pesticides and diesel fuel will increase with improved farming practices, changed cropping patterns, and increased farming intensification. Based on data supplied by the states, we estimate that with increased extension efforts the incremental requirements for the above items in the four states would be equivalent to about US$30-40 m annually. Additionally, under the proposed operation each state would prepare a long term strategy for agricultural development, defining clearly priorities for investments in agriculture. With increased focus on rainfed agriculture, soil and water conservation, rural roads and marketing facilities, minor irrigation, and improved utilization of existing irrigation facilities, the need for additional capital would increase significantly in each state. The amounts would be determined during appraisal.

9. The states have a fairly large investment program for agriculture, as well as the capacity to utilize significant amounts of additional resources for investment purposes. The size of the loan, US$200 m, which takes into consideration the overall country assistance strategy for agriculture and the 5-year lending program, is sufficient to ensure both credibility and leverage for Bank involvement, while at the same time

providing the states with some additional resources to finance incremental investments supporting agricultural development. Under the operation, each state could receive, on average, between US$12 m and US$17 m annually.

10. The proposed reforms under the project are significant: (a) the reforms would rationalize rather than increase the size of the organization, manpower, and extension related expenditures; (b) by integrating extension services the reforms would shift responsibilities among line departments, modify the role of the soil conservation department and rationalize the extension activities of the Indian Council of Agricultural Research (ICAR) and the State Agricultural University (SAU), with some implications on staff movements as well; (c) reforms would result in new staff deployment policies and administrative rules and regulations, thus requiring changes in attitude, operations and work performance; (d) by broadbasing extension support, extension workers would have more responsibility in terms of providing technical advice to farmers; (e) with improved programming and budgeting, extension would become more accountable to key agencies, such as Finance and Planning, and would also ensure proper budgeting of extension activities; and (f) the formulation of medium- and long-term agricultural development strategy by each participating state would define investment priorities and would improve resource allocation.

Item 5(b): Should counterpart funds be earmarked for agricultural investments in the four states?

11. For disbursement purposes, the proceeds of the Credit would finance a limited list of imports, mainly agricultural inputs (FEPS, para 11). In terms of using funds to benefit the participating states, in our covering note, dated August 30, to Mr. Qureshi, we outlined two options. One option would be to allow GOI to agree with the states on the financing arrangement to implement the adjustment program for strengthening extension services. In this situation, we would ensure that sufficient budgetary allocation would be made annually at the state level for extension support.

12. The second option, as stated in the FEPS, is more specific. This option would involve the use of equivalent local funds by the project states for investments linked to the states agricultural development plans to support priority investments. This approach undoubtedly departs from the Bank's general rule of using counterpart funds generated from adjustment lending.

13. Given Bank's policy we could accept the first option, using India's standard arrangements for passing funds to states from external assistance. In this case, the objective of assuring the state's incremental funding for the agricultural sector could be achieved by seeking agreement with GOI for the provision of agreed levels of funding to the states for investments in agriculture without any formal link in the loan documents between the provision of such funding and counterpart funds generated by the proposed credit (the amount of funding to be provided to the states would be determined with reference to the credit amount).

Item 5(c): Would incremental agricultural investments be a priority and economical use of funds? How would the state investment plan be reviewed?

14. Agriculture is a predominant sector in the economies of the participating states. While good progress has been made, there is still significant scope for increasing productivity and agricultural intensification, particularly in rainfed areas which account for most of the poor. Consequently, greater attention is given to the development of infrastructure and appropriate farming technologies to spur production. The incremental investments would allow the states to expand agricultural infrastructure, and to strengthen agricultural support services. At this time, the states are strapped of capital resources for expanded investments.

15. Each state will prepare a policy statement for agricultural development. The policy statement will define the thrust of the state's long-term development strategy, clearly defining development goals and priorities. During appraisal, we will examine the investment mix and the extent to which the plan focuses on soil and water conservation, rainfed agriculture, and rural infrastructure. However, each investment program will not be appraised for economic and technical viability, or ranked in any order. Also, we will reach an understanding with the states on possible areas of investments and criteria (subprojects to develop rural infrastructure in rainfed areas, mainly rural roads and marketing facilities, and subprojects to support soil and moisture conservation; subproject selection and appraisal requirements) will be established for incremental investments linked to the operation.

Item 5(d): Has Implementation of Extension Projects been satisfactory?

16. Extension projects in Tamil Nadu, Kerala and Maharashtra have been completed successfully and were fully disbursed at credit closing. The Andhra Pradesh Extension Project is expected to be completed and fully disbursed by March 1989.

17. The five ongoing projects, which cover other states, are contributing to the establishment of the organizational structure, including staffing, of a professional extension system, but implementation and disbursements have been lagging behind somewhat (in aggregate actual disbursements are about 76% of the disbursement profile).

18. Slow project start-up and budgetary constraints have slowed down project implementation. The past droughts have also adversely affected project execution because of budgetary shortfalls. The National Agricultural Extension I is about two years behind schedule. Andhra Pradesh and Madhya Pradesh are expected to be completed by mid-1989, each with one year of delay. The National Extension II and III projects are expected to be completed as scheduled in March 1991 and December, 1992, respectively.

19. Mid-term reviews have been completed under National Extension I and II and action plans have been drawn up to address key problems: funding, in-service training, district level planning, mid-management supervision of extension staff, and location specific research. Through these actions, project implementation is expected to accelerate.

Item 5(e): Should the Bank examine other aspects of agricultural policy in these four states and propose further conditionalities where needed?

20. Based on our experience to date, we consider institution development at the state level to be a key element for promoting agricultural growth. Therefore, at this time, we are only focusing on institutional, administrative and policy reforms dealing with extension. The proposed reforms under the project are significant and difficult to implement. To add other reforms to the operation at this time would be imprudent and would undermine the operation.

21. We have maintained dialogue and policy understanding with the Indians. Under the Drought Rehabilitation Loan, GOI provided a public communication on macroeconomic management, covering macroeconomic policy and agricultural development. Furthermore, we are in general agreement with the direction of the Government's long-term strategy for agriculture, with increased emphasis given to rainfed agriculture, resource conservation and agricultural efficiency. Greater attention is also proposed by GOI to support programs enhancing drought proofing, developing depressed regions, and strengthening support services. Our recent sector studies (extension, wastelands and rainfed agriculture) have initiated dialogue with GOI, which has been timely and has influenced GOI's approach to agriculture. Further, the comprehensive studies on the credit subsector which are now being completed under NABARD will open dialogue with GOI on credit policies relating to agriculture at the national level. Irrigation issues (such as dam safety, R&R, and cost recovery) are addressed under ongoing projects. More recently, through the National Dairy and the Seeds Projects, institutional reforms have been introduced to strengthen cooperatives and the state seed corporations. Also, we intend to further our dialogue by focusing the FY90 CEM on agriculture which will emphasize, among other things, incentives and subsidies. Finally, a number of these policies of national dimension will be discussed best within the context of our macroeconomic discussions with GOI rather than in the framework of a particular project.

Item 6(a): Should the loan be considered as an agricultural sector investment loan, while retaining the extension - related conditionality.

22. This will require a detailed appraisal of the state's investment program and ranking of projects. At this time, neither GOI nor the participating states will accede to this approach. Our intention is to agree with the state governments in this round on the

basic orientation of the investment programs, and the mix of activities rather than on the justification of individual projects. However, over time we expect to broaden the approach into full-fledged sector lending in these states, as well as in other states.

Item 6(b): Should the loan be broadened into an Agricultural Sector Adjustment Loan.

23. The Indians are reluctant to consider a sector adjustment loan with significant conditionality at this time. The proposed operation is in that direction. Moreover, we need additional dialogue with the Indians and more comprehensive sector work to develop an agricultural sector adjustment operation.

Item 6(c): Could extension conditionality be linked with another planned agricultural operation.

24. The adjustments are too numerous and too significant to be linked to another operation.

Item 6(d): Is there a scope for a TA and Training Project.

25. This would not be an appropriate operation, since there is no need for technical assistance.

Sharma:pt

cc: Operations Committee
Messrs. V. Dubey (EAS); D. Lee (COD); A. Shakow (SPR); J. Holsen (CEC); D.C. Rao, A. Steer (FRS); Burmester, Thahane (SEC); R. Liebenthal (SPRPA); T. Baudon (SVPOP); M. Wiehen, O. Yenal (ASIVP); B. Alisbah, D. Greene, W. Humphrey (AS4DR); B. Merghoub (AS4AG), D. Ritchie (AS4CO); A. Golan, R. Grimshaw (ASTAG)

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: October 12, 1988

TO: Mr. Moeen A. Qureshi, SVPOP

FROM: Ducksoo Lee, CODDR DLee

EXTENSION: 73353

SUBJECT: INDIA - Agricultural Extension Development Program
Operations Committee Meeting of October 17, 1988
Comments on the Supplementary Note of October 3, 1988

1. In preparation for the upcoming OC meeting on the above project, Messrs. Merghoub and Sharma of AS4AG had several meetings with staff of PPR, Legal and COD/EAS to provide additional explanations on the proposed operation. They have summarized these meetings in the attached memo from Mr. Merghoub to Mr. Alisbah.

2. I would like to draw your attention to the main points that are relevant to the agenda:

(i) The memo provides clarifications on some matters of project concept and design, but does not affect the point made in the agenda that the operation would be a new lending instrument. The proposal to disburse over a 3-4 year period (para 2 of the memo) does not make it an investment project, since the loan would not support an investment program, and, moreover, disbursements would be made against general imports, which has never been done before, as far as we are aware, for an investment project.

(ii) To support the proposed loan of US$200 million, the memo argues that improved extension in the four project states would result in additional import needs for fertilizer and other inputs amounting to US$30-40 million per year (para 9). There is a problem with this argument in that there is no connection between extension services and what is going to be financed by the Bank.

(iii) The operation would not provide direct financing for state level investments (para 6); instead, each project state would prepare a policy statement for agricultural development, and an understanding would be reached between the Bank and GOI/States on criteria for choosing incremental investments. This raises the question why the operation should not be changed to an investment project supporting directly a set of defined incremental investments.

3. In summary, the memo provides some additional background and clarification on the program, but it adds little to justify the operation as currently designed, or the introduction of a new lending instrument. As an alternative, you may wish to suggest that the project be redesigned as an investment operation to finance specific investments in agreed investment plans in the four states, with appropriate conditionalities to strengthen the extension services.

Attachment

cc: Messrs. Vergin, Baudon (SVPOP), Dubey (EAS)
Casley, Harris, Srinivasan (COD)

WSchwermer/mh
PC#2:WS2:AGR:ARO

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: October 3, 1988

TO: Mr. Bilsel Alisbah, Director, AS4

FROM: Baelhadj Merghoub, Chief, AS4AG

EXTN: 769921

SUBJECT: **INDIA - Extension Development Program**

1. Since last week, Mr. Sharma and I have met a number of key players in connection with the above operation, focusing on the agenda prepared for the OC meeting. We have had separate meetings with PPR (Messrs. Rajagopalan, Colaco, Petit, Vyas and Hayward), Legal (Messes Vorkink and Gopal), and EAS/COP (Messrs. Harris, Schwermer, Siraj and Mahar). On the whole, the discussions were constructive and they have clarified a number of issues and concerns regarding the operation.

2. In sum, we explained the project concept (refer to para--) and emphasized that the proposed credit would be a slow disbursing operation (3 to 4 years), supporting institutional reforms at the state level. We indicated that, based on our experience to date, we consider institution development at the state level to be a key element for promoting agricultural growth. Consequently, at this time, we are only focusing on institutional, administrative and policy reforms dealing with extension which will make extension more efficient, flexible and cost effective.

3. Further, we explained that agriculture is a predominant sector in the national economy, as well as in the economies of the participating states. While good progress has been made, agricultural growth remains low. The states are now challenged to expand the agricultural frontier. GOI and the state governments consider technological development as a "prime mover" of production. Consequently, greater attention is given to the development of infrastructure and appropriate farming technologies to spur production. The government maintains that a strong research and extension program is a necessary condition for the states to increase productivity, to intensify agriculture, and to promote agricultural diversification and resource conservation. Experience in the states shows that technological measures have increased productivity, changed cropping patterns, reduced production costs, and encouraged conservation measures. Therefore, further reforms to improve the efficiency of extension services are important to the success of GOI's current and future initiatives to promote growth and resource management in agriculture.

4. We indicated that the proposed reforms under the project were significant and difficult to implement because of vested interests and bureaucratic inertia. To add other reforms to the operation at this time would be imprudent and would undermine the operation. We noted that we have maintained dialogue and policy understanding with the

Indians. We added that the under the Drought Rehabilitation Loan, GOI provided a public communication on macroeconomic management, covering macroeconomic policies and agricultural development.

5. We stated that we were in general agreement with the direction of the Government's long-term strategy for agriculture, with increased emphasis given to rainfed agriculture, resource conservation and agricultural efficiency. Greater attention is also proposed by GOI to support programs enhancing drought proofing, developing depressed regions, and strengthening support services. We explained that our recent sector studies (extension, wastelands and rainfed agriculture) have initiated dialogue with GOI. We mentioned that this dialogue has been timely and has influenced GOI's approach to agriculture. Further, we noted that the comprehensive studies which are now being completed under NABARD will open dialogue with GOI on credit policies relating to agriculture at the national level. Also, we reported that we intend to further our dialogue by focusing FY90 CEM on agriculture which will emphasize, among other things, incentives and subsidies. Finally, we emphasized that a number of these policies of national dimension will be discussed best within the context of our macroeconomic discussions with GOI rather than in the framework of a particular project.

6. Concerning state level investments, we stated that under the proposed operation, each state will prepare a policy statement for agricultural development. The policy statement will define the thrust of the state's long-term development strategy, clearly defining development goals and priorities. We explained that the review will examine the investment mix and the extent to which the plan focuses on poverty areas: soil and water conservation, rainfed agriculture, and rural infrastructure. However, we asserted that each investment program will not be appraised for economic and technical inability, or ranked in any order. Also, we noted that an understanding will be reached on possible areas of investments and criteria will be established for incremental investments and linked to the operation.

7. The following comments clarify other matters brought up during the discussions:

8. Proposed Operation. The focus of the operation is on institution building. The proposed institutional, administrative and policy reforms are directed at "efficiency-enhancing" adjustments to improve public sector management of extension services and to make extension more efficient, flexible and cost effective. The operation will also be instrumental in getting the concerned state governments to prepare their medium and long-term strategy for agricultural development, with clearly defined priorities, and to strengthen state and district planning for agricultural development. At the state level, this will improve allocation of resources and will promote agricultural development based on production potential and comparative advantages.

9. Financing Need and Loan Amount. The proposed operation will generate the need for additional capital. By broadbasing and expanding the coverage of extension in irrigated and rainfed areas, the demand fertilizer, pesticides and diesel fuel will increase with improved farming practices, changed cropping patterns, and increased farming intensification. Based on past experience, increased extension efforts would result in incremental requirements for the above items in the four states equivalent to about US$30-40 m annually.[1] Additionally, under the proposed operation each state would prepare a long term strategy for agricultural development, defining clearly priorities for investments in agriculture. With increased focus on rainfed agriculture, soil and water conservation, rural roads and marketing facilities, minor irrigation, and improved utilization of existing irrigation facilities, the need for additional capital would increase significantly in each state.

10. The states have a fairly large investment program for agriculture, as well as the capacity to utilize significant amounts of additional resources for investment purposes. The size of the loan, US$200 m, which takes into consideration the overall country assistance strategy for agriculture and the 5-year lending program, is sufficient to ensure both credibility and leverage for Bank involvement, while at the same time providing the states with some additional resources to finance incremental investments supporting agricultural development.

11. Under the operation, each state could receive, on average, upto US$12 m to US$17 m annually over a 3-year period.

12. Use of Counterpart Funds. In our covering note to Mr. Qureshi, we outlined two options. One option would be to allow GOI to agree with the states on the financing arrangement to implement the adjustment program for strengthening extension services. In this situation, we would ensure that sufficient budgetary allocation would be made annually at the state level for extension support.

13. The second option, as stated in the FEPS, is more specific. This option would involve the use of equivalent local funds by the project states for investments linked to the states agricultural development plan to support priority investments. This approach undoubtedly departs from the Bank's general rule of using counterpart funds generated from adjustment lending.

14. Given Bank's policy we could accept the first option, using India's standard arrangements for passing funds to states from external assistance. Therefore, the objective of assuring the state's incremental funding for the agricultural sector could be achieved by seeking agreement with GOI for the provision of agreed levels of funding to

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[1] India presently imports certain quantities of fertilizer, pesticides and diesel fuel.

the states for investments in agriculture without any formal link in the loan documents between the provision of such funding and counterpart funds generated by the proposed credit (the amount of funding to be provided to the states would be determined with reference to the credit amount). This arrangement would be acceptable to Legal.

NSharma:pt

cc: Messrs: Karaosmanoglu, Wiehen, Yenal, (ASIVP); Rajagopalan
Colaco, (VPPRE); Petit, Vyas, Hayward, (AGRDR); Harris,
Schwermer, Siraj, (CODOP); Mahar (EAS); Vorkink, Gopal (LEGAS)
Humphrey (AS4DR); Ritchie, Blinkorn (AS4CO); Slade, Haji,
Oblitas (AS4AG)
Mrs. Thalwitz (AS4CO), Ms. Stern (AS4AG)

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: September 9, 1988

slow disbursing

TO: Operations Committee

FROM: Ducksoo Lee, CODDR

DLee

EXTENSION: 73348

SUBJECT: **INDIA - Agricultural Extension Development Program (Agenda)**

1. The Operations Committee will meet on Wednesday, September 14, 1988 at 3:00p.m. in Conference Room E-1243 to discuss the above project. A Final Executive Project Summary (FEPS) and covering note on the project were distributed by the Region.

2. The Region brought this project to the attention of the SVPOP because it faces a dilemma. Based on both sector work and ongoing projects in India, the Region has concluded that continued Bank involvement in agricultural extension is important for achieving further institutional reforms. However, no further investment or even incremental operating costs are required, so there is no investment project to attach these reforms to. Furthermore, there is neither an agreed agricultural sector-wide reform program nor a macro framework for developing a SECAL. Thus, the Region has come up with what is essentially a new lending instrument--in structure quite similar to a SECAL (lending based on policy/institutional reform; positive list; quick disbursing; tranched), but with the justification and conditionality more in line with that of an investment operation.

3. The first question the OC might consider is whether this is an acceptable new lending instrument for the Bank. There appear to be no close precedents, although in some ways this is similar to proposals for the adjustment components of hybrid loans. Such a new lending instrument would have potential applicability whenever the Bank wished to pursue reforms in a subsector that did not need further investment or incremental recurrent cost financing, and when the Bank did not wish to or feel able to encumber the operation with wider sectoral or macro conditionality.

4. The issues this new instrument would raise include the following:

a) it goes against the thrust of the VPDEC Report on Adjustment Lending, which stresses that quick disbursing operations should be justified in a macro context; the Region might explain the extent to which this could be done in India;

b) it provides little basis for determining the loan amount (see para 5a), as there is no specified project- or macro-level financing gap to be filled; and

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Steve/PC#6/AP5

c) it might be seen as an easy way to provide quick disbursing funds, without requiring a country to submit to the rigors of an adjustment program.

5. Should the OC consider this an acceptable new lending instrument, the main project-specific questions would be:

a) Is a $200 million loan justified? The initial agricultural extension projects in these four states totalled only $67 million (being constrained by investment and incremental recurrent cost needs), for the more basic reform of introducing the T & V system. The Region might explain how significant these further reforms are compared to past achievements, and on what basis the loan amount was determined.

b) Should the counterpart funds be earmarked as proposed for agricultural investments in the four states? While this would increase the project's appeal to the state agricultural departments, it runs contrary to the general Bank rule against earmarking counterpart funds.

c) Would incremental agricultural investments be a priority and economical use of funds in the four states? The Region might explain what role was envisaged for the Bank in reviewing overall state agricultural investment plans and criteria, and the specific incremental investments themselves.

d) Is implementation of the ongoing Indian extension projects in these four states good enough to justify this follow-up operation? The Region might quantify and elaborate on the disbursement delays and other problems.

e) Should the Bank examine other aspects of agricultural policy in these four states and propose further conditionality where needed? The Region might comment on the extent to which there are major issues on other aspects of agricultural policy, and how these might be tackled in conjunction with the project.

6. Should the OC reject the proposed new lending instrument, the main question would be which alternative approach for getting the reforms implemented would be best:

a) A broader agricultural sector investment loan for the four states, in which the Bank would finance incremental investments directly (instead of through counterpart funds, as proposed), while retaining the extension-related conditionality.

b) An agricultural sector adjustment loan.

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9-SEP-88/10:49:00

c) Putting the extension project conditionality into another planned agricultural project.

d) Continued dialogue in the context of sector work and supervision of ongoing projects, combined if possible with a small TA and training project for agricultural extension.

<u>The Region might comment on the feasibility, potential timing, costs and benefits of each of the above</u>.

cc: Messrs. A. Shakow (SPR); J. Holsen (CEC); D.C. Rao, A. Steer (FRS);
Burmester, Thahane (SEC); R. Liebenthal (SPRPA);
T. Baudon (SVPOP); B. Alisbah, W. Humphrey (AS4DR), N. Sharma,
B. Merghoub (AS4AG); D. Ritchie (AS4CO); O. Yenal (ASIVP);
R. Grimshaw (ASTAG)

<u>For Information Only</u>:

D. Hopper (SVPPR); D. Bock (DFS); D. Goldberg (VPLEG);
R. Frank (CFP); J. Parmar (CIO); G. Pfefferman (CEI);
J. Baneth (IEC); M. Haug, J. Tanaka (EXC); C. Robless (OPNMS)

SEttinger:mda
Steve/PC#6/AP5
9-SEP-88/13:18:00

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: August 30, 1988

TO: Mr. Moeen A. Qureshi

THROUGH: Mr. Attila Karaosmanoglu, ASIVP

FROM: Bilsel Alisbah, Director, AS4

EXTN: 73592

SUBJECT: **INDIA - AGRICULTURAL EXTENSION DEVELOPMENT PROGRAM**

1. Acting on your advice, as stated in Mr. Ducksoo Lee's memo of August 16, 1988, we have now prepared for your approval a revised proposal for the Agricultural Extension Development Program. Attached for your consideration is the FEPS, which includes details to ensure clarity on the project scope and concept, on the substantive content of the institutional and policy changes to be obtained from GOI and the participating states, and on the financing arrangement.

2. The above project is not an adjustment lending operation since it lacks macroeconomic conditionality. The project conditions, while significant and comprehensive, support only important reforms in the extension subsector.

3. By supporting significant institutional, administrative and policy reforms in four states -- Tamil Nadu, Kerala, Maharashtra and Andhra Pradesh -- the project would improve the efficiency and quality of extension services and would make extension more responsive to the changing needs of agriculture. The thrust of these reforms is to rationalize rather than increase extension related expenditures. The project would also aim to address some wider extension related issues, including the future role of the soil conservation services and the rationalization of central crop production schemes and the Indian Council for Agricultural Research extension oriented programs. Finally, to ensure that a strong extension program is developed, each state would prepare a policy statement with clearly defined priorities for long-term development in agriculture.

4. As indicated in the FEPS, the proposed reforms are far-reaching and difficult, given the existence of vested interests in the various line departments and entrenched bureaucracy. By integrating extension services, the reforms would shift responsibilities among line departments, with some implications for staff movements as well. Reforms would also result in new staff deployment policies, and administrative rules and regulations, thus requiring changes in attitude, operations and work performance. By broadbasing extension support, extension workers would have more responsibility in terms of providing technical advice to farmers. With improved programming and budgeting extension would also become more accountable to key agencies, such as Finance and Planning, and would ensure proper budgeting of extension activities.

5. The T&V system is recognized as an appropriate and effective approach to providing technical support to farmers, and since 1974, GOI has assisted 17 states in the reorganization and strengthening of their extension services. GOI considers that continued Bank support is needed for the further development and stabilization of extension services because of its long involvement with extension in India. The Bank, under the proposed operation, would act as a catalyst to induce GOI and the states to bring about timely reforms in an orderly manner, with strong commitment from the government.

6. Sustainability of the improved extension system would also be enhanced by the implementation of significant institutional, administrative and policy reforms. The establishment of a more efficient system, responding to the changing demands of agriculture, would receive strong support from the farming community and from key agencies (Finance, Planning) within the government, as it would not result in any significant increase in budgetary outlays.

7. Concerning project financing, we had originally proposed to finance the budget for extension services, but we recognize that this would depart from the Bank's policy on financing of recurrent costs. We therefore recommend that the proposed IDA Credit, US $200 million equivalent, finance a limited positive list of imports, mainly agricultural inputs (paragraphs 11 and 12, FEPS).

8. To provide adequate incentives to the participating states, we propose reaching agreement with GOI on the use of equivalent amounts of rupee funds available for productive purposes. One option would be to allow GOI to agree with the states on the financing arrangement to implement the adjustment program for strengthening extension services. In this situation, we would ensure that sufficient budgetary allocations would be made annually at the state level for extension support.

9. Another option, as stated in the FEPS, paragraphs 11 and 12, would involve the use of equivalent local funds by the project states for investments linked to the states agricultural development plan to support priority investments, such as soil and water conservation, rural roads and electrification, marketing infrastructure, and small-scale irrigation schemes. Each state already has a medium-term investment program for agriculture. The additional funds to the states would induce states to implement the adjustment program expeditiously, while at the same time alleviating their constrained budgetary position. During appraisal we will acquire a good understanding of the agricultural investment plan at the state level and ensure that the investment program reflects each state's overall development priorities. We will explore this subject further with GOI; however, we would appreciate your guidance on this matter.

10. The project is fully consistent with the Bank's Country Assistance Strategy and will have important impact on key objectives: agricultural growth, rural poverty alleviation, and improved services to women in agriculture. It will undoubtedly reach a wider rural audience in both irrigated and rainfed areas. A strong research and extension program is a

necessary condition for these states to accelerate agricultural growth by intensifying agriculture and increasing productivity through improved technology.

11. In summary, we would appreciate your agreement to appraise the project in mid-September, 1988, in accordance with the financing arrangements proposed above.

NSharma:pt

Cleared with and cc: Mr. Merghoub (AS4AG) and Mr. Ritchie (AS4CO)

cc: Messrs. Alisbah, Humphrey (AS4DR); Wiehen (ASIVP) (2);
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Ms. Stern (AS4AG);
Kraske, Baxter, Macklin, Venkataraman (AS4NA)
Asia Information Center; Blackbook

Final Executive Project Summary

India - Agricultural Extension Development Program

Borrower:	India, Acting by Its President
Beneficiaries:	Ministry of Agriculture and the State of Andhra Pradesh, and Kerala, Maharashtra and Tamil Nadu.
IDA Financing:	US$ 200 Million
Appraisal Date:	Mid-September — Tentative Board Date: 5/30/89

Background

1. Since the mid-1970s, the Bank has assisted GOI in the reorganization and Strengthening of its agricultural extension services based on the "Training and Visit" (T&V) approach.[1] Inasmuch as the development of an efficient professional extension system is a slow process, Bank assistance has implicitly involved a long-term commitment to strengthening extension services throughout the country. In the initial phase, it was envisaged that efforts would be directed toward establishing the basic features of the new organization (a single line of command, the concept of contact farmers and regularized farm visits, operational linkages with research and regularized training) and putting in place the required manpower for extension services. It was also envisaged that during this phase, simple improved technological messages, mostly for cereals, were to be disseminated to farmers, mainly in irrigated areas. This was consonant with GOI's policy at that time to achieve self-sufficiency in foodgrain production. As shown in Bank financed extension projects, the investment program during this phase of extension development required high capital expenditures (civil works, vehicles and equipment), with high incremental costs because of the substantial expansion of manpower.

2. It was also recognized that in the second phase, given rapid changes in agriculture, significant further reforms would be needed to integrate different services to farmers to cover all land-based activities (including fodder and animal husbandry, soil and moisture conservation, water management and farm forestry) and to make extension more efficient and responsive to the changing demands of agriculture. This phase of development would not involve the hiring of additional staff, except for some subject matter specialists. It was also recognized that these reforms would not involve significant capital expenditures, or incremental costs.

3. With the support provided under the Bank financed projects, the basic organizational structure of the reformed extension system, including the core staff, has been established in virtually all of the states throughout the country. Experience shows that improved extension services have had positive impact in the adaption of improved technology, productivity, use of modern inputs, and changes in cropping patterns, particularly in those foodgrains receiving extension focus. However, considerable scope

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1 The Bank has financed several projects (9 free-standing extension projects, and 6 projects with significant financing of extension), involving a total expenditure of $597 million, of which Bank's share was $335 million. By 1990, reformed extension is expected to affect over 90% of India's 90 million farm families in 17 major states.

remains for improving the efficiency and effectiveness of extension services. Extension is now at an important crossroads: timely institutional, administrative, and policy reforms, particularly in states where extension is more developed, would integrate into one agricultural extension service all land-based extension activities currently supported by several line departments, and would make extension more efficient, resilient and cost effective, thus allowing farmers to respond more quickly to emerging market opportunities. Such an approach would improve the quality of extension services and discourage the development of costly, parallel extension services. By broadening the coverage of extension services to include all on-farm, land based activities and by taking a farming system approach, the extension worker would be better equipped to provide comprehensive advice to farmers taking into consideration the entire farming operation and the available resources.

4. On the other hand, the nature of agriculture in India is changing. As more farmers are now becoming commercialized, the demand for extension services is becoming more broad-based in keeping with farming systems. Consequently, without further timely reforms the effectiveness of the existing extension system could decline, and such a trend could eventually lead to a progressive weakening of the professional extension services in the states. Also, further reforms to improve the efficiency of extension services are important to the success of the Bank's and GOI's current and future initiatives to improve resource management in the forestry, rainfed and irrigation subsectors. The combined benefits of these initiatives are likely to be very high as demonstrated by on-going pilot operations.

5. A comprehensive sector study of extension services in India was conducted by the Bank in FY88. The study, which identified a number of reforms needed to make extension more effective in the long run, concluded that the T&V approach is an appropriate and effective way of managing extension in circumstances prevailing in India. The study also concluded that extension has a central role for increasing farm income and agricultural production, especially for the 90 million small farmers. The findings of the study, in subsequent discussions, were endorsed by GOI. At the Center, GOI has established a high level Steering Committee, which has developed, together with the states, a long-term strategy for improving extension and is fully committed to the further development of extension services.

Experience with Ongoing Projects

6. Presently, five ongoing extension projects cover twelve states. Overall performance of ongoing projects is generally satisfactory in that the basic systems are firmly established and working well. Performance varies among states reflecting different agricultural conditions, availability of resources, and administrative abilities. However, there are several problems hampering implementation: (i) weak extension management; (ii) inadequate training of staff, especially Subject Matter Specialists (SMS); and (iii) in certain times inadequate budgetary provision and delayed sanction of funds for new project investments and extension operation. Project disbursements have lagged behind Bank's appraisal targets due to delays in project start-up and timely availability of counterpart funds. In some projects, the requirements for civil works, vehicles and staffing have been overestimated, particularly in the initial phases of project execution.

Rationale for Bank Involvement

7. The proposed credit is fully consistent with the Bank's Country Assistance Strategy and will have important impact on key objectives: agricultural growth, rural poverty alleviation and improved services to women in agriculture. It will support the development of more responsive and efficient extension to reach a wider rural audience in both irrigated and rainfed areas with information on the farming system as a whole. Bank support is crucial for the further development and stabilization of extension services in India. Because of vested interests and bureaucratic inertia important institutional, policy and administrative reforms would not be carried out readily or in a timely manner without Bank participation. Financial support from IDA would provide additional funds to states willing to undertake these important reforms, thus helping to alleviate their constrained budgetary position.

Objectives

8. The aim of the proposed credit is to improve the efficiency and quality of extension services and to make extension services more responsive to the changing conditions and demands of agriculture. Ongoing extension reforms which have established the organizational infrastructure for extension support would be broadened and deepened. The proposed credit would also aim to address some wider, extension related issues in India, including the future role and function of soil conservation services and the rationalization of central crop production schemes and the Indian Council for Agricultural Research (ICAR) extension oriented programs.

Project Description

9. In close collaboration with GOI and the states over the past 18 months, an Extension Development Program covering four states -- Tamil Nadu, Kerala, Maharashtra and Andhra Pradesh -- has been prepared. The program is designed to assist GOI and the participating states to introduce a series of important institutional, administrative and policy reforms which would improve extension services. The program would consist of clearly defined monitorable, time bound actions to improve efficiency, quality and sustainability of extension services. Crucial reforms such as broadbasing of extension would involve reallocation of responsibilities and staff among line departments. Such reforms would be demanding since they impinge on vested interests and entrenched organizational structures.

10. The measures, as shown in the attached matrix which includes various actions, timetable and the responsible agency, will focus on five main areas:

a) Broadbasing of Extension Services.

Under the operation, the states would broaden extension coverage to include all farm activities: crop management, animal husbandry, soil and moisture conservation, water management, fodder and agro-forestry, and prevent the development of costly parallel extension services. Coordination among key agencies dealing with state agriculture such as credit and input supply would also be improved. Significant actions would be taken by the states to integrate the roles of extension and conservation services in soil and moisture conservation and water management.

b) Improvement in Extension Management and the Quality of the Service.

Current staff deployment policy will be reviewed and rationalized, minimum entry qualifications raised, and staff training undertaken to upgrade technical as well as management skills so that the service can cover the new subjects and will meet the more sophisticated needs of farmers 10-15 years hence. Performance incentives will be introduced, and the quality of monitoring and evaluation improved. The current system of technology diffusion at village level would be strengthened, and special attention given to improvement of services to women who participate actively in farm operations and management.

c) Research Support to Extension.

The states would take steps to improve coordination between extension and research, to establish incentives to attract scientists to work at zonal research stations, and to broaden the coverage of zonal research to include all farm activities.

d) Rationalization of Centrally and State-Funded Special Programs.

GOI and the state governments would take steps to rationalize the special crop schemes and the ICAR and the State Agricultural University (SAU) extension programs with those of the state DOA to ensure efficiency in the extension operations. Also, measures would be taken to strengthen the Directorate of Extension (DOE) at the Center to play a more important role in training (technical and management) and in providing useful information to the states. DOE would also play a role as a facilitator of extension development in the states by making resources available and by supporting innovative programs for strengthening extension.

e) Planning and Funding of State Agricultural Extension.

The operation would induce states to articulate more clearly their medium- and long-term agricultural development strategy, as well as a strategy for extension development over the next 10 to 15 years. It is considered important that future state extension development be conceived within the context of a long-term strategy for state agricultural development. Furthermore, the establishment of a state consensus on future agricultural extension development will represent a key element of sustainability. To improve resource allocation, the operation would promote states to strengthen planning and budgeting and establish norms (number of travel days for functionaries at different levels, travel allowances, vehicle mileage, maintenance and replacement of vehicles and equipment) for extension support. This process would involve all line departments concerned in agricultural development and the Departments of Finance and Planning.

Proposed Financing

11. With 4 states participating, the proposed IDA Credit would amount to US$200 million, which would be disbursed over three years, in keeping with an agreed program of actions. For disbursement purposes, the proceeds of the Credit would finance a limited positive list of imports, mainly agricultural inputs. For Year 1, total disbursements would not exceed US$50 million; and Year 2 and 3, US$75 million each. In parallel, GOI would

provide, in the form of a fully Centrally Sponsored Scheme, equivalent incremental financing to the four project states for investments in agriculture (para 15); this funding would be additional resources to the state, above its plan and non-plan budgets (para 15 and 16).

12. A crucial question is how much would each participating state receive? One option is to give each participating state the same amount, over the 3-year disbursement period, from IDA credit. The states have a fairly large investment program for agriculture, as well as the capacity to utilize significant amounts of additional resources for investment purposes. The second option is to link the allocation of funds for each state to the size of the total extension program, i.e., to total extension costs annually. We propose that this issue be explored further with GOI before making a final recommendation.

13. Release of Bank Funds. The release of the Credit funds would relate to the actual implementation and satisfactory progress of specific measures and actions to strengthen extension services.

The following measures and actions are to be met by each participating state before negotiations:

(a) Establishment of a "Steering Committee" to provide policy direction, to coordinate inter-department activities in extension, and to guide and monitor the implementation of the adjustment program for improving extension services;

(b) Formulation of a policy statement, with long-term focus and with clearly defined priorities, for state agricultural development;

(c) Formulation of a long-term policy and strategy for extension development, including elements for broadbasing extension services while maintaining the essential features of a professional extension system; and

(d) Preparation of annual and five-year budget plan for extension support.

The proceeds of the Credit will be made available over three years to each respective state.

To begin disbursements for the first year, the following conditions are required to have been completed by each participating state or GOI:

(a) Issuance of government orders, including a timetable for implementation, for integrating and broadbasing of extension services to include all on-farm, land-based activities and execution of department orders to adjust the respective roles of agricultural extension and the soil conservation departments;

(b) Issuance of directive for streamlining the roles and functions of the Directorate of Extension at the Center; and

(c) Issuance of government order establishing standards for operational expenditures, and preparation of a revised five-year budget plan for extension services.

For the second years disbursements the following conditions are required:

(a) Preparation of district production programs and revised annual and medium-term budget plans;

(b) Implementation of a program for strengthening the monitoring and evaluation of extension services;

(c) Implementation of actions, including initiation of studies where necessary, to increase extension coverage to women;

(d) Preparation of a comprehensive training program, including a timetable for implementation, for technical and management staff; and

(e) Satisfactory overall implementation of the agreed program including adherence to the timetable for broad basing extension services and to some indicators of improved efficiency.

Finally, for the third years disbursements the following actions are required:

(a) Rationalization and adjustment of central and state crop schemes and ICAR/SAU extension programs to improve extension performance;

(b) Initiation of comprehensive long-term manpower development plan for extension personnel, and implementation of revised rules and procedures for minimum staff entry qualifications and for incentives and promotion;

(c) Execution of a plan for the expansion of zonal research to cover all on-farm land-based activities and establishment of financial and administrative incentives to attract suitable scientists; and

(d) Satisfactory overall implementation of the agreed program including adherence to the timetable for broad basing extension services and to some indicators of improved efficiency.

14. Release of Funds from GOI to the Participating States. During appraisal, agreement will be reached with GOI and the project states on the the mechanism and conditions for the release of funds to the states for increased investments in agriculture. At that time, agreement will also be reached with GOI and the states regarding priority areas for using transferred funds. Possible areas of investments could include soil and water conservation, rural roads and electrification, marketing infrastructure, and small-scale irrigation schemes.

15. Each state already has a medium-term investment program for agriculture. Under the project, each state would prepare a policy statement, as noted above, with clearly defined priorities for long-term development in agriculture. For the Eighth Development Plan (FY90-95), the states are presently finalizing their five-year development plan. Under the project, a Special Unit, headed by an Additional Secretary, would be established within the Ministry of Agriculture at the Center to ensure, in addition to monitoring the implementation of the adjustment programs in the participating states, that funds are used for agreed sub-projects in priority areas. The sub-projects would be approved annually by

a Committee, headed by DEA, and including representatives from the Ministries of Agriculture and Water Resources and the Planning Commission.

Issues and Recommendations

16. Project Financing and Disbursements. The principal issue relates to project financing; more specifically, against what would disbursements be pegged, bearing in mind that the primary objective of the project is to make extension more efficient and flexible in the long-run.

17. The proposed operation does not conform to the requirements of adjustment lending for balance of payment support and for correcting macroeconomic imbalances. The project conditions, while significant and comprehensive, support only important institutional, administrative and policy reforms in the extension subsector to be carried out by GOI and the participating states.

18. The proposed operation also does not fall in the mold of past and existing extension projects, which finance capital costs and some incremental recurrent costs. As the organizational structure, increased staffing, civil works, vehicles and equipment have already been funded under earlier projects, the need for additional investments and incremental recurrent costs in agricultural extension is marginal. The thrust of the reforms under the proposed operation is to rationalize rather than increase extension related expenditures. Therefore, disbursement under an investment lending operation would have to be against total, rather than incremental extension expenditures. This would, however, depart from the Bank policy of financing only incremental recurrent expenditures in cases where funding from other sources is scarce or unlikely.

19. In light of the above, we therefore recommend that project financing, (para 11 and 12) incorporate elements of both an adjustment operation and a sector investment credit with the states concerned receiving additional resources for increasing agricultural investments, in keeping with their agreed agricultural development strategy.

20. The project would have significant impact on improving the quality of extension services, which, in turn, would have a positive impact on agricultural growth. GOI now considers that continued Bank support is needed for the further development and stabilization of extension services in India. Because of its long involvement with, and working knowledge of extension in India, the Bank is in a strong position to assist. By providing continued support, the Bank will help establish in participating states an effective and flexible professional extension system which can adapt itself to changing farmer needs and be sustainable in the long-run.

21. Substantive Content of Reforms. The institutional, administrative and policy reforms proposed under the project are significant and difficult, given the existence of vested interests and entrenched bureaucracy. First, the reforms are designed to make extension more efficient and flexible. Second, the reforms would shift responsibilities among line departments, with some implications for staff movements as well. Reforms would also generate new administrative policies and procedures, thus requiring changes in attitudes, operations and work performance. By broadbasing extension support, extension workers would have more responsibility. With improved programming and budgeting, extension would become more accountable to key agencies such as Finance and Planning.

22. The Bank would act as a catalyst to induce GOI and the States to bring about timely reforms in an orderly manner, with strong commitment from the government. We consider the reforms to be far-reaching and significant to justify IDA participation.

Benefits and Risks

23. The proposed credit would have long-term beneficial impact on the quality and overall effectiveness of extension in promoting agricultural growth in four participating states and would provide the framework for similar interventions in other states as they become ready and willing to undertake similar reform programs. The proposed credit would support GOI's development efforts toward rapid and diversified agricultural growth, natural resource conservation and poverty alleviation. Finally, by using project funds for increasing investments in agriculture, the states would accelerate agricultural development. The main risk is the timely implementation of the proposed reforms by the participating states.

Sustainability and Replicability

24. The T&V system is recognized as an appropriate and effective approach to providing technical support to farmers. Since 1974, GOI has assisted 17 States in the reorganization and strengthening of their extension services. The national agenda, prepared recently by GOI and the States, for the long-term development of extension services and its continued support to the states, demonstrates the government's commitment to the T&V system. Sustainability of the improved extension system will be enhanced by the implementation of significant institutional, administrative and policy reforms, as outlined above. An efficient system, responding to the changing demands of agriculture, would receive strong support from the farming community, as well as from key agencies (Finance, Planning, Agriculture) within the government.

25. The project is also replicable; as other States establish the basic organizational structure and appoint qualified staff, reforms similar to those proposed under this operation could be implemented in these states to make extension more efficient and flexible.

NSharma:pt

August 26, 1988

SUMMARY MATRIX: MEASURES AND ACTIONS

Issue	Required Changes	Measures and Actions	Timing 1/	Responsible Agency
A. Broadbasing of Extension Services				
1. When T&V extension was introduced, the main emphasis was given to major cereal crops mainly in irrigated areas. Since then agriculture has changed dramatically and National priorities for agriculture have developed to encompass a broader production focus and increased emphasis on natural resource conservation and rainfed area development. The present approach to providing extension support lacks coordination among the natural resource line departments, and encourages development of costly, parallel extension services. In order to provide an effective service based on a farming system approach, state agricultural extension services should broaden the coverage of information they disseminate to include all on-farm, land-based activities.	1.1 Define long-term strategy for extension development and establish policies for the broadbasing of extension services.	(a) Formulate a long-term policy and strategy for extension development.	By negotiations.	Steering Committee.2/
	1.2 Responsbility for technology transfer for soil and moisture conservation on cultivated privately managed lands should become part of the broad based extension service.	(b) Redefine the responsibilities of agricultural extension services to include all on-farm land-based activities. Establish inter-departmental agreement on the reallocation of extension responsibilities.	Issue Government order by negotiations.	Steering Committee.
		(c) Adjust the respective roles of soil conservation units and agricultural extension.	Issue Departmental order by negotiations.	Secretary of Agriculture.
		(d) Prepare an Operational Plan for the establishment of procedures for involvement of concerned line departments in the operation of one integrated state extension service, development of revised job descriptions and of revised monitoring and reporting procedures.	Complete Operational Plan by June, 1989; issue Government Order to implement the above by September 1989.	Steering Committee.
2. Staff deployment has been largely mechanistic based on fixed staff to farmer or staff to staff ratio norms. As a result, deployment has not always been related to real workload and in the case of SMS there are several layers of often poorly qualified staff with disciplines and qualifications the same in each layer which has resulted in some proliferation.	2.1 Review and rationalization of current staff deployment policies, recruitment criteria and rules.	(a) Preparation of a comprehensive long-term manpower development plan for extension personnel based upon revised staff deployment strategies for extension.	June, 1989.	Secretary of Agriculture.
		(b) Start execution of staff redeployment plan for agricultural, forestry, horticultural and livestock extension staff.	September, 1989	Natural Resource Departments under guidance of Steering Committee.

Issue	Required Changes	Measures and Actions	Timing 1/	Responsible Agency
B. Improvement of Extension Management and the Quality of the Service				
1. To be more effective, extension services must work within the context of a well designed and prioritized district agricultural program. Current district planning is weak and lrgely based on a top down targeting approach rather than on district potentials.	1.1 Development of district agricultural production programs based on an assessment of natural resources and agricultural potentials.	(a) Analysis of natural resource and district agricultural potentials and the formulation of a district production program for FY90/91.	By negotiations.	Department of Agriculture/ Relevant Zonal Research Station.
		(b) Preparation of subsequent annual production programs	Annually, June.	Department of Agriculture.
2. To handle information transfer for a wider range of farm activities, for more sophisticated technologies and eventually to improve farm management, the qualitative capacity of extension staff at all levels will have to be significantly increased. Furthermore, current recruitment criteria and staff management systems neither adequately incite the employment of high quality staff, or motivate and reward good work performance. Line managers of extension usually have little training or experience in management per se, specifically in the techniques of planning and programming, financial and personal management.	2.1 Improvement in qualifications and skills of both technical and management staffs.	(a) Rules for minimum entry qualifications of SMS, AEO and VEW and increased direct appointment will be formulated and approved.	Formulate rules by September, 1989, and approve them by March, 1990.	Formulated by Secretary of Agriculture, and approved by Law and Public Service Commissioner.
		(b) Formulate plans for the upgrading of selected incumbent staff to minimum entry requirements.	April, 1990.	Department of Agriculture/State Agricultural University.
		(c) Conduct skill gap analysis to determine overall training needs.	September, 1989.	Department of Agriculture.
		(d) Prepare a comprehensive, costed training program for both technical and management personnel, covering both the upgrading of existing staff through in-service training and upgrading basic educational qualifications of selected young staff.	March, 1990.	Department of Agriculture/State Agricultural University.
		(e) Upgrade management training facilities at MANAGE and prepare a plan to upgrade three or four existing education institutes as regional training centers for the training of mid-level extension managers.	January, 1990.	GOI.

Issue	Required Changes	Measures and Actions	Timing 1/	Responsible Agency
		(f) Start execution of in-service and upgrading training plan.	April, 1990.	Department of Agriculture.
	2.2 Administrative adjustment to introduce incentives for improved performance.	(a) Prepare an action plan and introduce staff performance incentives, such as introduction of selection grades, higher starting salaries for more qualified staff and promotional incentives for SMS to stay within their respective disciplines.	Prepare plan by March, 1990 and introduce incentives by September, 1990.	Department of Agriculture.
3. Established monitoring and evaluation units do not, and lack the capacity to, give sufficient emphasis to evaluation, and extension managers are not making effective use of the information already being generated to improve planning and to assist in implementation.	3.1 Improvement in the quality and content of monitoring and evaluation.	(a) Reformulate FY90/91 work program of the Monitoring and Evaluation Unit.	July, 1989. Prepare M&E work program for FY90/91 by July, 1990.	Department of Agriculture.
		(b) Equip M & E Unit with computer facilities to improve and quicken evaluation studies.	January, 1990.	Department of Agriculture.
4. While the present conduit for message transfer to a wider audience, the "contact farmer", has been found generally effective in dissemination of uncomplicated technology messages, there is doubt that the transfer of more complex information on farm management and the allocation of scarce farm resources can be achieved using the same approach.	4.1 Improve Information Diffusion at Village Level.	(a) Review current system of technology diffusion at village level and prepare operational procedures to complement and strengthen the process.	July, 1989.	Department of Agriculture.
		(b) Issue new procedures to complement the extension process, conduct orientation training and start execution.	April, 1990.	Department of Agriculture.
5. Most state extension workers rarely contact women directly and also tend to give less emphasis to those agricultural activities that are more or less specific to women. Also, there are few women in the professional extension system providing technical support.	5.1 Modify and strengthen extension services to improve the level of contact with farm women.	(a) Initiate actions and where necessary studies to improve the performance of extension services in reaching women in agriculture.	July, 1989.	Department of Agriculture.

Issue	Required Changes	Measures and Actions	Timing 1/	Responsible Agency

C. Research Support to Extension

1. The technical strength of the extension service is, to a large extent, determined by the ability of the research system to generate improved location-specific technologies responsive to farmers' needs. The generation of such technology is at present limited, particularly weak in several rainfed ecologies and rarely backed by economic evaluation prior to dissemination to farmers.	1.1 Improved Support from Research.	(a) Establish financial and administrative incentives introduced to attract scientists and economists to work at zonal stations. Achieve full staffing at already established zonal research stations.	Introduce incentives by November, 1989. Achieve full staffing by October, 1990.	State Agricultural University.
		(b) Formulate and implement a plan under the context of NARP for the expansion of zonal research to cover horticulture, farm forestry, fodder and animal husbandry, etc.	Establish plan by September, 1989 and start implementation by June, 1990.	State Agricultural University.

D. Rationalization of Centrally and State Funded Special Programs and Role of the Directorate of Extension

1. Centrally funded special crop schemes are intended to encourage the development of particular crops or aspects of agricultural development of national importance. They mainly involve the distribution of large numbers of subsidized farm inputs and kits. In circumstances where the associated work load is high, extension work can be disrupted. Some old schemes may have become redundant and certain scheme components serve little purpose. In cases where the states do not exert sufficient flexibility to tailor given central scheme parameters to suit local conditions, management and resource allocation can become competitive and affect overall efficiency and performance of extension support.	1.1 Review and rationalize crop schemes, to fit local state conditions. Establish procedures whereby States have, and effectively employ, flexibility to design and modify special crop schemes in order that they respond to State priorities and local constraints and are fully integrated into extension work as tools in technology transfer.	(a) Review and rationalize central crop schemes and their components.	Start State review May 1989.	GOI and State Government.
			Complete scheme3/ review on national basis September, 1989.	GOI and State Government.
		(b) Prepare rules for state level execution.4/	April, 1990.	GOI and State Government.

Issue	Required Changes	Measures and Actions	Timing 1/	Responsible Agency
2. Similarly, aspects of several ICAR supported extension programs are no longer relevant or complementary to recent developments in extension and research.	2.1 Review and rationalize ICAR extension program and develop a plan for the improved utilization of available technical manpower and other resources.	(a) Review ICAR/SAU extension programs and prepare an action plan for their rationalization.	Complete review and preparation of action plan by January, 1990.	Indian Council for Agricultural Research/State Agricultural University/Department of Agriculture.
		(b) Joint agreement upon proposed action plan, including redeployment of staff as required by State's Steering Committee and execution of action plan.	Initiate Program by April, 1990.	State Agricultural University/Indian Council for Agriculture Research/Department
3. Also, the future role of the Directorate of Extension requires redefinition so that it focuses on those activities for which it has comparative advantage, particularly in the dissemination of information, data and field experience to all states.	3.1 Reorient the role of DOE to focus more on training and and disseminating relevant data and information to all states. Formulate a revised work program for the Directorate of Extension reflecting its comparative advantages.	(a) Redefine the roles and functions of Directorate of Extension and formulate programs of work for each unit.	By Negotiations.	GOI/ Directorate of Extension.
E. Planning and Funding of State Agricultural Extension				
1. The absence of a clear policy and a comprehensive long-term strategy for state agricultural development with clearly defined development goals and priorities, hampers effective planning and efficient allocation of resources. Such a framework is needed to improve key government interventions, such as support services.	1.1 There is a need for a coordinating group to provide policy direction for agricultural development and for effective planning and programming. Fomulation of a policy statement for state agricultural development.	(a) At the state level, establishment of a "Steering Committee", under the chairmanship of the Development Commissioner. The Committee members will be the Secretary of Agriculture and senior representatives of all natural resources line departments and Secretaries of Finance and Planning. The functions of the Committee will be the following: (i) Provide guidance and supervision in the preparation of an overall agricultural policy statement and	Submit a proposal to form Committee to the Cabinet by September, 1988. Establish Committee by November, 1988.	State Government. State Government.

Issue	Required Changes	Measures and Actions	Timing 1/	Responsible Agency
		strategy for extension development; (ii) Review the overall five-year budget plan for extension services, including detailed annual budget proposals; (iii) Monitor the implementation of the agreed changes under the extension development program for strengthening extension services; and (iv) Coordinate inter-departmental activities as they relate to the future development and broad-basing of extension.		
		(b) Formulation of a policy statement for state agricultural development.	By negotiations.	Steering Committee.
		(c) Formal acceptance by the State Government of the defined essential features of a professional extension service.	By negotiations.	State Government.
2. The planning and budgetary process for extension services could be improved further. Generally, budget plans are based on a short-term horizon, annually. Aggregate expenditures, both capital and recurrent, are not highly transparent. Consequently, it is difficult to determine readily the overall cost of extension services in the State. Effective planning and programming are not carried out at the district levels to ensure that budgetary allocations	2.1 There is a need for an effective framework for improved budget preparation and management. Agricultural planning and programming need to be strengthened at the district and state levels for determining proper budgetary allocations. Budget plans should reflect overall extension priorities and needs.	(a) Establishment of norms as guidelines for such items of expenditure as number of days of travel for functionaries at different levels, travel allowances, vehicle mileage, fixed travel allowance for staff who have their own transport, maintenance and replacement of vehicles, and of equipment and buildings.	Issue norms by April, 1989.	Steering Committee.

Issue	Required Changes	Measures and Actions	Timing 1/	Responsible Agency
reflect adequately the need for extension support at the field level. Because of the above shortfall, monitoring of resource utilisation is inadequate.		(b) A directive, outlining detailed planning and budget procedures, will be issued at the district and regional levels to ensure effective participation of lower levels of management and field staff in the budgetary process.	Issue directives by May, 1989.	Development Commissioner.
		(c) A five-year budget plan will be prepared by the Dept. of Agriculture and approved by the Steering Committee and the State Government. The budget plan will detail line item capital, as well as recurrent expenditures. Detailed annual budgets will also be prepared and approved with proper budgetary allocations for extension support.	Prepare district budgets for FY90/91 by July 1989, revised 5-year budget plan and the FY90/91 State budget for Agriculture by September 1989.	Department of Agriculture.
			Approve FY90/91 budget Plan by March, 1990.	State Government.
			Prepare subsequent district budgets annually in July, and State budgets by September.	

1/ This is indicative; exact timing will vary from state to state, depending on local needs and circumstances.

2/ A "Steering Committee" is to be formed to provide policy direction for agricultural development including extension services in the state. See Section E on Planning and Funding of State Agricultural Extension.

3/ To conform with the preparation of the VIIIth Five-year Plan.

4/ Agricultural Commissioner will arrange and oversee the review of individual state schemes and preparation of state specific programs.

October 14, 1988

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The World Bank
OPERATIONS COMMITTEE

CONFIDENTIAL

Minutes of the Operations Committee Meeting to Discuss TUNISIA's Country Strategy Paper and the Initiating Memorandum for a Second Agricultural Sector Adjustment Loan, held on October 14, 1988 in Mr. Qureshi's Conference Room, E-1243.

A. Present

Committee	Others
Messrs. M. A. Qureshi, Chairman	Messrs. T. Baudon, SVPOP
W. Thalwitz, EMNVP	K. Dervis, EM2
E. Jaycox, AFRVP	V. Dubey, EASDR
V. Rajagopalan, VPPRE	S. El Serafy, EAS
D. J. Wood, VPFPR	W. Grais, EM2
H. Fleisig, ASIVP	P. Hasan, EMNVP
D. Goldberg, VPLEG	S. Hassan, LEGEM
R. Martin, LACVP	D. Lister, EM2AG
	R. O'Sullivan, EM2
	O. Rahkonen, SEGGE
	D. C. Rao, FRS

B. Issues

1. The Operations Committee met on October 14, 1988 to discuss the Country Strategy Paper (CSP) for Tunisia and the Initiating Memorandum (IM) for an $84 million Second Agricultural Sector Adjustment Loan (ASAL II), which also includes an investment component (ASAL II). The discussion followed broadly the agenda prepared by the Economic Advisory Staff. For the CSP the Committee focused on a number of development strategy issues including the role of the private sector, and how to restore private investment; possible political opposition to adjustment, especially in the prevailing conditions of high unemployment; the environment; and land ownership. It also considered the levels of lending and the composition of the lending program; burden-sharing, and the slow rate of disbursement from adjustment loans already made. For ASAL II the issues included conditionality and whether the number of conditions was excessive; the formula proposed for agricultural price fixing; the employment implications of divestiture in public sector agriculture; the record of cost recovery in irrigation under a previous loan in order to assess the realism of the water pricing proposals; and provisions for improving land utilization.

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THE CSP

C. Discussion

2. The Region opened with a statement to the effect that the Tunisian economy was now performing well and that the balance of payments was showing signs of improvement -- to a greater degree in fact than had been predicted. The adjustment process began only in 1986, based on accelerating growth in order to redress high unemployment. As foreign exchange was being earned by the private sector, whereas debt was serviced by the public sector, it was important to transfer foreign exchange from the former to the latter. In Tunisia economic management has been traditionally sound, and important reforms are being pursued in taxation with the introduction of the VAT, and also in agriculture and the financial sector. The CSP elaborates on the liberalization drive begun under the Bourguiba regime, which has since developed into a political opening to a multi-party system seeking to draw opposition groups in, including the Islamicists. All this encourages confidence in the present regime. Consumer subsidies have become a heavy burden on the economy, and a program is in hand to phase them out or reduce them significantly, but this is not an easy task.

3. The Chairman asked the Region to elaborate further on a number of issues including growth and its nature (this being in the past based on depleting natural resources), income distribution, the high incidence of unemployment and the state of the infrastructure. He asked what our strategy should be regarding these, and in particular, how to raise investment. What kind of loans should the Bank be making, considering the slow disbursement of adjustment loans? And there was also the land use issue, he added.

4. The Region agreed that unemployment, as suggested in the agenda, was an issue of great importance, and that it should be addressed through labor absorbing growth with strong private sector participation. While it is true that we cannot be certain about private sector investment rising as projected, we must not fall in the trap of relying on the public sector to raise investment. True, the private sector was still small, and active significantly only in tourism and textiles, but it should be encouraged by the improvement in the political climate and by the trade liberalization measures being introduced. Unemployment is high, and the labor force is expanding, and there are many constraints on labor dismissal and other rigidities. The Region will be working on improving labor market conditions and the higher growth of the economy should also help. On the macroeconomy, progress since 1986 has been good both for stabilization and structural adjustment. The attention given to the private sector has not slowed work on the public sector, and a Public Enterprise Rationalization Loan (PERL) is in an advanced state of preparation. Slow disbursement under ITPA was due partly to delays in the completion of studies of labor market deregulation, and also slow progress on the Value Added Tax. Slow disbursement was perhaps also caused by the recent improvement of the balance of payments as the Government was not desperate for funds. On infrastructure, the Region was pursuing long-term issues like energy conservation.

5. As to burden sharing, the Region stressed that Tunisia has not resorted to rescheduling its debt and that the commercial banks were dealing with Tunisia on a case-by-case basis. It would not be advisable to approach them collectively as a heavy-handed approach might backfire. Meanwhile Bank disbursements will now slow down. The Region added that Bank disbursements should not be viewed in parallel with other disbursements and that Tunisia should have the freedom to pay off some banks in order to reduce its outstanding debt. A member said that while he welcomed the projected increase of investment, bank exposure is projected to rise rapidly between 1987 and 1991, whereas private creditors' exposure falls and that of the bilaterals tends also to fall. Of the share of the increase of MLT-DOD the Bank takes up half, the multilaterals as a whole double their share whereas private creditors adjust their exposure downward by a third. While accepting the Region's explanations, he wondered if anything could be done to encourage private financing. Are we doing everything we can to encourage the private sector to seek foreign capital inflows?

6. No IFC representative was present, and the Region said that though the size of the private sector in Tunisia was small it was increasingly becoming export-oriented. The Chairman remarked that Tunisia had sought preferred treatment for its exports to the EC, but could not get this in view of the fierce competition from other Mediterranean countries; so there has been no substantial increase in its exports of fruit, vegetables and other agricultural products. Only exports of tourism services by the private sector have improved, and the prospects for textiles must be judged limited in view of the tariffs and quotas facing their exports. On the other hand, he said, Tunisia has a great potential if it manages to put its house in order, and if foreign participation can be coaxed into this most francophile of the North African countries, and which outsiders find likable. The meeting agreed that encouraging foreign private investment, perhaps following the Mauritius model, should be part of Bank strategy, and the Chairman said that our lending for industry should perhaps be advanced.

7. The Region stated that while employment generating projects were not available at present, a hospitable environment is being created through the policy-based operations, which seek to remove rigidities from the labor market. Human resource development is being pursued also through an education project. This should be viewed as a long-term process. Part of the process is to reduce consumption subsidies, now that the capacity of the government to subsidize, as in Algeria, has been reduced. While this will be an irritant in the adjustment process, we should be looking more at targeting the subsidies, but as we have learned in Morocco this is not an easy task.

8. A member enquired about the extent to which the structural adjustment program has been the product of crisis control, and the Region responded by relating the progress under ongoing adjustment operations: the ITPA, the First Agricultural Sector Loan, and the SAL which had been negotiated, and was signed in Berlin. While QRs have been reduced they still affect about 40% of imports. Tariffs are now in the range 15-41% and are moving to 15-31%, with the Tunisians agreeing to impose the minimum tariff of 15% even on capital goods imports. Liberalization of

agricultural prices and retail prices has begun, and will intensify when the SAL becomes effective in November. Second tranche conditions under the SAL include further price liberalization measures, and reduction of consumer subsidies. The forthcoming PERL will support policy reforms in all the public enterprise sector. Further trade liberalization will be pursued after the SAL.

9. The Chairman said that it was clear that progress had been made in a number of policy areas and that the strategy proposed was the right one. He observed, however, that the investment program needed to be oriented more towards exports, and employment creation and that sector priorities should be indicated. Tourism seemed to have reached its limits of growth and it was necessary to promote exports from other sectors. He found the level of assistance proposed acceptable, but in view of the high incidence of unemployment human resource development was needed. The Region, however, could not promise to advance the FY92 health and population project. In reaction to a speaker's concern over the lack of a systematic treatment of environmental issues in the paper, the Region pointed out the progress made in the context of the Environmental Program for the Mediterranean, which is also supported by the European Investment Bank, but said it was not in a position to recommend a costly environment project with funds borrowed at market rates of interest. So much can be done, the Chairman added, by mobilizing political support, especially among the northern tier of the Mediterranean.

D. Decision

10. In conclusion the Chairman indicated the Committee's endorsement of the strategy as well as the lending program proposed at the level of $300 million a year in the period FY89-91, on the understanding that the Region will be preparing a new CSP in the spring of 1991.

ASAL II

E. Discussion

11. The Chairman then turned to the Agricultural Sector Adjustment Loan, and called attention to the issues raised in the agenda, taking up the first issue, namely the very large number of conditions attached to the operation. He said that while the conditions appeared to him to be well thought-out, we should concentrate on a few key actions that are monitorable. The Region should have another look at Attachment IV, integrate some conditions in the program itself, and reduce the number of conditions applying to effectiveness and tranche release to a few easily monitorable key actions along the lines suggested in the Fischer Report. {A member observed that some of the conditions appearing in Attachment IV were merely a continuation of earlier conditions}. The Chairman also asked if the political situation in Tunisia had been taken into consideration in the design of the operation.

12. The Region said that the conditions in neighboring Algeria were very much on the minds of everyone. In Tunisia people had had enough of repression, the absence of parties or elections, and that significant progress had now been made on all these fronts. While the IM had been

written before the Algeria riots, its authors were certainly conscious of the "Cairo-Rabat message." Attachment IV contained actions that would be taken under the program, but we should not interpret every action as a tranche release condition.

13. In regard to the agenda issue of land distribution, the Region said that indeed land ownership was very unevenly distributed in Tunisia. Forty percent of the farms measuring less than five hectares each were crowded on six percent of the total area. In fact, land distribution was surprisingly four times more uneven than that in Morocco. But the difference was that whereas 55% of people's income derived from farming in Morocco, only 35% did so in Tunisia, and many of the Tunisian small farmers had family members working in urban areas.

14. The Chairman thought that the land-use reform program was vague and also slow in view of the seriousness of the problem, and asked if we could not do more in this area. The Region responded that its approach to the problem was on two fronts: to get the farmers to farm more land, and to improve land use by making farming more profitable. As a result, absentee farming should lessen. Much progress under the first phase of the program is not conditioned. Better legislation on leases that regulate owner-farmer relations, greater security of tenure and lower transfer fees should all work to improve farming conditions. A special program would accelerate the completion of the Cadaster, which is very important since present land registration practices are costly and slow. With improved tenure conditions, farmers would have better access to credit.

15. As to the formula linking support prices to international prices, the Region said this already includes a forward element since futures prices are part of the formula. The future perspective, however, is constrained by the short period of contracts available on the exchanges. In regard to translating effective protection rates into nominal protection levels in order to facilitate monitoring, studies underway would help define these. As to employment loss as a result of public sector divestiture in agriculture, this would be small, perhaps at a rate of 100 persons a year since total public employment in the sector is in the neighborhood of 3,000 only. Lastly, the Region said that the Tunisians had conscientiously met price recovery targets for irrigation water in the past, and that progress in this regard is going even faster with the transfer of responsibility for maintenance to the water users associations.

F. Decision

16. In conclusion the Committee gave sanction for the Region to appraise this operation as proposed, subject to the concerns expressed in the discussion.

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October 25, 1988

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The World Bank
OPERATIONS COMMITTEE

CONFIDENTIAL

Minutes of the Operations Committee Meeting to Discuss
PAKISTAN - Financial Sector Adjustment Loan Initiating Memorandum

Held on October 14, 1988 in Room E-1243

A. Present

Committee	Others
Messrs. M. A. Qureshi, Chairman	Messrs. T. Baudon, SVPOP
W. Thalwitz, EMNVP	V. Dubey, EAS
E. Jaycox, AFRVP	S. El Serafy, EAS
W. Thalwitz, EMNVP	A. Hamid, LEGEM
V. Rajagopalan, VPPRE	P. Hasan, EMNVP
D. J. Wood, VPFPR	R. Kanchuger, EM1CO
I. Shihata, VPLEG	M. Klein, EM1ID
H. Fleisig, ASIV	Ms. M. Nishimizu, EM1
N. Roger, LACVP	O. Rahkonen, SECGE
	D. C. Rao, FRS
	G. Reif, SPRPA
	D. von Stauffenberg, CS2DE
	Ms. L. Yap, EM1CO
	T. H. Yoon, EM1
	S. Leite, IMF
	M. Vaez-Zadeh, IMF

B. Issues

1. The Operations Committee met on Friday, October 14, to discuss the Initiating Memorandum for a Financial Sector Adjustment Loan (FSAL) to Pakistan in the amount of $150 million. The discussion followed broadly the agenda prepared by the Economic Advisory Staff which covered, inter alia, the macroeconomic framework and the role of the IMF; the focus of the financial sector program; provisions to prevent crowding out of the private sector; reforming the nationalized commercial banks; and retroactive financing.

C. Discussion

2. The Region began by stating that the program being proposed reflected excellent collaboration with the government over diagnosing the ills of the financial sector, and also the wide range of measures to be taken to address them. Only part of these would be covenanted. The

macroeconomic situation was the real issue, with fiscal management being the most important. The political situation was uncertain, but the program included measures that would control the fiscal deficit if endorsed by the new government. The SAF/PFP under preparation would provide the necessary macroeconomic framework for this operation, but the political risk, of course, remained. The Fund was proceeding in the following week with a mission to Pakistan to make arrangements for the SAF, and also for a 15-month Stand-by which would be taken to the Fund's Board before the November 16 elections. The same political risk faces also the Fund's approach since the adherence to the program by the new government cannot be assured. The macroeconomic situation had become worse than indicated in Mr. Thalwitz's memorandum of September 20, with the FY88 current account deficit now closer to 4% of GNP (compared with the original estimate of 2.8%), and inflation proceeding at about 10% on an annual basis (the maximum had been envisaged at 7%), so that the objectives of the SAF would be that much more difficult to achieve. In order to realize the fiscal deficit target of 6.5% of GDP, revenue shortfalls would be matched by cuts in development expenditure beginning in the second quarter. Such cuts would be revised if the revenue, as the Government expects, exceeded current estimates. At the Annual Meetings in Berlin the Finance Minister, on the basis of two-months data, was optimistic about the fiscal deficit, claiming that new measures were yielding higher revenue than the Bank and Fund had anticipated. There has been much progress on the sectoral side, with the support of adjustment loans for energy, agriculture (fertilizers) and export promotion. Although there is no crisis situation in Pakistan, concern remains over the fiscal and external deficits.

3. The Chairman said that he thought that the program proposed was comprehensive, and that good progress had already been made. The success of the reforms, however, depended fundamentally on the management of the macroeconomic program. The major difficulty stems from the fact that the government is the major borrower, thus preempting the available resources. Unless this changes, the program will not succeed. Improving the budget deficit, therefore, will have to be a basic condition of tranche release. The Region responded that once a SAF was in place the budget deficit would be contained, but the Chairman thought that explicit language should be employed to this effect, similar to the language used by the Fund, but not a blanket statement like "satisfactory to the Bank." Borrowing should be cut down, he added, and we should be consistent with what the Fund is doing, though the Fund may be using a more precise target than the Bank.

4. The Chairman observed that it was inappropriate for us to use as a condition of Board presentation that "the Government would license at least four new private investment banks." It was none of our business, he said, to specify the number: we should focus on policy, indicating the objective of the actions required, and the criteria that have to be met for licensing such institutions. Conditionality should not be too detailed since this would make us appear to be responsible for the administration; it is sufficient to say that the government will have taken the necessary steps etc. Throughout, key conditions have to be identified, focusing on a few actions that are related to tranche releases. He agreed with a speaker that the number of conditions proposed for second tranche release should be drastically reduced. The same speaker had said that perhaps the large number of conditions reflected the tendency of Pakistan to meet the letter, but not always the spirit, of conditionality. The Region concurred that a balance was necessary between specificity and generality.

5. It was his understanding, the Chairman said, that the purpose of the auction in government paper was to get proper market signals for the price of government borrowing. One major objective was that private investors should not be discriminated against in favor of the Government. The question remained how much a shift towards the private sector was desirable, and how quickly should we aim at bringing this about? Rather than attempt to develop the semblance of a market, we should go behind the market in order to bring in the private sector to compete.

6. The Chairman added that we should be aiming at making the cost of borrowing higher to the Government, for this would increase the pressure on the Government to mobilize resources, whereas the auction in itself would not. A speaker commented that the Government has been in a position to borrow at 0% interest, thus raising interest on non-Government borrowing. Raising the cost of Government borrowing might provide an incentive for the Government to reduce its borrowing. The Region said that the program proposed provides for direct competition between the private sector and the Government as the banks with their present high liquidity would have to decide whether to acquire government paper or lend to the private sector.

7. A member said that Pakistan's economic growth has been quite rapid, and so far the financial sector has not played a significant part in this. The recapitalization of the banks may also have a negative impact on Government finances, so why aggravate the budget issue by this operation? Another issue he raised was whether the program would be "owned" by the new Government in the sense of the Fischer Report on adjustment lending. The Region responded that the liberalization process was already affecting other sectors, and that deregulation of trade could not very well be pursued further without reforming the financial sector. Another aim of the operation, the Region said, was to bring international standards to the banking sector. In any case bank recapitalization was being undertaken gradually, so as not to over-burden the budget. As to the political issue, it was the Region's impression that the operation now commands consensus at the Ministry of Finance and the monetary authorities, and that such a consensus might survive the change of Government.

8. A member said that the Board was firmly against any explicit linkage between Fund and Bank conditionality. It would not be proper to say that without a Stand-by we would not go forward as this would also limit our future actions. Also we should not assume that the private sector _per se_ is more efficient than the public sector. He cautioned against specifying as a condition for Bank lending the enactment of a law as we have no control over the legislative process. The Region assured him that they are being careful in not including as conditions what is outside Government control. Some of the reforms required legal changes, however, and as parliamentary approval was needed the proposed conditions would have to include submission of draft laws to Parliament. The Region also stressed that the IM nowhere says that a Fund Stand-by has to be in place, and paragraph 56 specifically states that without a Fund agreement, we should have an alternative program.

9. A speaker said that this was a well designed package and that he saw no conflict between the recapitalization of the banks and the macroeconomy in that he saw no burden on the budget. Another speaker

agreed, saying that deregulation of the banks, far from being too rapid, is perhaps not going fast enough. As to privatization, it is not the share in equity, whether private or public, that made a difference, but who, for instance, named the directors. The foreign exchange risk coverage schemes have discouraged private borrowing abroad and long-term credit is subject to a highly directed system.

10. A member questioned the reason behind the fast disbursing nature of the loan. The Region said it was not the purpose of the loan to address a critical need of cash. The operation had begun as a Government program aiming at defining the role of the commercial banks and the State Bank.

11. A member asked whether the size of the loan was too large, and the Chairman said it should not go higher than the $150 million proposed. He added that a more germane question was the prospects of cofinancing. The Region said that cofinancing by the Japanese would be explored during the next mission as the Government showed some reluctance against cofinancing at Berlin. As to the request for retroactive financing, the Chairman emphasized that such financing was far from being automatic, and was a concession to be used with discretion if there was sufficient justification for it. The Region said that loan proceeds would finance a negative list of imports, and that 20% not 25% of the loan was needed in retroactive financing. The Chairman said unless there were explicit and convincing reasons for retroactive financing, the proper proportion was zero.

12. As to the proposed auction, the Region said that provided the political conditions were favorable the pilot auction could still take place before Board presentation, but if not, that would not be an important omission, and the Chairman agreed.

13. The Chairman suggested that centralizing all regulatory activities of the banking system in the State Bank was perhaps a mistake. What should be centralized under the State Bank were the activities of deposit-taking banks in the interest of monetary policy and for credit control purposes, but not the activities of investment banks. The Region said that the operation aimed at a universal banking system, as new institutions have emerged, and that details would be clarified during appraisal.

D. Decision

14. In conclusion the Committee gave sanction for the Region to proceed with appraisal, subject to the concerns expressed and guidance given in the discussion summarized above.

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November 3, 1988

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The World Bank
OPERATIONS COMMITTEE

Minutes of the Operations Committee Meeting to Consider MEXICO - Industrial Sector Adjustment Loan, Public Enterprise Adjustment Loan, and Structural Adjustment Loan

Held on Friday, October 14, 1988 in Room E-1243

A. Present

Committee	Others
Messrs. M. Qureshi (Chairman)	Messrs. V. Dubey (EAS)
S. Husain (LACVP)	A. Ray (EAS)
E. Jaycox (AFRVP)	M. Martinez (LA2CO)
W. Thalwitz (EMNVP)	P. Knotter (LA2TF)
J. Wood (VPFPR)	E. Segura (LACVP)
V. Corbo (VPPPR)	J. Varallyay (LA2CO)
H. Scott (VPLEG)	

B. Issues

1. The OC met on October 14, 1988 to discuss the papers circulated by the Region for the above-mentioned adjustment operations. At the Chairman's request, Mr. Husain explained the background to the three proposed operations. These proposals respond to the strong request made by the Mexican Government during the Annual Meetings for help in insuring a smooth transition from the Pacto and in laying the basis for growth. The GOM approached the Bank because it regarded it as the only institution capable of designing an internally consistent program that gives emphasis to the resumption of sustainable growth. The proposed operations, on which a great deal of work has already been done, still require more definition. The papers submitted reflected the Region's preliminary views at this point; more specific proposals would be presented to the Committee after the missions' return.

2. The Chairman added that when the GOM made the request, they made it clear that a very quick response was needed because the outgoing President wanted to bring the process of reform as near to completion as possible before the new administration took over. We have promised to explore all the possibilities, but without making any commitment since much will depend on the extent of work the GOM itself has been able to do. The new administration must also fully agree with the operations as it will be in charge of implementing the reforms. The incoming administration has already appointed a high-level official to liaise with us; furthermore Mr. Husain will personally discuss these matters with Mr. Salinas, the incoming President.

3. The Chairman also said that we have urged the GOM to get the IMF, which only has responsibility for Enhanced Surveillance at this time, more involved in the process. The GOM has indicated its willingness to explore

Papers from
OC held
Oct. 14

use of the compensatory financing facility because of the oil price drop; however, it is unlikely that the GOM will seek a stand-by right now because of the political sensitivity of the issue. The GOM has also indicated to the G-7 ministers in Berlin that the basic issue in Mexico at the present juncture was not macro-stabilization but growth-oriented adjustment programs of the type being envisaged in the proposed operations. This is why they had approached the Bank to put together a growth-oriented program. The Chairman added that while the Bank will have to be satisfied with the macro-policy framework, it would need to be extremely sensitive to jurisdictional issues concerning the Bank and the IMF.

4. Two Committee members enquired about the financing situation. Who will provide the finance and would it be adequate for Mexico's debt situation? Can the financing gap be filled without debt-reductions? The Chairman said in response that the GOM wants to raise new money at this point leaving aside debt-reduction schemes. The Region added that it cannot be expected that all necessary finance will be firmly lined up by the time we proceed with these operations, although we hope that significant progress will be made.

5. Another Committee member enquired about the IMF's views on the macro-model being used, and about the specific things that we were expecting to achieve before December 1. The Region said that there was broad agreement about the macro model; a multi-year medium-term adjustment program and policy matrices for the three operations should be available by December.

6. A speaker emphasized the need for a four or five-year planning horizon and for settling the whole financing package over that horizon. The Region said that there is no possibility of such a "jumbo" approach succeeding. If, however, both the Bank and the IMF support the government, we should be able to maintain and enhance its credibility and induce more commercial money.

C. Decision

7. The Chairman agreed that the Regional proposals provided an adequate response to the Mexican request.

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October 17, 1988

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: October 13, 1988

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS VDubey

EXTENSION: 78051/2

SUBJECT: Mexico - Adjustment Operations

A restricted meeting of the Operations Committee (members only) will be held following the meeting on Mauritania on Friday, October 14 to discuss the proposed adjustment operations being explored for Mexico. Papers on the broad issues to be explored and refined during planned discussions on these operations are being sent to OC members by the Region.

cc: Mr. Steckhan

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: October 13, 1988

TO: Members of the Operations Committee

FROM: S. Shahid Husain

EXTENSION: 39001

SUBJECT: MEXICO--Proposed Adjustment Operations

With reference to Mr. Dubey's memorandum of October 13, 1988 on the above matter, attached are the Issues Papers prepared by LAC for the proposed Structural Adjustmenmt Loan, the Public Enterprise Restructuring Loan and the Industrial Sector Restructuring Loan.

Distribution:

Messrs/Mdmes. Qureshi, Jaycox, Karaosmanoglu, Thalwitz, Rajagopalan, Fischer, Shihata, Wood, Vergin, Dubey, Baudon.

E-1241

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: October 11, 1988

TO: Mr. S. Shahid Husain

FROM: Edilberto L. Segura

EXTENSION: 39003

SUBJECT: MEXICO--Reform of Public Enterprises Issues Paper

I. BACKGROUND

1. The Government of Mexico has requested World Bank assistance to restructure its public enterprise sector. It is prepared to make major decisions over the next few weeks in order to facilitate the initial work of the new administration and provide the basis for economic growth during the next sexenio. This memorandum outlines: (i) the current structure and problems facing the sector; (ii) a proposed adjustment program to deal with the issues; (iii) the scope and conditionality under the proposed loan; and (iv) proposed next steps. Despite the risks that such a quick operation entails, the opportunity for the Bank to act now is unique: both from the point of view of the urgency of the structural reforms that should be undertaken as well as the "window of opportunity" that the change of Government presents. This memorandum does not address the current macroeconomic framework for the proposed operation. Such framework is being provided under the proposed SAL operation which will be considered in parallel to this operation.

II. THE MEXICAN PUBLIC ENTERPRISE SECTOR.

(i) Growth and Size of the Sector

2. One of the causes of Mexico's economic and financial crisis since the 1970's has been the disproportionally large, growing and poorly managed public sector, particularly public enterprises. At present public enterprises contribute about 19% of GDP, employ about one million people and control the most important branches of basic industry and infrastructure. However, as noted below, they have also received substantial subsidies from the Government, aggravating fiscal deficits.

3. Except for a limited number of enterprises, the establishment of public enterprises in Mexico did not follow a preconceived plan. In fact, the sector grew rapidly in an *ad hoc* fashion without reflecting announced Government policies and without a clear definition of the roles of the Government and the private sector. A number of bankrupt private firms were acquired by the Government to avoid their closure and maintain employment. In addition, many enterprises were acquired by Government financial institutions, particularly NAFINSA and SOMEX, when the companies were unable to service their debt. As a result of this evolution, in 1982 the

Government owned over 1,200 public enterprises. Since then, parastatal adjustment has significantly reduced the number of public enterprises, which have declined by two-thirds to about 450 firms currently (the exact number has been changing rapidly due to recent privatizations, mergers and consolidations). However, reform has focussed on the smaller enterprises: about 95% of the value added in the sector is still contributed by a limited number of about 33 "basic industries and utilities" that were established purposefully by the Government, are controlled directly by it and are largely incorporated in the national budget. The rest of the PEs are relatively small and are neither budget-controlled nor closely monitored. In the industrial sector alone, the number of PE is close to 200 firms. Of these, about 27 were created by the Government (with direct equity or indirectly through NAFINSA/SOMEX or other Agencies). An additional 36 firms were created as subsidiaries of this group of PEs created by the Government. The rest were absorbed by NAFINSA/SOMEX and other Agencies as a result of bankruptcies, etc.

(ii) Control of Public Enterprises.

4. Before 1976, all public enterprises were controlled by the former Sectretariat for National Patrimony, which intervened in administrative, operational and technical matters. In 1976, the control of public enterprises was reformed by grouping the enterprises into several sectors. Each sector is now under the control of a Secretariat (Sector Heads). The main Secretariats are the Secretariat of Energy, Mines and Public Industry (SEMIP), the Sectretariat of Telecommunications and Transportation, and the Sectretariat of Agriculture and Water Resources. In the industrial sector, SEMIP is the principal Government agency supervising the large PEs, of which the main ones are the following: (i) Fertimex (fertilizers); (ii) Sidermex (steel); (iii) Dina (truck manufacturing); (iv) Concarril (locomotive manufacturing); (v) Pipsa (paper manufacturing); (vi) Astilleros Unidos (shipbuilding); and (vii) Pemex (the oil company, which de facto has enjoyed substantial autonomy). SEMIP also controls some public enterprises in the utility/infrastructure sectors, including CFE (the electric power company). SEMIP and the other Secretariats exercise close ex-ante control of the PEs, as noted in paragraph 6-7 below. In addition to the sector-head Secretariats, the Secretariat for Programming and Budgeting (SPP) exercise authority and control over the budgets of PEs. Further authority on financial matters is exercised by the Secretariat of Finance and Public Credit (SHCP) and the Controller General's Office.

5. The approximately 400 small PEs are controlled through a series of mechanisms. A large number of PEs are owned and controlled by NAFINSA; others are/were owned by SOMEX or directly by other Government agencies. This large number of small PEs represents a serious problem for at least three reasons. First, there is a perceptual problem with the private sector of excessive involvement by the Government in production. Second, there are 400 Board of Directors that have to be filled with high level officials with extremely tight agenda. The ministers, undersecretaries or director generals who have to participate in Boards of Directors may not be able to fully exercise their role. And third, these entities are small in relative terms, but some of them constitute critical bottlenecks to market efficiency since they are protected with high barriers to entry, high barriers to exit, and are subject to other complex regulations.

(iii) Main Sectoral Issues

6. The economic and financial performance of PEs during the last few years have not been satisfactory, though it has improved since 1982. These improvements since 1982, however, have taken place by limiting investments and capping PE budgets, rather than by introducing long lasting efficiency measures, restructuring or divestiture. Many enterprises are still facing sluggish demand, low capacity utilization, high operating costs and financial losses. Excluding Pemex, as a group the rest of PEs have received and continue to receive large subsidies from the Government, which the forthcoming mission will quantify. As noted below, part of the poor performance has been due to inadequacies in management, lack of managerial motivation and incentives, lack of accountability and inadequate Government polices towards the sector. But also, the parastatal sector overstepped its reasonable limits, entering into areas where the profile and size of enterprises made efficient public sector operation virtually impossible. In spite of the progress made during the last six years, major further actions are needed in the sector.

7. In 1985, a Bank mission that reviewed the public sector investment program identified a series of institutional, procedural and policy problems in the PE sector and made some recommendations that were partly accepted by the Government (paragraph 8). Subsequent missions in the fertilizer and steel industries made further ones. The core issues are several. In general, most PEs have ambiguous objectives. The management of the PE sector is still overcentralized, mostly with ineffective supervision. In fact, the most important budgeting, personnel, salary, investment, procurement and even some operational decisions are made at the ministerial level. The autonomy and accountability of PE management is limited. There is little incentive to improve performance. Financial autonomy is also quite limited. The annual operational budget of the large enterprises are formulated at the ministerial level and are fully incorporated in the Government Fiscal Budget; the role of the PEs in this budgeting process is minimal and the budgets are subject to serious rigidities. Many investment decisions are made without regard to international competitiveness. Furthermore, the budget for investments is approved annually for a single year, with the result that even economic investments cannot be implemented on time due to annual fluctuations in the provision of financing. Controls and local regulations are excessive, add greatly to costs, detract from a competitive environment and protect many PEs by impeding entry. Labor rigidities make it difficult for the PEs to adjust to new market conditions. The flow of information to the Government is excessive, ineffective and poorly organized. All these issues in the sector have made it impossible for PEs to achieve their potential level of efficiency. Drastic actions to correct these deficiencies is required.

(iv) Recent Government Actions on the Sector

8. In 1986, the Government embarked on a parastatal reform program. The most important objectives of the program were as follows: (i) redefine the role of the PE sector by adjusting its size and scope, privatizing a large number of firms and liquidating non-viable ones ; (ii) provide greater enterprise autonomy, accompanied by increased accountability and schemes for management motivation; (iii) restructure physically, financially and organizationally a number of enterprises; (iv) adjust

prices and reduce subsidies. As part of the program, the Congress adopted a "Law of Parastatal Entities". Unfortunately, even though some initial steps were taken, the program has so far not been very successful. The Law itself was vague and detailed regulations were never issued. Therefore, the interference of government agencies is still strong; many of the selected PEs never prepared the required plans nor did they receive the support to carry them out; the divestiture program advanced for small/medium firms, but has moved slowly for the large PEs. For five PEs (Sidermex, Fertimex, Ferrocarriles, Azucara S.A., and Conasupo), some restructuring activities have been carried out within the framework of "Convenios" (agreements) signed between the Government and the enterprise. However, the convenios provided principally debt forgiveness, as in many cases the measures to improve efficiency were only vaguely defined. Furthermore, even these enterprises still remain without managerial or financial autonomy. Although it is too early to judge the effectiveness of the convenios, it is felt that their vagueness could lead to ineffective implementation. In the meantime, Mexico remains with an overwhelmingly large, inefficient and poorly managed public enterprise sector.

9. The lack of progress in implementation of reforms has been due partly to the bureaucratic inertia characteristic of large public organizations, and partly to the political sensitivity of the issues. The purpose of the proposed operation is to break through these constraints and move the reform program forward.

III. THE PROPOSED ADJUSTMENT PROGRAM.

(i) Objectives of the Program.

10. The proposed sector adjustment operation is intended to support an agreed, time-phased program of: (i) further privatization for those enterprises whose efficiency can be enhanced by the private sector; (ii) policy, institutional and procedural reforms aimed at improving the efficiency of those PEs that would remain in the hands of the Government; and (iii) implementation of the above measures on a selected number of industrial PEs.

11. Physical restructuring of individual PEs will not be attempted in the proposed program. Rather, the operation would address across-the-board issues that affect all enterprises and which are major causes of current inefficiencies. From this viewpoint, the proposed reforms will address all PEs. However, actions and measures regarding privatization and the proposed institutional/supervisory/policy changes will be applied to a limited number of priority PEs. These "test cases" will be drawn from the most important--in financial, economic and employment terms--industrial and mining PEs controlled by SEMIP. These industrial enterprises in SEMIP will be handled as test cases for the implementation of the across-the-board measures, and will be subjected to a defined and timebound program of implementation of the reforms. The privatization program would also include those "small/medium sized" PEs that are owned by NAFINSA/SOMEX.

(ii) Privatization Program.

12. This program should constitute one of the key elements of the Government program to improve the efficiency of the PE sector. It should be based on a clear definition of the roles of the public and private sectors in the economy, with a view to: (i) withdraw the Government from areas that can not be served efficiently by the public sector by selling the PEs to the private sector; (ii) liquidate all the non-viable enterprises that are not attractive to the private sector; and (iii) clearly indicate those areas of industry where the Government intends to invest--either because of strategic considerations or because of clear market failures that can not be corrected in the mid-term; the rest of industry will be left entirely to the private sector.

13. Some of the larger "basic" PEs that are under the control of SEMIP--such as Sidermex, Dina, Concarril--should be considered for privatization under the proposed program. The Telephone Company could also be considered. In addition to the large PEs, the Government should continue to develop a program of privatization for the large number of small/medium sized enterprises that are currently owned by Nafinsa, Somex and other agencies. Many of these enterprises are operating in competitive sectors dominated by private industry, and therefore privatization could be implemented expeditiously. For these small/medium enterprises, a goal may be to transfer them from the portfolios of Nafinsa/Somex into a special assets management fund, which would have as its responsibility to privatize these enterprises within a reasonable period of time.

14. In any event, a privatization program should be developed and agreed upon, after a careful review of the experience gained in Mexico in the last two-three years with privatization. The privatization program may be gradual, as in a number of heavily protected subsectors, privatization efforts may need to be preceded by policy adjustments, regulatory reforms and even restructuring of some of the companies to be privatized. However, it is important to identify a number of PEs that could be privatize quickly to show early successes. In fact, it would be expected that under this operation there will be a number of privatization cases that would be clearly identified, and on which an agreement on an "Action Plan" can be reached with the Government. Other actions may need to be linked to tranche release conditions. In developing the privatization program, particular emphasis will be placed on the identification and evaluation of available options, including the leasing of assets, management contracts, privatization through the stock exchange, etc. In addition to the preparation of a privatization program, the Government may need to develop a legal and regulatory framework for privatization and may need to carry out external audits by independent auditors. For these purposes, specialized assistance may be needed. This work may be critical in determining the pace at which privatization may proceed. To facilitate the process, technical assistance may be included under the loan. In view of the large amount of work that may need to be carried out in this area, the Government may need to create a special agency (such as a Sectretariat for Privatization) to carry out the Government's privatization agency. This agency should receive sufficient enabling legal authority to proceed with privatization episodes expeditiously, without a need to receive Congress approval for each of them.

(iii) Institutional and Policy Reform.

15. Even under a very successful privatization program, there will be a number of companies that will remain under Government ownership. For these PEs, improvements in efficiency would be achieved by forcing them to operate on a commercial basis. For this purpose, there would be a need to implement reforms of the policy, institutional and procedural framework under which they operate. Some of the major reforms to be undertaken should include the following:

1. Measures to Improve the Competitive Environment for PEs.

16. Along with industrial deregulation, trade and financial sector reform, public enterprises operating in tradeables should be subject to competitive forces among themselves, with private firms and with imports. If necessary, large PEs should be broken down into smaller competing firms, if economies of scale are unimportant. The major deregulation measures for the industrial sector will be taken in connection with the proposed parallel Industrial Restructuring Loan. However, it is likely that there are in Mexico additional barriers to entry and exit, other legal and regulatory constraints and controls, as well as factor rigidities that affect particularly public enterprises. The proposed mission will need to review existing legislation for PEs, identify the required measures to improve the competitive environment, and reach agreement with the Government on their implementation.

17. Another important area that needs further reform to improve the competitive environment for public enterprises is procurement of goods and services. In November 1987, the Government amended procurement legislation for public enterprises with the objective of assuring, through public bidding, procurement from the cheapest sources taking into account quality, delivery time, and financing arrangements. Public enterprises may buy from either domestic and foreign sources, but the law "recommends" that they buy products of national origin, particularly if they incorporate national technology. For the large PEs, procurement decisions are made by procurement commissions made-up of members of the public and private sectors. The new legislation is a step in the right direction; however, it is apparent that the procurement commissions have any role other than giving domestic suppliers an unfair advantage against foreign suppliers. They should be phased out. As is now the case for procurement financed by international agencies, international competitive bidding (ICB) should be the norm for all procurement contracts above a certain size. To support efficient resource allocation, all public enterprise imports should be subjected to the same tariff schedule as the private sector. In this manner, the preference for domestic suppliers may be in line with the import tariff. For civil work contracts, no domestic preference is justified since the Mexican contracting industry has in general attained international levels of efficiency. For contracts of lower value, a more limited type of bidding (limited international bidding, local competitive bidding, or international or local shopping) should be instituted. The decision on awards and on the procurement procedure to be used (within the established limits) should be left to the PE procuring the goods or services. A thorough ex-post review of procurement decisions should be carried out by the Controller General's Office (a review for which the law makes it responsible)

2. Measures to Improve Managerial Autonomy and Accountability.

18. In order to encourage greater market orientation, PEs should be given greater managerial autonomy for operational, commercial, personnel, setting of salaries, and (self-sufficient) investment decisions. Such delegation of autonomy should be accompanied by clear accountability rules. In this regard, the new "Law of Parastatal Entities" (para 8) could be made effective by developing appropriate regulations. In fact, the mission would use local legal consultants with a view to achieve the objective of automomy/accountability, by agreeing on detailed regulations, without a need to modify the existing law. The mission would agree on specific actions/measures to provide a satisfactory level of managerial automomy and accountability, in particular by rationalizing the relationships between the Government and the enterprises. A clear demarcation of the roles and responsibilities of the Government, the Board of Directors and Management will need to be agreed upon during the forthcoming mission, along the traditional roles of ownership for the Government, policy/strategy setting for the Board of Directors, and day-to-day operations for Management.

19. In competitive markets, where the PE is competing with the private sector or with free imports, the performance of the enterprises can be judged simply on the basis of profitability results. In fact, in these markets, financial and economic profitability should be closely related. However, in monopolistic or oligopolistic markets, there may be a need to develop "market surrogate" systems that would induce PEs to undertake long-lasting and sustained searches for efficiency. For the larger PEs that would remain in the hands of the Government, in order to provide the equivalent to market motivators and regulators, this system should: (i) require PEs and Government to strictly adhere to well-defined objectives and targets developed through annual "Contract Plans" or a similar type of performance evaluation agreement; (ii) measure the performance of the PE against these targets in a transparent and systematic way; and (iii) provide large rewards for achievements or penalties to induce managers to achieve the objectives. The mission will review the experience with the Contract Plan developed for the railways and would propose and reach agreement on suitable modifications to be applied to other relevant PEs.

20. Given the importance of labor rigidities in PE efficiency, Contract Plans will need to include a labor/human resource plan. For this purpose, labor legislation will need to be reviewed as a separate important issue. The mission also anticipates that one major obstacle to PE reform is the fear that enterprise restructuring and privatization will lead to labor shedding. The mission will discuss with Government mechanisms to cushion the social impact of PE reform, including early retirement packages and training and redeployment funds.

21. In order to facilitate the surveillance role of the Government, while avoiding excessive control and interference, there will be a need to rationalize and redefine the roles of the Government agencies dealing with PEs (particularly SEMIP and SPP which may face significant reductions in their staffing). The goal would be to redirect their attention from supervision of current operations to ex-post surveillance, based on agreed upon contract plans. For example, a large majority of the staff currently in the Directorate of Fertilizers of SEMIP may need to be transferred to Fertimex. Similarly, there will be no need to have a large budgeting office

at SPP for the preparation and control of the PEs' annual budgets. The same changes may be needed for other subsectors, and in other Government agencies. The Government may need to create a streamlined focal point, such as a simple Secretariat to follow and evaluate the performance of PEs. The exact organizational form for Government control will be a key issue to be discussed. Furthermore, for the Government to exercise its new role, there may be a need to standardize the PE's accounting and auditing systems. These matters will need to be discussed and agreed upon with the Government during the forthcoming mission.

3. Measures to Improve Financial Autonomy and Accountability.

22. A major issue regarding the finances of PEs in Mexico is the practice of incorporating the budgets of the 30 "basic" PEs into the Public budget. PE revenues are incorporated as Government revenues, and PE costs and investments as Government expenditures. This practice introduces major distortions and rigidities in the operations of PEs, since the budgets do not fully reflect the priorities of the firms and even minor departures during the year require various levels of Government approvals. Therefore, the abolition of the central Government approval of the budget, and the separation of enterprise finances from the federal budget should be agreed upon. In addition, the PEs should be granted autonomy in dealing with commercial banks for working capital; currently approvals from SEMIP and SPP are still required even for minor working capital loans.

23. Together with the increased financial autonomy, accountability rules need to be developed. The enterprises should understand that the Government will use a "Hard Budget" posture: if the enterprises do not perform and are not financially self-sufficient, the Government will not bail them out through subsidies and transfers. The commercial banks will also enjoy autonomy in granting credits only to those enterprises that are creditworthy. The Government should not provide guarantees to enable PEs to borrow despite their financial condition. Such measures will ensure that commercial banks will contribute to financial discipline in the sector, principally if commercial banks are operating under the stricter central bank supervision to be achieved under the proposed SAL operation. These measures will also help in alleviating any crowding out of commercial lending to the private sector by state enterprises. In this connection, the mission will address issues associated with the relationship between PEs and commercial banks. Finally, PEs should be fully subject to bankruptcy laws to ensure that non-viable or inefficient PEs will be divested or liquidated. In this regard, the mission will also review the current bankruptcy laws to ensure that they are not unduly cumbersome. Otherwise, an agreement to make bankruptcy laws more expeditious may need to be reached.

24. With regard to investment planning, decision-making and implementation, general agreement on the principle of international competitiveness as the main criteria for investment decisions should be reached. For this purpose, clear guidelines for project preparation and appraisal are needed. Budgeting for investments should be carried out on a multiyear basis, in order to avoid the current major delays in implementation due to widely fluctuating allocations for investments.

25. Regarding pricing, there are still several PEs whose prices are controlled by the Government, set at unsatisfactory levels and reviewed in an inappropriate manner. These pricing policies reduce substantially the financial autonomy of enterprises. For example, the prices for fertilizers charged by Fertimex are still at about 60% of international prices. Fertimex therefore is still heavily dependent on Government transfers. Agreements should be reached that prices of key PEs will be liberalized under a specific timetable, or at least initially set at levels more consistent with international levels. In some cases, there may be a need to carry out pricing studies to develop appropriate pricing methods for non-competitive enterprises. Regarding price subsidies, if the Government were to decide to provide subsidies, they should be made transparent, as items in the budget. Furthermore, the Bank will need to agree with the Government on a well-defined program to quantify the subsidies and phase them out over time.

26. The October mission will also review whether there are financial problems that emerge from arrears among PEs or from/to the Government. Occasionally, the Government has used arrears with public enterprises as means to obtain financing for central operations. If this were to be the case, an agreement for the settlement of arrears may need to be reached.

(iv) Actions on Selected Public Enterprises.

27. It is envisaged that, under the proposed loan, the Government will develop the required legislation/regulations to achieve the policy, institutions and procedural changes discussed in preceding paragraphs. In addition, it is envisaged that detailed programs to implement these reforms on a "test case basis" will be prepared and agreed upon for a number of key enterprises, which may include the following:

a. Fertimex
b. Sidermex
c. Mining Sector
d. Telefonos de Mexico
e. Truck/Bus Manufacturing/Shipbuilding
f. Petrochemical/Ammonia production of Pemex

28. In addition to the institutional, policy, management and procedural reforms discussed in preceding paragraphs, the mission will discuss with the Government the possibility that for some of the PEs, additional organizational, business or financial restructuring activities may be incorporated as components of the proposed loan.

29. Several of the PEs do have a significant amount of foreign debt with international commercial banks. In connection with the privatization process, or in connection with financial restructuring activities for individual PEs, the Government and the Bank should explore the possibility of using the restructuring of selected enterprises to seek possible debt-to-bonds or debt-to-equity conversions. The possibility of converting foreign debt into equity in the same enterprise should be an attractive way to bring direct foreign investments, without an immediate monetary effect in the country. The possibility of associating this operation with such schemes should be discussed with the Mexicans.

(v) Technical Assistance.

30. It is anticipated that the level of preparation of some of the reforms will be insufficient to initiate their implementation immediately. In these cases, the Loan will include a provision of funds to carry out technical assistance and further consultant studies to ensure that required actions are taken in connection with second or third tranche releases. Technical assistance may be needed for the preparation of programs for privatization, standardization of accounting systems, calculation and arbitration of arrears, asset valuation, restructuring of the roles of Government agencies such as SEMIP and SPP, reforms of the legislation dealing with PEs, etc. Technical assistance may also be provided for the "twinning" of some Mexican with similar foreign enterprises, for the training abroad of selected officials, for the acquisition of computer information hardware, and similar activities. The scope and size of the technical assistance component will be identified during the forthcoming mission. Depending on the size, scope, and timing of the required technical assistance, the option of processing a parallel technical assistance loan (to be processed with the same documentation as the adjustment loan) should be considered.

IV. THE PROPOSED LOAN.

(i) Loan Amount and Tranche Release Conditions.

31. Given the importance of the PE reform program and the foreign exchange requirements of the country, a loan of US$500 million is proposed. The release of the loan could be effected in two/three tranches to be closely tied to specific monitorable policy actions that will be identified during the forthcoming mission. The proceeds of the loan will be used to finance either general imports or a positive list of imports that are closely related to the operations of the public enterprise sector. The peso equivalent of the loan proceeds may be utilized to provide equity or long-term financing to some of the PEs that require financial restructuring. Such financing may be needed to enable them to operate in a competitive environment, without Government financial support and obtaining their financing from commercial banks.

(ii) Implementation Arrangements.

32. It is envisaged that proposed operation will be implemented by a high level Government Executive Committee. SPP, SEMIP, the Controller General, NAFINSA and the selected PEs would also participate. The Government will be requested to provide such Executive Committee with sufficient authority to carry out any necessary work and ensure that the commitment for tranche release will be met. The exact organizational form to follow the implementation of this operation will depend on the form of the institutional arrangements to be agreed upon for the future surveillance by the Government of PEs.

(iii) Justification of the Operation.

33. The institutional and policy reform of the parastatal sector is urgently needed to improve the efficiency of a major segment of the Mexican economy. The Bank has strongly supported Mexico's decision in 1984 to restructure its macroeconomic policies, whose progress have been impressive so far, though they have failed to re-establish growth. At this stage, Mexico's goal to re-establish growth is dependent on its success to capture export markets and achieve full integration with the world economy. This objective can not be achieved unless the Government restructure its public enterprises and establish the conditions for an efficient basic industry. The proposed operation would be instrumental for this purpose. In fact, many of the reforms to be supported under this operation could not be addressed in individual subsector loans, since the required measures cover issues across sectors. Bank participation in it will facilitate the decision making process in Mexico and ensure that key measures are implemented. It is anticipated that the reform of the PE sector will required a sustained effort by the Mexicans during a relatively long period of time. The Bank will be providing continuous support on this matter through the structuring of the operation in several tranche release conditions. It is also possible that a second follow-up public enterprise restructuring loan will be needed to carry the reform forward. In this regard, the proposed loan can be considered as the initial assistance in a longer-term program of PE restructuring.

V. NEXT STEPS AND PROPOSED TIMETABLE

34. This memorandum provides a conceptual framework for the reform of PEs, as developed by Bank staff for discussion basis. It is expected that the Government will have also developed its own PE reform program, in much greater detail than the one provided here. During the forthcoming October 1988 mission, the mission will ascertain whether the Government's program and thinking in these areas are well developed, as well as the Government's willingness to proceed quickly in the areas identified herein. If a common viewpoint were to emerge, the operation could proceed. The reform program--with its specific actions over time--will be described in a draft Letter of Sector Development Policy, and such draft letter, together with an IM/MoP will be submitted to the Operations/Policy Committee with a view to negotiate the proposed operation at the end of November and submit it for Board Consideration in late December 1988. There is the risk, however, that the forthcoming mission may find that the Government has not carried out sufficient preparation work nor it is prepared to proceed at this stage in key areas. In this case, further mission work and discussions may be needed.

cc: Messrs/Mdmes Steckhan, Wessels, Selowsky, Binswanger, Halperin, Iskander, Knotter, Lee, Martinez, Quijano, Garcia-Zamor. Mission Members.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: October 13, 1988

TO: Mr. S. Shahid Husain, Vice President, LAC

FROM: Paul Knotter, Chief, LA2TF

EXTENSION: 38771

SUBJECT: MEXICO - Proposed Industrial Sector Loan Issues Paper

Please find attached for your review a revised version of the issues paper for the proposed Industrial Sector Operation.

Attachment

Distribution:

Messrs./Mesdames: Steckhan, Lee, (LA2DR); Selowsky, Segura, Linder, Roger, (LACVP); Halperin, (LA2IE); Jones, Musalem, Uy, Calvo, Mukherjee; (LA2TF); Binswanger, (LA2AG); Martinez, van Wijnbergen, Baran, Croce, Johnson, Varallyay, (LA2CO); Voljc, (Res. Rep.); Iskander, Rivera, (LATTF); Raghavan, Wellenius, (ASTIF), Dahlman, (IENIN); Messerlin, (IECIT); Riveros, (CECMG); Collell, Manley, (LEG); Konovalov, (IENIN)

October 13, 1988

INDUSTRIAL SECTOR LOAN

Issues Paper

Background

Mexico's industrial sector has contracted severely since 1982, after a period of prolonged growth. The industrial sector adjusted to the depressed domestic market of the eighties through reducing output, real wages, and employment, and redirecting production toward exports. At the same time, Mexico's ongoing economic adjustment process has created the opportunity for structural and sectoral reforms. Thus, the future policy agenda for the industrial sector would need to focus on how to create an environment that would provide a favorable climate for sustainable industrial growth, and how to assist subsectors that are restructuring toward the new policy environment.

Toward a new industrial policy framework

Within the context of the Government's overall program of economic reforms the first stage of trade and industrial restructuring efforts consisted of the trade liberalization program initiated in 1985. The subsequent steps will include defining an industrial policy that would encourage growth based on competitive goods and factor markets, an attractive investment environment, and technological change. The major task here is how to change an industrial policy framework which traditionally has been supportive of import substitution to one fostering market flexibility by removing rigidities, or introducing policy measures intended to offset market failure, e.g. externalities from R&D, imperfect credit and factor markets, adjustment costs of restructuring, and infrastructure development.

The following describes key issues relevant to assessing the role of industrial policy in achieving the above objectives, and possible actions that could be supported under the loan. While it may not be possible to deal in depth with all aspects of such a complex set of issues under the proposed loan, we would expect to initiate at least a policy dialogue and agree on some basic strategies (including identification of subject for further studies) as an absolute minimum. Follow up actions could then be supported under a possible follow up operation. Annex I provides a policy matrix outlining the various areas and possible actions under the proposed operation.

A. Price restrictions: Prior to the Economic Solidarity Pact (ESP), price controls were imposed mostly on "basic" commodities and their inputs. Some examples were energy, tortillas, maize, edible oil, processed milk, packaging materials for milk and other food items, fertilizers, steel, and pharmaceuticals. A strategy for rationalizing price controls in accordance with the strategy for phasing out of the ESP would need to be agreed upon under the loan.

B. Continued protection of some industries: Sectoral programs continue to provide protection through QRs to several industries (e.g. automobiles, computers, pharmaceuticals inputs and petrochemicals), and through DCRs to important inputs. In pharmaceuticals, health requirements serve as a NTB. Under the sectoral program, effective protection is raised through tariff exemptions on inputs (Rule 8). QRs are also maintained for a few other industries not covered by sectoral programs. Indications are that the antidumping system might be used increasingly as a tool to provide differential rates of protection. The proposed loan would support a strategy that would substitute NTBs (and other instruments) with equivalent tariffs, and that would establish a schedule to reduce these tariffs to levels compatible with the overall thrust of the trade policy. The strategy would also include the phasing out of all existing sectoral programs and prevent the introduction of new ones.

C. Entry barriers: Sectoral programs in pharmaceuticals and petrochemicals have built-in firm entry restrictions. Pharmaceutical firms cannot enter in items already being produced. Secondary petrochemical firms may not enter without a permit, and they have to deal exclusively with PEMEX to obtain their key inputs. The legislation and practice governing direct foreign investment also lead to differential entry restrictions across sectors. This legislation designates sectors reserved for state intervention and Mexican nationals. A strategy to dismantle these entry barriers will be needed, and would be agreed upon under the loan.

D. Investment incentives: Tax incentives reduce the marginal effective tax rate to firms, and also the cost of capital. The CEPROFI or tax credit system existing until its temporary suspension in end-1987 was very arbitrary and benefitted only a few firms. The objectives of the tax credit system were also unclear. In a period of restructuring and when investment is needed new and more general (across the board) tax incentive schemes may be justified. However, tax incentives directed to specific industries need to be abolished; an alternative strategy would be agreed upon in the loan.

Industry has been a major recipient of directed credit. Measures that would make credit accessible when the market cannot accommodate potentially profitable firms (e.g. small enterprises), and that would make cost and access more neutral, may be necessary. As a minimum the operation would allocate resources for studying this issue, and its findings and recommendations would be taken up in a future loan.

E. Cost of doing business: Licensing procedures increase substantially the cost of doing business in Mexico. Procedures are heavy not just for firm entry, but also for various activities that involve dealing with the public sector, e.g. tax incentives, customs, relocation and expansion (where permits are required for environmental reasons), and mergers. As a minimum, commitment to establish a task force to study and implement recommendations on institutional simplification and streamlining of procedures within an agreed time schedule should be obtained under the loan.

F. Factor mobility: Labor legislation and unions combine to make shedding labor difficult and labor costs higher than necessary. While the legislation may have legitimate social objectives in ensuring appropriate severance pay, the current administration of the system and the additional demands posed under union negotiations raise the cost of exit substantially. There is a need for an easier administrative dismissal process (courts, mediation, etc.) as well as for developing and implementing key elements of a viable labor retraining program (both outside and within the firm). The proposed loan would support a study of key issues in this highly sensitive area and any positive measure the Government may be willing to advance.

Another area related to factor mobility which is crucial to the development of the sector and that will have to be dealt with under this loan refers to industrial technology policy. A Government task force has reviewed the legislation and procedures on property rights and the whole subject of technology transfers and its "white paper" is being considered by the authorities. The loan may support further studies and measures that the Government may be ready to advance.

G. Provision of services: Road transport services are unreliable and costly and have a severe negative affect on the competitiveness of Mexican industry. There is reason to believe that the complex regulations governing this subsector explain much of its inability to supply industry with reliable and cost efficient service. Some of the important regulations are concessions, route restrictions, freight centers, and a monopoly in container transport. The proposed loan would focus on helping to design and lay the groundwork for implementing a strategy for an orderly deregulation of road transport services.

Telephone and other telecommunications services in Mexico have not caught up with industrial demand. The very slow growth of installed lines by TELMEX and the various other entry restrictions imposed on related information services have led to a subsector that has become an important obstacle to industrial and export growth. The operation would seek to improve the regulatory framework and support a study on the setting of telecommunications tariffs.

Rationale for Bank Involvement

The Bank has been involved in Mexico's industrial restructuring process since the start of the trade liberalization process in 1985. It has supported the trade opening through Trade Policy Loans I and II, and the non-oil export drive through Export Development Loans I and II. Furthermore, it has also been involved in parastatal restructuring under the Steel Sector Restructuring and Fertilizer Sector Adjustment Loans. It is also cooperating in Mexico's sectoral restructuring efforts through the Industrial Restructuring Loan (under negotiations) and technical assistance for the studies of the automotive, textile, and agroindustrial sub-sectors. The Bank's continued involvement in the restructuring of the industrial sector would be important through providing technical assistance and contributing funds necessary during the adjustment process in response to policy changes.

Project Objective/Description

The proposed loan would encourage a policy environment supporting more efficient resource allocation and growth in the industrial sector. Together with the proposed SAL and parastatal restructuring loan, it would strengthen private sector development in Mexico.

The proposed loan would seek an agreement with the Government on broad direction and necessary specific changes in Mexico's industrial policy, as discussed above. Policy changes would instill transparency, neutrality, and reduce entry restrictions, as well as a move away from import substitution objectives. The project would provide support for policy changes and would also make available funds to conduct studies and provide technical assistance necessary for continued policy discussions and restructuring efforts in specific subsectors. The loan would have at least two tranches depending on the type and timing of the actions to be agreed upon.

Project Risks

Several of the proposed policy components (e.g., price restrictions, continued protection of some industries, entry barriers and transportation and telecommunication services) can be expected to face strong opposition. These regulatory issues have always been sensitive areas because of strong vested interests, and little change has been seen in this area so far. There is also a question on the likely speed of policy action as a basis for possible lending and upfront conditionality to justify Board presentation.

Staffing

The preparation of the proposed project will be carried out under the overall responsibility of Paul Knotter. Mr. Jones will have responsibility for operational issues and report preparation and Mr. Musalem will have responsibility for the mission's economic and sector work and the respective contributions to the report. The mission members assigned part time are either expected to make also a significant contributions to the SAL and/or public enterprises loan or are only available for limited periods of time. The team is expected to include the following staff members and consultants:

Mission Members:

Industrial policies and deregulation
A. Musalem, (part-time), LA2TF
M. Uy, LA2TF
N. Roger, (part-time), LACVP
I. Lieberman, (part-time), (consultant)
S. Calvo, (part-time), (LA2TF)
I. Rivera, (part-time), (LATTF)
V. Konovalov, (part-time), (IENIN)
A. Ten Kaate, (Local Consultant)
Perez Motta, (Local Consultant)

Industrial Credit
H. Jones, (part-time), LA2TF
Y. Baran, (LA2CO)

Labor Market
L. Riveros, (CECMG)

Foreign Investment and Industrial Technology
C. Dahlman, (part-time), (IENIN)
A. Musalem, (part-time)
Y. Baran, (LA2CO)

Transportation
C. Hurtado, (Consultant)
M. Mukherjee, (part-time), (LA2TF)

Telecommunications
B. Wellenius, (part-time), (ASTIF)

Anti-dumping
N. Messerlin, (part-time) IECIT

MEXICO

INDUSTRIAL SECTOR RESTRUCTURING LOAN
Suggested Agenda for Policy Reform

OBJECTIVES	SUGGESTED MEASURES	POLICY ACTION
I. Promote Non-Distorted Markets		
a) Price Controls	Strategy to phase out price controls on competitive industrial sectors. Rationalization of price controls on non-competitive industrial sectors.	Appropriate legal measures
b) Sectoral Programs	Strategy to substitute price distortions stemming from QRs, DCRs, NTB, entry barriers, and tax and credit incentives, by equivalent tariffs and subsidies to production. Announce time schedule to gradually reduce protection in these sectors to those compatible with overall thrust of the trade policy.	Appropriate legal measures
c) Entry Barriers	Strategy to phase out entry barriers in general, and in the pharmaceutical and petrochemicals sectors in particular. DFI policy will need to define a negative list of subsectors, to follow a less restrictive policy and more automatic procedures.	Appropriate legal measures
d) Tax Incentives	A strategy to phase out non-neutral sectoral tax incentives.	Appropriate legal measures
e) Credit Policy	A strategy to phase out interest rate and credit subsidies. A strategy to improve access to credit for small and medium enterprises.	Appropriate legal measures

OBJECTIVES	MEASURES TO BE TAKEN	POLICY ACTION
II. Improve Factor Mobility		
a) Labor Market	Support a study on factors impairing the mobility of labor (e.g., legislation, labor unions, information cost, and cost of dislocation.	Terms of reference
	Strategy to improve the quality of the labor force and retraining.	Evaluation and supervision
b) Technology	Support measures on legislation and procedures on property rights and technology transfer, measures to be agreed upon with the Government.	Terms of reference for study. Appropriate legal and administrative measures.
III. Reduce Cost of Doing Business		
a) Private Sector Communication with Public Sector	Commitment to establish a task force to study and implement recommendations on institutional simplification and streamlining of procedures (e.g. licensing, customs, relocations, expansions, tax incentives, mergers).	Actual establishment and staffing of a task force
IV) Improve Services		
a) Transport	Strategy for an orderly deregulation of road transport services (e.g., route regulation and freight centers).	Appropriate legal measures
c) Telecommunications	Strategy to improve the regulatory framework and to expand services.	Appropriate measures
	Support study on setting of tele-communication tariffs.	Terms of reference

MEXICO

PROPOSED STRUCTURAL ADJUSTMENT PROJECT

ISSUES PAPER

1. The Government of Mexico has requested World Bank assistance in support of its program of structural adjustment. The World Bank is considering a Structural Adjustment Loan to support this effort. This paper outlines: (i) the current economic situation and future prospects; (ii) the proposed objectives of the structural adjustment project; (iii) The main issues; and (iv) staffing of the mission.

I. ECONOMIC SITUATION AND PROSPECTS.

2. Until 1974 Mexico was a high-growth, low-inflation economy, with real growth averaging 6.4% since 1950 and single digit inflation throughout the period. This period of fiscal conservatism came to an end in 1974, the beginning of an expansionary phase that lasted to 1982. After a brief faltering in 1976-1977, the economy recoveed, aided by major oil discoveries and the subsequent rise in oil prices, and the fiscal expansion continued at an increased pace. External debt in fact tripled over the period, from US$29 billion in 1978 to US$86 billion in 1982, the higher oil revenues notwithstanding. The appreciating exchange rate, a strong indication that the expansion was demand fueled, and the rapid growth in real GDP masked this increase in debt to some extent; nevertheless the ratio of external debt to GDP almost doubled, from 28 to 52 percent over the same period.

3. All this came to an end when rising interest rates and falling oil prices brought out much more clearly the unsustainability of the fiscal policies followed. Mexico saw itself suddenly cut off from external credit markets, leaving no option but strong fiscal retrenchment. This episode ushered in a prolonged period of basically zero real growth from which Mexico has still not recovered.

4. 1983 saw an IMF supported stabilization effort, during which the fiscal deficit was halved, international reserves recovered, and inflation came down. However in 1984 and 1985 there was some fiscal expansion and monetary relaxation. On top of that came the earthquake late 1985 and a major terms of trade deterioration in 1986 due to falling oil prices. In response, the authorities adopted a new stabilization program in July 1986. In return for renewed monetary and fiscal austerity, this program also called for a concerted financing effort on the part of Mexico's creditors.

5. In addition to demand-reducing measures, the 1986 package included new elements of policy reforms designed to eliminate structural rigidities in the economy. As a result, Mexico has made major progress in solving its macro imbalances in the past two years. On the external front, exports of manufactures, spurred by

a 36% real depreciation in the July 1985-December 1987 period, have overtaken oil exports and more than compensated for the 7 billion U.S. dollars oil revenue loss experienced in the same time span. In addition, the trade liberalization process gained momentum since 1985. QRs were more than halved, tariffs reduced sharply, and quantitative controls on non-oil exports almost eliminated. On the internal front, non-interest government expenditure was reduced from the equivalent of 34% of GDP in 1982 to about 25% in 1987 and the primary balance shifted from a 9% deficit to a surplus of over 4% of GDP in the same period. This was all the more astonishing because oil revenues declined by 5 percentage points of GNP between 1983 and 1987. Finally, the public enterprise divestiture program was successful in closing or selling roughly 600 smaller entities, out of a total of about 1200 at the beginning of the period, with negotiations initiated or scheduled to start on a few larger enterprises.

6. Not surprisingly, real growth again stopped. Also, inflation, rather than slowing down, in fact accelerated, partially in response to a sharp nominal devaluation. This devaluation had become necessary in part to compensate for the previous overvaluation, in part because of the abrupt oil price decline. Under these circumstances, the defacto targeting of the real exchange rate, together with an increase in the frequency of wage and cost adjustments, introduced an element of inherent instability into the system. The latter became fully apparent in November 18, 1987, when, perhaps reversible, exogenous shocks-- the bunching up of cancellation of private external debt and the stock market plunge-- triggered a run on the peso. This resulted in reserve losses, a 37% depreciation, fueling inflation and expectations of further exchange rate depreciations. Mexico responded by a concerted effort to bring down inflation that was now running well into triple digits.

7. In December 1987 the Government negotiated the Economic Solidarity Pact with labor, farming, and industry representatives. This program centered on further tightening of fiscal and monetary policy, and accelerated structural reform efforts. Trade liberalization was accelerated, credit subsidies substantially reduced, and the program of public enterprise divestiture reinforced. These measures were supplemented by a freeze of minimum wages, public sector prices and tariffs, and pegging of the exchange rate against the U.S. dollar. This partial freeze was originally intended for a couple of months only but it has systematically been extended.

8. Significant achievements have been obtained during the first half of 1988. A record-high primary fiscal surplus (about 8% of GDP) and an effective ceiling on domestic credit expansion have set the stage for a reduction in the monthly inflation rate from 15.5% in January to below 0.9% for the CPI and 0.4% for the WPI in August. On the external front, the continued expansion of non-oil

exports -- 20% p.a., in spite of an appreciating exchange rate -- has so far succeeded in partially containing the deterioration in the trade balance brought about by the rapid increase of imports. In addition, in spite of some capital outflow in mid-summer, the level of international reserves appears more than adequate, as they stand at about U.S.$ 12 billion, equivalent to over 6 months of imports of goods and non-factor services.

9. However, several external factors are moving against Mexico. Oil prices are down to $11 per barrel rather than the $15 p/barrel counted on at the beginning of the year, while world interest rates are creeping up. Each dollar off the price of oil costs Mexico $500 million, and each percentage point increase in world interest rates almost $1 billion. Therefore these adverse developments could, if sustained, very well lower Mexico's national income by several percentage points. Clearly, either further fiscal deficit reduction or more foreign financing will be necessary if additional crowding out of private investment is to be avoided. To the extent that these external shocks are likely to be long lasting, complete foreign financing would postpone and exacerbate rather than solve the problem. Internal adjustment to these shocks would certainly , among other things, require exchange rate adjustment. In addition, internal developments are also not altogether positive. With half of the commodities under fixed nominal price ceilings, a 1% per month inflation rate probably implies that inflation without price controls would move at 20-25% on an annual basis. Most disconcertingly, this is in fact the pace at which private sector wage increases have settled in throughout the year. Further negative external shocks might trigger expectations of devaluation at the very moment that these wage- price developments are putting upward pressure on the real exchange rate. As a consequence, internal real interest rates have failed to come down and are stuck at around 30% in real terms.

10. This clearly complicates the fiscal situation, which at current real interest rates and zero real growth rate is out of line with the inflation target implied by the fixed exchange rate. At single digit inflation and zero growth, revenue from monetization plus sustainable debt issue fall short of the current fiscal deficit (see Section III.1 below). Fiscal room for manoeuvre would be restored if output growth would resume; hence short-term concerns in fact lead to the same overriding agenda as do long term concerns. Restoration of output growth is necessary, not only to once again offer Mexico some prospect on growth in per capita real income, but also to enhance the survival chances of the short-term stabilization effort.

11. It is clear however, that because of the short-term problems, fiscal efforts cannot be the main source of growth. In the short run, BoP considerations leave no option but export led growth. Then however, supply bottlenecks will develop in time, with the consequent need for additional investment. At present, the latter

stands at the equivalent of 16% of GDP, its lowest historical level. Some calculations put the required increase in the investment ratio required for sustainable 5% growth at 4% of GDP. With fiscal retrenchment necessary in the face of low inflation targets and the likely negative impact of external shocks on public finance, private investment will have to lead the way. This is of course also more in line with the structural reforms currently underway in Mexico; these reforms seek to reduce rather than increase the role of the public sector. This then sets the stage for the proposed SAL: how to restore private sector based growth within the constraints set by external creditworthiness.

12. Where would the macroeconomic room for private investment based growth come from? If public sector revenue were to keep its ratio to GDP at the present level, public sector savings could only increase if further expenditure cuts could be secured. However, this would be a very difficult task indeed, given the extent to which cuts have already taken place and the possible need for additional government investment. In addition, even in the event that, with renewed confidence in the economy and with continued high real interest rates, private savings recover the two percentage points of GDP lost between 1985 and 1987, a 2% of GDP shortfall in investment would remain. A starting point would therefore have to be the design of a policy-financing package that will provide the framework for the increase in private investment necessary for resumed growth. The proposed SAL is clearly an important component of such a package.

II. PROPOSED SAL OBJECTIVES

13. To achieve its main objective, assist in setting off private sector based output growth, the SAL would concentrate on policy actions on Fiscal Policy, Trade and the Financial Sector (deregulation and praestatal reform issues would be addressed in the other two operations under preparation). These actions would focus on the following three major areas: the macroeconomic environment, the cost of investment and the available menu of financing; and the incentive system for private investment.

14. The macroeconomic environment. Even with external finance available for an increase in private investment, it is not automatically clear that private investment will in fact take place to a sufficient degree. Continued uncertainty clearly encourages people to invest their wealth in more liquid assets than physical capital. Hence a strongly sustained stabilization effort is essential, its potential short term depressing effects notwithstanding. A fiscal stance that does not conflict with sustained low inflation, even in the event of unfavorable external developments and continued high real interest rates is probably necessary to allay inflationary fears. This will require restrictions on both the overall deficit and its mode of financing. Second, policies that are compatible with a stable real exchange

rate, to the extent warranted by external developments, are important; this involves both supporting fiscal and monetary policies but also nominal exchange rate policy. A fixed exchange rate against the dollar is not compatible with anything but the US inflation rate in the long run; that is clearly below what currently seems to be the underlying inflation rate. Finally, even if all policy measures are at the desired levels, the sustainability of the implied policy changes themselves will be an important issue for the credibility of the package as a whole. This is especially important for the expenditure cuts undertaken in the past few years.

15. With macroeconomic stability ensured, <u>remaining issues involve the cost of investment and the available menu of financing, the second main area of focus for the SAL.</u> The system of tax incentives for investment is probably too cumbersome administratively and too arbitrary in its impact. Less discriminatory tax measures to lower the marginal cost of capital, such as accross the board investment tax credits could usefully be considered. In addition, continuation of the trade reform program, in particular where it addresses remaining barriers against imports of capital goods, could help. Finally, the major issue on cost of investment is of course the continued high level of real interest rates. This is also a macroeconomic issue, resolution of which will require the same measures already outlined under the heading of macroeconomic stability. Clearly, additional foreign financing will reduce the extent to which high real rates are necessary internally to reconcile fiscal deficits with feasible current account deficits.

16. The next set of issues hampering private investment does not so much involve the cost of financing it but the available financing options. There are two major problem areas. First, restrictive regulation of foreign investment has in the past kept direct foreign investment to a minimum. A reassessment of the role of foreign investment and a commensurate change in its regulation and tax treatment would seem advisable. The second problem area is more substantial and involves the state of the financial system in Mexico itself. This has over the past few years for all practical purposes ceased to fulfill its intermediary function. This is partly a consequence of monetary and fiscal policies. As part of the Pacto private credit is restrained through the imposition of 100% marginal reserve requirements against all commercial bank liabilities. Added to this are <u>average</u> liquidity requirements directing 35% of the Banks' lending potential towards funding of the fiscal deficit. Furthermore some banks are in doubtful shape because of loans of little market value in their portfolio.

17. Restoration of the banking system's intermediary function would be a major undertaking involving regulatory changes, changes in operating procedures of monetary policy and, most likely, extensive restructuring to resolve the problem of bad loans. This

would clearly be a complex operation; an initial assessment of the necessary reforms and their microeconomic and macroeconomic impact would be of the utmost importance.

18. Finally, even within a stable macroeconomic environment and with all distortionary measures raising the cost of capital out of the way, higher private investment would still not necessarily increase welfare if it is misdirected because of distorted incentives. To avoid this, <u>continued progress on reducing the distortionary impact of trade intervention and industrial regulation is imperative.</u> The latter issue would be addressed in the proposed Industrial Sector Project, while the continuation of the trade reform program would be <u>the third and last focal area of the proposed SAL</u>.

III. <u>MAIN ISSUES</u>

19. This section elaborates on the following major issues: macroeconomic consistency; sustainability of the fiscal effort; the financial sector; and trade reform.

III.1 Macroeconomic Consistency

20. Macroeconomic consistency is clearly a precondition for credibility of any policy package; its absence signals that policy changes are imminent. Hence an internally consistent set of macroeconomic policies is a necessary condition for a strong recovery of private investment. Macroeconomic consistency needs to be judged on two levels. <u>First,</u> are the measures taken, in particular fiscal policy measures, in line with the restrictions and self-imposed targets under which the economy needs to operate? For example is the fiscal deficit consistent with sustainable debt issue at current interest and growth rates, and with the revenue from monetization that can be expected at stated inflation targets? And for given deficit targets, is the private sector's savings over investment surplus that can be expected at given real interest rates and growth rates consistent with the public deficit on the one hand and available external financing on the other?

21. <u>Second</u>, are the measures themselves sustainable? For example, has the deficit been cut in ways that will make it impossible for the government to fulfill its remaining functions? We address each of these issues in turn. Below we discuss the first level of consistency needs while sustainability issues are presented in paragraphs 25-42.

22. Macroeconomic targets on inflation, output growth and so on imply restrictions on the fiscal deficit the public sector can support; similarly, levels of real interest rates and availability of foreign financing also influence the leeway the public sector has. So whether the fiscal deficit is consistent with stated

inflation targets depends on all these factors. Table 1 (page 7), based on Mexican data, gives the likely order of magnitude involved for the main variables under four different , hypothetical, scenarios.

TABLE 1: REQUIRED DEFICIT REDUCTION (RDR) FOR CONSISTENCY WITH VARIOUS MACROECONOMIC TARGETS (AS PERCENT OF GDP).

1. NO REAL EXCH. DEPRECIATION; INFLATION 5%; CONST.B/Y RATIO					
OUTPUT GROWTH TARGETS:	n:	0	2	5	
	RDR:	1.2	-0.5	-3	
2. NO REAL EXCH. DEPRECIATION; INFLATION 5%; ZERO OUTPUT GROWTH					
NON-INTEREST	nicad:	-2.5	0	2	
CURRENT ACC.DEFICIT	RDR:	3.7	1.2	-0.8	
(perc.of GDP)					
3. INFLATION 5%; OUTPUT GROWTH 5%; CONST. B/Y RATIO					
REAL EXCH.RATE	c:	0	5	10	
DEPRECIATION	RDR:	-3	-0.5	2.1	
4. NO REAL EXCH.DEPRECIATION; CONST.B/Y RATIO; ZERO OUTPUT GROWTH					
INFLATION TARGETS	p:	0	5	10	35
	RDR:	1.5	1.2	0.9	0

c :Rate of depreciation of the Real Exchange Rate
n :Growth rate of real GDP
p :Inflation Rates
RDR :Required cut in fiscal deficits compared with 1988 (operational) deficits
nicad: Non-interest current account deficit
B :Domestic Debt
Y :GDP

23. The Table shows one important point. At current low growth rates, fiscal consistency is very hard to achieve. A 5% inflation target, which would make the fixed dollar-Pesos rate sustainable, requires a further 1.2 % of GDP deficit reduction necessary over the 1% of GDP operational deficit expected in 1988 (case 1 in Table 1). However, increased output growth would bring the current fiscal

deficit within the constraints set by inflation targets, financial structure and sustainability of debt policies.

24. Hence with continued success on the inflation front and recovery of output growth, real rates can be expected to decline, with the attendant increase in room for fiscal manoeuvre. However, it cannot be stressed enough that this additional room should not be used until it in fact emerges, i.e. only when real interest rates on domestic debt do in fact decline. Otherwise the potential of failure reflected in the current high level of real interest rates could become a self-fulfilling prophesy.

25. The Table demonstrates that such a self-fulfilling prophecy scenario is more likely, the less the access to foreign financing. The need to effect a substantial resource transfer to foreign creditors clearly greatly complicates implementing the fiscal measures necessary to reduce inflation on a sustainable basis. Case 2 in the above Table shows how the required deficit reduction, for any given inflation target, increases as less external financing becomes available. This of course raises the issue of where the initial stimulus for output growth should come from; in the absence of more foreign financing, it is not clear that this stimulus can originate from fiscal policy.

III.2 Sustainability of the Fiscal Effort

A. Government Expenditures

26. Background. A key factor leading up to Mexico's financial crisis in 1982 was the rapid growth in public expenditures. Non-interest public spending as a share of GDP almost doubled between 1971 and 1982, from 17 percent of GDP to 33.7 percent. Non-interest current expenditure rose from 12.7 percent of GDP to nearly 24 percent. Similarly, public investment also doubled its share in GDP, from 5.1% to nearly 10% of GDP. The size and number of public enterprises increased rapidly, from less than 80 in 1970, to over 1200 by 1982.

27. Since 1982, a major retrenchment of public expenditure, unprecedented certainly in Mexican terms if not for all of Latin America, has taken place. Non-interest expenditure declined by 14 percentage points of GDP to a projected 19% of GDP in 1988. About one-third of this adjustment has been achieved via reductions in public investment, which declined from 9.9% of GDP to a projected 4.2%. But non-interest current outlays have also declined, by nearly 7 percentage points of GDP. The main factor was a 50 percent decline in real public sector wages, but transfers and outlays on current goods and services have also been curtailed.

28. This record suggests three major questions.

(a) How sustainable are the cuts already achieved? For example, has the decline in real public wages reached a point at which the public sector will no longer be able to compete for the skilled personnel it requires to achieve even a minimally-acceptable performance in providing vital infrastructure, public safety, etc.? In addition, the freeze on tariffs and public sector prices will require some adjustment before the reduced public enterprise profitability, compounded with continued oil revenue losses, adds pressure on the budget.

(b) What are the implications for growth and development of these expenditure reductions, particularly in the area of investment?

(c) In the medium term, is there scope for further economies in public expenditure, taking into account the requirements of public investment to support accelerated growth and other likely contingencies?

29. In what follows, selected topics for further analysis are proposed in the light of these concerns:

<u>Increased Targetting of Social Expenditures</u>

30. Since 1982, real spending on education, health, and related social areas has declined by over one-third, and in per capita terms by nearly half, mortgaging in many cases the future of Mexico's human potential. Any realistic assessment of spending priorities is likely to call for at least some recovery in social sector outlays. But given the country's severely constrained fiscal situation, how can this be prudently accomplished? One way, as the experience of the recently-introduced food stamp program suggests, is by replacing across-the-board consumer subsidies in areas such as power and water consumption with targetted subsidies, thereby cushioning the poorest while introducing further fiscal savings. (It is estimated that losses on subsidized power, urban transport, and water alone aggregate to over 2% of GDP, mostly benefitting residents of Mexico City).

31. In areas such as health, a shift in emphasis toward primary health care and increased user fees on an ability-to-pay basis would bring major benefits to the under-privileged while curbing waste and the regressive character of the current health system.

<u>Parastatal Crowding Out of Competing Needs in Infrastructure and Social Areas</u>

32. An overriding issue is whether spending priorities should continue to shift away from the expansion of parastatal production of goods the private sector might provide more efficiently in order to "make room" for urgent requirements to refurbish existing

infrastructure and reorient it toward outward-oriented growth, as well as accommodate competing social spending needs. Parastatal adjustment over the past sexenio has focussed mainly on the smaller and budgetarily insignificant state-owned enterprises, as the number of agencies and enterprises has declined by two-thirds from 1258 to around 450 currently. However, for budgetary purposes, there are only a handful of parastatals which account for nearly 90% of all parastatal spending -- PEMEX, CFE, FERTIMEX, the national railway company, CONASUPO, SIDERMEX, and AZUCAR, S.A.). Here, progress has been much more limited. Real wages have declined, albeit not in the same magnitude as in the federal government, while in most cases, the number of employees has grown. Tariffs and prices have been adjusted upward sharply, but remain in some cases, such as power, sharply below marginal unit costs. Investments have been cut severely, but, as in the case of the power company, plans are being laid for rapid expansion in the current sexenio. Financial restructuring has been achieved in some cases, but this has largely shifted the burden of debt service to the central government without resulting in a corresponding improvement in parastatal management or efficiency. With parastatals accounting for roughly a third of public employment and a similar share of spending, an aggressive program of privatization and improvements in internal efficiency would appear to offer major potential for further reductions in non-interest spending.

Public Investment Efficiency

33. Decades of subsidies for water and urban transport, mainly for residents of Mexico City, and for fertilizers, irrigation, and power nationwide, continue to pose an enormous burden on the public treasury, not only through costly transfers, but also via the encouragement of wasteful consumption of public services, and corresponding pressures on the budget. For example, over the past six years, power consumption has continued to grow by over 4% annually, despite a small cumulative decline in real economic output during this period. As a result, CFE now proposes to increase real investment by over 12% annually to catch up on the "backlog" of unmet power demand. Moreover, there are institutional issues of investment allocation, such as weaknesses in project analytic capabilities, the decentralization process which may place investment decisions increasingly in the hands of state and local governments ill-equipped to take them, and related issues of absorptive capacity among major central government ministries demoralized by declining salaries and investment budgets. Key decisions regarding the future role of the parastatals which currently absorb roughly half of investment resources, will also have a profound impact on investment allocation and efficiency, if not overall levels.

Other issues involving Public sector investment:

34. The main areas that could be explored are: changes in the public sector investment, Central Government capital expenditures and public enterprises.

35. Recent changes in public sector investment. After the rapid growth in the 70's, current and capital public expenditures were drastically cut during 1982/88. A first task is to describe those changes, particularly on the following dimensions:

- changes in investment of Central Government vs. public enterprises;
- changes in capital expenditures vs. current expenditures; recurring costs/maintenance vs. new projects;
- destination: sectoral composition.
- financing: borrowing/retained profits/central budget;
- domestic components vs. imported capital goods.

36. Central Government capital expenditures. The two main issues here are the extent to which the current level of capital expenditures by the Central Government is enough to meet the demands imposed by the political system, in regards to basic services to the population and business infrastructure. That is:

(a) Are basic public services (health, education, transportation) being provided at an 'adequate' level with the current infrastructure? Can it accomodate the expected increases in population? Related issue: should those services be provided at the federal or local levels? what is the role of the private sector in providing these services?

(b) Is the productivity of private production and the profitability of private investment being affected by inadequate maintainence/modernization of the required infrastructure (transportation, telecommunications, police)? Related issue: public investment on research and development: is it enough, too much?

37. Public enterprises. Given the decision on which enterprises should remain in the public sector, are their investment level compatible with an efficient performance in their sectors? Or are they overinvesting? Is there preferential access to bank financing? The role of investment of public enterprises have to be considered with due regards to their several levels of integration with the private sector: actual or potential competitors in products and factor markets, but also suppliers of basic inputs (e.g. steel) and important source of demand.

Growth of Public Sector Employment and Wage Policy

38. Between 1980 and 1987, public sector employment increased by over one-third to 4.4 million, representing roughly one in every five members of the economically active labor force. Thus, at a

time when the budget was under severe pressure, the task of shrinking expenditure was made far more difficult. This explains why the public sector wage bill has declined by slightly over one-quarter since 1982, although average real wages have fallen to a far greater extent, and, indeed, may have been forced down even more by the need to offset the growing employment rolls. Of the 24 largest parastatals, 17 experienced increases in employment during this period. Other sources of employment growth include teachers, health personnel and public safety. If real wages are to be selectively improved to attract qualified personnel, a coordinated strategy on future public employment growth would seem to be overdue.

III.2. B. Taxation

39. Mexico has recently gone through a series of tax reforms that have left it with by and large an efficient tax structure. About thirty percent of tax revenues is derived from the VAT, and roughly 40 percent from direct (corporate and personal) taxes. The remainder comes from trade taxes (less than 10 percent) and various excise taxes such as excises on alcohol, tobacco and so on. Tax revenues have hovered around 10% of GDP over the past few years, a relatively low level for a country of Mexico's state of development and size of government. Tax revenues are likely to increase as a proportion of GDP in spite of fairly extensive rate reduction because of the decline in inflation. Lower inflation reduces the losses in real tax revenue caused by inflationary erosion of tax obligation during collection delays inherent in the tax system (Tanzi-effect).

40. All tax systems are relatively straightforward, and have been made largely immune to inflation. This is done through regular adjustment or indexing of brackets and a proper definition of corporate income corrected for capital losses and gains caused by inflation. Furthermore, a VAT is from an economic point of view clearly the most efficient way of raising revenues.

41. There is therefore no need for comprehensive tax reform proposals.

42. Areas of potential improvement should therefore focus mainly on tax administration. Based on current information, the following areas seem important: (a) trade tax collection seems unusually cumbersome; (b) expansion of the tax base of the personal income tax to cover more of non-wage incomes; (c) the extent to which reallocation of responsibility between federal, state and local government could improve collection and reduce administrative costs.

43. As to tax structure, the issue of lowering marginal corporate tax rates through the use of investment tax credits has already been mentioned. In addition, the tax treatment of foreign

investment needs reassessment in the light of Mexico's increased need for external financing is growth is to resume. Finally, another area where additional efforts are likely to pay off is with property taxes. A Bank loan to BANOBRAS to update the cadastral map has been under discussion for some time and, perhaps, could be now revived.

III.3. Financial Sector Reform

44. Background. Mexico benefitted from decades of macroeconomic stability during the 1950s and 1960s to develop a sophisticated, diversified, and comparatively efficient financial sector. There was a a largely complementary relationship between privately-owned commercial banks and a state-owned system of development banks and trust funds. The former played a major role in mobilizing domestic private financial resources and providing short-term credit; the latter mobilized external finance and allocated the bulk of long-term credit with reasonable efficiency and regard for market criteria.

45. The advent of the 1970s introduced new and destabilizing elements into the financial picture, including rising inflation and, for the first time, extended periods of negative real interest rates. Nevertheless, the oil boom and the consequent enhanced access Mexico enjoyed to foreign savings permitted continued growth in the domestic financial system. By the late 1970s, it was mobilizing domestic financial resources equivalent to roughly 40% of GDP.

46. But the macro problems of the early 1980s, coupled with deteriorating returns to domestic assets and rising expectations of exchange rate adjustment triggered extensive capital flight. The strains on the financial system were buffered temporarily by recourse to massive amounts of foreign borrowing, but by 1982, Mexico could no longer maintain regular service on its external debt and the flow of fresh resources was interrupted. Compounding the financial crisis was the decision to nationalize the private domestic commercial banks and force the conversion of foreign currency-denominated assets at an artificially low exchange rate. The domestic financial system has yet to recover from these shocks. Moreover, the short-term effects of macroeconomic instability and nationalization have prevented adequate attention to longer-term structural issues having to do with the system of preferential credit allocation.

47. Our knowledge of current situation of the financial system is very limited because, as a matter of policy, the government has not allowed any involvement by the Bank in this sector. The lack of adequate sector work seriously hampers the possibility of developing a comprehensive approach in the short time available.

Some broad issues related to the link between macropolicies and finance reforms, quality of loan portfolios, and the preferential credit subsides schemes are discussed below.

Macroeconomic Policies, Structural Adjustment, and Financial Reforms

48. The principal concern here is determining what sorts of reform the financial sector requires to support broader stabilization and structural adjustment objectives. Large public financing requirements and high and variable inflation clearly hamper the financial system's ability to play its intermediary role. Also, financial sector reforms themselves will have an impact on the macroeconomic situation and may thus require supporting macroeconomic measures. For example lower reserve requirements increase the degree of intermediation but lower the public sector's revenue from monetization. Such measures would thus need to be complemented by fiscal changes providing an alternative source of revenue.

Debtor-Creditor Stress

49. Erratic inflation in combination with economic stagnation has produced major stresses in debtor-creditor relationships during the past five years which in turn have resulted in dangerous distortions in the operations of most financial intermediaries. The quality of loan portfolios and the adequacy of capitalization have deteriorated substantially. Successful stabilization is likely to reveal more clearly the weaknesses which accumulated during the period of prolonged inflation. The potential dangers for financial system liquidity and solvency during a disinflationary process must be anticipated by the financial authorities, who, ultimately, will be called upon to identify, realize, and allocate the financial losses coming due.

Preferential Credit and Subsidies

50. The proliferation of preferential credit schemes and interest rate subsidies had become excessive even before intensification of Mexico's financial sector problems in 1982 and thereafter. Moreover, by allowing some credit schemes to deviate sharply from their original aims, the Government institutionalized resource allocation inefficiencies and dysfunctional financial processes which currently impose a substantial burden on the economy. Moreover, the effectiveness of other monetary and fiscal policy instruments has been blunted.

51. Finally, the fact that the costs and benefits of these programs are not easily identified, whether in terms of amounts or incidences, further complicates the problem. A system of greater transparency in accounting for the volume and incidence of subsidies, followed up by explicit budgeting and control of credit

subsidies consistent with broader macroeconomic aims would be a first step. Beyond this,the rationale for such a significant share of credit to be intermediated by state-owned development banks mostly using non-market criteria, needs to be reexamined.

III.4 Trade Reform

52. Since mid-1985, in a radical departure from past policies and in concent with broader adjustment efforts, there has been a far-reaching liberalization of Mexico's trading regime. The reforms have aimed at expanding the tradables sector and opening it to international competition to encourage efficiency in expanding and import substitution. While the full impact will take time, the initial results are promising -- incentives have been redirected and restructuring toward efficient activity began.

53. Building on this progress requires:

(i) continuation of the trade reforms to further enhance eventuality and transparency;

(ii) co-ordination of trade and macroeconomic policies, particularly exchange rate management and fiscal consequences; in addition, trade reform may have an impact on domestic prices that could clash with some of the short term goals of the Pacto; for example export barriers on agricultural commodities clearly take pressure off domestic prices. Over an extended period however, such measures do not provide any serious relief against inflation.

(iii) co-ordination of trade and domestic deregulation policies to facilitate adjustment.

54. Continuing trade liberalization will require reductions in the remaining import QRs, tariffs, export controls and taxes, and improving temporary import and duty drawback systems. The majority of the remaining import QRs (covering some 23% of production of tradables) are on items with corresponding domestic regulation and price controls, so sequencing and coordination will be important. The tariff bond of 0 to 20% is moderate but variability of effective protection is still marked. Treatment of zero rates and tariff exemptions, and the possibility of binding the tariff reductions in the GATT will be important issues. Export controls are now fairly minor, and similarly to import QRs the majority are linked to domestic price controls and international agreements; again raising issues of sequencing and coordination.

55. While proceeding with further trade liberalization, it will be important that other trade affecting measures with quite legitimate objectives, such as anti-dumping mechanisms, sanitary rules and technical standards, are not used to circumvent progress. Similarly, simplification of customs procedures will further support reform.

56. Trade reform and macroeconomic stabilization need to be mutually supportive. The overall macroeconomic environment should facilitate economic restructuring and expansion of the private sector. The level and volatibility of the real exchange rate, and public sector balances are crucial here. Equally the revenue consequences of changes in trade taxes must be consistent with fiscal goals. The interaction of tariffs and other taxes needs to be considered; for example raising tariffs on capital goods clearly contravenes the effects of investment tax credits.

57. Similarly, domestic deregulation should support trade reform in encouraging economic restructuring. In Mexico domestic decontrol seems to be lagging. Financial market restructions, price controls, industrial programs, foreign investment rates, labor market restruction, transport regulation, etc., can all impair private sector adjustment to reform and policy improvements will be needed.

IV. STAFFING

58. The preparation of the proposed project will be carried out by a team led by Sweder van Wijnbergen (Lead Economist for Mexico) under the general direction of Miguel E. Martinez (Division Chief, LA2CO). The team will include the following staff and consultants (area coordinators are underlined):

Macroeconomics

S. Van Wijnberben	(LA2CO)
E. Croce	(LA2CO)
S. Pena	(LA2CO)
R. Lamdany	(DFS)

Fiscal Policy: Expenditures

J. Johnson	(LA2CO)
J. Varallyay	(LA2CO)
R. Martin	(LACVP)
I. Nabi	(LA2CO)

Fiscal Policy: Revenues

S. van Wijnbergen	(LA2CO)
E. Aninat	(Consultant)
L. Vazquez	(LAT)
R. Silva	(Consultant)
C. Dahlman	(Part-time) (PPR)
T. Castaneda	(Part-time) (LA2HR)

Financial Sector

M. Larrain	(LAT)
S. Ramachandran	(LAT)
A. de Juan	(EMENA)

Financial Sector

H. Jones	(Part-time) (LA2TF)

Trade

N. Rogers	(LACVP)
R. Herzt	(YP, LA2CO)
J. Garcia-Garcia	(LA2AG)
A. Musalem	(Part-time) (LA2TF)
P. Messerlin	(Part-time) (PPR)

Ji. Qureshi

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

SAL
2nd SAL
ESAF has been
Why do we want to fragment conditionality
Should we do more investment lending in agri

DATE : October 12, 1988

TO : Operations Committee

FROM : Vinod Dubey, Director, EAS

SUBJECT: MAURITANIA - Agricultural Sector Adjustment/Investment Project
Initiating Memorandum - OC Meeting Agenda.

1. The Operations Committee will meet on Friday, October 14, at 4:00 p.m. in Room E-1243 in order to discuss the above-referenced document which was circulated on September 30, 1988 under separate cover. The IDA amount proposed in support of the project is US$ 20 million: US$ 15 million for the sector adjustment component and the balance for the investment component. Co-financing in the amount of US$ 16 million is being sought from the Dutch Government, French Ministry of Cooperation, and the International Fund for Agricultural Development. A proposed local contribution of US$ 2 million would complete financing of total project costs of US$ 38 million.

Background

2. Mauritania is a large (1.1 million square kilometers), sparsely-populated (1.8 million inhabitants) country with a limited, and environmentally-fragile, natural resource base. Land suitable for farming under present development conditions amounts to only 0.1 hectare per inhabitant. Extensive animal husbandry, therefore, dominates the agricultural sector (accounting for 23.4% of GDP versus 5.4% for crop production); other important economic activities in the country include iron ore mining and fishing. Although its per capita income of US$ 420 puts Mauritania near the top of the "low-income country" category, incomes have stagnated over the past decade, and health and education indicators are among the lowest in the world.

3. The Mauritanian economy did not perform well between the mid-1970's and early 1980's. Growth faltered and large internal and external imbalances appeared: by 1984, the overall fiscal deficit and current account deficit were equivalent to 24.3% and 30.5%, respectively, of GDP. The three main factors responsible for this poor economic performance were droughts, a weak international market for iron ore, and inappropriate macroeconomic and sectoral policies. In order to deal with the latter, the Government embarked upon a comprehensive Economic and Financial Stabilization Program (PREF) for the 1985-88 period with the support of the Bank (through a first SAL approved in June 1987), the Fund (through successive stand-by arrangements and a SAF), and other members of the donor community. Satisfactory progress has been achieved with the PREF. In order to continue the process of structural adjustment, the Government has put together a new program, known as the PCR, for the 1989-91 period. It is expected that the PCR will be supported by a second Bank SAL and a Fund ESAF.

Issues

4. Macroeconomic context. The IM reports (para. 6) that good progress has been achieved under SAL I and that the basic macro indicators seem to be moving in the right direction. The Region may wish to summarize for the Committee the major accomplishments of SAL I, including progress to date in meeting second tranche conditions. The Region may also wish to brief the Committee on how the proposed operation would complement the proposed second SAL and Fund ESAF.

5. Rationale for size and packaging of loan. The proposed operation is described in the IM as a "hybrid", with both quick-disbursing and investment components. Although the rationale for the latter component is given in the text (para. 45), there is no clear statement of the merits of combining this component with a quick-disbursing element. There is also no clear statement of the justification for the total loan size or the relative size of the two major components. The Region may therefore wish to brief the Committee on why the "hybrid" approach was chosen for the proposed operation and why most of the loan proceeds (approximately two-thirds) would be quick-disbursing. Does the emphasis on sectoral adjustment imply that there are limited opportunities for public investment in the agricultural sector? Are future operations in the sector also likely to emphasize adjustment? When do we foresee a return to traditional investment operations? Also, the Region may wish to explain whether and, if so, how the adjustment component's conditionality would be linked to the investment component.

6. Improvement of incentives. One major objective of the sector adjustment component is to improve incentives to farmers and the private sector. This would be achieved through increases in the consumer prices of cereals (including wheat food aid) and a gradual disengagement of the public sector from cereals processing and marketing. What principles were used to determine the new cereal prices for 1988-89 specified in the Government food policy declaration? What effect are these new prices expected to have on domestic production, and on the real incomes and nutritional standards of the urban poor? What steps need to be taken to ensure "a complete transfer of public rice mills to the private sector" (second tranche condition [c])? Will the spread between the producer and consumer prices of rice allow an adequate profit for private millers?

7. Cost recovery. The investment component (para. 46 [a]) includes "a program of improved operation and maintenance of the irrigation scheme", but does not mention proposals on cost recovery. The Region may wish to clarify the proposals for cost recovery, particularly for the recovery of the system's operating and maintenance costs.

8. Credit. The investment component includes the introduction of credit by ODB to farmers, fisherman, and private entrepreneurs. As credit recovery is presently unsatisfactory (para. 37 of the IM mentions

a recovery rate of 70% for credit extended by SONADER), the Region may wish to explain how the proposed operation will ensure a better recovery rate for the credit component.

9. SONADER restructuring. It is proposed (para. 46 [c]) that the project finance part of SONADER's non-incremental recurrent costs. The Bank's policy (OMS 1.21) provides only for financing of incremental recurrent costs. The Region may wish to explain to the Committee why an exception to Bank policy is justified in this case.

10. Procurement. The IM explains only the arrangements for the project's adjustment component. The Region might therefore wish to clarify the proposed arrangements for the investment component.

cc: Messrs: D. Lee (COD), A. Shakow (SPR), J. Holsen (CEC), D.C. Rao (FRS), Burmester/Thahane (SEC), R. Liebenthal (SPRPA), A. Steer (FRS), T. Baudon (SVPOP), M. Gillette (AF5DR), L. Hinkle (AF5CO), S. Darghouth (AF5AG), D. Steeds (AF5AG), S. O'Brien (AFRCE).

For Information Only:

D. Hopper (SVPPR), D. Bock (DFS), D. Golberg (VPLEG), R. Frank (CFP), J. Parmar (CIO), G. Pfeffermann (CEI), J. Baneth (IEC), M. Haug (EXC), J. Tanaka (EXC), C. Robless (OPNMS), R. Agarwala (AFRCE).

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Less justified
depends what we do in SAL
Under the SAL agt to be
reached on a 3 year agt
on processing & pricing of cereals.
This will

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: October 12, 1988

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

EXTENSION: 78051

SUBJECT: TUNISIA: Country Strategy Paper
Second Agricultural Sector Adjustment Loan
Initiating Memorandum

1) The two scenarios
2. Political situation underplayed
3. Unemployment & Pop growth on projects com'ng late
4. Disbursements of Policy loans analogy

1. The Operations Committee (OC) will meet on Friday, October 14, at 10.00 a.m. in Room E-1243 to consider the Country Strategy Paper (CSP) for Tunisia, together with the Initiating Memorandum for an $84 million Second Agricultural Sector Adjustment Loan (ASAL II). The OC may wish to take up the following issues.

I. THE CSP

The Setting

2. The CSP paints an optimistic picture of the political situation and the state of the economy, which has suffered from oil depletion, worsened terms of trade, drought and locust attacks but has shown nonetheless many signs of strength. It presents two fairly similar scenarios of moderate growth, both of which appear feasible. The CSP refers to a period of aberration in the early eighties when economic policy deteriorated and the fiscal and exchange deficits widened, but describes more recent attempts at policy reform, many of which have been supported by the Bank. In fact the dialogue between the Bank and the country can be described as excellent. There remain, however, gaps both in the macroeconomic analysis regarding inflation and the exchange rate and whether further depreciation might be indicated; why investment has fallen so drastically, particularly private investment, [does private investment fall in response to liberalization?] and what sectors have been particularly hit by the reduced investment; what are the trends behind workers' remittances and tourism, both of which are important foreign exchange earners?; why unemployment is so high and what is the future of the labor market? The CSP is devoid of explanation of the factors affecting these phenomena. That is why a clear role for the Bank does not emerge, beyond supporting some changes in macroeconomic policy and certain sectoral reforms. It is not enough to say (in para. 4) that "a higher growth rate for the Tunisian economy, coupled with sustained efforts to reduce population growth, will be the best vehicle to promote job creation and tackle the severe unemployment problem," especially as no special role for the Bank in this area is delineated.

- The Region may wish to clarify the proposed Bank development strategy, particularly in respect of restoring private investment and creating job opportunities.

- Has country economic and sector work in the past sufficiently drawn attention to the false signs of rapid growth, obtained at the cost of depleting the country's hydrocarbon assets?

- Is there no danger that the adjustment process might provoke political opposition, particularly from fundamentalists, especially in conditions of high unemployment?

- What are the key environmental issues in Tunisia, and what can the Bank do about them?

- In view of the skewed land ownership in Tunisia, what do we know about income distribution and can we do something to improve it?

The Lending Program

3. The Bank lent to Tunisia an average of $313 million a year over FY87 and FY88, and the CSP proposes that roughly the same level of lending ($300 million a year) be maintained over the next few years. This is in line with the recommendations of the Lending Allocation Review. The case for the proposed level of lending is cogently made, and earlier plans to include a high content of adjustment lending have now been revised downward because of high Bank exposure. Accordingly with the new lending program Bank exposure in terms of long-term debt service would reach about 20% in 1991 rising to 23% by 1997; in terms of long-term debt outstanding (DoD), the share of the Bank reaches 20% in 1989 and remains in the range of 21-23% throughout the 1990s. Finance, using slightly different figures, calculates that preferred creditors' exposure in DoD would exceed 33% after 1989, but that IBRD's export service ratio would remain below 5% through 1995. Though we seem to be reaching the limits set by exposure guidelines, Tunisia's good credit record and moderate debt liability might suggest more lending.

- Would the Region consider a higher level of lending and a greater portion of policy-based operations if the problem of exposure were not present?

- Can we pursue burden sharing simultaneously with higher lending so that Tunisia might accelerate its growth?

4. The CSP admits the weakness of the project pipeline for Tunisia which is blamed on the recent change of lending plans from a high adjustment content to a low one. Three quick-disbursing policy-based components in hybrid projects are programmed: ASAL II, an Education and Employment Sector Loan and a Public Enterprise Rationalization Loan (PERL), the latter both in FY90. The last one would focus on reforming three public sector entities, dealing with the Railways, the Chemical Group and Phosphates. The sectoral distribution of lending in Annex D makes good sense, except that manufacturing does not receive a loan until FY91 although promoting its exports is a cornerstone of the proposed strategy. Population, said also to be a focus of development strategy, does not get a loan (with health) until FY92.

- Would the Region consider earlier lending for these two sectors?

Slow Disbursement of Adjustment Loans

5. In view of the fact that ASAL I which was approved in September 1986 (for $150 million) is not yet fully disbursed (balance undisbursed at end-August 1988 $58.73 million), and that the Industry and Trade Policy Adjustment Loan ITPA, approved in February 1987 (for $150 million), has not yet had its second tranche released, and has disbursed only $62.41 million by end-August 1988; also considering the fact that the SAL approved in June 1988 for $150 million has not yet become effective:

- The Region may wish to explain the reasons behind this tardiness in disbursement, and whether the same would apply to the new loan. In other words, does Tunisia really need quick-disbursing funds, or is the problem more fundamental and the reforms being pursued are met with resistance?

II. ASAL II

Conditionality

6. The proposed operation builds on the reforms already agreed under the SAL (which are being carried out in the context of the Seventh Development Plan), and also on the reforms begun under ASAL I. The authorities have launched a wide-ranging program of reforms within a clearly defined macroeconomic framework, in pursuit of economic and political liberalization. This trend started only about two years ago, and the transformation is planned to take place before the mid-nineties; hence the pace of the adjustment has to be brisk.

7. The loan, for $84 million (with $16 million cofinanced by Germany's KfW), consists of two-thirds import financing and one-third investment financing, covering a time slice of the second phase of the country's medium-term agricultural sector adjustment program whose first phase was supported by ASAL I. The quick-disbursing portion would disburse in two equal tranches against a positive list of imports. This being the fourth policy-based operation, it would complement the policy changes being undertaken under the SAL covering trade liberalization, interest rate adjustment and taxation reforms. Parastatal reforms in agriculture are covered by this operation, but reforms of other parastatals would be covered by the Public Enterprise Rationalization Loan (PERL). The final stages of the Medium-Term Agricultural Sector Adjustment Program will be supported by two Agricultural Sector Investment Loans (ASILs) in FY91 and FY93.

8. The reforms supported by this loan fall in four areas: (a) parastatal reform (institutional, monitoring, divestiture of irrelevant functions and elimination of public sector monopoly); (b) pricing and marketing (reduction or elimination of controls, continuing to reform price support formulas for cereals, edible oils, milk and meat, eliminating subsidies on inputs of fertilizers, animal feed, seed and others); (c) supporting services (to increase farmers' access to imports, improve farm mechanization by liberalizing spare part pricing and abolishing bans on tractor imports, privatizing livestock services, and improving extension services, credit, land titling and land consolidation); and (d) improving fisheries exploitation.

9. The conditionality involved in these reforms is spread over 16 pages of Attachment 3 and its timing is elaborated over another three pages of Attachment 4.

- The Region might wish to prune Attachment 3 as it is much too long, or even eliminate it altogether, condensing its contents into one paragraph of text.

- Can the three-year moving average for pricing imports incorporate a further year of projection, since the formula would for ever be lagging behind current events?

  Look forward.

- What are the employment implications of the divestitures planned for the public sector agricultural institutions?

- Has the 25% effective protection for cereals been translated into nominal protection guidelines for various crops to facilitate implementation?

- As the phase-out of subsidies on irrigation water by 1995 (with 65% O&M cost recovery by 1991) would seem to be the most difficult to achieve, can the Region update the OC on any progress made towards that end under the provisions of the Irrigation Management Improvement Loan, approved in FY85?

Land Utilization

10. Land titles are incomplete and often out of date for two-thirds of the available land, and the pace of registration in respect of the remaining third would require 60 years to complete land titling. Besides, ownership is skewed and fragmented, with a prevalence of absentee ownership for larger farms. Progress on improving the land titling situation is indicated under Urban V and under one of the forthcoming ASILs. Certain legislative and administrative changes are envisaged under this operation and are listed in Annex 3, but are, however, absent as conditions of either effectiveness or tranche release.

- In view of the importance of the problem, can the provisions for improving land use be more tightly conditioned?

  Program for land titling very vague.

cc: Messrs. Lee (COD), Shakow (SPR), Holsen (CEC), Rao (FRS),
Burmester/Thahane (SEC), Liebenthal (SPRPA), Steer (FRS),
Baudon (SVPOP), Hasan (EMNVP), Dervis, O'Sullivan, Grais (EM2).

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Aguirre-Sacasa (EXT), Tanaka (EXC), Robless (OPNMS),
El Maaroufi (EMNVP), Ms. Haug (EXC).

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: September 20, 1988

TO: Members of the Operations Committee

FROM: Wilfried P. Thalwitz, Vice President EMENA

EXT: 32676

SUBJECT: TUNISIA - Country strategy Paper (CSP) and Initiating Memorandum (IM) for a Second Agricultural Sector Adjustment Loan

1. Attached for your consideration are the documents mentioned above. A meeting to discuss both papers is scheduled on October 12, 1988.

2. The Bank strategy proposed, as summarized in para. 46 of the CSP, aims at helping Tunisia in its transition to a more liberal political and economic system and to resume sustained growth in the context of reduced oil resources. Despite excellent country performance, concern over increasing Bank exposure leads us to propose a lending program that significantly reduces the levels of adjustment lending that had been discussed with the Tunisian Government last year. The adjustment loans envisaged address the main development issues faced by Tunisia, that is, the need to redefine the role of the state and stimulate competitive private sector activity. Re-establishing the conditions for higher, sustainable growth will also be the only solution to the unemployment problem, which could become a major source of social tension.

3. The new Government of Tunisia is showing strong commitment towards increased political liberalization. Several moves have been made in this direction by President Ben Ali that give credibility to its stated intentions to put Tunisia on a more democratic path. The amendment of the Constitution

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Distribution:

Messrs. Qureshi (SVPOP), Jaycox (AFRVP), Karaosmanoglu (ASIVP), Husain (LACVP), Wood (VPFPR), Shihata (VPLEG), Rajagopalan (VPPRE), Duksoo Lee (CODDR)

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4. The Second Agricultural Sector Adjustment Loan follows up on the implementation of the program of sectoral reform defined in the Government's Medium-Term Agricultural Sector Adjustment Program, already being successfully implemented with Bank support. It will cover important areas of policy reform, namely the liberalization of pricing and marketing (including the redefinition of the role of key parastatal enterprises in the sector), and the improved delivery of support services to agriculture by privatizing some of the support activities and strengthening remaining essential services provided by the Government. The loan was originally prepared to provide only for import financing but, in line with the CSP objective of limiting Bank exposure, it has been redesigned to finance part of the Government's sector investment program. The investment financing component will provide experience with this type of operation, that we expect to follow up with a full scale Agricultural Sector Investment Loan in about two years time to support the final stages of the Government's medium-term program for the sector. The loan amount originally discussed has been reduced from $100 million to $86 million, the German Government having agreed to cofinance the balance.

5. In summary, the ASAL II pursues the objectives of economic efficiency and growth sought by the Government and the Bank within the macroeconomic framework agreed under the SAL, and will deepen the reform program in one of the key productive sectors. The policy changes to be introduced will contribute to the gradual dismantling of the excessive public sector intervention in agriculture, and will promote efficiency through increased competitive private activity and policy changes to achieve a better allocation of economic resources. The excellent implementation record of the Medium-Term Agricultural Sector Reform Program, which is the Government's own, attests to the commitment to policy reform in the country. In the medium term, the efficiency gains in production and marketing resulting from the program are expected to increase the incomes of most farmers. The operation thus meets the criteria associated with successful adjustment loans and, I believe, is a suitable vehicle to deliver the policy based lending needed by Tunisia at this time.

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: October 12, 1988

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

EXTENSION: 78051

SUBJECT: PAKISTAN - Initiating Memorandum for a Financial Sector Adjustment Loan

1. The Operations Committee will meet on Friday, October 14, at 11.00 a.m. in Room E-1243 to consider the Initiating Memorandum for a Financial Sector Adjustment Loan in the amount of $150 million to be released in two equal tranches. This would be the fifth adjustment operation in Pakistan after the $50 million Fertilizer Imports Credit (FY81), the $140 million SAL (FY82), the $178 million Energy Sector Loan (FY85) and the $70 million Export Development Loan (FY86).

Fin. Sector Loan 1988

Background

2. The proposed loan is wide ranging and addresses a most vital sector on a broad front. Building on an early drive for liberalizing interest rates, the program supported by the loan would strengthen the banking system and improve credit allocation. The program has been carefully worked out with the Fund, and is said to be in harmony with the draft PFP which has already been considered by the OC, and a Stand-by/SAF under preparation for which a macroeconomic framework is yet to be finalized. There is no crisis to be addressed, and the macroeconomic parameters now prevailing are projected to improve smoothly, with the government deficit declining gradually from about 9% to 5% of GDP over three years; inflation to remain roughly at the current annual rate of 7%; and the current account deficit at about 2-1/2% of GDP. The Region draws attention to the political uncertainties surrounding the change of government and the elections next month, but there is good reason to believe that a technical operation of this nature would have a strong chance to be implemented even under a new government.

The Macroeconomic Framework

3. Already many recommendations of the Bank's 1987 Financial Sector Report which is the basis for the proposed financial reforms, have been incorporated in the Seventh Plan and even begun to be implemented, including raising interest rates on commercial credit, introduction of new investment banks, and greater autonomy for the nationalized banks. Pakistan has profited considerably from its exports of goods and services to the oil rich Arab countries, but it has also pursued sound macroeconomic policies that have fostered rapid growth without serious inflation. It has relied increasingly on market forces and a flexible exchange rate. The IM

draws attention to two structural weaknesses, however, the vulnerability of the external current account and the large fiscal imbalance (8.7% of GDP in FY88). A financing gap is also indicated for 1991 to the tune of $900 million (para. 68). While taxation stagnated, resort by the Government to domestic borrowing raised domestic debt and the Government sought to minimize the monetization of the deficit by preempting savings schemes, while keeping both foreign borrowing and borrowing from the banking system under control and in harmony with GDP growth. This process seems now to have come to an end, and inflationary pressures are now bound to be created if high deficits continue and have to be financed. Meanwhile the external position has worsened, despite a growth of 23% of exports in FY88, largely on account of higher imports and lower workers' remittances. The IM states that the first year of the proposed adjustment program which would be supported by the SAF/Stand-by has already been put in place as part of the FY89 budget. This program emphasizes liberalization of non-tariff barriers to imports, a gradual reduction in tariff levels and dispersion, relaxation of regulatory controls especially on investment, and better pricing of sectoral inputs and outputs.

- The Region might give an updated report on the preparation of the SAF and the Stand-by.

- In case no agreement is reached on the SAF/Stand-by, how exactly can the Bank mount a substitute program and monitor its implementation as hinted at in the IM?

The Financial Sector Program

4. The proposed program addresses five areas of crucial importance, and aims at improving the management of public sector debt; controlling money supply and credit; reducing the cost of funds; strengthening bank administration, and increasing competition and autonomy of the banking system. Among the measures it seeks are better bank supervision; a strong legal framework for debt recovery and audit; restructuring of nationalized banks, including partial privatization; creation of new private banks; reduction of concessional and directed credit programs; creation of an auction market for Government debt, and deregulation of long-term interest rates. Through this, it is hoped that the banks would charge lower spreads to private borrowers, and the health of the banking system be raised and resource allocation improved.

- Selected issues in the area of capital markets and DFIs would be addressed under a separate operation (Industrial Investment Credit III) but the demarcation is not clear. For FSAL it is not clear from the design (despite para. 67) which are the most important measures that should have priority and which should be singled out for conditionality. Taken together, the objectives of the program might be too ambitious especially as they would have to be compressed in the period before second tranche release. Would the Region outline a core program of measures to be emphasized?

- If the interest rates on Government borrowing are raised as intended, the situation will improve provided the Government deficit remained in check. But assuming that the macroeconomic program went off track, and Government requirements to borrow expanded, what would the impact be on credit available to the private sector? The proposal to freeze credit targets as a percentage of total credit seems to contradict the aim of phasing out directed credit.

Other Issues

- Is the Pakistan Banking Council really necessary, or is it just one layer of bureaucratic interference sandwiched between the State Bank and the banking system? Instead of strengthening it as the program proposes, what if it were abolished altogether?

- Where would the trained manpower come from for strengthening the banking institutions and for creating new ones such as primary dealers for Government auction of treasury bills? And would not training take time?

- Why cannot the nationalized commercial banks be turned into limited companies and listed on the stock exchange? This would make them more efficient and save us from the more risky course of trying to reform these public sector entities.

- What is inhibiting the large number of foreign commercial banks in existence from providing the competition necessary to raise commercial banking efficiency?

- Should the guidelines for classification of advances in Annex IV be spelled out in the detail shown?

Retroactive Financing

5. Retroactive financing up to 25% of loan proceeds is suggested.

- The Region should be asked either to make a case for this retroactive financing or else delete it from the proposal.

cc: Messrs. Lee, COD; Shakow, SPR; Holsen, CEC; Rao, FRS; Burmester/Thahane, SEC; Liebenthal, SPRPA; Steer, FRS; Baudon (SVPOP); Hasan, EMNVP; Kopp, Cohen, Kanchuger, Ms. Nishimizu (EM1).

For Information Only:

cc: Messrs. Hopper, SVPPR; Bock, DFS; Goldberg, VPLEG; Frank, IFC (CFP); Parmar, IFC (CIO); Pfeffermann, IFC (CEI); Baneth, IEC; Tanaka, EXC; Robless, OPNMS; El Maaroufi, EMNVP; Ms. Haug, EXC.

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: September 20, 1988

TO: Mr. Vinod Dubey, Acting Senior Vice President (SVPOP)

FROM: Wilfried P. Thalwitz, EMNVP

EXT: 32676

SUBJECT: PAKISTAN - Operations Committee Review of Initiating Memorandum for Financial Sector Adjustment Loan

1. Please find attached the Initiating Memorandum for the proposed financial sector adjustment loan in Pakistan for review by the Operations Committee. The proposed loan builds on a major interest rate liberalization program, which was carried out in the early 1980s. The Government now intends to continue the deregulation process, to improve the mechanisms for Government debt management and to take preventive steps that will strengthen the banking system and prevent future possible financial distress. Specifically, the proposed loan would support a set of measures which would (a) strengthen the health and efficiency of the banking system (e.g. improved bank supervision and legal framework for debt recovery, audit and restructuring of nationalized banks including partial privatization, licensing of new private banks) and (b) improve the allocation of credit on the basis of market mechanisms (e.g. reduction in concessional and directed credit programs, creation of an auction market for Government debt and concurrent capital market development, further deregulation of long term interest rates). The loan has been prepared in close collaboration with the IMF (Middle Eastern Department and Central Banking Department) which has fully endorsed the Initiating Memorandum.

2. The proposed Loan is consistent with the structural adjustment measures for the financial sector outlined in the Policy Framework Paper (PFP), which was approved by the Operations Committee in February 1988 together with the Country Strategy Paper for Pakistan. A detailed macroeconomic framework is being finalized in the context of the PFP for a possible SAF. Its key features are:

- Government deficit reduction from 8.7 percent of GDP in FY88 to about 5 percent in FY91.

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- Maintenance of the current account deficit at about 2.4 percent of GDP (FY88:2.8 percent).
- Control of money and credit to limit inflation to a maximum of 7 percent (FY88: 6 to 7 percent).

At an inflation rate of 7 percent and an expected GDP growth rate of 5.5 percent a Government deficit of about 5 percent would appear sustainable, i.e. not raise the ratio of domestic and foreign debt to GDP. In combination with the proposed program for auctioning Government debt, this would significantly reduce crowding out of private sector investment. Debt service is forecast to decline from 27.5 percent of exports in FY88 to 20 percent by FY91 and gross reserves would be built up to at least 7 weeks of imports by FY89, up from around 3 weeks at present. The FY89 budget and the policy measures incorporated therein, which Government has already passed, are satisfactory for the first year of the medium-term SAF program. The program would form part of the proposed loan's conditionality. In the event agreement on the SAF cannot be finalized, the loan would only be processed if the Government agrees with the Bank on an equivalent medium-term macroeconomic adjustment program.

3. The macroeconomic implications of the proposed loan are being taken into account in the medium-term framework. The major budgetary impact of the financial sector reform program is expected to arise from recapitalization needs of the nationalized commercial banks. The precise needs would be determined following a comprehensive portfolio audit, which is presently underway. The order of magnitude of the possible budgetary impact is such that it can be accommodated in a phased way within the proposed macroeconomic framework.

4. Some political uncertainty surrounds the proposed loan. The dissolution of parliament and subsequently the death of President Zia are putting the stability of political institutions to a test. So far, continuity of policies and conformity with constitutional requirements are the order of the day. As one example of this, the IMF/Bank mission preparing a Standby/SAF is presently visiting Pakistan as scheduled to finalize the agreements. The results of this mission will be known prior to the OC meeting and will be communicated to the members of the OC.

5. As you know, elections are scheduled to be held on November 16 and it is not ruled out that the picture of continuity changes. At this time, however, the Government has communicated to the Bank that it wishes to proceed with project appraisal on schedule, i.e. in October 1988, following Operations Committee approval. Key Government officials involved in preparing the loan remain either in their old position or in new key positions, which would enable the dialogue to be continued without rupture. Therefore, to enable negotiations to take place around the end of the year, I propose to proceed with the project as indicated in the Initiating Memorandum (para 75) and to authorize appraisal for October of this year. In the event

(para 75) and to authorize appraisal for October of this year. In the event a newly elected Government were to ask for substantive changes following elections in November, I would consider sending a post-appraisal mission to explore ways of reaffirming the agreements reached so far and to make recommendations on how to proceed under changed circumstances.

Attachment

cc: Mmes/Messrs.: Qureshi, Baudon (SVPOP); Husain (LACVP); Jaycox (AFRVP); Karaosmanoglu (ASIVP); Rajagopalan (VPPRE); Fischer (VPDEC); Shihata (VPLEG); Wood (VPFPR); Vergin (SVPOP); Lee (CODDR); Shakow (SPRDR); Holsen (CECDR); Rao, Steer (FRS); Thahane, Burmester,(SEC); Liebenthal (SPRPA); Hopper (SVPPR); Bock (DFS); Goldberg (VPLEG); Frank (CFP); Parmar (CIO); Pfeffermann (CEI); Baneth (IEC); Haug, Tanaka (EXC); Robless (OPNMS); El-Maaroufi (EMNVP) EMENA Files

Mmes/Messrs.: P. Hasan (EMN), Köpp, Krishna, Cohen, Abe, Cuca, Elwan, Yoon, Nishimizu, Pernia, Klein, Annez, Yap, Kanchuger, Thomas (EM), Bouhaouala, Hinds, Amin (EMT),

de Azcarate (RMP)(3)

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