Folder Title:	Background Files for Privatization - Lessons of Experience, Prepared by Kikeri - Colombia, Costa Rica, Ecuador, El Salvador, Grenada, Guatemala, Guyana, Haiti, Nicaragua
Folder ID:	30451139
Series:	Background Materials Compiled by the Public Sector Management and Private Sector Development Division (CECPS), Country Economics Department (CEC) for Privatization: The Lessons of Experience
Dates:	03/01/1985 - 12/20/1991
Fonds:	Records of the Office of the Chief Economist
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COLOMBIA, NICARAGUA

v JJC

COLOMBIA

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: July 18, 1991

TO: Mr. James Hanna, Acting Division Chief, LA3TF

EXTENSION: 31982

FROM: Felipe Saez, Senior Operations Officer FSQ

SUBJECT: COLOMBIA: Public Sector Reform Loan
Back to office Report

1. I visited Santa Fe de Bogota[1/] from July 8 to 12, 1991 to carry out a joint World Bank/IDB supervision of the above referenced Project, in accordance with Terms of Reference dated July 1, 1991 (Annex 1). The mission consisted also of Mr. John Foster (IDB) and Mr. Diego Sepulveda (Consultant on Shipping Matters). Messrs. Ricardo Ramos and Guillermo Ramirez (Consultants on Port and Banking, respectively) made an advance visit during the week of June 24 under separate terms of reference. The mission left with the Government an Aide Memoire summarizing its main conclusions and recommendations (see Annex 2). The reports prepared by the consultants are attached as Annexes 3-5.

2. The overall conclusion of the mission is that progress in complying with second tranche conditions **is substantially on-track and that no serious obstacles are foreseen for completing a successful second tranche review** in early 1992.

3. In addition to having made satisfactory progress towards complying with second tranche conditionality, in many areas the Government has exceeded the Loans' conditionality and expectations. It had been agreed that one out of the three sector reforms envisaged under the Loan would have been complied by second tranche. At this point, however, the Government has virtually completed two of the sector reforms (low-income housing and agricultural marketing) and is making substantial progress in the implementation of the ports reform. The bank privatization component provided for the privatization of three nationalized banks (second tranche) and the definition of a strategy for the privatization of Banco de Colombia. The privatization of the nationalized banks is on-track as well as the preparation of the strategy for Banco de Colombia, which the Government is expecting to privatize during 1992. In addition, the Government has included Banco del Estado as a candidate for privatization in 1992 and has initiated a process leading to the privatization of Banco Cafetero, despite the strong opposition of the Coffee Growers Association. Finally, progress in reforming the shipping sector has advanced at a quicker pace than expected (see paragraphs 7-9)

[1/] The name of the city of Bogota has been changed under the recently approved Constitution.

controversy delaying the issuance of the decree refers to matters that we had expected to deal with at the time of third tranche release.

8. As condition of third tranche release we had requested an overall reform of the institutional and regulatory framework of the shipping sector aimed at improving sector competition. As a minimum it was expected a reduction in the reserve quota on total general imports from the current 50% to 30%. Recent developments in the sector point towards structural change, rather than the mere reduction of reserve quotas. As a result of decisions taken by the Junta del Acuerdo de Cartagena, the Government has agreed to provide free access for regional and third country liners to transport import/export cargo within the Andean Region. Moreover, there is consensus among the various parties (Government, shipping companies and users) to declare the freedom of access to all types of traffic subject only to reciprocal treatment by Colombia's trading partners. The decree providing for this change was reviewed and commented by the mission.

9. The only outstanding issue refers to the sequencing for arriving to the status of freedom of access. Domestic shipping companies, under the leadership of Flota Grancolombiana, are pressing for the transitory maintenance of reserve quotas. The reserve quotas would be dismantled gradually as a result of bilateral negotiations with its main trading partners. The Flota's position received an unexpected boost as a result of recent decisions by European shipping conferences (to which the Flota had been a member) to drastically limit non-EEC participation in their operations. The Flota position is being challenged by the association of importers/exporters who have lobbied for the up-front elimination of reserve quotas and the establishment of restrictions on an ad-hoc basis in the case of trading partners that do not provide for a reciprocal treatment for Colombian shipping companies. The mission advised the planning authorities it would prefer the adoption of this second scheme since it would be more transparent and would create a clearer incentive for the domestic shipping companies to negotiate the elimination of barriers to competition. Further assessment of developments in this field will be carried out in the next supervision mission.

10. **Bank Privatization.** The process of privatization of the three nationalized banks the Government agreed to bring to the point of sale in 1991 is on-track. The schedule for the privatization process is the following:

BANKS	Invitation pre-qualify.	End prequalific.	Award Decision
Trabajadores	June 12	July 10	end Oct.
Tequendama	July 12	August 12	end Oct.
Comercio	August 15	Sept. 15	end Nov.

11. The mission analyzed the terms and conditions for the sale of the banks and found them reasonable. The Government has taken various

decisions to overcome the problems faced with the aborted sale of Banco de los Trabajadores last year. It has guaranteed the outcome of judicial process pending in each of this banks, has allowed the possibility for awarding the total shares of the bank to an individual investor, and in the case of Bancos Tequendama and Comercio, it will provide financing for the acquisition of part of the shares of the bank. The main risk faced in the undergoing privatization is that there would be a substantial disparity between the minimum price assessed by the Fondo de Garantias for the banks and their market value. The Fondo's management is confident that the price set for each of the banks is reasonable and within market clearing range. There is no legal obligation for the Fondo to reject offers below the minimum price. In case none of the offers would reach the minimum price, the Fondo has the option to enter into direct negotiations with the higher bidders. The Fondo's Director assured the mission that the Government has placed a high priority in the divestment of this institutions and this has been a paramount consideration in the implementation of the privatization process.

12. **Agricultural Marketing.** As reported in the BTO Report for the previous supervision mission, the Government has put in place as of June 1, 1991 a free import regime for agricultural products. In the case of some key agricultural products the regime provides for a flexible tariff system that fluctuates in accordance with variations in the international price for those products to ensure a degree of price stability for domestic producers. Two exceptions for the application of this regime had been made in the case of wheat and barley because the gap between the international price and the floor of the price band would lead to an abrupt reduction of the protection levels afforded in the past to domestic producers. The Government decided to seek a mechanism to induce a smoother reduction of protection in these two cases. The mission was informed that the flexible tariff regime mechanism will be extended to wheat and barley in September, subject to the miller's association and the brewing industry, respectively, having undertaken a commitment to absorb domestic production during the next two years. Domestic production has not exceeded 10% of total domestic consumption in these two products.

13. **Low-income Housing.** The Government has made substantial further progress in making this sector reform operational. In June, the first 5000 housing grant subsidies were awarded to low-income families that ranked highest in a public process in which applicants were evaluated in accordance with transparent criteria (family size, income level and savings effort). INURBE (the former ICT) is relying exclusively on a tax on cement for the financing of these subsidies. The forced investments the financial sector was obliged to make on ICT bonds has been eliminated. The stock of debt accrued by ICT with the financial sector is due to be repaid in a ten year period. However, INURBE has identified sufficient assets--mainly lots with attractive commercial potential--that could go a long way towards prepaying most of the debt with the financial sector.

14. The private financial sector and the construction industry are taking an active interest in substituting ICT's role as constructor and financier in the sector. This will lead in the medium term to a substantial mobilization of resources into the sector and a significant improvement in the supply of social housing, with the public resources

PRIVATE SECTOR PARTICIPATION IN THE COLOMBIAN POWER SECTOR

Cartagena, Colombia
August 28-30, 1991

Sponsored by

Ministry of Mines and Energy
National Planning Department
National Energy Commission
National Council of Industrial and Business Associations
The World Bank
Office of Energy/U.S. Agency for International Development

Supported by the Private Sector Energy Development Program of the Office of Energy/U.S. Agency for International Development

OBJECTIVES

The objectives of the conference are:

1. to identify key policy issues, constraints, solutions, and the potential for private participation in the power sector of Colombia;

2. to discuss the merits of private sector participation techniques which have been developed in Chile, Dominican Republic, Pakistan, Philippines, New Zealand, Portugal and United States, and how these techniques may be modified to suit the specific requirements of the Colombian power sector.

3. to provide information on project finance and private power implementation requirements.

4. to discuss the legal aspects of private participation.

PARTICIPANTS

- Policy and decision makers
- Government Representatives
- Multilateral and bilateral development agencies
- Colombian Consultant/Contractor Firms
- Commercial Financial Institutions
- Project Developers
- Architect/Engineering Firms
- Equipment and Fuel Suppliers
- Energy/Power Service Companies
- Power Sector Lawyers

AGENDA

Wednesday, August 28, 1991

6:00 pm **Registration**

7:00 pm **Welcoming Remarks**
To be identified (Invited)

7:30 pm **Keynote Address**
Dr. Luis Fernando Vergara Munárriz, Minister of Mines and Energy

8:00 pm **Reception**

Thursday, August 29, 1991

9:00 am	**Conference Overview** *Dr. Francisco J. Ochoa, Executive Director, Comisión Nacional de Energía*
9:30 am	**The Treatment of Privatization in the Colombia's New Constitution** *Dr. Hernando Yepez Arcila*
10:00 am	**Overview of Global Electric Power - Demand & the Rationale for Private Sector Participation** *Dr. James B. Sullivan, Acting Agency Director, Directorate for Energy and Environment, Bureau for Science and Technology, U.S. Agency for International Development/Washington, DC*
10:30 am	**Coffee Break**
	Panel Discussion on Opportunities for Private Participation in the Colombian Power Sector *Moderator: Dr. Miguel Urrútia, Director FEDESARROLLO*
11:00 am	**The Perspective of the World Bank** *Mr. Ibrahim Elwan, Manager, Private Sector Financial Operations Group, The World Bank*
11:30 am	**The Perspective of the Colombian Financing Sector** *Dra. Flor Angela Gómez, President, Banking Association*
12 noon	**The Perspective of the Chambers of Commerce** *Dr. Mario Suárez Melo, President, Chamber of Commerce of Santa Fé de Bogotá*
12:30 pm	**Summary and Comments of Panel Discussion** *Dr. Miguel Urrútia, Director FEDESARROLLO*
12:50 pm	**Questions and Answers**
1:00 pm	**Lunch**
	Panel Discussion on International Models for Private Participation in the Power Sector *Moderator: Dr. Carlos Enrique Moreno General Manager, Empresas Públicas de Medellín*
3:00 pm	**The Experience of the United States** *Mr. Bob Carney, Director, Capacity Acquisition Virginia Electric Power Corporation* (Invited)
3:20 pm	**The Experience of Chile** *Mr. Mario Zenteno, Former General Manager, ENDESA, Chile*
3:40 pm	**The Experience of Pakistan** *Mr. Michael Kappaz, Chairman, Hab River Power Group*
4:00 pm	**The Experience of the Dominican Republic** *Mr. Ramón Pérez Martínez, President, Corporación Dominicana de Electricidad*

4:20 pm **Coffee Break**

4:50 pm **The Experience of the Philippines**
Mr. Ernest Lam, Bechtel Corporation

5:10 pm **The Experience of New Zealand**
Mr. Govind P. Saha, Partner,
Enrst and Young, International Utilities Consulting Group

5:30 pm **The Experience of Portugal**
Mr. Bernardo T. Fernandes,
R.W. Beck and Associates, Inc.

5:50 pm **Summary and Comments of Panel Discussion**
Dr. Carlos Enrique Moreno, General Manager,
Empresas Públicas de Medellín

6:10 pm **Questions and Answers**

Friday, August 30, 1991

Panel Discussion on Privatization Techniques
Moderator: Dr. Gustavo Moreno, Public Credit Director, Ministry of Finance

9:00 am **Privatization: Methods and Procedures, Practical Issues in Divestiture, and Company Valuation**
Mr. Jorge Segura, Senior Manager,
Ernst & Young International Services Office

9:30 am **Absorptive Capacity of Domestic Capital Markets**
Mr. Jon Webber, Vice President, Mergers and Acquisitions/Privatization, Salomon Brothers (Invited)

10:00 am **Capital Market in Colombia**
Dr. Julio Manuel Ayerbe, President,
Corporación Financiera del Valle S.A.

10:30 am **Management Contracts/Leasing**
Mr. Mangesh Hoskote, Director,
Private Sector Energy Development Program/THI

11:00 am **Coffee Break**

11:30 am **Legal & Economic Aspects of Joint Venture**
Mr. John Williams, Counselor-at-Law, Duncan & Allen

12 noon **Summary and Comments of Panel Discussion**
Dr. Gustavo Moreno, Public Credit Director,
Ministry of Finance

12:20 pm **Questions and Answers**

1:00 pm **Lunch**

Panel: Discussion on Implementation Requirements for Private Power Projects
Moderator: Dr. Daniel Camp, Energy Division Chief, Inter-American Development Bank (Invited)

3:00 pm **Financial & Legal Issues in Colombia**
Dr. César González, President,
Financiera Energética Nacional

3:20 pm **Regulatory & Pricing Issues**
Mr. John Thornton, Financial Economist,
Oregon Public Utilities Commission

3:40 pm **Legal Requirements/Security Arrangements**
Mr. John Sachs, Partner,
Olwine, Connelly, Chase, O'Donnell & Weyher

4:00 pm **Private Power Financing: The Role of International Finance Corporation**
Mr. Richard Frank, Vice President, Corporate Finance,
International Finance Corporation (Invited)

4:20 pm **Private Power Financing: The Role of Inter-American Investment Corporation**
Mr. Benjamin Vides, Division Manager III,
Inter-American Investment Corporation (Invited)

4:40 pm **Summary and Comments of Panel Discussion**
Dr. Daniel Camp, Energy Division Chief,
Inter-American Development Bank (Invited)

5:00 pm **Questions and Answers**

5:20 pm **Coffee Break**

5:50 pm **Private Sector Participation: Issues and Options for the Colombian Power Sector**
Dr. Carlos Arturo Angel, President,
National Association of Industrialists (ANDI)
Coordinator National Council of Industrial and Business Associations

6:30 pm **Conference Closure**
Dr. Armando Montenegro, Chief,
National Planning Department

9:00 pm **Cocktail and Dinner (Hilton Hotel)**

CONFERENCE HOTELS:

Cartagena Hilton
Single P40,950 (USD $72.00*)
Double P43,290 (USD $76.00*)

Hotel Caribe
Single/Double P33,813 (USD $59.00*)
Extra person in room P7,605 (USD $13.00*)

Conference hotel and airport transfer arrangements must be made through:

GEMA TOURS, LTDA.
Diana Gedeon, Manager
TEL: 57-953-655127 or
57-953-654832
FAX: 57-953-655628

* Exchange rate based on 570 P = $1.00 at time of printing

REGISTRATION FORM
CONFERENCE ON PRIVATE SECTOR PARTICIPATION IN THE ELECTRIC POWER ACITIVITIES OF COLOMBIA

Please print or type and complete a separate form for each person planning to attend.

Name: ____

Title: ____

Address: ____

____

Telephone and Facsimile: ____________________________________

Send to: Mr. William L. Polen
Private Sector Energy Development
Program/THI
1611 N. Kent Street, Suite 200
Rosslyn, VA 22209

Hotel Arrangements: ____________________

Airline Information: ____________________

____

Stuart -
file
Power

Agency for International Development
Washington, D.C. 20523

July 31, 1991

Dear Colleague:

I would like to take this opportunity to invite you to attend the *Conference on Opportunities for Private Participation in the Energy Sector of Colombia*, which will be held August 28-30, 1991 at the International Conference Center in Cartagena, Colombia. The conference is sponsored by the Colombian Ministry of Mines and Energy, the Colombian National Planning Department, the Colombian National Energy Commission, the Colombian National Council of Industrial and Business Associations, The World Bank, and the Private Sector Energy Development Program of the Office of Energy of the U.S. Agency for International Development.

The Government of Colombia is in the process of restructuring the electric power sector to encourage private participation in its development. Options being considered include investment in new electric power generating plants, leasing and operation of government-owned generating plants, private operation and maintenance contracts for generation, transmission and distribution, and privatization through divestiture of government-owned utility assets. The conference is designed to provide senior Government of Colombia energy and finance officials and officials of the domestic and international private sector with a forum to discuss opportunities for private companies in the Colombian energy sector.

If you would like to attend, please return the enclosed conference registration form. The official hotels for the conference are the Cartagena Hilton and the Hotel Caribe, both located a short distance from the convention center. Daily shuttle bus service to the convention center will be provided. Reservations must be made through Gema Tours, Ltd., located in Cartagena. The telephone number for Gema Tours is 57- 53-655627 or 57- 53-654832. The fax number is 57- 53-655628.

I look forward to seeing you in Cartagena. If you have any questions, please feel free to contact Mr. William Polen, Project Manager at the Private Sector Energy Development Program, for further information (703) 524-4400.

Sincerely,

David Jhirad
Acting Director
Office of Energy
Bureau for Science and Technology

Financial Advisory / Mergers and Acquisitions - Latin America

Privatizations in Colombia: Strategy & Methods

November, 1990

JPMorgan

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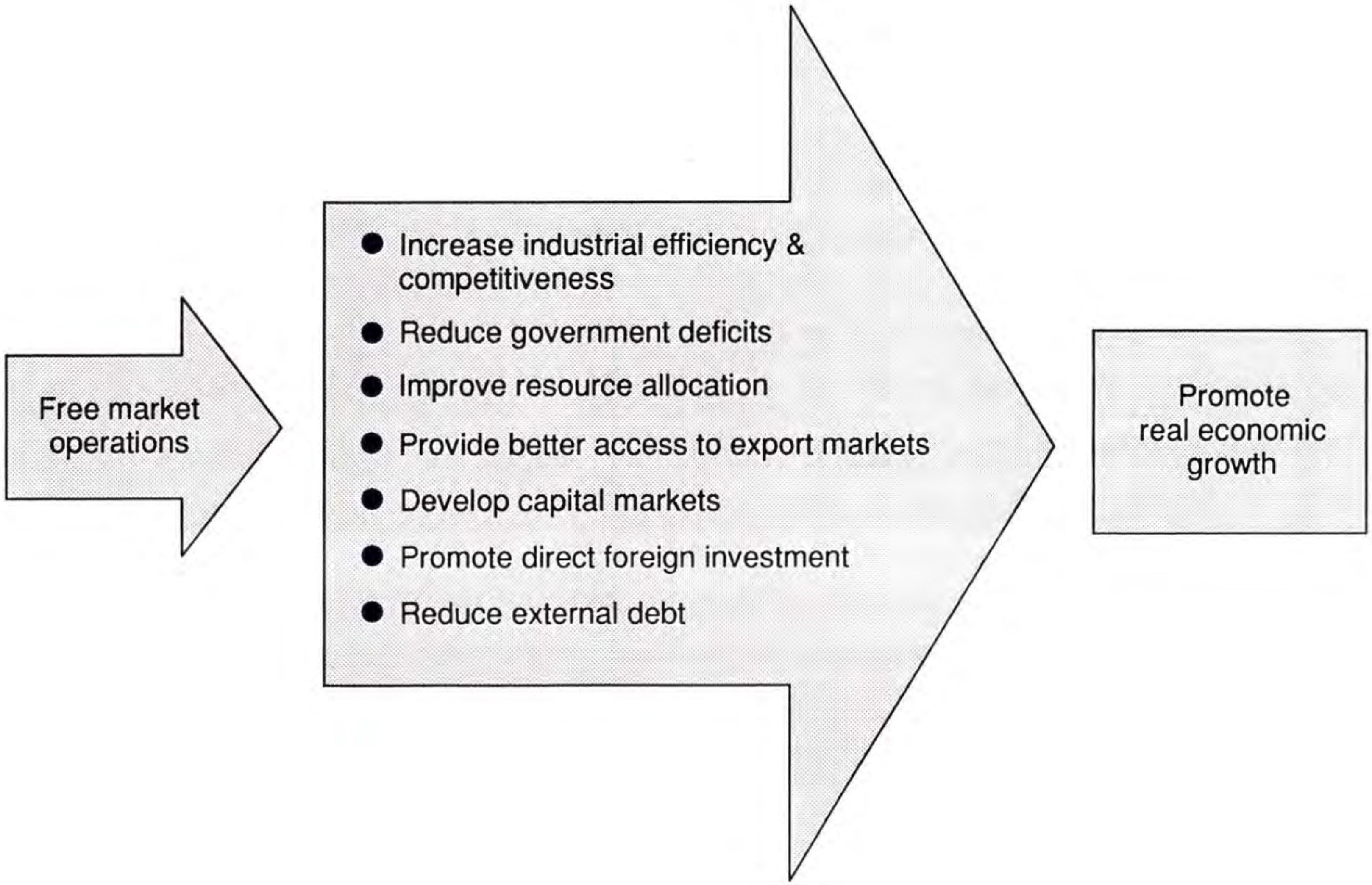
Section I

Privatization Rationale



Government Concerns

- Every country is unique
- Government objectives are critical
- Case by case transactions and selling strategies
- Social impact considerations
- Value expectations vs. economic reality

Critical Success Factors in Privatization

- Clearly defined objectives
- Coherence with economic policies
- Government, public opinion and investor support
- Carefully designed and implemented plan
- Transparent and clear selling process
- Suitable privatization method
- Objective and qualified advisors
- Adequate financing resources

Critical Success Factors In Privatization

Privatization Rationale

- Free market operations
- Increase industrial efficiency & competitiveness
- Reduce government deficits
- Improve resource allocation
- Provide bette access to export markets
- Develop capital markets
- Promote direct foreign investment
- Reduce external debt
- Promote real economic growth

Government Concerns

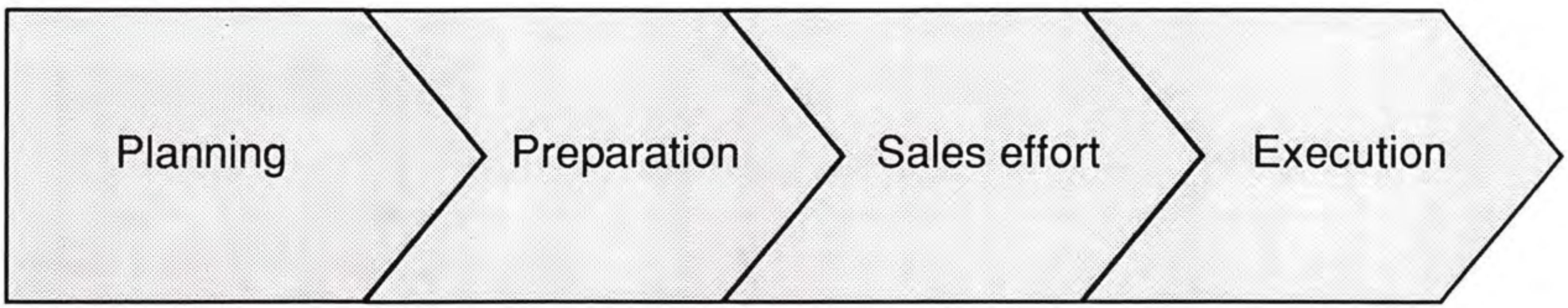
- Every country is unique
- Government objectives critical
- Case by case transactions
- Social impact considerations
- Value expectations vs. economic reality

Success
or
failure

Critical Success Factors

- Clearly defined objectives
- Coherence with economic policies
- Government, public opinion, and investor support
- Carefully designed and implemented plan
- Transparent and clear selling process
- Suitable privatization method
- Objective and qualified advisors
- Adequate financing resources

Steps to Follow



Planning

Prepare a privatization plan → Decide which firm to privatize →

Define objectives → Obtain government approvals → Select advisers

Preparation

Study and prepare firm

Decide method of privatization

Obtain legal clearance

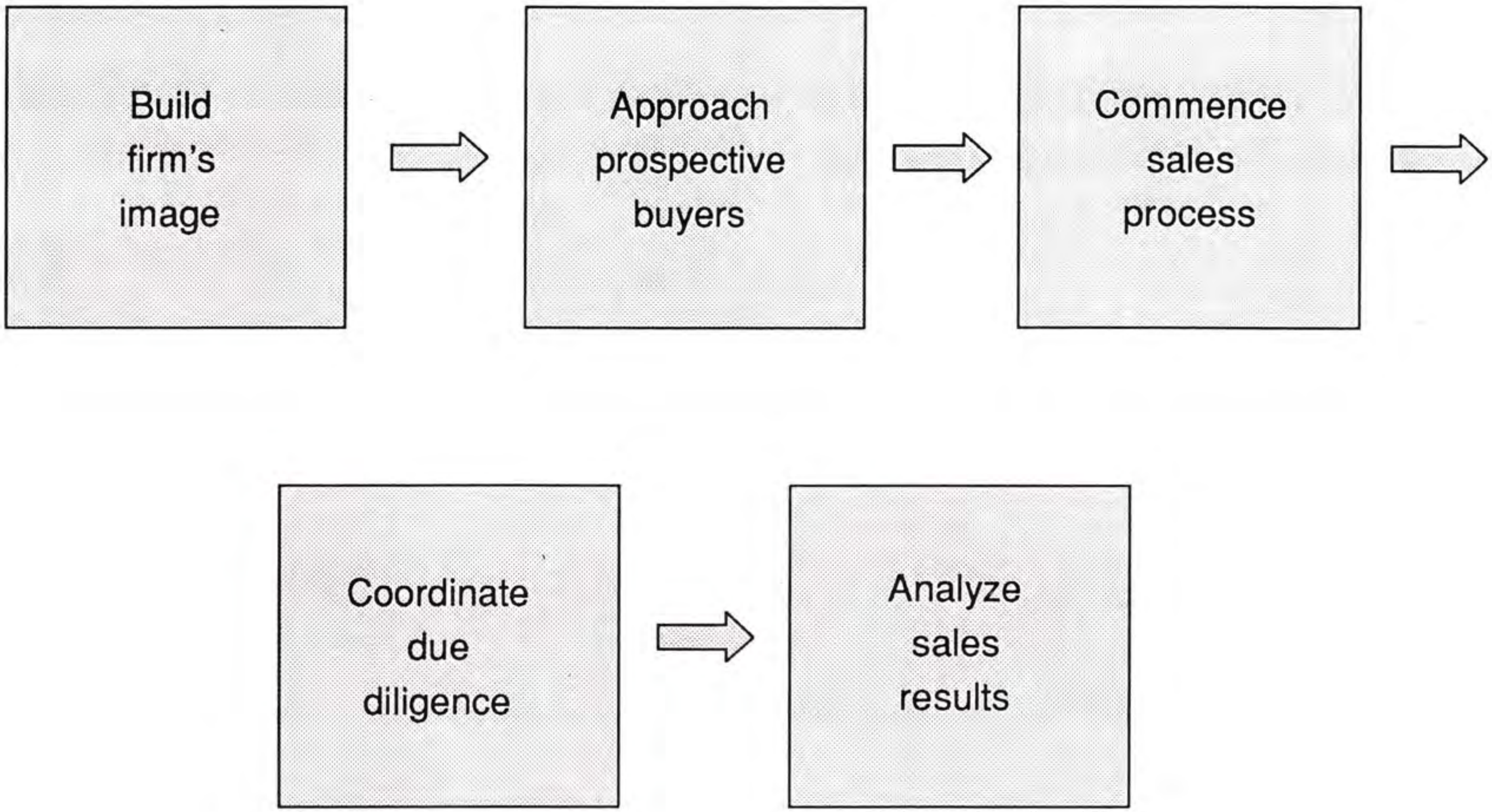
Determine price*
Conduct valuation

Identify prospective buyers

Prepare selling documents

* When sold at a predetermined price as opposed to auction or market based

Sales Effort

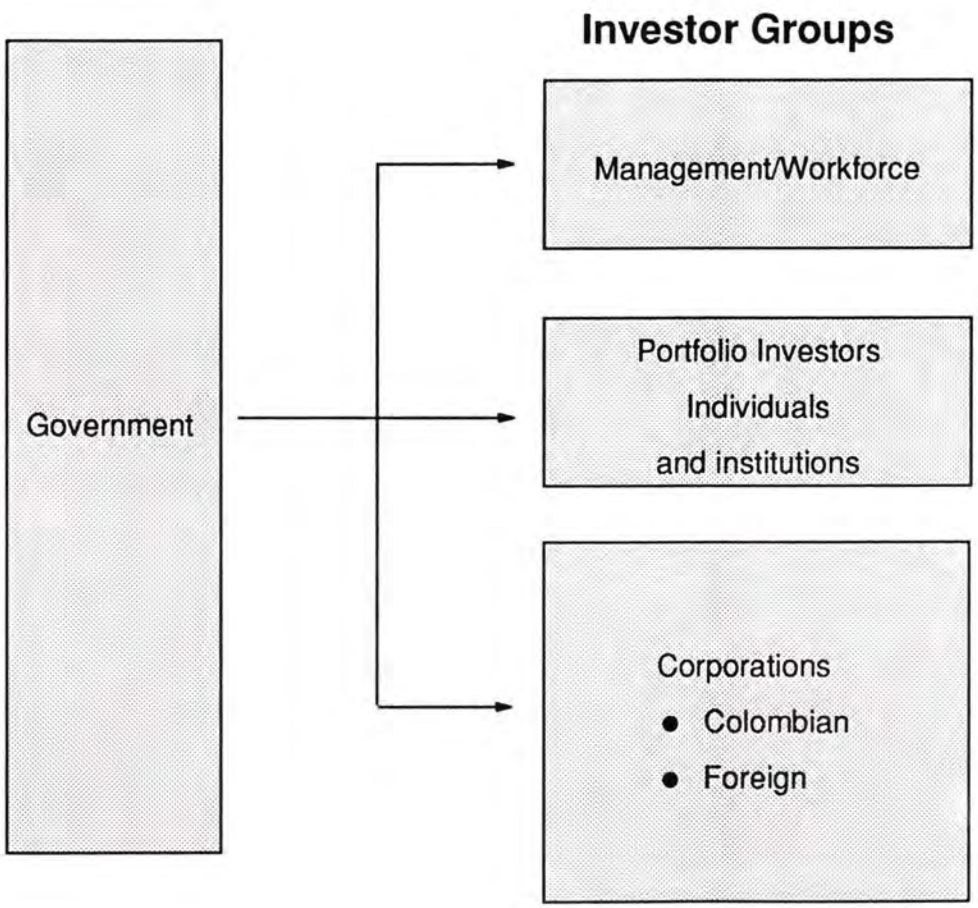


Execution

Document agreement in principal → Complete conditions precedent →

Agree final details → Lock financing/ conduct trades → Transfer ownership

Privatization Method Depends on the Public Assets to Be Sold and the Type of Buyer



Section II

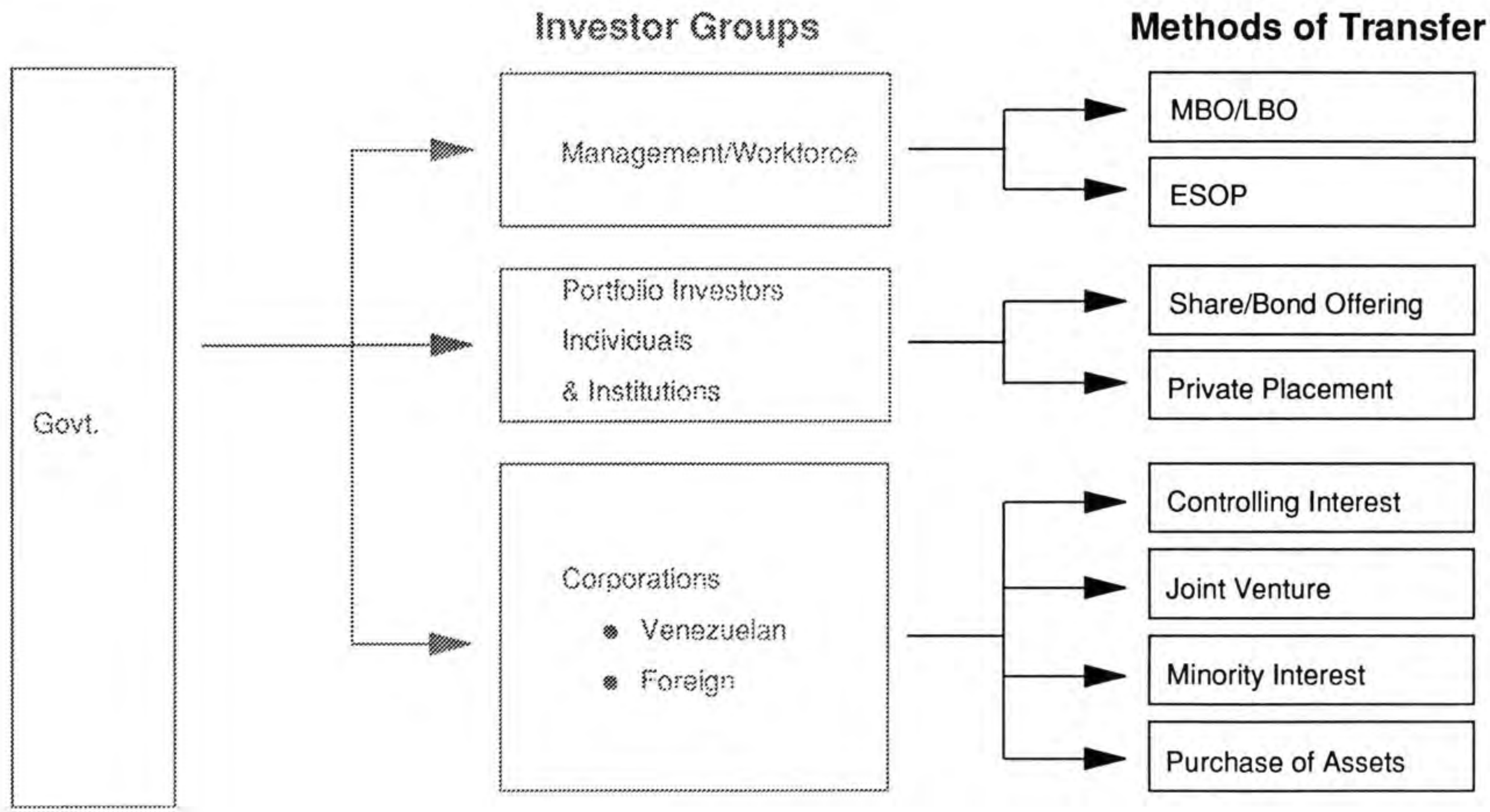
Privatization Methods

Transfer of ownership

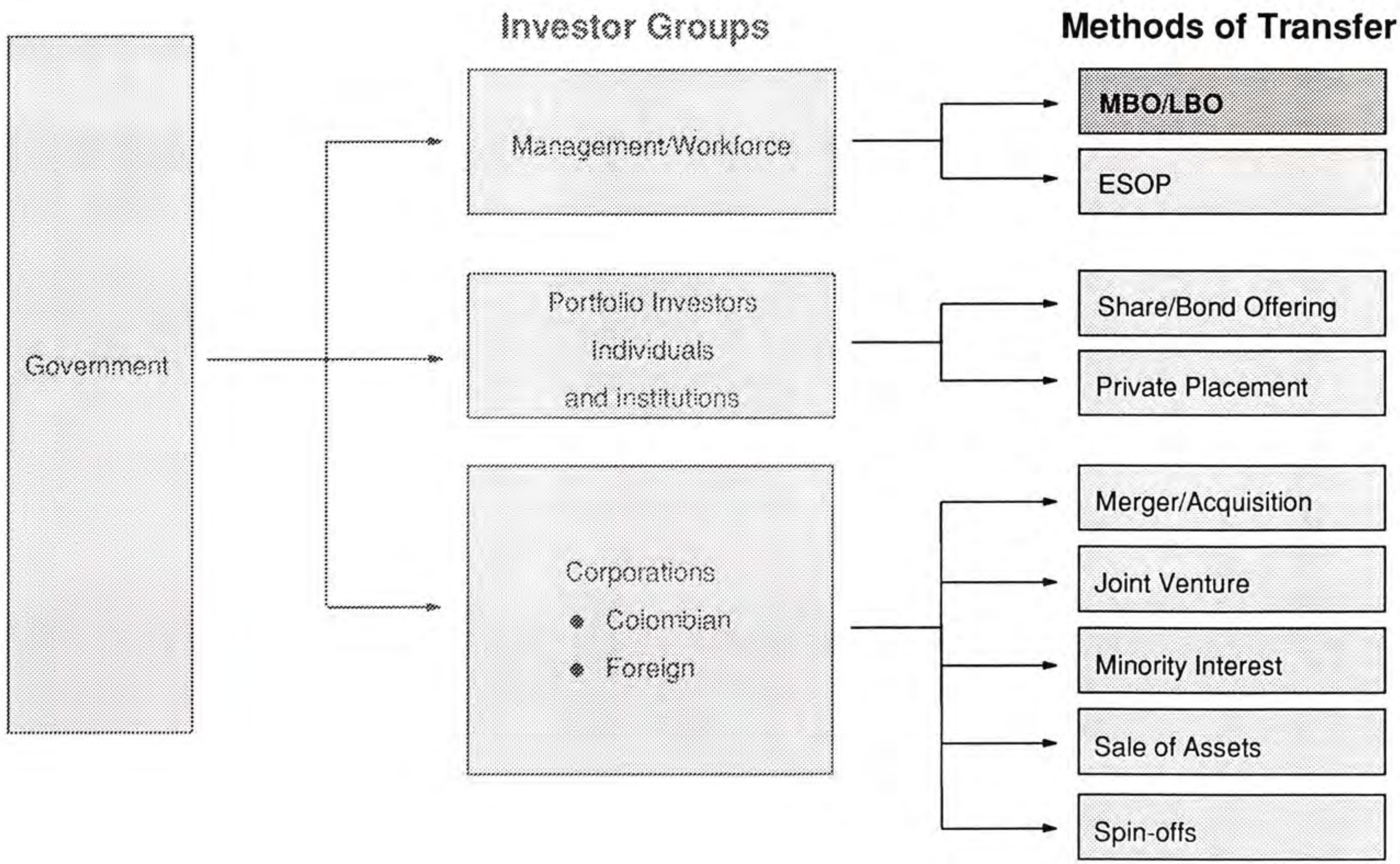
Other privatization methods

- **Most successful form of privatization**
- **Method depends on asset and targeted investor group**

Transfer of Ownership



Transfer of Ownership: MBO/LBO



MBO/LBO: Management/Leverage Buy-out

- Description:
  - Acquisition of the company by management/investors using a small amount of equity and a large amount of borrowed funds

- Candidates:
  - Companies with strong/predictable cash flow
  - Companies with saleable assets
  - Companies with entrepreneurial management

- Example:
  - National Freight Corporation (UK)

MBO/LBO: Management/Leverage Buy-out

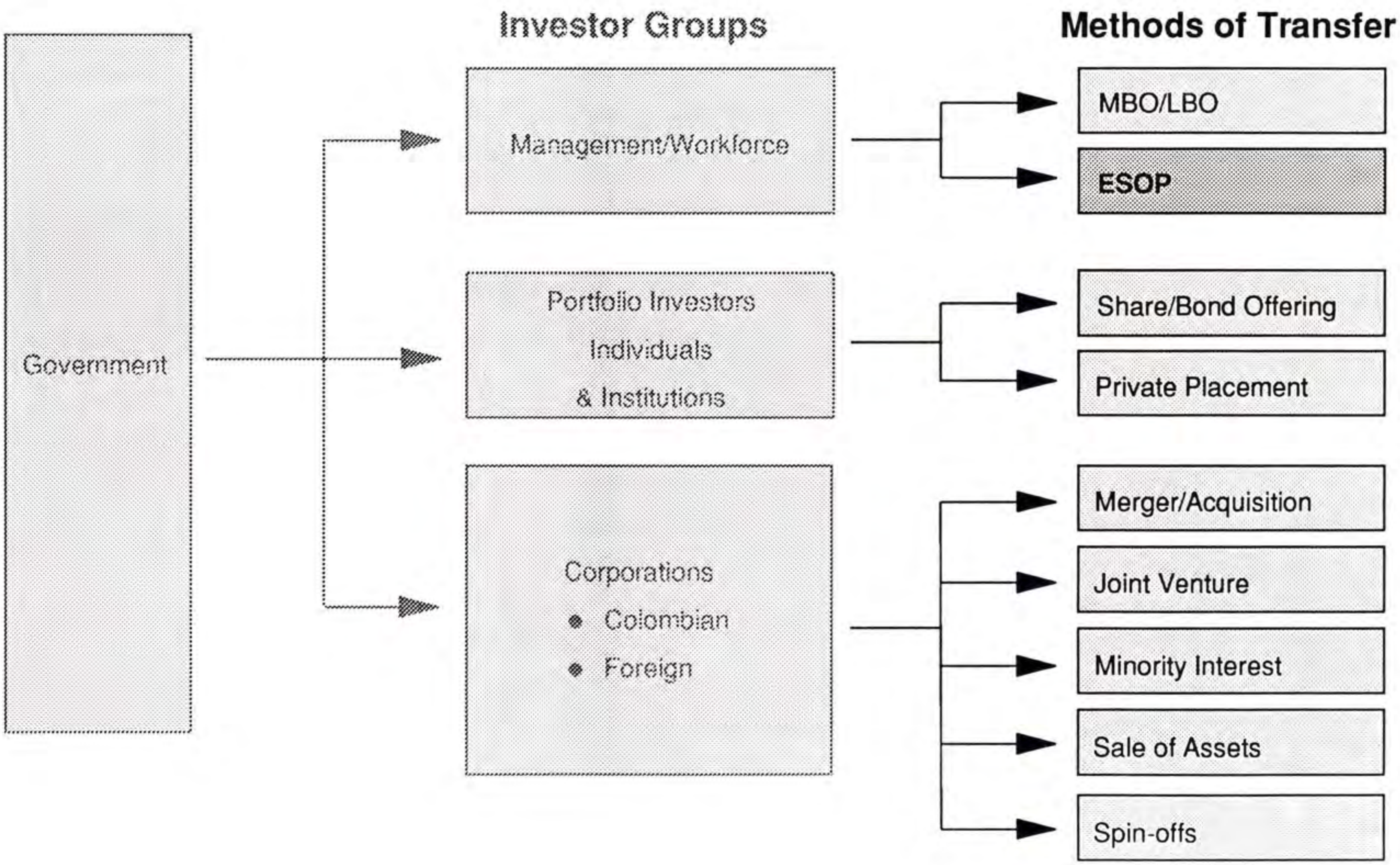
Advantages

- Strong incentive for management/investors to improve profitability of company
- Assets of the company utilized/deployed in a more productive manner

Disadvantages

- Long-term lenders are often unavailable
- Institutional providers of equity and mezzanine financing would be hard to find in Colombia
- Managements may be unable to contribute significant amounts of equity

Transfer of Ownership: ESOP



Section III

ESOP: Employees Stock Ownership Plan

- Description:
  - Acquisition of the company by management/workforce through stock ownership plan and leverage
- Candidates:
  - Service companies
  - Stable businesses with strong predictable cash flow
  - Companies having a motivated workforce and dynamic management
  - Companies not requiring large capital expenditures
- Example:
  - Privatizations in Chile

ESOP: Employees Stock Ownership Plan

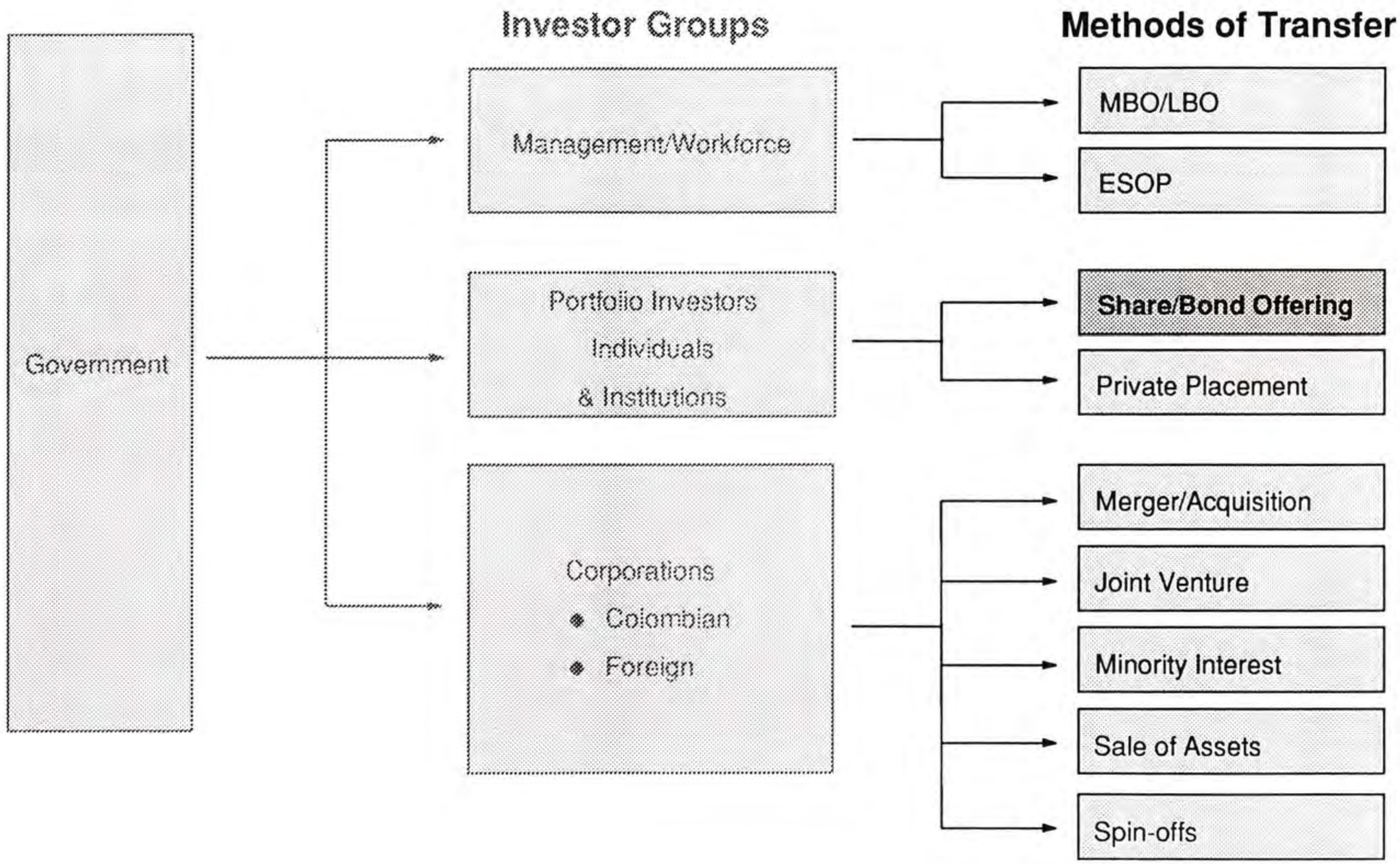
Advantages

- Higher morale, dedication and commitment leading to greater productivity
- Strong incentive for management/workforce to improve operating efficiency
- Promotion of capital markets
- Politically attractive

Disadvantages

- Poor financial performance could put workers' savings/pensions at risk
- In Colombia, low wages preclude large ESOP
- Productivity may not improve when the ESOP is not a significant shareholder

Transfer of Ownership: Share/Bond Offering



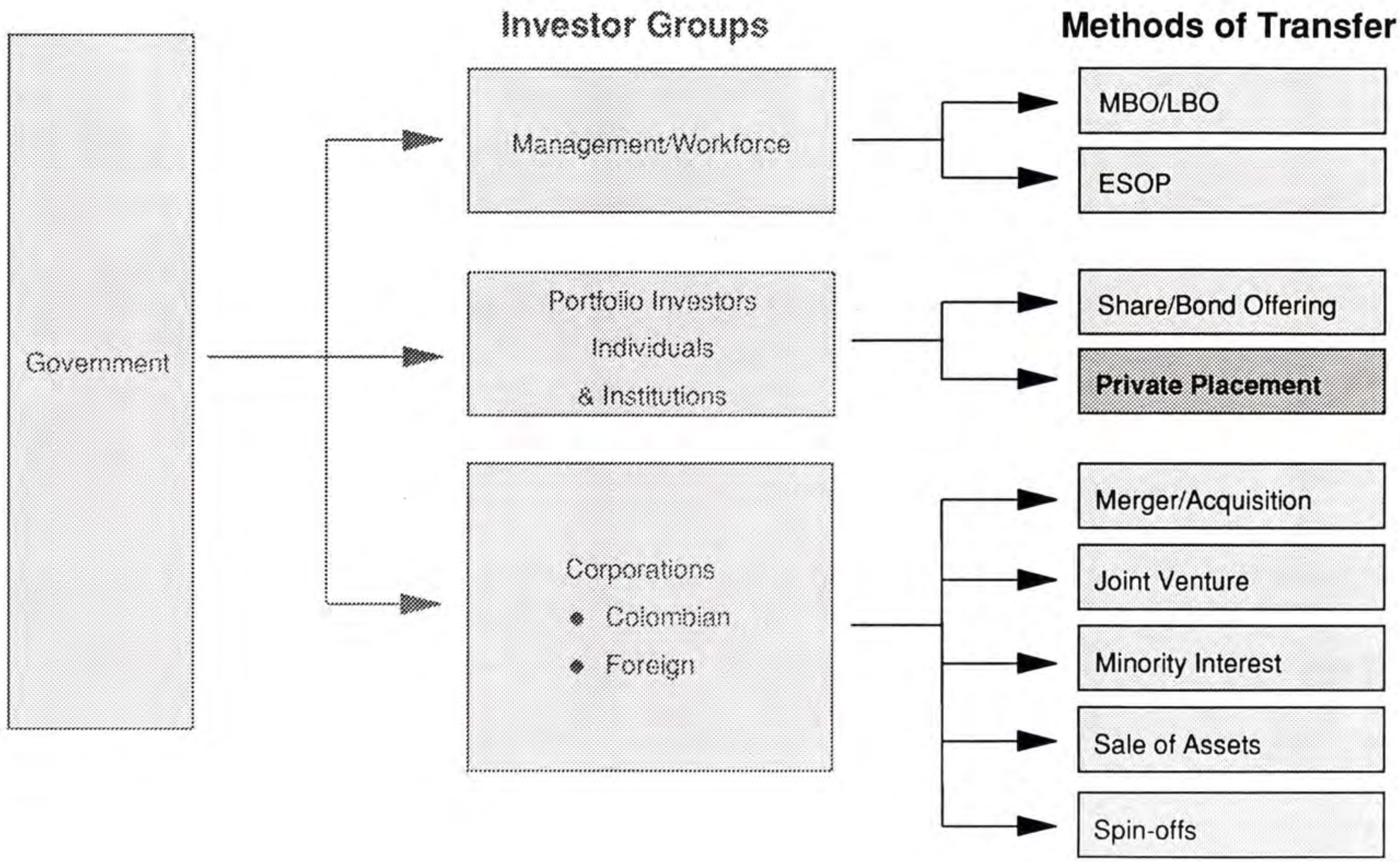
Public Share Offering

- Description:
  - Floating a company's shares on the stock market
- Candidates:
  - Profitable companies which have an attractive image
  - Companies that have widely-held ownership
- Example:
  - British Telecom
  - British Airways
  - Chile privatizations

Public Share Offering

Advantages	Disadvantages
• Wide spread stock ownership	• Size of issue limited by relatively undeveloped nature of Colombian capital markets
• Stimulates growth of capital market	• Offering in foreign markets constrained by poor accounting and disclosure
• Fosters competition among many investors	• A diffuse list of shareholders is not effective in producing responsive management

Transfer of Ownership: Private Placement



Private Placement

- Description:
  - Direct placement of shares with banks, pension funds, insurance companies, or corporations

- Candidates:
  - Complex businesses that only sophisticated investors can evaluate
  - Companies attractive to large, local economic group and/or foreign investors
  - Other companies that might be floated on the stock exchange

- Example:
  - Large privatizations in Latin America
  - Papelcol

Private Placement

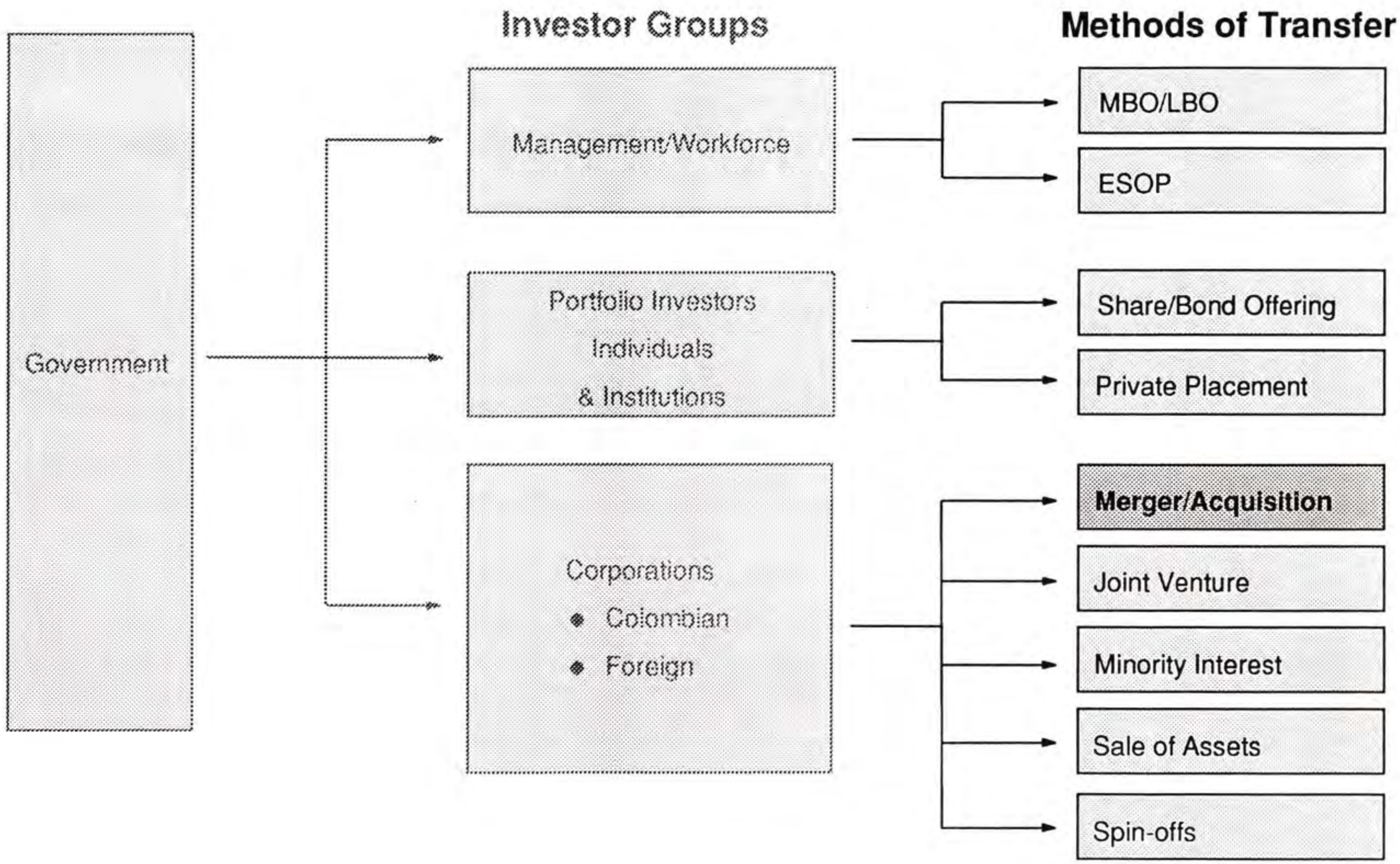
Advantages

- Easy way to sell shares if capital market is undeveloped
- Allows for a "tailored" selling effort
- Can shorten selling process

Disadvantages

- Management of company may not improve because of "passive role" of institutional investors
- Risk selling process fails because of lack of interest

Transfer of Ownership: Merger/Acquisition



M/A: Merger/Acquisition

- Description:
  - Sale to a foreign or domestic corporation
- Candidates:
  - Companies where "synergism" exist with the operations of the purchaser
  - Companies with strong cash flow and attractive assets
  - Companies in industries with attractive growth potential
- Example:
  - English Channel Ferry Services
  - Chilean telephone company
  - Lan Chile airlines

M/A: Merger/Acquisition

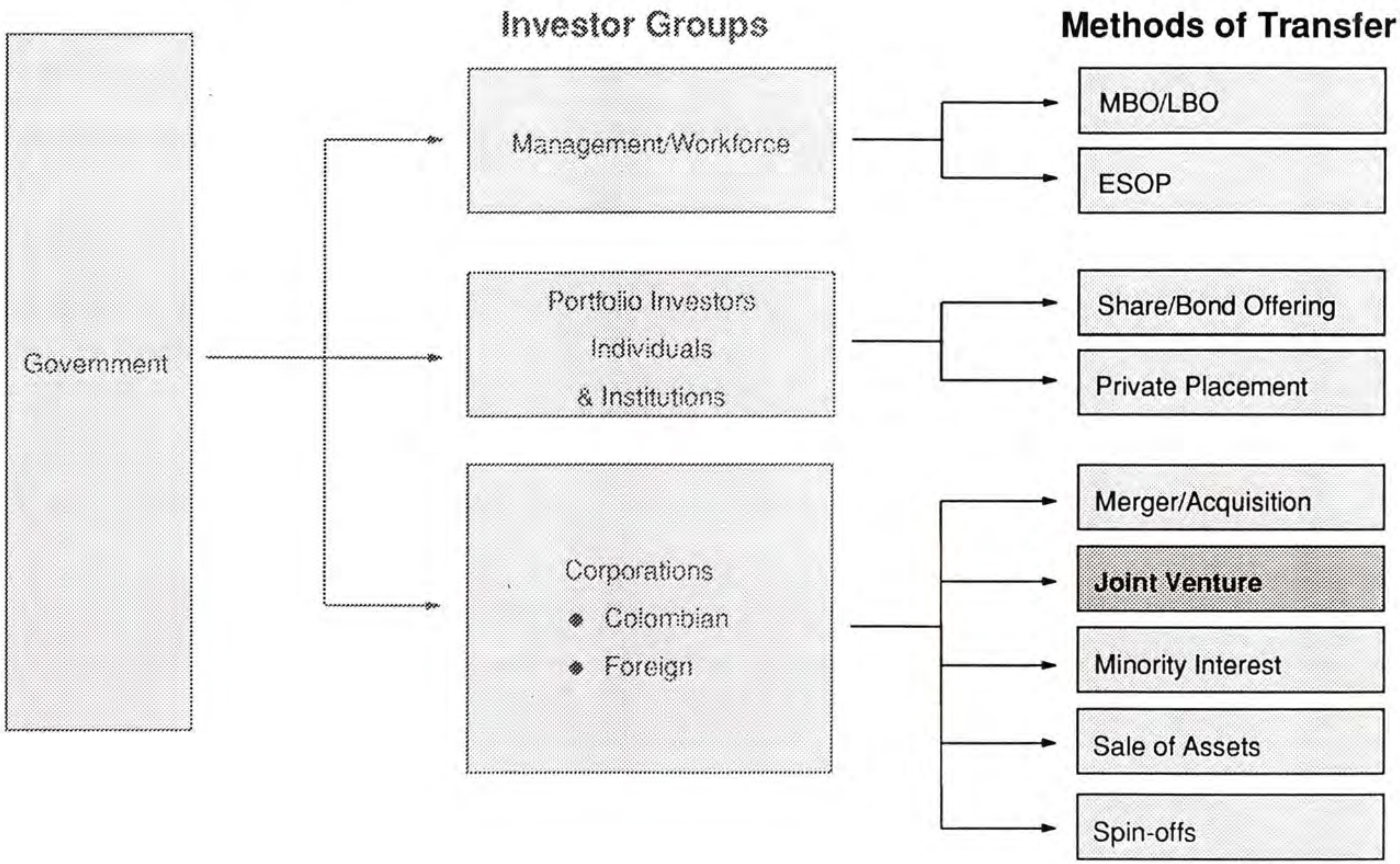
Advantages

- Economies of scale; vertical integration, global diversification
- Complementary strengths of corporations optimized
- Often the best way to obtain sophisticated management and technology

Disadvantages

- Concentration of economic resources in the hands of large corporations
- Potential reduction in competition
- Harmonious integration of managements and workforces difficult to achieve

Transfer of Ownership: Joint Venture



Joint Venture

- Description:
  - Significant equity participation (often 50%) in the state-company by domestic or foreign corporation

- Candidates:
  - Same as mergers/acquisitions candidates, but where government wishes to maintain some "influencing" or controlling stake in the company

- Example:
  - PIT (Turkey)
  - Aerolineas Argentinas
  - Empresa de telefonos (Argentina)
  - Telefonos de Mexico

Joint Venture

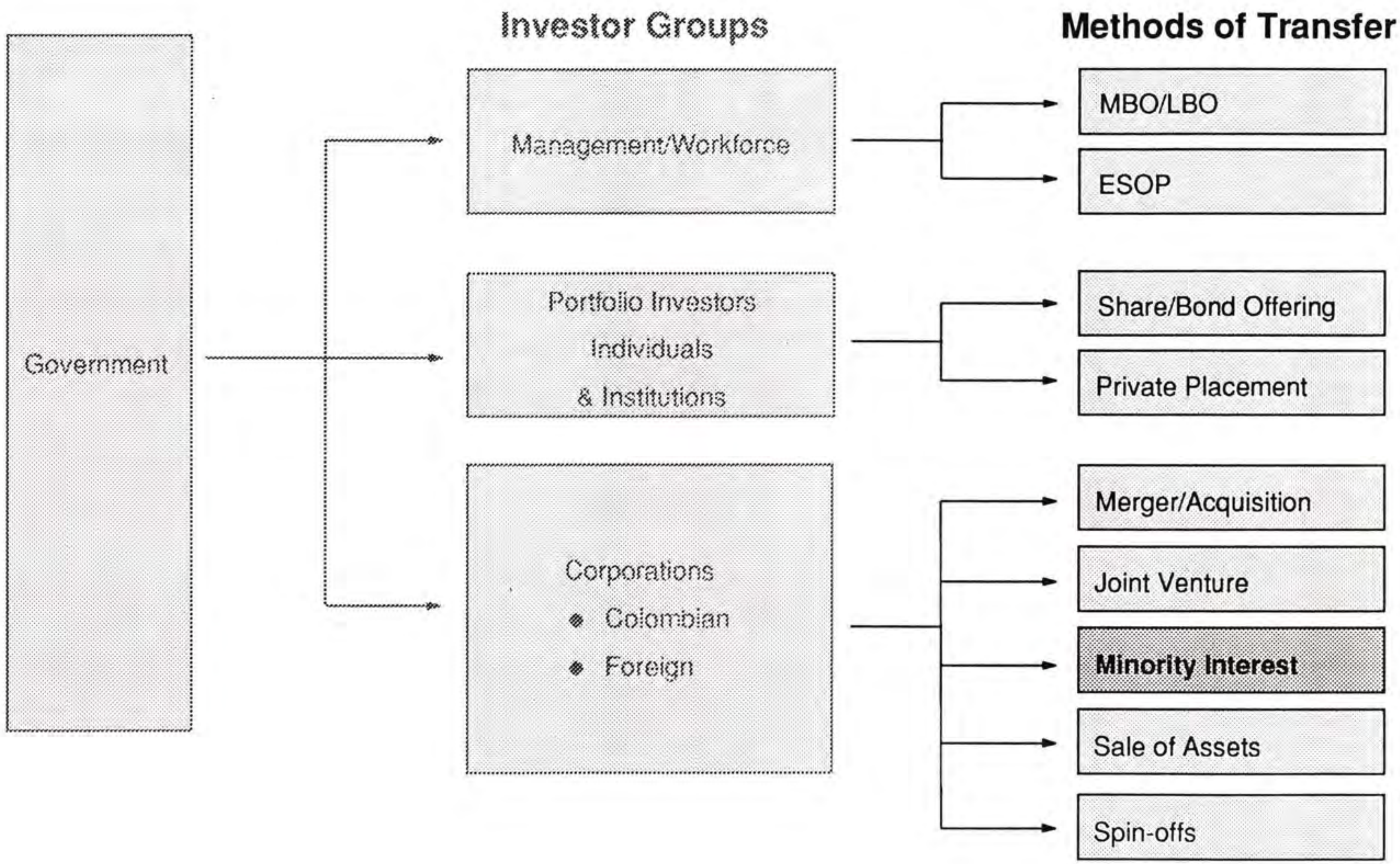
Advantages

- Management/technological expertise of the private-sector partner
- Marketing, financial and other strengths of both partners optimized
- Politically acceptable

Disadvantages

- Potential conflicts between partners, leading to insufficient planning, no decision-making
- Mutual weaknesses of partners might be exacerbated
- Private sector reluctance to enter joint venture

Transfer of Ownership: Minority Interest



Minority Interest

- Description:
  - Sale of less than 50% of a company to a private sector investor
- Candidates:
  - Companies where a small ownership stake by a private company is the precondition for the transfer of technology, etc.
  - Large companies where sale of a majority shareholding is presently not feasible
  - Minority participations in subsidiaries or in private-sector companies
- Example:
  - Telecom
  - Carbocol

Minority Interest

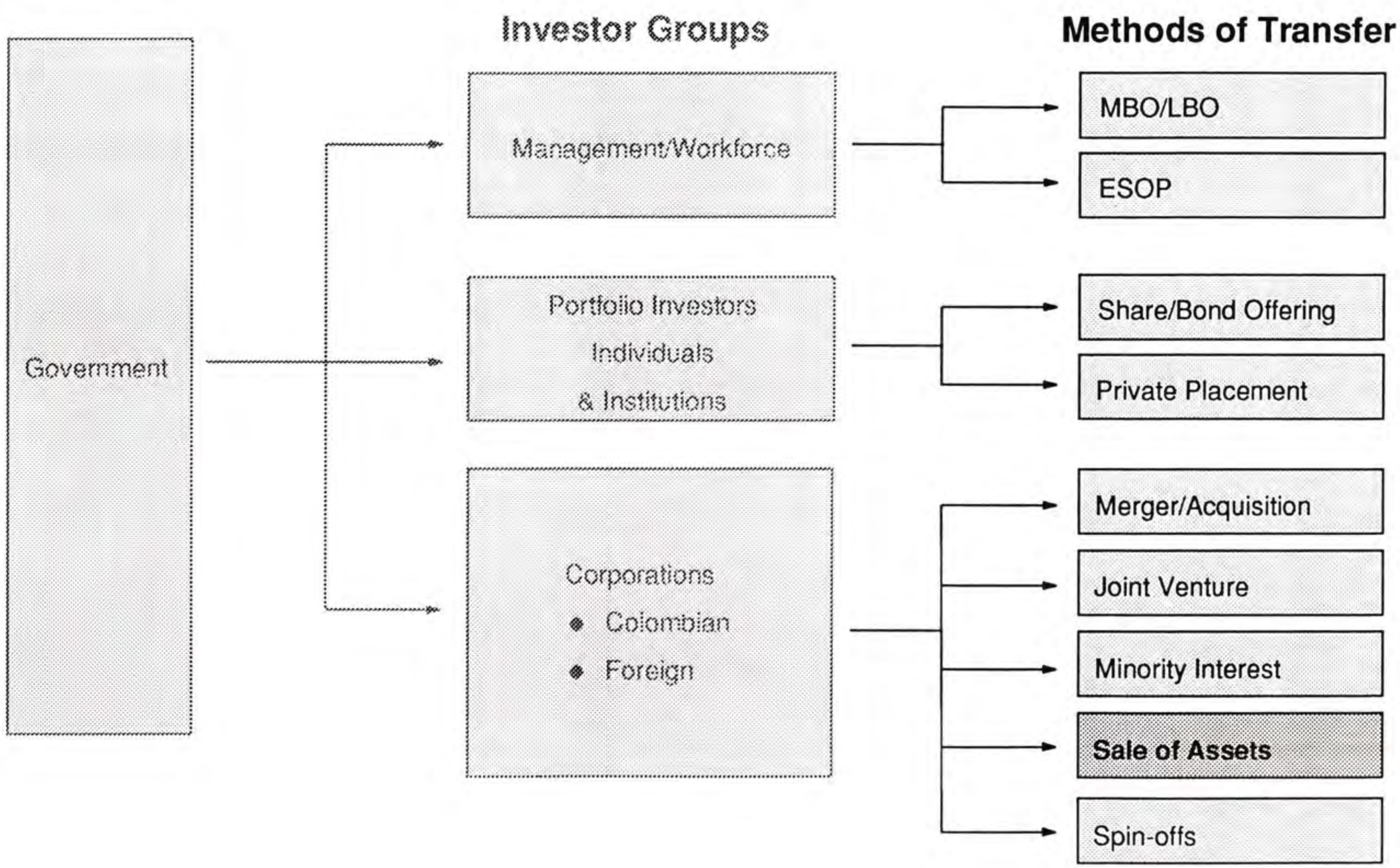
Advantages

- Introduction of private sector influence without giving up control
- Often only way to attract technology, management contractor, etc.
- Lower exposure level required of investors

Disadvantages

- Minority investors have little decision-making power
- Few corporate investors interested in ownership without ability to exercise significant control
- Price depressed by increased uncertainties related to control

Transfer of Ownership:
Sale of Assets



Sales of Assets

- Description:
  - Sale of assets to corporations who can use them more effectively
- Candidates:
  - Companies with assets not crucial to the main line of business
  - Companies whose rehabilitation costs are prohibitively high but where underlying land values may be high
  - Companies that are facing or are in liquidation
- Example:
  - Papelcol
  - Papeles Sudamerica
  - Cementos de Honduras

Sale of Assets

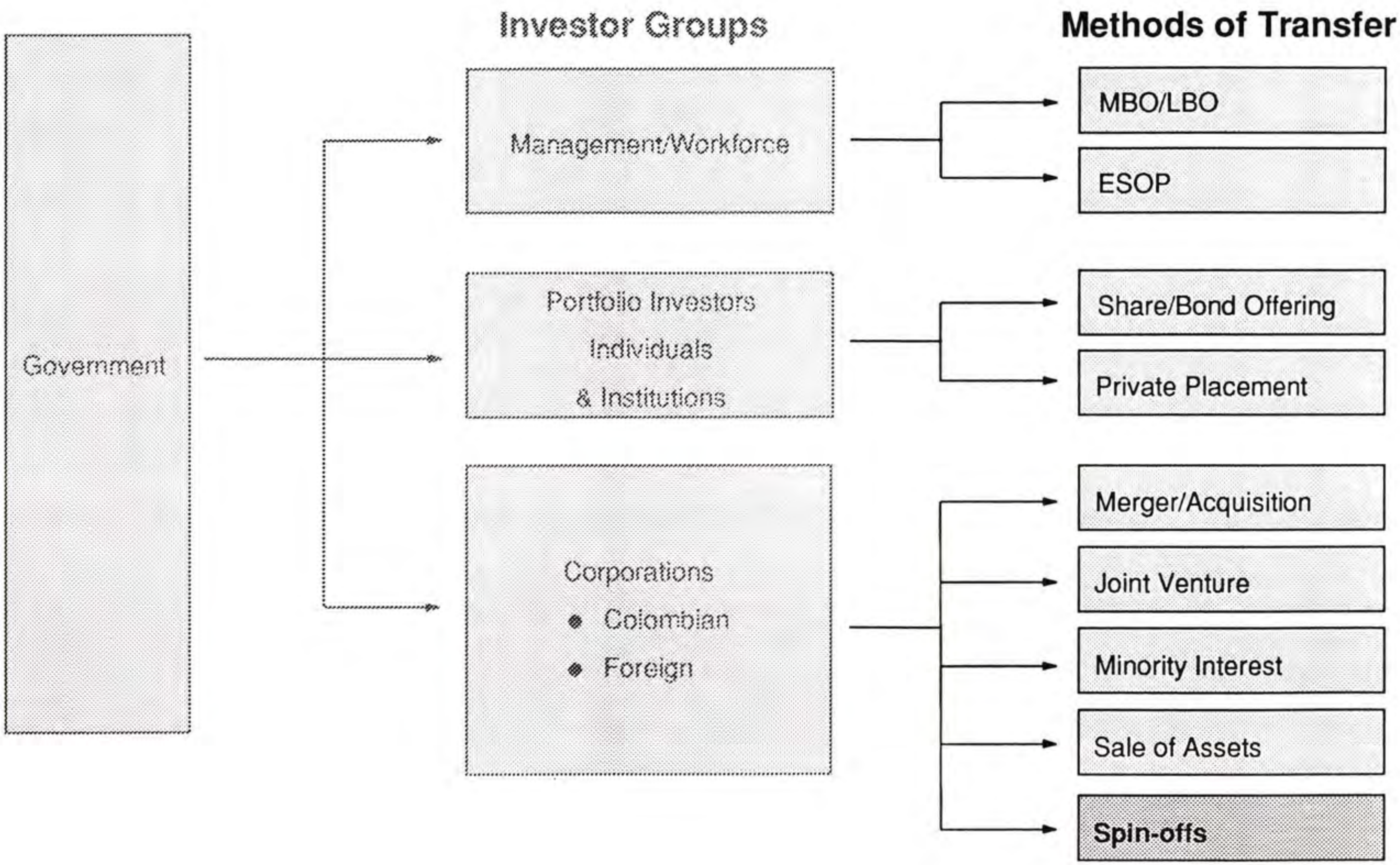
Advantages

- Generation of revenues by sale of idle, non-critical assets
- Method of realizing value from money-losing operations
- Protection to investors from legal and financial contingencies

Disadvantages

- State company often left only with unattractive assets
- Complex legal process required to separate assets from corporate entity
- Loss of tax credits

Transfer of Ownership: Spin-offs



Spin-offs

- Description:
  - Sale of a plant, subsidiary, division or line of business owned by a State entity
- Candidates:
  - Companies with multiple and discrete activities or business units
  - Companies with assets/subsidiaries that are not essential to their core activities
- Example:
  - Telecom
  - Ferrocarriles Nacionales

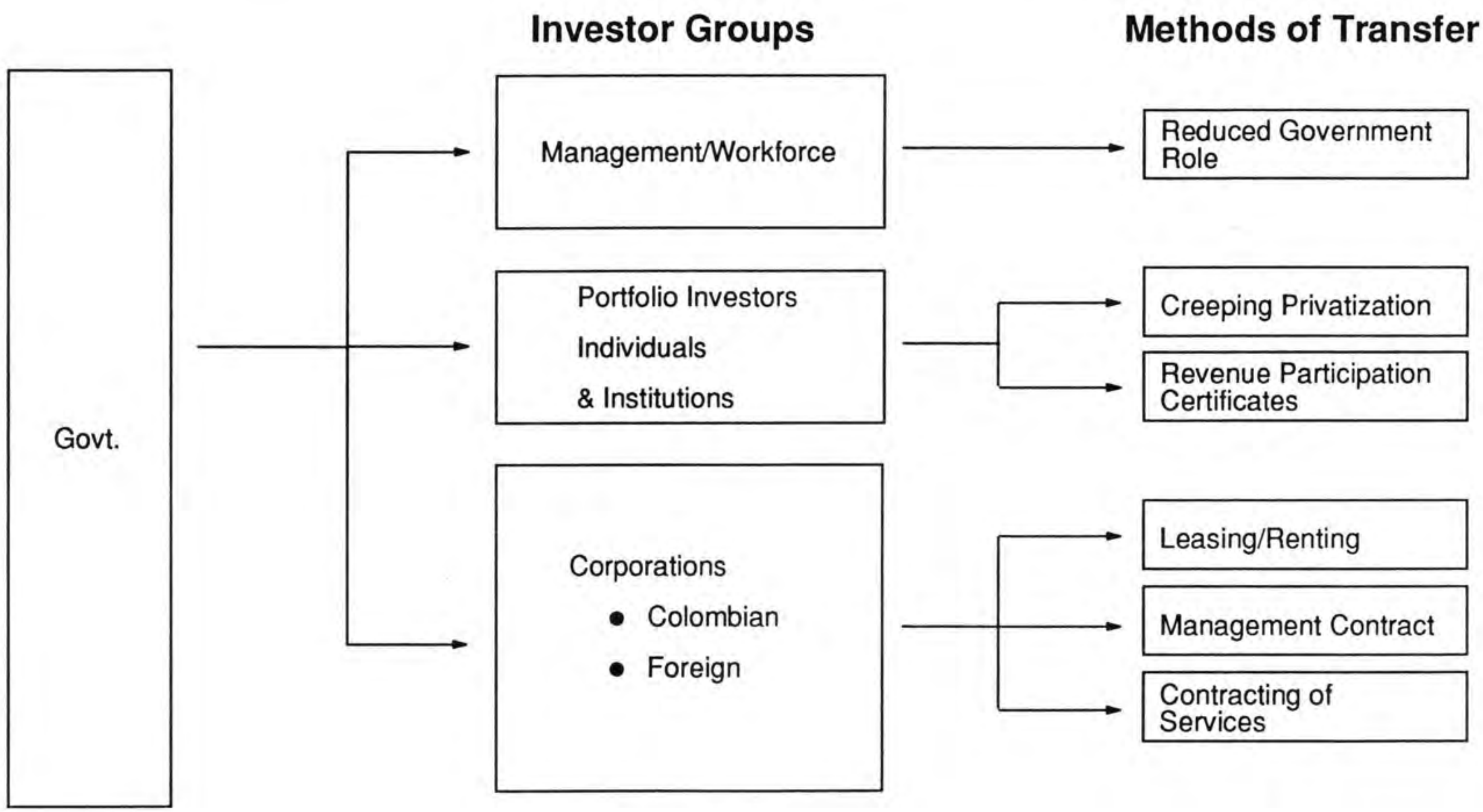
Spin-offs

Advantages	Disadvantages
• Serve as preparation for sale of main company	• Lack of adequate information on asset to be spin-off complicates analysis and valuation
• Reduces size of investment required up-front	• Complex legal process to separate assets/subsidiary from holding company

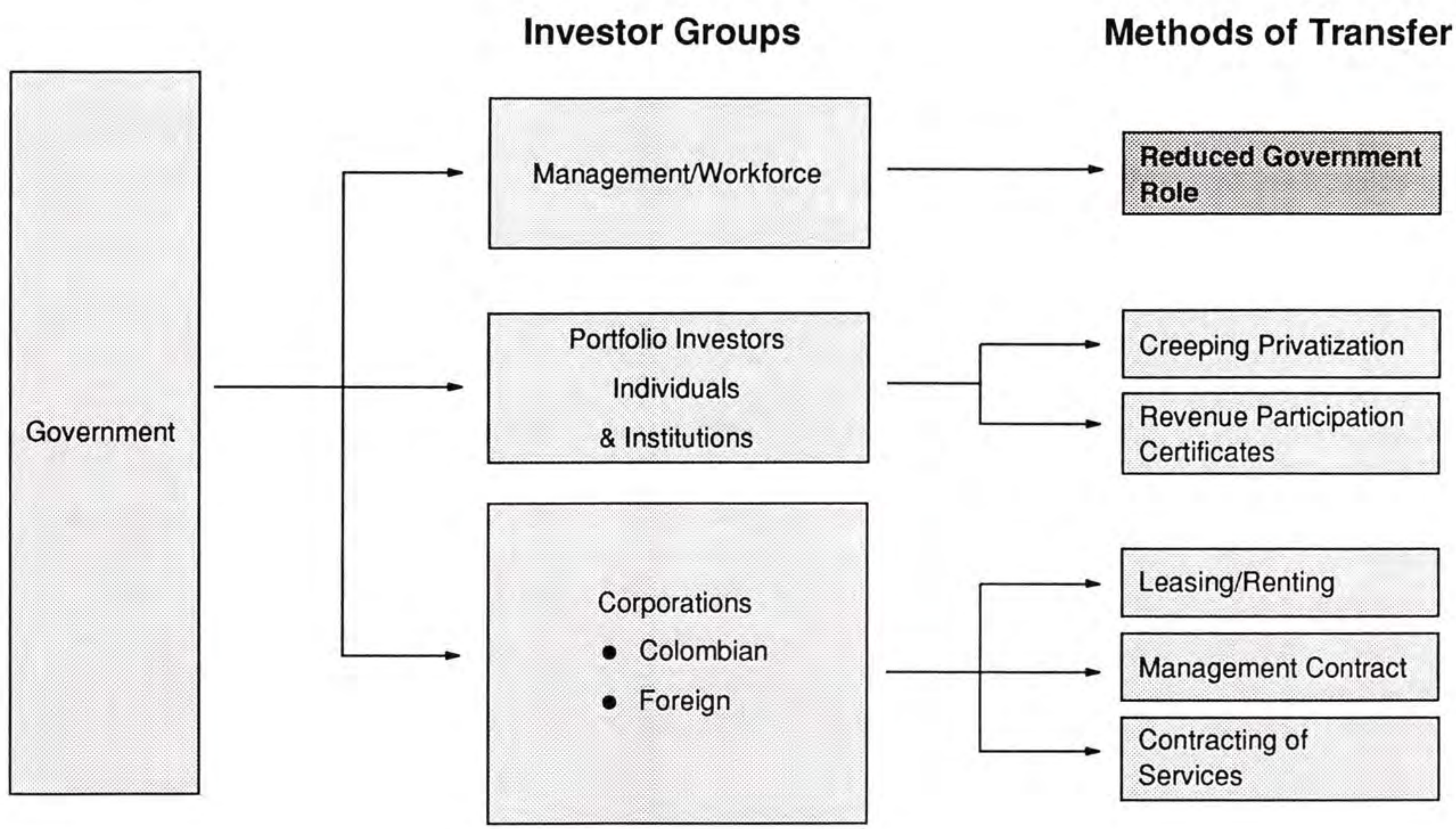
Privatization Methods

Transfer of ownership	**Other privatization methods**
• Most successful form of privatization	• **Some entities cannot be sold immediately**
• Method depends on onset and targeted investor group	• **Alternatives exist to attain objectives**

Other Privatization Alternatives



Other Privatization Methods: Reduced Government Role



Reduced Government Role

- Description:
  - Encourage private sector alternatives, curbing special advantages to promote their formation
- Candidates:
  - Companies that hold monopoly positions
  - Companies that enjoy government support
- Examples:
  - Telecommunication companies in Colombia

Reduced Government Role

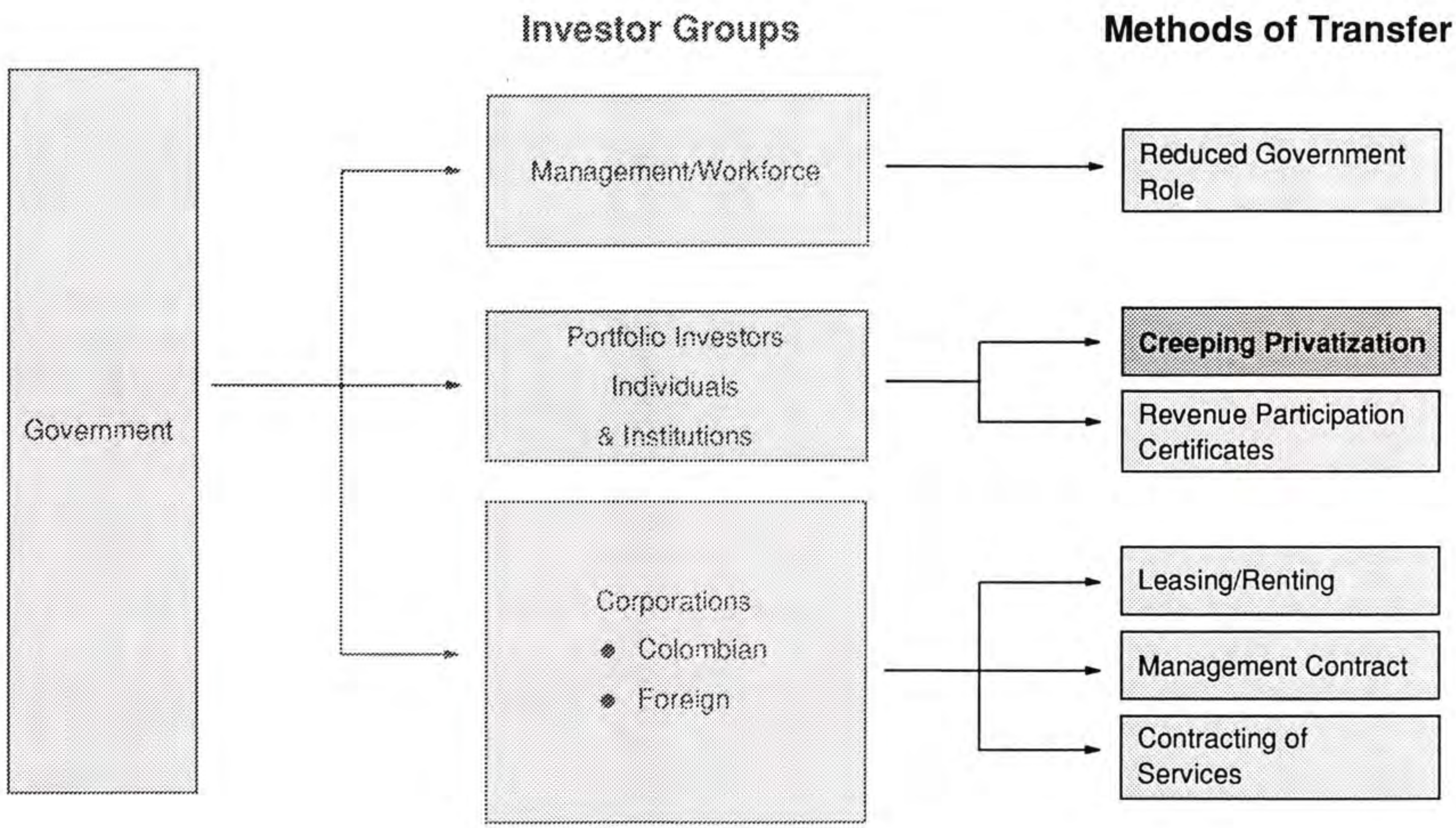
Advantages

- Competition introduced by new entrants into previously restricted field
- State enterprises forced to be more efficient after loss of preferential treatment

Disadvantages

- State enterprises may continue to dominate industry and deter private investment
- Process of improving efficiency via reduced government influences not effective in the short-term
- Natural barriers to entry discourages investors

Other Privatization Methods: Creeping Privatization



Creeping Privatization

- Description:
  - Gradual privatization of the company through the injection of private capital into new expansion or through gradual sale of shares onto the capital markets
- Candidates:
  - Companies that face high capital expenditures in the future
  - Large monopolies whose dominant position can only be reduced over time
- Examples:
  - Cerromatoso
  - Carbocol/Ecopetrol
  - Telecom

Creeping Privatization

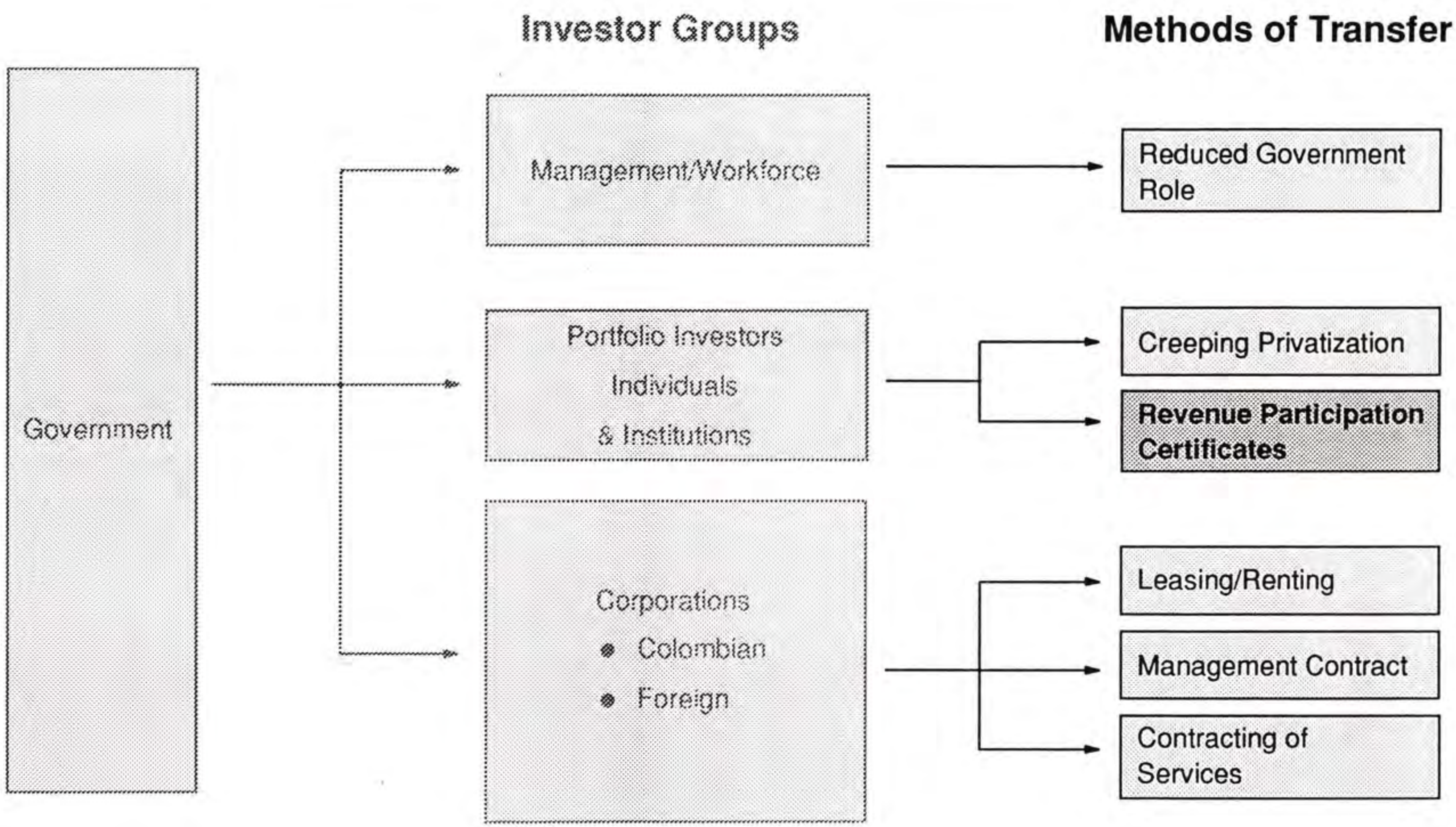
Advantages

- Government's investment in the company is reduced without changing the existing structure
- A gradual introduction to competition and free market forces

Disadvantages

- A slow process of privatization
- Private sector may be reluctant to enter industry still dominated by state company

Other Privatization Methods: Revenue Participation Certificates



Revenue Participation Certificates

- Description:
  - Instruments that allow private investors to share in the revenue but not in the ownership of the company
- Candidates:
  - Public service companies where government wishes to maintain ownership
  - Infrastructure projects with stable sources of revenue
- Examples:
  - Medellin Tunnel
  - Bogota Metro

Revenue Participation Certificates

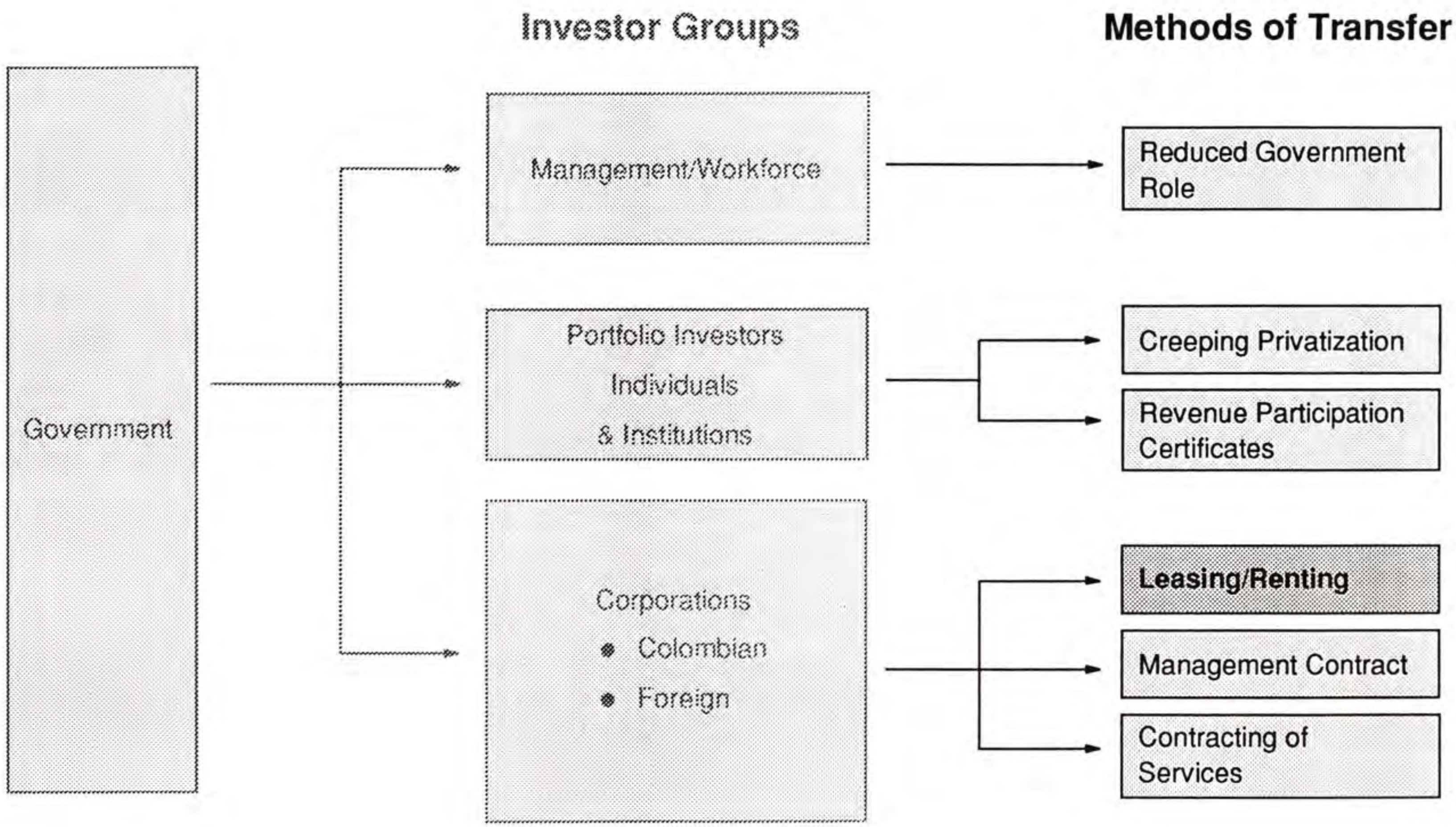
Advantages

- Efficiency/profitability may increase because of responsibility to certificate holders
- Government raises money without giving up control

Disadvantages

- Certificate holders have no decision-making power in company
- May perpetuate inefficiency because certificate holders cannot change management

Other Privatization Methods: Leasing/Renting



Leasing/Renting

- Description:
  - Assets of company leased/rented to/from outside parties
- Candidates:
  - Companies where permanent buyers cannot be found
  - Assets whose purchase costs are high but where yearly lease payments are affordable
- Examples:
  - Colpuertos
  - Cerrejon Central

Leasing/Renting

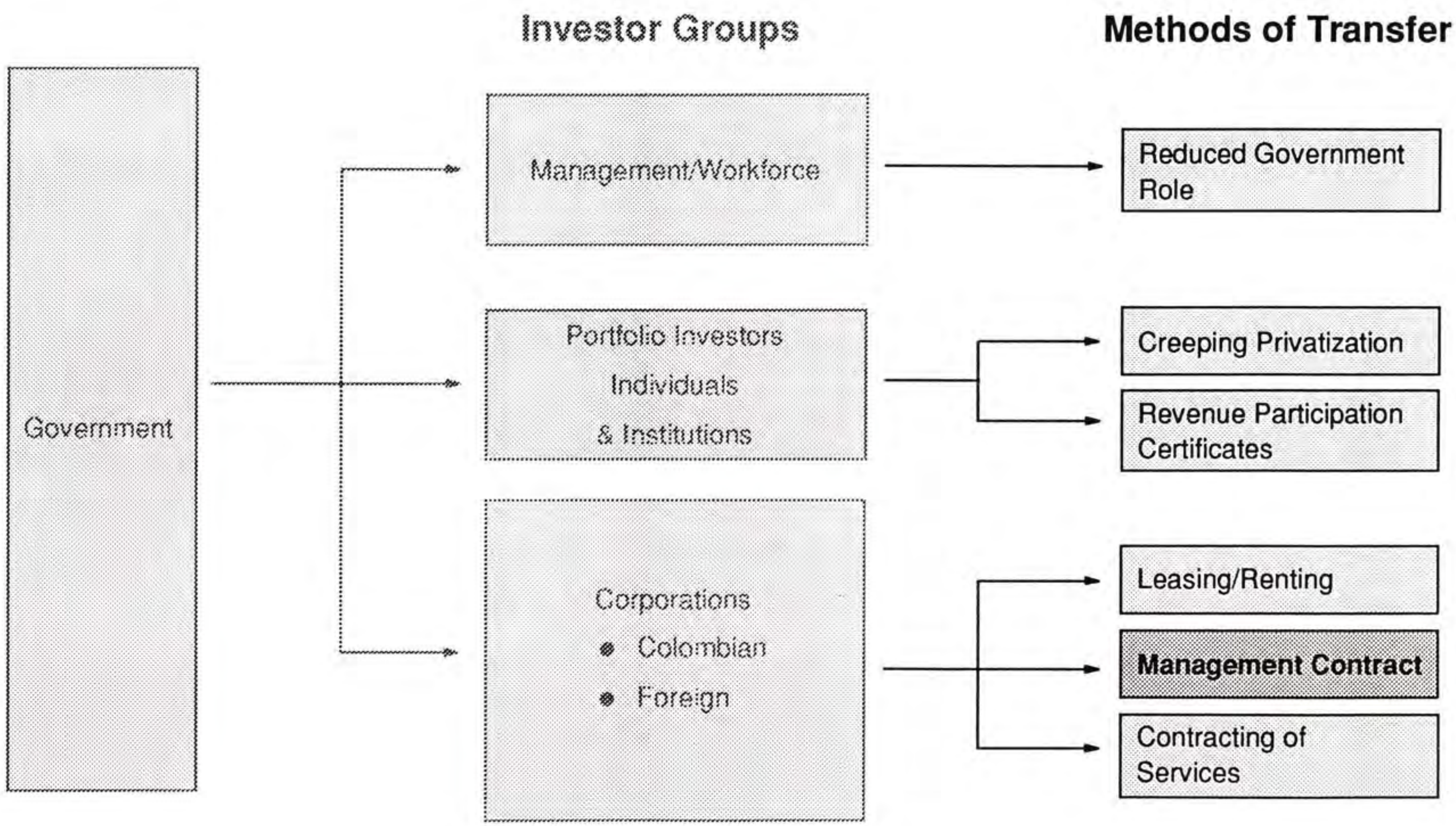
Advantages

- Precludes write-down of asset values
- Transfer of control but not ownership
- Appropriate where private sector cannot raise capital to purchase asset

Disadvantages

- Small stream revenues generated as compared to large sum obtained in outright sale
- Private operator's financial commitment may not be as strong as under ownership
- Asset maintenance may be neglected

Other Privatization Methods: Management Contract



Management Contract

- Description:
  - Private management brought into the company on a contractual basis

- Candidates:
  - Companies where government wishes to maintain ownership
  - Companies that cannot be sold immediately but need rehabilitation
  - Companies where inadequate management is a critical constraint to improved profitability
  - Companies in industries where private sector expertise (such as distribution capabilities) is very important

- Examples:
  - Pipelines
  - Cerrejon Central

Management Contract

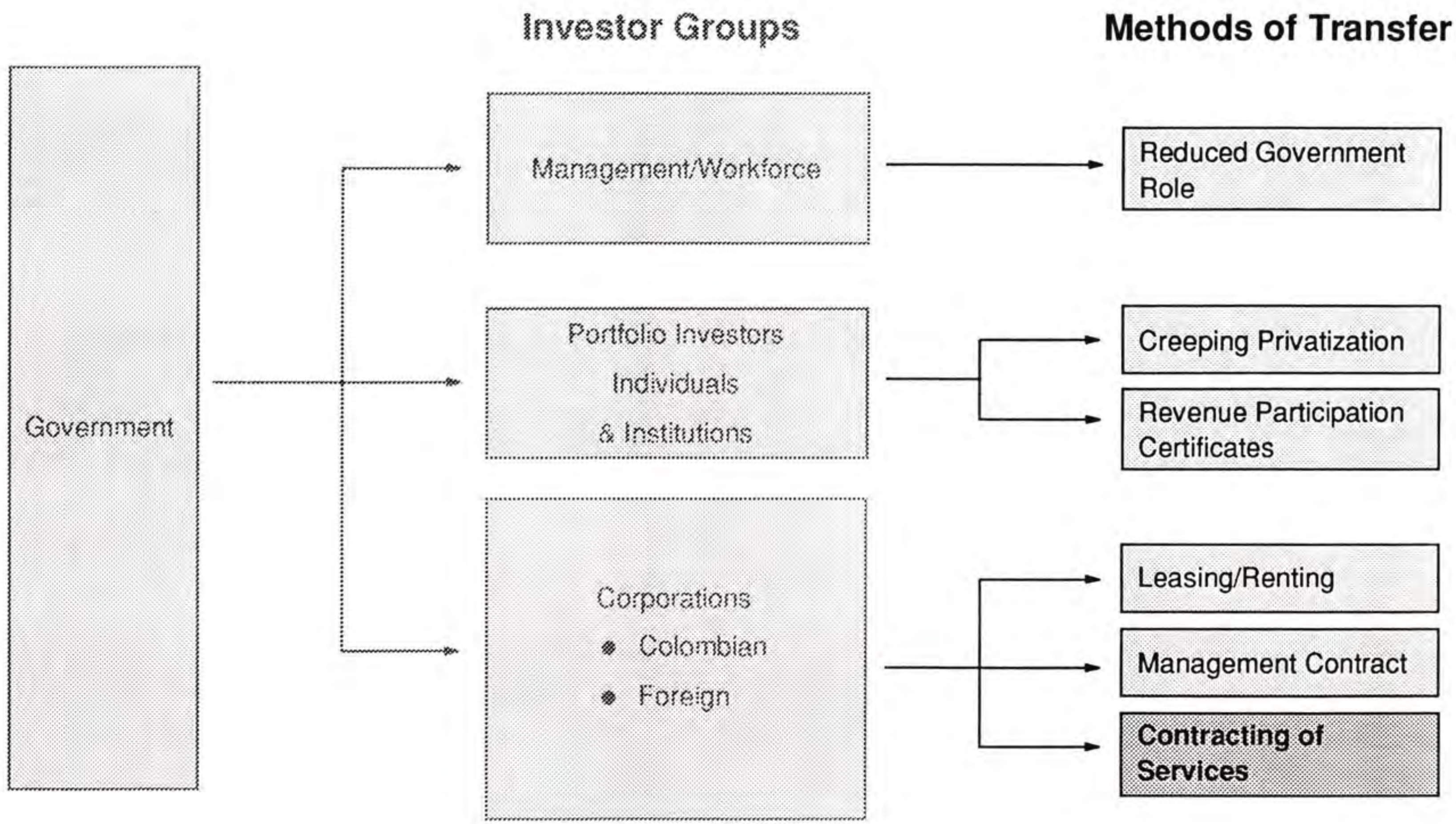
Advantages

- Greater economic discipline imposed and efficiency improved
- Private sector/market forces mentality introduced

Disadvantages

- Management may not be as concerned about longer term economic viability as under full ownership
- Difficulties in measuring contractor's performance if accounting/auditing standards are weak

Other Privatization Methods: Contracting of Services



Contracting of Services

- Description:
  - Specialized entities given management responsibility for a period of time, ofter with incentive compensation based on performance
- Candidates:
  - Companies where advanced technology is critical
  - Companies where efficiency of present workforce is very low
- Example:
  - Cuidad Limpia

Contracting of Services

Advantages

- Efficiency, timeliness of service enhanced
- Service quality is improved
- Reduction in administration burden for government

Disadvantages

- Social goals sometimes not attained
- Where service contractor has a monopoly, overall costs to the public may increase over time

Section IV

J.P. Morgan Possesses the Critical Qualities of a Good Advisor

Business philosophy + Commitment to Latin America and to success + Analytical capabilities +

Local knowledge + Knowledge of financial markets + Breadth of experience and trackrecord = **Results**

An Advisor Requires Credibility

Business philosophy

- Complete objectivity
- Emphasis on long term relationships
- Compensation based on added value and success
- Research free from conflict of interest
- Sound analytical approach

Advisory Work Takes Resources

Business philosophy	+	Commitment to Latin America and to success

- Integrated Advisory, Financing, and Trading units for Latin America
- Over 125 experienced professionals dedicated to the region
- Specialized analytical tools
- Comprehensive industry analysis
- Complete range of advisory and M&A services
- In depth international capabilities
- Commitment to success and client objectives

Value Added Advice Depends on Sophisticated and Focused Analytics

Business philosophy + Commitment to Latin America and to success + Analytical capabilities

- Country specific modeling
- Analytical framework and techniques
  - Measurement of true performance
  - Accurate forecast of cash flow
  - Separate sources of value according to risk
  - Design optimal/flexible capital structures
- Complete valuation and risk assessment techniques

Every Country Is Unique

Business philosophy + Commitment to Latin America and to success + Analytical capabilities +

Local knowledge

- Credibility with local and foreign investors
- Close relationship with governments
- Understanding of countries' economic and regulatory environments
- Extensive knowledge of companies markets and industries
- Particulars of doing business
- Local tax and accounting rules

Our Experience Endorses the Value of Our Advice

Business philosophy	+	Commitment to Latin America and to success	+	Analytical capabilities	+
Local knowledge	+	Knowledge of financial markets			

- Leading bank in Latin American Corporate Finance
- Most active secondary debt trading unit
- Access to and credibility with providers of debt financings
- Access to and credibility with providers of equity financings
- Single AAA rated bank in the USA

Our Experience Endorses the Value of Our Advice

Business philosophy + Commitment to Latin America and to success + Analytical capabilities +

Local knowledge + Knowledge of financial markets + Breadth of experience and trackrecord = **Results**

- Ten years of experience
- Over 250 advisory mandates in Latin America
- Over 10 privatization mandates in Latin America
- Numerous government advisory assignments globally
- Most active financial advisor in Latin American privatizations
- Experience across most industries in Latin American

J.P. Morgan Obtains Results

Business philosophy + Commitment to Latin America and to success + Analytical capabilities +

Local knowledge + Knowledge of financial markets + Breadth of experience and trackrecord = **Results**

Section V

Selected Government Advisory Assignments

1. Mandates received from a government entity:

Client	*Assignment*
Advised government of Colombia on the privatization of Papelcol, a paper manufacturing plant.	* Assisted in the buy out of debt and shareholders after Papelcol went bankrupt * Evaluated Colombian paper industry * Performed extensive market study * Developed sale strategy * Prepared information memorandum for local and international investors * Managed auction process * Negotiated with potential purchasers
Advised Corporación Venezolana del Guayana (CVG) on financing for Aluminios del Guayana. Advisory assignment expired at the end of 1988 before project had begun.	* Performed feasibility study for aluminum smelter project * Proposed financing structure including the use of novel instruments * Explored methods to use debt/equity conversions to enhance the value of the project * Contacted investors and proposed joint venture arrangements
Advised government of Chile on the restructuring of Empresa Nacional del Petroleo (ENAP).	* Analyzed ENAP and its subsidiaries * Studied the Chilean oil industry * Identified marketable business units * Assisted in preparation of units for privatization * Developed business plan * Recommended appropriate capital structures

Selected Government Advisory Assignments

Client	*Assignment*
Advised Petroleos de Venezuela (PDVSA) and joint venture partners on the financing for the Carbones del Guasare project.	* Performed feasibility study for coal expansion project * Prepared detailed financial plan * Proposed novel financing structure designed to minimize political risk * Studied use of debt/equity conversions to facilitate the execution of the project * Advised on complex tax issues
Advised the government of Turkey on developing a master plan for its privatization program.	* Defined objectives of privatization program * Set guidelines and policies * Devised solutions to constraints * Identified key privatization factors * Classified privatization candidates * Recommended implementation plan
Advised a Government Council in Chile on the sale of Papeles Sudamerica, a pulp and paper company.	* Performed historical analysis and financial projections * Prepared selling document * Established acceptable terms of sale * Negotiated investor financing with the Central Bank * Oversaw execution of sale

Selected Government Advisory Assignments

Client	*Assignment*
Advised the government of Malaysia in the partial privatization of Malaysian Mining Corp. (MMC)	* Evaluated the Malaysian tin industry * Devised a unique plan to achieve government objectives * Proposed the merger of 5 tin mining companies to consolidate industry * Recommended a reverse takeover to achieve goal of broader public ownership * Executed two phase transaction
Advised Chinese government owned firm, China Agribusiness Trust Investment Corp. (CATIC) in the purchase of Pesquera San José Coquimbo in Chile.	* Studied the Chilean fishing industry * Valued Pesquera San José Coquimbo * Recommended acquisition price and structure * Assisted in transaction negotiations * Executed transaction closing
Advised Cockerill-Sambre, a Belgian government owned steel company, on the spin-off of the mechanical engineering division.	* Analyzed the company and its industry * Evaluated the mechanical engineering division * Identified sources of value * Recommended new subsidiary structure to capture value in division * Suggested optimal capital structure to permit financing of growth * Left groundwork for future privatization

Selected Government Advisory Assignments

2. Mandates received from private sector entities:

Client	*Assignment*
Advised Grupo Industrial Minera Mexico, which joined with the National Union of Mining and Metal Workers, in acquiring Mexicana de Cobre from the government of Mexico.	* Performed a debt capacity and valuation of Mexcobre and parent company * Advised in the bidding strategy for the auction * U.S. $1.36 bn. acquisition price, payable in Mexican sovereign debt, makes Mexcobre Latin America's largest privatization
Advised Scandinavian Airlines System in the purchase of 40% of Aereolineas Argentinas. While agreement was reached, the Argentine government did not approve the transaction.	* Valued the airline * Determined adequate capital structure * Determined suitable legal structures * Formulated negotiation strategy * Negotiated on behalf of client * Obtained agreement from seller

Selected Privatization Assignments - Latin America

Client	*Assignment*
Advised Renault of the value of its joint venture investment with the he government of Colombia.	* Prepared in-depth analysis of local automobile market * Performed historical analysis and developed projections * Researched tax and legal consequences (local and home country) of acquisition * Identified major sources of value in company's key segments * Provided global automotive expertise to assess parent company's strategy in Latin America * Developed risk-return analysis which helped client decide to double its local investment by buying out its local partner
Advised an important Mexican investor in a bid for Mexicana de Aviación. The bid was won by another bidder.	* Valued the airline * Devised a future operating plan * Prepared a detailed bid package * Presented bid to government
Advised a large Mexican Group in the proposed acquisition of a privatized petrochemical plant.	* Explored the benefits of a diversification strategy * Performed a global petrochemical study * Valued plant and performed financial projections * Studied alternatives to enhance value of client's business * Proposed a bidding strategy

Selected Privatization Assignments - Latin America

Client	*Assignment*
Adviced Grupo Industrial Mexico in the successful acquisition of Minera Cananea	* Performed valuation and debt capacity of Cananea and determined the impact on the debt capacity of parent company * Advised on the bidding strategy for the auction * Raised committed financing for client in order to comply with privatization rules * Assisted client in the negotiations * U.S. $475 million acquisition

Selected Government Advisory Assignments

3. Active mandates received from private sector entities:

Client	*Assignment*
Adviced Mazda and Sumitomo in the valuation of Compañia Colombiana Automotriz (CCA) and in developing a negotiating strategy	* Evaluated expected impact of the "Apertura" * Performed valuation of CCA under different scenarios * Developed alternative acquisition structures * Recommended on negotiating options * Identified potential sources of debt and equity financing
Adviced consortium of international investors, including mayor telephone company, in the privatization of Entel, the Argentine telephone company	* Valued the target * Determined adequate capital structure * Formulated negotiation strategy and assisted in the negotiations * Obtained agreement from seller * Sourced Argentine debt included in the consideration

Efficiency, Corporate Indebtedness and

Directed Credit In Colombia

by

Izak Atiyas

Draft: May 29, 1991

I am grateful to Jim Tybout for many discussions which gave rise to ideas explored in this paper. I am also grateful to Basanta Chauduri for his competent work; the paper owes a lot to his expert assistance. Mark Dutz, Haluk Unal and David Wheeler have provided detailed comments which led to many improvements. A good part of the data used in this paper was put together for the World Bank Project on Industrial Competition, Productive Efficiency and Their Relation to Trade Regimes, RPO 67446. Thanks to Wilson Peiris and Mary Beth Ledesma for word-processing.

EFFICIENCY, CORPORATE INDEBTEDNESS AND DIRECTED CREDIT IN COLOMBIA

TABLE OF CONTENTS

I. INTRODUCTION

1.01 The impact and desirability of government intervention in developing country credit markets, especially directed credit mechanisms and interest rate controls, have been a source of controversy.[1/] On one side of the argument are those who believe that government intervention is necessary because the social desirability of the market's allocation of credit in developing countries is questionable. Among many justifications that have been cited in the literature, two are most relevant for the present study. First, proponents have argued that government intervention is necessary because markets for long-term credit do not exist in most developing countries; directed credit programs enhance the availability of long-term finance, which is crucial for investment. Second, certain types of borrowers, especially small and young firms, are disadvantaged in credit markets. Hence, it is argued, directed credit mechanisms are necessary to redistribute financial resources to groups that have little or no access to external credit.

1.02 Proponents of government intervention can claim both theoretical and empirical support for their concerns. In many cases, liberalization in financial markets has not resulted in the automatic emergence of markets for long-term finance. Access to credit is raised as a legitimate concern in many World Bank publications.[2/] Recent theoretical literature has shown that problems of imperfect information and costly contract enforcement may make external finance more costly than internal finance, and may result in credit rationing even in the absence of administrative controls.[3/] It is generally believed that this wedge between the costs of internal and external finance is larger for small and young

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1/ World Bank (1989) and Fry (1988) present critical evaluations of government intervention in credit markets in developing countries. Amsden (1989) takes a contrary view and argues that government control has been an essential factor behind Korea's success.

2/ A recent World Development Report contends "bankers everywhere are reluctant to lend to small borrowers," (World Bank, 1989, p. 100).

3/ For a lucid exposition of these problems, see Gertler and Rose (1991).

firms.[4] In fact, concern with access to finance is not limited to developing countries. Ample recent empirical evidence for several OECD countries indicates that firms indeed are differentiated by the degree to which they face financial constraints.[5]

1.03 Opponents of intervention see government policy itself as a major cause of under-financing of small firms. It is argued, first, that if small firms are perceived as riskier by lenders, or if there are fixed transactions costs associated with advancing loans, binding ceilings on interest rates limit the risk premium that lenders can charge to small borrowers. Therefore, small borrowers are rationed out of the markets (World Bank, 1989; Tybout, 1984). Second, small firms have less political influence. To the extent that such influence affects the distribution of credit, smaller firms get a less than proportionate share. Hence, government intervention has segmented credit markets: some firms have access to cheap credit whereas others have to rely on internally generated funds.

1.04 Unfortunately, most of the discussions have been carried out without much direct empirical evidence.[6] The purpose of this paper is to present some empirical results for the case of Colombia. Specifically, the paper uses firm-level financial and production data to answer the following questions: To what extent are market imperfections important in explaining variations in the

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4/ In a less academic and more popular vein, it is also argued that the oligopolistic nature of product and financial markets allow a handful of firms to command large amounts of resources and restrict the access of potential competitors. This exercise of monopoly power is seen as undesirable on both equity and efficiency grounds.

5/ See for example, Fazzari et. al. (1988) on the US, Hoshi et. al (1988) on Japan, Devereux and Schiantarelli (1990) on the UK. In their analysis of corporate competitiveness in Europe, Geroski and Jacquemin (1985) conclude:"A coherent European industrial policy must tackle financial markets, which presently favor established firms but hamper new enterprises through lack of funding...We recommend that public support or private incentives be provided to ensure that a larger fraction of total funding is channeled towards ***new, smaller*** firms," (p. 203-4, emphasis added).

6/ Tybout (1984) is an exception. See footnote 10.

financial structure of firms? How does the financial structure of young and small firms differ from that of older and larger firms? How does government intervention affect the distribution of credit? Does directed credit flow to more or less efficient, smaller or larger, younger or older firms? Is there empirical evidence to compare market based and government-directed distribution of credit?

1.05 The paper draws on and extends the literature on determinants of financial structure. This literature attempts to explain inter-firm variations in corporate indebtedness by variables that capture firm characteristics as well as imperfections in financial markets that arise from problems of imperfect information and contract enforceability.[7/] An explicit focus on market imperfections makes this literature suitable for application to developing countries, where these imperfections are likely to exist in aggravated form.

1.06 The paper relies on extensive firm-level data on Colombia from 1981 to 1987. Colombia presents itself as an interesting case study. The characteristics of credit markets during the sample period and the nature of available data allow some comparisons, albeit imperfect, between market-based and government-directed distribution of credit. Whereas controls on interest rates were removed from a substantial part of credit markets, the Colombian government nevertheless retained several subsidized directed credit programs that channeled credit through financial intermediaries at fixed margins. More important, almost all long-term credit for industry during that period was directed credit. Hence, most long-term funded debt in company balance sheets consist of directed credit. By contrast, the share of directed credit in short term corporate debt was much smaller; hence short term debt in balance sheets is much more influenced by market imperatives. Inferences about government versus market-based allocation of credit can be made by comparing the magnitude and significance of factors that explain variability in short versus long-term indebtedness.

7/ See Ravid (1988) and Harris and Raviv (1991) for recent reviews of the literature on determinants of firms' capital structure. Recent empirical applications include Bradley et. al. (1984), Fischer et. al. (1989), MacKie-Mason (1990) and Titman and Wessels (1988).

1.07 Most of the variables used in this study to explain variations in indebtedness are similar to those employed in the literature on determinants of corporate capital structure, with some additions. The empirical analysis will place special emphasis on the roles of firm size and age in explaining firm indebtedness. Especially in the context of developing country corporate finance, size and age are often treated as interchangeable attributes. Even though it is true that in many countries young firms are on average smaller than old firms,[8] one would expect them to have independent effects on the amount of external finance companies can raise. Size is likely to be important because of fixed transactions costs. Age may affect indebtedness because it allows firms to build reputation and therefore decrease the cost of borrowing. Alternatively, given the difficulty of raising outside equity and the consequent reliance on personal wealth in a country like Colombia, young firms may in fact be over-indebted relative to more mature firms. I can differentiate between these two hypotheses by treating age as an independent determinant of indebtedness.

1.08 The paper will also emphasize the role of technical efficiency in explaining cross-sectional variations in corporate indebtedness.[9] This is important for two reasons. Taking account of inter-firm heterogeneity in efficiency is necessary to make a correct interpretation of any positive relation between indebtedness and size. Generally, such a relation is presumed to reflect that large firms have easier or cheaper access to credit markets, because they can save on fixed transactions costs.[10] However, as is well known in the industrial organization literature, differences in firm size may well reflect

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8/ See Roberts (1989) for evidence on Colombia.

9/ Availability of production data allows the estimation of an index of firm-level efficiency in a manner that is more precise than would be possible than when relying on financial data alone. The index is estimated through a stochastic production frontier.

10/ Tybout (1984) develops a model of lending with interest rate ceilings and fixed transactions costs and shows that indebtedness is positively correlated with size in a sample of Colombian manufacturing firms. The present paper may be seen as an extension of this study.

heterogeneity in firm level efficiency.[11/] Therefore, when firms differ in efficiency, a correlation between size and efficiency may reflect not differences in the cost of or access to credit, but simply a demand size variation in financial policy. One possible reason for that variation is bankruptcy costs: more efficient firms are less concerned with bankruptcy and relatively more willing to accumulate debt. (This idea is developed formally in Appendix 1). Studies of market structure in Colombia establish statistically significant differences in the efficiency levels of individual firms (Roberts, 1989). Hence a-priori, heterogeneity in efficiency is expected to be important in explaining cross sectional variations in indebtedness.

1.09 Firm-level efficiency also provides an interesting measure to compare market-based and government-directed allocation of credit. Even though it is generally believed that distribution of credit through administrative channels does not result in the allocation of funds to most efficient uses, empirical evidence is scarce.

1.10 In general, evidence in this paper is not favorable towards directed credit in Colombia. Since directed credit programs vary substantially across countries, the results of this paper cannot be easily generalized. However, they are quite informative about broad handicaps of similarly designed programs. I find strong evidence of imperfections in credit markets, even in the case of short term credit--which, according to theory should be relatively free of problems of imperfect information and contract enforcement. Evidence also suggests the existence of transactions costs that create additional difficulties for small firms. These findings justify policy makers' concerns about the desirability of market-based allocation of credit. However, I also find that small firms are even more constrained in accessing long-term credit, most of which is directed. This is consistent with suggestions in the literature that

11/ For example, in a standard model of Cournot oligopoly, firms that exhibit higher production efficiency or lower marginal cost produce more output in equilibrium.

intermediaries may compensate for fixed margins by savings from transactions costs. There is also evidence that whereas short term credit is mostly allocated to more efficient firms, the relation between long-term credit and efficiency is negative. Finally, young firms seem to be more indebted than old firms, a finding that potentially explains high failure rates among young firms and suggests that equity rather than credit may be the binding financial constraint on young firms. A general conclusion is that subsidized directed credit programs of the type that existed in Colombia fail to address the root causes of differential access to credit and absence of term finance. Evidence suggests that root causes have to with imperfect information and costly contract enforcement which may be addressed better by improvements in legal and institutional infrastructure rather than through interest subsidies.

1.11 The rest of the paper is organized as follows. Section II reviews the relevant characteristics of credit markets in Colombia, summarizes the nature of government intervention and provides preliminary empirical evidence on the financial structure of firms. Section III reviews various firm-level characteristics that have been discussed in the literature and that are used in this paper. Section IV describes the estimation of the efficiency index and reports results from a regression analysis of inter-firm variation in indebtedness. There are firms in the data set that did not have any long-term funded debt throughout the sample period. I have estimated a simple selection model to see which firm-level characteristics determine whether a firm gets long-term credit or not. Results of this estimation are also reported in section IV. Finally, Section V discusses the policy implications of the results, and concludes the paper.

II. THE NATURE OF INDUSTRIAL FINANCE IN COLOMBIA

2.01 This section first discusses the nature of directed credit programs that target industrial firms in Colombia. It then provides statistics on asset and liability structures of firms grouped by size and age. The final subsection summarizes important features of financial markets in Colombia, which the empirical analysis needs to take into account.

A. Regulation and directed credit[12]

2.02 The allocation of funds in the Colombian financial system in the 1980's exhibited an interesting combination of market forces and government control. During the 1960's and most of the 1970's, interest rates in the institutionalized credit markets were subject to administered ceilings. The system underwent limited deregulation in 1980. Term deposit and lending rates were freed, in principle eliminating the administrative causes of credit rationing in some segments of the credit markets.

2.03 By contrast, directed credit mechanisms have persisted throughout the 1980's. During that period, the main sources of directed for industry have been Banco de Republica (BR) development credit lines,--which were mainly intermediated by commercial banks and financial corporations (Corporaciones Financieras, CFs)--; external credit from international organizations administered by the BR and channeled mainly by CFs; credit from the Instituto de Fomento Industrial (IFI) (a development finance institution); and export oriented financing through Fondo de Promocion de Exportaciones (PROEXPO).

2.04 According to World Bank estimates the share of directed credit in total credit provided by commercial banks and CFs to industry and mining was

12/ This section draws heavily from Dailami (1989) and World Bank (1990a, 1990b). Tybout (1983) discusses the nature of financial repression in Colombia in the 1970's.

high, on average 62% between 1984-87.[13] Even though directed credit consisted of lending instruments of various maturities, its most important role was in long term financing. In fact, an independent market for long term loans to manufacturing sector does not exist in Colombia; the share of directed credit in long term loans to manufacturing is estimated to be close to one hundred percent.[14]

2.05 Besides constituting the main source of long-term finance, another important feature of directed credit programs was that they were heavily subsidized. Whereas interest rates on credit extended on commercial terms was between 33% and 36% in 1983-87, those on directed credit were on average about 12 percentage points lower (World Bank, 1990b, Table 4.6). Intermediary margins on directed credit lines were statutorily fixed and kept narrow. Hence, rationing in the allocation of long-term credit is expected.

2.06 Given rationing, criteria used in allocating credit gain importance. According to anecdotal evidence, criteria used in the allocation of directed credit did not necessarily include efficiency considerations. Instead, emphasis was on expanding industrial capacity. The reason was that in order to succeed in receiving credit, firms had to demonstrate that installed capacity in the sector constituted a binding constraint on output.[15] This bias in the distribution of credit in favor of new capacity in the industry made it difficult for firms "to use this credit to increase efficiency in sectors with sufficient capacity."[16] There was also a bias towards large firms, although that was

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13/ The ratio was 50-60% in 1984-86 and reached an unusually high level of 81% in 1987. See World Bank (1990a), Table 2.19.

14/ For example, a recent analysis of the financial system in Colombia concludes that "long term credit to the industrial sector comes almost exclusively from BR development credit lines, intermediated by a small number of banks and CFs" (World Bank, 1990b, p. 116). See also Dailami (1989) on the short-term emphasis of financial markets in Colombia.

15/ World Bank, 1990a, pp. 33-34.

16/ Colombia, Financial Sector Strategy Paper (Report No.8276-CO), December 15, 1989, p. 15.

partially offset by the existence of special lines of credit for small and medium enterprises. Finally, given the low margins allowed for intermediaries channeling directed credit to final users, financial intermediaries have had a strong preference to lend to less risky clients, and to minimize risk by demanding high collateral, often in excess of the loan amount."[17/] It has also been argued that by making credit less available to new entrants, the directed credit programs may have reinforced the oligopolistic structure in product markets.[18/]

B. Financial structure of manufacturing firms in Colombia

2.07 This subsection provides descriptive statistics on the financial characteristics of companies in Colombia. It also discusses how these characteristics change with size and age.

2.08 There are two different sources of data. Age and real-side variables such as output, capital, labor, materials, and investment are obtained from a cross-sectional census of manufacturing plants. The data, which covers 5,000-6,000 plants per year is available for the years 1977-87; this paper concentrates only on the period 1981-87. Details about this data set can be found in Appendix 2 and Roberts (1989). The second source is financial data in the form of income statements and balance sheets of manufacturing industry firms registered at the Superintendencia de Sociedades. The size of that data set is smaller, about 900-1,000 observations per year. The data are available for 1983-1987. This data set tends to comprise the larger firms in Colombia. This sample selection bias should be kept in mind in interpreting results.

17/ Colombia, Financial Sector Strategy, December 15, 1989.

18/ "Colombia: Recent Financial Sector Reforms, Current Issues and Priorities," mimeo, March 30, 1990, p. 8.

2.09 Since most of the empirical analysis in this paper required using both real and financial data, observations on individual firms in the two sets had to be matched. Appendix 2 provides details of the matching algorithm.[19]

2.10 Table 2.1 summarizes the liability structure of firms registered at the Superintendencia de Sociedades over the years 1983-1987.[20] Observations on firms are divided into three groups of roughly equal size according to the book value of total assets (in constant 1985 prices). An observation is classified as small (Group 1) if assets are less than 250 million pesos, as medium (Group 2) if assets are between 250 million and 1 billion pesos, and as large (Group 3) if assets are larger than 1 billion pesos. Because of observed skewness in the distribution of some variables and the presence of influential observations, both means and medians are reported.

2.11 The following patterns emerge from the data. The average debt-to-asset ratio of the whole sample is 65%. On average, three-quarters of total debt consists of short-term debt. The mean share of long-term loans in total debt is only about 17%, supporting the view that much industrial finance is concentrated on the shorter end of the maturity structure. The median is much lower, 8%, reflecting substantial skewness in the distribution of long-term loans. When one includes other non-funded long-term liabilities (primarily future severance payments to workers), the mean share of long-term liabilities increases to a quarter of total debt. The share of bonds in total debt is very small.

19/ As a rule, the largest possible data set is used in the empirical analysis presented in this paper. For example, the estimation of the production function and the index of technical efficiency reported in section IV.A rely on all of the census data. The regressions in sections IV.B and IV.C are carried out on the matched data set. The descriptive statistics provided in this subsection rely on all observations in the financial data set whenever possible. In cases where variables from the census data set are involved, the statistics are obtained from the matched data set.

20/ Due to missing values, change in reporting rules, and multiple sources of data, the number of observations from which the descriptive statistics in Tables 2.1-2.4 are constructed changes, depending on the variable analyzed.

Table 2.1: LIABILITY STRUCTURES OF COLOMBIAN FIRMS, 1983-87 (%)								
Group 1: Total Assets ≤ 250 m. Group 2: 250 m. < Total Assets ≤ 1 b. Group 3: Total Assets > 1 b.								
	GROUP 1		GROUP 2		GROUP 3		TOTAL	
	Mean	Median	Mean	Median	Mean	Median	Mean	Median
Total debt/Total Assets	58.5	62.9	69.2	71.4	65.3	66.9	65.0	68.0
Short term debt/Total assets	43.7	44.1	51.7	51.53	46.2	45.7	47.7	48.3
Long term debt (1)/Total assets	10.0	0	12.1	6.1	12.0	6.6	11.5	5.0
Long term debt (2)/Total assets	14.7	6.8	17.5	12.7	19.1	15.1	17.2	12.3
Short term/Total debt	76.7	87.3	75.0	30.4	70.8	74.1	74.1	79.6
Long term debt (1)/Total debt	15.2	0	16.6	9.1	17.5	11.2	16.5	8.1
Long term debt (2)/Total debt	23.3	12.7	25.0	19.6	29.2	25.9	25.9	20.4
Frequency of non zero long term debt	48		77		85			
Financial expenses/Total debt	14.0	5.6	12.6	11.9	14.4	13.7	13.2	11.5
Number of Observations	1,260		1,826		1,461		4,546	

File: TA1UNI
(1) Includes funded debt only
(2) Includes funded debt and other long term liabilities

2.12 There are significant differences in the liability structure of groups of firms of different sizes. First, as expected, large firms use more debt than small firms. Second, the composition of debt changes significantly over size classes. Small firms rely more heavily on short-term debt than do large firms. Note in this context that the median of the ratio of long-term to total debt is zero for small firms. In fact, 52% of Group 1 observations do not have any long-term debt, whereas that ratio is 23% and 15% for observations in groups 2 and 3, respectively.[21/] Since most long-term debt was subsidized, these findings suggest that (i) firms did not have uniform access to directed credit, and a large number of firms were rationed out of the market for long-term debt, and (ii) small firms were more often rationed than were large firms.

21/ All of these results are reinforced when the cutoff point for small firms is at 100 million pesos. In particular, among 659 observations with assets less than 100 million pesos, 75% do not have any long term debt.

2.13 More insight can be gained by looking at the composition of long-term and short-term debt in more detail. Such data are available for the years 1985-86 and are tabulated in Table 2.2. In that table, the cutoff point for Group 1 is reduced to 100 million pesos to emphasize the characteristics of small firms.[22/] The table shows that small firms rely more heavily on trade credit, most of which is credit form non-financial institutions, than do large firms; the median values suggest that the relation may not be linear. By contrast, the share of bank loans in short-term debt is higher for large firms. Note again that the median of the ratio of bank loans in short-term debt is zero for small firms. The exact nature of short term secured debt is ambiguous; it is not clear from available information whether these are loans from financial institutions. In any case, even if one assumes that all secured short-term debt is from the financial sector, it is clear that an important part of short term borrowing even by large firms is against non-financial institutions. In fact, the next-to-last column of Table 2.1 shows that on average slightly more than one-third of all debt is from non-financial firms. As observed in Villate (1989), this reflects the existence of an active inter-firm market of short-term loans in Colombia.[23/] It seems that small firms make relatively more use of this market.

2.14 As for long-term loans, it is unfortunate that the data do not indicate the actual lenders; bank and non-bank sources are not distinguished. Moreover, a substantial part of long-term debt is classified under the category "Other". Nevertheless, it is interesting to note that for large firms almost half of long-term debt is classified as "unsecured", an observation that is not consistent with the claim that availability of collateral is an absolute necessity for obtaining long-term loans.

22/ 100 million pesos is likely to be a more realistic cutoff point for firms that are typically considered as small in Colombia. In any case, the qualitative results are quite robust to different rules of classification and the classification adopted in Table 2.2 is for exposition purposes only.

23/ A similar pattern has been observed in Turkey. See Ersel and Ozturk (1990).

Table 2.2: COMPOSITION OF CORPORATE DEBT, 1985-1986

Group 1: Total Assets $\leq$ 110 m.
Group 2: 100 m. < Total Assets $\leq$ 1 b.
Group 3: Total Assets > 1 b.

	GROUP 1		GROUP 2		GROUP 3		TOTAL	
	Mean	Median	Mean	Median	Mean	Median	Mean	Median
Trade credit/Short term debt	34.8 (248)	26.3	32.6 (969)	28.0	29.1 (588)	24.6	31.8 (1805)	26.5
Short term bank loans/Short term debt	13.1 (248)	0	27.5 (969)	22.8	29.9 (588)	25.4	26.3 (1805)	21.3
Short term secured debt/Short term debt	2.1 (248)	0	7.3 (969)	0	7.8 (588)	0	6.8 (1805)	0
Long term secured debt/Long term debt	15.5 (91)	0	30.2 (696)	0	30.0 (503)	0	29.1 (1290)	0
Long term unsecured debt/Long term debt	31.9 (91)	0	41.8 (696)	13.9	48.4 (503)	45.7	43.7 (1290)	23.3

Note: Number of observations in parentheses.

Trade credit includes current account and suppliers' credit.

File: TA8586

2.15 The importance of trade credit in the balance sheets of smaller firms would suggest that small firms may have a higher average cost of debt. Surprisingly, that does not seem to be the case. The last row of Table 2.1 provides an estimate of average (nominal) financial expenses per unit of total debt. This measure of average cost of debt is lowest among medium-sized firms; moreover, small firms and large firms seem to have similar levels of cost of funds. In fact, the median of average financial expenses is much lower in Group 1 observations. These results were also robust to changes in the classification rule as well as to changes in the measure of financial expenses. Such findings may be partly explained by the treatment of interest charges in trade credits, which are often subsumed in the cost of real transactions but are not recorded as payments in income statements.

2.16 Table 2.3 provides additional relevant characteristics. First, a lower portion of the assets of small firms are "collateralizable".[24]/ If bank loans require collateral, then lower collateral would result in a proportionately lower level of bank loans, as evidenced by data in Table 2.2. On the other hand, this may also indicate a desire to hold a higher level of liquid assets for precautionary reasons. Second, the ratio of earnings-before-interest-and-taxes (EBIT) to total assets is substantially lower among smaller firms. The rate of capital accumulation (investment divided by capital stock) is also lower among small firms. This finding is consistent with both lower profitability and a higher degree of financial constraints. Finally, smaller firms typically carry more liquid assets: all three liquidity measures displayed in the table tend to decrease with size.

Table 2.3: ASSET STRUCTURE AND EARNINGS OF COLOMBIAN FIRMS, 1983-87

	GROUP 1		GROUP 2		GROUP 3	
	Mean	Median	Mean	Median	Mean	Median
Fixed assets/Total assets	18.3	11.0	18.8	14.7	20.2	15.3
Inventories/Total assets	21.9	18.3	26.6	25.2	24.1	23.1
(Fixed assets + Inventories)/Total Assets	40.2	41.4	45.4	45.8	44.2	44.1
Ebit/Total assets *	5.5 (1,262)	5.0	10.4 (1,826)	10.2	12.1 (1,461)	11.2
Investment/Capital Stocks	8.5 (398)	5.6	12.3 (1,157)	8.7	14.1 (858)	11.4
Short term assets/Short term debt	4.39 (1,241)	1.50	1.73 (1,826)	1.33	1.55 (1,461)	1.36
(Short term assets-Inventories)/Short term debt	3.76 (1,241)	0.94	1.15 (1,826)	0.81	0.99 (1,461)	0.83
(Short term assets-Inventories)/Total assets	0.46 (1,256)	0.43	0.4 (1,826)	0.43	0.40 (1,461)	0.39

Number of observations in parantheses

For breakdown of groups, see Table 2.1

* Two extreme observations deleted

File: Asset, QASSET and ASSET1

24/ Collateralizable assets are defined as fixed assets plus inventories.

Table 2.4: FINANCIAL STRUCTURE OF FIRMS SPLIT BY AGE, 1983-1987				
Group 1: Age ≤ 5 Group 2: Age > 5				
A. LIABILITY STRUCTURE	Group 1		Group 2	
	Mean	Median	Mean	Median
Total Debt/Total Assets	69.6	71.1	66.8	68.7
Short Term Debt/Total Assets	43.0	40.8	49.8	50.2
Long Term Debt (1)/Total Assets	23.7	19.6	10.8	5.5
Long Term Debt (2)/Total Assets	26.6	21.0	17.0	13.3
Short Term Debt/Total Debt	62.0	66.9	74.8	79.0
Long Term Debt (1)/Total Debt	33.0	27.3	15.3	8.7
Long Term Debt (2)/Total Debt	38.0	33.1	25.2	21.0
Financial Expenses/Total Debt (3)	13.9	12.9	13.7	12.9
No. of Observations	185		2228	
B. COMPOSITION OF SHORT TERM AND LONG TERM DEBT (Number of Oberservations in Parentheses)	Group 1		Group 2	
	Mean	Median	Mean	Median
Informal Credit/Short Term Debt	29.37 (67)	27.3	31.2 (917)	27.7
Short Term Bank Loans/Short Term Debt	29.9 (67)	21.5	29.5 (917)	25.8
Short Term Secured Debt/Short Term Debt	9.4 (67)	0	7.6 (917)	0
Long Term Secured Debt/Long Term Debt	34.0 (58)	10.0	31.1 (727)	0
Long Term Unsecured Debt/Long Term Debt	48.5 (58)	47.1	45.4 (727)	31.1
C. ASSET STRUCTURE AND EARNINGS	Group 1		Group 2	
	Mean	Median	Mean	Median
Fixed Assets/Total Assets	34.5	33.3	18.0	14.3
Inventories/Total Assets	20.8	18.6	26.9	25.5
(Fixed Assets + Inventories)/Total Assets	55.3	54.4	44.8	45.1
EBIT/Total Assets	9.9	9.9	11.7	11.2
Investment/Capital Stock	17.2	10.4	11.9	9.1
Number of Observations	185		2228	

2.17 Table 2.4 presents financial statistics when observations are classified by firm age. Younger firms are more leveraged. Moreover, a higher proportion of their liabilities consists of long-term debt. This finding suggests that, contrary to expectations, younger firms have more access to directed credit. There is no significant difference between total average financial expenses of young and old firms. Given that long-term debt is on average cheaper than short-term debt, the data suggest that young firms may have higher average financial expenses on short-term debt. Another interesting finding is that young firms have higher ratios of assets that can be used as collateral. On average, young firms also grow faster but their profitability, as measured by the EBIT ratio, is lower than older firms.

C. Important features of the financial sector in Colombia

2.18 First, it is clear that an empirical analysis of corporate indebtedness in Colombia needs to distinguish between short- and long-term credit. The allocation of short-term credit, whether from the banking system or from the inter-firm loan market, is likely to be more closely determined by market imperatives than the allocation of long-term loans. This is primarily because the use of long-term debt is heavily influenced both by government policy priorities and by rigid margins, in the case of directed credit intermediated by financial institutions. Given that long-term credit consist predominately of subsidized directed credit, balance sheet data can in fact be used to compare market-based and government-directed mechanisms for the allocation of credit.

2.19 Second, a liquid stock market does not exist in Colombia. Family wealth and retained earnings constitute the only two sources of corporate equity. Firms with foreign equity may be exceptions to these rules because they can rely on head offices for externally financed increases in equity capital.

2.20 Third, most funded debt consists of bank loans and trade credit rather than bonds. The most important difference between these types of loans and bonds is that lenders are much more active in monitoring borrowers relative to bondholders, especially when information-producing entities such as rating agencies are not available. It is well known that in economies with developed financial markets, agency problems can be resolved through complex contracts that specify covenants and limit the actions of borrowers. In Colombia, actual monitoring by banks or suppliers replaces such covenants. This does not mean that monitoring by banks solves all agency problems; monitoring itself is a costly activity. Hence, one would expect that agency problems that limit the degree of bond indebtedness also hinder borrowing from banks or suppliers of trade credit.

2.21 Finally, creditor/shareholder agency problems are much reduced when banks and firms are organized under common ownership and control. Hence, we membership in a financial-industrial conglomerate is expected to be important in explaining inter-firm variability of indebtedness. Unfortunately, information on the detailed ownership structure of firms or on the patterns of cross ownership with banks is not available.

III. DETERMINANTS OF CORPORATE INDEBTEDNESS: THEORY

3.01 This section summarizes basic approaches to determinants of corporate financial structure. A review of firm characteristics that are considered in the empirical analysis follows.

A. Approaches to determinants of corporate financial structure

3.02 Two broad classes of factors affect the choice of indebtedness. The first set of factors relates to taxes. The second set of factors focuses on problems of asymmetric information and contract enforcement that cause agency costs and create a wedge between the prices of external and internal finance.

3.03 One of the trade-offs that the tax approach has concentrated on is that between tax shelters generated by the deductibility of interest payments on debt and the higher likelihood of costly bankruptcy associated with the increased use of debt (e.g. Kim 1978, Scott 1976). Tax deductibility of interest should be an important incentive to use debt in Colombia; the fact that not only real but also nominal interest payments were deductible over the sample period would reinforce this incentive. However, this would not be an important factor in explaining cross-sectional variations in indebtedness. Others (DeAngelo and Masulis, 1980, Dotan and Ravid, 1985 and Dammon and Senbet, 1988) have emphasized that tax factors need also take into account the existence of non-debt tax shields, such as depreciation and investment credits. The existence of non-debt tax shields makes firms uncertain whether they can fully use their debt tax deductions: if there is not enough income, the firm loses its debt-related tax shields. If excess tax shields are costly to transfer, corporations will issue debt up to that point where the expected net tax advantages of debt are exhausted. Therefore, a firm's effective tax rate on interest deductions depends on non-debt tax shields, and non-debt tax shields can act as substitutes for debt-related tax shields.[25/]

3.04 The second approach focuses on various agency costs associated with different forms of finance. Conflicts of interest between shareholders and managers and between shareholders and bondholders give rise to agency costs; optimal leverage occurs when the marginal agency costs of equity and debt are equalized. Since most corporations in Colombia, as well as in other developing countries, are owned and managed by families, separation of ownership and control is less a source of agency problems than conflicts of interest between shareholders and creditors. The problem arises either because creditors cannot observe all the relevant actions of borrowers after a contract is signed, or, even if they can, such actions are difficult or costly to verify by third parties such as courts. Hence, borrowers have incentives to undertake actions that increase the value of their equity claim at the expense of other claimants. Of course lenders anticipate this and include an agency premium in the price of their loans; this premium increases the cost of debt. Several examples of such activities have been given in the literature. Myers (1977) has argued that because shareholders of debt-financed firms are interested only in cash flows over and above the repayment of debt--that is, they are only interested in non-bankrupt states, they may forego projects with positive net present values. The literature has also mentioned increasing the risk of investment (Jensen and Meckling, 1976,Green, 1984) or overproduction of output (Brander and Lewis, 1986) as actions that shareholders may use to transfer wealth from bondholders and that therefore generate agency problems.

25/ One way to think of a firm's marginal effective tax rate is as the statutory rate multiplied by the probability of having positive taxable income. See MacKie-Mason (1990).

B. Firm characteristics and corporate indebtedness

3.05 With this background, we can now review what observable firm-level characteristics can be used in explaining inter-firm variability in the level of indebtedness. The paper uses three measures of indebtedness: total liability (Debt1), long-term funded debt (Debt2), and short-term debt (Debt3), all expressed per unit of assets. Based on the discussion in Section II, I presume that most of Debt2 consists of directed credit. The degree of government involvement in Debt3 is much lower. Due to the absence of stock prices, all variables are expressed in book values. The following firm characteristics are employed in the empirical model:

3.06 Efficiency Theoretical studies that focus on the relationship between debt and efficiency have reached different predictions, depending on the type of agency problems that they concentrate on. Those that focus primarily on the conflicts of interest between managers and shareholders (Grossman and Hart, 1982, and Jensen, 1986), predict a positive correlation between indebtedness and efficiency: because debt increases the probability of costly bankruptcy, and therefore the cost of diverting resources to unproductive uses, it may be used by managers as a bonding device to convince shareholders that they act in the latter's interest. In a study that focuses on shareholder/bondholder conflicts, and is therefore more relevant to developing countries, Brander and Spencer (1989) develop a model where higher levels of debt decrease the manager/owner's effort, for a given level of investment. Hence holding investment constant, that model predicts a negative correlation between efficiency and debt. Kim and Maximovic (1990) apply these ideas empirically: they estimate a cost function where the level of debt is exogenous and show that debt indeed has a negative effect on cost efficiency.

3.07 In both models described above, heterogeneity in firm-level efficiency is completely due to debt. Starting with the premise that firms are differentiated according to their managerial efficiency, this paper takes a different route by assuming that managerial efficiency is predetermined at the time the debt level is chosen. It is easy to show (see Appendix 1) that in a simple model of capital structure that relies on debt-related tax shields and bankruptcy costs, more efficient firms will be both larger and carry more debt in equilibrium. This result would imply that a positive correlation between indebtedness and size does not necessarily imply that larger firms have easier or cheaper access to credit. To see whether size really captures transactions costs, one would have to control for differences in efficiency.

3.08 These arguments would suggest that short-term debt in Colombia should be positively correlated with efficiency. By contrast, the allocation of long-term debt is affected by governmental priorities. Even though cursory evidence cited in the previous section would suggest that long-term debt would be either not correlated or negatively correlated with efficiency, there are no strong priors to suggest one way or the other.

5.09 I use two proxies for firm-level efficiency. TRANS is estimated as the fixed effects from a translog production function and CD from a Cobb Douglas (see Section IV.A for details).

3.10 Age It is surprising that despite widespread concern over access to finance by younger firms, firm age has not been considered in the literature explaining inter-firm variation in indebtedness. There are strong arguments supporting the prediction that younger firms will be less indebted. Younger firms have shorter track records, which makes it more difficult for lenders to judge their quality. Moreover, younger firms are more risky because they exit more frequently, as evidenced by Roberts (1989). In a model where firms build reputation over time, Diamond (1989) predicts that old firms will find it optimal to choose safer projects whereas young firms with little reputation may choose riskier projects. Even though the level of debt is fixed in the Diamond model, Harris and Raviv (1990) conjecture that other things being equal, an extension of the model implies that younger firms have lower debt.

3.11 However, if wealth constraints are binding when firms are established, and if entrepreneurs cannot rely on outside equity, it is also possible that a negative relationship exists between age and indebtedness. The reason is that since equity finance is limited to initial wealth and retained earnings, firms may rely more heavily on debt during their initial years of operation and build up equity as time passes. In summary, although age would be important, its sign could go either ways.

3.12 Size [26/] If controlling for efficiency and other firm-level characteristics, size is positively related to short-term debt, one would conclude that fixed transactions costs make it more difficult for smaller firms to have access to credit, presumably due to fixed transactions costs, as in Tybout (1984). The role of the size variable in the equation for long-term debt would reflect to what extent directed credit programs make loans more accessible to small firms. Size is represented by the logarithm of total assets in constant prices.

3.13 Collateral value of assets Assets that can be used as collateral ameliorate agency costs. Firms that have a lower level of collateral assets will face higher borrowing costs and therefore are likely to use relatively less debt. For total and long-term debt, assets for collateral are represented by the ratio of inventory-plus-fixed assets to total assets (CA1). For short-term debt, the ratio of inventories to total assets is used (CA2).

3.14 Non-debt tax shields. Non-debt tax shields reduce the tax advantages of debt. A decrease in non-debt shelters would therefore result in an increase in the amount of debt used. On the other hand, when firms are constrained in the amount of debt they can raise at the market price, decreases in non-debt tax shields should not affect indebtedness. In the case of Colombia, non-debt tax

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26/ The rest of the variables reported in this section have been extensively discussed in the literature. The exposition here follows Titman and Wessels (1988). The informed reader may skip to the next section.

shields (NDTS) should be negatively related to short-term debt. If firms are indeed rationed in the market for long-term debt, then NDTS may be insignificant in the equation for long-term debt. Following Titman and Wessels (1988), the level of NDTS is estimated through the following equation:

$$NDTS = OI - i - (T/t)$$

where OI stands for operating income, i for interest expenses, T for corporate taxes, and t for the corporate tax rate.[27]

3.15 Profitability It was mentioned above that agency costs create a wedge between the costs of internal and external funds and generate a preference for internal finance. Higher profitability should increase internally-generated funds that can be retained. Therefore, more profitable firms should carry relatively less debt. Another possible cause of a negative relation between indebtedness and profitability is rationing: when the amount of credit is below the levels desired by firms at the ruling interest rate, firms would not be able to match increases in equity, due to high retention, with increases in debt. The ratio of earnings before interest and taxes (EBIT) to total assets is used as the profitability variable.

3.16 Variability Both the tax/bankruptcy cost approach and the agency approach to corporate indebtedness predict that firms with more variable earnings should have lower leverage. The former predicts that variability in earnings implies larger probability of failure, therefore making debt less attractive.[28] The latter predicts that higher variability may reflect a tendency by owner/managers to choose riskier projects at the expense of creditors; therefore, higher volatility of earnings increases the cost of debt. The indicator of volatility that is used in this paper is the standard deviation of EBIT.

27/ MacKie-Mason (1990) has argued that the effects of tax shields are better assessed when one focuses on incremental financing decisions rather than debt ratios. That would require data on flows of financing, which were not available.

28/ This result is sensitive to model specifications. See, for example, Jaffe and Westerfield for a model where the optimal level of debt may be increasing with variability of earnings.

3.17 Growth opportunities and intangible investments The decision on how to measure growth opportunities that give rise to agency problems of the type discussed by Myers depends on the complexity of the contracts that can be written between creditors and debtors to alleviate the problem. If lenders incur large costs in monitoring borrowers' investments, and if including covenants that would limit borrowers' discretionary investments in debt contracts is costly, then most discretionary investment opportunities, including investment in machinery and equipment, R&D, and intangible assets, would be negatively correlated with debt. However, when costs of monitoring are not high and complex contracts are feasible, Long and Malitz (1985) have argued that agency costs associated with investments in machinery and equipment would not be so severe. However, effectiveness of covenants in investments that are firm-specific and intangible would still be quite limited. In that case, only investment in intangibles would be negatively related to indebtedness.

3.18 Another distinction relates to the role of long-and short-term debt. Myers (1977), Barnea, Haugen and Senbet (1980) suggest that the use of short-term debt would mitigate the agency problem. In that case, short-term debt may be positively correlated with growth opportunities and intangible investments.

3.19 Investment opportunities in tangible assets are captured by the ratio of investment in plant, machinery and equipment to the stock of physical capital (GROWTH). Even though most empirical work identifies advertising and research and development expenditures as examples of intangible and non-monitorable investment opportunities, only advertising expenditures are available in the Colombian data. Hence the ratio of advertising expenditures to total assets (ADV) is used as a measure of intangible investment.

3.20 Legal status The data set provides information on the legal status of firms. To control for differences in legal status, three sets of dummies are used. TYPE1 is equal to 1 when the company is a joint stock company and zero otherwise. TYPE2 is equal to 1 for companies whose headquarters are in foreign countries (hereafter foreign firms) and zero otherwise. TYPE3 is equal to 1 for limited companies and zero otherwise.

IV. DETERMINANTS OF CORPORATE INDEBTEDNESS: EMPIRICAL FINDINGS

4.01 This section is divided into three subsections. The first discusses the derivation of the technical efficiency index. The second reports the main regression results on inter-firm variation in indebtedness. The third discusses results obtained from a simple selection model for analyzing characteristics that determine whether a firm obtains long term credit.

A. Estimation of the efficiency index

4.02 The firm-level efficiency index is estimated via stochastic production frontiers.[29] The production function is specified as translog, although a Cobb-Douglas specification is also estimated. The translog model is the following:

$$Y_{it} = \alpha + \beta_{Lj}L_{it} + \beta_{Kj}K_{it} + \beta_{Mj}M_{it} + \beta_{LKj}L_{jt}K_{jt} + \beta_{LMj}L_{jt}M_{jt} + \beta_{KMj}K_{jt}M_{jt}$$
$$+ \beta_{LLj}L^2_{it} + \beta_{KKj}K^2_{it} + \beta_{MMj}M^2_{it} + v_{it} - u_i,$$
$$i=1,\ldots,I;\ j=1,\ldots,J;\ t=1981,\ldots 1987.$$

where i indexes firms, t indexes time periods, j indexes industries, and y, K, L and M stand for logarithms of output,[30] capital stock, labor and materials, respectively. In our case, I = 11981 and J = 29 (3-digit SIC industries).[31] The v_{it} terms are uncorrelated with the regressors. The u_i terms represent technical efficiency. Hence $u_i \geq 0$ for all i. Note that the model allows for two sets of effects. First, industry effects are captured through the coefficients on the terms that involve inputs, which are allowed to vary across industries. These will be called industry (slope) effects. Second, firm effects are captured

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29/ For a survey of the literature on frontier production functions and estimation of various types of efficiency, see Forsund, Lowell and Schmidt (1980) and Schmidt (1985). The presentation in the text follows closely Schmidt and Sickles (1984).

30/ See Appendix 2 for details on the variables.

31/ The data is not balanced, that is, the number of observations is not equal for each firm.

through u_i, which is allowed to vary across firms. These are called firm (intercept) effects. One may think of an intermediate model where firm intercept effects are suppressed and replaced by industry intercept effects amounting to a model where technical efficiency varies across industries but not across firms. That model is also estimated below in order to test the significance of firm effects.

4.03 Various approaches are available for estimating u_i. Availability of panel data allows the treatment of efficiency as fixed effects that can be estimated through a dummy variable model. This approach has two advantages. First, one does not need to make distributional assumptions about u_i. Second, no assumptions need to be made on whether technical efficiency is correlated with the other regressors.

Let $E(u_i) = \mu > 0$ and define $\alpha_i = \alpha - u_i$. Then the model becomes

$$y_{it} = \alpha_i + \beta_{Lj}L_{it} + \beta_{Kj}K_{it} + \beta_{Mj}M_{it} + \beta_{LKj}L_{jt}K_{jt} + \beta_{LMj}L_{jt}M_{jt} + \beta_{KMj}K_{jt}M_{jt}$$
$$+ \beta_{LLj}L^2{}_{it} + \beta_{KKj}K^2{}_{it} + \beta_{MMj}M^2{}_{it} + v_{it}$$

Normally, the α_i are estimated by expressing all data in terms of deviations from firm means, applying OLS and retrieving the N intercepts $\hat{\alpha}_i$. In our case, this would have amounted to estimating 261 parameters, nine for each sector. To reduce the dimensionality of the estimation, firms that changed sectors over the sample period were deleted from the sample. This makes the matrix of regressors in deviations form block diagonal. As a result, separate regressions may be run over each industry, and the intercepts retrieved from each regression are identical to $\hat{\alpha}_i$. The number of firms deleted in this way was 747.[32] The intercepts are referred to as the "efficiency index" and are labelled TRANS.

32/ There was an 8.5 percent reduction in total number of observations, from 45,950 to 42,017.

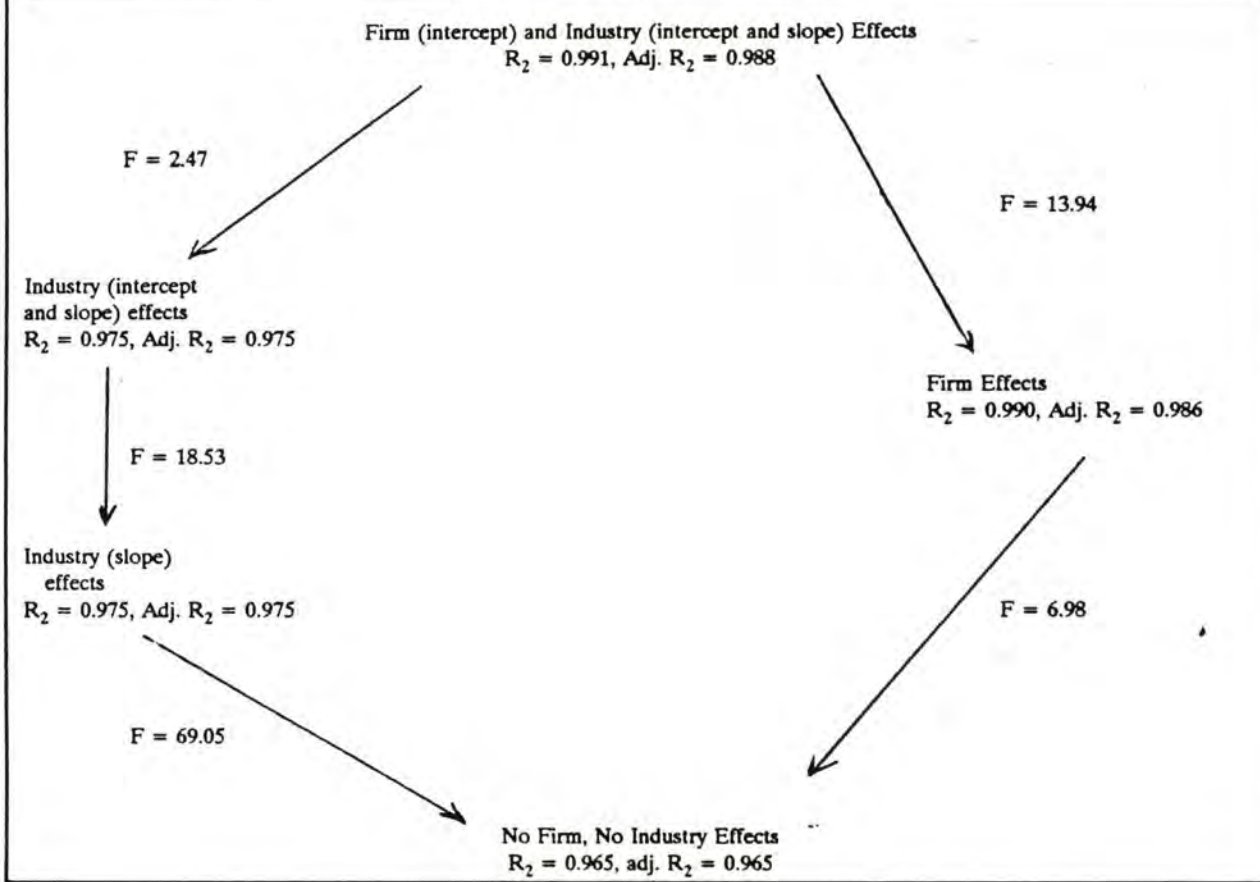
4.04 It is worthwhile to review the statistical significance and quantitative importance of various effects discussed above. These are summarized in Table 4.1.33/ Each arrow in the table corresponds to the imposition of a restriction that an effect captured by either the slope or intercept coefficients is absent. Along each arrow, the table shows the F-tests corresponding to these restrictions. Moving down the table, the path most relevant for our purposes is represented by the top arrow on the left: the null hypothesis that restricts firm effects to zero is rejected at conventional levels of significance (an F-test statistic of 2.5) even when the alternative hypothesis includes industry effects both in the slope and intercept coefficients. This finding confirms that firm-level heterogeneity is indeed statistically significant. In fact, both firm effects and industry effects belong to the equation; all hypotheses about their absences are rejected. On the other hand, one can also see from the adjusted R-squared of regression equations that the quantitative contributions of firm and industry effects are not substantial. Their joint presence improves adjusted R-squared only by a few percentage points.34/

4.05 To test the sensitivity of results to the specification of the production side, an additional index was constructed from a Cobb-Douglas production function. In what follows, this index is referred to as CD. F-tests revealed that restrictions on coefficients that would reduce the translog production to a Cobb-Douglas are rejected at conventional levels of significance for 27 of the 29 industries. Hence, I place more confidence on the index derived from the less restrictive translog production function.

33/ See Schmalensee (1985) and Kessides (n.d.) for similar representations of firm effects in a different context.

34/ Note that since firms that change industries were deleted from the sample, industry-intercept effects are nested in the firm-intercept effects. In other words, industry intercept effects can simply be obtained by summing up the coefficients of firms effects of firms belonging to the same industry.

Table 4.1: SIGNIFICANCE AND IMPORTANCE OF
FIRM AND INDUSTRY EFFECTS



File: TRTEST

B. Regression results on corporate indebtedness

4.06 This section presents basic results on determinants of corporate indebtedness in Colombia. The linearized version of the following equation is estimated through ordinary least squares:

Debt = f (TYPE, Age, Size, SDEBIT, CA, ADV, Growth, NDTS, TRANS).

The equation is estimated separately for the three different measures of indebtedness.

Table 4.2: CORRELATION COEFFICIENTS

	DEBT1	DEBT2	DEBT3	TRANS	AGE	SIZE	EBIT	SDEBIT	CA1	ADV	NDTS	GROWTH	CA2
Debt1	1.000	0.353	0.647	0.045	-0.067	0.019	-0.230	0.009	0.288	-0.164	-0.261	-0.076	0.291
Debt2		1.000	-0.385	0.110	-0.224	0.041	-0.147	-0.056	0.319	-0.034	-0.100	0.021	-0141
Debt3			1.000	0.113	-0.081	-0.033	-0.062	0.055	0.041	-0.129	-0.119	-0.101	0.395
TRANS				1.000	0.071	0.176	0.120	0.068	0.040	-0.291	-0.028	0.055	-0.027
AGE					1.000	0.324	0.005	-0.098	-0.093	0.008	0.001	0.031	0.063
SIZE						1.000	0.174	-0.214	-0.032	-0.012	-0.037	0.129	-0.105
EBIT							1.000	-0.261	0.042	0.029	0.300	0.073	0.085
SDEBIT								1.000	-0.089	0.042	-0.038	-0.106	-0.124
CA1									1.000	-0.158	-0.023	0.088	0.489
ADV										1.000	-0.023	0.112	-0.034
NDTS											1.000	-0.016	0.001
GROWTH												1.000	-0.014
CA2													1.000

4.07 Average values of the variables over the sample period are used in the estimations; firms that do not have observations in each year are excluded from the data set. Table 4.2 reports the correlation coefficients between the variables. Several observations can be made. First, note that the efficiency index, TRANS, is positively correlated with both SIZE and EBIT, the profitability variable. Thus, more efficient firms tend to be larger and more profitable. In both cases, however, the correlation coefficient is not very high although significant. Second, note that AGE is negatively correlated with all three measures of indebtedness. Third, the two measures of collateralizable assets, CA1 and CA2, are strongly positively correlated. Finally, we can identify three potential sources of multicollinearity, between ADV and TRANS, NDTS and EBIT, and SIZE and AGE.

4.08 Table 4.3 reports the first set of regression results. The first three columns contain results on the full equation. For comparison, results of additional regressions, where the efficiency index is deleted from the set of regressors, are reported in the next three columns.

4.09 Coefficients on the categorical variables Type1-Type3 suggest that everything else being constant, joint stock and foreign companies use less debt per unit of assets, most likely reflecting easier access to equity capital. The coefficient on AGE is negative and significant for long-term debt and short-term debt. This finding is consistent with the view that as firms age, they have more time to build reserves and increase their equity base. Both findings suggest that the availability of equity capital may be an important factor that explains cross-firm variation in our measures of indebtedness. Note also that the coefficient in equation (2) is twice as large as that in equation (3). This suggests that directed credit programs may have been successful in making long-term credit available to relatively younger firms.

4.10 All indicators of indebtedness are positively correlated with SIZE. However, note that both the magnitude and significance of the coefficient on

SIZE, in the case of short-term debt, is reduced (to a P-value of 0.048) when efficiency is included in the equation. This finding reinforces our suspicion that unless firm-level differences in efficiency are controlled for, the SIZE variable captures some of these effects. Moreover, the coefficient of size in equation (2) is both larger and more significant than in equation (3). This suggests that small firms find it more costly to access long term credit relative to short term credit.

4.11 The coefficients on EBIT bring out an interesting distinction between short-term and long-term debt. The coefficient on EBIT for total and long-term debt is significant and has the expected negative sign. This suggests that increases in equity due to higher operating earnings are not offset by increases in long-term debt. This could reflect firms' preference for internal funds over external long-term funds. However, given that long-term funds are subsidized and rationed, the result is more likely to reflect firms' inability to raise additional long-term debt to match the increase in equity. On the other hand, the coefficient on EBIT in the equation for short-term debt is both low and insignificant, suggesting that increases in equity are easily offset by increases in short-term debt. These results seem to reflect both that firms have easier access to short-term debt and that complementarity between short-term debt and internal funds is higher than that between long-term debt and internal funds.

4.12 The volatility variable is either insignificant or significant with a positive sign, in the case of short-term debt. Using the standard deviation of the percentage change in earnings, rather than the standard deviation of the EBIT ratio, produced significant and positive coefficients for both total and short-term debt.

4.13 The coefficients on collateral assets are high and positive for all measures of indebtedness, suggesting that existence of collateral reduces agency costs of debt. Fixed assets were included in the equations for short-term debt but turned out to be insignificant, suggesting that fixed assets are not used as collateral for short-term debt.

Table 4.3: REGRESSION RESULTS
Efficiency Index from Translog Production Function

Equation	(1)	(2)	(3)	(4)	(5)	(6)
Dependent Variable	Debt1	Debt2	Debt3	Debt1	Debt2	Debt3
Intercept	0.593 (8.416)	0.113 (1.841)	0.297 (4.064)	0.595 (8.546)	0.091 (1.491)	0.319 (4.382)
Type1	-0.120 (-2.489	0.100 (-2.367)	-0.074 (-1.448)	-0.120 (-2.491)	-1.00 (-2.359)	-0.074 (-1.435)
Type2	-0.192 (-2.771)	-0.149 (-2.467)	-0.086 (2.768)	-0.191 (2.768)	-0.154 (-2534)	-0.081 (-1.107)
Type3	-0.012 (-0.228)	-0.046 (-1.029)	-0.025 (0.457)	-0.011 (-0.231)	-0.045 (-0.995)	-0.026 (0.478)
Age	-0.0003 (-0.650)	-0.0024 (-5.544)	-0.0012 (-2.201)	-0.0003 (-0.644)	-0.0025 (-5.592)	-0.0011 (-2.123)
Size	0.017 (2.474)	0.019 (3.334)	0.014 (1.988)	0.017 (2.548)	0.017 (2.838)	0.017 (2.335)
EBIT	-0.223 (-2.872)	-0.213 (-3.133)	-0.056 (-0.679)	-0.220 (-2.878)	-0.243 (-3.610)	-0.026 (-0.321)
SDEBIT	0.063 (0.498)	-0.181 (-1.647)	0.404 (3.024)	0.069 (0.557)	-0.235 (-2.175)	0.458 (3.481)
CA1	0.236 (5.291)	0.215 (5.504)		0.236 (5.294)	0.216 (5.505)	
CA2			0.558 (9.784)			0.557 (9.726)
ADV	-0.488 (-1.770)	0.100 (0.414)	-0.451 (1.564)	-0.510 (-1.959)	0.298 (1.301)	-0.646 (-2.362)
GROWTH	-0.043 (-1.853)	0.005 (0.261)	-0.055 (-2.244)	-0.043 (-1.844)	0.002 (0.113)	-0.052 (-2.122)
NTDS	-1.011 (-5.459)	-0.242 (-1.500)	-0.497 (-2.543)	-1.016 (-5.531)	-0.195 (-1.208)	-0.544 (-2.788)
TRANS	0.001 (0.241)	-0.013 (-2.516)	0.013 (2.054)			
Adj R^2	0.242	0.211	0.245	0.244	0.201	0.239

Number of Observations: 413
t-statistics in parenthesis
File: DATR18 and DATR19

4.14 The coefficients on variables representing growth opportunities that give rise to agency problems have the right sign in the equation for short-term debt, and GROWTH is statistically significant. Moreover, note that the coefficient of ADV is significant in equation (6), suggesting perhaps that the larger standard error in equation (3) may be due to multicollinearity between ADV and TRANS. We take these results as evidence that short-term debt indeed suffers from agency problems. It is also interesting to note that contrary to results in Long and Malitz, investment in tangible as well as intangible assets suffers from agency problems. The coefficients of ADV and GROWTH in the equation for long term debt are not significant. This result suggests that the government's emphasis on directing credit to growing sectors has balanced the intermediaries' unwillingness to lend to firms that present agency problems.

4.15 The coefficient on NDTS has the correct sign but is not significant in the case of long-term debt. This is consistent with a situation where firms face binding constraints in the amount of long-term debt they can raise. With such binding constraints, there would remain unexploited debt-related tax shields; a decrease in non-debt tax shelters would not result in an increase in long-term debt. In the equations for short-term debt and total debt, the coefficient of NTDS has the expected negative sign and is significant.

4.16 The coefficient on the efficiency variable is positive and significant in the equation for short-term debt: more efficient firms carry a higher level of short-term debt per unit of assets. Long-term debt, however, is negatively correlated with efficiency. This may reflect either of two possibilities. First, directed credit may be primarily distributed to inefficient firms that are experiencing financial difficulties as a way of alleviating current financial distress.[35/] Second, it may also reflect reverse

35/ Such a tendency is often seen, for example, in the distribution of credit from development finance institutions. For the case of Brazil, see World Bank (1990c).

causality: provision of subsidized debt may be causing a reduction in managerial effort and an increase in x-inefficiency.36/

4.17 For comparison, the same equations were estimated after replacing the efficiency index TRANS by that estimated from a Cobb-Douglas production function, CD. The results are reported in Table 4.4. Most estimates are similar to those in the first three columns of Table 4.3, with a few important exceptions. First, note that the coefficients on the efficiency index become insignificant; also, the coefficients in the equations for long-term debt and short-term debt switch signs. Since tests on the production function regressions rejected a Cobb-Douglas specification in favor of a translog, it appears that mis-specification in functional forms of the production function may lead to biases in estimating the role of efficiency variables. Second, the coefficient on ADV in the equation for short term debt becomes significantly negative. This may suggest again that the larger standard errors on ADV in equations with TRANS may be due to multicollinearity.

36/ In that case technical efficiency would not be exogenous with respect to long term debt and the estimates would suffer from a simultaneity bias.

Table 4.4: REGRESSION RESULTS
Efficiency Index from Cobb-Douglas Production Function

Dependent Variable	Debt1	Debt2	Debt3
Intercept	0.597 (8.869)	0.022 (0.358)	0.394 (5.402)
Type1	-0.137 (-2.997)	-0.090 (-2.190)	-0.100 (-1.989)
Type2	-0.205 (-3.181)	-0.122 (-2.094)	-0.124 (-1.739)
Type3	-0.043 (-0.906)	-0.045 (-1.044)	-0.064 (-1.223)
Age	-0.0006 (-1.189)	-0.0023 (-5.526)	-0.0014 (-2.616)
Size	0.018 (3.145)	0.021 (3.923)	0.015 (2.278)
EBIT	-0.231 (-3.269)	-0.239 (-3.740)	-0.046 (-0.593)
SDEBIT	-0.025 (-0.220)	-0.158 (-1.569)	0.264 (2.137)
CA1	0.235 (5.800)	0.249 (6.791)	
CA2			0.524 (9.547)
ADV	-0.446 (-1.784)	0.242 (1.070)	-0.583 (-2.127)
GROWTH	-0.042 (-1.797)	-0.004 (-0.201)	-0.044 (-1.712)
NDTS	-0.923 (-5.903)	-0.186 (-1.321)	0.482 (-2.793)
CD	0.0058 (0.754)	0.0046 (0.653)	-0.0036 (-0.423)

t-statistic in parenthesis

File: DA14

C. Who obtains long term credit? A simple selection model

4.18 The presence of firms that do not have any long-term debt suggests that ordinary least-squares regressions may be biased. An alternative estimation methodology would explicitly take care of the selection that is present in the data set.

4.19 One way to take care of the selection problem is to set up the problem as an intermediary's choice on whether to advance long-term credit to a particular firm; it is hypothesized that intermediaries make this decision on the basis of relevant firm characteristics. Let $V(X_i)$ denote the value to the lender of advancing long-term credit to company i, where X_i is the set of relevant company characteristics. Define a dummy variable I which is equal to 1 if a firm obtains long-term loans and 0 otherwise. An intermediary advances long-term credit to a firm only if the value of lending plus an error term is positive. Then,

$$\begin{aligned} E[I|X_i] &= Pr[\epsilon_i > -V(X_i)] \\ &= F[V(X_i)] \end{aligned}$$

where ϵ_i is a normally distributed disturbance term with mean zero and unit variance and F is the cumulative normal distribution function. This equation is a standard probit regression. The determination of long-term debt is represented by the following equations:

$$\begin{aligned} \text{Debt2} &= Z_i\beta + u_i \quad &\text{if } I=1 \\ &= 0 \quad &\text{if } I=0. \end{aligned}$$

Z_i is the set of company characteristics that explain variations in indebtedness. These two equations represent a standard sample selection model and are estimated by the two step procedure proposed by Heckman (1976).[37]

4.20 A linear approximation is used for the value function V. Variables that should be considered in Z_i are the same as those that have been discussed in the previous section. A priori, one would expect that X_i would also comprise the same company characteristics, except perhaps for the proxy for non-debt tax shields, since this is clearly a demand-side variable. Several experiments were done, and variables whose coefficients were insignificant were removed from the profit equation.

4.21 The results of the estimation are reported in Table 4.5. Firm size seems to influence the choice to advance long-term debt in a major way. Once size is controlled for, it is interesting that age affects negatively the choice of lending, suggesting that long-term loans are advanced to younger firms. The coefficient of GROWTH is positive. Even though the coefficient is not very significant (a P-value of 7%), this result is consistent with the view that capacity expansion is an important consideration in the distribution of directed credit. Finally, the coefficient on the efficiency variable TRANS is negative and significant.

4.22 The second column of Table 4.5 reports the results of ordinary least-squares regression on the set of firms with positive long-term debt. In general the estimates are similar to those in Table 4.3. One interesting difference is that the coefficient on the efficiency variable has a larger standard error (a p-value of 6.6%) although its sign is still negative. The coefficient on the inverse Mill's ratio (lambda) is positive but not significant; the error terms of the selection and indebtedness equations are not correlated.

37/ See Maddala (1983) for a discussion of the method. The model used here is very similar to those used in the literature on firm growth; see for example Evans (1987), Hall (1987) and Dutz (1990).

Table 4.5: SELECTION MODEL FOR LONG TERM DEBT		
	Selection Equation	Indebtedness Equation
Intercept	-0.269 (-0.463)	-0.166 (-0.139)
Type1		-0.089 (-1.943)
Type2		-0.110 (-1.606)
Type3		-0.051 (-1.066)
AGE	-0.0015 (-2.074)	-0.0028 (-3.573)
SIZE	0.402 (4.586)	0.034 (2.101)
EBIT		-0.242 (-3.068)
SDEBIT		-0.134 (-1.156)
CA1		0.267 (6.128)
ADV		0.115 (0.396)
GROWTH	0.966 (1.798)	0.016 (0.219)
NDTS		-0.236 (-1.413)
TRANS	-0.206 (-2.195)	-0.017 (-1.837)
LAMBDA		0.199 (1.116)
Number of Observations	478	440

t-statistics in parenthesis.
File: R04

4.23 It is interesting to note that the ratio of collateral assets does not seem to play a significant role in whether a firm receives long-term loans or not. Additional variables were included in the selection equation for further experimentation. Alternative measures of profitability, such as gross margins, were not significant. Export orientation, as measured by the share of exports in total sales, was also not significant. This is a surprising result since one of the more important directed credit programs specifically targeted exporting firms.

V. CONCLUSION

5.01 Perhaps the most important conclusion that may be derived from the findings reported in this paper is that there are important differences between short-term and long-term debt. The complementarity between short-term debt and internal funds seems to be much larger than that between long-term debt and internal funds. Size is an important element in both types of debt but seems to be more important for long-term debt both in terms of magnitude and significance. There is a positive relationship between short-term debt and efficiency, whereas that relation is negative in the case of long-term debt. The volume of long-term debt is not sensitive to the existence of non-debt tax shields, but the volume of short-term debt is.

5.02 These findings are consistent with a market structure where there is severe rationing of long-term debt but a relatively active and fluid market for short-term debt. That does not mean that the market for short-term debt is free of agency problems. In fact, contrary to predictions of the literature, variables that capture the agency problems of the type discussed by Myers (1977) are negatively related to short-term debt, suggesting that even short-term debt contracts suffer from these problems. Furthermore, results indicate that even in the case of short-term debt, fixed transaction costs make borrowing relatively more expensive for smaller firms.

5.03 The empirical results also suggest that "small" and "young" do not necessarily mean the same thing. More important, controlling for size, young firms seem to be more indebted than old firms. This finding deserves several comments. First, concerns that directed credit programs may be reinforcing the dominant position of incumbents seem unfounded. In fact, empirical results suggest that making long-terms funds available to young firms may be one of the few successes of government intervention in credit markets, if any. Second, this finding may also provide a partial explanation of the observed high incidence of exit among young firms:[38] It is well known that indebtedness is an important factor that increases the probability of bankruptcy. Hence, it is likely that a higher level of indebtedness is one of the factors behind high exit rates among younger firms. In fact, these findings suggest that the real constraint young firms face is equity rather than credit. The policy implication is that if governments want to increase the access of young firms to external finance, they should promote the provision of equity capital rather than credit.[39] Of course, this conclusion needs to be qualified since the financial data set in this paper excludes very small firms. It may be that very small firms are completely financed by equity, and indebtedness may increase with age within that group.

5.04 The empirical evidence does not present a favorable picture of the way government intervention has operated in Colombia. The data clearly indicate that concern with absence of long term credit is justified. However, existence of subsidized directed credit programs does not seem to have solved the problem. Compared to large firms, a much larger portion of small firms are completely cut off from subsidized long term loans; in fact, size turns out to be a significant determinant of whether a firm obtains long term credit or not. Given the additional evidence of a negative relation between long term indebtedness and efficiency, the social desirability and efficiency of the subsidized credit programs in Colombia are highly questionable.

5.05 The problem seems to be that directed credit programs did not adequately take account of the main imperfections in the financial sector, namely problems of costly contract enforcement and imperfect information. The severity

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38/ See Roberts (1989) for evidence that exit rates are higher among younger firms.

39/ Admittedly, causality is not clear in this issue. The modern literature on firm growth and exit emphasizes learning rather than financial constraints (Jovanovic, 1982). In that context, high indebtedness of young firms could be viewed as a result of poor performance rather than equity constraints. Clearly, this is an important empirical issue that deserves future research.

of agency problems may explain the intermediaries' unwillingness to allocate subsidized loans to small firms. Problems were possibly aggravated by requiring banks to allocate these loans to sectors which faced capacity constraints, that is, sectors that are characterized by additional agency problems due to high growth potentials. Indeed, given the design of the directed programs, it seems that high collateral requirements and savings on transactions costs were the only way that intermediaries could make such lending profitable. This, of course, beats the purpose of directed credit.

5.06 The absence of an independent market for long term debt, and the modalities in which short term debt substitutes for it remains as an enigma, possibly in a large number of other countries as well. It seems that further research should focus on an important feature of short term debt in developing countries, namely that it is often rolled over and therefore represents a stable source of financing even in the long run. In that sense, it may represent an implicit commitment by the lender, who nevertheless retains the option of terminating this commitment. At first sight, this solution to the long term financing problem may be seen as inferior to a long term contract which would specify explicitly conditions under which the contract would be terminated. However, feasibility of such a long term financing contract requires that breach of contract can be identified by an authorized third party, most notably the court system, in a relatively easy and costless manner. When such an enforcement mechanism does not exist (due to inaccuracy and the slowness with which the court system can resolve conflicts), a contract which delegates the decision to terminate an implicitly long term financing relation to one of the parties may be superior to an explicitly long term contract.[40/],[41/] Theoretical explora

40/ See Mayer (1989) for a somewhat similar discussion about the contractual characteristics of long term debt.

41/ An interesting reflection of the weaknesses in the court system in Columbia was the recent decision to transfer the authority to resolve bankruptcies of large firms from the courts to the Superintendency of Companies, which is an administrative body. One of the main reasons of this move was to speed up the bankruptcy procedures, which, under the court system, took extremely long. See Atiyas (1989) for a review of the bankruptcy procedures in Colombia.

tion in this area needs to be supplemented by further empirical evidence on the roles of short- and long-term debt in capital accumulation.

5.07 If contract enforceability is indeed the main problem that hinders the development of markets for long term loans, then this would have important implications for government policy. The most important implication is that development of such markets may require more efficient legal and institutional infrastructure rather than directed credit mechanisms.

APPENDIX 1

A SIMPLE MODEL OF EFFICIENCY AND CAPITAL STRUCTURE

In section III it was argued that when firms are differentiated by their levels of efficiency, more efficient firms may be both larger and more indebted in equilibrium. The objective of the Appendix is to present a simple model of capital structure determination that generates these predictions. The model is a variant of those explored in Dotan and Ravid (1985) and Dammon and Senbet (1988).

Think of an entrepreneur whose gross revenues are given by a stochastic revenue function $G(\theta,K,\upsilon)$, where K stands for the capital stock, θ is a parameter that reflects the entrepreneur's degree of efficiency and υ is a random variable that takes values in $[v_1,v_2]$. Any realization of υ is denoted by v. The distribution function of υ is given by F and the density function by f. For the derivations below, it will also be useful to assume that the hazard rate which is defined as $h(v) = f(v)/[1-F(v)]$ is increasing in v; $h'(v) \geq 0$.[1/] Revenues are increasing in efficiency and the capital stock and concave in the latter: $G_\theta > 0$, $G_K > 0$ and $G_{KK} < 0$. I also assume that $R_v > 0$ so that higher v correspond to better states of the world. To make the analysis tractable I assume that the revenue function takes the special multiplicative form

$$G(\theta,K,\upsilon) = \theta R(K)\upsilon,\ R_K > 0,\ R_{KK} < 0.$$

There are two dates in the model. At date 0, the entrepreneur chooses the level of the capital stock and the amount of debt, D, that he borrows from a bank. Payments for the cost of physical capital is at date 0. I assume that the efficiency of the entrepreneur is exogenously given. The contractual interest factor (one plus the interest rate) is given by r; hence the face

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1/ This property is satisfied by many distributions, including the uniform, the normal, the logistic and the exponential.

value of debt is rD. At date 1, revenues are realized. The distribution of revenues to claimholders is as follows. Let the bankruptcy state, $v^b(K,D;r,\theta)$, be defined by

$$\theta R(K) v^b = rD \tag{1}$$

If gross revenues are higher then the face value of debt, (if $v \geq v^b$), then the entrepreneur repays the bank, pays taxes that amount to $t[\theta R(K)v - rD]$. Note that debt repayments are tax-deductable. If gross revenues fall short of the face value of debt ($v \leq v^b$), the firm goes bankrupt, the bank takes over the revenues, and the entrepreneur incurs a bankruptcy cost c. Assuming that the price of capital is unity, the future value of expected profits of the entrepreneur is given by

$$\Pi(K,D;r,\Theta) = (1 - t) \int_{v^b} [\Theta R(K) v - rD] \, dF(v) - F(v^b) c - K\rho \tag{2}$$

where ρ is the risk-free interest rate and v^b is as defined above.

The first term in (1) is expected after-tax profits, the second term is expected bankruptcy costs and the last term is the future value of the cost of capital.

The contractual interest rate must be such that the expected return to the bank is equal to the risk free rate. Hence r must satisfy the following arbitrage condition:

$$H(v^b(K,D;r,\theta),K,D;r,\theta) = \int^{v^b} \theta R(K) v dF(v) + [(1-F(v^b)] rD - \rho D = 0 \tag{3}$$

Expression (3) can implicitly be solved for r as a function of θ,K and D.

The entrepreneur maximizes Π over K and D, subject to (1) and (3). The problem can be simplified by substituting from (3) into (2). In that case, the future value of expected profits is given by

$$\Pi(K,D;\theta) = (1-t)E[\theta R(K)\upsilon] + t\rho D - F(v^b)c - K\rho \tag{4}$$

where E[] is the expectations operator. Hence, expected profits is equal to the after-tax expected gross revenues plus expected value of tax shields minus expected bankruptcy costs minus the cost of investment. Maximization of Π yields the following first order conditions

$$\Pi_K = (1-t)E[\theta R_K\upsilon] - cf(v^b)\frac{\partial v^b}{\partial K} - \rho = 0 \tag{5}$$

$$\Pi_D = t\rho - cf(v^b)\frac{\partial v^b}{\partial D} = 0 \tag{6}$$

Rewriting equation (6) in a different form will help the derivations below. Differentiating (3) totally, it is straightforward to derive:[2/]

$$\frac{\partial v^b}{\partial D} = \frac{\rho}{\theta R(1-F)} \tag{7}$$

Substituting, expression (6) can be rewritten as

2/ From (3), $\partial r/\partial D = -H_D/H_r$; and $H_D = (1-F)r - \rho$ and $H_r = (1-F)D$.

$$\Pi_D = t\rho - \frac{c\rho}{\theta R} h(v^b) = 0 \tag{8}$$

The first question one can ask is the following: How is size (capital) correlated with debt? More precisely, supposing that size increases due to exogenous reasons, what is the direction of change in the optimal level of debt? To answer that question, differentiate (8) totally, to obtain $\partial D/\partial K = -\partial\Pi_{DK}/\partial\Pi_{DD}$. $\Pi_{DD} < 0$ by the second order condition. Furthermore,

$$\Pi_{DK} = -\frac{c\rho}{\theta}\left[\frac{h'}{R}\frac{\partial v^b}{\partial K} - \frac{hR_K}{R^2}\right] > 0 \tag{9}$$

The second expression in the square brackets (including the minus sign) is negative. Since $h' > 0$, the first term is of the same sign as $\partial v^b/\partial K$. To evaluate the latter, differentiate (1):[3/]

$$\begin{aligned} \frac{\partial v^b}{\partial K} &= -\frac{rDR_K}{\theta R^2} + D\frac{\partial r}{\partial K} \\ &= -\frac{rDR_K}{\theta R^2} - \frac{\theta R_K F}{(1-F)} < 0 \end{aligned} \tag{10}$$

Therefore, $\Pi_{DK} > 0$ and $\partial D/\partial K > 0$. We therefore have

<u>Result 1</u>: An exogenous increase in the level of capital causes an increase in the level of debt; everything else constant, debt and size are positively correlated.

3/ Note that from (3), $\partial r/\partial K = -H_K/H_r$ and $H_K = \theta R_K F(v^b)$.

In order to interpret this result, note from equation (6) that at the equilibrium level of debt, the firm balances the marginal future value of debt related tax shields with expected marginal bankruptcy cost. An exogenous increase in capital reduces expected marginal bankruptcy costs, therefore calling for additional debt to restore equilibrium.

Note also that this result is different from that obtained in Dotan and Ravid (1985) where debt and capacity are negatively correlated.

We now concentrate on the case where size and debt are jointly determined and inquire about the effect of changes in the level of efficiency on size and indebtedness. Totally differentiating (5) and (6) with respect to θ and using the Cramer's rule, we obtain:

$$\frac{dD}{d\theta} = \frac{\Pi_{DK}\Pi_{K\theta} - \Pi_{KK}\Pi_{D\theta}}{H} \tag{11}$$

where $H = \Pi_{DD}\Pi_{KK} - \Pi_{DK}\Pi_{KD}$. If an optimum exists, then it must be true that $H > 0$, and Π_{DD}, $\Pi_{KK} < 0$. We now turn to the other terms in (11).

Starting with Π_{DK}, from (8) we have

$$\Pi_{DK} = -\frac{c\rho}{\theta}\left[\frac{h'}{R}\frac{\partial v^b}{\partial K} - \frac{hR_K}{R^2}\right] > 0 \tag{12}$$

where the inequality follows from the fact that $h' > 0$ and $\partial v^b/\partial K < 0$. Furthermore, $\Pi_{D\theta} = (c\rho h/\theta^2 R) - [(c\rho h'/\theta R)(\partial v^b/\partial\theta)$ which is larger than zero, since $\partial v^b/\partial\theta < 0$.[4] Finally, From Young's theorem, we know $\Pi_{K\theta} = \Pi_{\theta K} = (1-t)E[R_K \upsilon]-f(\partial v^b/\partial\theta) > 0$. Putting all these pieces together, we find

Result 2: $dD/d\theta > 0$; more efficient firms carry more debt in equilibrium.

To derive the effect of higher efficiency on the level of physical capital, use Cramer's rule to obtain:

$$\frac{dK}{d\theta} = \frac{\Pi_{KD}\Pi_{D\theta} - \Pi_{DD}\Pi_{K\theta}}{H} \tag{13}$$

The only additional information we need is the sign of $\Pi_{D\theta}$. From (8)

$$\Pi_{D\theta} = -\frac{c\rho}{R}\left[-\frac{h}{\theta^2} + \frac{h'}{\theta}\frac{\partial v^b}{\partial\theta}\right] > 0 \tag{14}$$

where the last inequality follows from the fact that $h' > 0$ and $\partial v^b/\partial\theta < 0$. Therefore,

Result 3: $dK/d\theta > 0$. More efficient firms are larger in equilibrium.

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[4] Note that $\partial v^b/\partial\theta = -(rD/\theta^2 R) + [(D/\theta R)(\partial r/\partial\theta)$. Furthermore, $\partial r/\partial\theta = -H_\theta/H_r$. H_r was derived above and is larger than zero. From ...., $H_\theta = \int^{v^b} Rv\, dF(v) > 0$. Hence $\partial r/\partial\theta < 0$ and $\partial v^b/\partial\theta < 0$.

APPENDIX 2

DATA PREPARATION

Sources of data

Data used in this paper come from two different sources. Age and real side variables such as output, capital, labor, materials, gross investment and advertising expenditures are obtained from cross sectional census of manufacturing plants (hereafter called the C data set). The data are available for the years 1977-87; this paper uses data from the period 1981-87. The census covers all manufacturing plants except in 1983 and 1984 when plants with fewer than 10 employees were not included in the surveys. There are about 5,000-6,000 observations per year and more than 11,000 plants that are followed over time. Details about this data set can be found in Roberts (1989).

The second source is financial data in the form of income statements and balance sheets of firms registered at the Superintendencia de Sociedades (hereafter called the S data set). Registration at the Superintendencia is required for the following firms in Colombia: firms which have foreign liabilities that are more than one third of the value of their assets, firms with more than 100 permanent workers and firms in which the government's equity participation exceeds 50 percent. The data set comprises about 900-1,000 observations per year, over the years 1983-1987.

Since most of the empirical analysis in this paper required using both real and financial data, as well as the estimates of technical efficiency, observations on individual firms in the two data sets had to be combined. Both data sets contained identification codes making it possible to trace, in each data set, observations on individual firms over time.[1/] However, since the two sets did

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1/ The Superintendencia data set was provided with identification codes. The codes for firms in the data set were constructed by Roberts through a cross-year matching process which is explained in detail in Roberts not use identical identification codes for individual firms, observations in the two sets had to be matched through common variables. Once the two sets were matched for a specific year, then existing identification codes could be used to consistently include information from other years.

Algorithm used to match real and financial data sets

The two data sets contain some common variables such as inventories, capital stock and sales. The matching was done through 8 of those variables. These *matching variables* were total inventories, inventory of raw materials, inventory of goods in process, inventory of finished goods, total buildings, plant and equipment, buildings, machinery and equipment and sales income. There were two potential sources of non-uniqueness and spurious matches. First, within each data set a variable could have non-unique values. This would result in the matching of a firm, say, in the S set to more than one firm in the C set through the same matching variable. Second, different matching variables could match a firm in, say set S, to more than one firm in set C. In the algorithm developed below, steps A and B address these problems, respectively:[2/]

Step A. (i) Start with original data sets S and C. Eliminate all observations in S and C where the first matching variable, m_1, is equal to zero. Match remaining observations in S and D through m_1, and create the matched data set M_1. (ii) Locate all non-unique matches in M_1. In each case, select one of the non-unique matches as the correct one, if that particular match results in the

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(1989).

[2/] The matchings were carried out through the Merge statement in SAS. The actual algorithm was slightly more complicated than what is described below because of the way the SAS Merge statement handles multiple values.

highest number of matches across matching variables other than m_1. In cases where none of the non-unique matches are superior, delete all matches. (iii) Repeat steps (i) and (ii) for matching variables m_i, $i = 2,..8$.

Step B. (i) Merge data sets $M_1,.., M_8$ into M. (ii) Locate all non-unique matches in M. Select the match that results the highest number of equalities across all matching variables as the best match, delete the rest. In cases where none of the non-unique matches are superior, delete them all.

The resulting set M contains the identifications codes of both sets S and C. A total of 550 observations from the two sets were matched in this way.

There is an important difference between the approach used here and that used in Roberts (1989). Roberts could use discrete variables (such as 4-digit SIC codes, region in the country, etc) in the matching procedure; this reduces considerably the danger of spurious matches. Such discrete firm characteristics were not present in the S data set, except for SIC codes. However, matching through SIC codes did not seem desirable: records in the S and C sets that clearly corresponded to the same firm frequently displayed different SIC codes. In any case, the number of spurious matches do not seem to be high relative to the number of observations in the resulting matched data set.

There are several problems with the approach adopted here. First, it requires values to be identical across data sets S and C. If, for example, the value of a characteristic of a firm is different in S and C only due to rounding-off, the procedure described above misses this match. Hence the procedure can be improved by matching not only identical values but also values that differ at most by one unit. Second, the matching was done for one year. The number of matches can be increased by following a similar procedure across other years. This would also provide a further check for spurious matches. In the present case, this could not be done for the years 1985-87 because for those years the S data set does not contain individual components of inventories and capital stock. This creates a problem because individual components of inventories and capital stock were the most useful variables in the matching procedures; they produced the highest number of pairs. It is still possible to carry out a matching for the year 1983 and for what common variables remain for 1985-1987. Since the matched data set was already sufficiently large, further matching was not done for the present paper to save on computer costs.

Further adjustments were made to the matched data set. First, observations that correspond to a status of bankruptcy and those where total debt is larger than total assets have been deleted from the data set. This was done because the financial data for these firms reflect extraordinary financial transactions, including agreements reached with creditors under a bankruptcy process or administrative interventions, which are beyond the scope of analysis of this paper. Second, as explained in section IV.A, firms that moved between sectors were deleted from the C data set in order to reduce the number of parameters that need to be estimated in the construction of the efficiency index. Finally, firms that did not have complete financial data throughout 1983-87 were also deleted. As a result, the number of firms available for the econometric analysis of indebtedness was 413.

As a general rule, the largest possible data set is used in each step of the empirical analysis presented in this paper. For example, the estimation of the production function and the index of technical efficiency reported in section IV.A relies on all of the census data. The regressions in sections IV.B and IV.C are carried out on the matched data set. The descriptive statistics in section II.B relies on all observations in the financial data set, whenever possible.

Description of variables

Whenever more than one variable was involved in constructing the variables used in the empirical analysis, these variables were chosen from the same data set. For example, the ratio of gross investment to the capital stock was constructed from the investment and capital stock variables available in the C data set, even though capital stocks were also available in the S data set. The ratio of collateralizable assets to total assets, on the other hand, was calculated directly from the balance sheet data in the S data set. Variables used in the empirical work on indebtedness were taken from the balance sheets in the S data set, except for age, the ratio of investment to capital stock, the ratio of advertising expenditures to total sales, and the efficiency variable. All variables used in the estimation of the production functions are obtained or constructed from the C data set.

Details on the variables constructed from the C data set can be found in Roberts (1989); here I only report further modifications. Real capital stock has been constructed through the perpetual inventory method, with a slight change from the method used in Roberts (1989): Whereas Roberts takes the investment flow as the base value of the capital stock of new entrants, I have taken the reported end of period capital stock as the base value. Individual components of investment flows were deflated through aggregate price index for capital goods which is separately available for buildings, land, and machinery. End-of-period capital goods prices were expressed as a geometric average of the mid-year capital goods price index. Output is defined as sales plus the change in inventories of finished goods. The values of both beginning and end-of-period inventories have been adjusted to account for inflation and to express inventories in mid-year prices. It was assumed that the value of inventories is recorded according to the weighted average method. Output price indices, available at the 3-digit SIC level, were used to convert sales and inventories into mid-1977 prices. Materials has been defined as output minus value added. Individual components of value added have also been adjusted to correct for inflation biases. The materials price index reported in Roberts (1989) has been used in the adjustment. Labor is defined as total employment. The advertising variable, ADV, is defined as advertising expenditures divided by sales, both expressed in nominal terms. AGE is defined as 1984 minus the year of startup of operations.

Variables constructed from the S data set are self-explanatory. All stock variables are expressed in end-of-year prices. Accounting rules in Colombia require firms to revalue fixed assets; no additional corrections for inflation were undertaken on the data set. This may cause some inflationary bias in the calculation of the ratio of earnings before interest and taxes to total assets (EBIT) due to the biases in the valuation of changes in inventories.

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June 6, 1991

SUBJECT: Progress of privatisation in Latin America (Part 4 of 6): Colombia.

SIGNIFICANCE: Progress towards privatisation has so far been slow, and will continue to be impeded by political uncertainties.

ANALYSIS: Privatisation is not a new idea in Colombia. In the 1940s, the Industrial Development Institute (IFI) was set up to create enterprises, which, when mature, were to be sold to the private sector. However, present thinking on selling off state assets has been stimulated by recent stabilisation agreements with the IMF, which are premised on moves towards economic liberalisation. Such moves include the privatisation of state enterprises, steps to attract foreign capital, and opening up the national market to foreign competition.

The ostensible aim of the privatisation programme is to improve the efficiency with which state companies are run, especially through the depoliticisation of management; to widen the extent of economic ownership; and to raise cash for the treasury. However, there has been considerable debate over which of these objectives should prevail, and this has been at the centre of disagreements over pricing policy:

-- If the main aim is to provide income, then selling the most profitable companies would bring a one-off cash injection, but deprive the state of revenue in the longer term.

-- If the idea is to democratise economic ownership, then prices should be pitched low enough so as to attract a wide spectrum of Colombian investors. In some cases, in order to sustain output, there are arguments in favour of companies being given away.

The current programme covers banks, ports, industrial enterprises and public utilities like waste disposal and telephones. Moreover, the Constituent Assembly -- which is currently rewriting the country's constitution -- is considering the privatisation of the Colombian Social Security Institute and the provincial liquor monopolies.

Banks. Having taken control of five banks in the course of the early 1980s -- the Banco del Estado, the Banco de Colombia, the Banco de Tequendama, the Banco de los Trabajadores and the Banco del Comercio -- at a time when they were facing severe economic difficulties, the government is now preparing for their eventual reprivatisation. The banks are now in better shape and confidence in them has been restored.

However, despite this, they are not proving easy to sell. This is in large part because of problems caused in the past by illegal banking practices which are still under investigation, the size of their debts, and legal wrangles with clients and former shareholders. Also, it has been difficult to evaluate their contingent liabilities and the scale of the investment needed to modernise their infrastructure. Meanwhile, the government's anti-inflation policy, with its tight squeeze on credit and its very high reserve requirements, has reduced banks' profit margins and undermined their plans for expansion.

Manufacturing industries. IFI is currently preparing for sale its shareholding in 20 manufacturing companies, in two separate stages. The first are to be sold off immediately. They include 11 companies in such sectors as textiles, fishing, shipbuilding, salt and coal. The second, which includes nine companies in a similar wide range of industrial sectors, will be put up for sale at an as yet unspecified future date. They are less attractive propositions than those on the first list, and may require considerable expenditure to prepare them for privatisation. Of the total, nine will be sold through the stock exchange, and four -- the largest holdings -- through auctions, for an estimated value of just over 20 billion pesos (32 million dollars).

Ports. Concerned to remove barriers to trade, the government is anxious to increase the efficiency of the country's ports. Up to now these have been run mainly by a state entity, Puertos de Colombia. Rather than transferring ownership of the ports to the private sector, it is planning to hire private sector companies to provide services.

In all cases, the extent to which privatisation brings an injection of cash into the public coffers and stimulates efficiency will hinge on the pricing policy to be adopted. This is not clear as yet. Also, the degree to which privatisation induces a redistribution of capital between the private and public sectors will depend on how the government spends the resulting revenue.

Where privatisation is achieved through the extension of management contracts to the private sector rather than through a transfer of ownership, the experience to date has not been very positive in fiscal terms. For instance, in the case of waste disposal contracts in Barranquilla and Bogota, and in that of Prodeco, a private port, private concerns took advantage of their monopoly position to sell services to the government at high rates.

LATIN AMERICA: Privatisation Progress

The government intends to attract foreign investment through its privatisation programme as well as through other avenues. To this end it has enacted reforms to the labour code, to the foreign exchange rules, and to the foreign investment regime itself (see OADB, March 18, 1991, IV). However, such incentives are likely to have only limited success, given that Colombia's record of political violence acts as a strong disincentive to would-be foreign investors.

CONCLUSION: The future of the programme will hinge on the pricing policy to be adopted.

Keywords: LA/C, Colombia, economy, industry, politics, private sector, foreign investment, policy, transport, banking, government, guerrillas

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: May 16, 1990

TO: Kanella Vasiliades, Acting Chief, LA3TF

FROM: Kristin Hallberg, LA3TF KH

EXTENSION: 31970

SUBJECT: COLOMBIA: IFI Divestiture and Restructuring Project Pre-Appraisal Mission: Back to Office Report

1. Per terms of reference dated April 20, 1990, I visited Colombia April 30-May 10, 1990, to pre-appraise the Instituto de Fomento Industrial (IFI) Divestiture and Restructuring Project. Also participating in the mission were Messrs. Jones and Lieberman and Ms. Keller.

2. The main objectives of the mission included clarifying IFI's future strategy and policies with IFI management and the Ministry of Economic Development; agreeing on a plan of implementation of the new strategy; reviewing IFI's financial situation and financial projections; and evaluating progress on the divestiture program. The mission was impressed with the speed and quality of work that IFI has done in recent months to define and implement its new strategy, to proceed with the divestiture program, and to resolve other financial problems of the institution. Looking back at the suggestions made by previous missions, it is clear that IFI has made substantial achievements in virtually all areas.

3. A Policy Letter outlining IFI's future role in industrial and financial development as well as the institution's credit and investment policies was drafted with IFI and discussed with the Minister of Economic Development (a copy is attached to the Aide Memoire, Annex 1). Some elements of this strategy that are worth noting include:

- IFI's strategy justifies its role as a public sector financial institution based on the financing needs of the Government's recently announced trade reform and industrial restructuring programs, and deficiencies in private financial markets. A central objective of the strategy is that IFI assume a catalytic role in financial sector development to help eliminate these deficiencies.

- As this occurs, and as IFI improves its own financial situation, IFI will attempt to attract private sector participation in its own capital. Thus the strategy contemplates a transitional role for IFI as it moves toward partial or complete privatization.

- In contrast to IFI's historical emphasis on large investments in industrial enterprises followed by credit support, in the future IFI will act mainly as a first tier credit institution, limiting direct investments to a small venture and seed capital fund. IFI will provide integrated financial support to industrial enterprises, developing packages of financial instruments and cofinancing arrangements with private institutions to finance individual projects.

- IFI will initially target the market segment of medium scale enterprises, allocating credit on the basis of economic and financial project evaluation and the cash flow prospects of the enterprise and project. In keeping with the financing needs of trade reform and industrial restructuring, priority will be given to financing new firms, products, markets, and/or technologies.

- The implementation of IFI's strategy will include replacement of earmarked Government sources of funds with resources mobilized from domestic and external markets. IFI's interest rates will be maintained at market rates, i.e., DTF plus a spread adequate to cover intermediation costs, maturity, risk, and a normal profit.

- IFI's general financial objective will be to generate sufficient earnings and dividend payments to attract both market sources of funds and private investment, which will eventually allow IFI to attract significant private participation in IFI's capital structure. IFI will develop financial performance criteria with respect to profitability, liquidity, portfolio management, leverage, and dividend payout policy.

4. The mission and IFI defined the issues that need to be resolved before loan negotiations, the most important being (i) significant progress on resolving the problem of the Bonos de Valor Constante deficit (in which the Government and IFI agree on IFI's share of the deficit and on the transfer of assets to settle this obligation); and (ii) significant progress on establishing a trust fund to handle several "problem cases" -- enterprises owned or managed by IFI that may need to be restructured prior to sale. With respect to the former issue, a task force including representatives of IFI, the Ministry of Economic Development, the Ministry of Finance, and the National Planning Department will prepare an implementation plan for presentation to CONPES.

5. The mission received or is being sent all information necessary to complete the Staff Appraisal Report for the project. On this basis, the mission informed IFI management and the Government that it would request that the current mission be upgraded to Appraisal, and that the draft SAR be used as the basis for loan negotiations. The mission also discussed with the Minister of Economic Development, during both the initial and wrap-up meetings on the project, the issues likely to be raised by Bank management during further project processing, including the need to harmonize and reduce interest rate subsidies rates across sectors.

cc: Messrs./Mesdames. Garcia-Zamor, LA3DR; Page, LA3C1; Hari Prasad, Res. Rep.; Ramirez/Hwa, LA3C1; Jones/Keller/Hanna, Saez, LA3TF; Lieberman, Consultant; Linares, LA3IE; Iskander, LATTF; Hernandez, IFC; LAC Info. Center

IFI DIVESTITURE AND RESTRUCTURING PROJECT

AIDE MEMOIRE

May 8, 1990

Introduction

1. A World Bank mission visited Colombia April 30-May 9, 1990, to pre-appraise the Instituto de Fomento Industrial (IFI) Divestiture and Restructuring Project. Participating in the mission were Kristin Hallberg, Howard Jones, Ira Lieberman, and Jennifer Keller. The mission would like to express their appreciation to the Government and particularly to the staff and management of IFI for their cooperation and continued close working relationship.

2. The mission was impressed with the speed and quality of work that IFI has done in recent months to define and implement a new strategy, to proceed with the divestiture program, and to resolve other financial problems of the institution. Looking back at the suggestions for reform made by previous missions, it is clear that IFI has made substantial achievements in virtually all areas. This allowed the current mission to focus on a few remaining key project issues, which are detailed below.

IFI's New Strategy

3. The mission and IFI agree on the proposed new strategy for IFI as expressed in a draft Policy Letter for the institution (Annex 1). The mission will recommend that the Bank seek Government approval of a Policy Letter for IFI as a condition of loan presentation to the Bank's Board of Directors.

4. The Bank will also require, as a condition of the loan, a plan to implement IFI's new strategy with benchmark dates for key actions. The mission proposes that IFI prepare a draft matrix outlining this implementation plan (including key steps and timing) for inclusion in the staff appraisal report for the project. The implementation plan and matrix will be reviewed during loan negotiations.

5. The mission would like to express its views on a few aspects of IFI's proposed strategy:

(a) IFI's strategy justifies its role as a public sector financial institution based on the financing needs of the Government's recently announed trade reform and industrial restructuring program, and deficiencies in the private financial sector. One objective of the strategy is that IFI assume a catalytic role in financial sector development to help eliminate these deficiencies. As this occurs, and as IFI improves its own financial situation, IFI should attempt to attract private sector participation in its own capital.

(b) The implementation of IFI's strategy should include replacement of earmarked Government sources of funds (e.g., Bonos de Valor Constante (BVCs), Fondo Automotriz, and Law 68/83) with resources mobilized from domestic and external markets.

(c) The local capital goods industry should not receive preferred access to IFI financing; credit should be allocated according to the same evaluation criteria as for other sectors.

The BVC Fund Deficit

6. The mission will recommend to Bank management that the problem of the BVC deficit be resolved by IFI and the Government before Board presentation, and that significant progress be made before loan negotiations. This resolution should include the following:

(i) IFI and the Government should agree on IFI's obligation to ultimately resolve the BVC problem, and IFI should transfer assets to the BVC Fund to settle its obligation.

(ii) IFI's responsibility for administering the BVC Fund should be transferred to other(s), and a program for transferring BVC assets and liabilities to this new body should be agreed.

IFI would need to demonstrate to the Bank that after payment of its final obligation to the BVC Fund, its financial position (including its equity base) would be such as to justify the proposed Bank loan. This implies that a speedy resolution of the BVC problem is essential.

7. To achieve a resolution of the BVC problem, the mission recommends that a task force including representatives of IFI, the Ministerio de Desarrollo Economico, the Ministerio de Hacienda y Credito Publico, and the Departamento Nacional de Planeacion attempt to resolve legal issues and prepare an implementation plan for presentation to CONPES.

Divestiture Program

8. The mission notes that progress on IFI's 1989-91 divestiture program is in line with the plan previously submitted to the Bank, and in addition includes holdings not previously scheduled for divestiture. Moreover, IFI has engaged the services of investment banks and brokerage firms to assist them

in this process, which ultimately should accelerate divestiture. The pending privatization of Papelcol will resolve one of IFI's most pressing divestiture problems.

Trust Fund for Problem Cases

9. The mission proposes the establishment of a trust fund containing specific "problem cases" of parastatal enterprises currently owned or managed by IFI (Alcalis de Colombia, Conastil, and Concesion Salinas) to handle their restructuring, liquidation, and/or privatization. IFI's obligations as trustee of this fund should be clearly defined. The mission will recommend to Bank management that the trust fund be established before Board presentation of the proposed loan.

Financial Projections

10. Detailed financial projections covering the next five years were prepared by IFI and discussed with the mission. The mission considers the model to provide an adequate methodology to estimate the future financial condition and results of IFI, and will be useful in estimating the volume of credit to be provided by IFI and IFI's sources of funds. The mission has requested that IFI re-run the model under a set of modified assumptions that were specified.

Amount and Components of the Proposed Loan

11. More work needs to be done to define the amount and components of the proposed loan. Specifically, estimates are needed for:

(i) technical assistance requirements and proposed retroactive financing of technical assistance already completed or in progress;

(ii) a component to cover restructuring of problem cases, assuming that the final loan agreement will allow some flexibility to transfer funds between this component and the credit component of the proposed loan; and

(iii) the credit component, using the revised financial projections.

These issues will be resolved jointly by IFI and Bank staff prior to loan negotiations.

12. The mission noted that in projects of this type, the Bank normally does not finance more than three years of commitments.

Foreign Exchange Risk

13. A decision is needed on which institution will assume the foreign exchange risk of the proposed loan. The mission and IFI discussed two possible alternatives:

(a) that IFI takes the full foreign exchange risk, provided that it can enter into satisfactory hedging arrangements with the Banco de la Republica (BR) to cover this risk; or

(b) that the Government takes the cross-currency risk for a fee, and IFI takes the peso-U.S. dollar risk.

14. The mission favors the first option, and suggests that BR consider establishing a system to provide this hedging mechanism to IFI. Such a service might also be extended to the private sector to allow them to hedge foreign currency-denominated loans. The mission will recommend that this issue be resolved before loan negotiations.

Next Steps

15. Upon return to Washington, Bank staff will complete the Staff Appraisal Report for the project. The mission requests that before loan negotiations, IFI resolve the issues outlined above, namely:

(i) significant progress on resolving the BVC deficit (paras. 6-7);

(ii) significant progress on establishing a trust to handle special "problem cases" (para. 9);

(iii) preparation of a draft matrix including targets and timing of the implementation of IFI's new strategy (para. 4);

(iv) provision of information necessary to determine the size of the components of the proposed loan (paras. 10-11); and

(v) a decision on how foreign exchange risk associated with the proposed loan will be handled (paras. 13-14).

16. The mission notes that approval of its recommendations and conditions for further project processing are subject to review by Bank management.

Kristin Hallberg

Kristin Hallberg
Mission Leader
The World Bank

Eduardo Robayo Salom
Gerente General
Instituto de Fomento Industrial

IFI Restructuring and Divestiture Project

IFI Policy Letter

May 8, 1990

Introduction

1. The Instituto de Fomento Industrial (IFI) was established in 1940 with the objective of promoting the establishment of basic industry and the initial transformation of domestic raw materials to substitute for imported raw materials. This was in accordance with Colombia's import substitution model of development. IFI's role was basically to invest where the private sector did not wish to invest due to high initial investment costs and higher than normal commercial risk. In addition, since 1963, IFI has been authorized to function as a development bank, lending to industrial firms directly or through other development institutions.

2. In its early years, IFI made direct investments in the food, beverages, tobacco, chemicals, basic metals, and textiles industries. Since 1975, emphasis has shifted to the promotion of exports (such as ferronickel and coal) which the Government supported after the unexpected increase in petroleum prices. In recent years, IFI has tended to concentrate its investments in a few enterprises. This was a likely development as IFI's sources of finance have been relatively limited and the typical investment for IFI was in relatively large projects. A significant share of IFI credit has gone to enterprises in which IFI has an equity participation.

3. In retrospect, many of IFI's investments fell short of expectations. IFI often has felt obliged as a public sector institution to enter into politically motivated investments. IFI has also taken over ownership or management of parastatal enterprises that have performed poorly, keeping uneconomic enterprises in operation through repeated financings. This has slowed or prevented the exit of unprofitable public enterprises, and has led to a drain on IFI's resources. In some cases in which other investors have failed to provide their share of investment costs, or where there have been cost overruns or large operating losses, IFI has been forced to step in to provide additional resources.

4. As the result of the accumulation of financial problems over time, it has become clear to the Government and IFI that the institution must be restructured in all aspects. This would include financial restructuring, portfolio divestiture, restructuring and privatization of problematic parastatal enterprises owned or managed by IFI, and internal reorganization of the institution. The most significant financial issue would

be the resolution of the accumulated deficit of the Bonos de Valor Constante (BVC) Fund.

5. All of these issues are currently being addressed by the Government and IFI, with substantial achievements in all areas. Particular progress has been achieved in defining IFI's corporate mission and product/market strategy, in restructuring its financing and credit policies, and in accelerating its portfolio divestiture. These transition moves have been accompained by a strengthening in various operational capabilities and a subtantial internal reorganization and staffing effort.

General Context

6. IFI's role in industrial development. The reorientation of IFI's operations must be placed within the framework of the trade reform program recently initiated by the Government as an element of the "Programa para la Modernizacion de la Economia Colombiana". IFI's strategy is designed to address the need for industrial restructuring and facilitate the export supply response to the trade reform. The program creates the need for financing new firms, products, and technologies, with a wider range of financial instruments. In addition, IFI's new role complements the Government's efforts to strengthen public sector management, promote private sector development, and improve the allocation of public sector resources. Specifically, IFI's operations will address the following industrial development issues:

- The trade reform program creates the need for long term credit to finance the restructuring of enterprises and for financing the acquisition of new technologies in order to modernize production techniques and improve international competitiveness.

- This additional need for credit occurs precisely at a time when the private financial sector's capability to support new investments and industrial restructuring, in addition to the expected growth in imports, is insufficient.

- Restructuring requires more than credit: an entire pool of financial services will be necessary to support industrial enterprises in their adjustment efforts. In addition, financial institutions involved in restructuring can only succeed if a close and direct relationship with the customer is maintained.

- The need for financing is especially acute for medium scale enterprises, as this market segment currently receives a disproportionately low share of credit relative its production and needs.

- Financial intermediaries tend to make credit decisions based on collateral rather than on projected project profitability or cash flow. The reallocation of productive resources required during the trade reform program will require a more efficient allocation of financial resources to sectors in which Colombia enjoys a comparative advantage.

- The new trade policy regime implies greater levels of risk for financial institutions. Close contact with and knowledge of the industrial sector are prerequisites for sound risk management.

7. <u>IFI's role as a financial institution.</u> IFI's comparative advantages as a financial institution include its knowledge of the industrial sector and its close contact with industrial enterprises; its large size in a relatively small financial sector; and its access to external sources of funds. In its new strategy, IFI's comparative advantages will be related to a more focused financial support business. The historical emphasis on large investments followed by credit support will be replaced by financing of more modest scope in participation with other financial institutions. IFI will act mainly as a first tier credit institution, limiting direct investments to venture and seed capital, and will focus on the market segment of medium scale enterprises.

8. IFI will offer a broad array of financial instruments, in order to provide integrated financial support to industrial enterprises. IFI's financial services will include assistance to determine optimal financial structures, the provision of loans directly or through loan syndication with other intermediaries, assistance to find and coordinate the provision of complementary sources of financing, and taking temporary equity positions via minority share participations and the provision of seed capital.

9. IFI will play a catalytic role in financial markets by developing packages of financial instruments and cofinancing arrangements with other institutions to finance individual projects. Thus IFI will stimulate financial sector development by cofinancing and coinvesting, promoting competition, and stimulating financial innovation. By organizing loans and syndicating project finance packages, IFI will invite the participation of other financial institutions, both domestic and foreign, which will greatly reduce the potential for IFI's participation in unviable projects.

10. In summary, the restructured IFI will focus its financial services on:

- o the provision of medium and long term credit as a first tier financial institution;
- o financing new firms, products, technologies, and markets;
- o evaluation criteria for credit allocation based on project profitability and cash flow;
- o stimulating financial sector development by participating in packages of financing with the private sector;
- o quick and efficient approval and disbursement processes; and
- o the promotion of competition in the financial sector through a more proactive and market oriented strategy that offers the industrial sector a wider and more attractive set of products and services.

<u>Objectives</u>

11. The basic objectives of a restructured IFI are:

- o to finance industrial sector development;
- o to promote financial sector development;
- o to meet clearly stated financial performance criteria; and
- o ultimately, as these objectives are met, to privatize part or all of IFI itself.

<u>Policies</u>

12. <u>Target market.</u> IFI will initially concentrate its industrial financing on the market segment of medium scale enterprises (currently estimated as firms with total assets between Col$1 billion and Col$12 billion). In addition, within its financial capabilities, it will finance and will prepare financial packages for large scale enterprises.

13. <u>Lending policies.</u> IFI's interest rates will be maintained at approximately commercial market rates, i.e., DTF plus a spread adequate to cover intermediation costs, maturity, risk, and a normal profit. IFI will mainly provide medium and long term credit, as required by the financing needs of the project. IFI will limit its credit exposure to any individual client to ten percent of IFI's equity. Credit evaluation will be based on the project's economic and financial viability and the cash flow.

prospects of the enterprise and project, supplemented by appropriate collateral. IFI will offer both local and foreign-currency denominated loans according to the financing needs of individual projects, and will continue to build its letter of credit operations.

14. Investment policies. IFI will distinguish between equity investments in ongoing concerns and requirements for seed or venture capital. For ongoing concerns, investment policies will be the following:

- an adequate economic and financial rate of return;
- exposure limits of no more than ten percent of IFI's equity and no more than thirty percent of the total equity of the enterprise;
- such investments will require a clear definition of IFI's exit strategy;
- consideration will be given to quasi-equity instruments, such as convertible debentures or subordinated debt with warrants, such that the IFI will receive a return on its investment and have the opportunity to benefit from its conversion privileges.

For seed or venture capital, investment policies will be the following:

- the total of IFI's venture and seed capital investments will be limited to a pool of funds representing a percentage of proceeds from ongoing divestitures. The pool would be initially limited to ten percent of IFI's equity, and its growth would be dependent on the success of these investments;
- individual investments will be limited to fifteen percent of the pool;
- such investments will require a clear definition of IFI's exit strategy; and
- priority will be given to projects involving exports, new products, markets, or technologies.

For both categories of investments, IFI will place priority on syndication and the attraction of foreign direct investment.

15. Fee-based business. Fee-based business will be derived from corporate advisory services, restructuring services, and syndication, trust, and other services.

16. Sources of funds. IFI will access market sources of funds in local and foreign markets, including *inter alia* term deposits, credit lines rediscounted through the Banco de la Republica, direct investment through capital markets, bonds, external commercial banks, and bilateral institutions. Multilateral sources will be considered a transitional source of funds.

17. Financial performance criteria. IFI's general financial objective will be to generate sufficient earnings and dividend payments to attract both market sources of funds and private investment, which will eventually allow IFI to attract significant private participation in IFI's capital structure. IFI will develop a concise financial strategy covering the following areas: profitability, liquidity, portfolio management, leverage, and dividend payout policy.

Plan of Action

18. In order to achieve its objectives and stated policies, IFI and the Government will implement the following plan of action:

Financial restructuring of IFI:

- resolution of IFI's liability for the deficit in the BVC Fund and its transfer of fiduciary responsibility and fund management to a third party;
- implementation of the 1989-91 divestiture program;
- establishment of a trust fund containing specific problem cases of parastatal enterprises owned or managed by IFI (Alcalis, Conastil, and Concesion Salinas), for the purpose of their restructuring, liquidation, and/or privatization.

Operational strengthening:

- implementation of new policies and procedures;
- design, development, and implementation of new control and management information systems;
- reorganization of the internal audit function;
- development and implementation of a promotional and marketing strategy.

Internal reorganization of IFI:

- establishment of the new organizational structure;

- development and implementation of a plan to retrain, recruit, and retrench staff.

19. IFI has prepared an overall implementation plan that defines specific steps and timing. A matrix specifying these steps in more detail and an implementation timeframe will be prepared by IFI in support of this policy letter. In addition, IFI has retained the services of external consultants to assist in implementation.

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Initial Executive Project Summary
Revised April 12, 1990

Country:	Colombia	
Project Name:	IFI Divestiture and Restructuring Project	
Implementing Agency:	Instituto de Fomento Industrial	
Tentative Financing Plan:	IBRD	US$ 100 million
	Borrower	US$ 50 million
	Total	US$ 150 million
Tentative Appraisal Date:	June 1990	
Tentative Board Date:	September 1990 (FY91)	

1. Background. The Instituto de Fomento Industrial (IFI) was created in 1940 as a state-owned institution whose objective was the promotion of industrial development through equity investments in basic industries. In addition, since 1963, IFI has been authorized to function as a development bank, lending both to enterprises in its investment portfolio and to non-affiliated firms. As a development bank, IFI also intermediates industrial credit lines rediscounted by the central bank. IFI receives funds for its operations from various sources, the most important traditionally being (i) constant purchasing power bonds (bonos de valor constante, or BVCs) held by the Social Security Institute; (ii) bonds purchased by multinational corporations with profits exceeding allowable remittances; and (iii) earmarked import taxes.

2. At the end of 1988, IFI's investment portfolio, valued at Col$18.8 billion, consisted of equity holdings in 29 operating enterprises in the industrial, agroindustrial, mining, and financial sectors. IFI's investments have generally supported Colombia's import substitution strategy, though they have very dissimilar characteristics in terms of age, size, degree of participation by IFI, and objectives. A large share of the portfolio is concentrated in a few large projects, putting the portfolio at greater risk. In 1988, IFI granted Col$41.1 billion in credit; a significant share of this credit has gone to firms in which IFI had equity participation.

3. In 1988, the Government of Colombia, through the Ministry of Economic Development (IFI's controlling institution) and the National Economic and Social Policy Council (CONPES), decided to restructure IFI's investment portfolio through the divestiture of equity investments in 23 enterprises, which represent 65% of the portfolio. Since that time, IFI has proceeded to sell equity investments according to a phased program of divestiture. In addition, IFI hired an international consulting firm to prepare a strategic plan for the institution, proposing a redefinition of its role in industrial development and financial markets, and developing credit and investment policies consistent with that new role. The strategic plan subsequently adopted by IFI and the Ministry of Economic Development, based on the consultants' report recommendations, forms the basis of the proposed project.

4. Project Objectives. The objectives of the Project are (i) to assist in the implementation of IFI's divestiture program, including the development and implementation of individual restructuring and divestiture plans for several "problem cases"; (ii) to implement a new strategy for IFI's future objectives and functions, which will reorient IFI's role in industrial and financial sector development; and (iii) to support the financial and institutional strengthening of IFI. IFI's new role as a financial sector institution will focus on providing financial services and instruments that are currently underprovided by the private sector, and acting as a catalyst for increased private sector participation in these services and instruments. In the industrial sector, IFI's new role is intended to support investments in new products, markets, and technologies, consistent with the Government's trade reform and industrial restructuring programs.

5. Project components. The Project would include (i) a credit program to finance investment and working capital of industrial enterprises (US$70.0 million); (ii) credit for restructuring and eventual divestiture of three enterprises in which IFI has majority ownership or control (US$75.0 million); and (iii) technical assistance to support strategic and organizational changes in IFI, investment banking and other services to assist IFI in implementing its divestiture program, and engineering and other technical support needed for restructuring IFI owned or managed enterprises (US$5.0 million).

6. Project issues. (i) An issue that has been raised throughout project preparation has been the question of what is the appropriate role (if any) for a public sector financial institution in Colombian financial markets. IFI's strategy reflects an attempt to provide financial products and services that are currently underprovided by the private sector, and also to promote private sector development in these markets. (ii) IFI's financial situation is heavily influenced by a large deficit reflecting accumulated losses on the BVC Fund. After considerable discussion between the Government and IFI as to the assignment of responsibility for these losses, a tentative agreement between IFI and the Ministry of Finance was reached, but has not yet been approved by Congress. A satisfactory agreement between the Government and IFI to eliminate the BVC deficit within an acceptable time frame would be a condition of the proposed loan. (iii) A final issue is how to ensure that IFI successfully adopts its new role, avoiding the politically motivated investments and lending that have led to its past financial problems. This will depend on careful preparation of implementation plans, a sequenced adoption of new functions, and organizational and institutional changes in IFI. It will also depend on the commitment of the new government, which takes office in August 1990, to support the strategy.

Rationale for Bank involvement. During the last two years, the Bank has focused its policy dialogue with the Government on the need to initiate a medium-term development strategy to accelerate economic growth by raising the efficiency of resource use. With a Public Sector Reform Loan, the Bank's lending program in Colombia supports the Government's efforts to strengthen public sector management, promote private sector development, and improve the allocation of public sector resources. The proposed IFI project complements these efforts by supporting IFI's divestiture program and refocusing public sector involvement in industrial finance. The proposed project and the Industrial Restructuring and Development Project form a package of investment loans designed to facilitate the supply response to the recently announced trade reform program. In the financial sector, the proposed project is consistent with the Government's efforts to increase the efficiency of financial institutions and reduce distortions in the sector.

Benefits and risks. The Project will improve the financial situation and operational efficiency of IFI, and reduce the scope for politically-motivated financing by the main public sector financial institution for industry; contribute to the development of long term credit and capital markets; and facilitate the supply response to trade reform. Project risks include the possibility that the Government and IFI will fail to complete the divestiture program; that IFI will have problems implementing its new investment and lending strategy; and that the Government and IFI will fail to resolve the problem of the BVC deficit.

Project processing. Over the past eighteen months, project processing has focused on an analysis of IFI's financial situation and divestiture program, and the development of a strategic plan for IFI's future role. With the recent adoption of this plan by IFI and the Ministry of Economic Development, the focus will shift toward (i) defining specific policies, procedures, and the internal organization of IFI in its new role, and (ii) defining a plan of implementation of the new strategy. A pre-appraisal mission is scheduled for the first two weeks in May. Assuming agreement on key issues, the project could be appraised in June 1990, with negotiations in July and Board presentation in September.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

OED FILE COPY
Please return within 5 days

DATE: December 22, 1988

TO: Mr. John M. Page, Jr., Division Chief, LA3TF

FROM: K. Hallberg, H. Jones (LA3TF); M. C. Franco (LATTF); I. Lieberman (Consultant)

EXTENSION: 31970

SUBJECT: COLOMBIA - Privatization Project Identification Mission
Back to Office Report

1. Per our terms of reference of November 30, 1988, we visited Colombia from December 5-16 to identify a potential project with the Instituto de Fomento Industrial (IFI), to discuss related financial sector issues, and to review the status of the consultants' reports for the Industrial Sector Report. Annex 1 summarizes issues related to the preparation and design of the Privatization Project, which were discussed at a final wrap-up meeting with the Minister of Economic Development and the Managing Director of IFI.

Privatization Project

2. Project Components. Three potential components of a Privatization Project have been identified (see Back to Office Report of November 17, 1988):

(i) privatization of IFI's holdings in 23 companies;

(ii) restructuring of IFI itself;

(iii) restructuring of Alkalis de Colombia, a 100% holding of IFI.

3. IFI Privatization Program. IFI's privatization program is based on a plan approved by the national planning commission (CONPES), for the divestiture of shares held by IFI in 23 enterprises, which comprise a substantial part of IFI's investment portfolio. To date, IFI has sold its shares in five additional enterprises, and is in the process of liquidating its holdings in eight other enterprises.

4. Based on the CONPES document, IFI's management has prepared a phased program of divestiture. The program contains divestiture plans for four types of holdings:

(i) Group 1: relatively small holdings in eight enterprises, whose shares IFI will sell via direct negotiations. IFI plans to sell these holdings in the first quarter of 1989.

(ii) Group 2: more significant holdings in four enterprises which are to be sold in various ways --sale on the stock exchange, public offering or auction, or direct negotiation. IFI plans to sell these enterprises in 1989.

(iii) Group 3: more complex cases for which neither a divestiture strategy nor timetable has been established as yet. These enterprises account for a substantial proportion of the value of holdings originally proposed for divestiture in the CONPES plan.

(iv) Group 4: one enterprise, Papelcol, an investment project in a large paper mill which has incurred substantial difficulties coming on stream. The investment is estimated at US$500 million, substantially over budget, and there is a large quantity of funds still to be invested to complete the plant. The technology for the project was supplied by Creusot Loire and financing by a consortium of French Banks. IFI, at the behest of the Government of Colombia (GOC), agreed to purchase US$250 million in credits from the French banks for US$70 million, thereby becoming the major creditor in the project. Morgan Guaranty has been hired by IFI to assist in the divestiture of Papelcol, based on their experience with a divestiture of a similar project, in Chile.

5. The mission reviewed IFI's divestiture program, raising several issues:

(i) The divestiture program approved by IFI's Board of Directors represents only 12% of the value of the divestments proposed in the CONPES plan, and extends only through 1989. The current IFI program is inadequate from the perspective of CONPES objectives and as a basis for a World Bank project. IFI's Managing Director has agreed that a more complete program will be prepared and reviewed with the Bank in January.

(ii) The valuations prepared by IFI's Investment Division do not appear to reflect realistic market values. The mission suggested that IFI hire investment bankers to assist in both valuation and divestiture of the more substantial holdings in Groups 2 and 3. A continuing relationship with such an institution could attract external investors and would provide additional benefits such as training of IFI staff in future projects and assist in future divestitures.

(iii) IFI needs a clear policy for future investment and divestiture (entry and exit strategies). This point is addressed in more detail below (paras. 6-7).

6. IFI Restructuring. Restructuring of IFI would include: (i) definition of a future role and strategy for IFI; (ii) potential reorganization of IFI in line with its future strategy; (iii) financial restructuring, involving one-time write-offs to clean up IFI's portfolio of investments and credits; (iv) resolution of IFI's main financial problem: refinancing of the losses in its trust fund for the social security system financed with bonds known as Bonos de Valor Constante; and (v) improvement of management information systems.

7. **The mission raised several issues related to the restructuring of IFI:**

(i) IFI needs to define its future strategy and its role in financial markets. Specifically, the mission suggested that IFI explore a future role as a second tier lending institution. IFI should begin this exercise as soon as possible, with external consulting support.

(ii) IFI needs high quality personnel in the following areas:

- Strategic Planning - to work in tandem with the consultants discussed in point (i);

- Industrial Economists - to form a "think tank" to assist IFI and the Government in defining future industrial strategies and policies.

(iii) It was recommended that IFI separate, for the present, the staff responsible for divestiture from those responsible for new project development and control over existing investments. The divestiture team would work with the investment bankers hired during the privatization process.

(iv) Until a proper restructuring of its financial situation has occurred, IFI should limit new investments to projects already approved or in progress. New loans to firms whose holdings IFI plans to divest should also be limited (over 70% of IFI's loan provisions arise from loans to enterprises in its investment portfolio).

(v) IFI should perform a detailed examination of its provisions in both its investment and credit portfolio and increase them to reasonable levels.

(vi) IFI and the Government should prepare an actuarial study and sensitivity analysis on the future use of the Bonos de Valor Constante as a source of funds for IFI, and resolve how the problem of closing the existing financial gap in this fund, estimated at Col$42 billion, will be solved. The mission indicated that this would have to be resolved satisfactorily for the Bank to provide credit to IFI.

(vii) IFI should appoint independent external auditors. Among other things they could help IFI review its provisions for doubtful accounts and investments and its overall policy for establishing such provisions, which is inadequate.

8. Restructuring of Alkalis de Colombia. The mission reviewed Alkalis' situation, discussing its operating and financial problems with Alkalis' management and visiting Alkalis' plant in Betania, near Bogota.

9. **The following issues emerged:**

(i) **The plants are not currently viable, and it is doubtful that it will be worthwhile investing in the rehabilitation of the Betania plant.**

(ii) The next mission would include an engineering inspection of both the Betania and Cartagena plants to investigate options for rehabilitation.

(iii) The present viability of Alkalis is based on a series of circumstances which do not offer much optimism for future viability: (a) a financial restructuring of Alkalis (Chapter 11), which consolidated IFI's loans to Alkalis at 15% interest, while market rates are above 40%; and (b) an import monopoly for caustic soda. Colombia currently imports 180,000 tons per year of caustic soda and world prices are extremely high at present, due to product shortages. Alkalis enjoys a monopoly on caustic imports and in 1987 generated a profit of Col$3 billion on these imports, which covered plant losses and allowed the company to generate a profit. The mission indicated to IFI's management that any restructuring support for Alkalis would have to be based on economic viability and the termination of the monopoly.

(iv) Alkalis has a history of severe labor problems and any solution to its problems would need to address this issue.

10. We discussed the following alternatives for Alkalis with IFI's management:

(i) closure of the plants;

(ii) concentrating all management and production operations in Cartagena, where import facilities are located;

(iii) establishing Alkalis as a distribution operation (without an import monopoly);

(iv) providing for a management/worker buyout of the operation.

11. Next Steps. The next steps in project preparation are:

(i) preparation of an Initiating Executive Project Summary;

(ii) preparation of an Action Program to be discussed with IFI's Management in mid-January.

Financial Sector Issues

12. Because of Mr. Montes delayed return from Brazil, the mission was unable to hold a full range of meetings on financial sector issues.

Nevertheless, we did have meetings on credit lines and interest rates with Banco de la Republica, in addition to our meeting with Mr. Montes, and met with Corporacion Financiera del Valle. It appears that because of a heavy focus on the activities of the congress, the Junta Monetaria is unlikely to develop financial sector proposals until late January. In anticipation of such proposals we propose to prepare a draft financial strategy paper by mid-January.

Industrial Sector Report

13. First drafts are complete for four of the five local consultants' reports that will be incorporated into the Industrial Sector Report. A meeting of the consultants and the Industrial Sector Working Group was postponed by the Ministry of Economic Development until end-January. In the meantime, the mission will send written comments on each of the draft reports to the Vice Minister for distribution.

cc: Messrs. Selowsky, LACVP
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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: December 22, 1988

TO: Mr. John M. Page, Jr., Division Chief, LA3TF

FROM: K. Hallberg, H. Jones (LA3TF); M. C. Franco (LATTF); I. Lieberman (Consultant)

EXTENSION: 31970

SUBJECT: COLOMBIA - Privatization Project Identification Mission Back to Office Report

1. Per our terms of reference of November 30, 1988, we visited Colombia from December 5-16 to identify a potential project with the Instituto de Fomento Industrial (IFI), to discuss related financial sector issues, and to review the status of the consultants' reports for the Industrial Sector Report. Annex 1 summarizes issues related to the preparation and design of the Privatization Project, which were discussed at a final wrap-up meeting with the Minister of Economic Development and the Managing Director of IFI.

Privatization Project

2. Project Components. Three potential components of a Privatization Project have been identified (see Back to Office Report of November 17, 1988):

(i) privatization of IFI's holdings in 23 companies;

(ii) restructuring of IFI itself;

(iii) restructuring of Alkalis de Colombia, a 100% holding of IFI.

3. IFI Privatization Program. IFI's privatization program is based on a plan approved by the national planning commission (CONPES), for the divestiture of shares held by IFI in 23 enterprises, which comprise a substantial part of IFI's investment portfolio. To date, IFI has sold its shares in five additional enterprises, and is in the process of liquidating its holdings in eight other enterprises.

4. Based on the CONPES document, IFI's management has prepared a phased program of divestiture. The program contains divestiture plans for four types of holdings:

(i) Group 1: relatively small holdings in eight enterprises, whose shares IFI will sell via direct negotiations. IFI plans to sell these holdings in the first quarter of 1989.

(ii) Group 2: more significant holdings in four enterprises which are to be sold in various ways --sale on the stock exchange, public offering or auction, or direct negotiation. IFI plans to sell these enterprises in 1989.

(iii) Group 3: more complex cases for which neither a divestiture strategy nor timetable has been established as yet. These enterprises account for a substantial proportion of the value of holdings originally proposed for divestiture in the CONPES plan.

(iv) Group 4: one enterprise, Papelcol, an investment project in a large paper mill which has incurred substantial difficulties coming on stream. The investment is estimated at US$500 million, substantially over budget, and there is a large quantity of funds still to be invested to complete the plant. The technology for the project was supplied by Creusot Loire and financing by a consortium of French Banks. IFI, at the behest of the Government of Colombia (GOC), agreed to purchase US$250 million in credits from the French banks for US$70 million, thereby becoming the major creditor in the project. Morgan Guaranty has been hired by IFI to assist in the divestiture of Papelcol, based on their experience with a divestiture of a similar project, in Chile.

5. The mission reviewed IFI's divestiture program, raising several issues:

(i) The divestiture program approved by IFI's Board of Directors represents only 12% of the value of the divestments proposed in the CONPES plan, and extends only through 1989. The current IFI program is inadequate from the perspective of CONPES objectives and as a basis for a World Bank project. IFI's Managing Director has agreed that a more complete program will be prepared and reviewed with the Bank in January.

(ii) The valuations prepared by IFI's Investment Division do not appear to reflect realistic market values. The mission suggested that IFI hire investment bankers to assist in both valuation and divestiture of the more substantial holdings in Groups 2 and 3. A continuing relationship with such an institution could attract external investors and would provide additional benefits such as training of IFI staff in future projects and assist in future divestitures.

(iii) IFI needs a clear policy for future investment and divestiture (entry and exit strategies). This point is addressed in more detail below (paras. 6-7).

6. IFI Restructuring. Restructuring of IFI would include: (i) definition of a future role and strategy for IFI; (ii) potential reorganization of IFI in line with its future strategy; (iii) financial restructuring, involving one-time write-offs to clean up IFI's portfolio of investments and credits; (iv) resolution of IFI's main financial problem: refinancing of the losses in its trust fund for the social security system financed with bonds known as Bonos de Valor Constante; and (v) improvement of management information systems.

7. The mission raised several issues related to the restructuring of IFI:

(i) IFI needs to define its future strategy and its role in financial markets. Specifically, the mission suggested that IFI explore a future role as a second tier lending institution. IFI should begin this exercise as soon as possible, with external consulting support.

(ii) IFI needs high quality personnel in the following areas:

- Strategic Planning - to work in tandem with the consultants discussed in point (i);

- Industrial Economists - to form a "think tank" to assist IFI and the Government in defining future industrial strategies and policies.

(iii) It was recommended that IFI separate, for the present, the staff responsible for divestiture from those responsible for new project development and control over existing investments. The divestiture team would work with the investment bankers hired during the privatization process.

(iv) Until a proper restructuring of its financial situation has occurred, IFI should limit new investments to projects already approved or in progress. New loans to firms whose holdings IFI plans to divest should also be limited (over 70% of IFI's loan provisions arise from loans to enterprises in its investment portfolio).

(v) IFI should perform a detailed examination of its provisions in both its investment and credit portfolio and increase them to reasonable levels.

(vi) IFI and the Government should prepare an actuarial study and sensitivity analysis on the future use of the Bonos de Valor Constante as a source of funds for IFI, and resolve how the problem of closing the existing financial gap in this fund, estimated at Col$42 billion, will be solved. The mission indicated that this would have to be resolved satisfactorily for the Bank to provide credit to IFI.

(vii) IFI should appoint independent external auditors. Among other things they could help IFI review its provisions for doubtful accounts and investments and its overall policy for establishing such provisions, which is inadequate.

8. Restructuring of Alkalis de Colombia. The mission reviewed Alkalis' situation, discussing its operating and financial problems with Alkalis' management and visiting Alkalis' plant in Betania, near Bogota.

9. The following issues emerged:

(i) The plants are not currently viable, and it is doubtful that it will be worthwhile investing in the rehabilitation of the Betania plant.

(ii) The next mission would include an engineering inspection of both the Betania and Cartagena plants to investigate options for rehabilitation.

(iii) The present viability of Alkalis is based on a series of circumstances which do not offer much optimism for future viability: (a) a financial restructuring of Alkalis (Chapter 11), which consolidated IFI's loans to Alkalis at 15% interest, while market rates are above 40%; and (b) an import monopoly for caustic soda. Colombia currently imports 180,000 tons per year of caustic soda and world prices are extremely high at present, due to product shortages. Alkalis enjoys a monopoly on caustic imports and in 1987 generated a profit of Col$3 billion on these imports, which covered plant losses and allowed the company to generate a profit. The mission indicated to IFI's management that any restructuring support for Alkalis would have to be based on economic viability and the termination of the monopoly.

(iv) Alkalis has a history of severe labor problems and any solution to its problems would need to address this issue.

10. We discussed the following alternatives for Alkalis with IFI's management:

(i) closure of the plants;

(ii) concentrating all management and production operations in Cartagena, where import facilities are located;

(iii) establishing Alkalis as a distribution operation (without an import monopoly);

(iv) providing for a management/worker buyout of the operation.

11. Next Steps. The next steps in project preparation are:

(i) preparation of an Initiating Executive Project Summary;

(ii) preparation of an Action Program to be discussed with IFI's Management in mid-January.

Financial Sector Issues

12. Because of Mr. Montes delayed return from Brazil, the mission was unable to hold a full range of meetings on financial sector issues.

Nevertheless, we did have meetings on credit lines and interest rates with Banco de la Republica, in addition to our meeting with Mr. Montes, and met with Corporacion Financiera del Valle. It appears that because of a heavy focus on the activities of the congress, the Junta Monetaria is unlikely to develop financial sector proposals until late January. In anticipation of such proposals we propose to prepare a draft financial strategy paper by mid-January.

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COLOMBIA

PUBLIC SECTOR REFORM LOAN

INITIATING MEMORANDUM

I. INTRODUCTION

1. This memorandum seeks authorization to appraise a Public Sector Reform Loan to Colombia. The proposed operation would support reforms in the public sector considered essential for the achievement of the objectives pursued by the Government's Economic Modernization Program (EMP). The reforms are designed to increase productivity in the use of public sector assets and improve efficiency in the allocation of resources by the public sector. These will consist of policy actions and institutional reforms to improve the management of the decentralized public sector (DPS) and improve the competitive environment in those areas where the public sector has played a dominant role through the exercise of a public monopoly or by heavily regulating entry and operations.

2. Despite careful macroeconomic management and sustained growth, Colombia's economic performance weakened during the 1980s, due to low productivity growth and increasingly extensive use of inputs, under a pattern of growing resource constraints. The Government has recently adopted the EMP which constitutes the Government's development strategy aimed at accelerating economic growth by raising the efficiency of resource use. Implementation of this strategy will require introduction of structural changes in major sectors of the Colombian economy. The center piece of this strategy is a recently initiated trade reform aimed at increasing outward orientation and efficiency of tradeable goods production. This trade reform process will be further supported by a program of industrial restructuring and continuing reforms in the financial sector aimed at strengthening the domestic savings effort and improving resource allocation. Another key element in the EMP is the program of reform of the public sector that will be supported by the proposed operation. A bold and accelerated pace of implementation of the EMP would allow Colombia to reach an annual average economic growth of above 5.5% of GDP during this decade.

3. The Colombian public sector has not followed the typical pattern of public sectors in the Region. It is not characterized by over extension and gross fiscal imbalance. In addition to its traditional role in the provision of education and health services, its operations are concentrated mainly in the infrastructure, petroleum and mining sectors. The Government has promoted domestic and foreign private investments in the petroleum and mining sectors. While maintaining the public sector's overall control of the petroleum sector, it has allowed significant domestic and foreign private sector participation in exploration, production and transport of oil. In the mining sector, it has participated as a joint venture partner in investments in coal and nickel which were deemed of strategic importance, leaving the other areas open for the private initiative, either foreign or domestic. The Government has, however, drastically limited private sector participation in the infrastructure sector. This has been reserved mainly for the Central Government in the transport sector, and to municipal companies in the areas of telecommunications (with the Central Government retaining the monopoly on long

distance communications), power and water supply. In addition, the Government plays a dominant role in the financial, agricultural marketing and low-income housing sectors and maintains some presence in the manufacturing sector through the mainly minority capital risk investments of IFI (the Government's industrial development agency).

4. Despite the relatively limited role played by the public sector in Colombia, it constitutes a substantial contributor to the low productivity growth of the Colombian economy as a result of the poor efficiency performance of public sector entities (as reflected in their financial and operational results), the poor quality and high costs of key services provided by public entities to the productive sectors (mainly by the transport sector) and the hindrances to competition derived from public sector's regulation and dominant role in certain economic sectors (mainly shipping, agricultural marketing, banking and low-income housing).

5. The Government proposes to deal with the low productivity performance of public sector assets through the implementation of a management planning and evaluation system for public sector entities and the privatization of assets whose continued holding by the public sector is not justified on the basis of policy or strategic considerations. In addition, it will seek to improve efficiency in resource allocation and use in sectors dominated and regulated by the public sector which are critical to the successful implementation of the EMP by the establishment of a level playing field between the public and private sector in areas where public sector participation is expected to remain significant in the future and enhancing the competitive environment in sectors in which competition has been severely constrained by public sector regulations.

6. In the area of public sector management the first objective of the operation is to deepen and broaden the implementation of the substantive legislative reforms introduced by the Barco administration in programming and budgeting by establishing a performance planning and evaluation system (PPES) for the public decentralized sector. Recent legislative reforms have strengthened the linkages between macroeconomic and sector planning, eliminated rigidities in budget programming and streamlined the procedures for committing and disbursing budget resources. The principal institutional feature of this reform is the establishment of the Consejo Superior de Politica Fiscal (CONFIS) as a high level inter-governmental commission in charge of defining public sector financing policy and of ensuring public expenditure efficiency. The Government has assigned CONFIS the responsibility of establishing and operating the PPES for the main public sector entities. The PPES will define the strategic objectives for each of the selected public sector entities, the specific tasks the entity will undertake to achieve those objectives and the performance indicators to evaluate the effectiveness of the entities' management in achieving the tasks. In defining the public entities strategic and corporate objectives the Government shall seek to establish for each of them clear policies in the pricing of goods and services, investment, and its management's autonomy and accountability. The establishment of the PPES will be underpinned by the revision of the institutional framework under which decentralized entities operate to increase the level of autonomy and accountability of public sector managers.

7. A second objective of this operation will be elimination of restrictions and regulations limiting private sector development and competition, including privatization of public assets. It will build upon

recent Government measures in ports, railways and low-income housing and seek further definitions and actions aimed at ensuring an adequate incentive structure for private sector participation in those areas. It will also seek to reduce public sector participation in the industrial, financial and agricultural marketing sectors and eliminate the regulatory hindrances to competition in the shipping sector.

8. The proposed reforms are expected to result in significant improvements in the productivity levels of the public sector and in the efficiency in the allocation and use of resources in economic areas dominated by the public sector. Productivity of public sector assets is expected to increase through the implementation of the proposed PPES which will introduce clear economic and efficiency oriented criteria in the management of public entities, specifically in the areas of pricing, investment planning and operating costs. This will result in improved financial performance of public decentralized entities which will be expected to start generating overall surpluses by 1992, thereby contributing to reach fiscal balance, or even a small surplus, by that year. The implementation of the PPES will be extended to ten public sector entities by second tranche release (representing not less than 60% of expenditures of the decentralized public sector) and to five additional public entities by third tranche (representing not less than 70% of expenditures of the decentralized public sector). The Government's intention is to apply this system to all significant public sector entities (representing over 90% of decentralized sector expenditures). The increased private sector participation and competition in sectors which have been subjected to regulatory restrictions and public sector monopolies will result in improved efficiency in the delivery of services that are critical for an adequate supply response to the trade reform program (mainly the transport sector) and accelerated growth and resource use efficiency in key economic sectors (shipping, agricultural marketing, banking and low-income housing).

9. The proposed operation will assist Colombia in meeting the financing requirements derived from the implementation of the EMP, which are estimated at about $476 million per annum for the period 1990-92. The Bank's financial assistance provided through the proposed operation will be critical to attain the expected contribution of multilateral institutions, maintain burden sharing arrangements with commercial banks, and, consequently, ensure the viability of the proposed financing plan and Colombia's balance of payment equilibrium in the medium-term.

10. The proposed operation will also assist the Government in financing the costs associated with the restructuring of inefficient public entities. This will be represented mainly by the incremental fiscal transfers required to finance staff reduction programs in the railways, telecommunications and ports companies and the low-income housing agency.

11. Section II of this memorandum outlines the evolution of macroeconomic policies in Colombia since the mid-1980s, the experience with structural change, the overall development strategy for the nineties and proposed Bank assistance in the implementation of this strategy. Section III provides a diagnosis of the public sector in Colombia. Section IV describes the policy content and the reform program supported by the proposed operation, and discusses the loan's features, its expected economic and social impact, and its risks.

II. MACROECONOMIC SETTING

Recent Macroeconomic Policies.

12. After a period of serious economic crisis in the early eighties followed by successful and sweeping macroeconomic adjustment in 1984-86, Colombia has reestablished its record as a well-managed economy, achieving macroeconomic stability, avoiding fluctuating inflation and interest rates, and sharply reducing structural fiscal deficits. During 1986-87 GDP growth reached an (annual average) of 5.6 percent, the unemployment rate was reduced by 5 percentage points to about 10%, inflation was kept at annual average of about 22%, the current account balance improved from a deficit of 6 percent of GDP to about zero in 1986, and international reserves recovered to above 5 months of imports of goods and services.

13. Subsequently, however, food shortages, and the lagged effects of an expansionary credit policy in the second half of 1987 contributed to an increase in inflation to 28% in 1988. A decline in coffee production, lower coffee export quotas and a reduction of petroleum output and exports contributed to an increase in the fiscal deficit to 2.8% of GDP (from a small surplus in 1986 and from a deficit of 1.2% of GDP in 1987), and to a deceleration of the rate of real GDP growth to 3.7% in 1988. The collapse of the International Coffee Agreement (ICA) and the initiation of a generalized conflict between the drug traffickers and the Government in mid-1989 compounded uncertainties. The economic authorities reacted quickly to ameliorate the negative impact of this "coffee-drug" shock with a tighter credit policy, investment cuts, and reductions in subsidies which helped reduce the fiscal deficit to about 2.4% of GDP in 1989 and inflation to about 26%. Real GDP growth, however, slowed to about 3% by the end of the year.

14. Most of the effect of the "coffee-drug" shock, however, is expected to materialize in 1990 and after. The government, therefore, adopted serious economic measures to further adjust to the shock. These measures include: i) a devaluation of 6-8% of the exchange rate in real terms by end-1990 (in addition to several percent already achieved since last August), representing a decision to devalue the real rate beyond the December 1986 benchmark used so far; ii) enhanced fiscal austerity through a variety of measures, viz. eliminating major subsidies in the coffee sector and enforcing a decline in the real price of coffee paid to producers, holding down public sector wage increases to below expected inflation for 1990, raising the domestic price of gasoline, and postponing public sector investments in selected areas. These measures together represent a reduction in the consolidated non-financial public sector deficit of about 1.5% of GDP. Coming in the last year of the Barco Administration, the program demonstrates the Government's intention of not permitting an economic destabilization before the change in Administration. These decisions are courageous in resisting mounting pressures for expansionary policies and diverge from the usual pattern of fiscal laxity in the last year of a Government. They represent a consistent response to the external shocks, have been discussed with IMF staff, and have been approved by the Fund's Board as part of 1989's Article IV consultations.

Medium-Term Economic Modernization Program

15. The main objective of the measures undertaken in the last quarter of 1989 was to stabilize the economy in the aftermath of the coffee-drug shock.

These measures did not, however, deal with the lack of growth in productivity that has constrained most economic sectors in Colombia for the last two decades. This issue has been the focus of the Bank's economic policy dialogue with the Government during the last two years. The latest CEM and the Industrial Sector Report were important elements in advancing the discussions with the economic team on the need to design a medium term program aimed at dealing with the structural distortions affecting efficiency performance. Last November, a consensus was reached within the Colombian economic team on the need to define a medium-term program as a result of the increased resource constraint scenario brought about by the coffee-drug shock. This program would go beyond stabilization and address the need to accelerate growth through improved economic efficiency. The EMP was approved recently by the Council of Economic and Social Policy, which is the highest policy-making body in the Government.

16. The key goal of higher growth will be achieved in the EMP through sector reforms which would progressively reduce distortions and improve efficiency in resource allocation and use while enhancing competition. The center piece of the EMP is a trade reform program aimed at gradually eliminating the strong anti-export bias prevalent in Colombia's incentive structure and increasing efficiency of tradeable goods production. The trade reform will be accompanied by reforms in other sectors aimed at improving resource mobilization and ensuring an adequate supply response from the productive sectors. The proposed changes in the financial sector and the industrial restructuring program, together with the proposed Public Sector Reform Program, constitute key elements of the overall EMP strategy. In addition, the EMP will be underpinned by stabilization measures in fiscal and exchange rate policies to maintain balance of payment equilibrium. Major macroeconomic targets and other indicators for the expected outcome of the medium term policy framework and the proposed financing plan are given in Table 1 attached to this memorandum. The scenario presented is consistent with annual GDP growth of about 4.5%, with inflation stabilizing at about 20% by 1995, with the debt service ratio gradually declining from an estimated 53.6% in 1989 to 31% in 1995, with gross investment stabilizing at 18% of GDP, with the fiscal deficit declining from an estimated 2.4% of GDP in 1989 to less than 1% in 1995, and with the external current account deficit stabilizing at about .7% of GDP. This is a cautious scenario, which assumes that the traditional style of seeking consensus to achieve gradual --rather than shock-induced-- structural changes will continue to prevail. Since there is already wide consensus about the need for the reforms, the final outcome may well be one of a faster pace of reforms leading to a growth rate of more than 5.5% in real terms by 1995 and beyond.

17. The main features of the trade and financial sector reforms and the industrial restructuring program are as follows:

18. <u>Trade Reform</u>. The Government has concluded that the main instrument to bring about a change in the prevailing incentive structure towards a more competitive environment is the opening of the economy to increased international competition. Last February the Government publicly announced a trade reform program consisting of two phases. The first phase seeks elimination of QRs within a two-year period. Implementation of this phase began with the movement of 861 tariff positions (representing 27.8% of the positions requiring prior import licence before the program) to the free import list. In addition, the Government is committed to increase flexibility in the issuance of licenses and to transfer the remaining positions requiring

prior import licences to the free import list by January 1992, except for qualified exceptions based on security, health and welfare considerations. By the end of the first phase, the main instruments of protection would be tariffs and an actively-managed exchange rate. The second phase, expected to last three years, would seek a reduction of tariff protection to an average 25% and also diminish tariff dispersion.

19. **Financial Sector Reform**. The Government will continue efforts aimed at improving the sector's efficiency by increasing competition, reducing segmentation and forced investments, allowing market determination of interest rates, and eliminating barriers to entry in the sector. The Government has taken significant policy decisions in this area. Reserve requirements have been substantially reduced, interest rates on directed credit to industry and agriculture have been increased and linked to market rates, and foreign control of financial entities has been authorized by a recently approved law. In addition, there have been substantial improvements in the prudential regulation and supervision of the financial sector by the Superintendencia de Bancos and in the sector's accounting and reporting capability. The program will pursue privatization of those banks that fell under Government control as a result of the early-1980s crisis in the sector (to be supported under the proposed operation) and further actions to reduce the levels of reserve requirements and mandatory investments, increase remuneration to financial institutions on those investments, move interest rates on directed credit towards market rates, and reduce the volume of directed credit to meet only term transformation needs.

20. **Industrial Restructuring**. The Government will initiate this program in order to facilitate supply response by the industrial sector to the recent changes in the incentive structure brought about by the trade reform. The program will aim specifically at improving the industrial sector's international competitiveness and ensuring an efficient utilization by the sector of Colombia's comparative advantages which are currently offset by a plethora of regulatory and institutional constraints and rigidities. The specific objectives of the program are improving efficiency of existing production capacity, the reallocation of resources towards goods in which Colombia has comparative advantages and the phasing-out of capacity which is unlikely to produce acceptable long run returns.

Bank support for the Economic Modernization Program

21. The Government has requested the Bank's assistance for the implementation of the EMP through a policy based loan to support its public sector reform program. This reform program has been identified as a critical element of the EMP's strategy due to the public sector's negative contribution to overall economic productivity and the limitations it poses on an adequate supply response by the productive sectors and an increased efficiency and growth of key economic sectors. The proposed reform program would seek increased productivity of public sector assets and the elimination of distortions in the incentive structure caused by undue public sector intervention. The proposed operation would be followed-up by investment loans which will build upon and seek further implementation of the proposed reform program, including financing the investment requirements derived from the reforms implemented in the infrastructure sectors (i.e. railways, ports, highways), and further implement the Government's strategies for the low-income housing, industrial promotion and financial sectors.

22. The Government has decided to initiate the trade policy reform program without seeking Bank financial assistance under a specific adjustment operation in order to reduce susceptibilities on the domestic political scene. The Bank is in agreement with the objectives and targets proposed. It would have preferred, however, a more accelerated pace and clearer criteria for removing QRs during the transitional stage and specific targets for the tariff structure to be reached by the end of the reform program. It is aware, on the other hand, of the need faced by the Government to compromise on the pace of trade adjustment to ensure a consensus among the groups supporting this change. The Bank has indicated it would consider a policy adjustment loan to support continuing progress and further deepen the trade reform process by the time the removal of QRs is completed. In the meanwhile, the Government has requested Bank's financial assistance for the implementation of the Industrial Restructuring Program and has agreed to include conditionality in it that would link loan disbursements to the definition of intermediate steps in QR removal and tariff reform and to satisfactory progress in the implementation of the reforms.

23. The Government's request for a policy based loan in an amount of $200 million to support its public sector reform program is critical in ensuring the viability of the financing plan proposed for the implementation of the EMP and, thereby, Colombia's balance of payment equilibrium in the medium-term. The following table describes Colombia's financing requirements consistent with the macroeconomic framework described in Table 1, the proposed contribution from the main groups of creditors and the expected outcome under scenarios with and without the proposed operation.

COLOMBIA
Economic Modernization Program
1990-92 Financing Plan
(Annual Averages)

	Including PSRL		Excluding PSRL	
	(US$mm)	(%)	(US$mm)	(%)
1. Current Account balance	491.2		491.2	
2. Net Financing requirements	476.8		476.8	
3. Financing Plan	476.8		335.8	
IBRD	-66.1	-13.8	-132.76	- 27.8
IDB	177.3	37.2	110.63	23.2
Bilateral	154.3	32.36	154.3	32.36
Suppliers credits	181.7	38.10	181.7	38.10
Commercial banks	22.0	4.6	22.0	4.6
4. Financing Gap (3-2)	-		140.9	29.55

24. The proposed operation would result in a slower pace of reduction of Bank exposure and, as a result of IDB's associated cofinancing, in an increase in the multilateral institutions' net contribution to Colombia's financing requirements by 23% per annum. In case the Bank would abstain from financing the proposed operation, a financing gap of US$141 million would emerge and the multilaterals' net contribution to Colombia's financing requirements would be negative. In a scenario where multilateral institutions would be reducing their exposure in Colombia, it could reasonably be expected that commercial banks would become increasingly reluctant to maintain at least constant their exposure in Colombia and that Colombia's debt strategy with commercial banks would be seriously endangered. This debt strategy has been aimed at a phased return to voluntary lending by avoiding debt restructuring and seeking semi-voluntary lending to maintain commercial banks' exposure constant in nominal terms.

25. After three difficult, but successful, refinancing operations concluded with commercial banks since 1986 Colombia has been able to maintain commercial bank exposure at nearly nominal levels and avoid debt restructuring. Colombia is expected to start negotiations soon on a refinancing request of US$ 1.3 billion to cover the amortizations falling due in 1991-92. This would be the last of four such operations before Colombia's repayment obligations to the banks fall to a much lower level of $400-500 million annually for a number of years. The Government is expected to face serious difficulties in obtaining the full amount. In the last refinancing operation, the free/cheap rider phenomenon led the Government to compromise in part its objective of maintaining the banks' nominal exposure (banks' commitments were about 90% of 1989-90 amortizations). In the coming round it is expected the banks will be even more reluctant. The financial gap that would be generated by a Bank's decision not to provide quick disbursing support to Colombia under the proposed operation and its departure from the burden sharing arrangements in meeting the medium-term financing requirements of the country would clearly exacerbate commercial banks' reluctance to participate in the up-coming refinancing operation.

26. In addition, the proposed operation will assist the Government in financing the costs associated with restructuring inefficient public entities. This will imply mainly incremental fiscal transfers to finance staff reduction programs. Staff redundancies have been a major factor contributing to low productivity in the railways, ports and telecommunications companies and in the low-income housing agency. As part of the restructuring plans for these entities the Government will include staff reduction programs. Due to the financial condition of these entities, severance payments will have to be financed by the Government. The Government has already initiated the process of liquidating the existing railways company. The total cash outlays to meet severance payments for this company have been estimated in the order of US$65 million for the period 1990-92. In addition, emergency investment requirements to bring some key traffic corridors back to working conditions have been estimated to be US$12 million. Estimates are not yet available on the costs associated with the restructuring of the other entities.

27. In addition to the support to the Government's EMP, the Bank will continue to maintain its priority for poverty alleviation programs, such as the proposed Rural Investment Development Program, the Community Child

Nutrition Project and the Municipal Development Project. Under this scenario, the Bank would step up its annual lending program to about US$ 600 million by FY95. Despite this step up in annual IBRD commitments, the repayments coming due from previous adjustment operations and the prevalence of investment lending operations in the Bank's future program may delay net disbursements becoming positive until 1994-95. The Bank may consider an additional adjustment operation to support the on-going trade reform program after the removal of QRs has been completed.

28. The fact that the program is being initiated in the closing months of this administration raises the issue of continuity in the implementation of the program by the new administration and of the timing for proceeding with the appraisal and negotiation of this loan. There are clear reasons for utilizing the window of opportunity that has been created by the Barco administration and finalize loan negotiations with them. A wide consensus has been built in support for the program as a result of a long and intense policy dialogue. The outgoing Government has indicated its commitment to take all the critical actions to put the program in place. There is a tradition of continuity in the management of economic policy in Colombia that is expected to prevail and be consolidated by the new administration. The new administration will have been elected prior to the appraisal mission's departure. The Bank will seek confirmation with representatives of the new authorities of the understandings reached with the outgoing Government prior to submitting the operation for consideration by the Board, which has been tentatively schedule for August.

III. PUBLIC SECTOR IN COLOMBIA: STRUCTURE AND PERFORMANCE

The Public Sector in Colombia

29. Size and Composition. During the period 1981-86, the public sector in Colombia contributed about 20% of GDP and 18% of total final demand. The public sector's share of GDP has been generally increasing during recent decades, as reflected in the increase from 13.9% of GDP in 1970 to 21.5% in 1986. The sector's share of total wages in the economy is about 33%, and its contribution to total fixed capital formation has been about 50%, over the period 1982-86. The provision of health, education, and other social services continues to represent the sector's main economic activity. However, the share of these activities in total public expenditure has declined significantly during the period 1982-86, while the share of manufacturing has increased, mainly as a result of petroleum production increases starting in 1986. (Annexes 1-5).

30. Goods and services are provided through a widely dispersed network of national, departmental, and municipal governments and public bodies, adding up to a total of 1,892 entities (Annex 6). The basic administrative structure is described below:

i) The public administration sector, composed of national, departmental, and municipal governments totalling, 1,076 governmental institutions. The sector's main function is the provision of collective services and the execution of public policy goals. Its financing is provided mainly through mandatory contributions, such as taxes, charges, etc.

ii) About 473 entities incorporated by national, departmental, or municipal governments as public authorities ("establecimientos públicos), operating with legal and administrative autonomy. These are financed mainly through transfers or mandatory contributions of their government sponsors.

iii) The non-financial public enterprise sector (NFPE), composed of 273 companies with majority holdings of the public sector, which produce marketable goods or services. They are expected to finance their operations mainly through internally-generated funds. These companies are incorporated and operate in accordance with private sector regulations. They have traditionally had substantial autonomy from their respective governmental authority.

(iv) The financial public sector is composed of 28 financial entities owned by the Central Government, including the Central Bank, the state-owned commercial banks and insurance companies, and some specialized financial institutions, such as the industrial bank (IFI) and the housing banks (ICT and BCH). There are in addition some 42 development finance institutions at the departmental and municipal level.

31. Despite the abundance of governmental bodies and public entities, over 90% of the 1,892 agencies mentioned above correspond to entities at the departmental and municipal levels with very limited economic and fiscal significance. In fact, over 90% of total expenditures of the decentralized public sector (746 public authorities and NFPEs, representing about 10% of GDP and 50% of total public sector expenditures) are concentrated in about 30 entities at the national and municipal levels. The proposed operation will deal with issues arising from the management by the Central Government of those public entities, and the Fondo Nacional del Cafe. This limited group of public sector entities will be referred to as the decentralized public sector (DPS).

Performance of the Decentralized Public Sector

32. **Size, Composition and Financial Performance**. Based on figures issued by the National Planning Department (DNP), which monitors DPS cash operations, the DPS contributed about 10% of GDP, and about 60% of public savings and of public sector fixed capital formation over the period 1985-88.

33. The commercially-oriented public sector in Colombia shows substantial differences from the pattern of development in other countries in the Region. In the case of Colombia, public sector involvement in the manufacturing sector has been marginal, mainly through the operations of the Institute for Industrial Development (IFI). As a consequence of IFI's privatization program the only remaining Government-controlled manufacturing operation is ALCALIS. The Government maintains significant interests in two other operations (Monomeros Colombo Venezolanos and Cerro Matoso) which are controlled and operated by the private sector. The DNP figures do not reflect financial performance of IFI holdings.

34. As reflected in Annex 7-A, DPS operations are concentrated mainly in the electric power and mines sector, with the communications, transport and agricultural sectors also showing significant shares in total DPS operations. Central Government-owned enterprises are predominant in the mines, transport and agricultural sectors. There is a mixed participation of Central Government- and municipally-owned companies in the power and communication sectors and total control of water supply operations by municipal entities. The municipally owned companies show a deteriorating financial performance during the period 1984-89 (Annex 7-B) as a result mainly of the difficulties faced by municipally-owned power companies and the financial strain faced by the Medellin Metro. Poor performance of these companies has created increased pressures on the Central Government that has met a substantial portion of their debt service requirements.

35. Despite DPS operating surpluses during the period 1985-88, internal cash generation did not keep pace with capital expenditures and debt servicing requirements. As a result, the DPS has become increasingly dependent on debt financing and inter governmental transfers, with the sole exception of ECOPETROL that has consistently shown strong financial performance since 1986 as a result of growing petroleum exports. During the years 1985-86, the DPS contributed to over 50% of the consolidated public sector deficit, reducing its share to 40% in the years 1987-88. An analysis of the major economic sectors of DPS operations (Annex 7-C) confirms the very low reliance on the sectors' capacity to generate internal resources and its increasing dependency on debt financing and inter governmental transfers.

36. Despite efforts by the Government to define tariff policies and nationwide tariff structures for the power and water supply sector, a main source of financial unbalance in the public sector has been the lack of a consistent and general policy for public goods pricing and the failure by the Government to define appropriate cost recovery policies for various public sector entities. Further actions are required in this area to ensure financial sustainability and the prevalence of adequate economic criteria as the determining factor in public goods pricing.

37. <u>Economic Performance</u>. The inadequate productivity of public sector resource use in Colombia constitutes a substantial contributor to the low productivity growth of the Colombian economy. This is reflected in the financial performance of decentralized entities and in the low productivity of capital use in the public sector, which contributed an average 42% of fixed capital formation during the period 1971-83. The Bank's latest Country Economic Memorandum calculated that the incremental capital-output ratio for the period was 7.8 for public capital compared with a rate of 2.9 for private capital. In the case of the DPS, there are three main factors explaining the sector's low levels of efficiency performance:

38. **Inadequate Public Sector Management Policies and Structure.** Prior to the issuance of the new Budget Law, the Central Government lacked effective instruments to control DPS operations and investment decisions and to ensure DPS adherence to macroeconomic programming and sectoral priorities. The main linkage between the DPS and the Central Government

had been provided by the entities' boards of directors, headed by the sector minister. In some cases, these boards were composed of presidential appointees, with no reporting responsibility to the planning or economic authorities, and, in other cases, of the main beneficiaries of the entities' operations.

39. Due to the technical weakness of sector planning in Colombia and the lack of effective mechanisms for the Central Government to set objectives for the DPS and to monitor their implementation, most DPS entities have been managed on an ad hoc basis, with no defined strategic objectives. DPS entities responded mainly to public sector priorities as perceived by managers, labor pressures, the Government's short-term political objectives, and the vested interests of the entities' constituencies, especially in those cases where these interests were represented in the entities' boards.

40. Additionally, DPS management has been hampered by poorly focussed and pervasive intervention by the Central Government in operations. This has seriously affected DPS entities long-term planning capability and operational efficiency. Failure by the Central Government to define clear and permanent policies on pricing of public sector goods and services, the appointment and removal of senior managers based on political considerations, and Government's active participation in day-to-day personnel, procurement and organizational matters are examples of such undue intervention. As a result, there have been serious investment mistakes, a generalized lack of financial discipline, increasing reliance on debt financing and Central Government transfers, and no sense of clear corporate objectives and strategy. These deficiencies are reflected in the serious administrative, operational, and labor crises faced by most entities in the DPS sector and the virtual abandonment of efficiency standards as the basis for measuring managerial and corporate performance.

41. **The Existence of Public Sector Monopolies**. Despite the relatively mild intervention of the State in the economy, the existence of some public sector monopolies has led to very low resource use efficiency, limited economic growth and the provision of low quality and high cost goods and services. The main sectors affected by the monopoly role played by the public sector are the following:

(i) Transport Sector. The Government has held a monopoly in ports and railways and has heavily regulated the shipping sector, providing a virtual monopoly to the Flota Mercante Gran Colombiana, a quasi-public shipping company. These monopolistic arrangements have led to an inefficient provision of port, railways and shipping services to the productive sectors. Further, they constitute a barrier to increased productivity and economic growth and may become a major bottleneck to the Government's objective of opening the economy to external competition. In addition to the adverse effects on economic efficiency, the public monopolies in railways and ports have led to extremely inefficient public sector companies plagued with excessive labor costs and serious operational, financial, and administrative problems. In the case of shipping, the Government's protection of the quasi-public shipping line has resulted in inefficient and costly services. The company has had poor operational and financial performance over the years, including continued reduction of its fleet capacity and increasing reliance on conference partners and leasing of liners to cope with its captive demand. The public sector does not have a direct participation in the airline and trucking sectors. Government regulations in those sectors do not unduly restrict entry or competition.

(ii) Power and Water Supply Sectors. These two sectors, which represent about 10% of GDP and 26% of total DPS expenditures have been reserved for the public sector. Power sector development has been based in the power utilities owned by the municipalities in the main urban areas. The Central Government participates in the sector through two companies (ICEL and CORELCA) which are mainly in charge of power distribution in areas not covered by the main municipal utilities and a company with a mix of Central Government and regional capital (ISA) designed to develop large hydro resources of national interest, provide interconnection services and rationalize investment planning in the sector. Sector investment has been influenced strongly by competition among the main municipal companies to develop the hydroelectric potential of their respective regions. There have also been imbalances among the generation, transmission and distribution shares of the sector's investment programs and periodic financial crises derived from poor investment planning and tariff policies, which have been traditionally set based on political considerations. The Central Government has recently strengthened its planning and tariff setting authority in the sector which is undergoing a serious financial crisis. As a result, planning in the sector has been substantially improved and the sector is basing its future investment decisions on a sound least-cost expansion program. The financial crisis remains unresolved mainly due to failure by the Government to make progress on the tariff front. The issues related to the power sector are being dealt with under an existing sector adjustment operation, however, those Government-owned power utilities that present serious performance and financial problems, i.e., ICEL and CORELCA, will be subject to the performance planning and evaluation system supported under this operation. The development of the water supply sector has followed a different dynamic. While the main urban centers have been successful in developing their water supply resources and financing their investments and operations, the Central Government played an active role in financing the development and operation of water companies in middle- and small-size cities. This scheme led to gross inefficiencies in resource use, poor quality and low growth in water supply services and chronic shortages of financing to meet even operational needs in most companies. In 1987, as part of a wider process of decentralization, the Government introduced a wide ranging reform of the sector's structure by transferring to the municipal level the exclusive responsibilities for the development and administration of water resources. The Bank is supporting this process through a sector adjustment operation. The Government is not considering opening these two sectors to private sector participation.

(iii) Low-income Housing Sector. The Government has assigned to the housing institute (ICT) the virtual monopoly in providing low-income housing by creating substantial disincentives for participation of the private sector through the establishment of highly subsidized interest rates for low-income housing lending and the provision to ICT of subsidized financing for its operations. The main mechanism for financing low-income housing has been forced investments by the financial sector in ICT bonds, paying rates substantially below market levels. ICT bonds represent about 15% of total forced investments by the financial sector and represented a stock of liabilities with the financial sector of about US$178 million as of December 1989. Net transfers from the financial sector to ICT to finance low-income housing have at this time become totally insufficient to meet ICT's investment targets, as a result of: (i) a mismatch between ICT's borrowing and onlending terms that creates significant losses to ICT; (ii) ICT's high administrative and operational costs, also financed through this mechanism; and (iii) ICT's extremely poor portfolio management. In addition, ICT has showed an extremely inefficient administrative performance that has led to the delivery of an ever decreasing number of poor quality/high cost houses. The role of ICT in promoting low-income housing and the viability of maintaining forced investment financing for its operations has at this point come under Government scrutiny.

(iv) Agricultural Marketing. The Government has a dominant role in the import of the main food and feed products through the Ministry of Agriculture's power to set import quotas for these products and IDEMA's role as the sole importer of items subject to quota. IDEMA's role as importer has restricted competition and prevented the development of a transparent market for these products, creating significant distortions in the producers' incentives and monopolistic rents for private groups that control the distribution channels and for IDEMA itself.

42. **Inefficiencies in the Allocation of Public Resources.** The following are the main sources of inefficiencies in the allocation of public resources in Colombia.

(i) The programming and budgeting procedures under the old budget law. On the one hand, this law covered only those public entities that were dependent on Central Government transfers. Revenue generating public entities had ample autonomy to define their expenditure levels and investment priorities. The Central Government had limited instruments to ensure the adherence of these entities to its macroeconomic program and investment priorities, e.g., approval of external borrowing and the tutelary role played by sector ministries. As a result, the scope for inefficiencies in the allocation and use of public resources was significant. This has been mainly reflected in the overinvestment in the power sector, poor investment decisions in the telecommunication company and the difficulties encountered by the Central Government in mobilizing resources within the public sector.

On the other hand, those entities that were subject to the budget process had serious constraints in carrying out their operations in an efficient manner due to the rigidities imposed by the budget process which prevented an adequate coordination between the planning and budgeting functions. The initial annual budget appropriations for these entities usually reflected only a portion of the actual expenditures planned for the year. This was a result of a requirement posed by the law that revenues derived from debt financing -the main source of public investment financing- could only be incorporated in the budget when the respective loan agreements had been signed. In order to comply with this requirement, budget appropriations were supplemented during the course of the year as the borrowing program materialized. Each supplemental budget required Congressional approval and hence implied a time consuming and politically burdensome process. The uncertainty in the programming of public expenditures was compounded by extremely cumbersome procedures for disbursing budget appropriations.

(ii) A second source of inefficiencies in the allocation of public resources has been the lack of clear and uniform criteria in the evaluation of public sector projects and of an institutional arrangement that would enable consistency in the screening of project proposals in accordance with consistently applied economic criteria and sector specific technical guidelines. As a result, the quality of public investments varies widely and political considerations, absorption capacity of the sectors and regional pressures have played a major role in deciding the content of the public investment program.

(iii) The rigidities and uncertainties prevailing in the programming and budgeting of public resources under the old Budget Law led to an average earmarking during the 1980s' of about 9% of total Central Government revenues. The main sources of earmarked revenues are constituted by the gasoline tax utilized for the financing of transport infrastructure investments (representing about 33.3% of total earmarked revenues), the tax on imports that benefits PROEXPO, IFI and Caja Agraria (equivalent to 19% of total earmarked revenues) and the payroll taxes benefitting ICBF, SENA and the compensation funds (representing 23.8% of total earmarked revenues). Of these sources of earmarked revenues, the tax on imports to finance mainly PROEXPO operations is the one that raises most serious questions in terms of benefit rationale, potential for mismatch between the amounts assigned and expenditure requirements and the priority the Government should assign to this form of public expenditure. The Government expects to maintain the current source of financing as an interim measure so as not to arouse the opposition of powerful interest groups to the trade policy reforms in implementation. However, in the context of the trade reform, the Government has undertaken to gradually reduce the tax on imports because of its anti-export effects. It has already reduced the total tax from 18% to 16% of CIF cost of imports. The announced final objective under the trade policy reform program is to bring average tariffs, including any applicable import tax, to an average 25% of CIF cost. This objective will imply further cuts and the eventual elimination of the import tax in the medium-term.

Recent Developments in Public Sector Reform

43. The Government has made significant progress in dealing with some of the issues described above. A description of the main changes in public sector management is made below.

44. The centerpiece of the public sector management reform effort is the New Organic Law of the Budget, approved in December 1988. This legislative initiative has set the stage for major improvements in public sector management:

i) The lack of effective linkages between macroeconomic and sector programming has been dealt with through a significant expansion of budget coverage to include all public entities (except for the National Coffee Fund operations, covered under a separate agreement between the Government and the Coffee Federation) and with the creation of the Consejo Superior de Politica Fiscal (CONFIS). CONFIS will be in charge of defining and overseeing public financial policy and of ensuring its consistency with the macroeconomic program. CONFIS will carry out this function through the establishment of multi-year financial plans for the public sector, that will set the major financial performance targets (investment and indebtedness ceilings and deficit/surplus targets) for the Central Government and each of the DPS entities. In addition, and based on the framework provided by the financial plan, CONFIS will approve the annual budgets for all decentralized public entities. The Government has initiated implementation of this aspect of the Budget Law this year, by approving for the first time the FY90 financial plan for the public sector and the budgets of the major DPS entities.

ii) The weakness in public investment programming and monitoring has been dealt with through the establishment of a nation-wide project evaluation and monitoring unit in DNP. This unit will be responsible for screening all project proposals in terms of their economic and technical viability and maintain a pool of eligible projects which may be selected for financing under the public investment program in accordance with the prevailing investment priorities. In addition, the unit will monitor efficiency in project implementation by public agencies. The Government is in the process of issuing the regulations, designing the information systems and developing the economic evaluation manuals and technical guidelines required to make the project unit operational.

iii) The issue of rigidity in budget programming has been resolved by eliminating the requirement that loans should be contracted prior to their inclusion in the budget. The new budget law allows the appropriation in the budget of revenues the Government expects to secure during the course of the fiscal year through borrowings. In addition, the procedure for disbursing budget funds has been drastically streamlined.

iv) The issue of rationalizing the Central Government's role in the management of the DPS will be dealt with by establishing a performance plan and evaluation system with selected public entities, pursuant to the authority granted by the new Budget Law to CONFIS. This is an area in which the Government has made significant progress in the course of preparing the proposed operation.

v) The Government has attempted to introduce some flexibility in the allocation of earmarked revenues. Law 55 of 1985 enabled the planning and sector authorities to finance with earmarked revenues programs which would extend the original objective assigned to the earmarked taxes. The application of this law resulted in the reassignment of 11.9% and 15.2% of total earmarking in the years 1986 and 1987. While the amount reallocated appears significant, the impact in terms of efficiency gains may be overstated by the fact that the Government had to reallocate the earmarked funds within certain predetermined categories related to the original purpose of the earmarking.

45. In addition, the Government has made significant progress in developing the institutional framework to ensure adequate coordination between macroeconomic policies and sector programming in two key sectors:

i) In late 1988, the Government renegotiated with the Coffee Producers Association the Coffee Fund management contract, introducing several covenants aimed at increasing Government's role in the management of the Coffee Fund resources. These covenants include Government approval of the Fund's annual budget, rationalization of existing subsidies to coffee producers, the need to ensure economic justification of investments, and a program of divestment. The Government's increased role has been critical in defining and implementing the adjustment program aimed at containing and eventually eliminating the Coffee Fund's operational deficit which resulted from the plunge in international coffee prices.

ii) In late 1989, the Government obtained passage by Congress of a law establishing a Commission with the role of formulating investment and pricing policy for the energy sector. This Commission has recently become operational, and will fill a significant vacuum in the policy decision-making process, while ensuring adequate coordination between sector developments and macroeconomic objectives and constraints.

IV. THE PUBLIC SECTOR REFORM LOAN

Objectives of the Proposed Operation

46. The proposed operation will support the Public Sector Reform Program. The specific objectives pursued by this Program are improving productivity in the use of public sector assets, improving efficiency in the delivery of services that are critical to an adequate supply response to the EMP and eliminating hindrances to competition in key economic sectors that have up to now been dominated by the public sector.

47. The objective of improving productivity in the use of public sector assets will be achieved by: (i) the establishment of a performance planning and evaluation system for the public decentralized sector. This system will seek to rationalize the relations between the Central Government and DPS entities by, on the one hand, introducing an institutional channel by which the former can set for each of the DPS entities clear strategic and corporate objectives (including specific policies in the areas of public sector pricing, investment and managerial autonomy and accountability) and performance targets (translating the objectives into operational terms and allowing the evaluation of the entities' management effectiveness), and, on the other hand, allowing greater autonomy to DPS entities in pursuing their corporate objectives and tasks; and (ii) the privatization of public assets whose continued holding by the public sector is not justified on strategic or policy grounds.

48. The objective of improving efficiency in resource allocation and use in sectors critical for EMP implementation will be sought by: (i) the elimination of public sector monopolies and the establishment of a level playing field for competition between the public and private sector; and (ii) the enhancement of the competitive environment through ensuring

freedom of entry and an adequate incentive structure in areas where resource allocation and use has up to now been heavily regulated by the public sector.

Main Components of Proposed Operation

49. The proposed operation will include policy decisions and actions in the areas of public sector management and private sector development.

Public Sector Management.

50. The proposed operation will support establishment at the level of CONFIS of a performance planning and evaluation system (PPES). This PPES will become the main institutional link between the Central Government and its DPS entities. It will define, through a process of negotiation among all parties involved (economic and sector authorities and the entity's management), the entity's strategic role pursuant to the Government's sector policies and macroeconomic objectives, main operational targets and objectives for efficiency improvement, and indicators for evaluating management's performance in achieving its objectives and targets. The Letter of Development Policy will define as the main objectives to be pursued by the PPES: (i) to maximize the economic return on public sector assets through the establishment of prices for public sector goods and services based on economic efficiency and financial self-sufficiency objectives and the setting of performance targets that ensure cost efficiency in the operations of public entities; (ii) to limit the role of public sector participation in the provision of goods and services to cases where there are qualified policy considerations which would be made explicit in the definition of the strategic objectives of the DPS entities and to cases of market failure; and (iii) to establish an incentive structure in those sectors where the Government has decided to maintain its presence that would promote competition between the public and private sector in the provision of goods and services. The Government, in the course of preparing this operation, has already defined methodological, organizational, and legal aspects related to the establishment of the PPES (Annexes 8-9).

51. Initial diagnosis of the DPS entities selected for the first round of performance plans (ECOPETROL, TELECOM, ICT, and HIMAT) has been started. During appraisal, the mission is expected to agree on the strategic objectives that will be pursued for each of the selected entities and on the performance and evaluation indicators that reflect those objectives. The performance plans content will be defined on a case by case basis, given the present conditions of the entity and the sector policies and corporate objectives the Government has decided to pursue. While in some cases performance plans will focus on efficiency improvements due to the adequacy of sector policies and the consistency of the entity's objectives with those policies, in other cases the performance plan exercise will lead to major reforms in sector policies and to substantial restructuring of the entities. A key objective of the performance plans is the definition and implementation of pricing and investment policies for each of the selected entities that will be consistent with the general policy objectives set forth in the Letter of Development policy. Some additional aspects which are expected to be systematically covered under the performance plans is the improvement of managerial practices and structures and the strengthening of accounting and commercial practices.

The objectives pursued in the case of the four entities selected the first round of performance plans vary with the specific issues. In case of ECOPETROL and TELECOM there are no major sector policy issues tanding and the two entities seem to have corporate objectives sistent with the Government's sector priorities. In these cases the main ective of the performance plans will be to obtain efficiency gains. liminary diagnoses have identified a number of areas and targets to rove efficiency in the short term. However, the lack of a cost ounting system to assist management in planning and controlling routine rations (cost of products and services provided and the sources of ome and loss in their operations) and in the formulation of major plans l corporate policies have been identified as a major constraint to a stained effort of efficiency improvement in these companies. The rformance plans for both companies will include, as a medium-term task, e carrying out of studies for the establishment and development of nagement cost accounting systems. These systems will become the main nagerial tool to improve overall efficiency in the medium-term. The udies will be financed out of the technical assistance component of the an. In the case of TELECOM, the study will include a calculation of the ong-run marginal cost of its main telecommunication services and their omparison with the current tariff structure. The Letter of Development olicy will include the Government's commitment to adjust TELECOM's tariffs o reflect their economic costs (except in the case of rural elecommunications where subsidies are expected to be maintained since services are targetted to low-income beneficiaries which cannot pay their full cost) and the performance plan will include efficiency measures to adjust the current costs to economic efficiency levels. There are no significant distortions in domestic consumer prices for gasoline since current prices, including taxes, are at export opportunity cost levels. The Letter of Development Policy will include Government policies in this field. ECOPETROL and TELECOM are the major contributors to public sector finances. They represented over 45% of DPS revenues in the year 1989 (about 5.4% of GDP).

53. In the case of ICT, the plan will consist in a major restructuring effort including financial, operational and administrative reforms aimed at streamlining and reducing the scope of ICT's operations to allow increased private sector participation and at rationalizing Government subsidies in the area of low-income housing. In the case of HIMAT (the Government's irrigarion agency) the basic focus of the plan will be to strengthen the cost recovery practices of this entity, ensure an appropriate administrative decentralization of its operations and define targets for the transfer of the operation and maintenance of the irrigation districts operated by HIMAT to its beneficiaries.

54. The Government has already made the PPES operational. It has appointed two senior advisers in charge of preparing and negotiating performance agreements with each of the selected entities and CONFIS has already approved the regulatory and organizational arrangements for the PPES. As a condition of Board presentation, the Bank will require that at least two of the performance agreements with DPS entities selected for the first round would have been finalized in form satisfactory to the Bank. The completion of the two remaining will be required by September 30, 1990. As a condition of second tranche release, the Bank will expect satisfactory

progress in the initial operation of the PPES, including overall compliance with the objectives and performance targets set forth in the first-round performance plans and that CONFIS has entered into performance plans with six additional DPS entities. The list of these entities will be agreed at the time of appraisal, however, it is expected to include Colpuertos and some of the other public entities that present serious efficiency problems and have significant fiscal weight. As a condition of third tranche release, continued satisfactory progress in the implementation of the PPES and in the performance by the selected public entities with its performance targets will be expected and that at least five additional public entities would have entered into performance plans with the Central Government. These entities would be selected on the basis of the same criteria described above.

Improvement of the Policy and Institutional Environment for the management of DPS Operations.

55. A scenario where DPS entities are evaluated in terms of their efficiency in carrying out specific mandates from the Central Government requires clear delimitation of the entities' sphere of management responsibilities, rationalization of Government intervention in their management processes, and streamlining of administrative and legal procedures, with a view towards increasing the entities' autonomy and accountability. Under the current environment, the pervasive ad hoc intervention of the Central Government in such areas as pricing, managerial appointments, labor benefits, and organizational structure, as well as the inefficiencies derived from the existing regulations on procurement and reporting requirements, make the role of the boards of directors and managers of public entities rather marginal.

56. The proposed operation will seek definition of a policy for the rationalization of DPS management, under which the Central Government will limit its intervention to specific strategic roles, i.e., ensure consistency of the entity's operation with macroeconomic constraints (Financial Plan); define the strategic objectives to be pursued by the entity, based on sector policy priorities (performance plans); appoint the entity's board members and senior management; evaluate management's performance (performance plans); define clear and permanent pricing and investment policies to be followed by each entity (performance plans); and refrain from taking any other action. To minimize interventionism, the Bank will seek regulatory changes aimed at transferring responsibilities in such areas as personnel, organizational structure, and day-to-day pricing to DPS management and streamlining administrative procedures affecting DPS efficiency.

57. The operation will seek a substantial reform of current procurement regulations, which are a major contributor to public sector inefficiency. This reform will focus on eliminating the countless review procedures applicable to procurement decisions, reducing the focus of current regulations on the compliance with formal and legal requirements that have perverted the basic economic nature of procurement procedures, eliminating the requirement of prior registration of contractors and suppliers and eliminating preferences granted to domestic producers under the public procurement laws that exceed the tariff protection levels under the general trade regime.

58. As a condition of Board presentation, the Government will present to the Bank a Letter of Development Policy that will define its basic policies and strategies in managing the DPS and in streamlining the regulatory environment under which the DPS operates. In addition, this Letter will include the Government policy objectives and actions aimed at improving public sector productivity and improving efficiency in resource allocation and use in areas where the public sector has up to now played a dominant role, including the elimination of public monopolies and changes in the regulatory framework of key economic sectors to enable free entry and increased competition. A draft of this letter will be agreed at negotiations. As a condition of second and third tranche release, the Government will have complied with the agreed policy objectives in terms satisfactory to the Bank.

Extension of PPES to Municipally-Owned Entities Benefitting from External Credit.

59. A constitutional provision establishing the autonomy of municipalities and municipally-owned entities from the Central Government has prevented the Government from including some municipally-owned DPS entities under the newly established controls for DPS operations. Some of these entities have significant macroeconomic impact derived from their financial results, borrowing requirements, and investment programs. The main utility companies are municipally-owned and have in the past relied on Central Government guarantees for access to external credit markets. While some of these utilities have consistently presented satisfactory financial results, others have become significant burdens on the Central Government, which has in practice no effective recourse to seek compensation or urge remedial action from the respective municipal authorities.

60. In order to ensure greater financial discipline by municipally-owned companies benefitting from Governmental debt guarantees and an equitable treatment for DPS entities, the proposed operation will seek the Government's commitment to deny Government debt guarantees to municipally-owned companies, unless agreement has been reached on a performance plan defining specific financial and investment efficiency targets and the company has agreed to close Government monitoring, through CONFIS, of such a plan.

Private Sector Development

61. This component will seek improved resource use efficiency through the promotion of private sector participation and competition in sectors dominated by the public sector, through public monopolies, over- extended public sector presence or by public regulatory restrictions on entry and competition. It will build upon recent Government decisions aimed at promoting private sector development in railways, ports, shipping, low-income housing, and in the industrial and financial sectors and will seek the implementation of those decisions as well as their deepening and broadening to ensure an adequate competitive incentive structure.

62. **Railways.** The Government has taken significant actions to deal with the inefficiencies generated by the public sector monopoly in

railways. After obtaining Congressional authority in late 1988, the Government issued in July 1989 various decrees liquidating the existing company, terminating the public sector monopoly in railways operations and establishing the free entry of private investors to operate freely in the sector, either by the establishment of wholly-private enterprises or through joint ventures with the public sector.

63. In order to provide to the private sector track infrastructure services and to manage the assets of the liquidated railway company, the Government created two officially-sponsored companies: a Government-owned company in charge of the operation, rehabilitation, and maintenance of the rail system (FERROVIAS) and a majority Government-owned rolling stock company in charge of transport operations (STF). FERROVIAS is expected to provide rail services charging tariffs in accordance with the principles set forth below and regulate traffic and security matters. STF will inherit all rolling stock assets and seek to form joint ventures with private partners. The establishment of STF will not preclude the establishment and operation of fully private rolling stock ventures. STF and the private ventures providing transport and cargo services will operate on a commercial basis. Tariffs and other conditions for the provision of services will be set freely by the operating companies.

64. Liquidation of the existing Government-owned railways company has proceeded on schedule. A total of 1,240 workers had accepted voluntary termination with compensation by December 1989. No serious problems are foreseen in meeting the personnel reduction targets, since a climate of cooperation has developed between the unions, the company, and the Government. The newly established companies are expected to engage only 1,000 workers, down from the total of 7,000 of the previous company. The operational, investment, and financial plans for FERROVIAS and STF are being finalized and the promotional efforts to attract private sector participation should be initiated in the coming weeks. The proposed operation will support Government efforts aimed at liquidating the existing company and establishing an adequate incentive structure for private sector participation. There is a possibility that the private sector may not be interested in participating in the sector despite the attractiveness of the new incentive structure, due to the comparative advantage of other transport modes in Colombia. The operation has sought to limit public sector investments in FERROVIAS to the minimum until clear commitments of private sector participation are made. Moreover, it will seek to terminate public sector involvement in the sector if private sector interest does not materialize.

65. <u>As a condition for Board presentation</u>, the Bank will seek completion of the commercial, operational, investment, and financial plans required for establishment of the two new companies; initiation of promotional efforts to attract private sector participation in the rolling stock company; and continued progress in the liquidation of the existing company. <u>As a condition for second tranche</u>, the proposed operation will seek that progress has been made: (i) in the liquidation of the existing company; (ii) in the establishment and initial operation of FERROVIAS, including its investment and pricing policies. The proposed operation will support a study to define the tariff structure for the provision of rail services by FERROVIAS that will take into account the need to ensure

IAS' financial independence through the recovery of its operation and nance costs and a reasonable contribution towards rehabilitation and ion of the rail system and the comparative advantages of the railways vis the existing incentive structure for the provision of other ort services. By second tranche, the Government would have put into t FERROVIAS' tariff structure based on the conclusions of the study; iii) in attracting private sector participation to the sector. This condition will require that firm and substantial commitments have been d by investors to participate in the equity of STF or in a private re in railways transport. In case the expected progress in attracting ate sector participation is not attained, the Government will review economic and commercial feasibility of its current railways strategy, provide the Bank a plan of action containing its future strategy in railways sector. The Bank should be in agreement with any redefinition he current strategy, including the investment program for the sector. A dition for third tranche release will be applicable in case the ernment shall have failed to attract private sector participation to the tor and a plan of action containing the Government's future role in the tor would have been provided to the Bank. In this case, the Government ld have complied with the policy decisions and actions contained in the an of action.

. Ports. COLPUERTOS' initial monopoly in the handling of trade rgo, has been tempered by the Government over the years by allowing on a iscretionary basis the handling of port operations by third parties (both ublic and private) to avoid bottlenecks and to enable the viability of ertain economic activities that were especially vulnerable to COLPUERTOS' nefficiencies. As a result of this process, by 1988, COLPUERTOS was andling only 14.8% of total import/export cargo, with the public pecialized ports for oil, coal, and banana handling 63.4% of the cargo and rivate docks handling 20.8% of total cargo (Annex 10). In the area of eneral cargo handling, however, COLPUERTOS continued to have substantial articipation (41.6% of total general cargo) and a monopoly on the rovision of port services on a commercial basis (Annex 11). Private docks ave only been allowed to handle cargo directly related to the operator's ndustrial or commercial operations. In the context of the proposed peration, the Government has recently allowed two private sector investors o initiate commercial port activities that would compete directly with the ervices provided by Colpuertos. The new port terminals will be located in hree of the four cities where Colpuertos' terminals operate, e.g., Santa arta, Cartagena and Buenaventura. However, to enable COLPUERTOS to adjust o the new competitive conditions, the Government has established a tariff tructure for the private ports that incorporates a sliding surcharge that ill put COLPUERTOS' and the private ports initially at the same port ariff levels. This surcharge will be reduced to a nominal fee after a eriod of six years. The Government has argued that despite the initially igh tariff levels, port users will benefit from substantial savings in hipping costs derived from the shorter turn-around period at the private orts and introduce a substantial element of competition in terms of uality of service. Preliminary indications are, however, that the initial quivalence in tariff treatment for the public and private sector will nduly limit competition in an area that is critical for the improved fficiency performance of the productive sectors and may constitute a isincentive for private investors in the sector. As a condition for Board resentation, the Bank will seek: (i) the issuance of a policy statement by the Government establishing that tariffs for ports operations by the private and public sector will be based on the reasonable economic cost of the service to enable efficient port operators to cover all operational costs, debt service, make a reasonable contribution to expansion and earn a reasonable return on investment. For the implementation of this policy the Government will undertake to carry out a study aimed at defining a uniform tariff structure that would ensure an increased competitive environment and improved economic efficiency in the sector; (ii) progress in the negotiations with the private investors which have been authorized to operate commercial port facilities; and (iii) the Government's agreement to carry out a study aimed at defining general and transparent rules to allow entry to the ports sector by private investors, including the revision, if necessary, of current procedures to grant the required authorizations in order to limit discretionality in the review of entry applications. As a condition for release of the second tranche, progress will be expected in the promotion of private sector participation in ports, including that negotiations with the two private investors for which participation has been authorized have been successfully completed, that the uniform tariff structure for ports operations has been approved and implemented to public and private commercial port operators and that a transparent policy and a non-discretionary procedure has been defined to approve entry by private investors in port operations. As a condition of third tranche release, the Government will have consistently applied and implemented the new policy framework allowing private sector participation in the ports sector, specifically in terms of the uniform tariff policy and the non-discretionary entry regulations and procedures.

67. COLPUERTOS continues to provide extremely inefficient operations as a result of poor management, obsolete equipment, poor maintenance practices and the concessions granted to the labor unions in the organization and implementation of ports operations. COLPUERTOS is, in addition facing mounting financial difficulties as a result of excessive labor and pension costs and a distorted tariff system. The Bank made a loan to COLPUERTOS in 1985 aimed at improving basic infrastructure and providing technical assistance to improve corporate performance. Project execution has been very slow while COLPUERTOS' operational and financial condition continues to deteriorate. These developments and the expected increase in competition from the private sector have created the need for a major restructuring of this company. As a condition of Board presentation, the proposed operation will seek a definition by the Government on the restructuring of COLPUERTOS, including, promoting the maximum operational, administrative, and financial autonomy of the company's terminals and competition among them; establishing a tariff system that will reflect Colpuertos' costs based on economic efficiency objectives, in line with the tariff structure proposed for the overall ports sector; defining a program to reduce redundant personnel in the various port terminals and in the Bogotá headquarters; and divesting all operational authority from the Bogotá headquarters. As a condition of second tranche, the Government will have agreed to define a performance plan for COLPUERTOS consistent with the restructuring objectives and subject this plan to CONFIS monitoring and evaluation. As a condition of third tranche release, the Government will review the performance of COLPUERTOS in order to assess its progress in terms of financial performance and operational efficiency pursuant to the

targets set forth in the performance plan. In case COLPUERTOS would have substantially deviated from the financial and operational efficiency targets, the Government will provide the Bank a time-bound action plan for privatization of COLPUERTOS operations.

68. Shipping. The basic objective of the flag law of establishing a strong national shipping line that would meet the country's trade needs have not been fulfilled in the case of Colombia. After nearly a decade of providing virtual monopolistic protection to the Flota Mercante Grancolombiana and other minor carriers, the result has been inefficient services at high costs and increased dependency on foreign liners, which have become the main beneficiaries of the protection granted by the flag law (Annex 12).

69. The Colombian Government has proposed a two-pronged approach to deal with this matter. In the short term and as a result of statutory limitations that would prevent it from moving further without legislative changes, the Government has increased the level of competition in the sector by reducing the level of cargo subject to flag law protection. In early March, the Government issued a decree reducing the reserve for national liners on bulk cargo to only 10% (against the prior requirement of 50% of the total bulk cargo) and reduced protection for general import cargo to a level not exceeding 50% (against the prior requirement of not less than 50% of total general import cargo, which had resulted in an effective reserve average of about 75%). In addition, the decree provides for more flexible procedures and controls for the administration of the quota system.

70. However, the quota-based flag law protection and the procedures for its implementation will continue to limit the access of importers and exporters to the various opportunities available in the international markets. To deal with this issue, the Government has proposed to undertake a review of the shipping protection system that would seek to assess the impact arising from the implementation of the recent reforms, identify the actions required to dismantle the current quota-based protection system and define a plan of action to phase-out the quota-based system and the policy and administrative basis for the establishment of a new shipping system based on freedom of entry to enable importers/exporters to select shipping services on the basis of convenience and economy.

71. The Government has already put in place the short-term actions aimed at improving competition under the current flag law scheme. As a condition of second tranche release, the Government would have completed the study referred to above, and agreed with the Bank on a plan of action for the dismantling of the quota-based system and its replacement by a system allowing freedom of entry. As a condition of third tranche, the Government would have complied with the terms of the agreed plan of action, including completion of all administrative actions aimed at enhancing freedom of entry and submission to Congress of the legislative initiatives required to eliminate the quota-based system..

72. Low-Income Housing. The Government has agreed to carry out a restructuring of ICT aimed at redefining the role of the public sector in low-income housing and improving ICT's financial, administrative and

operational position. The main features of the restructuring plan would be: (i) defining specific targets for ICT operations in terms of beneficiaries (ICT would provide housing for families earning up to two-and-a-half times the minimum wage) and housing costs (not to exceed US$6,000 per unit and an average cost of about US$4,000); (ii) improving ICT's financial position through programs of staff reductions, asset divestment, and aggressive portfolio recuperation (providing for the sale of loans to borrowers at a discount in exchange for up-front cash payments); and (iii) redesigning ICT's operation by subcontracting with the private sector the planning and development of construction projects, redefining credit policies and operations for its target population, and providing up-front subsidies to eligible families who will obtain housing finance from the private sector.

73. In addition to ICT's restructuring, the proposed loan will seek from the Government a program for gradually dismantling the forced investment financing for ICT and establishing a new strategy for financing low-income housing. The proposed strategy will consist of increasing the incentives for private sector financing of low-income subsidies by dismantling interest rate controls and provisioning any required subsidies to these sectors through up-front Government grants financed from the Government's budget. These subsidies would be complementary to the private sector's financing and seek to improve creditworthiness and access to housing. Definition of a satisfactory program for reforming sector financing consistent with the objectives set forth above <u>will be a condition for second tranche release</u>. Timely implementation of the agreed strategy <u>will be a condition for third tranche release</u>.

74. **<u>Agricultural Marketing</u>**. The proposed operation would support a study to determine the cost effectiveness of Government involvement in this area, including the function of import quotas, and alternative market-based mechanisms that would increase transparency and efficiency in food marketing. <u>As a condition of second tranche release</u>, the proposed loan would seek policy decisions and definition of a plan of action for the dismantling of the state monopoly in food marketing, the alternative market-based mechanisms that should replace the present system, and the appropriate role of IDEMA under an alternative market-based mechanisms. <u>As a condition of third tranche release</u>, the Government shall have complied in a timely manner with the actions included in the plan of action, including the elimination of import quotas and of IDEMA's monopoly.

75. **<u>Financial Sector</u>**. The financial sector in Colombia has shown steady improvement since the crisis in the early eighties that led to the nationalization, liquidation or temporary intervention of a significant share of the private banking sector. As a result of the Government's decisive measures, the sector shows at this time substantial improvements in terms of overall solvency, profitability and capitalization level. In addition, the Government has taken steps to strengthen prudential regulation of the sector. The policy priorities for the Government in the financial sector are rapidly shifting towards the need to increase competition in order to improve allocative efficiency, reduce intermediation costs and broaden the range of financial instruments. The financial sector's structure is recognized as a major obstacle to competition. This is characterized by a few large financial intermediaries,

g a dominant presence of Government-owned banks, combined with a f small inefficient institutions. Recently, the Government has .gnificant actions to eliminate barriers to entry in the financial ıs a means to improve competition and strengthen the sector's base. It obtained passage of a law in December 1989 allowing investors' control of financial institutions. Negotiations are y regarding two banks where foreign investors are interested in .ng controlling interest from national shareholders. The Government :cted to approve the outcome of those negotiations. Moreover, the ment intends to use the privatization of nationalized banks as a instrument to attract foreign investment to the sector. In mid-1989, vernment issued regulations for the privatization of publicly-owned which provide for the selling of shares through an auction of three of share packages. The first group of shares will provide control of management and will be awarded after a pre-qualification of bidders in of financial solvency and business experience. Foreign investors are ted to bid for these shares. The other two groups of shares will be able to the general public, the banks' staff, and pension funds, and seek mainly wider distribution of bank ownership. The proposed ation will support the Government's strategy aimed at improving etition and strengthening the sector's capitalization, through atization of nationalized banks and promotion of foreign investment in sector. The Government is committed to bring about the privatization of .onalized banks, subject only to their compliance with minimum solvency liquidity standards applicable to the overall banking sector.

The group of five banks nationalized in the 1980s, represents ut 25% of total banking sector assets. The nationalized banks faced ious liquidity and solvency problems, which forced the Government to ly the extreme measure of nationalization. The largest bank in the group the Banco de Colombia (representing 61% of total nationalized assets), lowed by Banco del Estado (18.8%), Banco del Comercio (16.5%), uendama (3%) and Trabajadores (2.23%). Of these five banks, only the ee smallest ones have substantially recuperated their financial ndness. The Banco del Estado has also improved its financial formance, however, it is the subject of a court claim that, if cessful, would wipe out the totality of the bank's capital and reserves. ally, the Banco de Colombia is still in a process of strengthening its ancial position and there is uncertainty as to the type and level of ancial assistance that would be required to put the bank in a sound ancial footing. Public sector participation in commercial banking is stituted also by its ownership of Banco Popular (representing about 10% total banking sector assets) and two quasi-public banks which are owned administered by trust funds established with the participation of the ernment and the coffee growers (Banco Cafetero) and the cattle raising nco Ganadero) associations (representing about 23% of total banking tor assets).

Last March the Government brought to the market the Banco de bajadores. The term for bidding for the majority share package is still n, and there has been interest expressed by various private groups in uiring the bank. The Government has also indicated its intention to ng to the market in the coming months at least one more of the banks quendama or Comercio) which are close to complying with the minimum financial conditions for privatization. As a condition for Board presentation, the Bank will require that at least two of the nationalized banks have been brought to the point of sale. As a condition for second tranche release, the Bank will require that the Government has completed the sale of two banks and brought the third one to the point of sale. In addition, it will require that the Government has defined a strategy to deal with Banco de Colombia, Banco del Estado and any of the other nationalized banks brought to the point of sale for which no acceptable bids were received. The strategies for all these banks should include a definition of the viability and costs associated with bringing them to the stage of privatization and an assessment of alternative courses of action (including liquidation) available to the Government, with their respective cost-benefit analysis. As a condition for third tranche release, the Government will have implemented the strategy defined for Banco de Colombia and Banco del Estado and any remaining non-privatized nationalized bank.

78. Industrial Sector. IFI's industrial investment activities have made it the principal instrument for public sector participation in the industrial sector. By July 1988, IFI's investment portfolio consisted of participations in 54 enterprises. IFI's equity holdings in 25 of these companies exceeded 30% of their capital. IFI has initiated an aggressive program of divestiture of its investment portfolio as part of a broader restructuring plan aimed at its financial rehabilitation and the redefinition of its role as the Government's bank for industrial development. The proposed operation will support the portfolio divestiture program of IFI. As a condition of Board presentation, the Bank will seek that, in addition to the seven companies already sold, at least eight more of the original 18 companies included in the 1989-90 Privatization Program are brought to the point of sale.

79. Also as a condition of Board presentation, the Government shall have agreed on terms of reference and the selection of consultants to carry out a study to determine the feasibility of restructuring ALCALIS, with a view to its later privatization or, alternatively, a plan for its liquidation. ALCALIS, a company wholly owned by IFI producing basic chemical inputs and raw materials for domestic industries, represents IFI's third largest investment and its second largest debtor. It is the only remaining manufacturing concern controlled by the public sector. ALCALIS has been facing serious financial and operational problems for the last decade as a result of Government price controls, technological obsolescence, and excessive labor costs and pension burden. The Government has been reluctant to order its liquidation since it is the sole provider of chlorine for water supply and refined salt for private consumption. No private sector interest has been expressed in acquiring the company. As part of the technical assistance component of the proposed operation, it is proposed to study options for ALCALIS' privatization or liquidation, with the assistance of qualified consultants. Agreement on a plan of action for dealing with ALCALIS, based on the study's recommendations, will be a condition for second tranche disbursement.

80. Additional conditions of second tranche release will be the completion of the 1989-90 IFI Privatization Program and definition of a 1991-92 Privatization Program that will include not less than half of the assets in IFI's mature investments. As a condition of third tranche

release, the Government shall have brought to the point of sale at least half of the assets included in the 1991-92 Privatization Program and timely implemented the plan of action for ALCALIS.

Rationale for Bank Involvement

81. During the last two years, the Bank has focussed its policy dialogue with the Colombian economic authorities on the need for the country to initiate a comprehensive development strategy, with a view to accelerating economic growth by raising the efficiency of resource use. Discussions followed on a diagnosis of the structural changes required in major economic sectors, including trade, finance, industry, and the public sector, and the pace and sequencing of those changes. During the last months, the Government has reached a consensus on the medium-term strategy described above, and has indicated its intention to take decisive actions towards its implementation during the last months of the Barco administration. In this context, the announcement last February of a trade policy reform and the various actions the Government has undertaken as a result of preparation of the proposed operation reflect a clear Government commitment to its medium-term program.

82. The proposed operation constitutes a key element in the Government's strategy, since it will contribute to improving public sector efficiency, lay the basis for changes in other sectors of the economy--especially by improving the delivery of public services to the productive sectors-- and will ensure a fiscal performance that is consistent with proposed changes in the trade and financial sectors. The Bank's support for the proposed Public Sector Reform Program will demonstrate backing for the significant policy decisions and actions undertaken by the Government in the sector and an endorsement of the Government's recently defined EMP.

83. In addition, the structural reforms sought by this operation in the areas of ports, railways, low-income housing, shipping, and industrial promotion will lay the basis for specific investment lending, aimed at financing the investment requirements derived from those reforms. The Bank's future involvement, to ensure the appropriate implementation of agreed structural reforms, seems warranted.

Tranching and Disbursement Arrangements

84. The proposed loan would be for US$200 million. The Government has requested that IDB cofinance the proposed operation. IDB has expressed its initial interest in participating, and is expected to join the Bank's appraisal mission. Loan disbursements would be linked to satisfactory progress in carrying out the reform program and to compliance with the specific second and third tranche conditions that have been tentatively defined in the attached Policy Matrix (Annex 13). Loan proceeds would be used to finance general imports, excluding a negative list, and the cost of a technical assistance component that would support preparation and implementation of performance plans by selected public entities and studies required to define policies in the areas of shipping, public enterprise restructuring, railways, ports and agricultural marketing. It is proposed the loan be disbursed in one initial tranche of US70 million and two US$65 million tranches.

Expected Economic and Social Benefits and Risks

85. The proposed reform program should have a significant impact on the public sector's structure and efficiency in the medium term. The privatization of public banks, the improvements in resource allocation in key economic sectors, the breaking-up of monopolies in ports and railways and improvements in the competitive environment in shipping, banking, housing and agricultural marketing, will result in major efficiency gains and in less public sector intervention in the economic process. In addition, the reforms proposed in public sector management in a more efficient use of public sector resources.

86. There may be some adverse social effects derived from the need to lay off personnel from various public entities that have gross overstaffing problems e.g., railways, ports, ICT and Telecommunications. The recent initial experience in the railways shows that the short-term negative effects can be substantially neutralized by providing adequate compensation packages, allowing early retirement for people that have completed a significant period of service, and phasing layoffs during a period of two to three years, thereby providing staff with a transition period to seek other employment opportunities.

87. The main risk in the proposed operation would be a lower level of commitment to the medium-term development strategy and to the program of public sector reform from the new Government that is expected to take power in August, 1990. The current Government has committed itself to initiate the most critical actions under its mandate and to ensure adequate transfer arrangements with the new Administration, to ensure continuity and consistency in implementing the reform program. It is generally expected that any of the two main contenders to the presidency will follow substantially the same policy orientations and priorities set by the Barco Administration, and may in fact deepen and accelerate the implementation of the policy measures prescribed under the EMP.

Timetable

88. The appraisal mission has been scheduled tentatively for mid-June to finalize the policy discussions with the Colombian authorities and deal with some outstanding preparation matters. The agreements reached with the Government on the various policy and implementation issues related to the Public Sector Reform Program and the relevant aspects of the EMP will be spelled out in a Letter of Development Policy. Negotiations are expected to take place in late July 1990, and Board presentation is expected in August, 1990.

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COLOMBIA - Key Macroeconomic Indicators

Key Indicators 1/	Actual 1986	1987	Prelim. 1988	Estimate 1989	Projections 1990	1991	1992	1993	1994	1995
GDP Growth	5.8%	5.3%	3.7%	3.0%	2.8%	3.0%	3.5%	4.0%	4.5%	4.5%
GDY Growth	5.6%	2.4%	3.6%	2.8%	1.1%	2.8%	3.4%	4.2%	4.8%	4.9%
GDY/Capita Growth Rate	3.8%	0.6%	1.8%	1.0%	-0.7%	0.9%	1.6%	2.3%	2.9%	3.0%
Consumption/Capita Growth Rate	1.2%	2.3%	3.2%	1.2%	0.3%	0.5%	0.1%	1.9%	2.7%	3.2%
Debt Service (US$ millions)	2435.5	2719.2	3199.4	4075.9	3811.2	3728.9	3636.3	3803.6	3777.5	3960.7
Debt Service/XGS	35.8%	41.1%	46.2%	53.6%	47.8%	41.9%	36.0%	34.8%	32.1%	31.0%
Debt Service/GDP	7.0%	7.2%	7.8%	9.2%	8.1%	7.8%	7.5%	7.6%	7.1%	6.8%
Gross Investment/GDP	17.2%	17.4%	18.1%	17.5%	16.5%	16.5%	17.0%	17.5%	18.0%	18.0%
Domestic Savings/GDP	19.4%	20.3%	19.3%	19.2%	19.8%	20.4%	21.6%	21.8%	21.7%	21.3%
National Savings/GDP	19.2%	20.2%	19.2%	19.1%	19.6%	20.2%	21.4%	21.6%	21.6%	21.2%
Marginal National Savings Rate	n.a.	37.6%	-7.9%	18.4%	39.5%	38.7%	57.1%	26.8%	20.3%	12.4%
Public Fixed Investment/GDP	6.1%	5.3%	5.5%	5.2%	5.5%	5.5%	5.5%	5.5%	6.0%	6.0%
Public National Savings/GDP	n.a.	5.2%	3.3%	3.9%	4.4%	4.4%	4.4%	4.4%	4.4%	4.4%
Private Fixed Investment/GDP	10.1%	10.0%	10.3%	10.0%	9.5%	10.0%	10.5%	11.0%	11.5%	11.5%
Private National Savings/GDP	n.a.	15.0%	15.9%	15.2%	15.3%	15.8%	17.1%	17.2%	17.2%	16.7%
Ratio of Public/Private Investment	60.4%	53.0%	53.4%	52.0%	57.9%	55.0%	52.4%	50.0%	52.2%	52.2%
Government Revenues/GDP	23.5%	21.7%	20.8%	20.8%	20.5%	20.7%	20.8%	20.9%	20.9%	21.0%
Government Expenditures/GDP	23.8%	23.5%	23.6%	23.2%	23.2%	22.3%	21.4%	21.5%	21.6%	21.6%
Deficit (-) or Surplus (+)/GDP	-0.3%	-1.8%	-2.8%	-2.4%	-2.7%	-1.6%	-0.6%	-0.6%	-0.7%	-0.6%
Export Growth Rate 2/	43.7%	-3.3%	1.6%	10.5%	5.5%	13.2%	14.9%	8.2%	7.4%	8.6%
Exports/GDP 2/	15.5%	13.9%	13.0%	13.3%	13.2%	14.7%	16.7%	17.5%	17.6%	17.4%
Import Growth Rate 2/	-7.2%	11.3%	19.0%	4.7%	4.2%	8.2%	8.0%	10.7%	11.3%	10.3%
Imports/GDP 2/	9.8%	10.0%	11.0%	10.6%	10.5%	11.1%	11.9%	12.7%	13.2%	13.3%
Current Account (US$ Million)	564.7	-20.5	-355.0	-310.4	-787.4	-561.9	-124.4	-183.7	-374.0	-408.6
Current Account/GDP	1.6%	-0.1%	-0.9%	-0.7%	-1.7%	-1.2%	-0.3%	-0.4%	-0.7%	-0.7%

1/ All National Accounts GDP ratios are at constant prices. External Accounts are at current prices.
2/ Exports and imports of goods (Balance of Payments).

COLOMBIA - BALANCE OF PAYMENTS

(US$ millions at current prices)

	Actual 1986	1987	Prelim. 1988	Estimate 1989	Projections 1990	1991	1992	1993	1994	1995	1996	1997
A. Exports of Goods & NFS	6643.9	6421.6	6684.5	7306.6	7694.5	8635.0	9821.7	10643.7	11475.0	12482.4	13352.3	14374.1
1. Merchandise (FOB)	5433.0	5254.5	5339.5	5899.5	6223.8	7045.9	8096.5	8761.5	9411.8	10220.7	10901.3	11718.0
2. Non-factor services	1210.9	1167.1	1345.0	1407.1	1470.7	1589.0	1725.3	1882.2	2063.3	2261.8	2451.0	2656.0
B. Imports of Goods & NFS	5325.6	5751.1	6408.0	6754.6	7107.9	7682.2	8302.8	9140.2	10116.0	11127.1	12054.2	13047.0
1. Merchandise (FOB)	3409.2	3793.5	4515.3	4727.7	4926.7	5332.2	5758.7	6372.6	7090.8	7820.4	8467.4	9156.3
2. Non-factor services	1916.4	1957.6	1892.7	2026.9	2181.2	2350.0	2544.1	2767.6	3025.2	3306.7	3586.8	3890.7
C. Resource Balance	1318.3	670.5	276.5	552.0	586.7	952.8	1519.0	1503.5	1359.1	1355.3	1298.0	1327.1
D. Net Factor Income	-1538.3	-1691.9	-1596.9	-1877.4	-1994.1	-2164.8	-2293.4	-2367.2	-2452.1	-2507.7	-2572.6	-2639.4
1. Factor Receipts	152.9	192.7	247.4	302.3	277.7	272.4	276.2	282.6	286.8	302.7	321.0	335.5
2. Factor Payments	1691.2	1884.6	1844.3	2179.7	2271.8	2437.2	2569.6	2649.8	2738.9	2810.4	2893.6	2974.9
(interest payments)	1315.6	1341.5	1414.9	1643.0	1670.7	1709.6	1723.9	1718.4	1726.6	1748.5	1792.4	1833.0
E. Net Current Transfers	784.7	1000.9	965.4	1015.0	620.0	650.0	650.0	680.0	719.0	743.8	769.5	796.2
F. Current Account Balance	564.7	-20.5	-355.0	-310.4	-787.4	-561.9	-124.4	-183.7	-374.0	-408.6	-505.1	-516.1
G. Long-Term Capital Inflow	2194.6	202.9	872.6	584.5	1064.4	783.6	664.4	509.5	609.7	858.6	866.9	836.2
1. Direct Investment	562.1	287.1	186.4	458.0	339.1	294.6	448.3	240.4	232.4	243.8	252.8	262.2
2. Official Capital Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
3. Net LT Loans (DRS data)	1632.5	-84.2	686.2	126.5	725.3	489.0	216.1	269.1	377.3	614.8	614.1	574.0
a. Disbursements	2753.4	1293.6	2470.8	2559.5	2865.9	2508.4	2128.6	2354.4	2428.3	2827.0	3032.6	3112.9
b. Repayments	1120.9	1377.8	1784.6	2432.9	2140.5	2019.4	1912.5	2085.2	2050.9	2212.2	2418.5	2538.9
4. Other LT Inflows (Net)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
H. Total Other Items (net)	-1295.6	-204.6	-157.6	-439.1	-249.2	-105.2	-226.7	94.2	129.8	0.0	0.0	0.0
1. Net Short-Term Capital	-1550.2	-194.1	235.1	-139.1	0.8	74.8	-66.7	94.2	129.8	0.0	0.0	0.0
2. Capital Flows N.E.I.	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
3. Errors and Omissions	254.6	-10.5	-392.7	-300.0	-250.0	-180.0	-160.0	0.0	0.0	0.0	0.0	0.0
I. Changes in net reserves	-1463.7	22.2	-360.0	165.0	-27.8	-116.5	-313.3	-420.0	-365.5	-450.0	-361.9	-320.1
1. Net Credit from the IMF	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2. Other reserve changes 1/ (- indicates increase)	-1463.7	22.2	-360.0	165.0	-27.8	-116.5	-313.3	-420.0	-365.5	-450.0	-361.9	-320.1

1/ Includes Reserve Adjustment

COLOMBIA - BALANCE OF PAYMENTS

(US$ millions at current prices)

	Actual 1986	1987	Prelim. 1988	Estimate 1989	Projections 1990	1991	1992	1993	1994	1995	1996	1997
J. Shares of GDP (current US$)												
1. Resource Balance	3.8	1.8	0.7	1.2	1.2	2.0	3.1	3.0	2.5	2.3	2.1	2.0
2. Total Interest Payments	3.8	3.5	3.4	3.7	3.6	3.6	3.6	3.4	3.2	3.0	2.8	2.7
3. Current Account Balance 1/	1.6	-0.1	-0.9	-0.7	-1.7	-1.2	-0.3	-0.4	-0.7	-0.7	-0.8	-0.8
4. LT Capital Inflow (line G)	6.3	0.5	2.1	1.3	2.3	1.6	1.4	1.0	1.1	1.5	1.4	1.2
5. Net Credit from the IMF	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum Item:												
GDP (millions of current US$)	34943.0	37918.9	41135.2	44517.6	47006.3	47944.2	48392.1	50009.9	53518.8	58667.6	63259.7	67985.8
Foreign Exchange Reserves:												
1. Net International Reserves	3477.7	3455.5	3815.5	3650.5	3678.3	3794.8	4108.1	4528.1	4893.6	5343.6	5705.5	6025.5
2. Net Int'l Reserves Months Imports G&S	5.9	5.4	5.5	4.9	4.7	4.5	4.5	4.6	4.6	4.6	4.6	4.5
Exchange Rates												
1. Nom. Off. X-Rate (IFS rf)	194.3	242.6	299.2	382.9	490.5	640.1	815.5	971.2	1147.0	1343.2	1591.7	1878.2
2. Real Eff. X-Rate Base 1980	100.0	99.7	97.7	100.0	106.0	116.0	124.5	124.5	124.5	124.5	126.3	127.6
3. X-Rate for GDP/Capita (Atlas Method)	175.7	229.4	296.2	369.8	461.7	587.9	748.6	930.8	1120.4	1312.3	1554.8	1839.5
4. Domestic Inflation (CPI, %)	20.9%	24.0%	28.1%	26.0%	25.0%	24.0%	23.0%	22.0%	21.0%	20.0%	20.0%	20.0%

1/ Includes Official Transfers.

COLOMBIA - Projected Long-Term Financing Requirements

(US$ millions, annual average)

Gross Disbursements	1986-89	1990-92	1993-95
Long-Term Sources:			
Multilateral	672.1	723.7	815.8
of which IBRD	438.6	384.7	438.3
Bilateral	265.0	391.3	474.9
Suppliers Credits	190.2	358.0	454.6
Financial Markets to Public Sector	1006.1	857.5	666.5
Private Non-Guaranteed LT	135.9	170.3	124.7
IMF Purchases	0.0	0.0	0.0
Financial Gap	0.0	0.0	0.0
TOTAL	2269.3	2500.9	2536.6

Net Disbursements	1986-89	1990-92	1993-95
Long-Term Sources:			
Multilateral	278.1	111.2	67.0
of which IBRD	125.5	-66.1	-23.0
Bilateral	90.4	154.3	121.4
Suppliers Credits	50.1	181.7	131.0
Financial Markets to Public Sector	255.0	22.0	104.9
Private Non-Guaranteed LT	-83.4	7.7	-3.9
IMF Purchases	0.0	0.0	0.0
Financial Gap	0.0	0.0	0.0
TOTAL	590.3	476.8	420.4

COLOMBIA - Debt Service Assumptions

(US$ millions, annual average)

Principal Repayments	1986-89	1990-92	1993-95
Multilateral	394.0	612.5	748.8
of which IBRD	313.1	450.8	461.2
Bilateral	174.6	237.0	353.5
Suppliers Credits	140.1	176.3	323.7
Financial Markets to Public Sector	751.1	835.6	561.6
Private Non-Guaranteed LT	219.2	162.7	128.6
IMF Repurchases	0.0	0.0	0.0
Financial Gap	0.0	0.0	0.0
TOTAL	1679.1	2024.1	2116.1

Interest Payments	1986-89	1990-92	1993-95
Multilateral	417.6	468.9	479.7
of which IBRD	296.1	309.7	290.0
Bilateral	188.9	277.3	290.2
Suppliers Credits	63.8	115.3	145.8
Financial Markets to Public Sector	436.6	511.1	489.2
Private Non-Guaranteed LT	121.4	137.6	127.4
IMF Service Charges	0.0	0.0	0.0
Short-Term Debt	161.1	191.1	198.8
Financial Gap	0.0	0.0	0.0
TOTAL	1389.3	1701.4	1731.1

Key Ratios	1988	1989	1990	1991	1992	1993	1994	1995
Total Interest/XGS	20.4%	21.6%	21.0%	19.2%	17.1%	15.7%	14.7%	13.7%
DOD/XGS	246.1%	225.9%	225.9%	208.2%	186.3%	175.5%	166.7%	158.5%
Net Disbursements/Total Interest 1/	65.1%	-0.8%	43.5%	33.0%	8.7%	21.1%	29.4%	35.2%
Net Transfers/GDP 1/	-1.2%	-3.7%	-2.0%	-2.4%	-3.3%	-2.7%	-2.3%	-1.9%

1/ Includes IMF, Financial Gap and Short-Term Debt.

ANNEX 1

PUBLIC SECTOR CONTRIBUTION TO GROSS DOMESTIC PRODUCT, 1981-1986
(%)

YEAR	PUBLIC SECTOR	(AS % OF PUBLIC SECTOR DOMESTIC PRODUCT) Public Administration	Non-Financial Public Sector	Financial Public Sector
1981	17.8%	50.7%	40.3%	9.0%
1982	18.6%	52.2%	39.0%	8.8%
1983	19.8%	49.6%	39.7%	10.7%
1984	21.3%	51.0%	39.9%	9.2%
1985	20.4%	51.3%	38.3%	10.4%
1986	21.5%	50.7%	41.6%	7.7%

Source: Departamento Administrativo Nacional de Estadisticas (DANE).

COSTA RICA

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EVALUATION OF THE DIVESTURE PROGRAM OF CORPORATION COSTARRICENSE DE DESARROLLO, S.A. ("CODESA")

COSTA RICA

1984 - 1988

REPORT BY

Alexander C. Tomlinson

and

Ismael Benavides

CENTER FOR PRIVATIZATION

2000 Pennsylvania Avenue, N.W., Suite 2500

Washington, D.C. 20006

Project No. 71

May 1988

Prepared for the

BUREAU FOR PRIVATE ENTERPRISE

U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT

CENTER FOR PRIVATIZATION

The Center for Privatization was established in October 1985 as a coordinating office for a group of leading consulting firms which had been selected by the U. S. Agency for International Development (AID) to fulfill Contract No. DPE-0008-C-00-5058-00. The Contract provides for technical assistance to the AID Bureau for Private Enterprise (PRE) and to USAID missions in developing countries around the world relating to divestiture and privatization of state-owned enterprises and other government services and activities which might more appropriately be transferred to the private sector.

The Center has provided technical advisors on privatization matters in over 35 developing countries and has active work continuing in many of them.

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COSTA RICA

1984 - 1988

REPORT BY

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Alexander C. Tomlinson

Mr. Tomlinson was Executive Director of the Center for Privatization from its founding in 1985 to his retirement December 31, 1987. During this period he supervised provision of technical advisory services to over 30 countries planning or engaging in privatization activities under a program sponsored by the U.S. Agency for International Development. He previously served as President of the National Planning Association following an active 32-year career with Morgan Stanley & Co. and with The First Boston Corporation, of which he served as Chairman of the Executive Committee. During his service as an investment banker he was involved in all aspects of corporate finance, both domestic and international, including large and small financings, mergers and acquisitions, financial advisory and planning services and foreign government and multilateral development bank financings.

Ismael Benavides

Mr. Benavides, presently a private consultant residing in Peru, has extensive experience in the managerial and financial areas both in the private sector and in government. During his tenure as Minister of Fisheries in Peru he designed and implemented a plan for the divestiture of Peru's state owned fishing industry and the promotion of private sector activities. He was also Vice Minister of Finance and General Manager of COFIDE, Peru's state development finance company, where he was involved in privatization and restructuring of state owned enterprises.

As a private consultant Mr. Benavides has participated in privatization projects in Bolivia and Panama, and has written various reports and articles on the subject.

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Appendices

NOTE ON EXCHANGE RATES

Costa Rica uses a system of frequent minidevaluations based on the estimated difference between domestic and international inflation. In 1987 there were 25 minidevaluations with a 17.7% increase in the exchange rate. When dollar or colon equivalents are given in the text for dates in the past, they are expressed in terms of the exchange rate at the time unless otherwise specified. The current exchange rate for the U.S. Dollar is approximately US$ 1 = c 76

EVALUATION OF THE DIVESTITURE PROGRAM OF CODESA IN COSTA RICA 1984 - 1988

EXECUTIVE SUMMARY

<u>Introduction</u>:

The writers have been asked by the Center for Privatization, in accordance with a request from the Agency for International Development (AID), to make an evaluation of the CODESA divestiture program commenced in Costa Rica in 1984 and now well along toward completion. The purpose of the evaluation, as described in the Scope of Work, is "to review the steps taken by the Mission in its ongoing dialogue with the Government of Costa Rica (GOCR) over the divestiture, to appraise the effectiveness of those steps in dealing with the divestiture process as it developed, and to distill lessons learned which may be applicable for future divestiture efforts". We were asked to assess whether the original conception was prudent under the circumstances at the time and evaluate the changes along the way, appraise each of the major elements of the process and determine their respective contributions, review changes in the attitude of the Government of Costa Rica (GOCR) toward the project and, to the extent possible at this date, appraise the political, social, fiscal and economic impact of the process.

Based on extensive interviews in Costa Rica and in the United States in March, late April and early May, 1988, and on our own considerable experience with privatization in other developing countries, it is our conclusion that:

A. The USAID Mission in San Jose has pioneered in a new field with impressive success. The Costa Rica privatization program has been a unique experience, but many of the elements designed for it and the problems solved can be useful in planning privatizations elsewhere.

B. Creation of a private sector trust to function as an intermediary in divestiture activities solved problems which might otherwise have led to failure of the program.

C. The use of local currency generated in connection with AID's Economic Stabilization Fund (ESF) programs, and held on deposit with the Central Bank of Costa Rica (BCCR), to offset CODESA borrowings from the BCCR in amounts related to an adjusted cost basis valuation of assets divested was essential to the success of the program, had little (if any) cost to USAID, and facilitated the demonetization of those funds and avoidance of their potential inflationary effect.

D. The key individuals involved in the program, particularly those working on behalf of the USAID Mission, FINTRA and (since mid-1986) CODESA, have done an outstanding job of initiating, planning and carrying out an extremely difficult and challenging task in a highly professional manner.

E. A number of mistakes and miscalculations were made in the planning and carrying out of the program. These were principally (1) a failure to define the valuation method to be employed (or at least to recognize the magnitude of the potential problems which might result), (2) the adoption of an overly optimistic timetable that underestimated bureaucratic resistance, political delays and problems in the individual enterprises (although it did take into account the probable political need to complete divestiture before the end of President Monge's term), and (3) a failure to require a change in CODESA management at the outset of the program, or to require that the law enacted provide for the ultimate liquidation of CODESA at the end of the program. These errors or misjudgments (or, in most of the cases cited, acceptance of apparent political reality) are understandable in the light of the pioneering nature of the program, and in fact correspond to identical mistakes since made in privatization programs in other countries. In the CODESA case the resulting difficulties encountered were resolved as necessary without long term damage to the process.

Background:

During the first few years of the 1980's annual AID funds directed to Costa Rica were increasing rapidly, and by the middle of the decade GOCR was receiving more per capita than any other country except Israel. A major portion of the funds being granted was for balance of payments support and therefore was being used for such purposes as payments on dollar indebtedness, purchases of imports from the United States of machinery, equipment, materials, etc., and meeting other needs for foreign exchange. For each grant received, the GOCR agreed to provide an equivalent amount of local currency in a special account in the BCCR, to be programmed jointly by AID and the GOCR. This arrangement avoided any requirement under Costa Rican law that use of the funds be directed by the legislature, and more than in most other countries AID was in a position to influence their use within the country. Conventionally their use would be to fund expenditures on agreed projects, which had the effect of putting the local currency funds into circulation and thus significantly increasing inflationary pressures and fueling import demand. Because of this, the IMF imposed a limit on monetization of annual AID grants to $60 million in 1984 ($80 million in 1985). Daniel Chaij, Mission director, had the same concern that the growing ESF counterpart funds threatened to become a major contributor to inflation and import pressures if they were dispensed on conventional projects, and found it important to search for significant allocations which would avoid this.

By 1983 it had become evident that a dominant factor endangering the Costa Rican economic situation was Corporacion Costarricense de Desarrollo, S.A. (CODESA). Founded in 1972 to fund establishment or strengthening of private sector enterprises, it had been subjected to major abuses and had developed an assortment of money losing, mismanaged investments, and was making heavy use of its unlimited access to credit at the Central Bank (BCCR), the latter in part reflecting the fact that CODESA also made loans to other borrowers. CODESA's BCCR borrowings were by then absorbing over one-third of GOCR public sector credit but it was generating only 1% of GNP and less than 0.5% of the nation's employment.

It was clear that anything to improve or restrict the operations of CODESA would be highly beneficial to the Government's budget and economic stabilization plans. There also was beginning to be a recognition in AID generally that privatization or divestiture of government-owned activities of this sort could help to resolve problems created by such entities as prime contributors to the excessive quantities of international debt incurred by developing countries.

Through policy dialogue and extensive negotiations with the Monge administration, Mr. Chaij was able to develop Government support for a program to divest CODESA of its various corporate assets, thereby reducing the drain on the Government budget. While it would have little cost for AID, the support of the latter could be expressed through the cancellation of BCCR ESF credits against cancellation of CODESA debt owed to the BCCR, in amounts which were initially related to the proceeds of the disposal of divested assets. None of the funds applied to this purpose would result in monetization; there would simply be a bookkeeping transaction within the BCCR. Initially an amount equal to the local equivalent of US$140 million was allotted for this purpose. The plan, largely embodied in Law 6955 enacted by the Legislature in 1984, included establishment (by Executive Decree) of a National Commission to oversee implementation of the law by CODESA, and a private sector trust (FINTRA) was established which would be funded at the direction of USAID from the local currency ESF special account to "purchase" holdings of CODESA for packaging and resale to the private sector.

The National Commission

A National Commission was established to enforce and give political respectability to the CODESA divestiture program, being viewed as necessary because of the lack of support for it by the then CODESA management and some politicians. Its membership was bipartisan, since it was recognized that the chances for success of the CODESA divestment program would be dependent on agreement by vocal party factions as well as both major political parties, to assure the continuing support of any successor regime. The initial expectations as to the short time required may not have made the concern for continuity seem an important consideration, but there was concern in AID that the program might not survive a change of administration and this importantly influenced the schedule adopted. In any event subsequent experience all over the developing world suggests that the time expectations were wildly optimistic, so that this protective factor seems to have been prudent.

In the fact, the National Commission proved not to be motivated to press forward with the program, nor to be able to contain widespread political misgivings and foot dragging. As the record shows, very little happened for a year or more because of such problems, and it was only after the inauguration of President Arias and the development of his personal commitment to the program that things began to move. In view of this, the National Commission must be viewed as unnecessary and probably a mistake in the initial planning. That it was not able to paper over the political differences may reflect the degree to which the adoption of the program by the legislature was less the result of political agreement than an acceptance of the clout AID's grants enjoyed.

After President Arias appointed Mr. Edgar Brenes to head CODESA the National Commission became completely redundant because of his personal commitment to the divestiture program, and the Commission's scheduled termination date of March 31, 1988 was only extended a month to assure an orderly winding up of its affairs.

The Private Sector Trust

The independent private sector trust, administered by Fiduciaria de Inversiones Transitorias, S.A. (FINTRA), both having been established with the support and backing of AID, has been an extremely important factor in the progress made in the CODESA program. The keys to its success appear to have been the following:

1. The members of the trust and the staff, who were carefully selected with significant input by Mr. Chaij and the President of the Republic, are all private sector individuals of the highest personal integrity and prestige, and with the energy and varied skills and abilities necessary to the successful carrying out of the trust's purpose. The original trustees were Ernesto Rohrmoser, Carlos Manuel Gonzales, Omar Dengo, Emilio Garnier and Carlos Araya. Their personal standing and commitment has assured the independence of FINTRA. Because of the varied qualifications of this group, FINTRA has functioned very much as a merchant bank in improving the operations of the companies bought and working out arrangements for their sale. If these talents by the trust are not represented in a trust created for similar purposes, hiring a merchant bank would be required to carry out these tasks effectively.

2. Use of the trust serves to assure that, whether or not investments are ultimately successfully sold into private hands, they do not remain under government control in CODESA. In fact, certain assets have been sold directly without passing through FINTRA where sale was feasible, and CODESA holdings headed for liquidation likewise have not passed through FINTRA ownership. However, where improved operation of an enterprise appeared to be necessary prior to sale, transfer to FINTRA has been made.

3. The trust has served to assure that final sales to the private sector are made at arm's length and in the public interest without political interference or the likelihood that favoritism will be used in selection of purchasers or prices. The independence of FINTRA has been carefully guarded, and AID has assisted in defending its freedom of action.

4. In the CODESA divestiture program the creation of FINTRA (with close ties to USAID) was an essential ingredient to make possible the application of ESF credits in the BCCR to cancellation of CODESA debt at levels corresponding to asset valuations. FINTRA and USAID served to diffuse some of the political heat which in any privatization is likely to be generated by the private sale of government assets at prices well below their cost-related values, even though they represent realistic prices for unprofitable enterprises. In another country the mechanism might be quite different, and probably should be, but such a trust may still serve to protect politicians somewhat from accusations of selling the "national patrimony" at apparent distress prices.

5. As a generalization for any privatization program, the logic of forming such a trust is clearly that an organization such as CODESA, given the background of mismanagement, political interference, spendthrift operation and bad investments, cannot be expected to have the competence or motivation to preside over its own liquidation. The techniques required to carry out such a program are sufficiently specialized that the assignment should be given to appropriately qualified persons under conditions of independence. In the CODESA case, the creation of FINTRA provided this assurance. However, President Arias' later appointment of Mr. Edgar Brenes to head CODESA made this possibly less important in the light of his outstanding skills and personal prestige, his lack of identification with prior activities of CODESA, and his dedication to the divestiture program.

The operations of FINTRA are reviewed in detail elsewhere herein, supporting, we believe, the view that it has been a successful and very essential element of the CODESA divestiture program. We strongly recommend that the USAID Mission continue to support FINTRA. We understand the Mission may cast FINTRA loose, providing it with some residual funds for use in managing FERTICA and CEMPASA after their proposed transfer from CODESA. We would recommend, however, that consideration also be given by the Mission to using FINTRA for future Costa Rican privatization transactions supported by USAID, or leaving it with funding enabling it to work on those projects with which AID may prefer not to be identified.

Valuation Problems

Law 5955 provided for a valuation ("minimum bid price") to be set by the Controller General of Costa Rica for each holding of CODESA to be divested. It appears that insufficient thought was given at the outset to defining the valuation method intended, or what might be the effect of a valuation based on original cost of assets adjusted for inflation to provide a replacement cost basis. The Controller General in fact chose this approach and proved intractable when asked to value on a more realistic basis related to reasonable sales prices taking into account the potential or recorded earnings capability. Political considerations made the possibility of any flexibility remote. In the case of ALUNASA, the first major holding to be addressed, the Controller's valuation was the equivalent of about US$52 million - for an operation that had lost substantial sums during its short period of operation and closely resembled a competitive enterprise in Venezuela (with older equipment) built at a cost of about US$8 million. AID approved a credit to FINTRA of US$52 million (equivalent in local currency) by BCCR, with which FINTRA made the purchase from CODESA through an offset (debit) of the same amount on the books of the BCCR against CODESA debt to BCCR. Extensive attempts to market ALUNASA at any price were made worldwide by The First Boston Corporation over a period of more than a year, and a sale was ultimately made (only three submissions that could remotely qualify as "bids" were received) at a price of about US$7 million.

In the past a major criticism of the Mission program has focused on this discrepancy, suggesting that AID funded the apparent very significant difference between FINTRA's purchase cost and the sale proceeds. A careful examination of the transaction form that had been established makes it evident that there was no real cost to AID. [In so saying we except any theoretical loss of an alternative opportunity to use the equivalent ESF credit, although the lack of other means of avoiding the monetization of such a sum - a clearly important consideration - makes this highly academic.] A separate section of this report attempts to explain the effects of this transaction form in detail. The evaluators are quite clearly of the opinion that, given the merits of the program, this criticism of the use of ESF credits was unwarranted. Although local politicians saw AID as having "facilitated" the divestiture through its intermediation, we found little evidence in the community of a feeling that they had passed on actual losses to AID. This may be explained in part by an assumption (inappropriate in the light of anti-inflation constraints) that the GOCR would have otherwise had the funds available to it for use in some other way. The feeling that "Uncle Sam had been taken" was very largely confined to Washington.

Assets of CODESA and Divestiture Progress to Date

At the time the CODESA divestiture program was launched, the Company's records were chaotic. It was ultimately determined that CODESA was the owner of 30 subsidiaries (owned 51% or more) and 12 affiliates (owned less than 50%). Seven of the subsidiaries constituted over 90% of CODESA's net operating assets; their disposition has been or will be as follows:

ALUNASA (aluminum) - purchased by FINTRA and sold to an individual (together with a Venezuelan group) as a going concern.

CATSA (sugar refinery) - transferred to FINTRA (in trust), who is working on sale to cooperatives and individual members of co-ops as required by Law 6955. It is hoped this sale can be completed before year end 1988.

CEMVASA (cement) - after study, sale was found not to be possible; being liquidated.

FERTICA (fertilizer) and CEMPASA (cement) are to be transferred to FINTRA under present plans. The law permits only 40% of them to be sold, preparation for which is being worked on currently; the sale is scheduled to be completed before year end 1988. The remainder will be held and managed by FINTRA in trust for later sale if authorized by the GOCR.

FECOSA (railroad) and TRANSMESA (buses) have been transferred to other government agencies as required by Law 6955.

Two of the remaining 23 small subsidiaries, ATUNES (tuna fishing) and ALCORSA (cotton gins), have been sold to private buyers. Three have been transferred to other government agencies, and the remainder have been or are being liquidated and dissolved.

Of the 12 minority holdings, seven have been or will be sold to private buyers, two have been transferred to other GOCR agencies, two are being liquidated and one (a 40% interest in the Stock Exchange - together with a seat on the Exchange) will be retained by CODESA.

Even liquidation has been found to require considerable time for legal steps; however, complete divestiture by CODESA is expected (with the exception of the Stock Exchange interest and its seat on the Exchange) over the coming year. As indicated above, a 60% interest in FERTICA and CEMPASA will continue to be held by FINTRA as beneficial owner, in trust for possible later sale.

Time Required to Complete Divestiture

Initial planning in 1984 contemplated total divestiture of CODESA assets in about 18 months. Subsequent experience, including difficulties described above, made it evident this was unrealistic. It must be kept in mind that this was (to our knowledge) the first AID experience with a divestiture operation of this kind and there was little precedent to go by. It has been the experience of the Evaluators in a wide variety of transactions commenced more recently, including in particular Honduras, Panama, Ecuador, Peru and Bolivia in Latin America alone, that it is impossible to forecast either the time required or the many problems and delays that will be encountered - politically, bureaucratically, market related or otherwise. Delays or obstacles were encountered in the CODESA program from all these sources. Having in mind the sum total of experience in this regard, the Center for Privatization nevertheless customarily recommends adoption of probably unrealistic target dates as an important discipline to assure that privatization will ultimately be achieved. In reviewing the CODESA experience, we feel the Mission should be commended for helping CODESA and FINTRA to meet and deal with every delay and maintain the momentum of the program. We should note that in the 1986 PAAD a new and far more realistic time schedule was set forth as agreed with the GOCR; this also has not been achieved by the GOCR and AID has been reluctant to press unduly because of the evident progress being made. At the present time those involved confidently hope that the program will be essentially complete over the next year (assuming completion of marketing arrangements for CATSA and the initial blocks of FERTICA and CEMPASA), except for a few remaining legal matters and the transfer of state ownership of FERTICA and CEMPASA to FINTRA for later disposition. The new focus on wide sale to small shareholders makes the time schedule for CATSA and the above mentioned blocks particularly subject to delays. We believe, however, that this new interest in broadening ownership, more appropriate to CATSA, FERTICA and CEMPASA than to companies marketed earlier, is a desirable development, even if it does lead to delays during a new learning process.

It is important to note that the law does not provide for the ultimate dissolution of CODESA itself, although it has at least been deprived of access to BCCR credit for the future. While it was not found politically feasible to include dissolution in Law 6955, it is probable that dissolution of the CODESA corporate shell has little to do with the prospect of any further GOCR forays into parastatal investment and operation, despite past history.

Role of USAID Mission

As indicated above, the Mission Director was primarily responsible for the conception of the divestiture plan for CODESA and for persuading GOCR officials to put it into action. USAID also was the prime mover in the establishment of FINTRA and the private sector trust it administers. It took direct contact with President Monge and later President Arias to keep the process going. This was continued by the Mission Director and later the Private Sector Officer on a "hands on" basis. Essential to this process was the existing strong and well staffed private sector program in the Mission, and two highly skilled Private Sector Officers, at the outset Aaron Williams and since late 1985 Richard Rosenberg. Because of the varied private sector activities being carried on by the Mission, it is evident that an important decision was to retain an outside full-time consultant to stay on top of and keep the process moving. Mr. John Robinson in this role coordinated the program (until the end of March, 1988) by maintaining close contact with all the various parties and working to resolve hangups.

It must be recognized that all these elements should be regarded as contributing importantly to the success of the program.

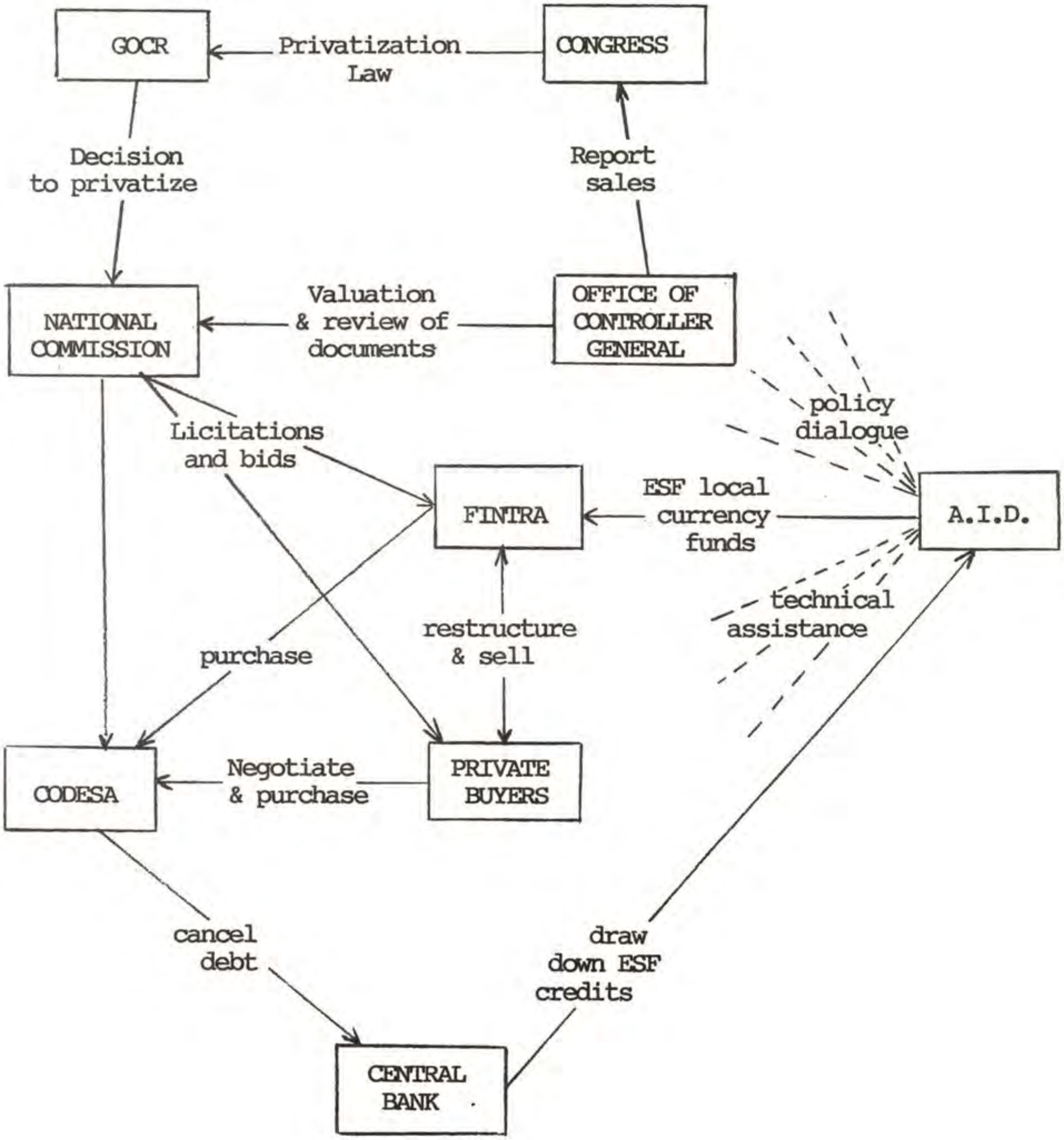
It is clear that, aside from any cost which might be said to attach to the application of ESF credits to purchase of CODESA assets, the staffing (and consultant) expenses in USAID have been very substantial. Such expenses have been rewarded by the very substantial favorable impact of the program on the country, both economically in relation to the heavy costs being incurred earlier by CODESA and attitudinally in the increasingly favorable view toward privatization in general that has developed, reflected not only in the Government but in the press and the views of the general public*. As an important element of a private sector program it must be regarded as having justified the cost and effort invested in it.

The diagram on the next page shows the flow of authority and funds in the process of carrying out the divestiture of a CODESA subsidiary.

It is understood that the new interest in privatizing other SOE's, such as the telecommunications activities of ICE, has arisen because of the attention focused on the CODESA privatization.

SCHEMATIC DIAGRAM

DIVESTITURE OF A CODESA SUBSIDIARY



Lessons Learned

An important part of this evaluation is to determine what lessons may be drawn from the USAID experience with the CODESA divestiture which might have broad application in other developing countries that may undertake privatization programs. The following, which attempt to take into account other relevant experience also, may be useful:

1. The earliest lesson learned by the Center for Privatization, and one having almost universal application as a basic rule, is that privatization is a political process having economic and financial consequences, rather than the other way around. In developing countries most privatization programs arise out of necessity, stemming from (a) the need to reduce unsupportable losses by state owned enterprises (SOE's) or (b) the inability of government to obtain capital to provide for the needs of SOE's providing important public services. Ideological preconceptions have to be overcome by such practical considerations. The Costa Rican experience is a perfect example, and the reason it became one of the first examples in which a USAID mission has taken part was the recognition by Daniel Chaij, Mission Director in 1984, of this very basic rule, which caused him to choose the approach he used.

2. An essential ingredient for the success of a privatization program anywhere is strong support from the chief executive of the country. The CODESA program has succeeded because (a) President Monge got behind it initially, although it lacked broad political consensus (even in his own party) and, more important, (b) beginning with his inauguration in mid-1986 President Arias has given it strong and continuing support. Without his clear and firm backing it would very likely have died long before now.

It is important to have legislation in place before starting a privatization process, even if not technically required. This will demonstrate a government's commitment.

3. Determination of the current book value of an investment being prepared for divestiture is generally regarded as an appropriate starting place. Unfortunately, this focus tends to lead to exactly the problem experienced in the CODESA case, i.e. that for political reasons governments are reluctant to be seen as selling part of "the national patrimony" at a price below what has been "invested" in it. In fact, enterprises that have been experiencing heavy losses are rarely, if ever, worth what has been invested in them. Excessive original acquisition cost is frequently the reason; in many countries there are examples similar to the ALUNASA case, where the cost of the assets included

a number of elements inappropriate for one reason or another but which, in aggregate, put its "valuation" at about US$52 million - whereas its value to a buyer was more like US$7-10 million.

In this regard the lesson to be learned is clearly to make sure at the outset of a privatization program that legal and other arrangements recognize as explicitly as possible that sales will be made at prices reflecting realistically obtainable market prices. It is likely to be a waste of time to require that bids first be invited at the government's total imbedded cost. Valuation procedures should be negotiated in advance with governments and preferably done by independent experts acceptable to the government.

4. The establishment of a central body or unit to carry out the privatization process, headed up by independent and highly respected persons can be a useful way to energize and enforce the carrying out of the program and defuse political criticism. It is important that both political and business leaders be represented in such a body. The National Commission was to perform this role in the CODESA case; it appears to have failed, but later FINTRA (with strong political support from President Arias but essentially a private sector entity) assumed the lead and has been highly successful.

FINTRA, the private sector trust, proved to be a useful vehicle to carry out the divestiture process with USAID support, not only as an instrument to buy and resell companies, but as a "halfway house" where SOE's could be restructured and refurbished (by qualified private sector people) before being offered for final sale. It is important to note that in the Costa Rica example, it was FINTRA (with private sector talents) that was successful and not the National Commission (which provided political protection but was otherwise bogged down in bureaucratic procedures).

5. In planning the divestiture of the holdings of a government owned development institution which has been subjected to all forms of mismanagement, waste, excess employment, corruption and political exploitation, specific legal provision for the ultimate liquidation of the institution itself is highly desirable. In the CODESA case, where there was not real consensus when the legislature enacted Law 6955, we understand it was not found politically feasible to include this. Hence the divestiture effort and expense entails the risk that some future government may wish to revert to practices which got it into trouble. While present plans for a limited future for the CODESA corporate shell are commendable, the only protection against this risk is that CODESA has been deprived of its earlier open access to BCCR credit

- and that also could be restored by future legislative action. Ultimately, the only real protection is public awareness of past disasters, and the CODESA divestiture program has drawn wide (and favorable) public attention.

6. USAID had a high profile in the political and public arena at the time the CODESA program was launched, and in the first years of the process. In the Costa Rica case this was important to progress; it may be equally important to continued success that USAID is now not seen as the prime mover the way it once was. The principals in the Government and in CODESA and FINTRA are now seen as essentially committed and proceeding relatively independently. It is important in any country to give careful consideration to the degree to which the United government and USAID should be in the position where they could be seen as controlling or pressing a privatization program; often success is more likely if its influence and financial support are almost invisible. Recent events in Central America certainly suggest caution in this regard.

7. Whether or not a high profile is found desirable, it is generally important that a member of the USAID staff, or a Consultant, be charged with the full time oversight of a privatization project in which the mission is involved. It is generally agreed that Mr. John Robinson, assigned such a role from 1986 to early 1988, carried out a very important function in the CODESA program.

8. The CODESA experience is a clear demonstration that a divestiture program - for a development institution or a single enterprise - takes more time than might be supposed by anyone who had not been through the process. To a very important degree, the various necessary steps have to be carried out in sequence, and delays are almost inevitable at any stage. The major steps that may be identified and planned for will usually include at least those listed below:

Prioritization of divestiture candidates
Legal steps to prepare enterprise for private sector ownership
Fact finding and description of the enterprise to be divested
Valuation of fixed assets (if needed) and determination of minimum acceptable selling price for the enterprise as a going concern (or, as a later alternative, obtain a "fairness opinion" by an

outside expert when sale has been negotiated
Development of marketing program (broad public sale or single or few buyers)
Determination of realistic offering price
Negotiation or public sale
Consummation of transfer or liquidation

For a program involving all the subsidiaries of an investment company such as CODESA, it would be desirable to have these steps being taken for a number of companies simultaneously, keeping in mind the priorities established. We were told that in CODESA this was not feasible with the limited number of people available.

9. Early experience with CODESA demonstrates that on adoption of a divestiture or privatization program the existing management of an enterprise or investing institution should not be left in charge of implementing such a program. Not only is it a full time job requiring specialized skills, but most executives in SOE's do not have the time - nor the talents or motivation - to carry out such a process. In the case of CODESA this was fortunately (although belatedly) recognized and President Arias after his inauguration appointed a new and highly qualified CODESA head (Mr. Edgar Brenes) specifically charged with the divestiture program.

10. It is recognized that the attitude toward ESF local currency credits has changed, and that there are few countries where they bulk so large in relation to the economy as Costa Rica. However, the way they were used in Costa Rica was instrumental in making privatization possible; another time under similar circumstances they should perhaps be used for "block grants" to encourage progress, rather than as direct purchases (which gave rise to the "buy high, sell low" perception).

* * *

The foregoing summarizes the more detailed information contained in the full evaluation report (of which this Executive Summary is a part) on the CODESA divestiture program prepared by Alexander C. Tomlinson and Ismael Benavides for the Center for Privatization, Washington, D.C. at the request of the U. S. Agency for International Development (AID).

SEQUENCE OF EVENTS IN THE CODESA DIVESTITURE PROGRAM

AID begins conversations with GOCR on Privatization	Summer 1983
Costa Rican Congress approved Law 6955	24 Feb 1984
Arthur D. Little and Coopers & Lybrand contracted to do paper on CODESA in January 1984 - submitted	June 1984
ESR III requires CODESA to develop a divestiture strategy	Aug 1984
Request for assistance by GOCR sent to U.S Ambassador	5 Oct 1984
AID PAAD prepared end 1984, for US$140 million ESF support, and presented	Feb 1985
Memorandum of Understanding (MOU) between GOCR and AID re funding for National Commission	18 Jan 1985
Decree 16007-P-MEC regulating the application of Law 6955	1 Feb 1985
Decree 16520-P-MEC creating National Commission	1 Mar 1985
AID PAAD approved	19 Mar 1985
MOU between AID/GOCR/CODESA/BCCR/ re donation of US $140 mm in local currency	13 May 1985
RFP for technical assistance to FINTRA issued	25 Jun 1985
FINTRA legally established	21 Aug 1985
Selection of Technical Assistance group	2 Sep 1985
MOU between AID and FINTRA (Fiduciary arrangement)	6 Sep 1985
Technical Assistance Contract with IRG signed	4 Oct 1985

Regulation for operation of National Commission issued	Oct 1985
ALUNASA offered by public bid ("licitation")	Nov 1985
ALUNASA purchased by FINTRA	23 Dec 1985
First Boston retained to handle sale of ALUNASA	4 Apr 1986
MOU originally signed between AID and FINTRA on 6/Sep/85 completely amended	7 Apr 1986
President Arias takes office as successor to Monge	8 May 1986
Edgar Brenes appointed President of CODESA	Jun 1986
First actions by new administration on CODESA divestiture (Cabinet resolution No. 15)	24 Jun 1986
Initial licitation for ATUNES	Aug 1986
Initial licitation for CATSA	20 Nov 1986
ATUNES purchased by FINTRA	13 Feb 1987
ATUNES sold by FINTRA	30 Apr 1987
Transfer of CATSA to FINTRA in trust	10 Sep 1987
ALUNASA sold by FINTRA to Gurdian Group	23 Oct 1987

Note: See also schedule of issuance of valuations by the Controller General under "The Valuation Issue and the Controller General of Costa Rica", page 31.

CODESA AND THE DIVESTITURE PROCESS

Numerous documents and reports have been prepared on the history of CODESA and its impact on monetary and credit policies as well as on the general economic situation in Costa Rica. Of particular importance is a report by Arthur D. Little Inc. commissioned by AID-Costa Rica in 1984, which for the first time gave a comprehensive perspective of the situation of CODESA. This section provides a summarized version of many of those reports and other information obtained.

A Brief History of CODESA until 1984

CODESA was a late comer among the Latin American state holding companies set up to engage in development finance. Established by Law 5122 of November 16, 1972, with the stated objective of "strengthening private Costa Rican enterprises within the regime of a national mixed economy", CODESA quickly became an instrument for the establishment of ill conceived and badly mismanaged government investment projects in productive enterprises, created within a statist development orientation. Its major growth occurred during the government of President Daniel Oduber (1974-1978). It was used for political purposes and frequently exploited for financial gain.

The period 1979 to 1984 saw new annual investments averaging 1.5 billion colones. The investment stopped in 1984, after the passage of Law 6955 and the first GOCR covenants with AID. The growth of net operating assets of CODESA is shown below. These figures exclude the effects of passive "pass through" finance activities, and should be considered in the light of experience which has shown that the investments in operating assets were for all practical purposes largely losses the day they were made; real value is typically under 20% of cost:

CODESA

Net Operating Losses
(in billions of colones)

1979	2.2	1983	8.1
1980	3.8	1984	8.0
1981	6.0	1985	7.9
1982	7.3	1986	8.2*

* The ALUNASA sale in 1986 reduced operating assets, but this was offset by bank revaluations to reflect depreciation of the colon.

Articles 28 and 29 of the law creating CODESA granted it virtually unlimited credit from the BCCR, which allowed it to absorb large amounts of resources to fund its investments. Between 1979 and 1984, CODESA's annual share of total BCCR credit increased from 10.7% to 18.2% and, of credit to the public sector, from 28.8% to 52%. At September 30, 1984 total Central Bank credit to CODESA was c 8,801,600,000, or approximately US$200 million, which represented 35.6% of total credit granted by the Central Bank to the public sector. Despite this enormous absorption of resources, also depriving the private sector of productive capacity, CODESA's subsidiaries only contributed 1.8% of GDP and 2,122 jobs, or 0.3% of the total labor force.

At the time Law 6955 was enacted providing for the CODESA divestiture, it owned a total of 30 companies outright, and had partial interests in 12 other subsidiaries and affiliates. Following are the principal holdings, of which the first seven listed account for over 90% of net operating assets (i.e. not including "pass-through" credit operations to non-subsidiary companies):

CODESA's Principal Investments

Name	Business	Origin	Year Established
ALUNASA	Aluminum Mill	CODESA Project	1978
ALCORSA	Cotton Gin	CODESA Project	1977
CATSA	Sugar Mill	CODESA Project	1975
CEMPASA	Cement	CODESA Project	1983
TRANSMESA	Buses	CODESA Project	N.A.
FECOSA	Railroad	GOCR Project	N.A.
CEMVASA	Cement	Private Bankruptcy	1978
ATUNES	Tuna Fishing	Cooperative	N.A.
FERTICA	Fertilizer	Purchase from Private Owner	1960
TEMPISQUE FERRY	Ferry Boats	CODESA Project	1975
STABAPARI	Wood	Mixed Project	1969
DAISA	Agroindustry	CODESA Project	1979

During the 1977-1983 period, all of CODESA's subsidiaries, with the exception of STABAPARI, generated losses, accumulating a total of c 2,059 million for the period, without including revaluation of assets which reduced losses. The A.D. Little report indicates, furthermore, that during the period, losses always exceeded 25% of the assets of all CODESA subsidiaries. CODESA's total losses added up to c 4,990 million at June 30, 1984.

Despite its stated objective, CODESA's actual channelling of resources to the private sector was negligible. Only 14% of its direct loan portfolio had gone to the private sector at June 30, 1984; and of its total liabilities only 4% were oriented to support private sector activities. In sum, CODESA devoted the great majority of its resources to supporting its own unprofitable ventures, while minimizing the flow of resources to more productive ventures in the private sector.

Political Environment Affecting CODESA'S Operation

Until 1984, CODESA was regarded as the model for development by an important part of the PLN party. At the same time, CODESA had also become political booty for the different governments in power since 1972.

Many of the major projects, including CATSA and CEMPASA, were done without complete feasibility studies, and reflected the fact that in the 1970's readily available foreign credit made the purchase of equipment too easy. Jobs were handed out with largesse by the different administrations and overstaffing became a common problem in all the subsidiaries. Despite all the negative signals produced by CODESA, an important number of legislators and politicians actively defended the institution.

It was within this framework and political environment that President Monge decided to act with regard to CODESA.

The Negotiation Process for the Divestiture of CODESA

The economic crisis inherited by the Monge administration, compounded with lack of international reserves and foreign credit, dictated that significant measures were required to improve its finances and obtain foreign assistance.

Policy dialogue leading to the divestiture of CODESA began to take shape during 1983 in a series of conversations held between the AID director, other senior AID officers, and high level government officials, including President Monge himself. These culminated in the drafting of legislation which was enacted in early 1984 as Articles 55 and 56 of Law 6955 "The Law of Financial Equilibrium of the Public Sector". (See Appendix B)

The acceptance of those articles required a great deal of political maneuvering as they generated great resistance and a prolonged debate among the supporters of CODESA. The original version of the law, which among other things had limited to 60% the sale of FERTICA and CEMPASA shares, was changed to reduce that to 40%; other changes were also introduced, none of which made the divestiture of CODESA any easier.

Once the law was approved, President Monge created by decree the "National Commission" which was designed to reduce political frictions and to enforce and give protective coverage to the privatization of CODESA.

Resistance to the divestiture process continued during the Monge administration, not only at the political level, but at the bureaucratic level within CODESA. It was only with the Arias administration, when the privatization program was in place and President Monge's administration had assumed the political liabilities, that the process really began to show forward movement to achieve its original objective.

CODESA Management in the Divestiture Process

The management of CODESA has played a special role in the privatization process, both in the initial process during the Monge administration, and during the Arias administration, where marked differences can be observed.

At the beginning of the privatization process in 1984, the traditional entrenched CODESA bureaucracy was able to delay privatizations by taking advantage of the rifts in the PLN party on the CODESA issue. Mr. Juan Bonilla, General Manager at the beginning of the process in 1984, and Mr. Luis Garita, Executive President in 1985, either opposed divestiture or took a non-collaborative position. The only transaction carried out in that period was the sale of ALUNASA to FINTRA in December 1985. That transaction enabled CODESA to show a profit in 1985, which was hailed as an achievement by the administration of CODESA, although it was only a product of a sale at the inflated price dictated by the Controller General's valuations.

The Arias administration took office on May 8, 1986, and in June appointed new management for CODESA. Mr. Edgar Brenes, a highly qualified young executive, was named Executive President of CODESA. Mr. Brenes understood his mission clearly, and rapidly established a good working relationship with AID and FINTRA. The Arias administration actively supported the divestiture of CODESA and some of its high level members have a close working relationship with Mr. Brenes.

The administration of CODESA under Mr. Brenes has not only moved rapidly in the sale of many enterprises, but has also liquidated a number of others, including numerous inactive companies. Mr. Brenes has also taken important measures to contract the size of CODESA. Staff has been reduced from 250 to 75, the office has been concentrated in one building and the legal department has been "privatized".

The legislation has made no provision, and none is expected to be made, for the ultimate liquidation of CODESA itself. Mr. Brenes has suggested that it be restructured to serve as an advisor to the private sector, rather than an investor, and there may be an important role for it to play providing research capability for private investment. The government has not taken any position yet on its future. CODESA will not, under present law, have access to BCCR credit, but will retain its minority (40%) ownership interest in the Bolsa Nacional de Valores S.A. (Stock Exchange) and its seat on the Exchange.

CODESA Divestiture Activity Since 1984

The initial time estimates for the divestiture of CODESA holdings (18 months) proved overly optimistic. A more realistic schedule in the 1986 PAAD has also fallen behind. The lack of relevant experience of USAID Mission personnel and other participants contributed to the early delay, as did AID Washington's refusal to allow the Mission to go forward with the original plan (FINTRA purchases at the Controller General's prices) and the necessity of negotiating a new mechanism with the Controller General. Other factors which contributed to the delays included:

- Political and bureaucratic resistance, particularly during the Monge administration.
- Ineffectiveness of the National Commission.
- Time consuming valuation procedures by the Controller General.
- Market limitations within and outside Costa Rica as to possible buyers.
- The new democratization process of President Arias that requires lengthy sales time to involve large numbers of stockholders.
- The complex legal and financial status of many of CODESA's subsidiaries.

Despite these limitations the advances made in the program are notable, particularly during the Arias administration and under Edgar Brenes in CODESA. Compared to other privatization programs, the Costa Rican effort has not been slow at all and has had considerable success. The divestiture should be completed by the end of the Arias administration in May 1990. A detailed summary status is presented in Appendix C.

Of the 5 major subsidiaries that comprise 80% of CODESA's assets, one, ALUNASA has been sold, CATSA is in the process of sale and CEMVASA is in liquidation. The permitted 40% interest in the two remaining ones, FERTICA and CEMPASA, is expected to be sold in the 1988-1989 period. By the end of 1989 CODESA is expected to have liquidated all remaining corporate shells it owned.

Currently 13 subsidiaries and affiliates are being liquidated, and the process should be completed by the end of 1988. Three major subsidiaries are in the process of sale; CATSA should be sold by sometime in the fourth quarter of 1988, according to the present schedule, and a management contract is expected to be executed for the management of FERTICA by Norsk Hydro by June 30, 1988. Once CATSA is sold, FERTICA and CEMPASA will be the focus of CODESA and FINTRA's efforts until the end of the present administration.

Examination of the sales that have been or are currently being made, i.e. ALUNASA, ATUNES, CATSA and ALCORSA, indicates that the necessary and appropriate procedures have been carried out, and with complete transparency, both by CODESA and FINTRA. No sales have been considered which would depend in any way on the provision of GOCR credit. Significantly, no major public complaints have been voiced about favoritism or unclear sales procedures by CODESA or FINTRA.

The sale of ALUNASA was carried out by an independent and prestigious company, The First Boston Corporation, through an open international search for bidders. That process assured that the ultimate sale price reflected a realistic valuation of the company.

A crucial element in the completion of this effort is the stated policy of the Arias administration to "democratize" the property of state owned enterprises by public sale to a widespread shareholder group in Costa Rica, which has been extended from CODESA to the telecommunications company and other possibilities.

ATUNES was sold by FINTRA as a result of a public invitation for bids ("licitation"), and ALCORSA's assets are being publicly sold by CODESA after two failed licitations to sell the company's shares. CATSA is proposed to be sold in a widespread public offering that aims to attract 250,000 buyers, although an attempt by the GOCR to develop a group of coop members as initial subscribers has not been successful; the sale will be handled by CODESA through the Stock Exchange.

It is difficult at this stage of the privatization process to fully assess the economic, fiscal and social impact of the divestitures, particularly while they are still in process. Nevertheless, a number of significant favorable developments are evident:

(1) CODESA has received no Central Bank credit since 1985, and has even reduced its outstandings. This has freed up resources for more productive uses in the public sector. See following table:

CENTRAL BANK CREDIT TO CODESA

	Balance at Year End			
	1984	1985	1986	1987
c million	9,069	8,310	9,106**	7,396
$ million*	191	155	156	108

* Equivalent at year end exchange rate
** Includes interest and FERTICA refinancing in 1986 of c 1,237.5 million.

(2) A substantial portion of ESF generated local currency has been demonetized, allowing for compliance with IMF standby targets and avoidance of inflationary pressures. To date this has aggregated approximately c 6,650 million - equivalent to about 6% of the money supply.

(3) Two major money losing enterprises, ALUNASA and CATSA, have been restructured and are now profitable.

(4) The enterprises retained by the GOCR are being rationalized and restructured to reduce their demand for resources from the budget.

(5) CODESA has been significantly down-sized in order to adapt it to its new role.

(6) Thousands of individuals are becoming shareholders of some of the companies being privatized, dramatically increasing the number of owners of stocks in the country.

THE MAJOR ELEMENTS OF THE CODESA PRIVATIZATION PROCESS

The privatization process of CODESA has included a number of key elements, most of which were a result of policy dialogue between AID and the GOCR, some part of the overall project design by the AID mission, and others part of the political necessity identified by the GOCR to carry out the privatization of CODESA's subsidiaries. These elements, important at one time or another, include:

- the privatization law,
- the National Commission,
- the valuation issue with the Controller General,
- the private trust fund (FINTRA),
- the FINTRA technical assistance contract,
- the use of ESF local currency funds in the privatization process,
- AID management of the privatization project.

Each of these is discussed in a separate sub-section below.

There has been some criticism of the unwieldy and complex structure of the CODESA divestiture program. Nevertheless, our review suggests that the various objectives of the program and the political and other issues, as well as the difficult tasks of restructuring and marketing CODESA's holdings all led to a need for one or another of the components of the structure.

It can be argued that the National Commission was unnecessary, and that the valuation process would have been more realistic if an independent body had carried it out. However, it appears that political realities of the moment created the necessity to involve the Controller General and highly respected politicians in the process.

THE PRIVATIZATION LAW

The final text of Law 6955, as it related to the CODESA divestiture, was not the original text sent by the executive power, but the result of a political compromise between factions of the PLN ruling party, one of which opposed any sale of assets or reduction of CODESA. The end result was a law that authorized the sales, (although some argue that legally CODESA did not need a law to sell), but also imposed a number of restrictions on the sale. The main provisions of the law were:

(1) Authorization for CODESA to sell its subsidiaries.
(2) Sales were to be made through public invitations for bids ("licitations") and with the valuation of the Controller General of Costa Rica.

(3) A number of enterprises could not be sold because they were "public utilities" under the constitution. (Transmesa, Fecosa, Zona Franca de Exportaciones S.A.)
(4) CATSA and CEMVASA could only be sold to the cooperative sector.
(5) Only 40% of FERTICA and CEMPASA could be sold.
(6) Special credit facilities were to be provided by the national banking system to buyers.

Articles 55 and 56 of Law 6955, which enabled the privatization program to begin, reflected the political conflicts within the PLN, and in effect introduced a number of restrictions to the selling process that limited the options for the GOCR and CODESA to divest their holdings. Although those limitations were more evident during the initiation of the privatization process in the Monge administration, the Arias administration has demonstrated considerable flexibility and creativity in the interpretation of the law in order to facilitate sales. This has made possible the CATSA transaction and the plans for FERTICA and CEMPASA, where the use of FINTRA as an intermediate trust may facilitate sales and remove the required 60% continued holdings from direct GORC control.

After the agreement between AID and the GOCR for the 1985 ESF grant, which included the privatization mechanism for CODESA, the GOCR issued Decree No. 16007-P-MEC, dated February 1, 1985, which provided the detailed operating system required by the Costa Rican constitution to put the law into effect. The decree contained the following principal provisions:

(1) The valuation and bidding procedures.
(2) The use of the proceeds from the sales by CODESA.
(3) The transfer of those enterprises considered public utilities to direct government ownership.

In addition to the selling restrictions, the principal impediments created in the law and Decree 16007-P-MEC are the valuation procedure, which has been interpreted with extreme rigidity by the Controller General, and the sales procedure which calls for public "licitations" above the Controller General's valuations.

THE NATIONAL COMMISSION

The National Commission for the restructuring of CODESA was created during the Monge administration by Decree 16520-P-MEC of February 25, 1985.

The Commission was created by President Monge in order to provide political protection from factional attacks on the privatization process of CODESA from within the PLN and the opposition and also to enforce the CODESA liquidation as provided by law. The main provisions of the decree regarding the Commission are:

(1) It was bipartisan, consisting of three members, all well respected and active politically: Mr. German Serrano of the opposing Unidad Nacional Party, and Claudio Volio and Ricardo Echandi of the ruling PLN party.

(2) The Commission was given ample powers to execute and supervise the sale of CODESA's assets, including:
   a) the authority to carry out the sales and issue public tenders,
   b) coordinate valuations and other actions with the Controller General,
   c) recommend actions to the Central Government.

(3) CODESA could not make any sale without the authorization of the Commission.

Operations of the Commission

The Commission began operations in March, 1985, and its first actions were to coordinate the initiation of the valuation process by the Controller General's office. The first company to be valued was ALUNASA, which was completed in August 1985. Valuation of the remaining seven major enterprises was completed by July 1987.

After a company was valued, the Commission would prepare the documentation for the "licitation" or invitation to bidders, and remit it to the Controller General for approval. Once approved, after as much as a two months wait, the Commission would, in conjunction with CODESA, publish the offers in national newspapers. Interested parties could then obtain the instructions for offers from the Commission in order to submit proposals by the specified date. Final sales transactions and legal documentation were then negotiated with CODESA.

By April, 1988, the Commission had published "licitations" for all the CODESA subsidiaries that were to be sold on a going concern basis to private buyers, as follows:

COMPANY	STATUS
ALUNASA	Sold
ALCORSA	In process of sale of assets
ATUNES	Sold
TEMPISQUE FERRY BOAT	No bidders, in liquidation
CATSA	Transferred to FINTRA in trust
FERTICA (1)	Deferred, not yet sold to FINTRA
CEMPASA (1)	Deferred, not yet sold to FINTRA

(1) The sale of FERTICA and CEMPASA will occur once the trust mechanism and conditions are worked out between the GOCR, CODESA and FINTRA. Public offerings will be made by FINTRA, and wide distribution is anticipated.

The Commission was terminated on April 30, 1988, and is to submit a detailed report of its activities to the Cabinet.

Funding of the Commission

The operations of the Commission have been financed with funds from the local currency generated by ESF loans, deposited in the AID special account with the BCCR.

The first memorandum of understanding to finance the Commission was signed by AID and the GOCR on January 18, 1985. It was extended and amended ten times until April 30, 1988. The total amount of funds allocated to the Commission add up to the following:

ESTIMATED BUDGET (in colones)
Feb. 1985 - March 1988

Salary for members	9,435,000
Salary executive secretary	2,005,366
Secretarial and administrative services	1.226,788
Various administrative expenses	378,634
Travel expenses	319,550
Consultants fees	11,032,171
Auditors fees	2,070,000
CODESA retirement incentive program	5,000,000
Miscellaneous	1,136,524
TOTAL	32,604,033

The Commission's actual expenditures through April, 1988, when it wound up its operations, totalled about c 29,000,000.

Some Conclusions on the Activities of the Commission

The initial intent for the establishment of the Commission was to set up a buffer or umbrella to give political protection to the privatization process. It was felt at the time that the presence of three well known and respected individuals with close political connections would give the process greater legitimacy and fend off possible attacks from political factions within the PLN and from the opposition. Although this could be said to be correct since there was little overt political criticism of the process, nevertheless, the Commission's incompetence, caution and inflexibility combined with bureaucratic resistance in CODESA during the Monge Government and problems created by the valuation issue, effectively prevented any major action. In the end, the lengthy valuation procedures and bidding processes prolonged the life of the commission for more than three years. The record of the Commission does not suggest that it was an important or necessary element in the concept of the CODESA divestiture process.

After the Arias administration took office the need for the Commission was even less apparent, as the political circumstances for its creation because less relevant in light of President Arias' strong advocacy of privatization. Further, the new management in CODESA, with a firm commitment and full political support to carry out the sales of the enterprises, made the Commission completely redundant.

FINTRA, THE PRIVATE SECTOR TRUST

FIDUCIARIA DE INVERSIONES TRANSITORIAS, S.A. (FINTRA) was established in accordance with the "Memorandum of Understanding" (MOU) signed between AID and the GOCR on May 13, 1985, to provide for the management of the trust fund set up for the purchase of CODESA's subsidiaries with the local currency generated by the 1985 ESF funds, and their subsequent resale to the private sector. (A detailed description of the proposed trust fund was contained in Annex III of the PAAD for the 1985 ESF facility, submitted to AID Washington in February 1985, which was subsequently approved on March 19, 1985.)

FINTRA has been legally operating since August 1985, and has to date participated in the coordination and supervision of the technical assistance contracts for the evaluation of nine of CODESA's major subsidiaries; it has also served as an important policy instrument for the Costa Rican divestiture program and a vehicle to facilitate the sale of CODESA companies. FINTRA has carried out the successful privatization of ALUNASA and ATUNES, is in the process of privatizing CATSA (which is scheduled to be completed by September 30, 1988,) and is expected to participate in the privatization of FERTICA and CEMPASA before the end of the Arias administration in 1990.

In addition to facilitating the sale of CODESA's enterprises, FINTRA has proved to be successful in carrying out the restructuring of companies in process of sale, avoiding political backlash to the government and AID, and enabling the management of the enterprises to act in an entrepreneurial fashion without the constraints of central government budgetary regulations and the supervision of the Controller General's office.

Establishment of the Trust

The concept of the trust mechanism was worked out between AID and the GOCR in the discussions held during 1984.

The Memorandum of Understanding (MOU) between AID and the GOCR on May 13, 1985 formally laid the ground rules for the establishment of a trust mechanism to facilitate the divestiture of CODESA's subsidiaries and enable AID to use the local currency generated by the ESF grant of US$140 million in 1985 for the purchase of the subsidiaries, thereby assuring its demonetization.

FINTRA was legally established as a corporation under Costa Rican law on August 21, 1985. Its main objective was the management of trusts and trust funds, as well as a broad range of commercial activities. The capital of the corporation was set at 10,000 colones, subscribed and paid by Ernesto Rohrmoser, Carlos Manuel Gonzales, Omar Dengo, Emilio Garnier and Carlos Araya, who were subsequently appointed Directors of FINTRA and Trustees of the Trust. All five men were highly respected successful business men with the personal prestige to assure their independence from GOCR or political dictation. The life of the company was set at five years, at which time it would be dissolved unless otherwise agreed by the shareholders.

The management of FINTRA is entrusted to the President, and in his absence, the Vice President of the Board of Directors, both of whom are also legal representatives of the company.

FINTRA permanent staff is small, consisting basically of an executive secretary, Mr. Gonzalo Vega, a project manager, Mr. Guillermo Arguedas, and a financial administrative manager Ms. Martha Arrea, later replaced by Oscar Gomez. Secretarial and support personnel is minimal.

The Operations of FINTRA

FINTRA was originally designed to participate in most, if not all, of the invitations for bids ("licitations") on CODESA subsidiaries in order to purchase the enterprises, as a buyer of last resort, at the price established by the Controller General of Costa Rica.

In practice, however, FINTRA has acquired few companies, having avoided purchasing those that had legal or political problems. In those cases FINTRA has been an instrument of policy dialogue with CODESA and the GOCR.

The operations carried out by FINTRA since August 1985, can be summarized as follows:

Purchase and sale of ALUNASA: The company was purchased on December 23, 1985, for c 2,619,384,827. FINTRA continued the operations of the company while at the same time carrying out a restructuring process, as is detailed in Appendix D. The sale of ALUNASA was entrusted to The First Boston Corporation which, after a lengthy process that included contacting 119 companies in 27 countries worldwide, managed to sell the company 21 months later to a group headed by Costa Rican entrepreneur Rodolfo Gurdian for c 390,275,000.

Purchase and sale of Atunes de Costa Rica, S.A. (ATUNES): Following long and difficult negotiations with StarKist, a creditor, the company was acquired by FINTRA on February 13, 1987 for c 101,519,394 which included c 87.7 million of debts owed to the BCCR. ATUNES was sold through a public "licitation" in April 1987, the best offer being presented by a Venezuelan group Atun C.A. for c 90,000,000.

Establishment of trust for CATSA shares: According to Law 6955 CATSA could only be purchased by the cooperative sector. A trust was established in FINTRA, with the authorization of the GOCR, which will hold the shares of CATSA until they are sold, and in the interim the company will be managed and restructured by FINTRA. The sales process is expected to be completed by September 30, 1988. During 1987, AID donated c 3,500,000,000 to the BCCR to cancel CODESA debt. Of this total c 3,427,584,197 was initially attributed to the price set by the Controller General for CATSA. The actual amount of the net "attribution" by the Controller General will depend on the purchase price received by CODESA for CATSA (expected to be about c 450 million).

Other Activities: In conjunction with AID and CODESA, FINTRA contracted for and supervised the evaluations of the following enterprises by International Resources Group Inc. or its subcontractors under a technical assistance contract (see below). The results of these studies have enabled FINTRA to assess the true situation of the companies and establish realistic values for them:

ALUNASA	FINTRA
ALCORSA	TEMPISQUE FERRY BOAT
ATUNES	CEMPASA
CATSA	CEMVASA
FERTICA	

FINTRA also valued the assets of STABAPARI and DAISA, two of CODESA's subsidiaries.

Current Activities of FINTRA: FINTRA is currently involved in the following activities:

(a) Restructuring and privatization of CATSA
(b) Design of privatization of CATSA
(c) Planning the establishment of a trust and a marketing plan for the privatization of FERTICA and CEMPASA.
(d) Maintaining a policy dialogue with CODESA and the GOCR on privatization.
(e) Negotiating purchase and disposition of CODESA's 40% share in STABAPARI.
(f) Managing a severance pay fund for discharged CODESA employees.

The Financial Operations of FINTRA

The entire amount of FINTRA's operating costs and purchases of CODESA subsidiaries were designed to be covered by the local currency generated from ESF grants. This has so far included the 1985 ESF grant of US$140 million and an additional estimated US$34 million from the 1986 ESF grant. Transfers would be made from time to time from the AID special local currency account in the BCCR to FINTRA, and the income would be increased by interest earned on any excess funds FINTRA may have, and the proceeds of sales of companies.

Total accumulated expenses for FINTRA's operations, including costs of managing enterprises it has acquired, from September 6, 1985 to March 31, 1988, add up to approximately c 118,814,255 or about US$1,600,000. After initial disbursement from AID, these costs have been funded monthly from interest on deposits and proceeds of the sale of companies.

Considering the time period involved, and the results obtained, FINTRA would seem to be a cost effective institution in the Costa Rican privatization program. Its demonstrated ability to turn losses into profits has paid off in the ability to sell at higher prices than might otherwise have been anticipated.

The use of funds from the AID special local currency account in connection with the CODESA privatization program to March 31, 1988 can be summarized as follows:

LOCAL CURRENCY RESOURCES
COMMITTED TO CODESA DIVESTITURE

RESOURCES OBLIGATED BY AID/GOCR:		
1984 ESF	c 11,401,000	
1985 ESF (US$140,000,000)	c 7,021,990,000	
1986 ESF (US$ 34,000,000)	c 2,031,800,000	
TOTAL BUDGETED		c 9,065,191,000
DISBURSEMENTS FROM ESF SPECIAL ACCOUNT:		
FINTRA:		
Operating expense advances	c 12,932,000	
Alunasa deposit (5% of purchase price)	c 139,778,000	
Alunasa purchase	c 2,795,641,000	
Alunasa working capital	c 50,000,000	
NATIONAL COMMISSION:		
Operating expenses	c 28,895,000	
BLOCK TRANSFERS TO REDUCE CODESA's BCCR DEBT		
1986 Transfer	c 119,282,000	
1987 Transfer	c 3,500,000,000	
TOTAL DISBURSEMENTS		c 6,646,528,000
NET UNDISBURSED RESOURCES		c 2,418,663,000
FINTRA BALANCE		c 903,000,000
RESOURCES AVAILABLE FOR REMAINDER OF PROCESS*		c 3,221,663,000

* The available resources will be increased by interest from CATSA, FERTICA and CEMPASA

(continued...)

ESTIMATED FUTURE DISBURSEMENTS

FINTRA OPERATING EXPENSES	
(2 years)	c 120,000,000
DEBT REDUCTION TRANSFERS TO	
COVER CONTROLLER GENERAL VALUATION	
40% of FERTICA shares	c 1,309,108,000
40% of CEMPASA shares	c 1,722,629,000**
	c 3,151,737,000

** The CEMPASA figure reflects a reduction in the Controller General's valuation to reflect an imminent transfer out of CEMPASA of limestone deposits which the company will probably never need.

The projected deficit in FINTRA's finances could be funded from interest generated in the AID special account in the BCCR, or from the proceeds of sales of the enterprises by FINTRA.

FINTRA is required to present periodic reports (quarterly) to AID, and submit yearly audited financial statements. The auditing firm of Peat, Marwick & Mitchell approved the internal accounting and control procedures which have been followed by FINTRA since its inception.

Comment

Certain criticisms have been made of FINTRA and the privatization process in general, which appear unwarranted in the light of the circumstances in Costa Rica, and particularly if compared to privatization processes elsewhere in the developing world.

Some of the major problems with which FINTRA had to deal were:

- Bureaucratic resistance on the part of CODESA staff during the Monge administration, delays in valuation and sales procedures, and the natural slowdown of an outgoing administration and startup of a new one over the six months ending in June, 1986 when Arias took office.

- The unexpectedly high prices set by the Controller General for the enterprises valued, which slowed down FINTRA's activities after the ALUNASA purchase in December 1985.

- The extreme difficulty in finding a buyer for ALUNASA, despite the considerable effort expended.

It seems clear that FINTRA has achieved already, or is in the process of achieving, its original objectives. The conception of FINTRA has been undoubtedly prudent, original and creative, and has proved to be an interesting vehicle which may be used in other privatization programs. It has served AID's interests as well as Costa Rica's. Furthermore, FINTRA has proved to be an effective and flexible body able to adapt to the changes in circumstances of the privatization process and the political environment. Over the period of its activity it has built up a technical expertise in privatization and restructuring of state enterprises, which it is hoped can be put to use in future non-CODESA privatization efforts in Costa Rica.

FINTRA has achieved in a significant measure the original objectives of its creation:

(1) It has participated in the purchase and resale of two of the three CODESA wholly owned subsidiaries already sold: ALUNASA and ATUNES (ACUACULTURA was sold before the creation of FINTRA). It will participate in the sale of three out of CODESA's four remaining subsidiaries (CATSA, FERTICA, and CEMPASA).

(2) It has proved to be an adequate vehicle to ease the transfer and restructuring of CODESA's enterprises before sale to the private sector.

(3) It has permitted the use of ESF funds by demonetizing them in a way which is positive for the GOCR economy.

(4) It has minimized AID's involvement in the privatization process, such criticism as there has been not having originated in Costa Rica, and furthermore has also shielded the GOCR from the political heat generated when necessary restructuring measures are taken.

THE FINTRA TECHNICAL ASSISTANCE CONTRACT

The privatization program of CODESA's subsidiaries, agreed to between AID and the GOCR, also involved the provision of dollar-funded technical assistance to FINTRA and CODESA for the evaluation of the enterprises from a technical/financial viewpoint and the establishment of commercial values for them.

The RFP was issued on June 28, 1985, to solicit proposals from four firms selected by AID staff. First Boston (which later joined IRG), Morgan Grenfell, Arthur D. Little Inc., and International Resources Group Inc. (IRG). On August 7, 1985, three participating consortia made offers:

a) Arthur D. Little Inc., Ulhin, Morton Badley & Welling Inc.

b) Morgan Grenfell, Coopers & Lybrand, IESC

c) International Resources Group, Price Waterhouse and First Boston (FBC)

The regional contracting officer in Panama was requested to negotiate with the above consortia in the indicated order of precedence.

The PIO/T was submitted on September 30, 1985, and approved by the Mission Director on October 19, 1985. A memorandum of understanding was signed between AID and the GOCR on September 30, 1985, for the use of PO and E funds to finance the hiring of the technical advisor.

The contract between AID and IRG was signed on November 22, 1985. The initial contract was for US$667,692 of which US$288,500 was obligated the first year, US$200,000 obligated the second year, and US$120,000 the third year. On December 31, 1987 when the IRG contract was completed, the total cost added up to US$592,692.26.

The IRG contract was concentrated on the larger and more complex CODESA subsidiaries. The participation of First Boston and Price Waterhouse was minimal. While First Boston did valuation and diagnostic work on ALUNASA under the IRG contract, the international marketing and negotiation was done on a success fee based on resale proceeds under separate contract between FINTRA and First Boston/Interfin. In the light of the extensive marketing effort mounted, their fee of 32.9 million colones was a reasonable one by prevailing investment banking standards.

For much of its work on individual enterprises, IRG relied on subcontractors that were specialized in the activities of those companies. CATSA was evaluated by F.C. Schaffer & Associates of Baton Rouge, Louisiana, the cement companies CEMPASA and CEMVASA by Mr. Kenneth D. Simmons, and FERTICA by Manderson & Associates and Price Waterhouse. Overall the subcontractors and staff hired by IRG were well qualified to fulfill FINTRA requirements.

IRG prepared detailed reports and participated in the restructuring of ALUNASA, ATUNES, ALCORSA, FERTICA, CEMPASA, CEMVASA and TEMPISQUE FERRY BOAT.

Their reports have been reviewed and have been found for the most part to be satisfactory, and the evaluators concur with Mr. John Robinson's favorable assessment of the quality of the work involved. The problems that occurred during the execution of the Technical Assistance program were mostly due to: (1) an overly optimistic initial timetable, (2) operational delays due to IRG's apparent lack of capacity to handle AID administrative procedures, (3) problems derived from a lack of adequate coordination between FINTRA and IRG on the sequence and timeliness of reports, and (4) a confusion arising from an unclear reporting relationship to AID and FINTRA by IRG. This latter problem was solved by an amendment to the contract in December 1986, which required IRG to submit work plans for each activity it carried out, which could be approved by the AID project manager. IRG's work functioned more smoothly after that change was instituted.

Conclusion

The activities carried out by IRG specialists, and the individual company reports prepared by IRG, have proved to be a valuable tool for AID, FINTRA and CODESA, enabling them to have a realistic overview of the enterprises and their market values, and a clear idea of the measures necessary to restructure or liquidate the business. Without the information provided in the reports submitted, any action by FINTRA and CODESA would have been difficult to plan.

THE VALUATION ISSUE AND THE CONTROLLER GENERAL OF COSTA RICA

The Controller General of Costa Rica, who as in most Latin American countries reports directly to Congress, was designated to play a crucial role in the privatization process under Article 55 of Law 6955, and Decree 16007-P-MEC. He was authorized to:

a) Appraise all the companies to be privatized, and establish the minimum value for the sale.
b) Approve the tender documents and the sales notices in each case.
c) Resolve any appeals by the bidders.
d) Report all sales to the Costa Rican Congress within 30 days of execution.

The assignment of responsibility to the Controller General, for carrying out the valuation process for the enterprises which CODESA was to privatize, proved to be a crucial issue in the execution of the privatization process and how it was viewed externally.

The Valuation Method

A major problem arose when the Controller General's office decided to use "the adjusted book value of assets method" to value the companies. This method consisted in adjusting the value of all fixed assets by indexing them upwards to reflect the national rate of inflation and devaluations of the currency and applying depreciation to the new values. Liabilities maintained their book value.

A clear indication of the Controller General's line of thought on the valuation issue was a section introduced in all his official valuations entitled "Methodology", which stated the following:

> "An enterprise can be valued according to liquidation value, an earnings multiplier, the value of expected dividends, a sales to equity ratio, adjusted book value, insurance value and others"
>
> "Taking into account the high risk involved to quantify the value of shares, projected on information on the basis of merely speculative variables or unconfirmed data, this office decided to use the adjusted book value method, with the purpose of obtaining a just and reasonable price for the shares"
>
> "The method in reference is based on the premise that the equity of a company is equal to the adjusted value of the assets at a set date, less total liabilities".

The above indicates clearly a preconceived intention to use the valuation method to cover the government's original investment costs rather than determining value of the companies as going concerns. The end product was inflated values that did not reflect the market value or the earnings potential of the companies. The first valuation, that of ALUNASA, produced a value of c 2,796 million, while the market price of the company was closer to c 400 million at the time. A potential loss of such magnitude brought the privatization program to a halt while attempts were made to persuade the Controller General to adopt a more realistic approach. It was not possible to get him to alter his view.

Some of the justifications by the Controller's office for the method employed were:

(1) A political responsibility, as values had to be reported to Congress.

(2) There were no comparable companies to provide reference values, as the companies were "unique" in Costa Rica.
(3) Lack of adequate information
(4) The valuation of fixed assets were made by the tax administration which generally values assets at high prices for revenue purposes.

Valuations Carried Out by the Controller General

Between 1984 and 1987 the following valuations were completed by the Controller General. The disparity with values actually realized from sale or expected to be realized is apparent.

		Value (c millions)	
Company	Date	Contr.General	Realized
ALUNASA	Aug 1985	c 2,796	c 390
ALCORSA	Oct 1985	c 289	c 45*
ATUNES	Apr 1986	c 102	c 90
CATSA	Jun 1986	c 3,428	c 450
CEMVASA	May 1986	c 1,123	N.A.
FERTICA (40%)	Nov 1986	c 1,309	N.A.
CEMPASA (40%)	Jul 1987	c 2,090	c 532*

*estimated

As can be observed from the time span involved, the valuation process was lengthy, and was one of the major causes for the delay in the privatization process. The Controller General has argued that poor accounting records, lack of information and lengthy procedures by the tax administration valuators were the cause for the delays.

Conclusion

The lengthy valuation procedures and the inflated prices for the companies that the Controller General produced were one of the main causes for the delay of the privatization process, and for the creation of the "buy high - sell low" problem which generated internal conceptual problems in AID.

It is generally felt by those involved in the process that the Controller General viewed the valuation issue from a political standpoint, and took the "safe" route, using the adjusted book value method which in theory would reflect the original investment by the GOCR.

Could the Controller General have acted differently? Possibly, if the valuation method had been negotiated with him, in advance of any pronouncement, and technical assistance supplied. On the other hand, the availability of local currency ESF credits and the need to demonetize them made the difference less critical. Furthermore, under the circumstances, it is likely that any Latin American Controller General would have adopted the same protective approach.

ESF LOCAL CURRENCY FUNDS IN THE CODESA DIVESTITURE PROGRAM

The original divestiture project envisioned the use of the equivalent of US$140 million in ESF funds to be applied through FINTRA to the purchase of the shares of CODESA subsidiaries. The mechanism was quite simple and straight-forward: for each purchase of a CODESA company by the FINTRA trust an equivalent amount of local currency would be debited to the AID special local currency account in the BCCR and credited to CODESA's debt with the BCCR, in essence a book transaction, with no monetary consequences.

Use of the ESF Funds:

Questions have been raised (primarily in Washington, where there has been some misunderstanding of the mechanism) as to whether this was an appropriate use of ESF local currency funds.

ESF loans and grants for balance of payments support programs have been a major part of AID assistance to Costa Rica, in the following amounts (millions of dollars)

	1983	1984	1985	1986	1987
Amount	$155.7	$130.0	$160.0	$ 80.6	$120.0
As % of Exports	18.3%	13.0%	17.0%	7.4%	10.8%

AID management of local currency funds generated under ESF programs has varied from mission to mission. In the Costa Rican case it was based on direct mission control for programs agreed with the government. Project design, implementation and management have followed established AID procedures and monitoring, while the amount of direct AID involvement in execution has varied.

The amount of currency obligated by AID for its various programs in Costa Rica on September 30, 1987 added up to c 19,348,087,000, of which c 7,034,793,000 or 36.36% were obligated for the CODESA divestiture project, the largest of all the programs. On December 31, 1987 the balance of the AID special account with the Central Bank was c 15,676,000,000 (equivalent to US$248,825,390).

The AID special account with the BCCR has been increasing due to the continuous ESF programs since 1983. The balance in the account has evolved as follows:

AID SPECIAL ACCOUNT WITH BCCR

Year End (millions of colones)			
1984	1985	1986	1987
4,478	8,880	13,803	15,676

The continual growth of the special account clearly (despite the CODESA program of cancellations) reflects the cautious handling of local currency generated by ESF grants and loans.

Economic Significance of ESF local Currency

The significance of ESF transfers to Costa Rica, and the build up of local currency in the special AID account with the BCCR has been a subject of concern to BCCR and to AID and other international agencies, in particular the IMF and the World Bank.

The unrestricted monetization of the special account colones (if disbursed for use within Costa Rica) could, because of the size of the account in relation to the economy, have devastating consequences on the monetary program of the BCCR, on inflation, on import demand and on the general economic stabilization objectives of the GOCR.

The balance of the special account at December 31, 1987 (c 15,676,00,000) is equal to about 14% of the money supply, and seven times the currency issue of the BCCR in 1987.

Accordingly, limits have been established in conjunction with the BCCR and the IMF on the amount of local currency funds generated under the ESF program that could be permitted to enter the economy under the Costa Rican AID programs. The amount has fluctuated between US$60 million and US$80 million per year. The remainder is held in the AID special account in the BCCR. The problem is then to dispose of those funds in a way that will result in demonetization. This problem had a fundamental role in the design of the CODESA privatization program.

Conclusion

The AID mission in Costa Rica creatively designed a process whereby two major objectives were to be obtained, the divestiture of CODESA and the reduction of the special account through demonetization. What in effect happens when AID uses the ESF generated colones in the special account to reduce CODESA's debt with the BCCR is that the funds are simply transferred on the BCCR books from the special account to the CODESA debt account, reducing both accounts.

While there may have been alternative uses for the funds in the special account there would have been substantial risk in using more than a very minor portion of them. An open economy the size of Costa Rica can simply not absorb those resources without creating enormous import demand and inflationary pressures. The most appropriate alternative would have been a simple write-off of the funds, or an indefinite sterilization which is politically difficult to handle. The effect, demonetization, is achieved just as well whether an amount in the AID special account is written off or applied to "pay" an inflated "price" for a CODESA company.

In sum, the process designed to use the ESF local currency funds for the privatization of CODESA has achieved the important goals of privatizing a number of enterprises, reducing a drain on the economy and solving a monetary problem in a fashion consistent with the BCCR's and the GOCR's overall objectives of economic stabilization. The funds at AID's disposal were used to solve a significant political problem - the sale of investments at well below their cost - as they were being at the same time cancelled or written off. It was this legerdemain which led to suspicions in Washington of "buying high and selling low", which had no factual basis. If this conception is "stood on its head" and it is asserted - as in many countries - that the ESF funds are really at the disposition of the recipient government, then it will immediately be seen that the GOCR itself footed the bill for the divestiture price discrepancies and acquiescing in this use of the funds instead of insisting on their being invested in some other use.

USAID MANAGEMENT OF THE CODESA DIVESTITURE PROGRAM

AID participation in the privatization of CODESA's subsidiaries has been very active, both in the policy dialogue and the execution of the program.

The concept and project were developed by Daniel Chaij, AID Mission Director in high level meetings during 1983 and 1984 with top officials and ministers of the Monge administration.

Initiation of the Project

As the result of the policy dialogue the GOCR submitted the "Law of Financial Equilibrium" to Congress, which included two articles on the privatization of CODESA's subsidiaries. The law was approved, after a prolonged debate in Congress, in February of 1984. This step was the starting point of the privatization program in Costa Rica.

The AID mission then retained the consulting firms Arthur D. Little and Coopers & Lybrand to assist in the design of a divestiture strategy for CODESA. Their report was a valuable document.

Between July 1984 and February 1985, the final details were worked out for the establishment of the privatization program, including the establishment of the trust, the sales process, the monetization issue, and the valuation issue. The PAAD submitted in February 1985 and approved the next month reflected in general terms all those details. All the concepts and the final procedures designed were a product of concerted efforts of AID officers, and advisors, and high level officials of the GOCR. The 1985 PAAD states on page 30 "Due to the sensitive nature of the activities and requirements surrounding the GOCR's proposed divestiture of CODESA enterprises, negotiations have been carried on at the highest levels, and in confidence. Thus, the details of the proposed covenants have not yet been fully reviewed at the staff level of the GOCR ". The AID mission's treatment was appropriate for a project of this sort. In view of its political sensitivities, any other handling could have created problems before the project got off the ground.

The Implementation of the Project by AID

Problems arose when the actual execution of the privatization program began. The valuations by the Controller General proceeded very slowly. CODESA management resisted the privatization process and delayed most initiatives to start the execution of the program, through lengthy procedures and political discussions.

It is difficult to attribute the principal failures and delays in the implementation of the privatization program to AID. It is true nevertheless that, through lack of experience, Chaij in his initial planning and the Mission staff when implementation got under way failed to foresee some of the practical issues that arose, particularly after an optimistic timetable had been established.

Finally the sale of ALUNASA was carried out in December 1985. At that time CODESA management was more interested in appearing to generate a profit on its books from the sale of ALUNASA, than in the divestiture itself. However, the magnitude of the difference between what FINTRA paid and what it could get for ALUNASA slowed the project, because of the concerns expressed, and at the same time the upcoming change of administration paralyzed the government.

With the initiation of the Arias administration, most of AID's problems with the privatization program disappeared. The President became committed to the process and appointed Edgar Brenes to CODESA, who easily established a close relationship with AID and FINTRA, and rapidly began executing the program originally designed. The arrival of Mr. Jack Robinson as project manager in November 1986, added to the impetus given to the process by the Arias government.

It can be concluded that had the GOCR originally appointed the right people to carry out the program and established more expeditious procedures for the sale of the enterprises, the delays would have been less and the political problems substantially defused.

Concluding Comments

From our evaluation of all the steps taken by AID from the initiation of the privatization negotiations to the execution of the process, and the procedures followed in each case, we have concluded that the Mission Directors in Costa Rica and the other AID officers involved acted properly in designing and helping carry out a complex program with multiple goals and in a difficult political environment.

The lack of experience in the privatization process itself did cause some mistakes such as an overly optimistic timetable, underestimating initial opposition within the CODESA administration and the possibility of problems in the individual enterprises. Nevertheless, the main problems and delays were caused by persons and institutions within the GOCR and CODESA, and not AID, which was resourceful in solving them.

Overall, the privatization program in Costa Rica was ingeniously conceived and planned by USAID which also played a vital role in developing and maintaining the momentum of the program; delays in carrying it out have been caused by circumstances not primarily attributable to the Mission.

APPENDICES

APPENDIX A

CODESA DIVESTITURE EVALUATION

PERSONS INTERVIEWED

USAID Costa Rica:

Robert Adler	Leonard Kornfeld
Richard Archi	John Robinson
Neil Billig	Richard Rosenberg
Kevin Kelly	Joseph Wargo
Carl Leonard	

USAID Washington:

Daniel Chaij	Aaron Williams

National Commission:

Claudio Volio, President
Ricardo Echandi, Director
German Serrano, Director
Ricardo Charpentier, Executive Secretary

FINTRA:

Ernesto Rohrmoser (Chairman)
Carlos M. Gonzalez, President
Carlos Araya, Trustee
Emilio Garnier, Trustee
Gonzalo Vega, Executive Secretary

Other:

Rodrigo Arias, Minister of the Presidency
Edgar Brenes, President CODESA
Mario Carvajal, Congressman, cooperative movement leader
Carlos Espinach, Advisor, Presidency of Costa Rica
Rodolfo Gurdian, purchaser of ALUNASA
Carlos Hernandez, Gen. Manager, Central Bank of CR
Luis Alberto Monge, former President of Costa Rica
Jorge Eladio Mora, Office of Controller General of CR
Manuel Peralta, attorney for FINTRA
Humberto Perez, Executive President, Scott Paper, etc.
Carlos Quiros, Tax Consultant, Peat Marwick & Mitchell
William Phelps, General Manager, COFISA
Otton Solis Fayes, Minister of Planning
Guillermo von Breyman, President FINTECH
Jorge Woodbridge, President, Chamber of Industries

APPENDIX B

Government of Costa Rica

Law 6955
Articles 55, 56 and 57

(English translation)

LAW 6955

1. Article 55

CODESA is authorized to sell the shares of its businesses, with prior agreement, in each case, of the Council of Government, in the form and conditions that the same establish in accordance with the following stipulations:

a) CODESA will be able to sell all of its shares of businesses created by public document, except those set forth in inserts g) and h).

b) The Controller General of the Republic will render a report about the sale of each business, to the Legislative Assembly at the latest 30 days after they are effectuated.

c) The sale of whatever shares referred to in this article will be done by public bid, except for those set forth in insert 1) and the respective announcement must be approved before the sale by the Controller General within a period of 15 days.

ch) The bid will not be awarded if the offer is less than the value of the shares that the Controller General of the Republic must have established prior to the publication of the announcement, within a thirty day period.

d) Appeals of awards will be done before the Controller General of the Republic, in accordance with what is established in the Financial Administration Law of the Republic and in the Administrative Contracting Regulations. The Controller must resolve the appeal within two months.

e) In the sale of shares, all other conditions being equal, social organizations of workers will be given priority. The National Banking System will create preferential lines of credit, through a system that permits priority financing to such organizations as well as for those (bids made by) small national investors who want to acquire shares of the businesses of CODESA.

f) From the income that CODESA receives in 1984 from the sale of shares its businesses, 50%, up to a maximum of $500,000,000, will be given as a special contribution to the Government of the Republic. These funds shall be incorporated in the budget of the Government. The other 50% will go to CODESA to pay its obligations with the Banco Central.

g) Of the stock belonging to the State in the firms FERTICA and Cementos del Pacifico S.A., only 40% can be sold.

h) None of the businesses that develop whatever of the activities specified in Article 121, paragraph 14 of Political Constitution, may be reduced by any percentage. (Note: No sales of power companies, minerals, communications, railroads, docks, airports, etc.)

i) The National Banking System may finance small national investors and social organizations of workers in the purchase of the shares of CODESA.

j) In the purchase of the shares, no employee or staff member of CODESA, nor any of their subsidiaries, may participate, unless it is a group of employees or workers of the same constituted as some kind of social organization of workers. The sale of shares referred to in this article will be subject to the prohibitions established in article 107 of the Financial Administration Law.

k) The shares belonging to CODESA in CATSA and Cementos del Valle, can be sold only to the national cooperative sector, according to a prior appraisal on the part of the Controller General of the Republic, and following the steps of a public bid.

2. Article 56

The Costa Rican Central Bank is authorized to finance CODESA at the same average rate that CODESA had to pay during 1984 for loans granted before January 1, 1984. This financing will have the following characteristics:

a) Credit given to finance interest on loans granted to CODESA with external resources will use an interest rate equal to the weighted average of the interest on the original loans, with a grace period of three years.

b) Credit given to finance interest on loans given to CODESA with domestic funds will use an interest rate equal to the weighted average on the original loans, with loans of a grace period of three years and a twenty year maturity.

The Costa Rican Central Bank will demand the guarantees required for the loans hereby authorized.

3. <u>Article 57</u>

All the public institutions and enterprises that buy stocks or that carry out whatever other stock exchange operations, must do it through the post CODESA has in the National Stock Market. The State Banks are an exception to this stipulation.

APPENDIX C

STATUS OF CODESA HOLDINGS

April 30, 1988

STATUS OF CODESA SUBSIDIARIES
April 30, 1988

Company	Status	Date
Acuacultura, S.A.	Sold	1984 C
Algodones de Costa Rica, S.A. (ALCORSA)	Sale of Assets & liquidation	9/88 T
Aluminios Nacionales S.A. (ALUNASA)	Sold by FINTRA to private sector	9/87 C
Atunes de Costa Rica S.A. (Atunes)	Sold by FINTRA to private sector	4/87 C
Atunes de Puerto S.A.	Being dissolved & liquidated	5/88 T
Cia. Industrial Pesca Escama S.A.	Dissolved and liquidated	1/88 C
Central Azecarera Tempisque S.A. (CATSA)	Transferred to FINTRA in trust; to be sold to co-ops & members	9/88 T
Cementos del Valle S.A. (CEMVASA)	Assets being transferred to be dissolved & liquidated	10/88 T
Cementos del Pacifico S.A. (CEMPASA)	Transfer to FINTRA in trust 40% of shares to be sold	6/88 T 12/88 T
Consolidacion de Companias Agricolas Industriales S.A.	Dissolved and liquidated	1986 C
Consorcio de Exportacion de Productos Costarricenses S.A.	Dissolved and liquidated	2/88 C
Corporacion para la Desarrollo Agroindustrial	Assets to be sold To be dissolved & liquidated	5/88 T 11/88 T
Corporacion de Zonas Francas de Exprotacion	Transferred to CENPRO (GOCR)	
Distribuidora Costarricense de Cemento S.A.	Dissolved & liquidated	1984 C
Ferrocarriles de Costa Rica	Assets transferred to INCOFER Dissolved and liquidated	 2/88 C
Fertilizantes de Costa Rica S.A. (FERTICA)	To be transfered to FINTRA in trust 40% of shares to be sold	6/88 T 1989 T
Guacamaya, S.A.	Being dissolved and liquidated	5/88 T
Guanacal S.A.	Being dissolved and liquidated	6/88 T
Ingenio Tempisque S.A.	Being dissolved and liquidated	5/88 T
Inmobiliarias Temporales S.A.	Being dissolved and liquidated	10/88 T
Officina de Fletamiento Maritimo, S.A. (FLEMAR)	Dissolved and liquidated	7/87 C
SEDEMAT S.A.	Dissolved and liquidated	1/88 T
Tempisque Ferry Boat, S.A.	Assets to be sold To be dissolved and liquidated	4/88 T 10/88 T
TRANSMESA	Transferred to MOPT (GOCR)	8/87 C
Transportes Aereos Continentales, S.A.	Being dissolved and liquidated	6/88 T
Centro Permanente de Ferias y Convenciones, S.A.	Being dissolved and liquidated	5/88 T
Industria Petrolera del Atlantico S.A.	Dissolved and liquidated	1/88 C
Asufrera de Guanacaste, S.A.	Dissolved and liquidated	1980 ?
MINASA	Transferred to the MIEM (GOCR)	
CODESA seat on Bolsa	Retained in CODESA by law	

AFFILIATES AND MINORITY SHAREHOLDINGS

Sub-Products del Cafe S.A.	Sold	
Bolsa Nacional de Valores S.A.	Retained by law in CODESA	
Servicios Aereos Nacionales, S. A. (SANSA)	Sold	
LACSA	Sold	
Naviera Multinacional del Caribe S.A. (NAVICAR)	Transferred to MOPT (GOCR) To be dissolved and liquidated	
MULTIPERT	Transferred to MOPT (GOCR)	
PASCAFE	Dissolved and liquidated	
MACASA	Sold	
STABAPARI	In process of sale with FINTRA	5/88 T
Cia. de Terrenos de Oro S.A.	Sold	

SUBSIDIARIES OF DAISA

Industria Aceitera Costarricense S.A. (INACO)	Being dissolved and liquidated	5/88 T
EXPOFRESCO	Being dissolved and liquidated	5/88 T

NOTE: The process of dissolution and liquidation takes approximately six months, in order to comply with Costa Rican law. In the case of CODESA subsidiaries and additional period of restructuring accounting and legal information was required.

Under Date, "C" indicates process completed; "T" indicates target date for completion

APPENDIX D

ENTERPRISES OWNED BY CODESA:

DESCRIPTION, MANNER OF DISPOSITION AND SELECTED CASE HISTORIES

SALE OF CODESA SUBSIDIARIES

ALUMINIOS NACIONALES, S.A. (ALUNASA)

Background

Was established by CODESA in 1975, and began operations in 1981, for the production of aluminum sheet and foil to serve the Costa Rican and Central American markets. Due to the international recession in the early eighties, when aluminum prices dropped, and the ensuing crisis in the Central American common market, the company immediately began to generate losses. Poor management, coupled with government controls and political intervention, added to the company's inability to make a profit. By the end of 1984 the company had run up cumulative losses of about US$28,949,000, and had never shown an operating profit.

The Privatization Process

In December, 1985, the GOCR sold ALUNASA in a public tender to FINTRA, (in accordance with the divestiture program agreed to with USAID) for 2,619,384,827 colones, the value established by the Controller General's office. FINTRA appointed a new board of directors, replaced the general manger, and immediately began a reorganization and restructuring process aimed at reducing costs and increasing productivity.

On April 4, 1986, FINTRA signed an agreement with The First Boston Corporation (FBC) to handle the sale of ALUNASA, for which FBC would be compensated with a fixed fee and a success fee on a sliding scale.

The time period for carrying out the sale was estimated at four months, i.e. by the end of July 1986. The actions taken by FBC were:

Phase 1 Initial Contacts: 119 companies throughout the world were contacted, 61 did not answer, 34 turned down the offer and 24 requested documentation.

Phase 2, Visits to data rooms, specially set up in San Jose, New York and London, where potential buyers could obtain detailed information, including a sales brochure.

Phase 3, Visits to Alunasa's Plant

Phase 4, Presentation of letters of intent: Only two letters of intent were submitted.

Phase 5. Presentation and evaluation of offers. As no adequate offers were presented by July 21, 1986, the period for presentation of offers was extended to December 31, 1986, when four offers were received:

- Highland Supply Ltd. / T. Kader
- Aluminio del Caroní, S.A. (ALCASA)
- Craft Asia Private, Ltd.
- Kaiser Aluminum

No agreement was reached with any of the above parties and the negotiation period was again extended to June 16, 1987. Three new offers were then presented:

- Highland Supply Ltd.
- T. Kader, R. Gurdian and Hidro Aluminum
- ALCASA

In July, FBC invited all three to visit San Jose and negotiate with FINTRA. No acceptable offers were received as most required extended payment terms. FINTRA requested new offers in cash.

The best cash offer FINTRA received was presented by the Costa Rican group headed by Mr. Rodolfo Gurdian. Negotiations were finally completed and the sale closed on October 23, 1987, for a total price of colones 390,275,000. These proceeds have been left by AID on deposit with FINTRA to finance its operations. A periodic accounting is rendered.

The cost of FBC services over an 18 month period was colones 32,920,769. Several factors contributed to the extended period required to complete ALUNASA's sale, despite a major effort by FBC. Among these were the world aluminum situation, the Latin American debt crisis, the general Central American economic and political developments, and the poor earnings record of ALUNASA.

ALUNASA was purchased with no debt on its books, all debts having been assumed by CODESA. The new owners of ALUNASA have aggressive production plans for 1988. With the aid of ALCASA of Venezuela, who purchased 40% of ALUNASA and is assisting with the supply of raw aluminum, the company expects to process 7,000 tons during 1988.

An experienced production manager (a U.S. expatriate) has been hired for ALUNASA and the company has immediate investment plans of US$2.2 million in equipment which will allow product improvement and increase in volume and productivity.

FINTRA'S Management of ALUNASA

FINTRA effectively managed ALUNASA from December 1985 to October 1987, i.e. 1 year and 9 months. A considerable managerial effort was input, by FINTRA, including foreign technical assistance, which allowed an important restructuring of the company and kept it operating during the sales period. Some of the main actions taken were:

- Appointment of a new general manager
- Hiring of technical assistance through IRG contract, (Mr. Douglas Graham)
- Reorganization of the managerial structure
- Reduction of excess personnel
- Transfer of the administrative and accounting offices from San Jose to the plant.
- Increase in productivity.

The management of ALUNASA in the end produced a net positive balance of income to FINTRA, according to information supplied. This is summarized as follows:

Total expenses including provisions of working capital	c 119.8 million
Less: sales deposits and other income	(c 39.8) "
Gross deficit	(c 80.0) "
Plus: ceding of current assets to FINTRA	c 169.0 "
Net income for FINTRA	c 89.0 "

ATUNES DE COSTA RICA S.A.

ATUNES is a tuna fishing company whose main assets were two tuna fishing boats; only one of the boats was in partial operation. It is reported that the one boat in operation was primarily used by government officials for entertaining purposes. Net losses were substantial.

The Privatization Process

During August 1986, the National Commission issued an invitation for tenders for the sale of the company which was won by a Venezuelan group. StarKist Inc., a creditor of Atunes managed to block the sale, which was then assigned to the second highest bidder, FINTRA. In the interim StarKist obtained judgment against Atunes and on that basis negotiated a settlement, which included receiving one of the tuna boats in payment, a transaction which was completed in December, 1986.

FINTRA acquired Atunes on February 13, 1987, with one boat, at a cost of c 101,519,394. broken down as follows:

Net equity	c 13,769,326
Debts to Central Bank	c 87,750.068
Net asset value	c 101,519,394

On March 9, 1987, one month later, FINTRA issued a tender invitation for Atunes requesting offers by April 9, 1987. Six offers were received. A c 90 million offer was presented by Atun, C.A. from Venezuela and was the best by more than 63%. On April 30, 1987, only 2 1/2 months after purchase, FINTRA closed the sale with Atun C.A.

The net result to FINTRA on this transaction was a loss of c 11,519,394. AID's fear of a much larger loss proved unwarranted. There is no information presently available on the situation of ATUNES, as the new owners are operating the boat out of Venezuela.

CENTRAL AZUCARERA DE TEMPISQUE, S.A. (CATSA)

Background

CATSA, an integrated sugar mill which includes agricultural lands and an alcohol distillery, located in the Tempisque area, began operations in 1979.

Due to low productivity, bad management, political intervention, high operating costs, and lack of controls the company never turned a profit in its years of operation. By the end of June 1987, CATSA had accumulated book losses of c 874,213,000 (not including c 600 million of losses written off on the books) and had built up debts of c 1,150,722,000. to CODESA and the National Banking system, making it CODESA's largest problem debtor.

The Privatization Process

Law 6955 established that CATSA could only be sold to the national cooperative system, i.e. cooperatives and members of cooperatives.

The Controller General's office completed their valuation in June of 1986, and the National Commission issued the tender invitation on November 20, 1986. It was clear to everyone involved that this licitation would receive no response. It was carried out to satisfy the requirement imposed by the law and clear the way for subsequent steps. There were no bidders as the price set by the controller was too high, c 3,427,584,197, the cooperative movement had not been mobilized. and FINTRA (not being a cooperative) was legally barred from purchasing.

During that period, through the technical assistance program with IRG, FINTRA hired F.C. Schaffer & Associates, sugar specialists from Baton Rouge, Louisiana to make a technical evaluation and establish a price for CATSA. The report presented in July 1987 came up with a price range of 7-9 million dollars (c 500-650 million, or around 15% of the Controller General's valuation).

After the failed licitation. CODESA negotiated and obtained from the GOCR Cabinet (Consejo de Gobierno) an agreement which allowed FINTRA to participate in the CATSA privatization. The arrangement consisted basically of:

(a) authorization to transfer the GOCR's CATSA shares to FINTRA under a trust agreement for a fixed time period, where the beneficial owner would still be CODESA, and FINTRA would have limited rights.

(b) FINTRA would hold the shares in trust for a fixed period, and manage CATSA during that period, without the restrictions of budget regulations and the Controller General's supervision required for state owned companies.

(c) CODESA and the GOCR would carry out the marketing of CATSA shares to the cooperative sector and would instruct FINTRA as to the sale of shares.

On September 10, 1987 CODESA signed the trust agreement with FINTRA and on September 24, 1987, the transfer of CATSA's shares took place with the authorization of the Cabinet, the Controller General and the National Commission.

In this case, in order to avoid criticism and the "buy high, sell low" problem, AID made a direct donation of c 3,500,000 to the Central Bank, to be applied to reduction of the CODESA debt. A portion of the above amount would then be "privately" attributed to the transfer of CATSA shares to FINTRA, as valued by the Controller General. This operation was agreed to by the Controller General.

The trust arrangement also established that FINTRA would in turn sell the shares of CATSA to the cooperative sector by September 30, 1988. A sales price of c 450,000,000 has been set.

The agreement also establishes that the actual marketing process will be done by CODESA and the GOCR, who would promote the sale and negotiate with the cooperatives. AID and FINTRA expressly avoided participating in this process, because of the political implications in the determination of which types of cooperatives would be allowed to participate.

Status

FINTRA has taken over supervision of CATSA management and CODESA and the GOCR are actively involved in the selling process.

The GOCR has targeted the approximately 600,000 individual members of the cooperative sector. President Oscar Arias has actively promoted the sale as part of his democratization process, including personal letters to the cooperatives urging the individual cooperative members to participate. The target is to attract at least 100,000 buyers of five shares at c 1,000 each. CODESA expects the 500,000 share issue (which includes c 450 million purchase price and c 50 million for working capital) to be fully subscribed and paid by September 30, 1988.

The original target date established by CODESA for the transfer, March 31, 1988 was not met due to implementation delays, the lack of an offering memorandum and the operating complexities of having to deal with large numbers of individuals. CODESA expects the cooperatives to begin making payments by April 30, 1988, and continue making monthly payments until September 20, 1988. It is likely to fall behind this schedule.

The major problem still unanswered is the management that CATSA will need to assure its future profitability. FINTRA intends to lock adequate management in place through a three-year contract.

<u>FINTRA'S Management of CATSA</u>

FINTRA assumed the management of CATSA on September 24, 1987 only three months before the sugar harvest (January-April), and in that time had to implement major changes in the business. The Schaffer study was an important guidance for the restructuring.

Some of the measures taken were:

- Reduction of costs, including closure of the San Jose office.

- Reduction of personnel.

- Increase efficiency of some equipment.

- Appointment of 3 new key executives:
  Financial and administrative Manager
  Controller
  Technical advisor with ample sugar experience

- Lease of land not appropriate for sugar production.

FINTRA's costs for managing CATSA have been minimal. It loaned c 63.5 million to CATSA for working capital, which has already been repaid.

The company will generate a profit of about c 100 million in its 1987-1988 fiscal year. Although this profit may include a non-recurring element, an analysis made by Peat Marwick & Mitchell for FINTRA clearly indicates the potential for a profitable year for CATSA under new management.

CEMENTOS DEL VALLE, S.A. (CEMVASA)

Background

This cement producing company promoted by a private group was established in 1978. The operation was too small and production costs too high.

When the company went into bankruptcy it was acquired by CODESA. Minority share holders still retain about 16% of company shares.

CEMVASA stopped operating due to uneconomic results in 1982. In October 1986, IRG cement industry expert Ken Simmons submitted a detailed evaluation of CEMVASA. On the basis of the evaluation, the liquidation of the company was recommended.

The Privatization Process

Law 6955 established that CEMVASA could be sold only to the national cooperative sector. After the controller's office established a value for the company, the national Commission issued a licitation for offers to be presented by February 11, 1987. No bids were submitted and FINTRA did not participate. CODESA concluded that the company should be liquidated and the assets transferred or sold.

CODESA presented a request to the cabinet to authorize the dissolution and liquidation of CEMVASA. The cabinet authorized the action in its meeting of May 1, 1987 and confirmed the resolution on May 14, 1987. This authorization represented a departure from the spirit of Law 6955, based on a conclusion that the the Controller General's valuation requirements did not have to be met in the case of liquidation.

CODESA signed a management contract with CEMPASA for the maintenance, custody of CEMVASA's assets, and the termination of about 50 remaining staff. CODESA is acting as liquidator of CEMVASA and is presently in the process of completing the transfer of fixed assets to CEMPASA. A certain amount of other assets will be distributed to the minority shareholders to pay for their shares.

The minority shareholders will receive their 12% holdings in a combination of equipment, cement, and liquid investments through a corporation specially set up for that purpose. Another minority shareholder, the Institute Nacional de Vivienda y Urbanismo, a GOCR entity, that holds 4% of CEMVASA stock will receive property and 25,000 bags of cement.

The process of liquidating CEMVASA has taken a year to date, and is expected to be completed by the summer of 1988.

CEMENTOS DEL PACIFICO, S.A. (CEMPASA)

Background

CEMPASA was one of the first enterprises created by CODESA. It was legally established in February 1973, but it only began operating in October 1980.

CEMPASA produces portland type cement in its plant located in the central valley of Costa Rica. It has a concession with ample limestone deposits near to its plant. Production capacity of the plant is 410,000 tons per year. Production has increased constantly in recent years, as follows (tons):

1983	1984	1985	1986	1987
110,139	179,754*	198,402	227,678	239,011

*The important production increase in 1984 is due to the closing of CEMVASA.

On February 28, 1984 CEMPASA and Industria Nacional de Cemento, S.A. (INCSA) (the private sector cement company) assumed the management of CEMVASA, and the obligation to pay 2 colones for each bag of cement sold to pay for CEMVASA's maintenance and administration. Presently CEMPASA has a market sharing agreement with INCSA granting 50% of the market to each company. In addition, INCSA assumed 14% of CEMPASA's share, for which it agreed to pay c 44.60 per bag of cement sold. Prices are also set between the companies. The Costa Rican market is presently divided 57% INCSA and 43% CEMPASA. 1987 sales of CEMPASA added up to about c 673 million, or approximately US$10 million, including the compensation received from INCSA.

CEMPASA, according to its evaluators, has a good, well designed modern mill which is capable of meeting increased demand, and could augment its capacity and improve its production process with relatively small investments. Although the management of CEMPASA is highly qualified and able to produce good results, the company is overstaffed by industry standards, with a total of 324 employees.

Financial Situation

CEMPASA is the only major profitable subsidiary of CODESA, it maintains a healthy working capital position and is able to service its debts. Profits in the past 3 years have been as follows:

(thousands of colones)

1985	1986	1987
37,431	46,972	38,013

The Privatization Process

Law 6955 established that only 40% of CEMPASA could be privatized, and CODESA would retain the remaining 60%. This provision has limited the possibilities and scope of buyers, as it is unlikely any significant investor would enter in a minority relationship with the GOCR.

The Controller General presented a valuation for CEMPASA on July 30, 1987, of c 5,224,238,000 for 100% of the company, or c 2,089,695,200 for 40%. This valuation included c 1,200,000,000 for the limestone deposits, far in excess of CEMPASA's needs. The independent valuation of CEMPASA produced a "fair market value" of US$7.2 million, or about c 532,800,000.

The 40% portion of the company has been offered by the National Commission in a licitation, without any bidders, and there has been no concrete privatization process initiated.

CODESA's management is presently thinking along the following lines:

1) Transfer 100% of CEMPASA's shares to FINTRA, in trust, in a similar arrangement to CATSA's

2) Widespread sale of the 40% to small shareholders, to include "solidarity groupmembers", users, employees, investors on the Stock Exchange.

3) Submit legislation to Congress to permit an additional 20-30% to be sold.

4) Complete the transfer by the end of 1989, within President Arias's "democratization" plan.

The final decision is expected to be taken by the end of June 1988.

FERTILIZANTES DE CENTRO AMERICA S.A. (FERTICA)

Background

FERTICA is the principal manufacturer and distributor of fertilizers in Costa Rica, accounting for about 70 to 75% of the market.

The company was established in 1961 by Standard Oil Co. of New Jersey, and began operations in 1963. In 1970 Guanos y Fertilizantes de Mexico, S.A. acquired the operation, and in 1978 Refinadora Costarricense de Petroleo, S.A. (owned by the GOCR) bought 10% of the shares. In 1980 CODESA purchased the remaining 90%.

FERTICA's product line consists mainly of ammonium nitrate which it manufactures at its Puntarenas industrial plant, and chemically mixed fertilizers with imported materials which it processes at its Puntarenas and Limon facilities. During 1987 its sales mix was as follows:

Type of Fertilizer	Tons Produced
Complex mixed fertilizers (NPK's)	85,291
Ammonium nitrate	42,742
Other mixed fertilizers	11,975
Urea	3,046
Ammonium sulfate	2,018
Other fertilizers	6,160
	151,232

The Financial Situation

FERTICA is a high cost operation and normally does not make a profit on its manufacturing and mixing operations despite tariff protection. Commencing in 1986 it has shown a profit through the reduction of interest costs when CODESA assumed its debt obligations.

The main reasons for its high costs are:

(a) Outdated and inefficient production facilities

(b) Excess capacity which has led to high fixed costs.

(c) Excess personnel and overall high production and administrative costs; FERTICA has 641 employees, of which 504 are at Puntarenas.

FERTICA is protected by a tariff (20% for ammonium nitrate and 10% for NPK's) which has resulted in higher costs to the farmers. The GOCR is presently considering the elimination of that tariff.

The evaluation of FERTICA made by IRG and Manderson Associates, assisted by Price Waterhouse, concluded that FERTICA would have to undergo a major restructuring, including the closing of the Puntarenas plant, in order to make it profitable again. The possible plant closing has become a major political issue in the Puntarenos area.

The Privatization Process

Law 6955 established that only 40% of FERTICA could be sold, and the GOCR (through CODESA) would retain the rest. On November 21, 1986 the Controller General completed its valuation of the company establishing a price of c 4,363,750,138 for 100% of the company or c 1,309,107,586 for 40%. The company was offered publicly by the National Commission, but there were no bidders at the price set, and FINTRA did not participate. There was little interest in being a minority partner with the government.

During 1987 the Cabinet authorized CODESA to begin negotiating with the Norwegian group, Norsk Hydro, concerning the possibility of arranging a management contract and possibly a 10% participation. This would allow for a non-political restructuring of the company and would assure the small investors of a professional, non-politicized management. The negotiations with Norsk Hydro are continuing; they expect to conclude by the end of June 1988.

The plan currently being studied by the GOCR, CODESA and FINTRA with regard to FERTICA would:

(a) Conclude a management contract with Norsk Hydro.

(b) Create a trust with FINTRA and transfer 100% of the shares of FERTICA to the trust, which would give the management of the company greater operating latitude by removing it from public sector restrictions mandated by law (Controller, budget supervision, personnel requirements, etc).

(c) Sell the permitted 40% of the shares of FERTICA to employees, farmers, cooperatives and other users, once Norsk Hydro has demonstrated capacity to generate profits, with the aim of achieving as broad a shareholder participation as possible.

(d) Once the first portion is sold, submit a bill to the legislative assembly for authorization to sell an additional 20 or 30% of FERTICA shares, thereby reducing the government to a minority shareholding. The remaining GOCR shares would then be transferred to universities or government research centers.

This process is expected to be carried out over the next two or three years.

Concluding Comments

FERTICA is probably the largest and most complex of CODESA's subsidiaries to be privatized. It has legal limitations which tend to be a hindrance to its sale and to adding a large number of minority shareholders. FERTICA has also structural, production cost and marketing problems which have to be solved in order to make it profitable and attractive to investors.

The GOCR and CODESA fully recognize the problems and risk attached to the sale of an unprofitable enterprise to a large number of shareholders.

The scheme in process to privatize FERTICA is imaginative and demonstrates a political commitment by the GOCR to achieve that objective.

ALGODONES DE COSTA RICA S.A. (ALCORSA)

Background

ALCORSA owns a cotton gin located in Guardia, Liberia province. It began operations in February, 1978, with the objective of providing ginning facilities to serve growers on about 15,000 hectares of cotton slated for production at that time. This was part of a project to make Costa Rica a significant cotton producer, which has not been succesful.

The company has two gins, one of which is installed and operating, and the second, of a similar capacity, has never been installed. Each plant has a capacity to produce 32,670 bales per annual 110 day harvest season.

Production has been far below capacity as can be seen in the following table:

YEAR	BALES
1981	3,321
1982	2,476
1983	2,705
1984	5,937
1985	5,800

Presently the demand of the Costa Rican market is estimated at 15,000 bales per year.

ALCORSA has also been involved in the production of cotton, and the management of agricultural lands. It ceased agricultural operations in 1987. Presently, the company is not operating and CODESA has liquidated all the personnel, except the manager, the accountant and a secretary.

The Financial Situation of Alcorsa

The company has never made a profit in all its years of operation. At December 31, 1987 ALCORSA had accumulated losses of c 319,145,575 - compared with a capital of c 32,548,948.

In its present structure, ALCORSA cannot operate profitably unless it is relieved of its debt burden, it sells the unused gin, and increases its production levels. High operating costs were also a major problem for ALCORSA. At one point it had 170 workers, 50% of which were redundant.

The Privatization Process

The Controller General valued ALCORSA at c 288,969,442 without debt, on October 18, 1985.

The company was offered in a public invitation for tenders in January 1986. Two offers were received, one from a Costa Rican group and another from a Mexican group. FINTRA did not participate in the tender. The offering was suspended.

Legal problems with minority shareholders (who have about 6% of the shares), embargoes and other actions by creditors that had to be cleaned up, delayed the sales process during 1986 and 1987. FINTRA also continued to refuse to participate as it felt that the price set by the controller was excessively high, and the company had little future possibilities. Furthermore, FINTRA did not want to incur the political risks involved in being the only cotton gin in an area serving numerous small farmers. During that period IRG and Price Waterhouse did an evaluation of ALCORSA which pointed toward liquidation.

CODESA has now decided to liquidate ALCORSA and sell the cotton gins as independent assets. It has made a public offering of the operating gin, limited to cooperatives, and expects to sell it to the local Liberia cotton growers cooperative. The second gin, also offered publicly, is expected to be sold to the Mexican group for export.

The offering of the equipment was made at market prices, as legally the Controller General valued the Corporation's shares, not the assets. Each gin is expected to be sold in the c 20 to c 25 million range. The sale of the equipment will be completed by the summer of 1988, and the company liquidated by November 1988.

SUBSIDIARIES OF CODESA TRANSFERRED TO THE CENTRAL GOVERNMENT

Under the law, a number of CODESA's subsidiaries were transferred to other GOCR agencies during 1986 because constitutionally they are considered as public services, therefore subject to government ownership. These companies were:

	NAME	BUSINESS
1.	Transportes Metropolitanos S.A.(TRANSMESA)	bus system
2.	Ferrocarriles de Costa Rica, S.A. (FECOSA)	railroads
3.	Corporacion de Zonas Francas de Exportacion, S.A.	free trade zone
4.	MINASA	mining concessions

Cabinet resolution No.15 of June 24, 1986, ordered the transfer of those companies to various government departments and the payment to the BCCR of their debts to CODESA through the issuance of bonds in the amount of c 1,250,000,000.

Present Status

TRANSMESA was transferred to the Ministry of Public Works, (MOPT), and is presently undergoing a major restructuring. Costs are being cut and staff has been reduced from 700 to 400. Almost all assets (buses) were transferred to private operators; because of defaults in payment TRANSMESA may have to repossess many of their buses. The company has not received any budget allocations during 1987 and 1988.

FECOSA assets were transferred to the Costa Rican Railway Institute (INCOFER). The old corporate shell is in process of liquidation.

This railroad is also undergoing a major restructuring, reducing costs, eliminating unprofitable passenger services and negotiating increased cargo rates with the private sector. Staff has been reduced from 3,200 to 2,400. These actions have resulted in lower expenses and less budget support from the GOCR, as can be observed in the following table.

Railway Institute of Costa Rica (INCORSA)
(in millions of colones)

	1986	1987	1988 (budget)
Revenues	c 408	c 598	c 601
Total Expenses	c 1,017	c 959	c 781
Budget Transfers GOCR	c 609	c 360	c 180

MINASA has been transferred to the Ministry of Energy and Mines, (MIEM), and does not have a major impact on public finances. Budget transfers by GOCR are estimated at 9 million colones in 1988.

CORPORACION DE ZONAS FRANCAS DE EXPORTACION, S.A. was transferred to CENPRO, the government export promotion agency. Its expenditure levels have been reduced from c 73 million in 1986 to an estimated level of c 29 million for 1988.

OTHER CODESA SUBSIDIARIES

TEMPIESQUE FERRY BOAT, S.A.: This company has operated two obsolete ferry boats on the Tempisque river, but is presently not functioning. The Controller General valued the company at an excessively high figure, and not even the employees are interested at that price, particularly if the ferry rates are fixed at unreasonably low prices by the GOCR. CODESA plans to sell the franchise and liquidate the company.

STABAPARI S.A.: A wood processing company in which CODESA holds a 23% interest. The Controller General set a price of c 32 million and the only possible buyers are the majority owners of STABAPARI who have offered c 6 million. Sale to this group is impossible because of a local political scandal.

CODESA is working on a deal with FINTRA whereby FINTRA would receive assets (a farm) worth c 6 million from STABAPARI for the shares, and donate it to a GOCR university or technical institution for c 32 million. Both the above actions are expected to be completed during 1988.

OTHER: Of the remaining subsidiaries of CODESA all the minority holdings have been sold, and most of the wholly owned subsidiaries, which are empty corporate shells, have been liquidated or will be liquidated by the end of 1988. The properties of DAISA, an agroindustrial company, will be sold during May 1988.

CODESA will retain its 40% ownership of the Bolsa de Valores S.A. (Stock Exchange) and its seat on the Stock Exchange, as required by law.

ALEXANDER C. TOMLINSON

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Born: May 13, 1922
Married
Three grown children

EXPERIENCE:

1985 to 1987 — CENTER FOR PRIVATIZATION
Washington, D.C.

Director of Center, the coordinating office for six consulting firms which have contracted with the Agency for International Development (State Department) to provide expert advisory services to developing country governments which wish to privatize or divest government owned enterprises. Act as CEO for project and also do some advisory assignments.

1982 to 1985 — NATIONAL PLANNING ASSOCIATION
Washington, D.C.

President and CEO; member of committees sponsored by NPA: British-North American Committee, Canadian-American Committee, Committee on Changing International Realities, Committee on New American Realities.

Brought into 50-year old "think tank," operating primarily through standing committees of leading citizens from industry, organized labor, banking, agriculture and the professions, to assist in financial recovery and re-establishment of leadership record in long-range national policy studies. Primary focus international trade, industrial productivity, national competitiveness.

Have continued as Trustee since retirement in January, 1985.

1976 to 1982 — THE FIRST BOSTON CORPORATION
New York, N.Y.

Chairman of Executive Committee, Director of holding company First Boston, Inc., Director of Financiere Credit Suisse First Boston, Chairman of First Boston (Canada) Limited.

Serving as head of Corporate Finance from 1976 to 1978, brought about redirection and expansion Corporate Finance Department; directed new emphasis on specialized advisory services, i.e. Mergers and Acquisitions, Project Finance, and initiated organized Business Development Program. Significantly improved profitability of Department.

As Chairman of the Executive Committee throughout, participated in the rejuvenation of First Boston, which has been dramatically successful. Average annual net income of $11.4 million for the years 1974-1975 rose to $69.6 million for the years 1981 - 1982. Spearheaded design and establishment of Managing Equity Incentive Plan, making compensation of senior people more competitive, encouraging retention of key people and stimulating focus on profitability. Made major contributions to development of affiliation with Credit Suisse First Boston. Primary activity developing business relations at senior level with U.S. corporations and developing and overseeing the firm's government and private relationships in Canada, Mexico, Argentina, Australia, Japan and Germany.

Have remained on Board of Directors of First Boston, Inc. since retirement in January, 1982.

1950 to 1976 — MORGAN STANLEY & CO.
New York, N.Y.

Primary activity Corporate Finance. Became Partner (later "Managing Director") in January, 1958, at which time was youngest person (other than member of Morgan family) to become partner in history of firm. Served (1968-1972) as member of Policy Committee. Over entire period engaged in broad range of corporate finance activities providing financing and advisory services and maintaining relationships with variety of major corporate clients.

Played major role in many landmark investment banking transactions of all types, including initiation of merger concepts, coordination of large stockholder subscription offers, testimony before courts and public bodies, rescue of corporations in financial difficulties, taking companies public, financing of the World Bank and foreign governments, etc.

Served (1972-1976) as President (and founder) of Morgan Stanley Canada Limited resident in Montreal, and built successful investment banking enterprise despite intense opposition of Canadian competitors.

Established (and have maintained since return) wide personal reputation in Canada and U.S. as financial authority on Canada, reflected in frequent speeches, television appearances, service as intermediary in a critical inter-provincial issue and participation in study groups.

EDUCATION:

1943	HAVERFORD COLLEGE - B.Sc., Economics
1948	LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE - graduate study
1950	HARVARD BUSINESS SCHOOL, MBA with distinction, Baker Scholar, Member of Century Club.

MILITARY:

1943 to 1946	UNITED STATES NAVY in World War II, served on Destroyer Escorts on anti-submarine convoy patrol. Final assignment Commanding Officer, released as Lieutenant, USNR.

DIRECTOR or TRUSTEE:

FIRST BOSTON, INC.

THE DISTILLERS COMPANY LIMITED (U.S.) (1984-1986)

UNITED STATES ADVISORY BOARD, HYDRO QUEBEC

CHURCHILL FALLS (LABRADOR) CORPORATION (1973-1976)

HAVERFORD COLLEGE

SALISBURY SCHOOL

CARNEGIE FOUNDATION FOR THE ADVANCEMENT OF TEACHING

NATIONAL PLANNING ASSOCIATION

COLD SPRING HARBOR LABORATORY (1978-1984)

INCORPORATED VILLAGE OF COVE NECK, N.Y. (1958-1982)

NATURE CONSERVANCY, LONG ISLAND CHAPTER (1970-1982)

N.Y INFIRMARY-BEEKMAN DOWNTOWN HOSPITAL (1970-1982)

OTHER:

Chairman, HARVARD BUSINESS SCHOOL FUND (1980-82)
Chairman, (former President), AMERICAN FRIENDS OF CANADA
Treasurer, YOUNGS MEMORIAL CEMETERY, Grave of Theodore Roosevelt, Oyster Bay, N.Y. (1979-1984)
Member, Loan Review Board, AGENCY FOR INTERNATIONAL DEVELOPMENT (U.S. Department of State), Bureau for Private Enterprise.

MEMBERSHIPS:

Professional:	Council on Foreign Relations The Canadian-American Committee (sponsored by National Planning Association and C.D. Howe Institute) - since 1976. The Economic Club of New York The Bond Club of New York
Social:	The Links, New York Piping Rock Club, Locust Valley, N.Y. Mount Royal Club, Montreal 1925 F Street Club, Washington The Metropolitan Club of the City of Washington D.C.

ISMAEL A. BENAVIDES F.

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Peru
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Born: May 10, 1945
Married
Four children

EXPERIENCE:

1985 to date — PRIVATE CONSULTANT

Specializing in privatization and restructuring of State Owned Enterprises, solving problems of public sector management, in the financial area. Management of Development Finance Corporations including managerial and financial restructuring of private companies. During this period, I have done consulting work for private Peruvian companies, prepared reports for the World Bank on state owned enterprises in Peru, and for U.S. AID have evaluated the possibility of financing severance pay for employees of public sector enterprises in Panama and participated in developing privatization plan for Bolivia.

1984 to 1985 — MINISTER OF FISHERIES OF PERU

Member of the Cabinet of President Fernando Belaunde, in charge of fisheries sector of Peru. Responsible for all policy matters relating to fisheries operation and development in the country, which is one of the principal sectors of Peru's economy.

The reforms introduced in the fisheries sector were:

- Privatization of the sector, involving reduction of the government's presence in the fishing industry, i.e., liquidation of one enterprise and reduction of two others, which reduced employment by 6,700 persons, closure of 30 out of 37 fishmeal plants, and sale or lease of the assets to the private sector.

- Enacting measures to promote private sector activity, including the modernization of Peru's fishing fleet and elimination of 90% of regulatory red tape.

- Enacting measurements to improve management of fishing activities, including strengthening of research by treating a private and government-funded foundation to finance marine research activities.

1982 to 1983

VICE MINISTER OF FINANCE OF PERU

This is the second highest position in the Ministry of Economics and Finance of Peru with the prime responsibility to manage the country's finances including the central government budgeting administration, the treasury, public credit including foreign and local debt, and revenue administration with tax and customs administration.

- In addition to the operating responsibilities, was responsible for controlling the design and implementation of a new budget system for the government and new treasury management procedures. Participated in the 1983 foreign debt rescheduling program of Peru; designed and implemented a new system for registration and control of foreign debt; initiated administrative reforms to improve collection of taxes and customs.

- In 1982 completed the first complete evaluation of Peru's state-owned enterprises, and in 1983 initiated a program to supervise and monitor these enterprises to improve their financial situation by adequate pricing policies and rationalizing spending and investments.

- Supervised Peru's public sector management loan, partially financed by the World Bank, which successfully introduced important policy and administrative reforms in Peru's public sector.

1980 to 1982 GENERAL MANAGER "COFIDE" (The State Development Finance Company of Peru)

Chief Executive Officer of COFIDE, which involved general operating, credit and investment responsibilities. Reforms accomplished within COFIDE included:

- The setting up of a State Holding Company (CONADE) to (1) assume all the shares of about 40 companies owned by COFIDE, whose weak situation affected COFIDE's capital, and (2) assume all or most of the state's holdings in diverse enterprises to improve management, reduce political interference and facilitate their eventual sale or foreclosure.

- Reorganization and streamlining of COFIDE's including more delegation of responsibilities, modernization of credit analysis and approval procedures, and establishing credit committees.

- Reorientation of COFIDE's resources to second floor banking or financial intermediation through the existing financial system to increase coverage and share the risks.

- Initiation of a process of analysis and evaluation of state-owned enterprises to faciliatate selling, reducing, liquidating or restructuring them.

During the 1980 to 1983 period, served as representative of the Peruvian Government on the Board of Directors of:

- Banco de la Nacion
- Inversiones COFIDE S.A.
- AEROPERU S.A.
- Minero Peru S.A.
- Banco de Materiales S.A.
- Banco Central de Reserva del Peru

1971 to 1980	Between 1971 and 1980, left Peru to work in Venezuela and Ecuador; became involved in various activities in family-held companies primarily in the financial area. I held the following positions:
1975 to 1979	UNIVEST C.A. - Quito, Ecuador General Manager and CEO of this financing company involved in consumer financing, factoring and receivables financing. VIGOR S.A. - Quito, Ecuador Vice Chairman of the largest integrated animal feed processor in Ecuador.
1971 to 1974	CIA. DE SERVICIOS ALPASA - Caracas, Venezuela Financial Manager of a group of companies involved in real estate, agriculture and metalworks.
1967 to 1970	CITY BANK N.A. Pro-Manager in charge of planning and development, reporting to the senior officer in charge of Peru, Ecuador and Bolivia.

EDUCATION

1967	M.B.A. Finance, University of California at Berkeley
1965	B.A. Agricultural Economics, University of California at Berkeley
	St. Bernard's College, University of Alabama
1960	St. John's School, Lima, Peru

LANGUAGES

Fluent in Spanish and English
Basic knowledge and understanding of French.

8K

EVALUATION OF THE DIVESTURE PROGRAM OF CORPORATION COSTARRICENSE DE DESARROLLO, S.A. ("CODESA")

COSTA RICA

1984 - 1988

REPORT BY

Alexander C. Tomlinson

and

Ismael Benavides

CENTER FOR PRIVATIZATION

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Project No. 71

May 1988

Prepared for the

BUREAU FOR PRIVATE ENTERPRISE

U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT

CENTER FOR PRIVATIZATION

The Center for Privatization was established in October 1985 as a coordinating office for a group of leading consulting firms which had been selected by the U. S. Agency for International Development (AID) to fulfill Contract No. DPE-0008-C-00-5058-00. The Contract provides for technical assistance to the AID Bureau for Private Enterprise (PRE) and to USAID missions in developing countries around the world relating to divestiture and privatization of state-owned enterprises and other government services and activities which might more appropriately be transferred to the private sector.

The Center has provided technical advisors on privatization matters in over 35 developing countries and has active work continuing in many of them.

The services of the Center are available under the Contract with AID through Louis R. Faoro at PRE (202-647-7474) or through USAID missions throughout the world

The Center's services are also available to other donor agencies, multilateral development banks and directly to governments by application to the Center.

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EVALUATION OF THE DIVESTITURE PROGRAM OF CORPORACION COSTARRICENSE DE DESARROLLO, S.A. ("CODESA")

COSTA RICA

1984 - 1988

REPORT BY

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Project No. 71 May 1988

Prepared for the
BUREAU FOR PRIVATE ENTERPRISE
U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT

Alexander C. Tomlinson

Mr. Tomlinson was Executive Director of the Center for Privatization from its founding in 1985 to his retirement December 31, 1987. During this period he supervised provision of technical advisory services to over 30 countries planning or engaging in privatization activities under a program sponsored by the U.S. Agency for International Development. He previously served as President of the National Planning Association following an active 32-year career with Morgan Stanley & Co. and with The First Boston Corporation, of which he served as Chairman of the Executive Committee. During his service as an investment banker he was involved in all aspects of corporate finance, both domestic and international, including large and small financings, mergers and acquisitions, financial advisory and planning services and foreign government and multilateral development bank financings.

Ismael Benavides

Mr. Benavides, presently a private consultant residing in Peru, has extensive experience in the managerial and financial areas both in the private sector and in government. During his tenure as Minister of Fisheries in Peru he designed and implemented a plan for the divestiture of Peru's state owned fishing industry and the promotion of private sector activities. He was also Vice Minister of Finance and General Manager of COFIDE, Peru's state development finance company, where he was involved in privatization and restructuring of state owned enterprises.

As a private consultant Mr. Benavides has participated in privatization projects in Bolivia and Panama, and has written various reports and articles on the subject.

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NOTE ON EXCHANGE RATES

Costa Rica uses a system of frequent minidevaluations sed on the estimated difference between domestic and ernational inflation. In 1987 there were 25 minidevaluons with a 17.7% increase in the exchange rate. When lar or colon equivalents are given in the text for dates the past, they are expressed in terms of the exchange e at the time unless otherwise specified. The current hange rate for the U.S. Dollar is approximately US$ 1 = c 76

EVALUATION OF THE DIVESTITURE PROGRAM
OF CODESA IN COSTA RICA
1984 - 1988

EXECUTIVE SUMMARY

Introduction:

The writers have been asked by the Center for Privatization, in accordance with a request from the Agency for International Development (AID), to make an evaluation of the CODESA divestiture program commenced in Costa Rica in 1984 and now well along toward completion. The purpose of the evaluation, as described in the Scope of Work, is "to review the steps taken by the Mission in its ongoing dialogue with the Government of Costa Rica (GOCR) over the divestiture, to appraise the effectiveness of those steps in dealing with the divestiture process as it developed, and to distill lessons learned which may be applicable for future divestiture efforts". We were asked to assess whether the original conception was prudent under the circumstances at the time and evaluate the changes along the way, appraise each of the major elements of the process and determine their respective contributions, review changes in the attitude of the Government of Costa Rica (GOCR) toward the project and, to the extent possible at this date, appraise the political, social, fiscal and economic impact of the process.

Based on extensive interviews in Costa Rica and in the United States in March, late April and early May, 1988, and on our own considerable experience with privatization in other developing countries, it is our conclusion that:

A. The USAID Mission in San Jose has pioneered in a new field with impressive success. The Costa Rica privatization program has been a unique experience, but many of the elements designed for it and the problems solved can be useful in planning privatizations elsewhere.

B. Creation of a private sector trust to function as an intermediary in divestiture activities solved problems which might otherwise have led to failure of the program.

C. The use of local currency generated in connection with AID's Economic Stabilization Fund (ESF) programs, and held on deposit with the Central Bank of Costa Rica (BCCR), to offset CODESA borrowings from the BCCR in amounts related to an adjusted cost basis valuation of assets divested was essential to the success of the program, had little (if any) cost to USAID, and facilitated the demonetization of those funds and avoidance of their potential inflationary effect.

D. The key individuals involved in the program, particularly those working on behalf of the USAID Mission, FINTRA and (since mid-1986) CODESA, have done an outstanding job of initiating, planning and carrying out an extremely difficult and challenging task in a highly professional manner.

E. A number of mistakes and miscalculations were made in the planning and carrying out of the program. These were principally (1) a failure to define the valuation method to be employed (or at least to recognize the magnitude of the potential problems which might result), (2) the adoption of an overly optimistic timetable that underestimated bureaucratic resistance, political delays and problems in the individual enterprises (although it did take into account the probable political need to complete divestiture before the end of President Monge's term), and (3) a failure to require a change in CODESA management at the outset of the program, or to require that the law enacted provide for the ultimate liquidation of CODESA at the end of the program. These errors or misjudgments (or, in most of the cases cited, acceptance of apparent political reality) are understandable in the light of the pioneering nature of the program, and in fact correspond to identical mistakes since made in privatization programs in other countries. In the CODESA case the resulting difficulties encountered were resolved as necessary without long term damage to the process.

Background:

During the first few years of the 1980's annual AID funds directed to Costa Rica were increasing rapidly, and by the middle of the decade GOCR was receiving more per capita than any other country except Israel. A major portion of the funds being granted was for balance of payments support and therefore was being used for such purposes as payments on dollar indebtedness, purchases of imports from the United States of machinery, equipment, materials, etc., and meeting other needs for foreign exchange. For each grant received, the GOCR agreed to provide an equivalent amount of local currency in a special account in the BCCR, to be programmed jointly by AID and the GOCR. This arrangement avoided any requirement under Costa Rican law that use of the funds be directed by the legislature, and more than in most other countries AID was in a position to influence their use within the country. Conventionally their use would be to fund expenditures on agreed projects, which had the

effect of putting the local currency funds into circulation and thus significantly increasing inflationary pressures and fueling import demand. Because of this, the IMF imposed a limit on monetization of annual AID grants to $60 million in 1984 ($80 million in 1985). Daniel Chaij, Mission director, had the same concern that the growing ESF counterpart funds threatened to become a major contributor to inflation and import pressures if they were dispensed on conventional projects, and found it important to search for significant allocations which would avoid this.

By 1983 it had become evident that a dominant factor endangering the Costa Rican economic situation was Corporacion Costarricense de Desarrollo, S.A. (CODESA). Founded in 1972 to fund establishment or strengthening of private sector enterprises, it had been subjected to major abuses and had developed an assortment of money losing, mismanaged investments, and was making heavy use of its unlimited access to credit at the Central Bank (BCCR), the latter in part reflecting the fact that CODESA also made loans to other borrowers. CODESA's BCCR borrowings were by then absorbing over one-third of GOCR public sector credit but it was generating only 1% of GNP and less than 0.5% of the nation's employment.

It was clear that anything to improve or restrict the operations of CODESA would be highly beneficial to the Government's budget and economic stabilization plans. There also was beginning to be a recognition in AID generally that privatization or divestiture of government-owned activities of this sort could help to resolve problems created by such entities as prime contributors to the excessive quantities of international debt incurred by developing countries.

Through policy dialogue and extensive negotiations with the Monge administration, Mr. Chaij was able to develop Government support for a program to divest CODESA of its various corporate assets, thereby reducing the drain on the Government budget. While it would have little cost for AID, the support of the latter could be expressed through the cancellation of BCCR ESF credits against cancellation of CODESA debt owed to the BCCR, in amounts which were initially related to the proceeds of the disposal of divested assets. None of the funds applied to this purpose would result in monetization; there would simply be a bookkeeping transaction within the BCCR. Initially an amount equal to the local equivalent of US$140 million was allotted for this purpose. The plan, largely embodied in Law 6955 enacted by the Legislature in 1984, included establishment (by Executive Decree) of a National Commission to oversee implementation of the law by CODESA, and a private sector trust (FINTRA) was established which would be funded at the direction of USAID from the local currency ESF special account to "purchase" holdings of CODESA for packaging and resale to the private sector.

The National Commission

A National Commission was established to enforce and give political respectability to the CODESA divestiture program, being viewed as necessary because of the lack of support for it by the then CODESA management and some politicians. Its membership was bipartisan, since it was recognized that the chances for success of the CODESA divestment program would be dependent on agreement by vocal party factions as well as both major political parties, to assure the continuing support of any successor regime. The initial expectations as to the short time required may not have made the concern for continuity seem an important consideration, but there was concern in AID that the program might not survive a change of administration and this importantly influenced the schedule adopted. In any event subsequent experience all over the developing world suggests that the time expectations were wildly optimistic, so that this protective factor seems to have been prudent.

In the fact, the National Commission proved not to be motivated to press forward with the program, nor to be able to contain widespread political misgivings and foot dragging. As the record shows, very little happened for a year or more because of such problems, and it was only after the inauguration of President Arias and the development of his personal commitment to the program that things began to move. In view of this, the National Commission must be viewed as unnecessary and probably a mistake in the initial planning. That it was not able to paper over the political differences may reflect the degree to which the adoption of the program by the legislature was less the result of political agreement than an acceptance of the clout AID's grants enjoyed.

After President Arias appointed Mr. Edgar Brenes to head CODESA the National Commission became completely redundant because of his personal commitment to the divestiture program, and the Commission's scheduled termination date of March 31, 1988 was only extended a month to assure an orderly winding up of its affairs.

The Private Sector Trust

The independent private sector trust, administered by Fiduciaria de Inversiones Transitorias, S.A. (FINTRA), both having been established with the support and backing of AID, has been an

extremely important factor in the progress made in the CODESA program. The keys to its success appear to have been the following:

1. The members of the trust and the staff, who were carefully selected with significant input by Mr. Chaij and the President of the Republic, are all private sector individuals of the highest personal integrity and prestige, and with the energy and varied skills and abilities necessary to the successful carrying out of the trust's purpose. The original trustees were Ernesto Rohrmoser, Carlos Manuel Gonzales, Omar Dengo, Emilio Garnier and Carlos Araya. Their personal standing and commitment has assured the independence of FINTRA. Because of the varied qualifications of this group, FINTRA has functioned very much as a merchant bank in improving the operations of the companies bought and working out arrangements for their sale. If these talents by the trust are not represented in a trust created for similar purposes, hiring a merchant bank would be required to carry out these tasks effectively.

2. Use of the trust serves to assure that, whether or not investments are ultimately successfully sold into private hands, they do not remain under government control in CODESA. In fact, certain assets have been sold directly without passing through FINTRA where sale was feasible, and CODESA holdings headed for liquidation likewise have not passed through FINTRA ownership. However, where improved operation of an enterprise appeared to be necessary prior to sale, transfer to FINTRA has been made.

3. The trust has served to assure that final sales to the private sector are made at arm's length and in the public interest without political interference or the likelihood that favoritism will be used in selection of purchasers or prices. The independence of FINTRA has been carefully guarded, and AID has assisted in defending its freedom of action.

4. In the CODESA divestiture program the creation of FINTRA (with close ties to USAID) was an essential ingredient to make possible the application of ESF credits in the BCCR to cancellation of CODESA debt at levels corresponding to asset valuations. FINTRA and USAID served to diffuse some of the political heat which in any privatization is likely to be generated by the private sale of government assets at prices well below their cost-related values, even though they represent realistic prices for unprofitable enterprises. In another country the mechanism might be quite different, and probably should be, but such a trust may still serve to protect politicians somewhat from accusations of selling the "national patrimony" at apparent distress prices.

5. As a generalization for any privatization program, the logic of forming such a trust is clearly that an organization such as CODESA, given the background of mismanagement, political interference, spendthrift operation and bad investments, cannot be expected to have the competence or motivation to preside over its own liquidation. The techniques required to carry out such a program are sufficiently specialized that the assignment should be given to appropriately qualified persons under conditions of independence. In the CODESA case, the creation of FINTRA provided this assurance. However, President Arias' later appointment of Mr. Edgar Brenes to head CODESA made this possibly less important in the light of his outstanding skills and personal prestige, his lack of identification with prior activities of CODESA, and his dedication to the divestiture program.

The operations of FINTRA are reviewed in detail elsewhere herein, supporting, we believe, the view that it has been a successful and very essential element of the CODESA divestiture program. We strongly recommend that the USAID Mission continue to support FINTRA. We understand the Mission may cast FINTRA loose, providing it with some residual funds for use in managing FERTICA and CEMPASA after their proposed transfer from CODESA. We would recommend, however, that consideration also be given by the Mission to using FINTRA for future Costa Rican privatization transactions supported by USAID, or leaving it with funding enabling it to work on those projects with which AID may prefer not to be identified.

Valuation Problems

Law 5955 provided for a valuation ("minimum bid price") to be set by the Controller General of Costa Rica for each holding of CODESA to be divested. It appears that insufficient thought was given at the outset to defining the valuation method intended, or what might be the effect of a valuation based on original cost of assets adjusted for inflation to provide a replacement cost basis. The Controller General in fact chose this approach and proved intractable when asked to value on a more realistic basis related to reasonable sales prices taking into account the potential or recorded earnings capability. Political considerations made the possibility of any flexibility remote. In the case of ALUNASA, the first major holding to be addressed, the Controller's valuation was the equivalent of about US$52 million - for an operation that had lost substantial sums during its short period of operation and closely resembled a competitive enterprise in Venezuela (with older equipment) built at a cost of about US$8 million. AID approved a credit to FINTRA of US$52 million (equivalent in local currency) by BCCR, with which FINTRA made the

purchase from CODESA through an offset (debit) of the same amount on the books of the BCCR against CODESA debt to BCCR. Extensive attempts to market ALUNASA at any price were made worldwide by The First Boston Corporation over a period of more than a year, and a sale was ultimately made (only three submissions that could remotely qualify as "bids" were received) at a price of about US$7 million.

In the past a major criticism of the Mission program has focused on this discrepancy, suggesting that AID funded the apparent very significant difference between FINTRA's purchase cost and the sale proceeds. A careful examination of the transaction form that had been established makes it evident that there was no real cost to AID. [In so saying we except any theoretical loss of an alternative opportunity to use the equivalent ESF credit, although the lack of other means of avoiding the monetization of such a sum - a clearly important consideration - makes this highly academic.] A separate section of this report attempts to explain the effects of this transaction form in detail. The evaluators are quite clearly of the opinion that, given the merits of the program, this criticism of the use of ESF credits was unwarranted. Although local politicians saw AID as having "facilitated" the divestiture through its intermediation, we found little evidence in the community of a feeling that they had passed on actual losses to AID. This may be explained in part by an assumption (inappropriate in the light of anti-inflation constraints) that the GOCR would have otherwise had the funds available to it for use in some other way. The feeling that "Uncle Sam had been taken" was very largely confined to Washington.

Assets of CODESA and Divestiture Progress to Date

At the time the CODESA divestiture program was launched, the Company's records were chaotic. It was ultimately determined that CODESA was the owner of 30 subsidiaries (owned 51% or more) and 12 affiliates (owned less than 50%). Seven of the subsidiaries constituted over 90% of CODESA's net operating assets; their disposition has been or will be as follows:

ALUNASA (aluminum) - purchased by FINTRA and sold to an individual (together with a Venezuelan group) as a going concern.

CATSA (sugar refinery) - transferred to FINTRA (in trust), who is working on sale to cooperatives and individual members of co-ops as required by Law 6955. It is hoped this sale can be completed before year end 1988.

CEMVASA (cement) - after study, sale was found not to be possible; being liquidated.

FERTICA (fertilizer) and CEMPASA (cement) are to be transferred to FINTRA under present plans. The law permits only 40% of them to be sold, preparation for which is being worked on currently; the sale is scheduled to be completed before year end 1988. The remainder will be held and managed by FINTRA in trust for later sale if authorized by the GOCR.

FECOSA (railroad) and TRANSMESA (buses) have been transferred to other government agencies as required by Law 6955.

Two of the remaining 23 small subsidiaries, ATUNES (tuna fishing) and ALCORSA (cotton gins), have been sold to private buyers. Three have been transferred to other government agencies, and the remainder have been or are being liquidated and dissolved.

Of the 12 minority holdings, seven have been or will be sold to private buyers, two have been transferred to other GOCR agencies, two are being liquidated and one (a 40% interest in the Stock Exchange - together with a seat on the Exchange) will be retained by CODESA.

Even liquidation has been found to require considerable time for legal steps; however, complete divestiture by CODESA is expected (with the exception of the Stock Exchange interest and its seat on the Exchange) over the coming year. As indicated above, a 60% interest in FERTICA and CEMPASA will continue to be held by FINTRA as beneficial owner, in trust for possible later sale.

Time Required to Complete Divestiture

Initial planning in 1984 contemplated total divestiture of CODESA assets in about 18 months. Subsequent experience, including difficulties described above, made it evident this was unrealistic. It must be kept in mind that this was (to our knowledge) the first AID experience with a divestiture operation of this kind and there was little precedent to go by. It has been the experience of the Evaluators in a wide variety of transactions commenced more recently, including in particular Honduras, Panama, Ecuador, Peru and Bolivia in Latin America alone, that it is impossible to forecast either the time required or the many problems and delays that will be encountered - politically, bureaucratically, market related or otherwise. Delays or obstacles were encountered in the CODESA program from all these sources. Having in mind the sum total of experience in this regard, the Center for Privatization

nevertheless customarily recommends adoption of probably unrealistic target dates as an important discipline to assure that privatization will ultimately be achieved. In reviewing the CODESA experience, we feel the Mission should be commended for helping CODESA and FINTRA to meet and deal with every delay and maintain the momentum of the program. We should note that in the 1986 PAAD a new and far more realistic time schedule was set forth as agreed with the GOCR; this also has not been achieved by the GOCR and AID has been reluctant to press unduly because of the evident progress being made. At the present time those involved confidently hope that the program will be essentially complete over the next year (assuming completion of marketing arrangements for CATSA and the initial blocks of FERTICA and CEMPASA), except for a few remaining legal matters and the transfer of state ownership of FERTICA and CEMPASA to FINTRA for later disposition. The new focus on wide sale to small shareholders makes the time schedule for CATSA and the above mentioned blocks particularly subject to delays. We believe, however, that this new interest in broadening ownership, more appropriate to CATSA, FERTICA and CEMPASA than to companies marketed earlier, is a desirable development, even if it does lead to delays during a new learning process.

It is important to note that the law does not provide for the ultimate dissolution of CODESA itself, although it has at least been deprived of access to BCCR credit for the future. While it was not found politically feasible to include dissolution in Law 6955, it is probable that dissolution of the CODESA corporate shell has little to do with the prospect of any further GOCR forays into parastatal investment and operation, despite past history.

Role of USAID Mission

As indicated above, the Mission Director was primarily responsible for the conception of the divestiture plan for CODESA and for persuading GOCR officials to put it into action. USAID also was the prime mover in the establishment of FINTRA and the private sector trust it administers. It took direct contact with President Monge and later President Arias to keep the process going. This was continued by the Mission Director and later the Private Sector Officer on a "hands on" basis. Essential to this process was the existing strong and well staffed private sector program in the Mission, and two highly skilled Private Sector Officers, at the outset Aaron Williams and since late 1985 Richard Rosenberg. Because of the varied private sector activities being carried on by the Mission, it is evident that an important decision was to retain an outside full-time consultant to stay on top of and keep the process moving. Mr. John Robinson in this role coordinated the program (until the end of March, 1988) by maintaining close contact with all the various parties and working to resolve hangups.

It must be recognized that all these elements should be regarded as contributing importantly to the success of the program.

It is clear that, aside from any cost which might be said to attach to the application of ESF credits to purchase of CODESA assets, the staffing (and consultant) expenses in USAID have been very substantial. Such expenses have been rewarded by the very substantial favorable impact of the program on the country, both economically in relation to the heavy costs being incurred earlier by CODESA and attitudinally in the increasingly favorable view toward privatization in general that has developed, reflected not only in the Government but in the press and the views of the general public*. As an important element of a private sector program it must be regarded as having justified the cost and effort invested in it.

The diagram on the next page shows the flow of authority and funds in the process of carrying out the divestiture of a CODESA subsidiary.

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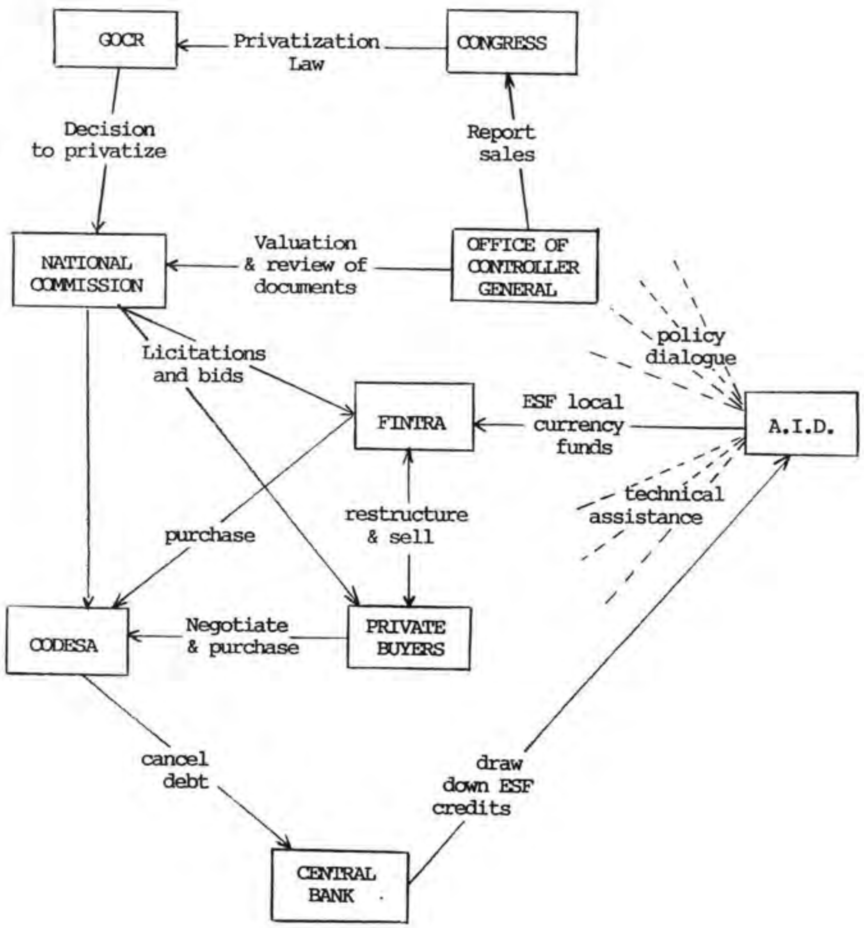
* It is understood that the new interest in privatizing other SOE's, such as the telecommunications activities of ICE, has arisen because of the attention focused on the CODESA privatization.

SCHEMATIC DIAGRAM

DIVESTITURE OF A CODESA SUBSIDIARY



Lessons Learned

An important part of this evaluation is to determine what lessons may be drawn from the USAID experience with the CODESA divestiture which might have broad application in other developing countries that may undertake privatization programs. The following, which attempt to take into account other relevant experience also, may be useful:

1. The earliest lesson learned by the Center for Privatization, and one having almost universal application as a basic rule, is that privatization is a political process having economic and financial consequences, rather than the other way around. In developing countries most privatization programs arise out of necessity, stemming from (a) the need to reduce unsupportable losses by state owned enterprises (SOE's) or (b) the inability of government to obtain capital to provide for the needs of SOE's providing important public services. Ideological preconceptions have to be overcome by such practical considerations. The Costa Rican experience is a perfect example, and the reason it became one of the first examples in which a USAID mission has taken part was the recognition by Daniel Chaij, Mission Director in 1984, of this very basic rule, which caused him to choose the approach he used.

2. An essential ingredient for the success of a privatization program anywhere is strong support from the chief executive of the country. The CODESA program has succeeded because (a) President Monge got behind it initially, although it lacked broad political consensus (even in his own party) and, more important, (b) beginning with his inauguration in mid-1986 President Arias has given it strong and continuing support. Without his clear and firm backing it would very likely have died long before now.

It is important to have legislation in place before starting a privatization process, even if not technically required. This will demonstrate a government's commitment.

3. Determination of the current book value of an investment being prepared for divestiture is generally regarded as an appropriate starting place. Unfortunately, this focus tends to lead to exactly the problem experienced in the CODESA case, i.e. that for political reasons governments are reluctant to be seen as selling part of "the national patrimony" at a price below what has been "invested" in it. In fact, enterprises that have been experiencing heavy losses are rarely, if ever, worth what has been invested in them. Excessive original acquisition cost is frequently the reason; in many countries there are examples similar to the ALUNASA case, where the cost of the assets included

a number of elements inappropriate for one reason or another but which, in aggregate, put its "valuation" at about US$52 million - whereas its value to a buyer was more like US$7-10 million.

In this regard the lesson to be learned is clearly to make sure at the outset of a privatization program that legal and other arrangements recognize as explicitly as possible that sales will be made at prices reflecting realistically obtainable market prices. It is likely to be a waste of time to require that bids first be invited at the government's total imbedded cost. Valuation procedures should be negotiated in advance with governments and preferably done by independent experts acceptable to the government.

4. The establishment of a central body or unit to carry out the privatization process, headed up by independent and highly respected persons can be a useful way to energize and enforce the carrying out of the program and defuse political criticism. It is important that both political and business leaders be represented in such a body. The National Commission was to perform this role in the CODESA case; it appears to have failed, but later FINTRA (with strong political support from President Arias but essentially a private sector entity) assumed the lead and has been highly successful.

FINTRA, the private sector trust, proved to be a useful vehicle to carry out the divestiture process with USAID support, not only as an instrument to buy and resell companies, but as a "halfway house" where SOE's could be restructured and refurbished (by qualified private sector people) before being offered for final sale. It is important to note that in the Costa Rica example, it was FINTRA (with private sector talents) that was successful and not the National Commission (which provided political protection but was otherwise bogged down in bureaucratic procedures).

5. In planning the divestiture of the holdings of a government owned development institution which has been subjected to all forms of mismanagement, waste, excess employment, corruption and political exploitation, specific legal provision for the ultimate liquidation of the institution itself is highly desirable. In the CODESA case, where there was not real consensus when the legislature enacted Law 6955, we understand it was not found politically feasible to include this. Hence the divestiture effort and expense entails the risk that some future government may wish to revert to practices which got it into trouble. While present plans for a limited future for the CODESA corporate shell are commendable, the only protection against this risk is that CODESA has been deprived of its earlier open access to BCCR credit

- and that also could be restored by future legislative action. Ultimately, the only real protection is public awareness of past disasters, and the CODESA divestiture program has drawn wide (and favorable) public attention.

6. USAID had a high profile in the political and public arena at the time the CODESA program was launched, and in the first years of the process. In the Costa Rica case this was important to progress; it may be equally important to continued success that USAID is now not seen as the prime mover the way it once was. The principals in the Government and in CODESA and FINTRA are now seen as essentially committed and proceeding relatively independently. It is important in any country to give careful consideration to the degree to which the United government and USAID should be in the position where they could be seen as controlling or pressing a privatization program; often success is more likely if its influence and financial support are almost invisible. Recent events in Central America certainly suggest caution in this regard.

7. Whether or not a high profile is found desirable, it is generally important that a member of the USAID staff, or a Consultant, be charged with the full time oversight of a privatization project in which the mission is involved. It is generally agreed that Mr. John Robinson, assigned such a role from 1986 to early 1988, carried out a very important function in the CODESA program.

8. The CODESA experience is a clear demonstration that a divestiture program - for a development institution or a single enterprise - takes more time than might be supposed by anyone who had not been through the process. To a very important degree, the various necessary steps have to be carried out in sequence, and delays are almost inevitable at any stage. The major steps that may be identified and planned for will usually include at least those listed below:

- Prioritization of divestiture candidates
- Legal steps to prepare enterprise for private sector ownership
- Fact finding and description of the enterprise to be divested
- Valuation of fixed assets (if needed) and determination of minimum acceptable selling price for the enterprise as a going concern (or, as a later alternative, obtain a "fairness opinion" by an outside expert when sale has been negotiated
- Development of marketing program (broad public sale or single or few buyers)
- Determination of realistic offering price
- Negotiation or public sale
- Consummation of transfer or liquidation

For a program involving all the subsidiaries of an investment company such as CODESA, it would be desirable to have these steps being taken for a number of companies simultaneously, keeping in mind the priorities established. We were told that in CODESA this was not feasible with the limited number of people available.

9. Early experience with CODESA demonstrates that on adoption of a divestiture or privatization program the existing management of an enterprise or investing institution should not be left in charge of implementing such a program. Not only is it a full time job requiring specialized skills, but most executives in SOE's do not have the time - nor the talents or motivation - to carry out such a process. In the case of CODESA this was fortunately (although belatedly) recognized and President Arias after his inauguration appointed a new and highly qualified CODESA head (Mr. Edgar Brenes) specifically charged with the divestiture program.

10. It is recognized that the attitude toward ESF local currency credits has changed, and that there are few countries where they bulk so large in relation to the economy as Costa Rica. However, the way they were used in Costa Rica was instrumental in making privatization possible; another time under similar circumstances they should perhaps be used for "block grants" to encourage progress, rather than as direct purchases (which gave rise to the "buy high, sell low" perception).

* * *

The foregoing summarizes the more detailed information contained in the full evaluation report (of which this Executive Summary is a part) on the CODESA divestiture program prepared by Alexander C. Tomlinson and Ismael Benavides for the Center for Privatization, Washington, D.C. at the request of the U. S. Agency for International Development (AID).

SEQUENCE OF EVENTS IN THE CODESA DIVESTITURE PROGRAM

AID begins conversations with GOCR on Privatization	Summer 1983
Costa Rican Congress approved Law 6955	24 Feb 1984
Arthur D. Little and Coopers & Lybrand contracted to do paper on CODESA in January 1984 - submitted	June 1984
ESR III requires CODESA to develop a divestiture strategy	Aug 1984
Request for assistance by GOCR sent to U.S Ambassador	5 Oct 1984
AID PAAD prepared end 1984, for US$140 million ESF support, and presented	Feb 1985
Memorandum of Understanding (MOU) between GOCR and AID re funding for National Commission	18 Jan 1985
Decree 16007-P-MEC regulating the application of Law 6955	1 Feb 1985
Decree 16520-P-MEC creating National Commission	1 Mar 1985
AID PAAD approved	19 Mar 1985
MOU between AID/GOCR/CODESA/BCCR/ re donation of US $140 mm in local currency	13 May 1985
RFP for technical assistance to FINTRA issued	25 Jun 1985
FINTRA legally established	21 Aug 1985
Selection of Technical Assistance group	2 Sep 1985
MOU between AID and FINTRA (Fiduciary arrangement)	6 Sep 1985
Technical Assistance Contract with IRG signed	4 Oct 1985

Regulation for operation of National Commission issued	Oct 1985
ALUNASA offered by public bid ("licitation")	Nov 1985
ALUNASA purchased by FINTRA	23 Dec 1985
First Boston retained to handle sale of ALUNASA	4 Apr 1986
MOU originally signed between AID and FINTRA on 6/Sep/85 completely amended	7 Apr 1986
President Arias takes office as successor to Monge	8 May 1986
Edgar Brenes appointed President of CODESA	Jun 1986
First actions by new administration on CODESA divestiture (Cabinet resolution No. 15)	24 Jun 1986
Initial licitation for ATUNES	Aug 1986
Initial licitation for CATSA	20 Nov 1986
ATUNES purchased by FINTRA	13 Feb 1987
ATUNES sold by FINTRA	30 Apr 1987
Transfer of CATSA to FINTRA in trust	10 Sep 1987
ALUNASA sold by FINTRA to Gurdian Group	23 Oct 1987

Note: See also schedule of issuance of valuations by the Controller General under "The Valuation Issue and the Controller General of Costa Rica", page 31.

CODESA AND THE DIVESTITURE PROCESS

Numerous documents and reports have been prepared on the history of CODESA and its impact on monetary and credit policies as well as on the general economic situation in Costa Rica. Of particular importance is a report by Arthur D. Little Inc. commissioned by AID-Costa Rica in 1984, which for the first time gave a comprehensive perspective of the situation of CODESA. This section provides a summarized version of many of those reports and other information obtained.

A Brief History of CODESA until 1984

CODESA was a late comer among the Latin American state holding companies set up to engage in development finance. Established by Law 5122 of November 16, 1972, with the stated objective of "strengthening private Costa Rican enterprises within the regime of a national mixed economy", CODESA quickly became an instrument for the establishment of ill conceived and badly mismanaged government investment projects in productive enterprises, created within a statist development orientation. Its major growth occurred during the government of President Daniel Oduber (1974-1978). It was used for political purposes and frequently exploited for financial gain.

The period 1979 to 1984 saw new annual investments averaging 1.5 billion colones. The investment stopped in 1984, after the passage of Law 6955 and the first GOCR covenants with AID. The growth of net operating assets of CODESA is shown below. These figures exclude the effects of passive "pass through" finance activities, and should be considered in the light of experience which has shown that the investments in operating assets were for all practical purposes largely losses the day they were made; real value is typically under 20% of cost:

CODESA

Net Operating Losses
(in billions of colones)

1979	2.2	1983	8.1
1980	3.8	1984	8.0
1981	6.0	1985	7.9
1982	7.3	1986	8.2*

* The ALUNASA sale in 1986 reduced operating assets, but this was offset by bank revaluations to reflect depreciation of the colon.

Articles 28 and 29 of the law creating CODESA granted it virtually unlimited credit from the BCCR, which allowed it to absorb large amounts of resources to fund its investments. Between 1979 and 1984, CODESA's annual share of total BCCR credit increased from 10.7% to 18.2% and, of credit to the public sector, from 28.8% to 52%. At September 30, 1984 total Central Bank credit to CODESA was c 8,801,600,000, or approximately US$200 million, which represented 35.6% of total credit granted by the Central Bank to the public sector. Despite this enormous absorption of resources, also depriving the private sector of productive capacity, CODESA's subsidiaries only contributed 1.8% of GDP and 2,122 jobs, or 0.3% of the total labor force.

At the time Law 6955 was enacted providing for the CODESA divestiture, it owned a total of 30 companies outright, and had partial interests in 12 other subsidiaries and affiliates. Following are the principal holdings, of which the first seven listed account for over 90% of net operating assets (i.e. not including "pass-through" credit operations to non-subsidiary companies):

CODESA's Principal Investments

Name	Business	Origin	Year Established
ALUNASA	Aluminum Mill	CODESA Project	1978
ALCORSA	Cotton Gin	CODESA Project	1977
CATSA	Sugar Mill	CODESA Project	1975
CEMPASA	Cement	CODESA Project	1983
TRANSMESA	Buses	CODESA Project	N.A.
FECOSA	Railroad	GOCR Project	N.A.
CEMVASA	Cement	Private Bankruptcy	1978
ATUNES	Tuna Fishing	Cooperative	N.A.
FERTICA	Fertilizer	Purchase from Private Owner	1960
TEMPISQUE FERRY	Ferry Boats	CODESA Project	1975
STABAPARI	Wood	Mixed Project	1969
DAISA	Agroindustry	CODESA Project	1979

During the 1977-1983 period, all of CODESA's subsidiaries, with the exception of STABAPARI, generated losses, accumulating a total of c 2,059 million for the period, without including revaluation of assets which reduced losses. The A.D. Little report indicates, furthermore, that during the period, losses always exceeded 25% of the assets of all CODESA subsidiaries. CODESA's total losses added up to c 4,990 million at June 30, 1984.

Despite its stated objective, CODESA's actual channelling of resources to the private sector was negligible. Only 14% of its direct loan portfolio had gone to the private sector at June 30, 1984; and of its total liabilities only 4% were oriented to support private sector activities. In sum, CODESA devoted the great majority of its resources to supporting its own unprofitable ventures, while minimizing the flow of resources to more productive ventures in the private sector.

Political Environment Affecting CODESA'S Operation

Until 1984, CODESA was regarded as the model for development by an important part of the PLN party. At the same time, CODESA had also become political booty for the different governments in power since 1972.

Many of the major projects, including CATSA and CEMPASA, were done without complete feasibility studies, and reflected the fact that in the 1970's readily available foreign credit made the purchase of equipment too easy. Jobs were handed out with largesse by the different administrations and overstaffing became a common problem in all the subsidiaries. Despite all the negative signals produced by CODESA, an important number of legislators and politicians actively defended the institution.

It was within this framework and political environment that President Monge decided to act with regard to CODESA.

The Negotiation Process for the Divestiture of CODESA

The economic crisis inherited by the Monge administration, compounded with lack of international reserves and foreign credit, dictated that significant measures were required to improve its finances and obtain foreign assistance.

Policy dialogue leading to the divestiture of CODESA began to take shape during 1983 in a series of conversations held between the AID director, other senior AID officers, and high level government officials, including President Monge himself. These culminated in the drafting of legislation which was enacted in early 1984 as Articles 55 and 56 of Law 6955 "The Law of Financial Equilibrium of the Public Sector". (See Appendix B)

The acceptance of those articles required a great deal of political maneuvering as they generated great resistance and a prolonged debate among the supporters of CODESA. The original version of the law, which among other things had limited to 60% the sale of FERTICA and CEMPASA shares, was changed to reduce that to 40%; other changes were also introduced, none of which made the divestiture of CODESA any easier.

Once the law was approved, President Monge created by decree the "National Commission" which was designed to reduce political frictions and to enforce and give protective coverage to the privatization of CODESA.

Resistance to the divestiture process continued during the Monge administration, not only at the political level, but at the bureaucratic level within CODESA. It was only with the Arias administration, when the privatization program was in place and President Monge's administration had assumed the political liabilities, that the process really began to show forward movement to achieve its original objective.

CODESA Management in the Divestiture Process

The management of CODESA has played a special role in the privatization process, both in the initial process during the Monge administration, and during the Arias administration, where marked differences can be observed.

At the beginning of the privatization process in 1984, the traditional entrenched CODESA bureaucracy was able to delay privatizations by taking advantage of the rifts in the PLN party on the CODESA issue. Mr. Juan Bonilla, General Manager at the beginning of the process in 1984, and Mr. Luis Garita, Executive President in 1985, either opposed divestiture or took a non-collaborative position. The only transaction carried out in that period was the sale of ALUNASA to FINTRA in December 1985. That transaction enabled CODESA to show a profit in 1985, which was hailed as an achievement by the administration of CODESA, although it was only a product of a sale at the inflated price dictated by the Controller General's valuations.

The Arias administration took office on May 8, 1986, and in June appointed new management for CODESA. Mr. Edgar Brenes, a highly qualified young executive, was named Executive President of CODESA. Mr. Brenes understood his mission clearly, and rapidly established a good working relationship with AID and FINTRA. The Arias administration actively supported the divestiture of CODESA and some of its high level members have a close working relationship with Mr. Brenes.

The administration of CODESA under Mr. Brenes has not only moved rapidly in the sale of many enterprises, but has also liquidated a number of others, including numerous inactive companies. Mr. Brenes has also taken important measures to contract the size of CODESA. Staff has been reduced from 250 to 75, the office has been concentrated in one building and the legal department has been "privatized".

The legislation has made no provision, and none is expected to be made, for the ultimate liquidation of CODESA itself. Mr. Brenes has suggested that it be restructured to serve as an advisor to the private sector, rather than an investor, and there may be an important role for it to play providing research capability for private investment. The government has not taken any position yet on its future. CODESA will not, under present law, have access to BCCR credit, but will retain its minority (40%) ownership interest in the Bolsa Nacional de Valores S.A. (Stock Exchange) and its seat on the Exchange.

CODESA Divestiture Activity Since 1984

The initial time estimates for the divestiture of CODESA holdings (18 months) proved overly optimistic. A more realistic schedule in the 1986 PAAD has also fallen behind. The lack of relevant experience of USAID Mission personnel and other participants contributed to the early delay, as did AID Washington's refusal to allow the Mission to go forward with the original plan (FINTRA purchases at the Controller General's prices) and the necessity of negotiating a new mechanism with the Controller General. Other factors which contributed to the delays included:

- Political and bureaucratic resistance, particularly during the Monge administration.
- Ineffectiveness of the National Commission.
- Time consuming valuation procedures by the Controller General.
- Market limitations within and outside Costa Rica as to possible buyers.
- The new democratization process of President Arias that requires lengthy sales time to involve large numbers of stockholders.
- The complex legal and financial status of many of CODESA's subsidiaries.

Despite these limitations the advances made in the program are notable, particularly during the Arias administration and under Edgar Brenes in CODESA. Compared to other privatization programs, the Costa Rican effort has not been slow at all and has had considerable success. The divestiture should be completed by the end of the Arias administration in May 1990. A detailed summary status is presented in Appendix C.

Of the 5 major subsidiaries that comprise 80% of CODESA's assets, one, ALUNASA has been sold, CATSA is in the process of sale and CEMVASA is in liquidation. The permitted 40% interest in the two remaining ones, FERTICA and CEMPASA, is expected to be sold in the 1988-1989 period. By the end of 1989 CODESA is expected to have liquidated all remaining corporate shells it owned.

Currently 13 subsidiaries and affiliates are being liquidated, and the process should be completed by the end of 1988. Three major subsidiaries are in the process of sale; CATSA should be sold by sometime in the fourth quarter of 1988, according to the present schedule, and a management contract is expected to be executed for the management of FERTICA by Norsk Hydro by June 30, 1988. Once CATSA is sold, FERTICA and CEMPASA will be the focus of CODESA and FINTRA's efforts until the end of the present administration.

Examination of the sales that have been or are currently being made, i.e. ALUNASA, ATUNES, CATSA and ALCORSA, indicates that the necessary and appropriate procedures have been carried out, and with complete transparency, both by CODESA and FINTRA. No sales have been considered which would depend in any way on the provision of GOCR credit. Significantly, no major public complaints have been voiced about favoritism or unclear sales procedures by CODESA or FINTRA.

The sale of ALUNASA was carried out by an independent and prestigious company, The First Boston Corporation, through an open international search for bidders. That process assured that the ultimate sale price reflected a realistic valuation of the company.

A crucial element in the completion of this effort is the stated policy of the Arias administration to "democratize" the property of state owned enterprises by public sale to a widespread shareholder group in Costa Rica, which has been extended from CODESA to the telecommunications company and other possibilities.

ATUNES was sold by FINTRA as a result of a public invitation for bids ("licitation"), and ALCORSA's assets are being publicly sold by CODESA after two failed licitations to sell the company's shares. CATSA is proposed to be sold in a widespread public offering that aims to attract 250,000 buyers, although an attempt by the GOCR to develop a group of coop members as initial subscribers has not been successful; the sale will be handled by CODESA through the Stock Exchange.

It is difficult at this stage of the privatization process to fully assess the economic, fiscal and social impact of the divestitures, particularly while they are still in process. Nevertheless, a number of significant favorable developments are evident:

(1) CODESA has received no Central Bank credit since 1985, and has even reduced its outstandings. This has freed up resources for more productive uses in the public sector. See following table:

CENTRAL BANK CREDIT TO CODESA

	Balance at Year End			
	1984	1985	1986	1987
c million	9,069	8,310	9,106**	7,396
$ million*	191	155	156	108

* Equivalent at year end exchange rate
** Includes interest and FERTICA refinancing in 1986 of c 1,237.5 million.

(2) A substantial portion of ESF generated local currency has been demonetized, allowing for compliance with IMF standby targets and avoidance of inflationary pressures. To date this has aggregated approximately c 6,650 million - equivalent to about 6% of the money supply.

(3) Two major money losing enterprises, ALUNASA and CATSA, have been restructured and are now profitable.

(4) The enterprises retained by the GOCR are being rationalized and restructured to reduce their demand for resources from the budget.

(5) CODESA has been significantly down-sized in order to adapt it to its new role.

(6) Thousands of individuals are becoming shareholders of some of the companies being privatized, dramatically increasing the number of owners of stocks in the country.

THE MAJOR ELEMENTS OF THE CODESA PRIVATIZATION PROCESS

The privatization process of CODESA has included a number of key elements, most of which were a result of policy dialogue between AID and the GOCR, some part of the overall project design by the AID mission, and others part of the political necessity identified by the GOCR to carry out the privatization of CODESA's subsidiaries. These elements, important at one time or another, include:

- the privatization law,
- the National Commission,
- the valuation issue with the Controller General,
- the private trust fund (FINTRA),
- the FINTRA technical assistance contract,
- the use of ESF local currency funds in the privatization process,
- AID management of the privatization project.

Each of these is discussed in a separate sub-section below.

There has been some criticism of the unwieldy and complex structure of the CODESA divestiture program. Nevertheless, our review suggests that the various objectives of the program and the political and other issues, as well as the difficult tasks of restructuring and marketing CODESA's holdings all led to a need for one or another of the components of the structure.

It can be argued that the National Commission was unnecessary, and that the valuation process would have been more realistic if an independent body had carried it out. However, it appears that political realities of the moment created the necessity to involve the Controller General and highly respected politicians in the process.

THE PRIVATIZATION LAW

The final text of Law 6955, as it related to the CODESA divestiture, was not the original text sent by the executive power, but the result of a political compromise between factions of the PLN ruling party, one of which opposed any sale of assets or reduction of CODESA. The end result was a law that authorized the sales, (although some argue that legally CODESA did not need a law to sell), but also imposed a number of restrictions on the sale. The main provisions of the law were:

(1) Authorization for CODESA to sell its subsidiaries.
(2) Sales were to be made through public invitations for bids ("licitations") and with the valuation of the Controller General of Costa Rica.

(3) A number of enterprises could not be sold because they were "public utilities" under the constitution. (Transmesa, Fecosa, Zona Franca de Exportaciones S.A.)
(4) CATSA and CEMVASA could only be sold to the cooperative sector.
(5) Only 40% of FERTICA and CEMPASA could be sold.
(6) Special credit facilities were to be provided by the national banking system to buyers.

Articles 55 and 56 of Law 6955, which enabled the privatization program to begin, reflected the political conflicts within the PLN, and in effect introduced a number of restrictions to the selling process that limited the options for the GOCR and CODESA to divest their holdings. Although those limitations were more evident during the initiation of the privatization process in the Monge administration, the Arias administration has demonstrated considerable flexibility and creativity in the interpretation of the law in order to facilitate sales. This has made possible the CATSA transaction and the plans for FERTICA and CEMPASA, where the use of FINTRA as an intermediate trust may facilitate sales and remove the required 60% continued holdings from direct GORC control.

After the agreement between AID and the GOCR for the 1985 ESF grant, which included the privatization mechanism for CODESA, the GOCR issued Decree No. 16007-P-MEC, dated February 1, 1985, which provided the detailed operating system required by the Costa Rican constitution to put the law into effect. The decree contained the following principal provisions:

(1) The valuation and bidding procedures.
(2) The use of the proceeds from the sales by CODESA.
(3) The transfer of those enterprises considered public utilities to direct government ownership.

In addition to the selling restrictions, the principal impediments created in the law and Decree 16007-P-MEC are the valuation procedure, which has been interpreted with extreme rigidity by the Controller General, and the sales procedure which calls for public "licitations" above the Controller General's valuations.

THE NATIONAL COMMISSION

The National Commission for the restructuring of CODESA was created during the Monge administration by Decree 16520-P-MEC of February 25, 1985.

The Commission was created by President Monge in order to provide political protection from factional attacks on the privatization process of CODESA from within the PLN and the opposition and also to enforce the CODESA liquidation as provided by law. The main provisions of the decree regarding the Commission are:

(1) It was bipartisan, consisting of three members, all well respected and active politically: Mr. German Serrano of the opposing Unidad Nacional Party, and Claudio Volio and Ricardo Echandi of the ruling PLN party.

(2) The Commission was given ample powers to execute and supervise the sale of CODESA's assets, including:
   a) the authority to carry out the sales and issue public tenders,
   b) coordinate valuations and other actions with the Controller General,
   c) recommend actions to the Central Government.

(3) CODESA could not make any sale without the authorization of the Commission.

Operations of the Commission

The Commission began operations in March, 1985, and its first actions were to coordinate the initiation of the valuation process by the Controller General's office. The first company to be valued was ALUNASA, which was completed in August 1985. Valuation of the remaining seven major enterprises was completed by July 1987.

After a company was valued, the Commission would prepare the documentation for the "licitation" or invitation to bidders, and remit it to the Controller General for approval. Once approved, after as much as a two months wait, the Commission would, in conjunction with CODESA, publish the offers in national newspapers. Interested parties could then obtain the instructions for offers from the Commission in order to submit proposals by the specified date. Final sales transactions and legal documentation were then negotiated with CODESA.

By April, 1988, the Commission had published "licitations" for all the CODESA subsidiaries that were to be sold on a going concern basis to private buyers, as follows:

COMPANY	STATUS
ALUNASA	Sold
ALCORSA	In process of sale of assets
ATUNES	Sold
TEMPISQUE FERRY BOAT	No bidders, in liquidation
CATSA	Transferred to FINTRA in trust
FERTICA (1)	Deferred, not yet sold to FINTRA
CEMPASA (1)	Deferred, not yet sold to FINTRA

(1) The sale of FERTICA and CEMPASA will occur once the trust mechanism and conditions are worked out between the GOCR, CODESA and FINTRA. Public offerings will be made by FINTRA, and wide distribution is anticipated.

The Commission was terminated on April 30, 1988, and is to submit a detailed report of its activities to the Cabinet.

Funding of the Commission

The operations of the Commission have been financed with funds from the local currency generated by ESF loans, deposited in the AID special account with the BCCR.

The first memorandum of understanding to finance the Commission was signed by AID and the GOCR on January 18, 1985. It was extended and amended ten times until April 30, 1988. The total amount of funds allocated to the Commission add up to the following:

ESTIMATED BUDGET (in colones)
Feb. 1985 - March 1988

Salary for members	9,435,000
Salary executive secretary	2,005,366
Secretarial and administrative services	1,226,788
Various administrative expenses	378,634
Travel expenses	319,550
Consultants fees	11,032,171
Auditors fees	2,070,000
CODESA retirement incentive program	5,000,000
Miscellaneous	1,136,524
TOTAL	32,604,033

The Commission's actual expenditures through April, 1988, when it wound up its operations, totalled about c 29,000,000.

Some Conclusions on the Activities of the Commission

The initial intent for the establishment of the Commission was to set up a buffer or umbrella to give political protection to the privatization process. It was felt at the time that the presence of three well known and respected individuals with close political connections would give the process greater legitimacy and fend off possible attacks from political factions within the PLN and from the opposition. Although this could be said to be correct since there was little overt political criticism of the process, nevertheless, the Commission's incompetence, caution and inflexibility combined with bureaucratic resistance in CODESA during the Monge Government and problems created by the valuation issue, effectively prevented any major action. In the end, the lengthy valuation procedures and bidding processes prolonged the life of the commission for more than three years. The record of the Commission does not suggest that it was an important or necessary element in the concept of the CODESA divestiture process.

After the Arias administration took office the need for the Commission was even less apparent, as the political circumstances for its creation because less relevant in light of President Arias' strong advocacy of privatization. Further, the new management in CODESA, with a firm commitment and full political support to carry out the sales of the enterprises, made the Commission completely redundant.

FINTRA, THE PRIVATE SECTOR TRUST

FIDUCIARIA DE INVERSIONES TRANSITORIAS, S.A. (FINTRA) was established in accordance with the "Memorandum of Understanding" (MOU) signed between AID and the GOCR on May 13, 1985, to provide for the management of the trust fund set up for the purchase of CODESA's subsidiaries with the local currency generated by the 1985 ESF funds, and their subsequent resale to the private sector. (A detailed description of the proposed trust fund was contained in Annex III of the PAAD for the 1985 ESF facility, submitted to AID Washington in February 1985, which was subsequently approved on March 19, 1985.)

FINTRA has been legally operating since August 1985, and has to date participated in the coordination and supervision of the technical assistance contracts for the evaluation of nine of CODESA's major subsidiaries; it has also served as an important policy instrument for the Costa Rican divestiture program and a vehicle to facilitate the sale of CODESA companies. FINTRA has carried out the successful privatization of ALUNASA and ATUNES, is in the process of privatizing CATSA (which is scheduled to be completed by September 30, 1988,) and is expected to participate in the privatization of FERTICA and CEMPASA before the end of the Arias administration in 1990.

In addition to facilitating the sale of CODESA's enterprises, FINTRA has proved to be successful in carrying out the restructuring of companies in process of sale, avoiding political backlash to the government and AID, and enabling the management of the enterprises to act in an entrepreneurial fashion without the constraints of central government budgetary regulations and the supervision of the Controller General's office.

Establishment of the Trust

The concept of the trust mechanism was worked out between AID and the GOCR in the discussions held during 1984.

The Memorandum of Understanding (MOU) between AID and the GOCR on May 13, 1985 formally laid the ground rules for the establishment of a trust mechanism to facilitate the divestiture of CODESA's subsidiaries and enable AID to use the local currency generated by the ESF grant of US$140 million in 1985 for the purchase of the subsidiaries, thereby assuring its demonetization.

FINTRA was legally established as a corporation under Costa Rican law on August 21, 1985. Its main objective was the management of trusts and trust funds, as well as a broad range of commercial activities. The capital of the corporation was set at 10,000 colones, subscribed and paid by Ernesto Rohrmoser, Carlos Manuel Gonzales, Omar Dengo, Emilio Garnier and Carlos Araya, who were subsequently appointed Directors of FINTRA and Trustees of the Trust. All five men were highly respected successful business men with the personal prestige to assure their independence from GOCR or political dictation. The life of the company was set at five years, at which time it would be dissolved unless otherwise agreed by the shareholders.

The management of FINTRA is entrusted to the President, and in his absence, the Vice President of the Board of Directors, both of whom are also legal representatives of the company.

FINTRA permanent staff is small, consisting basically of an executive secretary, Mr. Gonzalo Vega, a project manager, Mr. Guillermo Arguedas, and a financial administrative manager Ms. Martha Arrea, later replaced by Oscar Gomez. Secretarial and support personnel is minimal.

The Operations of FINTRA

FINTRA was originally designed to participate in most, if not all, of the invitations for bids ("licitations") on CODESA subsidiaries in order to purchase the enterprises, as a buyer of last resort, at the price established by the Controller General of Costa Rica.

In practice, however, FINTRA has acquired few companies, having avoided purchasing those that had legal or political problems. In those cases FINTRA has been an instrument of policy dialogue with CODESA and the GOCR.

The operations carried out by FINTRA since August 1985, can be summarized as follows:

Purchase and sale of ALUNASA: The company was purchased on December 23, 1985, for c 2,619,384,827. FINTRA continued the operations of the company while at the same time carrying out a restructuring process, as is detailed in Appendix D. The sale of ALUNASA was entrusted to The First Boston Corporation which, after a lengthy process that included contacting 119 companies in 27 countries worldwide, managed to sell the company 21 months later to a group headed by Costa Rican entrepreneur Rodolfo Gurdian for c 390,275,000.

Purchase and sale of Atunes de Costa Rica, S.A. (ATUNES): Following long and difficult negotiations with StarKist, a creditor, the company was acquired by FINTRA on February 13, 1987 for c 101,519,394 which included c 87.7 million of debts owed to the BCCR. ATUNES was sold through a public "licitation" in April 1987, the best offer being presented by a Venezuelan group Atun C.A. for c 90,000,000.

Establishment of trust for CATSA shares: According to Law 6955 CATSA could only be purchased by the cooperative sector. A trust was established in FINTRA, with the authorization of the GOCR, which will hold the shares of CATSA until they are sold, and in the interim the company will be managed and restructured by FINTRA. The sales process is expected to be completed by September 30, 1988. During 1987, AID donated c 3,500,000,000 to the BCCR to cancel CODESA debt. Of this total c 3,427,584,197 was initially attributed to the price set by the Controller General for CATSA. The actual amount of the net "attribution" by the Controller General will depend on the purchase price received by CODESA for CATSA (expected to be about c 450 million).

Other Activities: In conjunction with AID and CODESA, FINTRA contracted for and supervised the evaluations of the following enterprises by International Resources Group Inc. or its subcontractors under a technical assistance contract (see below). The results of these studies have enabled FINTRA to assess the true situation of the companies and establish realistic values for them:

ALUNASA	FINTRA
ALCORSA	TEMPISQUE FERRY BOAT
ATUNES	CEMPASA
CATSA	CEMVASA
FERTICA	

FINTRA also valued the assets of STABAPARI and DAISA, two of CODESA's subsidiaries.

Current Activities of FINTRA: FINTRA is currently involved in the following activities:

(a) Restructuring and privatization of CATSA
(b) Design of privatization of CATSA
(c) Planning the establishment of a trust and a marketing plan for the privatization of FERTICA and CEMPASA.
(d) Maintaining a policy dialogue with CODESA and the GOCR on privatization.
(e) Negotiating purchase and disposition of CODESA's 40% share in STABAPARI.
(f) Managing a severance pay fund for discharged CODESA employees.

The Financial Operations of FINTRA

The entire amount of FINTRA's operating costs and purchases of CODESA subsidiaries were designed to be covered by the local currency generated from ESF grants. This has so far included the 1985 ESF grant of US$140 million and an additional estimated US$34 million from the 1986 ESF grant. Transfers would be made from time to time from the AID special local currency account in the BCCR to FINTRA, and the income would be increased by interest earned on any excess funds FINTRA may have, and the proceeds of sales of companies.

Total accumulated expenses for FINTRA's operations, including costs of managing enterprises it has acquired, from September 6, 1985 to March 31, 1988, add up to approximately c 118,814,255 or about US$1,600,000. After initial disbursement from AID, these costs have been funded monthly from interest on deposits and proceeds of the sale of companies.

Considering the time period involved, and the results obtained, FINTRA would seem to be a cost effective institution in the Costa Rican privatization program. Its demonstrated ability to turn losses into profits has paid off in the ability to sell at higher prices than might otherwise have been anticipated.

The use of funds from the AID special local currency account in connection with the CODESA privatization program to March 31, 1988 can be summarized as follows:

LOCAL CURRENCY RESOURCES
COMMITTED TO CODESA DIVESTITURE

RESOURCES OBLIGATED BY AID/GOCR:		
1984 ESF	c 11,401,000	
1985 ESF (US$140,000,000)	c 7,021,990,000	
1986 ESF (US$ 34,000,000)	c 2,031,800,000	
TOTAL BUDGETED		c 9,065,191,000
DISBURSEMENTS FROM ESF SPECIAL ACCOUNT:		
FINTRA:		
Operating expense advances	c 12,932,000	
Alunasa deposit (5% of purchase price)	c 139,778,000	
Alunasa purchase	c 2,795,641,000	
Alunasa working capital	c 50,000,000	
NATIONAL COMMISSION:		
Operating expenses	c 28,895,000	
BLOCK TRANSFERS TO REDUCE CODESA's BCCR DEBT		
1986 Transfer	c 119,282,000	
1987 Transfer	c 3.500,000,000	
TOTAL DISBURSEMENTS		c 6,646,528,000
NET UNDISBURSED RESOURCES		c 2,418,663,000
FINTRA BALANCE		c 903,000,000
RESOURCES AVAILABLE FOR REMAINDER OF PROCESS*		c 3,221,663,000

* The available resources will be increased by interest from CATSA, FERTICA and CEMPASA

(continued...)

ESTIMATED FUTURE DISBURSEMENTS

FINTRA OPERATING EXPENSES (2 years)	c 120,000,000
DEBT REDUCTION TRANSFERS TO COVER CONTROLLER GENERAL VALUATION	
40% of FERTICA shares	c 1,309,108,000
40% of CEMPASA shares	c 1,722,629,000**
	c 3,151,737,000

** The CEMPASA figure reflects a reduction in the Controller General's valuation to reflect an imminent transfer out of CEMPASA of limestone deposits which the company will probably never need.

The projected deficit in FINTRA's finances could be funded from interest generated in the AID special account in the BCCR, or from the proceeds of sales of the enterprises by FINTRA.

FINTRA is required to present periodic reports (quarterly) to AID, and submit yearly audited financial statements. The auditing firm of Peat, Marwick & Mitchell approved the internal accounting and control procedures which have been followed by FINTRA since its inception.

Comment

Certain criticisms have been made of FINTRA and the privatization process in general, which appear unwarranted in the light of the circumstances in Costa Rica, and particularly if compared to privatization processes elsewhere in the developing world.

Some of the major problems with which FINTRA had to deal were:

- Bureaucratic resistance on the part of CODESA staff during the Monge administration, delays in valuation and sales procedures, and the natural slowdown of an outgoing administration and startup of a new one over the six months ending in June, 1986 when Arias took office.

- The unexpectedly high prices set by the Controller General for the enterprises valued, which slowed down FINTRA's activities after the ALUNASA purchase in December 1985.

- The extreme difficulty in finding a buyer for ALUNASA, despite the considerable effort expended.

It seems clear that FINTRA has achieved already, or is in the process of achieving, its original objectives. The conception of FINTRA has been undoubtedly prudent, original and creative, and has proved to be an interesting vehicle which may be used in other privatization programs. It has served AID's interests as well as Costa Rica's. Furthermore, FINTRA has proved to be an effective and flexible body able to adapt to the changes in circumstances of the privatization process and the political environment. Over the period of its activity it has built up a technical expertise in privatization and restructuring of state enterprises, which it is hoped can be put to use in future non-CODESA privatization efforts in Costa Rica.

FINTRA has achieved in a significant measure the original objectives of its creation:

(1) It has participated in the purchase and resale of two of the three CODESA wholly owned subsidiaries already sold: ALUNASA and ATUNES (ACUACULTURA was sold before the creation of FINTRA). It will participate in the sale of three out of CODESA's four remaining subsidiaries (CATSA, FERTICA, and CEMPASA).

(2) It has proved to be an adequate vehicle to ease the transfer and restructuring of CODESA's enterprises before sale to the private sector.

(3) It has permitted the use of ESF funds by demonetizing them in a way which is positive for the GOCR economy.

(4) It has minimized AID's involvement in the privatization process, such criticism as there has been not having originated in Costa Rica, and furthermore has also shielded the GOCR from the political heat generated when necessary restructuring measures are taken.

THE FINTRA TECHNICAL ASSISTANCE CONTRACT

The privatization program of CODESA's subsidiaries, agreed to between AID and the GOCR, also involved the provision of dollar-funded technical assistance to FINTRA and CODESA for the evaluation of the enterprises from a technical/financial viewpoint and the establishment of commercial values for them.

The RFP was issued on June 28, 1985, to solicit proposals from four firms selected by AID staff. First Boston (which later joined IRG), Morgan Grenfell, Arthur D. Little Inc., and International Resources Group Inc. (IRG). On August 7, 1985, three participating consortia made offers:

a) Arthur D. Little Inc., Ulhin, Morton Badley & Welling Inc.

b) Morgan Grenfell, Coopers & Lybrand, IESC

c) International Resources Group, Price Waterhouse and First Boston (FBC)

The regional contracting officer in Panama was requested to negotiate with the above consortia in the indicated order of precedence.

The PIO/T was submitted on September 30, 1985, and approved by the Mission Director on October 19, 1985. A memorandum of understanding was signed between AID and the GOCR on September 30, 1985, for the use of PO and E funds to finance the hiring of the technical advisor.

The contract between AID and IRG was signed on November 22, 1985. The initial contract was for US$667,692 of which US$288,500 was obligated the first year, US$200,000 obligated the second year, and US$120,000 the third year. On December 31, 1987 when the IRG contract was completed, the total cost added up to US$592,692.26.

The IRG contract was concentrated on the larger and more complex CODESA subsidiaries. The participation of First Boston and Price Waterhouse was minimal. While First Boston did valuation and diagnostic work on ALUNASA under the IRG contract, the international marketing and negotiation was done on a success fee based on resale proceeds under separate contract between FINTRA and First Boston/Interfin. In the light of the extensive marketing effort mounted, their fee of 32.9 million colones was a reasonable one by prevailing investment banking standards.

For much of its work on individual enterprises, IRG relied on subcontractors that were specialized in the activities of those companies. CATSA was evaluated by F.C. Schaffer & Associates of Baton Rouge, Louisiana, the cement companies CEMPASA and CEMVASA by Mr. Kenneth D. Simmons, and FERTICA by Manderson & Associates and Price Waterhouse. Overall the subcontractors and staff hired by IRG were well qualified to fulfill FINTRA requirements.

IRG prepared detailed reports and participated in the restructuring of ALUNASA, ATUNES, ALCORSA, FERTICA, CEMPASA, CEMVASA and TEMPISQUE FERRY BOAT.

Their reports have been reviewed and have been found for the most part to be satisfactory, and the evaluators concur with Mr. John Robinson's favorable assessment of the quality of the

work involved. The problems that occurred during the execution of the Technical Assistance program were mostly due to: (1) an overly optimistic initial timetable, (2) operational delays due to IRG's apparent lack of capacity to handle AID administrative procedures, (3) problems derived from a lack of adequate coordination between FINTRA and IRG on the sequence and timeliness of reports, and (4) a confusion arising from an unclear reporting relationship to AID and FINTRA by IRG. This latter problem was solved by an amendment to the contract in December 1986, which required IRG to submit work plans for each activity it carried out, which could be approved by the AID project manager. IRG's work functioned more smoothly after that change was instituted.

Conclusion

The activities carried out by IRG specialists, and the individual company reports prepared by IRG, have proved to be a valuable tool for AID, FINTRA and CODESA, enabling them to have a realistic overview of the enterprises and their market values, and a clear idea of the measures necessary to restructure or liquidate the business. Without the information provided in the reports submitted, any action by FINTRA and CODESA would have been difficult to plan.

THE VALUATION ISSUE AND THE CONTROLLER GENERAL OF COSTA RICA

The Controller General of Costa Rica, who as in most Latin American countries reports directly to Congress, was designated to play a crucial role in the privatization process under Article 55 of Law 6955, and Decree 16007-P-MEC. He was authorized to:

a) Appraise all the companies to be privatized, and establish the minimum value for the sale.
b) Approve the tender documents and the sales notices in each case.
c) Resolve any appeals by the bidders.
d) Report all sales to the Costa Rican Congress within 30 days of execution.

The assignment of responsibility to the Controller General, for carrying out the valuation process for the enterprises which CODESA was to privatize, proved to be a crucial issue in the execution of the privatization process and how it was viewed externally.

The Valuation Method

A major problem arose when the Controller General's office decided to use "the adjusted book value of assets method" to value the companies. This method consisted in adjusting the value of all fixed assets by indexing them upwards to reflect the national rate of inflation and devaluations of the currency and applying depreciation to the new values. Liabilities maintained their book value.

A clear indication of the Controller General's line of thought on the valuation issue was a section introduced in all his official valuations entitled "Methodology", which stated the following:

> "An enterprise can be valued according to liquidation value, an earnings multiplier, the value of expected dividends, a sales to equity ratio, adjusted book value, insurance value and others"

> "Taking into account the high risk involved to quantify the value of shares, projected on information on the basis of merely speculative variables or unconfirmed data, this office decided to use the adjusted book value method, with the purpose of obtaining a just and reasonable price for the shares"

> "The method in reference is based on the premise that the equity of a company is equal to the adjusted value of the assets at a set date, less total liabilities".

The above indicates clearly a preconceived intention to use the valuation method to cover the government's original investment costs rather than determining value of the companies as going concerns. The end product was inflated values that did not reflect the market value or the earnings potential of the companies. The first valuation, that of ALUNASA, produced a value of c 2,796 million, while the market price of the company was closer to c 400 million at the time. A potential loss of such magnitude brought the privatization program to a halt while attempts were made to persuade the Controller General to adopt a more realistic approach. It was not possible to get him to alter his view.

Some of the justifications by the Controller's office for the method employed were:

(1) A political responsibility, as values had to be reported to Congress.

(2) There were no comparable companies to provide reference values, as the companies were "unique" in Costa Rica.
(3) Lack of adequate information
(4) The valuation of fixed assets were made by the tax administration which generally values assets at high prices for revenue purposes.

Valuations Carried Out by the Controller General

Between 1984 and 1987 the following valuations were completed by the Controller General. The disparity with values actually realized from sale or expected to be realized is apparent.

		Value (c millions)	
Company	Date	Contr.General	Realized
ALUNASA	Aug 1985	c 2,796	c 390
ALCORSA	Oct 1985	c 289	c 45*
ATUNES	Apr 1986	c 102	c 90
CATSA	Jun 1986	c 3,428	c 450
CEMVASA	May 1986	c 1,123	N.A.
FERTICA (40%)	Nov 1986	c 1,309	N.A.
CEMPASA (40%)	Jul 1987	c 2,090	c 532*

*estimated

As can be observed from the time span involved, the valuation process was lengthy, and was one of the major causes for the delay in the privatization process. The Controller General has argued that poor accounting records, lack of information and lengthy procedures by the tax administration valuators were the cause for the delays.

Conclusion

The lengthy valuation procedures and the inflated prices for the companies that the Controller General produced were one of the main causes for the delay of the privatization process, and for the creation of the "buy high - sell low" problem which generated internal conceptual problems in AID.

It is generally felt by those involved in the process that the Controller General viewed the valuation issue from a political standpoint, and took the "safe" route, using the adjusted book value method which in theory would reflect the original investment by the GOCR.

Could the Controller General have acted differently? Possibly, if the valuation method had been negotiated with him, in advance of any pronouncement, and technical assistance supplied. On the other hand, the availability of local currency ESF credits and the need to demonetize them made the difference less critical. Furthermore, under the circumstances, it is likely that any Latin American Controller General would have adopted the same protective approach.

ESF LOCAL CURRENCY FUNDS IN THE CODESA DIVESTITURE PROGRAM

The original divestiture project envisioned the use of the equivalent of US$140 million in ESF funds to be applied through FINTRA to the purchase of the shares of CODESA subsidiaries. The mechanism was quite simple and straight-forward: for each purchase of a CODESA company by the FINTRA trust an equivalent amount of local currency would be debited to the AID special local currency account in the BCCR and credited to CODESA's debt with the BCCR, in essence a book transaction, with no monetary consequences.

Use of the ESF Funds:

Questions have been raised (primarily in Washington, where there has been some misunderstanding of the mechanism) as to whether this was an appropriate use of ESF local currency funds.

ESF loans and grants for balance of payments support programs have been a major part of AID assistance to Costa Rica, in the following amounts (millions of dollars)

	1983	1984	1985	1986	1987
Amount	$155.7	$130.0	$160.0	$ 80.6	$120.0
As % of Exports	18.3%	13.0%	17.0%	7.4%	10.8%

AID management of local currency funds generated under ESF programs has varied from mission to mission. In the Costa Rican case it was based on direct mission control for programs agreed with the government. Project design, implementation and management have followed established AID procedures and monitoring, while the amount of direct AID involvement in execution has varied.

The amount of currency obligated by AID for its various programs in Costa Rica on September 30, 1987 added up to c 19,348,087,000, of which c 7,034,793,000 or 36.36% were

obligated for the CODESA divestiture project, the largest of all the programs. On December 31, 1987 the balance of the AID special account with the Central Bank was c 15,676,000,000 (equivalent to US$248,825,390).

The AID special account with the BCCR has been increasing due to the continuous ESF programs since 1983. The balance in the account has evolved as follows:

AID SPECIAL ACCOUNT WITH BCCR

Year End (millions of colones)			
1984	1985	1986	1987
4,478	8,880	13,803	15,676

The continual growth of the special account clearly (despite the CODESA program of cancellations) reflects the cautious handling of local currency generated by ESF grants and loans.

Economic Significance of ESF local Currency

The significance of ESF transfers to Costa Rica, and the build up of local currency in the special AID account with the BCCR has been a subject of concern to BCCR and to AID and other international agencies, in particular the IMF and the World Bank.

The unrestricted monetization of the special account colones (if disbursed for use within Costa Rica) could, because of the size of the account in relation to the economy, have devastating consequences on the monetary program of the BCCR, on inflation, on import demand and on the general economic stabilization objectives of the GOCR.

The balance of the special account at December 31, 1987 (c 15,676,00,000) is equal to about 14% of the money supply, and seven times the currency issue of the BCCR in 1987.

Accordingly, limits have been established in conjunction with the BCCR and the IMF on the amount of local currency funds generated under the ESF program that could be permitted to enter the economy under the Costa Rican AID programs. The amount has fluctuated between US$60 million and US$80 million per year. The remainder is held in the AID special account in the BCCR. The problem is then to dispose of those funds in a way that will result in demonetization. This problem had a fundamental role in the design of the CODESA privatization program.

Conclusion

The AID mission in Costa Rica creatively designed a process whereby two major objectives were to be obtained, the divestiture of CODESA and the reduction of the special account through demonetization. What in effect happens when AID uses the ESF generated colones in the special account to reduce CODESA's debt with the BCCR is that the funds are simply transferred on the BCCR books from the special account to the CODESA debt account, reducing both accounts.

While there may have been alternative uses for the funds in the special account there would have been substantial risk in using more than a very minor portion of them. An open economy the size of Costa Rica can simply not absorb those resources without creating enormous import demand and inflationary pressures. The most appropriate alternative would have been a simple write-off of the funds, or an indefinite sterilization which is politically difficult to handle. The effect, demonetization, is achieved just as well whether an amount in the AID special account is written off or applied to "pay" an inflated "price" for a CODESA company.

In sum, the process designed to use the ESF local currency funds for the privatization of CODESA has achieved the important goals of privatizing a number of enterprises, reducing a drain on the economy and solving a monetary problem in a fashion consistent with the BCCR's and the GOCR's overall objectives of economic stabilization. The funds at AID's disposal were used to solve a significant political problem - the sale of investments at well below their cost - as they were being at the same time cancelled or written off. It was this legerdemain which led to suspicions in Washington of "buying high and selling low", which had no factual basis. If this conception is "stood on its head" and it is asserted - as in many countries - that the ESF funds are really at the disposition of the recipient government, then it will immediately be seen that the GOCR itself footed the bill for the divestiture price discrepancies and acquiescing in this use of the funds instead of insisting on their being invested in some other use.

USAID MANAGEMENT OF THE CODESA DIVESTITURE PROGRAM

AID participation in the privatization of CODESA's subsidiaries has been very active, both in the policy dialogue and the execution of the program.

The concept and project were developed by Daniel Chaij, AID Mission Director in high level meetings during 1983 and 1984 with top officials and ministers of the Monge administration.

Initiation of the Project

As the result of the policy dialogue the GOCR submitted the "Law of Financial Equilibrium" to Congress, which included two articles on the privatization of CODESA's subsidiaries. The law was approved, after a prolonged debate in Congress, in February of 1984. This step was the starting point of the privatization program in Costa Rica.

The AID mission then retained the consulting firms Arthur D. Little and Coopers & Lybrand to assist in the design of a divestiture strategy for CODESA. Their report was a valuable document.

Between July 1984 and February 1985, the final details were worked out for the establishment of the privatization program, including the establishment of the trust, the sales process, the monetization issue, and the valuation issue. The PAAD submitted in February 1985 and approved the next month reflected in general terms all those details. All the concepts and the final procedures designed were a product of concerted efforts of AID officers, and advisors, and high level officials of the GOCR. The 1985 PAAD states on page 30 "Due to the sensitive nature of the activities and requirements surrounding the GOCR's proposed divestiture of CODESA enterprises, negotiations have been carried on at the highest levels, and in confidence. Thus, the details of the proposed covenants have not yet been fully reviewed at the staff level of the GOCR ". The AID mission's treatment was appropriate for a project of this sort. In view of its political sensitivities, any other handling could have created problems before the project got off the ground.

The Implementation of the Project by AID

Problems arose when the actual execution of the privatization program began. The valuations by the Controller General proceeded very slowly. CODESA management resisted the privatization process and delayed most initiatives to start the execution of the program, through lengthy procedures and political discussions.

It is difficult to attribute the principal failures and delays in the implementation of the privatization program to AID. It is true nevertheless that, through lack of experience, Chaij in his initial planning and the Mission staff when implementation got under way failed to foresee some of the practical issues that arose, particularly after an optimistic timetable had been established.

Finally the sale of ALUNASA was carried out in December 1985. At that time CODESA management was more interested in appearing to generate a profit on its books from the sale of ALUNASA, than in the divestiture itself. However, the magnitude of the difference between what FINTRA paid and what it could get for ALUNASA slowed the project, because of the concerns expressed, and at the same time the upcoming change of administration paralyzed the government.

With the initiation of the Arias administration, most of AID's problems with the privatization program disappeared. The President became committed to the process and appointed Edgar Brenes to CODESA, who easily established a close relationship with AID and FINTRA, and rapidly began executing the program originally designed. The arrival of Mr. Jack Robinson as project manager in November 1986, added to the impetus given to the process by the Arias government.

It can be concluded that had the GOCR originally appointed the right people to carry out the program and established more expeditious procedures for the sale of the enterprises, the delays would have been less and the political problems substantially defused.

Concluding Comments

From our evaluation of all the steps taken by AID from the initiation of the privatization negotiations to the execution of the process, and the procedures followed in each case, we have concluded that the Mission Directors in Costa Rica and the other AID officers involved acted properly in designing and helping carry out a complex program with multiple goals and in a difficult political environment.

The lack of experience in the privatization process itself did cause some mistakes such as an overly optimistic timetable, underestimating initial opposition within the CODESA administration and the possibility of problems in the individual enterprises. Nevertheless, the main problems and delays were caused by persons and institutions within the GOCR and CODESA, and not AID, which was resourceful in solving them.

Overall, the privatization program in Costa Rica was ingeniously conceived and planned by USAID which also played a vital role in developing and maintaining the momentum of the program; delays in carrying it out have been caused by circumstances not primarily attributable to the Mission.

APPENDICES

APPENDIX A

CODESA DIVESTITURE EVALUATION

PERSONS INTERVIEWED

USAID Costa Rica:

Robert Adler	Leonard Kornfeld
Richard Archi	John Robinson
Neil Billig	Richard Rosenberg
Kevin Kelly	Joseph Wargo
Carl Leonard	

USAID Washington:

Daniel Chaij	Aaron Williams

National Commission:

Claudio Volio, President
Ricardo Echandi, Director
German Serrano, Director
Ricardo Charpentier, Executive Secretary

FINTRA:

Ernesto Rohrmoser (Chairman)
Carlos M. Gonzalez, President
Carlos Araya, Trustee
Emilio Garnier, Trustee
Gonzalo Vega, Executive Secretary

Other:

Rodrigo Arias, Minister of the Presidency
Edgar Brenes, President CODESA
Mario Carvajal, Congressman, cooperative movement leader
Carlos Espinach, Advisor, Presidency of Costa Rica
Rodolfo Gurdian, purchaser of ALUNASA
Carlos Hernandez, Gen. Manager, Central Bank of CR
Luis Alberto Monge, former President of Costa Rica
Jorge Eladio Mora, Office of Controller General of CR
Manuel Peralta, attorney for FINTRA
Humberto Perez, Executive President, Scott Paper, etc.
Carlos Quiros, Tax Consultant, Peat Marwick & Mitchell
William Phelps, General Manager, COFISA
Otton Solis Fayes, Minister of Planning
Guillermo von Breyman, President FINTECH
Jorge Woodbridge, President, Chamber of Industries

APPENDIX B

Government of Costa Rica

Law 6955
Articles 55, 56 and 57

(English translation)

LAW 6955

1. Article 55

CODESA is authorized to sell the shares of its businesses, with prior agreement, in each case, of the Council of Government, in the form and conditions that the same establish in accordance with the following stipulations:

a) CODESA will be able to sell all of its shares of businesses created by public document, except those set forth in inserts g) and h).

b) The Controller General of the Republic will render a report about the sale of each business, to the Legislative Assembly at the latest 30 days after they are effectuated.

c) The sale of whatever shares referred to in this article will be done by public bid, except for those set forth in insert l) and the respective announcement must be approved before the sale by the Controller General within a period of 15 days.

ch) The bid will not be awarded if the offer is less than the value of the shares that the Controller General of the Republic must have established prior to the publication of the announcement, within a thirty day period.

d) Appeals of awards will be done before the Controller General of the Republic, in accordance with what is established in the Financial Administration Law of the Republic and in the Administrative Contracting Regulations. The Controller must resolve the appeal within two months.

e) In the sale of shares, all other conditions being equal, social organizations of workers will be given priority. The National Banking System will create preferential lines of credit, through a system that permits priority financing to such organizations as well as for those (bids made by) small national investors who want to acquire shares of the businesses of CODESA.

f) From the income that CODESA receives in 1984 from the sale of shares its businesses, 50%, up to a maximum of \$500,000,000, will be given as a special contribution to the Government of the Republic. These funds shall be incorporated in the budget of the Government. The other 50% will go to CODESA to pay its obligations with the Banco Central.

g) Of the stock belonging to the State in the firms FERTICA and Cementos del Pacifico S.A., only 40% can be sold.

h) None of the businesses that develop whatever of the activities specified in Article 121, paragraph 14 of Political Constitution, may be reduced by any percentage. (Note: No sales of power companies, minerals, communications, railroads, docks, airports, etc.)

l) The National Banking System may finance small national investors and social organizations of workers in the purchase of the shares of CODESA.

j) In the purchase of the shares, no employee or staff member of CODESA, nor any of their subsidiaries, may participate, unless it is a group of employees or workers of the same constituted as some kind of social organization of workers. The sale of shares referred to in this article will be subject to the prohibitions established in article 107 of the Financial Administration Law.

k) The shares belonging to CODESA in CATSA and Cementos del Valle, can be sold only to the national cooperative sector, according to a prior appraisal on the part of the Controller General of the Republic, and following the steps of a public bid.

2. Article 56

The Costa Rican Central Bank is authorized to finance CODESA at the same average rate that CODESA had to pay during 1984 for loans granted before January 1, 1984. This financing will have the following characteristics:

a) Credit given to finance interest on loans granted to CODESA with external resources will use an interest rate equal to the weighted average of the interest on the original loans, with a grace period of three years.

b) Credit given to finance interest on loans given to CODESA with domestic funds will use an interest rate equal to the weighted average on the original loans, with loans of a grace period of three years and a twenty year maturity.

The Costa Rican Central Bank will demand the guarantees required for the loans hereby authorized.

3. Article 57

All the public institutions and enterprises that buy stocks or that carry out whatever other stock exchange operations, must do it through the post CODESA has in the National Stock Market. The State Banks are an exception to this stipulation.

STATUS OF CODESA HOLDINGS

April 30, 1988

STATUS OF CODESA SUBSIDIARIES
April 30, 1988

Company	Status	Date
Acuacultura, S.A.	Sold	1984 C
Algodones de Costa Rica, S.A. (ALCORSA)	Sale of Assets & liquidation	9/88 T
Aluminios Nacionales S.A. (ALUNASA)	Sold by FINTRA to private sector	9/87 C
Atunes de Costa Rica S.A. (Atunes)	Sold by FINTRA to private sector	4/87 C
Atunes de Puerto S.A.	Being dissolved & liquidated	5/88 T
Cia. Industrial Pesca Escama S.A.	Dissolved and liquidated	1/88 C
Central Azecarera Tempisque S.A. (CATSA)	Transferred to FINTRA in trust; to be sold to co-ops & members	9/88 T
Cementos del Valle S.A. (CEMVASA)	Assets being transferred to be dissolved & liquidated	10/88 T
Cementos del Pacifico S.A. (CEMPASA)	Transfer to FINTRA in trust	6/88 T
	40% of shares to be sold	12/88 T
Consolidacion de Companias Agricolas Industriales S.A.	Dissolved and liquidated	1986 C
Consorcio de Exportacion de Productos Costarricenses S.A.	Dissolved and liquidated	2/88 C
Corporacion para la Desarrollo Agroindustrial	Assets to be sold	5/88 T
	To be dissolved & liquidated	11/88 T
Corporacion de Zonas Francas de Exprotacion	Transferred to CENPRO (GOCR)	
Distribuidora Costarricense de Cemento S.A.	Dissolved & liquidated	1984 C
Ferrocarriles de Costa Rica	Assets transferred to INCOFER	
	Dissolved and liquidated	2/88 C
Fertilizantes de Costa Rica S.A. (FERTICA)	To be transfered to FINTRA in trust	6/88 T
	40% of shares to be sold	1989 T
Guacamaya, S.A.	Being dissolved and liquidated	5/88 T
Guanacal S.A.	Being dissolved and liquidated	6/88 T
Ingenio Tempisque S.A.	Being dissolved and liquidated	5/88 T
Inmobiliarias Temporales S.A.	Being dissolved and liquidated	10/88 T
Officina de Fletamiento Maritimo, S.A. (FLEMAR)	Dissolved and liquidated	7/87 C
SEDEMAT S.A.	Dissolved and liquidated	1/88 T
Tempisque Ferry Boat, S.A.	Assets to be sold	4/88 T
	To be dissolved and liquidated	10/88 T
TRANSMESA	Transferred to MOPT (GOCR)	8/87 C
Transportes Aereos Continentales, S.A.	Being dissolved and liquidated	6/88 T
Centro Permanente de Ferias y Convenciones, S.A.	Being dissolved and liquidated	5/88 T
Industria Petrolera del Atlantico S.A.	Dissolved and liquidated	1/88 C
Asufrera de Guanacaste, S.A.	Dissolved and liquidated	1980 ?
MINASA	Transferred to the MIEM (GOCR)	
CODESA seat on Bolsa	Retained in CODESA by law	

AFFILIATES AND MINORITY SHAREHOLDINGS

Sub-Products del Cafe S.A.	Sold	
Bolsa Nacional de Valores S.A.	Retained by law in CODESA	
Servicios Aereos Nacionales, S. A. (SANSA)	Sold	
LACSA	Sold	
Naviera Multinacional del Caribe S.A. (NAVICAR)	Transferred to MOPT (GOCR)	
	To be dissolved and liquidated	
MULTIPERT	Transferred to MOPT (GOCR)	
PASCAFE	Dissolved and liquidated	
MACASA	Sold	
STABAPARI	In process of sale with FINTRA	5/88 T
Cia. de Terrenos de Oro S.A.	Sold	

SUBSIDIARIES OF DAISA

Industria Aceitera Costarricense S.A. (INACO)	Being dissolved and liquidated	5/88 T
EXPOFRESCO	Being dissolved and liquidated	5/88 T

NOTE: The process of dissolution and liquidation takes approximately six months, in order to comply with Costa Rican law. In the case of CODESA subsidiaries and additional period of restructuring accounting and legal information was required.

Under Date, "C" indicates process completed; "T" indicates target date for completion

APPENDIX D

ENTERPRISES OWNED BY CODESA:

DESCRIPTION, MANNER OF DISPOSITION AND SELECTED CASE HISTORIES

SALE OF CODESA SUBSIDIARIES

ALUMINIOS NACIONALES, S.A. (ALUNASA)

Background

Was established by CODESA in 1975, and began operations in 1981, for the production of aluminum sheet and foil to serve the Costa Rican and Central American markets. Due to the international recession in the early eighties, when aluminum prices dropped, and the ensuing crisis in the Central American common market, the company immediately began to generate losses. Poor management, coupled with government controls and political intervention, added to the company's inability to make a profit. By the end of 1984 the company had run up cumulative losses of about US$28,949,000, and had never shown an operating profit.

The Privatization Process

In December, 1985, the GOCR sold ALUNASA in a public tender to FINTRA, (in accordance with the divestiture program agreed to with USAID) for 2,619,384,827 colones, the value established by the Controller General's office. FINTRA appointed a new board of directors, replaced the general manger, and immediately began a reorganization and restructuring process aimed at reducing costs and increasing productivity.

On April 4, 1986, FINTRA signed an agreement with The First Boston Corporation (FBC) to handle the sale of ALUNASA, for which FBC would be compensated with a fixed fee and a success fee on a sliding scale.

The time period for carrying out the sale was estimated at four months, i.e. by the end of July 1986. The actions taken by FBC were:

Phase 1 Initial Contacts: 119 companies throughout the world were contacted, 61 did not answer, 34 turned down the offer and 24 requested documentation.

Phase 2, Visits to data rooms, specially set up in San Jose, New York and London, where potential buyers could obtain detailed information, including a sales brochure.

Phase 3, Visits to Alunasa's Plant

Phase 4, Presentation of letters of intent: Only two letters of intent were submitted.

Phase 5. Presentation and evaluation of offers. As no adequate offers were presented by July 21, 1986, the period for presentation of offers was extended to December 31, 1986, when four offers were received:

- Highland Supply Ltd. / T. Kader
- Aluminio del Caroni, S.A. (ALCASA)
- Craft Asia Private, Ltd.
- Kaiser Aluminum

No agreement was reached with any of the above parties and the negotiation period was again extended to June 16, 1987. Three new offers were then presented:

- Highland Supply Ltd.
- T. Kader, R. Gurdian and Hidro Aluminum
- ALCASA

In July, FBC invited all three to visit San Jose and negotiate with FINTRA. No acceptable offers were received as most required extended payment terms. FINTRA requested new offers in cash.

The best cash offer FINTRA received was presented by the Costa Rican group headed by Mr. Rodolfo Gurdian. Negotiations were finally completed and the sale closed on October 23, 1987, for a total price of colones 390,275,000. These proceeds have been left by AID on deposit with FINTRA to finance its operations. A periodic accounting is rendered.

The cost of FBC services over an 18 month period was colones 32,920,769. Several factors contributed to the extended period required to complete ALUNASA's sale, despite a major effort by FBC. Among these were the world aluminum situation, the Latin American debt crisis, the general Central American economic and political developments, and the poor earnings record of ALUNASA.

ALUNASA was purchased with no debt on its books, all debts having been assumed by CODESA. The new owners of ALUNASA have aggressive production plans for 1988. With the aid of ALCASA of Venezuela, who purchased 40% of ALUNASA and is assisting with the supply of raw aluminum, the company expects to process 7,000 tons during 1988.

An experienced production manager (a U.S. expatriate) has been hired for ALUNASA and the company has immediate investment plans of US$2.2 million in equipment which will allow product improvement and increase in volume and productivity.

FINTRA'S Management of ALUNASA

FINTRA effectively managed ALUNASA from December 1985 to October 1987, i.e. 1 year and 9 months. A considerable managerial effort was input, by FINTRA, including foreign technical assistance, which allowed an important restructuring of the company and kept it operating during the sales period. Some of the main actions taken were:

- Appointment of a new general manager
- Hiring of technical assistance through IRG contract, (Mr. Douglas Graham)
- Reorganization of the managerial structure
- Reduction of excess personnel
- Transfer of the administrative and accounting offices from San Jose to the plant.
- Increase in productivity.

The management of ALUNASA in the end produced a net positive balance of income to FINTRA, according to information supplied. This is summarized as follows:

Total expenses including provisions of working capital	c 119.8 million
Less: sales deposits and other income	(c 39.8) "
Gross deficit	(c 80.0) "
Plus: ceding of current assets to FINTRA	c 169.0 "
Net income for FINTRA	c 89.0 "

ATUNES DE COSTA RICA S.A.

ATUNES is a tuna fishing company whose main assets were two tuna fishing boats; only one of the boats was in partial operation. It is reported that the one boat in operation was primarily used by government officials for entertaining purposes. Net losses were substantial.

The Privatization Process

During August 1986, the National Commission issued an invitation for tenders for the sale of the company which was won by a Venezuelan group. StarKist Inc., a creditor of Atunes managed to block the sale, which was then assigned to the second highest bidder, FINTRA. In the interim StarKist obtained judgment against Atunes and on that basis negotiated a settlement, which included receiving one of the tuna boats in payment, a transaction which was completed in December, 1986.

FINTRA acquired Atunes on February 13, 1987, with one boat, at a cost of c 101,519,394, broken down as follows:

Net equity	c 13,769,326
Debts to Central Bank	c 87,750,068
Net asset value	c 101,519,394

On March 9, 1987, one month later, FINTRA issued a tender invitation for Atunes requesting offers by April 9, 1987. Six offers were received. A c 90 million offer was presented by Atun, C.A. from Venezuela and was the best by more than 63%. On April 30, 1987, only 2 1/2 months after purchase, FINTRA closed the sale with Atun C.A.

The net result to FINTRA on this transaction was a loss of c 11,519,394. AID's fear of a much larger loss proved unwarranted. There is no information presently available on the situation of ATUNES, as the new owners are operating the boat out of Venezuela.

CENTRAL AZUCARERA DE TEMPISQUE, S.A. (CATSA)

Background

CATSA, an integrated sugar mill which includes agricultural lands and an alcohol distillery, located in the Tempisque area, began operations in 1979.

Due to low productivity, bad management, political intervention, high operating costs, and lack of controls the company never turned a profit in its years of operation. By the end of June 1987, CATSA had accumulated book losses of c 874,213,000 (not including c 600 million of losses written off on the books) and had built up debts of c 1,150,722,000, to CODESA and the National Banking system, making it CODESA's largest problem debtor.

The Privatization Process

Law 6955 established that CATSA could only be sold to the national cooperative system, i.e. cooperatives and members of cooperatives.

The Controller General's office completed their valuation in June of 1986, and the National Commission issued the tender invitation on November 20, 1986. It was clear to everyone involved that this licitation would receive no response. It was carried out to satisfy the requirement imposed by the law and clear the way for subsequent steps. There were no bidders as the price set by the controller was too high, c 3,427,584,197, the cooperative movement had not been mobilized, and FINTRA (not being a cooperative) was legally barred from purchasing.

During that period, through the technical assistance program with IRG, FINTRA hired F.C. Schaffer & Associates, sugar specialists from Baton Rouge, Louisiana to make a technical evaluation and establish a price for CATSA. The report presented in July 1987 came up with a price range of 7-9 million dollars (c 500-650 million, or around 15% of the Controller General's valuation).

After the failed licitation, CODESA negotiated and obtained from the GOCR Cabinet (Consejo de Gobierno) an agreement which allowed FINTRA to participate in the CATSA privatization. The arrangement consisted basically of:

(a) authorization to transfer the GOCR's CATSA shares to FINTRA under a trust agreement for a fixed time period, where the beneficial owner would still be CODESA, and FINTRA would have limited rights.

(b) FINTRA would hold the shares in trust for a fixed period, and manage CATSA during that period, without the restrictions of budget regulations and the Controller General's supervision required for state owned companies.

(c) CODESA and the GOCR would carry out the marketing of CATSA shares to the cooperative sector and would instruct FINTRA as to the sale of shares.

On September 10, 1987 CODESA signed the trust agreement with FINTRA and on September 24, 1987, the transfer of CATSA's shares took place with the authorization of the Cabinet, the Controller General and the National Commission.

In this case, in order to avoid criticism and the "buy high, sell low" problem, AID made a direct donation of c 3,500,000 to the Central Bank, to be applied to reduction of the CODESA debt. A portion of the above amount would then be "privately" attributed to the transfer of CATSA shares to FINTRA, as valued by the Controller General. This operation was agreed to by the Controller General.

The trust arrangement also established that FINTRA would in turn sell the shares of CATSA to the cooperative sector by September 30, 1988. A sales price of c 450,000,000 has been set.

The agreement also establishes that the actual marketing process will be done by CODESA and the GOCR, who would promote the sale and negotiate with the cooperatives. AID and FINTRA expressly avoided participating in this process, because of the political implications in the determination of which types of cooperatives would be allowed to participate.

Status

FINTRA has taken over supervision of CATSA management and CODESA and the GOCR are actively involved in the selling process.

The GOCR has targeted the approximately 600,000 individual members of the cooperative sector. President Oscar Arias has actively promoted the sale as part of his democratization process, including personal letters to the cooperatives urging the individual cooperative members to participate. The target is to attract at least 100,000 buyers of five shares at c 1,000 each. CODESA expects the 500,000 share issue (which includes c 450 million purchase price and c 50 million for working capital) to be fully subscribed and paid by September 30, 1988.

The original target date established by CODESA for the transfer, March 31, 1988 was not met due to implementation delays, the lack of an offering memorandum and the operating complexities of having to deal with large numbers of individuals. CODESA expects the cooperatives to begin making payments by April 30, 1988, and continue making monthly payments until September 20, 1988. It is likely to fall behind this schedule.

The major problem still unanswered is the management that CATSA will need to assure its future profitability. FINTRA intends to lock adequate management in place through a three-year contract.

FINTRA'S Management of CATSA

FINTRA assumed the management of CATSA on September 24, 1987 only three months before the sugar harvest (January-April), and in that time had to implement major changes in the business. The Schaffer study was an important guidance for the restructuring.

Some of the measures taken were:

- Reduction of costs, including closure of the San Jose office.
- Reduction of personnel.
- Increase efficiency of some equipment.
- Appointment of 3 new key executives:
  Financial and administrative Manager
  Controller
  Technical advisor with ample sugar experience
- Lease of land not appropriate for sugar production.

FINTRA's costs for managing CATSA have been minimal. It loaned c 63.5 million to CATSA for working capital, which has already been repaid.

The company will generate a profit of about c 100 million in its 1987-1988 fiscal year. Although this profit may include a non-recurring element, an analysis made by Peat Marwick & Mitchell for FINTRA clearly indicates the potential for a profitable year for CATSA under new management.

CEMENTOS DEL VALLE, S.A. (CEMVASA)

Background

This cement producing company promoted by a private group was established in 1978. The operation was too small and production costs too high.

When the company went into bankruptcy it was acquired by CODESA. Minority share holders still retain about 16% of company shares.

CEMVASA stopped operating due to uneconomic results in 1982. In October 1986, IRG cement industry expert Ken Simmons submitted a detailed evaluation of CEMVASA. On the basis of the evaluation, the liquidation of the company was recommended.

The Privatization Process

Law 6955 established that CEMVASA could be sold only to the national cooperative sector. After the controller's office established a value for the company, the national Commission issued a licitation for offers to be presented by February 11, 1987. No bids were submitted and FINTRA did not participate. CODESA concluded that the company should be liquidated and the assets transferred or sold.

CODESA presented a request to the cabinet to authorize the dissolution and liquidation of CEMVASA. The cabinet authorized the action in its meeting of May 1, 1987 and confirmed the resolution on May 14, 1987. This authorization represented a departure from the spirit of Law 6955, based on a conclusion that the the Controller General's valuation requirements did not have to be met in the case of liquidation.

CODESA signed a management contract with CEMPASA for the maintenance, custody of CEMVASA's assets, and the termination of about 50 remaining staff. CODESA is acting as liquidator of CEMVASA and is presently in the process of completing the transfer of fixed assets to CEMPASA. A certain amount of other assets will be distributed to the minority shareholders to pay for their shares.

The minority shareholders will receive their 12% holdings in a combination of equipment, cement, and liquid investments through a corporation specially set up for that purpose. Another minority

shareholder, the Institute Nacional de Vivienda y Urbanismo, a GOCR entity, that holds 4% of CEMVASA stock will receive property and 25,000 bags of cement.

The process of liquidating CEMVASA has taken a year to date, and is expected to be completed by the summer of 1988.

CEMENTOS DEL PACIFICO, S.A. (CEMPASA)

Background

CEMPASA was one of the first enterprises created by CODESA. It was legally established in February 1973, but it only began operating in October 1980.

CEMPASA produces portland type cement in its plant located in the central valley of Costa Rica. It has a concession with ample limestone deposits near to its plant. Production capacity of the plant is 410,000 tons per year. Production has increased constantly in recent years, as follows (tons):

1983	1984	1985	1986	1987
110,139	179,754*	198,402	227,678	239,011

*The important production increase in 1984 is due to the closing of CEMVASA.

On February 28, 1984 CEMPASA and Industria Nacional de Cemento, S.A. (INCSA) (the private sector cement company) assumed the management of CEMVASA, and the obligation to pay 2 colones for each bag of cement sold to pay for CEMVASA's maintenance and administration. Presently CEMPASA has a market sharing agreement with INCSA granting 50% of the market to each company. In addition, INCSA assumed 14% of CEMPASA's share, for which it agreed to pay c 44.60 per bag of cement sold. Prices are also set between the companies. The Costa Rican market is presently divided 57% INCSA and 43% CEMPASA. 1987 sales of CEMPASA added up to about c 673 million, or approximately US$10 million, including the compensation received from INCSA.

CEMPASA, according to its evaluators, has a good, well designed modern mill which is capable of meeting increased demand, and could augment its capacity and improve its production process with relatively small investments. Although the management of CEMPASA is highly qualified and able to produce good results, the company is overstaffed by industry standards, with a total of 324 employees.

Financial Situation

CEMPASA is the only major profitable subsidiary of CODESA, it maintains a healthy working capital position and is able to service its debts. Profits in the past 3 years have been as follows:

(thousands of colones)

1985	1986	1987
37,431	46,972	38,013

The Privatization Process

Law 6955 established that only 40% of CEMPASA could be privatized, and CODESA would retain the remaining 60%. This provision has limited the possibilities and scope of buyers, as it is unlikely any significant investor would enter in a minority relationship with the GOCR.

The Controller General presented a valuation for CEMPASA on July 30, 1987, of c 5,224,238,000 for 100% of the company, or c 2,089,695,200 for 40%. This valuation included c 1,200,000,000 for the limestone deposits, far in excess of CEMPASA's needs. The independent valuation of CEMPASA produced a "fair market value" of US$7.2 million, or about c 532,800,000.

The 40% portion of the company has been offered by the National Commission in a licitation, without any bidders, and there has been no concrete privatization process initiated.

CODESA's management is presently thinking along the following lines:

1) Transfer 100% of CEMPASA's shares to FINTRA, in trust, in a similar arrangement to CATSA's

2) Widespread sale of the 40% to small shareholders, to include "solidarity groupmembers", users, employees, investors on the Stock Exchange.

3) Submit legislation to Congress to permit an additional 20-30% to be sold.

4) Complete the transfer by the end of 1989, within President Arias's "democratization" plan.

The final decision is expected to be taken by the end of June 1988.

FERTILIZANTES DE CENTRO AMERICA S.A. (FERTICA)

Background

FERTICA is the principal manufacturer and distributor of fertilizers in Costa Rica, accounting for about 70 to 75% of the market.

The company was established in 1961 by Standard Oil Co. of New Jersey, and began operations in 1963. In 1970 Guanos y Fertilizantes de Mexico, S.A. acquired the operation, and in 1978 Refinadora Costarricense de Petroleo, S.A. (owned by the GOCR) bought 10% of the shares. In 1980 CODESA purchased the remaining 90%.

FERTICA's product line consists mainly of ammonium nitrate which it manufactures at its Puntarenas industrial plant, and chemically mixed fertilizers with imported materials which it processes at its Puntarenas and Limon facilities. During 1987 its sales mix was as follows:

Type of Fertilizer	Tons Produced
Complex mixed fertilizers (NPK's)	85,291
Ammonium nitrate	42,742
Other mixed fertilizers	11,975
Urea	3,046
Ammonium sulfate	2,018
Other fertilizers	6,160
	151,232

The Financial Situation

FERTICA is a high cost operation and normally does not make a profit on its manufacturing and mixing operations despite tariff protection. Commencing in 1986 it has shown a profit through the reduction of interest costs when CODESA assumed its debt obligations.

The main reasons for its high costs are:

(a) Outdated and inefficient production facilities

(b) Excess capacity which has led to high fixed costs.

(c) Excess personnel and overall high production and administrative costs; FERTICA has 641 employees, of which 504 are at Puntarenas.

FERTICA is protected by a tariff (20% for ammonium nitrate and 10% for NPK's) which has resulted in higher costs to the farmers. The GOCR is presently considering the elimination of that tariff.

The evaluation of FERTICA made by IRG and Manderson Associates, assisted by Price Waterhouse, concluded that FERTICA would have to undergo a major restructuring, including the closing of the Puntarenas plant, in order to make it profitable again. The possible plant closing has become a major political issue in the Puntarenos area.

The Privatization Process

Law 6955 established that only 40% of FERTICA could be sold, and the GOCR (through CODESA) would retain the rest. On November 21, 1986 the Controller General completed its valuation of the company establishing a price of c 4,363,750,138 for 100% of the company or c 1,309,107,586 for 40%. The company was offered publicly by the National Commission, but there were no bidders at the price set, and FINTRA did not participate. There was little interest in being a minority partner with the government.

During 1987 the Cabinet authorized CODESA to begin negotiating with the Norwegian group, Norsk Hydro, concerning the possibility of arranging a management contract and possibly a 10% participation. This would allow for a non-political restructuring of the company and would assure the small investors of a professional, non-politicized management. The negotiations with Norsk Hydro are continuing; they expect to conclude by the end of June 1988.

The plan currently being studied by the GOCR, CODESA and FINTRA with regard to FERTICA would:

(a) Conclude a management contract with Norsk Hydro.

(b) Create a trust with FINTRA and transfer 100% of the shares of FERTICA to the trust, which would give the management of the company greater operating latitude by removing it from public sector restrictions mandated by law (Controller, budget supervision, personnel requirements, etc).

(c) Sell the permitted 40% of the shares of FERTICA to employees, farmers, cooperatives and other users, once Norsk Hydro has demonstrated capacity to generate profits, with the aim of achieving as broad a shareholder participation as possible.

(d) Once the first portion is sold, submit a bill to the legislative assembly for authorization to sell an additional 20 or 30% of FERTICA shares, thereby reducing the government to a minority shareholding. The remaining GOCR shares would then be transferred to universities or government research centers.

This process is expected to be carried out over the next two or three years.

Concluding Comments

FERTICA is probably the largest and most complex of CODESA's subsidiaries to be privatized. It has legal limitations which tend to be a hindrance to its sale and to adding a large number of minority shareholders. FERTICA has also structural, production cost and marketing problems which have to be solved in order to make it profitable and attractive to investors.

The GOCR and CODESA fully recognize the problems and risk attached to the sale of an unprofitable enterprise to a large number of shareholders.

The scheme in process to privatize FERTICA is imaginative and demonstrates a political commitment by the GOCR to achieve that objective.

ALGODONES DE COSTA RICA S.A. (ALCORSA)

Background

ALCORSA owns a cotton gin located in Guardia, Liberia province. It began operations in February, 1978, with the objective of providing ginning facilities to serve growers on about 15,000 hectares of cotton slated for production at that time. This was part of a project to make Costa Rica a significant cotton producer, which has not been succesful.

The company has two gins, one of which is installed and operating, and the second, of a similar capacity, has never been installed. Each plant has a capacity to produce 32,670 bales per annual 110 day harvest season.

Production has been far below capacity as can be seen in the following table:

YEAR	BALES
1981	3,321
1982	2,476
1983	2,705
1984	5,937
1985	5,800

Presently the demand of the Costa Rican market is estimated at 15,000 bales per year.

ALCORSA has also been involved in the production of cotton, and the management of agricultural lands. It ceased agricultural operations in 1987. Presently, the company is not operating and CODESA has liquidated all the personnel, except the manager, the accountant and a secretary.

The Financial Situation of Alcorsa

The company has never made a profit in all its years of operation. At December 31, 1987 ALCORSA had accumulated losses of c 319,145,575 - compared with a capital of c 32,548,948.

In its present structure, ALCORSA cannot operate profitably unless it is relieved of its debt burden, it sells the unused gin, and increases its production levels. High operating costs were also a major problem for ALCORSA. At one point it had 170 workers, 50% of which were redundant.

The Privatization Process

The Controller General valued ALCORSA at c 288,969,442 without debt, on October 18, 1985.

The company was offered in a public invitation for tenders in January 1986. Two offers were received, one from a Costa Rican group and another from a Mexican group. FINTRA did not participate in the tender. The offering was suspended.

Legal problems with minority shareholders (who have about 6% of the shares), embargoes and other actions by creditors that had to be cleaned up, delayed the sales process during 1986 and 1987. FINTRA also continued to refuse to participate as it felt that the price set by the controller was excessively high, and the company had little future possibilities. Furthermore, FINTRA did not want to incur the political risks involved in being the only cotton gin in an area serving numerous small farmers. During that period IRG and Price Waterhouse did an evaluation of ALCORSA which pointed toward liquidation.

CODESA has now decided to liquidate ALCORSA and sell the cotton gins as independent assets. It has made a public offering of the operating gin, limited to cooperatives, and expects to sell it to the local Liberia cotton growers cooperative. The second gin, also offered publicly, is expected to be sold to the Mexican group for export.

The offering of the equipment was made at market prices, as legally the Controller General valued the Corporation's shares, not the assets. Each gin is expected to be sold in the c 20 to c 25 million range. The sale of the equipment will be completed by the summer of 1988, and the company liquidated by November 1988.

SUBSIDIARIES OF CODESA TRANSFERRED TO THE CENTRAL GOVERNMENT

Under the law, a number of CODESA's subsidiaries were transferred to other GOCR agencies during 1986 because constitutionally they are considered as public services, therefore subject to government ownership. These companies were:

	NAME	BUSINESS
1.	Transportes Metropolitanos S.A.(TRANSMESA)	bus system
2.	Ferrocarriles de Costa Rica, S.A. (FECOSA)	railroads
3.	Corporacion de Zonas Francas de Exportacion, S.A.	free trade zone
4.	MINASA	mining concessions

Cabinet resolution No.15 of June 24, 1986, ordered the transfer of those companies to various government departments and the payment to the BCCR of their debts to CODESA through the issuance of bonds in the amount of c 1,250,000,000.

Present Status

TRANSMESA was transferred to the Ministry of Public Works, (MOPT), and is presently undergoing a major restructuring. Costs are being cut and staff has been reduced from 700 to 400. Almost all assets (buses) were transferred to private operators; because of defaults in payment TRANSMESA may have to repossess many of their buses. The company has not received any budget allocations during 1987 and 1988.

FECOSA assets were transferred to the Costa Rican Railway Institute (INCOFER). The old corporate shell is in process of liquidation.

This railroad is also undergoing a major restructuring, reducing costs, eliminating unprofitable passenger services and negotiating increased cargo rates with the private sector. Staff has been reduced from 3,200 to 2,400. These actions have resulted in lower expenses and less budget support from the GOCR, as can be observed in the following table.

Railway Institute of Costa Rica (INCORSA)
(in millions of colones)

	1986	1987	1988 (budget)
Revenues	c 408	c 598	c 601
Total Expenses	c 1,017	c 959	c 781
Budget Transfers GOCR	c 609	c 360	c 180

MINASA has been transferred to the Ministry of Energy and Mines, (MIEM), and does not have a major impact on public finances. Budget transfers by GOCR are estimated at 9 million colones in 1988.

CORPORACION DE ZONAS FRANCAS DE EXPORTACION, S.A. was transferred to CENPRO, the government export promotion agency. Its expenditure levels have been reduced from c 73 million in 1986 to an estimated level of c 29 million for 1988.

OTHER CODESA SUBSIDIARIES

TEMPIESQUE FERRY BOAT, S.A.: This company has operated two obsolete ferry boats on the Tempisque river, but is presently not functioning. The Controller General valued the company at an excessively high figure, and not even the employees are interested at that price, particularly if the ferry rates are fixed at unreasonably low prices by the GOCR. CODESA plans to sell the franchise and liquidate the company.

STABAPARI S.A.: A wood processing company in which CODESA holds a 23% interest. The Controller General set a price of c 32 million and the only possible buyers are the majority owners of STABAPARI who have offered c 6 million. Sale to this group is impossible because of a local political scandal.

CODESA is working on a deal with FINTRA whereby FINTRA would receive assets (a farm) worth c 6 million from STABAPARI for the shares, and donate it to a GOCR university or technical institution for c 32 million. Both the above actions are expected to be completed during 1988.

OTHER: Of the remaining subsidiaries of CODESA all the minority holdings have been sold, and most of the wholly owned subsidiaries, which are empty corporate shells, have been liquidated or will be liquidated by the end of 1988. The properties of DAISA, an agroindustrial company, will be sold during May 1988.

CODESA will retain its 40% ownership of the Bolsa de Valores S.A. (Stock Exchange) and its seat on the Stock Exchange, as required by law.

ALEXANDER C. TOMLINSON

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Born: May 13, 1922
Married
Three grown children

EXPERIENCE:

1985 to 1987 CENTER FOR PRIVATIZATION
Washington, D.C.

Director of Center, the coordinating office for six consulting firms which have contracted with the Agency for International Development (State Department) to provide expert advisory services to developing country governments which wish to privatize or divest government owned enterprises. Act as CEO for project and also do some advisory assignments.

1982 to 1985 NATIONAL PLANNING ASSOCIATION
Washington, D.C.

President and CEO; member of committees sponsored by NPA: British-North American Committee, Canadian-American Committee, Committee on Changing International Realities, Committee on New American Realities.

Brought into 50-year old "think tank," operating primarily through standing committees of leading citizens from industry, organized labor, banking, agriculture and the professions, to assist in financial recovery and re-establishment of leadership record in long-range national policy studies. Primary focus international trade, industrial productivity, national competitiveness.

Have continued as Trustee since retirement in January, 1985.

1976 to 1982 THE FIRST BOSTON CORPORATION
New York, N.Y.

Chairman of Executive Committee, Director of holding company First Boston, Inc., Director of Financiere Credit Suisse First Boston, Chairman of First Boston (Canada) Limited.

Serving as head of Corporate Finance from 1976 to 1978, brought about redirection and expansion Corporate Finance Department; directed new emphasis on specialized advisory services, i.e. Mergers and Acquisitions, Project Finance, and initiated organized Business Development Program. Significantly improved profitability of Department.

As Chairman of the Executive Committee throughout, participated in the rejuvenation of First Boston, which has been dramatically successful. Average annual net income of $11.4 million for the years 1974-1975 rose to $69.6 million for the years 1981 - 1982. Spearheaded design and establishment of Managing Equity Incentive Plan, making compensation of senior people more competitive, encouraging retention of key people and stimulating focus on profitability. Made major contributions to development of affiliation with Credit Suisse First Boston. Primary activity developing business relations at senior level with U.S. corporations and developing and overseeing the firm's government and private relationships in Canada, Mexico, Argentina, Australia, Japan and Germany.

Have remained on Board of Directors of First Boston, Inc. since retirement in January, 1982.

1950 to 1976 MORGAN STANLEY & CO.
New York, N.Y.

Primary activity Corporate Finance. Became Partner (later "Managing Director") in January, 1958, at which time was youngest person (other than member of Morgan family) to become partner in history of firm. Served (1968-1972) as member of Policy Committee. Over entire period engaged in broad range of corporate finance activities providing financing and advisory services and maintaining relationships with variety of major corporate clients.

Played major role in many landmark investment banking transactions of all types, including initiation of merger concepts, coordination of large stockholder subscription offers, testimony before courts and public bodies, rescue of corporations in financial difficulties, taking companies public, financing of the World Bank and foreign governments, etc.

Served (1972-1976) as President (and founder) of Morgan Stanley Canada Limited resident in Montreal, and built successful investment banking enterprise despite intense opposition of Canadian competitors.

Established (and have maintained since return) wide personal reputation in Canada and U.S. as financial authority on Canada, reflected in frequent speeches, television appearances, service as intermediary in a critical inter-provincial issue and participation in study groups.

EDUCATION:

1943	HAVERFORD COLLEGE - B.Sc., Economics
1948	LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE - graduate study
1950	HARVARD BUSINESS SCHOOL, MBA with distinction, Baker Scholar, Member of Century Club.

MILITARY:

1943 to 1946	UNITED STATES NAVY in World War II, served on Destroyer Escorts on anti-submarine convoy patrol. Final assignment Commanding Officer, released as Lieutenant, USNR.

DIRECTOR or TRUSTEE:

FIRST BOSTON, INC.

THE DISTILLERS COMPANY LIMITED (U.S.) (1984-1986)

UNITED STATES ADVISORY BOARD, HYDRO QUEBEC

CHURCHILL FALLS (LABRADOR) CORPORATION (1973-1976)

HAVERFORD COLLEGE

SALISBURY SCHOOL

CARNEGIE FOUNDATION FOR THE ADVANCEMENT OF TEACHING

NATIONAL PLANNING ASSOCIATION

COLD SPRING HARBOR LABORATORY (1978-1984)

INCORPORATED VILLAGE OF COVE NECK, N.Y. (1958-1982)

NATURE CONSERVANCY, LONG ISLAND CHAPTER (1970-1982)

N.Y INFIRMARY-BEEKMAN DOWNTOWN HOSPITAL (1970-1982)

OTHER:

Chairman, HARVARD BUSINESS SCHOOL FUND (1980-82)
Chairman, (former President), AMERICAN FRIENDS OF CANADA
Treasurer, YOUNGS MEMORIAL CEMETERY, Grave of Theodore Roosevelt, Oyster Bay, N.Y. (1979-1984)
Member, Loan Review Board, AGENCY FOR INTERNATIONAL DEVELOPMENT (U.S. Department of State), Bureau for Private Enterprise.

MEMBERSHIPS:

Professional:

Council on Foreign Relations
The Canadian-American Committee (sponsored by National Planning Association and C.D. Howe Institute) - since 1976.
The Economic Club of New York
The Bond Club of New York

Social:

The Links, New York
Piping Rock Club, Locust Valley, N.Y.
Mount Royal Club, Montreal
1925 F Street Club, Washington
The Metropolitan Club of the City of Washington D.C.

ISMAEL A. BENAVIDES F.

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Born: May 10, 1945
Married
Four children

EXPERIENCE:

1985 to date — PRIVATE CONSULTANT

Specializing in privatization and restructuring of State Owned Enterprises, solving problems of public sector management, in the financial area. Management of Development Finance Corporations including managerial and financial restructuring of private companies. During this period, I have done consulting work for private Peruvian companies, prepared reports for the World Bank on state owned enterprises in Peru, and for U.S. AID have evaluated the possibility of financing severance pay for employees of public sector enterprises in Panama and participated in developing privatization plan for Bolivia.

1984 to 1985 — MINISTER OF FISHERIES OF PERU

Member of the Cabinet of President Fernando Belaunde, in charge of fisheries sector of Peru. Responsible for all policy matters relating to fisheries operation and development in the country, which is one of the principal sectors of Peru's economy.

The reforms introduced in the fisheries sector were:

- Privatization of the sector, involving reduction of the government's presence in the fishing industry, i.e., liquidation of one enterprise and reduction of two others, which reduced employment by 6,700 persons, closure of 30 out of 37 fishmeal plants, and sale or lease of the assets to the private sector.

- Enacting measures to promote private sector activity, including the modernization of Peru's fishing fleet and elimination of 90% of regulatory red tape.

- Enacting measurements to improve management of fishing activities, including strengthening of research by treating a private and government-funded foundation to finance marine research activities.

1982 to 1983 — VICE MINISTER OF FINANCE OF PERU

This is the second highest position in the Ministry of Economics and Finance of Peru with the prime responsibility to manage the country's finances including the central government budgeting administration, the treasury, public credit including foreign and local debt, and revenue administration with tax and customs administration.

- In addition to the operating responsibilities, was responsible for controlling the design and implementation of a new budget system for the government and new treasury management procedures. Participated in the 1983 foreign debt rescheduling program of Peru; designed and implemented a new system for registration and control of foreign debt; initiated administrative reforms to improve collection of taxes and customs.

- In 1982 completed the first complete evaluation of Peru's state-owned enterprises, and in 1983 initiated a program to supervise and monitor these enterprises to improve their financial situation by adequate pricing policies and rationalizing spending and investments.

- Supervised Peru's public sector management loan, partially financed by the World Bank, which successfully introduced important policy and administrative reforms in Peru's public sector.

1980 to 1982 GENERAL MANAGER "COFIDE" (The State Development Finance Company of Peru)

Chief Executive Officer of COFIDE, which involved general operating, credit and investment responsibilities. Reforms accomplished within COFIDE included:

- The setting up of a State Holding Company (CONADE) to (1) assume all the shares of about 40 companies owned by COFIDE, whose weak situation affected COFIDE's capital, and (2) assume all or most of the state's holdings in diverse enterprises to improve management, reduce political interference and facilitate their eventual sale or foreclosure.

- Reorganization and streamlining of COFIDE's including more delegation of responsibilities, modernization of credit analysis and approval procedures, and establishing credit committees.

- Reorientation of COFIDE's resources to second floor banking or financial intermediation through the existing financial system to increase coverage and share the risks.

- Initiation of a process of analysis and evaluation of state-owned enterprises to faciliatate selling, reducing, liquidating or restructuring them.

During the 1980 to 1983 period, served as representative of the Peruvian Government on the Board of Directors of:

- Banco de la Nacion
- Inversiones COFIDE S.A.
- AEROPERU S.A.
- Minero Peru S.A.
- Banco de Materiales S.A.
- Banco Central de Reserva del Peru

1971 to 1980 Between 1971 and 1980, left Peru to work in Venezuela and Ecuador: became involved in various activities in family-held companies primarily in the financial area. I held the following positions:

1975 to 1979 UNIVEST C.A. - Quito, Ecuador

General Manager and CEO of this financing company involved in consumer financing, factoring and receivables financing.

VIGOR S.A. - Quito, Ecuador

Vice Chairman of the largest integrated animal feed processor in Ecuador.

1971 to 1974 CIA. DE SERVICIOS ALPASA - Caracas, Venezuela

Financial Manager of a group of companies involved in real estate, agriculture and metalworks.

1967 to 1970 CITY BANK N.A.

Pro-Manager in charge of planning and development, reporting to the senior officer in charge of Peru, Ecuador and Bolivia.

EDUCATION

1967 M.B.A. Finance, University of California at Berkeley

1965 B.A. Agricultural Economics, University of California at Berkeley

St. Bernard's College, University of Alabama

1960 St. John's School, Lima, Peru

LANGUAGES

Fluent in Spanish and English
Basic knowledge and understanding of French.

Fr: L. Cowan Gray
Prvtzn in the Devlping World, 1990.

the PNP's position was well known, its ideological appeal did not overcome the prospect of profit from buying shares. There is no doubt that politics played an indirect role in that the issue served the purposes of the PNP as a weapon to attack the government in the legislature and gave the party a certain amount of free publicity in the process.

As a national issue, opposition arguments were of little long-range value, since any arguments against participation in buying shares fell on deaf ears once the share prices abruptly rose. The opposition realized that it was doing its own cause more harm than good in threatening renationalization. In the case of the CCC, the PNP's vituperative statements were almost pro forma, and they appeared to have little effect.

The Jamaican case illustrates two fundamental prerequisites in blunting political opposition to privatization. First, preliminary consultation with interest groups, particularly labor, paid off handsomely. Moreover, formal consultation with prominent opposition political leaders before the divestiture impressed on them that the government was concerned with hearing their point of view.

The skillful use of the mass media to explain stockholding, share purchase, and the potential uses of future dividend payments created a groundswell of popular support that the opposition could not overcome with theoretical argument. Careful and thorough preparation of the public may do more in the long run to ensure the success of a privatization than any amount of strategic planning confined only to government circles.

COSTA RICA: POLITICS AND PRIVATIZING CODESA

Introduction

Privatization has been of interest to the government of Costa Rica for several years. It is strongly supported by the president and the ruling National Liberation party. It has been assisted by the A.I.D. mission since the outset.

The Costa Rican political system is based on a weak presidential office with a strong legislature that has substantial power of decision. Despite these obstacles, President Arias has been able to overcome legislative opposition to privatization actions for seven companies, which constitute 90 percent of the holding company for state enterprises, CODESA.

The A.I.D. mission played a vital role in getting the privatization process under way. A principal supporter within the government was the Central Bank, which was highly conscious of the losses being suffered by the larger state-owned enterprises. In 1983–84, these enterprises were absorbing one-third of public sector credit to cover operating losses.

Objections to privatization were centered in opposition party legislators and among the bureaucracy. The former saw privatization as a threat to patronage jobs they could offer when in power; the latter as a threat to perquisites and position. In order to dispose of the enterprises, a mechanism for transfer from

the state to private hands had to be created in the absence of any consensus within the government on the management of the program. In February 1985, a national commission was appointed by cabinet resolution to be the final arbiter of sales recommendations. As part of the management structure for the sales, a trust (FINTRA) was established, based upon local currency accumulations of the A.I.D. mission. The commission's job was to offer the enterprise for sale; if there were no bidders from the private sector, the trust would buy the enterprise from CODESA and would become the selling agent. The commission, some of whose members had personal political agendas in accepting membership on it, failed to carry out the task for which it was appointed and, after a year and a half, was virtually cut out of the sale process.

The initial problem turned on the valuation of companies to be sold. It had been agreed that the controller general would be called upon to set the prices. The method he employed (beginning with the original price, to which operating losses, adjusted for devaluation of the colon, less a small depreciation, was added) resulted in a heavily inflated selling price that bore little relation to the current market price of the firms.

To support the privatization program, the mission agreed to use up to $140 million of local currency accumulation to permit the trust to make up the difference between the controller's valuation and the ultimate selling price of the firm. Since the government wanted above all to avoid monetizing this local currency, the plan was to reduce CODESA's debt through a bookkeeping entry at the Central Bank, balancing off the debt of the companies being sold with the local currency made available. The mission had not, however, counted on this excessive level of valuation, and it became clear that the mechanism could not work as envisaged. After a number of acrimonious meetings between the mission, FINTRA, and the members of the commission, attempts were made to strengthen FINTRA and make it more independent of A.I.D.

The decision was finally made to call upon an expert consultant, paid for by the mission, to attempt to solve the impasse. Approaching the problem from the point of view of the political relationships involved, he saw it as his task to establish a low profile, supportive relationship with the key people in the government in order to influence the decision-making process on privatization by working closely with them. His eventual success in doing this was in large part responsible for later progress in getting the divestment process under way.

He was gradually able to establish the government's confidence in him as it became clear that his perspective was 75 percent that of the government and 25 percent that of the mission. Through a lengthy process of negotiation, he was ultimately able to persuade the commission and CODESA to proceed toward the same goals. The government's goals were clear: (1) to avoid monetization of the large sum of local currency, (2) to cut the debt of CODESA, and (3) to privatize. Of these, the first was clearly of greatest importance since the accumulation of the generated counterpart funds in the Central Bank had become a source of embarrassment to the government.

Internal Politics and Privatization

Arias's position on privatization was clear. He was prepared to sell shares in the firms CODESA held not only to bring about reform of their operations but also to democratize ownership through sale of stock to the public. Privatization, if successful, would achieve a presidential objective of broadening Arias's political base, at the expense of the opposition, by creating a constituency of those who benefited from share purchase.

Costa Rica is a democratic country, with an operating opposition party structure, a relatively highly educated population, and a high quality of life. President Arias had become convinced by a visit to Margaret Thatcher in May 1987 of the advantages of privatization—both political and economic. Creation of a larger political constituency by democratizing ownership through stock holdings fit closely with the president's desire to work toward a centrist position to counter his right wing opposition.

However, the Costa Rican situation has a peculiarity that will affect the democratization process. The system has for a considerable period in the past relied on the Solidarity movement as a vehicle for social change. The movement, which embraces coops covering the entire country, would provide a method of distributing shares in divested firms that would ultimately reach large numbers of coop members as potential buyers. Accordingly, the president sent a letter to between 400,000 and 500,000 coop members urging them to buy shares directly through their coops for the sale of the sugar producing firm, CATSA.

The coop movement is fractured between moderate and liberal political positions; the far left has considerable political and economic power within the governing structure since a very substantial portion of Costa Rica's three million people are members of coops, particularly in the rural areas. The president's political goal in privatizing was to set a median course between two evils: accretion of power to the extreme left through control of divested industries by purchase of shares by left wing controlled coops and accretion of wealth in the hands of a few by allowing wealthy individuals to acquire substantial holdings in divested state-owned firms.

The left, however, recommended that CATSA be run as a type of super-coop, rather than as a fully privatized firm. However, the coops have, in Costa Rica as elsewhere, the reputation of being poorly managed, underfinanced, not profit-oriented, and disorganized. The governing party has maintained that CATSA should be run as an example of how a private company should operate; the only way this can be accomplished is by making coops shareholders in a private company that has a largely autonomous management.

The political objective of privatization, then, became clear. Presidential social objectives of bringing about change and reform in the economic system would be accomplished by democratization of ownership—but not democratization in the larger sense of the term implying individual ownership of shares. Rather, what was implied was ownership through membership in the coops of the Solidarity movement. The coops would provide a more solid political base for the president than would individuals, and they would be easier to persuade or even control. There was the risk that privatization could serve to increase the power of the left-dominated coops, but the president took the position that this risk would be substantially reduced if the opposition idea of one large company run as a super-coop could be defeated.

Opposition to privatization came also from another quarter. Within a few months after the the government announced plans to privatize parts of the public services sector, open trade union opposition arose. Union heads argued that privatization was not in the interests of labor, basing their arguments largely on the assumption that transfer of services to the private sector would cause loss of jobs and of employment guarantees now enjoyed by workers. Privatizations that involved worker participation in the management of the new firms generated some enthusiasm on the part of small groups of employees. But the unions claimed that the new privatized services were being established without adequate union consultation. Six central unions formed a permanent workers' council, which requested the legislative assembly to cease privatization efforts in areas considered strategic for social and economic development, such as banking, energy, health, communications, and transportation.

President Arias, with the help of his minister of planning, fulfilled the role of the leader committed to privatization. His influence was able to diminish union opposition to privatization from late 1987 on, but the privatizing process continued to be slow in view of the political pitfalls built into it.

The Role of the Donor in Privatization

The role of A.I.D. in Costa Rica was a complicated one. In its eagerness to pursue a privatization program, the mission ran the risk of getting out in front of both the government and public opinion. Not only was time needed to reduce political barriers, but an educational process also was required to overcome the skepticism of the potential share owners, the coop leadership. It became increasingly important to demonstrate that privatization was a Costa Rican government program, which had the full support of the majority party and that it was not a goal being pushed upon the government by an external agency. Moreover, it had to be transparent that the consultant furnished by A.I.D. had to be obviously first and foremost at the service of the government, acting only as a liaison with the mission.

To dilute the prominence of its role in the privatization process, A.I.D. was interested in having the British play a part. A representative of the Adam Smith Institute in London was invited to prepare a report on future privatizations in Costa Rica. The report recommended a number of possible companies to privatize, including the telephone company. These privatizations would be done with the assistance of British investment bankers and with support from the A.I.D. mission. It is unlikely, however, that the government will be interested in further privatization until it disposes of all the companies held by CODESA, particularly in view of the adverse political reaction to attempts to privatize parts of the national electric company in 1988.

By late 1988, only three major companies remained to be divested, CATSA, a sugar mill that was to be sold to the private cooperative sector; FERTICA, a fertilizer plant, 40 percent of whose shares were to be sold; and CEMPASA, a cement plant, in which an equal percentage of shares were to be divested. In the case of CATSA, the company was restructured into a profitable business by FINTRA and, after some early problems, is likely to be sold to several large cooperatives. Any remaining shares will be put through the securities exchange.

FERTICA shares were originally to be sold to a Norwegian company, Norsk Hydro, and a letter of intent was signed to permit the sale and negotiation of a management contract. However, the possibility of political backlash because of sale to a multinational caused the government to renege on the agreement. The government then planned to transfer the shares of FERTICA to FINTRA, which would arrange the sale of 40 percent of the shares to a wide group of Costa Rican investors that will likely include employees and some users of the firm's products. Political sensitivities were particularly strong in this case since Costa Rican agriculture is strongly impacted by FERTICA's pricing policies, and there is fear of unemployment resulting from privatization of the company.

CEMPASA, a well-managed and profitable firm, has been left to the last because FINTRA's attention has been devoted to the other two, but it is expected that CEMPASA will be restructured and offered in the same way as the preceding firms.

The government will continue to have political difficulties with privatization not only from the left but also from the old guard of Arias's own party, which was committed to the idea of CODESA as a holding company from the very beginning. The government is particularly anxious, however, to complete the sale of 40 percent of FERTICA before the end of its term of office in 1990, but if a reasonable price is to be obtained, FINTRA will probably require more time to reorganize the firm into a profitable operation.

Lessons from the Costa Rican Experience

The Costa Rican privatization program was clearly stimulated by the early interest of the A.I.D. mission, but substantial politically motivated delays were encountered at the early stages. It clearly was designed to have an important social and economic effect on the country, but at the same time it was meant to support the desire of the president to enlarge and solidify his party's political base through democratization of ownership in the peculiar circumstances of the Costa Rican internal political structure.

The privatization process would have been made easier if greater thought had been given initially to the political implications involved in a privatization program. The program was put in place too hurriedly without, it would appear, sufficient consultation with the interested parties or at least consideration of the intricacies of the local political situation. Technical errors were made in establishing FINTRA, and the whole process was made needlessly complicated by the establishment of the commission as an added layer of bureaucracy. Nevertheless, the accusation that too high a price was paid in local currency for firms to be divested is unfair. The chief point to be kept in mind is that the government's primary concern was to avoid monetizing any of the local currency balance so that what might have appeared to be an excessively high valuation in local currency is beside the point. The price was a bookkeeping transaction that served to lower the available local currency balance and concomitantly reduced pressure on the government to monetize any of it.

TUNISIA: INSTITUTIONAL DEVELOPMENT FOR PRIVATIZATION

Introduction

Tunisia has had a long-standing interest in privatization, beginning during the Bourghiba regime and continuing into the Ben Ali government. Most of the SOEs required subsidies that were proving to be an ever greater burden on an already strained national budget. Even more important was the need to increase the efficiency of firms engaged in export production in the light of the government's hope of greater entry into the European Common Market. Privatization, leading to a greater place for the private sector and reduction of the role of the state in the economy, was a major step forward in the government's planning.

The Decision to Privatize

The government made the formal decision to embark on a privatization program in 1986. Legislation was passed in 1987 (Law 87-47 of August 2; full text is in the *Journal Officiel* of August 14, 1987) formally setting up the commissions under which the restructuring of public sector enterprises (including privatization) would be accomplished.

Within the Sixth Plan of economic and social development, the law provided for creation by decree of a list of firms to be restructured. A seven member restructuring commission, composed of bureaucrats, was named to carry out the provisions of the law. Its major task was to evaluate the industries to be divested, completely or partially, according to currently used methods. The commission was free to consult with any experts it desired.

The commission's work was to be reported to a second interministerial commission that was to authorize, based on this report, the actions necessary to carry out the privatization. In turn, these actions were to be implemented by the Ministry of Finance and the ministry responsible for the industry being divested.

To add to this already cumbersome structure, a third commission was created

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Jeremy Oppenheim
38592

Pz in Costa Rica

- Empt xpn
  - Obj of Pz to reduce.
- CODESA - devt corp
  - 30 PEs
  - $140 m pkgs of money - losing corps with help of USAID.

- Countrol effcy → more than just Pz.

- Beg 80s → first phase of Pz
  - low key
  - div of CODESA, of all ents.
  - 7 yrs to divest CODESA.
  - polit sys did not notice.
  - AID - 140 m in a pte fund not mged by Govt but by gp of wellrespected pte sec Costa Ricans.
  - Clear regs of how Fund had to operate → when div process ends, Fund will cease to end.
- Main policy dec apprvd by legislature.
- Proc decs shifted fr. polit realm to pte Fund.

Alexander Tomlinson CPE

Check with gov

Losses → politicians do not want to
accept blame for past mistakes.
- Fund can bridge gap bt val. of asset
and sale price.
- Emph on local buyers.
- Lab opposition - esp unions.
- ~~Foreign~~
- Time →
7-9 yrs - 1st stage
10-15 yrs - second stage.
- Need for reg. policy.
→ Avoid ideological bias
→ Provide basis to compare pub + pte.

CODESA - 5 ents sold

2 to be sold → 1 worker owned.

→ Ents in both monop + comp. envt.
→ Quite big → only one had to compete.
→ De facto monopo.

→ Controller General oversaw the pz progr.
Inbd in getting pub opinion.

In paper → Over of pricing

- ~~Method~~ Liquidation
-

Redundancies

- 3 times the usual sev. pay.
- Recd money fr. the fund that was set up.
-

ECUADOR

Revised

Richard Mallon
Ravi Ramamurti

June 21, 1991

Stuart

REPORT ON PRIVATIZATION COMPONENT FOR USAID TRADE AND INVESTMENT PROJECT IN ECUADOR

I. Introduction

Richard Mallon and Ravi Ramamurti visited Ecuador at the invitation of the local USAID Mission during May 5-22, 1991 to assist in developing a strategy and specific interventions for supporting privatization as one component of the Mission's proposed Trade and Investment project. Their visit was financed through a buy-in under the CAER project between USAID/Washington and the Harvard Institute for International Development.

A list of interviews carried out and the main documents consulted by Mallon and Ramamurti is attached. They would like to express their appreciation to staff members of the local USAID Mission, especially Mssrs. Kent Eaton, Milton Nuñez, and Wayne Camard, for their help, which together with the generous cooperation of Ecuadorian officials and businessmen made it possible to complete their mission on time.

II. Scope of Privatization

The term "privatization" needs to be defined in the broadest terms. Private enterprise performs efficiently and effectively when it unleashes entrepreneurial skills and faces fierce competition. Simply transferring enterprise ownership from government to the private sector does not necessarily achieve these benefits if competition is weak.

Economic policy in Ecuador does not encourage competitive behavior. The environment has been described in the following terms:[1] "The state has responded (to deeply rooted regional, class, and ethnic differences) by establishing what is now a heavily entrenched system of import and export controls and prohibitions, protective tariffs, price controls, administrative restrictions,

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[1]. World Bank, "Ecuador Public Sector Finances: Reforms for Growth in the Era of Declining Oil Output," Report No. 8918-EC, January 23, 1991, p. 11.

tax concessions and exemptions, restrictive labor laws, public sector job creation, credit allocations, interest rate subsidies, and extensive public ownership of commercial enterprises."

Pervasive interference with market forces has created an interdependent government/private enterprise complex that restricts competition in both the public and private sectors and between them. Partly in response to the contra-competitive policies mentioned in the previous paragraph, many private businesses have found it beneficial to organize themselves in closely held conglomerates owned and controlled by a few "grupos." This form of organization maximizes the political clout businessmen can use to extract privileges from government, restrict competition, and take advantage of insider lending from "grupo"-owned banks.[2] Labor unions follow a similar organizational strategy to promote their own group interests.

Both the public and private sectors thus need to be "privatized" in Ecuador. Demonopolization to open up the economy to wider competition in markets for goods and services, factors, and financial services is essential to derive positive benefits from the divestiture of state-owned enterprises (SOEs). Equally important in a market economy is freedom of exit, that is, the obligation of failed firms in both the public and private sectors to declare bankrupcy and risk liquidation instead of relying on government bailouts.

III. Recent Progress Toward Opening Up the Economy

The movement toward Andean Pact integration, culminating in the May, 1991 meeting of member country presidents in Caracas, has obliged Ecuador to choose between increasing isolation or greater economic liberalization. The only concession that Ecuador was able to obtain in the meeting was a six month delay in eliminating trade barriers with other member countries. Since most of these countries have already advanced much further in liberalizing their economies, Ecuador has no choice but to follow suit to avoid suffering from a serious competitive disadvantage.

In preparation for the meeting of presidents, the Ecuadorian government set up eight Study Commissions with representatives from both the public and private sectors and coordinated by the "Oficina

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[2]. See for example Jaime Egas Vasco, miembro de la Intendencia de Estudios y Mercado de Valores, "La Concentración de la Riqueza en el Sector Societario Ecuatoriano," mimeo, N.D.; Wayne Camard, "Trade and Industry in Ecuador: Business Groups and Structural Adjustment," draft report to USAID/Ecuador, May 21, 1991; and Centro de Estudios y Difusión Social, Los Grupos Monopolicos en el Ecuador, fourth edition, February 1990.

Técnica de la Presidencia." The subjects studied were labor policy, trade promotion, industrial development policy, agricultural policy, tariff policy and methods of integration, efficiency and simplification of the public sector, financial policy and investment promotion, and policies for transportation, communications, and other services. The reports of these commissions are still confidential, but the consultants were able to learn about some of their recommendations by interviewing participants and observing recent government decisions.

For example, a new labor law drafted by representatives of labor, management, and government in May 1991 was expected to raise the minimum number of employees necessary for unionization from 15 to perhaps 30 or 35, reduce the compensation payable to laid off workers, question the legality of "sympathy strikes," and introduce a compulsory cooling off period before workers could strike. Yet, some formidable barriers to labor mobility would remain: for instance, the government would still have to approve firings.

With regard to stock market reform, the current situation is that secondary transactions in privately owned stocks account for less than one percent of all transactions in the exchanges at Quito and Guayaquil, with most of the rest being accounted for by government bills sold by public sector organizations. Most transactions in private paper are believed to occur in the over-the-counter (OTC) market which is not noted for its transparency, thus making it possible for intermediaries to earn excess profits at the cost of small investors who do not possess insider information. Recent government decisions have been aimed at correcting this situation and establishing a more openly competitive capital market.

The capital gains tax has been eliminated, the highest marginal tax rate has been reduced from over 70 percent to only 25 percent, and real interest rates for borrowers have been increased. Ecuadoran companies are therefore likely to find that equity rather than debt financing is becoming more attractive. A new stock market reform bill, drafted with inputs from the World Bank and the U.S. Securities Exchange Commission, proposes turning the stock exchanges into nonprofit organizations managed by stockbrokers themselves and supervised by an independent regulatory agency. This bill does not seem likely to be approved as proposed, but there is still hope that the reform that is finally approved will make the exchanges more responsive to the needs of investors.

The National Administrative Development Secretariat (SENDA) has been charged with evaluating SOEs and examining ways to encourage private sector participation through the creation of joint ventures and other means. The UNDP is providing technical assistance to help SENDA carry out this task. In the recent executive decree ordering a 15% across-the-board cut in government expenditures, a rider was attached requiring SENDA to submit its report by June 30th.

These and other recent developments indicate that reforms to open up the Ecuadorian economy and expand private sector participation are gaining momentum during the final year of the present administration and could well carry over into the next government. The time seems ripe to develop a USAID strategy and specific interventions to support privatization as a component of the Mission's proposed Trade and Investment project.

IV. State-Owned Enterprises

A. Relative importance of the SOE sector: Gross spending of public enterprises (excluding transfers and petroleum) increased from about 4% of GDP at the beginning of the 1970s to 14% in the early 1980s. New petroleum wealth was used to establish many SOEs during this period: ENFE in 1970, TRANSNAVE in 1971, IETEL in 1972, DINE and FLOPEC in 1973, ECUATORIANA and ENAC in 1974, etc.

Data are not available on the share of SOE value added in GDP, but it appears that Ecuador still ranks well below the world average for mixed economies of 10 to 15% (again excluding the petroleum sector). Fully owned public enterprises are limited mainly to infrastructure services, whereas government participation in manufacturing, finance, and other services is (unlike many other developing countries) mainly in mixed enterprises in which private owners hold substantial equity.

B. Major problems of the sector: The SOE sector has not accounted for a large part of the non-financial public sector deficit in Ecuador. When the NFPS deficit amounted to between 2 and 10% of GDP en 1986-89, SOEs contributed less than 15%, almost all of which was accounted for by a single enterprise, INECEL.[3] This does not by any means signify that the finances of other public enterprises are satisfactory; many of them do not generate sufficient funds to finance an adequate level of investment or to service fully their debt (but of course Ecuador's foreign debt is not now being fully serviced). The financial problems of SOEs are therefore likely to become increasingly serious in the future unless significant reforms are carried out.

At present the most serious problem of the public enterprise sector is that it is a major impediment to increasing the

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[3]. See Statistical Appendix Tables 12 and following in World Bank, Op. cit. SOE deficits are calculated as the difference between net operating income and capital expenditures. Transfers between government and SOEs and debt service are not included because of the lack of transparency in these transactions (e.g. public accounts do not make it clear who is subsidizing whom).

efficiency and international competitiveness of the Ecuadorian economy, precisely because it controls key infrastructure services. Without more efficient transportation, telecommunications, and energy, the country will not be able to take full advantage of the opportunities provided by Andean Market integration and the gradual opening of the economy to the world market. The main impediments are:

1. Fully owned SOEs operate under virtually the same regulations and controls as the central government bureaucracy. These enterprises have neither the autonomy nor the flexibility with respect to procurement, personnel, contracting, pricing, and other matters that managers require to be held accountable for results; and the accounting rules imposed by the "Contraloría" are completely unsuitable for controlling SOE operations as cost or profit centers as business firms should be. Ecuador appears to be almost a decade behind in reforming the relationship between governments and SOEs in the more advanced developing countries. As a first step toward necessary reforms, public enterprises should be converted into "sociedades anónimas" and placed under the supervision of the "Superintendencia de Compañías."

2. Before being given greater managerial autonomy, however, SOEs would have to be subjected to "hard" budget constraints to make them financially self-supporting without disguised subsidies; their relations with government would have to be regulated by some form of "performance contract" that specifies reciprocal commitments, sets measurable performance targets, and provides incentives and sanctions based on results; and outside interference by government officials, politicians, or boards of directors in day-to-day operations would have to be severely curtailed.

3. Many SOEs are given artificial monopoly rights that restrict competition (see section V below). Such rights should be eliminated and public enterprises exposed to as much competition as possible.

4. Some public service SOEs (or parts of them) are natural monopolies. Tariffs and service levels of these enterprises are currently regulated by their boards of directors or by the political process with disastrous results. INECEL, for instance, is managed by a board consisting of the ministers of economy, industry, planning, the presidency, workers, local power companies, private sector users, and a professor. Tariffs are set by the board unless Congress has involved itself in the process, as for example when it recently limited tariff increases to 3 percent per month, well below the rate of inflation. Average tariffs measured in US dollars fell for both bulk and small users between 1980 and 1987 and are presently well below long run marginal costs. Retail prices tend to be uniform regardless of cost of delivery and time of day.

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In the case of airlines, the agency responsible for regulation is the Dept. of Civil Aviation (DAC), which is controlled by the Air Force (which also owns the domestic airline, TAME). DAC is also responsible for running the airports and for setting landing fees. Besides the obvious conflicts of interest built into the regulatory arrangement, DAC is believed to lack technical and economic expertise to do its job well.

Independent, professional agencies should be set up to carry out these regulatory functions, especially for determining reasonable criteria for tariff rates and explicit subsidies. Creation of professional regulatory agencies would not of course eliminate political decisions, but they could help make the costs of low tariffs and subsidies more transparent.

5. A number of public service SOEs do not have sufficient access to the capital, technology, and/or management skills they need to provide efficient services. These enterprises are prime candidates for full or partial divestiture and/or contracting out operations.

V. Divestiture

A. Fully owned SOEs: A special law would be required to divest these enterprises unless they are first converted into "sociedades anónimas." Once this is done, selling shares to the private sector would not appear to pose insuperable legal obstacles. Before shares of enterprises were sold, however, it would be highly desirable if not indispensable to eliminate any artificial monopoly rights they may have, and if they have natural monopoly powers, to set up an appropriate government regulatory system. No fully owned SOE appears ready yet for complete divestiture, but several can be considered as candidates for partial divestiture or the spinning off of some of their activities.

1. ECUATORIANA: This enterprise is perhaps farthest along on the route to privatization. The plan is to sell it by early 1992, before the current government's term ends in August 1992. The national executive including the military have decided to request the legislature to permit conversion of ECUATORIANA into a mixed enterprise. The idea at present is to divide ownership into about one-third government (probably the military), one-third private domestic (including 5% for employees), and one-third foreign (the CEO favors making Japan or Korean Airlines the foreign partner). The present CEO is a private businessman who has been on the job for only two months and wants to make the airline a commercial success by selling shares on credit to travel agents, establishing a frequent flyer program, attracting more tourists (especially Japanese), giving generous baggage allowances to passengers, etc. His motivation for forming a mixed enterprise is not to obtain capital (he claims that fuel and repair savings alone

are sufficient to finance the lease-purchase of two new air buses) but to escape the stifling regulations of the "Contraloría" and to establish connecting routes with a major international carrier.

There is no doubt, however, that cutting operating costs and modernizing the fleet will be necessary to improve ECUATORIANA's financial performance and capacity utilization, especially in view of the fact that the antiquated aircraft now being used suffer exhorbitant downtime for repairs and will not be able to satisfy noise pollution standards that will come into force shortly in the U.S. The main issues that have to be resolved to pave the way for divestiture are: 1) Determination of the enterprise's net worth (valuation of tangible and intangible assets and a company audit); 2. revision of labor union contracts and work rules; 3) decision on who will exercise effective control of management (the foreign partner is likely to insist on control, but domestic control may be necessary for political reasons and to maintain ECUATORIANA's status as a national flag carrier); and 4) clarification of regulatory policies now exercised by the DAC. Very little thought seems to have been given to eliminating Equatoriana's artificial monopoly rights or to the regulatory regime after privatization. For instance, it is not clear if SAETA, the private airline that also operates on the Quito-Miami route, will be permitted in the future to also operate some flights on the lucrative Quito-New York route. (At present, Equatoriana is the only Ecuadoran carrier operating on that route.)

2. INECEL: The electric generation and transmission enterprise is fully owned by the central government, but the 18 local distribution companies are organized as "sociedades anónimas," about one-third of whose shares are owned by municipal councils and others (the other two-thirds are held by INECEL). The general manager has recently been quoted in the press as favoring privatization of local distribution companies, but there are at least three major obstacles: 1) Tariffs are politically determined with little concern for the financial viability of the enterprises -- small consumers are heavily subsidized with the result that INECEL is the main source of SOE deficits in Ecuador; 2) in the absence of any serious regulatory authority for this natural monopoly, there is little chance for rationalizing tariff policy or avoiding the abuses that EMELEC (the privately owned electric power company in Guayaquil) is accused of; and 3) divestiture is unlikely to enhance efficiency if the new owners lack the capital, know-how, and effective managerial control necessary to improve performance (e.g. the new ownership proposed for EMELEC and many electric power cooperatives in other countries).

Any serious privatization in the electricity sector would therefore have to be preceded by efforts to clarify the rules of the game (e.g. government regulation of tariff policy, permitted rates of return on new investment and its financing, the level and quality of service, etc.). Otherwise, companies with the capital and know-how to improve performance will not be interested. In the meantime, the most practical way to increase private participation in the sector would probably be to encourage contracting out maintenance, meter reading, and other ancillary services of the electric power companies.

3. Port of Manta: Port authorities have reportedly expressed an interest in privatizing operations. In view of the fact that a "zona maquilladora" is located in Manta, divestiture of all or part of port facilities or contracting out their operation to private management could be especially attractive to private business groups and to government as a pilot experiment.

4. "Agua Potable de Quito": Recent expansion was accomplished with a reduction in personnel because all possible construction and maintenance services have been contracted out. Management is trying to introduce internal financial and accounting reforms to facilitate operation of the enterprise along business lines, but these reforms are impeded by "Contraloría" restrictions. "Agua Potable de Quito" could serve as a model for other SOEs, not only other municipal water companies but enterprises such as ENFE, which could spin off activities to private contractors or leasees to reduce over-staffing and become more financially viable.

5. ENFE: The decline in railway passenger and cargo traffic by 75 and 82 percent respectively between 1980 and 1988 has made the enterprise unviable. Track and rolling stock need rehabilitation, but before rehabilitation the enterprise should be completely restructured by closing lines that are no longer competitive with road transport, contracting or leasing out operation of maintenance facilities, terminals and selective cargo movements, and reducing excess personnel. The performance contract recently signed with Bolivian ENFE could serve as a model. This contract calls for a 30% reduction in the railway work force in the first year and the sale of surplus property to the private sector to finance the corresponding worker indemnization payments.

B. Mixed SOEs: Government owned shares in these enterprises are mostly held by CFN, BNF, DINE, and IESS. They were acquired either for promotional purposes or to bail out failed private firms, or in the case of IESS to provide investment income. Eventual divestiture is a logical sequence for promotional enterprises; bail-outs should be divested after restructuring or liquidated (see below). The current situation with respect to these mixed SOEs is as follows:

1. CFN: During the period 1981-89 CFN sold its entire holdings in eight mixed enterprises and part of its holdings in another three. After Dr. Moscoso became chief executive, CFN sold the balance of its holdings in the latter three firms and its entire holdings in six additional enterprises. Although the number of firms divested may seem important, a mere S/.1.04 billion (US$

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1 million approximately) have been raised through these sales. As of May 1991, CFN held shares in 22 other companies with a total nominal value of S/.31.4 billion (about US$ 30 million). Three firms -- La Cementa Nacional, AZTRA (sugar), and Selva Alegre (cement) -- accounted for 80% of CFN's holdings. CFN's board has decided to divest <u>all</u> these holdings by the end of 1991 (see list attached).

All CNF holdings have been divested through the "Bolsas" (on which the Corporation holds a seat) at prices approved by the board based on book value and projected cash flows (using techniques learned from Price Waterhouse). No shares were sold on credit. According to the chief executive, some shares were disposed off in barely a few hours; others took 4-5 weeks to sell. No restrictions were placed on the nationality of the buyers or the amount of shares acquired by any single investor. The most marketable items in CFN's portfolio are the cement companies and the 15% holdings in Hotel Colon. Least marketable are firms like AZTRA and Chapas y Maderas (plywood).

2. BNF: A "Reglamento Para la Venta de Acciones de Propiedad" was adopted in February, 1990 and has been approved by the "Superintendencia de Bancos," and a list of 11 enterprises (out of a total of 15 in which the BNF owns shares) has been approved for sale (see attached). The BNF is obliged to give preference in the sale of shares to suppliers of raw materials and employees. If they are not interested, then the shares will be sold through the "Bolsas" as the CFN is doing. The President and General Manager claim that in future the BNF will only extend credit to borrowers, not buy shares in their enterprises. The Flota Mercante Grancolombia, in which the Banco holds 20% of the equity, represents the largest bundle of shares in the list. Management believes that an international shipping company should be interested in purchasing BNF's holdings in view of the new opportunities that will be provided by Andean Group integration. But some other enterprises will be difficult to sell: for example, the only investors that have so far expressed an interest in buying FERTIZA are creditor banks, and CEMENTO CHIMBORAZO needs to spend an estimated $13 million on the modernization of plant and equipment.

3. DINE: Fully owns two enterprises (FAME and Fábrica de Municiones) and holds shares in about 17 mixed SOEs; the number is may not be exact because DINE, unlike the CFN and BNF, is continually adding new firms to its portfolio. The policy of DINE is that private entrepreneurs/investors and the military make a perfect match in setting up and running new strategic enterprises, and that divestiture of DINE's holdings will only make sense when "national culture matures and democratic stability is assured." Two of DINE's joint ventures -- Iskra Emec (recently acquired from the CFN) and Agrincem Galápagos -- are export oriented. Plans for investing in new enterprises include production of generic

medicines, fertilizers, cement (possibly for export to Brazil), paper pulp using native raw materials, gold and other minerals (in which foreign partners would be welcome), agro-industry, and tourism (a five-star hotel and an ecological tourism operation in the Amazonas). To the extent that Ecuador opens up its economy to international competition, DINE will have to revise its import substitution industrialization strategy.

4. IESS: Only about 10% of investments are in enterprise shares, which would represent a very prudent investment of social security contributions if the portfolio were well selected and managed. The "Centro de Estudios y Análisis" claims that IESS investments in enterprises such as Banco del Pacífico, Cervecería Andina, Club de Ejecutivos, and Hotel Colón are very remunerative, whereas the World Bank maintains that IESS equity investments yielded a negative real rate of return between 1984 and 1987. But the problem in the case of IESS is not divestiture <u>per se</u> but proper management of its investment portfolio, in which demonopolization of social insurance could play a useful role.

VI. <u>Demonopolization</u>

A. Public sector: A number of SOEs enjoy artificial monopoly rights that often cannot be fully enforced (e.g. the municipal ordinance that requires that all local milk production be processed by PROLACOM). But these artificial restraints still constitute serious impediments to improving the efficiency and international competitiveness of the Ecuadorian economy and should be eliminated, especially in the following areas:

1. Transportation: TRANSNAVE is guaranteed the right to transport 50% of all sea cargo to and from Ecuador by the "protección de carga" law of 1973. FLOPEC has been granted a monopoly on transporting oil to and from Ecuador that it uses to extract fees from private carriers for waiving its monopoly privileges. ECUATORIANA is protected from competition from other international carriers in the provision of combined cargo-passenger services.

2. Telecommunications: The monopoly of IETEL is partly natural and partly artificial -- local residential phone service and operation of the national trunk line grid and satellite transmission tend to be natural monopolies, whereas individual long-distance and special services (e.g. electronic data transmission, cellular phones, etc.) can be provided competitively, especially if the national trunk line is converted into a common carrier. IETEL has permitted some competition (e.g. Banco del Pacífico has been permitted to install its own direct satellite transmission facilities), but permissions are tedious to negotiate. Such permissions should be made generally available, but only after current tariff policy that imposes exhorbitant charges on long

distance communications to cross-subsidize local calls is revised and the national communications grid is converted into a common carrier. Otherwise, a false incentive will be given to install private long-distance facilities that distort the allocation of the country's scarce resources and will turn out to be unprofitable once tariffs are rationalized.

3. Pension funds: The IESS presently enjoys an artificial monopoly in the administration of pension funds and other social insurance programs. This monopoly has led to massive inefficiency, as pointed out by the World Bank and other observers.[4] Private social insurance funds, perhaps modeled along the lines of the system in Chile, should be allowed to compete. A first step in this direction could be the introduction of private schemes for workers' reserve funds. Creation of private social insurance funds could greatly assist the diversification and deepening of domestic capital markets and the creation of new instruments such as mutual funds. The redirection of social insurance funds away from "privativas" (low-yielding personal and mortgage loans in which the IESS invests most of its money) toward productive investments would also help finance the government's privatization efforts and spur economic growth.

B. Private sector: Widespread monopolization or cartelization of private markets in Ecuador constitutes a formidable obstacle to privatization. Popular support for privatization is eroded by the perception that private monopolists exploit consumers, and professional analysts doubt that simply converting government monopolies into private ones is likely to improve enterprise efficiency. Demonopolization or "privatization" of the private sector could therefore contribute immensely to gaining support for and assuring positive results from privatization, especially in the following areas:

1. Anti-monopoly legislation could be considered to discourage vertical integration (e.g. Naboa and Wong in bananas, fruit packing boxes, and shipping) and horizontal integration (e.g. "grupo" domination of the press and television). Admittedly this is an area in which enforcement is extremely difficult, but at least membership in associations should not be required to participate in any economic activities. And where licensing is required to regulate public services such as transportation and communications, more concern could be shown for the dispersion of ownership and control.

2. "Grupo" domination of important sectors of the economy is facilitated by the organization of most Ecuadorian businesses in the form of closely-held family firms. The reluctance of businesses to "go public" and sell shares in the open market is

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[4]. See World Bank, <u>Op. cit.</u>, Chapter VI, pp. 69-82.

partly a matter of tradition but also represents a rational response to existing incentives. The most important disincentives for "going public" are probably financial (see below), but the virtual absence of any obligation on the part of privately held firms to disclose information is an added disincentive. On the other hand, more comprehensive disclosure rules for such firms would be extremely difficult to enforce.

3. Negative real interest rates currently prevailing in financial markets are probably the most important disincentive for family firms to "go public." It is obviously more attractive to rely on subsidized loans than on outside equity investments to finance enterprise needs, especially when the latter could also threaten family control. Interest rates have been increasing in real terms during recent months, but they are still not high enough to induce most firms to seek alternative sources of financing.

4. So long as real interest rates remain relatively low, "grupos" that own enterprises have a strong incentive to also own and control banks and other financial institutions. Preferential access to borrowed funds through "insider lending" is quite common within "grupo" conglomerates in Ecuador. This source of financing is not only cheaper but also allows debtor firms to transfer business risks away from equity holders to bank depositors (or to government if it guarantees bank deposits either de jure or de facto).[5] One step that could be taken to ameliorate this situation and strengthen financial markets would be to empower the "Superintendencia de Bancos" to restrict insider lending.

5. A complementary step in this direction would be to strengthen the capacity of the "Superintendencia de Compañías" to assure full disclosure of the financial status of companies that wish to float paper on the stock exchanges. Currently any nonfinancial company, whether public or private, which has 5 or more shareholders and S/.2 million in sales is required to file annually its balance sheet, income statement, imports, exports, and number of employees with the Superintendencia de Compañías. Compliance is poor, however, because the penalties for filing late are very small. Only companies whose stock is traded on the Bolsas are required to publicly disclose their balance sheets, but not their income statements or notes to the accounts. It is thus very difficult to make sense of the published information.

VII. Liquidation

A. Freedom of exit through liquidation is just as important as

[5]. See Wayne Camard, "Trade and Industry in Ecuador: Business Groups and Structural Adjustment," Draft Report to USAID, May 21, 1991.

freedom of entry to assure adequate competition. If firms are not allowed to go broke, entrepreneurs will have little incentive to compare the risks and returns of alternative investments. And so long as government stands ready to bail out failed firms, the dividing line between private and state-owned enterprises will remain blurred.

B. Among state-owned firms there are undoubtedly a number of candididates for liquidation. Chapas y Maderas de Esmeraldas mentioned earlier appears to be one of them; it will most like remain on the books of the CFN forever unless it is closed down. Similarly, ENPROVIT is economically unviable and seems to have forgotten its social mission of supplying essential goods to the poor. ENAC also has serious problems, but perhaps a case can be made for retaining it rice operations to assist small farmers and spinning off its procurement of beans. Mexico's experiment with privatizing CONASUPO may be relevant here.

Liquidation is of course a very politically sensitive policy, mainly because of the impact it has on employment in the absence of government retraining and job placement programs. In the case of liquidating failed financial institutions there is the additional problem of protecting depositors, which can turn into a financial "black hole" if bank regulation is lax. Despite the difficulties, however, this remains an area where reform is necessary.

VIII. Possible Areas for AID Assistance

A. Restructuring and improving the efficiency of SOEs: This is an area in which the World Bank and the UNDP are very active. It would thus appear that this area should not receive AID's priority attention, but the UNDP (Luís Alfredo Maldonado) expressed an interest in AID collaboration with their project when they reach the stage of spinning off public enterprise activities. In the meantime AID might wish to consider the following:

1. Assist government to carry out a comprehensive managerial, financial, and technical audit of a major SOE, perhaps ICETEL, to identify opportunities for spinning off or contracting out activities to the private sector, for allowing competition where natural monopoly conditions are absent, for restructuring management and MIS along business lines, and for rationalizing tariffs and personnel.

2. Offer technical assistance to ENFE on how to become more competitive by spinning off losing services, contracting out activities to the private sector, and disposing of idle properties. The studies carried out in formulating a performance contract with Bolivian ENFE could serve as a guide.

3. Offer to help DINE set up a joint venture ecological

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3. Offer to help DINE set up a joint venture ecological

tourism project in collaboration with Smithsonian (this initiative could help mend fences with the Ecuadorian military).

B. Divestiture: There is considerable scope for AID assistance in the area of conceptualizing and sharing divestiture experiences, and selectively in the process itself:

1. Include more sessions on the subject of divestiture in the policy dialogues led by INCAE.

2. Sponsor a study on the use of debt-equity swaps for financing foreign acquisitions. It is apparently poorly understood in Ecuador, for example, that swaps involving the transfer of ownership of existing assets are not inflationary.

3. Organize a seminar on the selection of joint venture partners. This is likely to be one of the main forms of divestiture used in Ecuador, and serious people like Edison Ortiz (member of the Commission on divestiture of ECUATORIANA) are asking relevant questions about the compatibility of foreign and local partners (e.g. experience of SAS in Chile), the feasibility of extracting advance commitments from foreign partners on improvements to be made (e.g. Mexican vs. Argentine experience with telecommunications), the valuation of intangible assets such as airline routes and landing rights, etc.

4. Assist Ecuatoriana to carry out a financial audit, to assess the value of its tangible and intangible assets, and to prepare a prospectus for partial divestiture.

5. Organize a seminar on contracting out SOE management and other services to the private sector, using Agua Potable de Quito and international case studies and inviting active participation of Manta Port authorities.

6. Since BNF has no previous experience with divestiture, the President and General Manager would welcome technical assistance in preparing sales prospectuses and evaluating offers from buyers, similar to the assistance provided by Robert Laport to the CFN several years ago. The BNF would also welcome assistance in identifying a foreign buyer for its shares in the Flota Mercantil Grancolombia; this assistance could be linked to relaxing "reserva de carga" restrictions on maritime transport.

7. Offer technical assistance for setting up independent, professional bodies for regulating levels and tariffs of public services, especially for electricity and telecommunications. The U.S. has more experience than any other country in government regulation of the private provision of public services, and strengthening regulatory systems to clarify rules of the game is an indispensable first step toward eventual privatization of these services.

C. Demonopolization: This is an innovative area that deserves high priority attention from AID, especially because it offers an opportunity to broaden private sector participation in activities currently dominated or restricted by government:

1. Organize a seminar on the competitive provision of long distance and special telecommunications services, the real cost reductions that can be achieved by adopting advanced communications technology, the relation between efficient communications and international competitiveness of the economy, and benefits that can be obtained by converting the national IETEL network into a common carrier. International travel could also be financed for seminar participants to learn how this is being done in the U.S., Chile, and other countries.

2. Provide technical assistance to a consortium of private financial firms (Ramiro Crespo of INVESTBAN would be a good counterpart) on the development of new instruments such as mutual funds that could be transacted in the stock exchanges for mobilizing private savings for risk capital investment. Such instruments would help bring smaller savers into a market now dominated by large investors in short-term securities and by government financial institutions in longer term lending.

3. Sponsor a study of the development of private pension and social insurance funds to provide competition for the IESS. The Federación de Industrias (contact Gustavo Pinto) and the Fundación Adam Smith (see letter to Mr. Costello of May 8, 1991) would be delighted to collaborate, but an effort should also be made to include some of the more enlightened labor unions to convince them that they would be the main beneficiaries. Creation of private pension funds would also help increase funds available for investment in the savings instruments mentioned in para. 2 above.

4. Offer technical assistance in drafting anti-monopoly legislation (covering both state-owned and private enterprises) and setting up an implementing body.

5. Provide technical assistance to the Superintendencia de Compañías to strengthen its surveilance of the Bolsas to assure full disclosure of information about firms and funds quoted in the exchanges and the content and accuracy of information contained in prospectuses for new issues of securities on the exchanges. Strengthening of stock market supervision is essential to inspire confidence of new investors and to broaden Bolsa operations.

6. Provide technical assistance to the Superintendencia de Bancos to strengthen surveilance of insider lending and the soundness of financial institution portfolios. Strengthening regulation of financial institutions is indispensable for creating

confidence on the part of savers and investors who do not belong to the "grupos" and for broadening and deepening capital markets.

7. Demonopolization of Conuep's of higher education should receive AID's highest priority, because without an adequate supply of well trained managers and technicians Ecuador cannot possibly compete in the international market. But it is not at all clear how AID can help resolve such an explosive political bottleneck, especially in view of the unsatisfactory result of the Houston University contract (source: Marcelo Laniado of the Banco del Pacífico). Perhaps as a first step the new INCAE MBA program could be supplemented by in-service training provided by major Ecuadorian companies.

D. Liquidation: The main barrier to liquidation of non-viable enterprises in which government holds equity is the threat of unemployment. To help solve this problem AID could sponsor an experimental retraining and rehabilitation program to assist unemployed workers to find alternative employment. If IMPROVIT were liquidated, for example, AID could conceivably provide modest financing to help displaced employees set up private retail establishments.

LIST OF INTERVIEWS

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Randy Reed
Milton Nuñez
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Herman Hiño
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Ing. Victor Salgado
Asesor del Subsecretario de Electrificacion
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Bolsa de Valores

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Econ. Section
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Dr. Polit
Lawyer for petroleum compoanies

Duty Greene and Esteban Chiriboga, IDEA

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Asesor Economico de la Presidencia de la Republica

Ing. Edison Ortiz, FILANBANCO

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Superintendencia de Companias

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Director Desarrollo Administrativo, SENDA

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Banco del Pacifico

Dr. Henry Raad
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Walter Spurrier
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Jacinto Jouvin
President of Ecuatoriana

Franklin Proano
Gerente Division Tecnica
Banco Cental del Ecuador

Dr. Socrates Navas Mendoza
Presidente Banco Nacional de Fomento

Jorge Davalos
Gerente General Banco Nacional de Fomento

Ing. Gustavo Pinto
Gerente Hilos Pinto

Ing. Antonio Gaybor
Director de Planificacion, ENAC

Coronel Marco Mino Montalvo
Director, DINE

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Director of Planning, INECEL

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TELEGRAMAS: BANFOMENTO

APARTADO 685

QUITO

LISTA DE EMPRESAS QUE CONSTAN EN EL PLAN DE DESINVERSION

- LECOCEM
- PROLACEM
- COMPROLACSA
- ALMACAO
- BANCO DE GUAYAQUIL
- MERCADO MAYORISTA
- DACA
- ALGRACESA
- ALMACOPIO
- FERTISA
- FLOTA MERCANTE GRANCOLOMBIANA

CFN CORPORACION FINANCIERA NACIONAL

QUITO - ECUADOR

Juan León Mera 130 y Avda. Patria
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Apartado Postal: 163
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VENTA DE ACCIONES

MILES DE SUCRES

		VALOR NOMINAL	VALOR DE VENTA	UTILIDAD (PERDIDA)	%	FECHA VENTA
1.	PROFARAM	262	262	-	-	VIII-81
2.	OPTIMUS ANDINA	3.245	2.920	(325)	(10)	VI-81
3.	DACA	8.453	12.090	3.637	43	X-81
4.	CEMENTOS ECUATORIANOS	2.400	2.210	(190)	(8)	VI-82
5.	HOTELERA GUAYAQUIL	38.100	49.530	11.430	30	VI-83
6.	EDESA	8.000	30.000	22.000	275	I-84
7.	FIDASA	12.040	18.060	6.020	50	X-87
3.A	DACA	14.999	38.848	23.849	159	X-87
8.	POLIECSA	497	1.072	575	116	XII-87
9.	FINANQUIL	27.156	34.785	7.629	28	II-88
10.	ECUFINSA	20.818	35.207	14.389	69	I-88
11.	PROCAESA	41.569	77.485	35.916	86	XII-87
8.A	POLIECSA	16.926	71.461	54.535	322	XI-89
7.A	FIDASA	28.393	50.265	21.872	77	II-90
11.A	PROCAESA	350	1.003	653	186	VII-90
12	ISKRAEMEC	51.000	295.514	244.514	479	VII-90
13.	GANESA	2.180	10.852	8.672	398	VII-90
14.	ECASA	120	245	125	104	IX-90
15.	UNIWELD ANDINA	1.000	10.413	9.413	941	XI-90
16.	COFIEC	125.585	154.470	28.885	23	II-91
17.	LIPCEM	8.500	159.631	151.131	1.778	III-91
	TOTAL:	441.593	1.056.323	644.730	147	

CFN CORPORACION FINANCIERA NACIONAL

QUITO - ECUADOR

Juan León Mera 130 y Avda. Patria
Conm. Troncal: 564-900
Télex 2193 - 2444

Apartado Postal: 163
Cable: CORFINAL

CRONOGRAMA DE VALORACION DE ACCIONES

EMPRESA	ACTIVIDAD	VALOR NOMINAL MILLONES S/. 1/	PARTICIP. CFN %
PALMORIENTE	Aceite de palma	684	7.3
FRIOEXPORT	Cuartos frios	10	50.0
PROCAESA	Caucho seco	29	31.0
FINANCIERA GUAYAQUIL	Financiera	4	0.2
FERTISA	Fertilizantes	99	23.3
PISCIFACTORIA MOJANDA	Aluvines de trucha	3	50.0
LA CEMENTO NACIONAL	Cemento gris	11.929	47.0
PARQUE IND. RIOBAMBA	Urbanizac. lotes	29	18.0
CHAPAS Y MADERAS	Madera	913	99.7
AZTRA 2/	Azúcar	11.964	98.7
CODADE	Alcohol	368	99.7
SELVA ALEGRE	Cemento gris	3.995	46.2
HOTEL COLON	Turismo	324	15.0
EMSEMILLAS	Semillas certificadas	38	16.5
IDEAL ALAMBREC	Alambre de púas	314	20.0
CEMENTO CHIMBORAZO	Cemento gris	14	0.8
ECUACARDOSA	Achiote y jengibre	36	50.0
ECUASIDER	Siderúrgica	26	27.0
ARTEPRACTICO	Muebles	561	16.6
PROM. TURISTICAS BOLIVAR	Turismo	1	10.0
BOLSA DE VALORES QUITO	Financiera	35	32.1
BOLSA DE VALORES GUAYAQUIL	Financiera	62	77.0

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EL SALVADOR

Stuart Chandler

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: **November 5, 1991**

TO: Hans Binswanger, Chief, LA2AG

FROM: Cora Shaw, Task Manager, LA2AG

EXTENSION: 39263

SUBJECT: El Salvador - Agricultural Sector Reform and Investment Program (ASRIP)
- Appraisal Mission
- Back to Office Report and Issues Memo

1. In accordance with our terms of reference dated September 27, 1991 a mission constituted by Cora Shaw (mission leader); John Glenn (Cons.) and Francisco Reifschneider (FAO/CP) for the research and extension component; Carlos Montoya (Cons.) for the privatization component; and Roger Pinto (AFTIM), Mariana Delbue (IECDI) and Adalberto Paniagua (Cons.) for the reform component visited el Salvador from September 30 to October 11, 1991 to appraise the proposed Agricultural Sector Reform and Investment Project (ASRIP). An IDB mission accompanied the Bank mission, constituted by F. Villamizar (agricultural economist and mission leader), A. Blandon (agriculturalist), and R. Tamayo (operations officer). Mr. Martin Raine (RUTA) accompanied the mission as per MAG's request, and E. Montes (RUTA-UTN) facilitated the work of the mission. The decisions taken at the debriefing meeting held on Friday, October 25, 1991, are summarized in annex I.

2. Mission Findings and Recommendations. The mission found that the Government of El Salvador (GOES) had made progress in the preparation of the conditionality and the different components, but some information gaps precluded finalizing the appraisal. Progress in conditionality and by component are summarized below and more details are given in the aide-memoire (annex II) and its annexes (see para. 10). The main information gaps were on the timing of the draft voluntary staff reduction legislation (see para. 4. a. ii), and of a complete inventory and status of physical assets (extension agencies, laboratory equipment).

3. On the conditionality, agreement was reached on the following points (see FEPS para. 10): (a) a first draft of a Sector Development Policy (annex III); (b) a draft plan and timetable for minimum staff reduction targets to be refined based on the legislation mentioned above; (c) confirmation from the Minister of Finance that the salary savings from these reductions would remain in the sector's budget; (d) Banks's comments on the draft CENTA Law would be included in the next version of the Law; (e) CENTA's recruitment process; and (f) indemnification financing. Agreement on (g) a supervision plan will be sought during post-appraisal.

4. Progress by components is detailed below.

   a. institutional reform and strengthening:
      i. the new MAG organization structure was decided (and a decree issued) and the Division of Institutional Strategy and Planning was operational (appraisal conditions). The organizational structure below the Directorates, though, still needs to be refined, as a consensus has not yet been built on the nature and location of services (other than extension) to be provided at the field level. The aide-memoire recommended and the Minister of Agriculture agreed to the organization of a workshop with middle-level managers to arrive at a consensus (currently planned for the beginning of December when the selected facilitator will be available);
      ii. the Minister of Finance informed the mission that the Law to allow payment for indemnifications for public employees' voluntary retirement had been approved by the President and was being reviewed by the Minister of Justice. He anticipated that the Law would be presented to the Assembly during the month of November, and that it would be approved. Moreover, there seemed to be a consensus that resources would be available for the ordinary budget to finance the reduction, not the least because USAID had agreed to an "arrears" exercise from the extraordinary

budget of Colones 154 million, to be transferred to the ordinary budget. Another possible source proposed by the Minister of Planning was the local currency generation from the US$100 million IDB Investment Loan, now in preparation and expected to become effective in March of 1992. We expressed our concern for the optimism implied in this timing;

iii. the request for financing the construction of a building was made again. The PPF included funds for studying the best solution to MAG's headquarters' dispersion into 15 different locations in San Salvador. The mission warned again that while the functional review had not been conducted (and therefore the staffing of MAG not determined), it would be difficult to advance into a design stage. In the attached appraisal letter we suggest a cost study comparing the cost of building to buying or renting, indicating also that the Bank could not finance the purchase or renting options (annex IV a);

b. privatization:

i. the mission proposed a pragmatic strategy to deal with the sale of IRA assets the assets would be classified according to their "salability", depending on their location in or outside of conflict areas. The "unsalable" assets would be transferred out of IRA to another institution (the National Privatization Commission was recommended), to prevent any possible backsliding on privatization of IRA assets and until the security situation allowed for their sale; the "salable" ones would be put up for sale either as on-going concerns, or as scrap;

ii. we urged that the target market for IRA and BFA assets be expanded to the general public after a period of offering them to the cooperatives, as is now the current policy. The Minister of Agriculture seemed to agree to this option, particularly for BFA assets;

c. research and extension;

i. the extension sub-component has been operating in about 15 extension agencies. The mission visited one agency and observed an extension agent deliver his message; farmers' response was quite positive. It was agreed that targeting of extension services to women would be monitored by the number of female contact farmers ("productoras de enlace") recruited, and that this would constitute on average 25 percent of national "productores de enlace". Subsequently, the Bank will propose that, to facilitate achieving this target, women candidates for extension agents positions with same qualifications as men be given preference for recruitment up to this percentage;

ii. the decree with MAG's organizational structure states that CENTA (the agency to merge plant and livestock research and extension) would become autonomous and that the corresponding law would be presented to the Assembly by the end of the year. It was agreed that this new CENTA would start operations on the basis of new organization and salary structures which would define CENTA's scope and research program (commodity research projects), recruitment on competitive grounds, and a training program to fill estimated post-recruitment gaps. There was also agreement on changes necessary to make the draft Law satisfactory to the Bank. The technical assistance for CENTA's organization and work program is scheduled to start on November 11;

iii. because the port-recruitment gaps are expected to be substantial, the mission would like to suggest to MAG to adopt a "twinning" arrangement with another agricultural research institution, preferably from Latin America tropical and/or sub-tropical zones, for at least the transition period while the program leaders will be in post-graduate training, and possible beyond. This arrangement would be developed along the lines of the "twinning" proposed in the Bolivia Agricultural Development Project. The attached letter to the Minister of Agriculture explains this option (annex IV a).

5. The components to be financed by IDB, i.e. support to private sector marketing of basic grains; irrigation rehabilitation; and plant and animal health are discussed in the IDB's Aide-Memoire (annex V).

6. Project financing. As mentioned in para. 2, information gaps precluded from finalizing the sizing of the research and extension component. A detailed list of further information to be provided to the bank was agreed and signed by both the mission and the director on CENTA. This information should be available in about two months, mainly due to the difficulties of assessing the status of some extension agencies in conflict zones.

7. The PPF. The PPF funds to be disbursed through the Special Account may become available. Disbursement of these funds had been blocked by the Corte de Cuentas which did not approve of the legal terms (a trust) that had been used to described the PPF. Subsequently, the Corte de Cuentas proposed to change this legal term to that of "Funds Requiring Special Handling (Fondos de Manejo Especiales)". The Minister of Finance has already approved, and the Corte de Cuentas is expected to approve shortly.

8. Next Steps.

i. Send appraisal letters to ministers who received mission members (annex IV a and b), confirming aide-memoire (annex II);

ii. Follow-up that mechanisms be approved as soon as possible to allow continuation of disbursements of PPF funds;

iii. Prepare post-appraisal mission after:
(1) consultants' mission to work with CENTA to define their work program and organization (November 1991);
(2) the inventory of research and extension physical assets has been completed (expected by late December 1991).

iv. Prepare Draft yellow cover SAR to be completed after post-appraisal.

9. Proposed Project Timetable.

January 1992	Post-appraisal mission
March/April 1992	Negotiations
June 1992	Board presentation

10. Annexes to the aide-memoire (about 80 pages) are available upon request.

cc: Mmes./Messrs. Knotter (LA2DR); Voljc, Lachler, Grandolini, Cooke (LA2C2); Duer, Abramovich, McIntire (LA2AG); Pinto (AFTIM), Delbue (IECDI); Tobelem (LATPS), Cornejo, Raine (RUTA), Montes (RUTA-UTN); Collell, Laver, Jamarne (LEGLA); Sugar (LOALA)

Peer reviewers: Mss. Nunberg, Kikeri (CECPS), Mr. McMahon (LATAG)

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CS

Stuart ✓
Charlie ✓

THE WORLD BANK/IFC/MIGA
OFFICE MEMORANDUM

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FROM: Cora Shaw, Task Manager, LA2AG

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- Back to Office Report and Issues Memo

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Peer reviewers: Mss. Nunberg, Kikeri (CECPS), Mr. McMahon (LATAG)

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THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: November 1, 1991

TO: Files

FROM: John McIntire, LA2AG

EXTENSION: 31893

SUBJECT: EL SALVADOR--Agricultural Sector Reform and Investment Program (ASRIP) Appraisal Mission Debriefing Meeting--October 25, 1991

1. The above-referenced meeting was attended by Messrs/Mmes. Hans Binswanger, Tia Duer, John McIntire, Cora Shaw (LA2AG), Ulrich Lachler (LA2C2), and John Glenn (Consultant). The following details decisions made at this time.

2. Should the Bank finance construction of a building for Ministry of Agriculture and Livestock (MAG)? The option of construction of MAG's headquarters should be compared in terms of total expected lifetime building cost to that of renting and the costs of geographic dispersion of MAG's offices. The Bank could not finance purchase or renting of a building.

3. Project research and extension component:

a. A MAG study of the functions, work plan, staffing, and skills will be the basis of the new CENTA. A plan to recruit competitively all of the new CENTA's staff will be devised, based on the MAG study. The competitive recruitment will be done after a new salary structure has been announced for CENTA.

b. A twinning arrangement with an appropriate foreign institution for agricultural research and extension would be appropriate for the life of the project. This would provide long-term technical assistance for the development of the new CENTA.

c. There would be an average national target of 25% of women contact farmers (productores de enlace).

d. The recommendations from the study by Ernst Lutz (ENVPR) and CATIE with national collaborators would be taken into account in the design of research and extension on soil conservation. It should be noted that Mr. Lutz believes that the El Salvador study is the weakest of the regional studies presented at the recent workshop.

e. The size of the research and extension component will be determined at postappraisal.

4. Privatization: IRA's assets would be brought to the point of sale except in conflict areas.

5. <u>Funding of indemnifications for staff choosing voluntary retirement</u>:

   a. The law to approve payments for the voluntary retirement plan (retiro voluntario) has been approved by the President although not yet by the Legislative Assembly, and there is money from USAID for the purpose. It was agreed that voluntary retirement should not be limited to specific groups with the aim of retaining the best people in the government, as the best people would ultimately leave anyway and such a restriction would probably disrupt the process.

6. <u>The role of the IDB Institutional Strengthening Project</u> (PFI) will be in long-term sector planning in institutional development.pment. ASRIP will do short- and medium-term planning and implementation of institutional development activities.

7. <u>Relations with the Inter-American Institute for Cooperation in Agriculture (IICA)</u>: Ms. Shaw will consider the issues on a regional basis and make a recommendation for Mr. Binswanger's action.

cc: Messrs./Mmes. Binswanger, Abramovich, Duer, Shaw (LA2AG); Cooke, Lachler (LA2C2); Glenn (Consultant); Cornejo, Raine (RUTA)

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EL SALVADOR

PROYECTO DE REFORMA E INVERSION SECTORIAL AGROPECUARIA (PRISA) MISION DE EVALUACION (30 de Septiembre al 11 de Octubre de 1991) AYUDA DE MEMORIA

I. ANTECEDENTES

1. Una misión de evaluación del Banco Mundial (BM) visitó San Salvador, compuesta por los Señores/as: Cora Shaw (Jefe de Misión), Carlos Montoya (componente Privatización), Rogerio Pinto, Mariana Delbue y Abelardo Paniagua (componente Reforma), y Francisco Reifschneider y John Glenn (componente Investigación y Extensión). La misión fué acompañada por una misión del Banco Interamericano de Desarrollo compuesta por los Sres. Fernando Villamizar (Jefe de Misión), Alfonso Blandón y Rodrigo Tamayo, así como por los Sres. Martin Raine (RUTA), cuya presencia fué solicitada por el Gobierno de El Salvador (GOES) y el Sr. Eduardo Montes (RUTA-UTN).

II. OBJETIVOS

Los objetivos de la misión fueron los de evaluar los tres componentes del PRISA y acordar con el Gobierno de El Salvador (GOES) la condicionalidad inicial del préstamo. Esta condicionalidad incluye:

(a) la formulación preliminar de una Carta de Política de Desarrollo Sectorial;

(b) la formulación preliminar de un plan calendarizado de estimativos de retiro voluntario y de jubilación temprana o normal del personal;

(c) confirmación de que los ahorros salariales que se obtuvieran por el punto (b) se retendrían en el sector para su programa de reforma institucional;

(d) la formulación de una versión satisfactoria al Banco de la Ley de Creación del CENTA;

(e) acuerdo de que el proceso de creación y reclutamiento de personal del CENTA autónomo sería uniforme con el del MAG;

(f) acuerdo con el GOES de que si se requiriesen recursos adicionales para financiar (b) en el MAG, éstos estarían disponibles; y

(g) acuerdo sobre un plan de supervisión del proyecto propuesto.

Además, la misión buscó profundizar los logros obtenidos en la definición de la estructura del MAG y del CENTA hasta los niveles de entrega de servicios a los productores.

III. COMENTARIOS GENERALES

La misión estableció una comunicación franca y fluída con sus contrapartes nacionales en los tres componentes, y reconoce que fue gracias a la disponibilidad y el empeño de estos funcionarios que se haya progresado mancomunadamente en la definición de los componentes. A pesar de ésto, el progreso obtenido no fue suficiente para poder definir los componentes de Reforma e Investigación y Extensión con suficiente precisión como para poder evaluarlos en su totalidad. Las contrapartes solicitaron el apoyo de asistencia técnica para poder analizar la información requerida por ésta y misiones pasadas y definir estos componentes con más precisión. Por lo tanto, la misión acordó con sus contrapartes nacionales el programa de trabajo para poder completar esta labor, la asistencia técnica requerida con sus términos de referencia y sus fuente de financiamiento identificadas de manera preliminar, y que se detalla en los anexos respectivos a cada componente de este ayuda de memoria.

La misión informó que el Banco acordaría otorgar financiamiento retroactivo por 10 por ciento del monto del préstamo propuesto, el que se estima preliminarmente entre 30 y 34 millones de dólares. Se sugirió que el MAG comenzara a gestionar estos fondos a la brevedad.

IV. COMENTARIOS SOBRE LA CONDICIONALIDAD

Con respecto a ésta se logró lo siguiente:

(a) se completó la formulación preliminar de una Carta de Política de Desarrollo Sectorial;

(b) se discutió la formulación preliminar de un plan tentativo y calendarizado de metas de retiro voluntario y de jubilación temprana o normal del personal. El Sr. Ministro de Agricultura reiteró su categórica decisión de que no se contemplaban licenciamientos. De acuerdo a encuestas realizadas por el MAG, se identificaron 500 jubilaciones tempranas y 210 retiros voluntarios, para cuando se halle vigente la ley de indemnizaciones voluntarias, lo que se estima sería el primer trimestre del 1992;

(c) el Sr. Ministro de Hacienda acordó que los ahorros salariales que se obtuvieran por el punto (b) se retendrían en el sector para su programa de reforma institucional. En otras palabras, que se mantendría el techo presupuestario;

(d) se avanzó en la formulación de una versión satisfactoria al Banco de la Ley de Creación del CENTA mediante el análisis conjunto de la Ley y la entrega de sus comentarios al CENTA (ver anexo II, apéndice I);

(e) se acordó que el proceso de creación y reclutamiento de personal del CENTA autónomo no podría ser exactamente uniforme con el del MAG porque se trata de comenzar una nueva institución. Se acordó, en consecuencia, que el reclutamiento del personal del CENTA autónomo se haría por concursos específicos para cada tipo de cargo, diseñados para que sean objetivos y transparentes, y que se ofrecerían con prioridad al personal del MAG y luego, si fuera necesario, a candidatos externos. Paralelo a este proceso se elaborará la estructura interna del CENTA, su descripción de funciones y dotaciones óptimas, y su régimen de remuneraciones. Esta labor serviría de base para la elaboración de los concursos arriba mencionados y estará coordinado por un grupo de trabajo conformado por la DIPEI/OSPA y la UPI del CENTA.

(f) se acordó con el MAG de que solicitaría al Ministerio de Planificación que los recursos adicionales para financiar (b) en el MAG, deberían hacerse disponibles por presupuesto ordinario y ser prioritarios. No se pudo por el momento, sin embargo, asegurar la disponibilidad de recursos adicionales a los presupuestados, pero que una posibilidad para el año 1992 podría originarse en el proceso de arrastres (en negociación) y para el año 1993, los fondos en moneda local generados por el programa de Inversión en preparación por el BID, y por el PL-480 Titulo I;

(g) se estableció un plan de supervisión preliminar del componente de investigación y extensión (anexo III, apéndice II).

V. <u>COMENTARIOS Y RECOMENDACIONES SOBRE LOS COMPONENTES ESPECIFICOS</u>

Los anexos detallan los comentarios a los que se llegó en forma conjunta con las contrapartes nacionales sobre la evolución de cada componente y las recomendaciones al respecto, así como el listado de la información adicional indispensable para finalizar el diseño de cada componente. Las recomendaciones a subrayar son las siguientes:

<u>Privatización</u>: 1) se sugiere traspasar activos del IRA en zona de conflicto a la Comisión Nacional de Privatización hasta que se encuentre un momento más oportuno para su traspaso al sector privado. Sería además beneficioso obtener el aval de esta Comisión de las actividades de venta programados para el

futuro próximo;

2) se sugiere obtener una simple dispensa ("waiver") para poder vender activos del BFA construídos con financiamiento BID; y que éstos se ofrezcan a la venta al público en general.

Reforma:

1) se apoya fuertemente la recomendación surgida de la DIPEI de se que realice un taller con la participación de los Sres. Ministro, Viceministro, y el CTA para discutir y adoptar planes de acción estratégicos y lograr el consenso entre el despacho y los directores, sobre todo sobre las microestructuras del MAG y del CENTA.

2) se solicita que se dé el apoyo necesario a la DIPEI para que ejecute las labores de preparación de este componente que afecta a todo el MAG, incluído al CENTA pre-autónomo.

Investigación y Extensión:

1) que se sostenga el ritmo de progreso que se ha logrado en la definición del programa de trabajo de investigación, y que se dé prioridad al trabajo de elaborar la estructura orgánica del CENTA, con asistencia técnica adecuadamente seleccionada;

2) que se permita al servicio de extensión continuar progresando gradualmente, conforme se disponga de personal previamente capacitado y capacidad gerencial de manejar estas operaciones;

3) que se dé estabilidad de liderazgo al personal de extensión capacitado en la metodología del EDO para no perder la motivación que se ha logrado hasta el presente.

VI. COMENTARIOS FINALES

La misión agradece la colaboración y dedicación de los equipos de trabajo que se han constituído en el seno del MAG, así como a MIPLAN, al Ministerio de Hacienda, el PNUD y el PFI, y otras entidades involucradas.

La misión y el Gobierno acordaron hacer todo lo posible para mantener el calendario de procesamiento establecido para finalizar la evaluación del proyecto, a saber:

Diciembre 1991	El MAG enviará al Banco la información requerida para finalizar la evaluación del proyecto PRISA con dos semanas de anterioridad a la venida de una misión de post-evaluación;
Enero/Febrero 1992	Negociaciones con el Banco Mundial
Abril/Mayo 1992	Presentación al Directorio del Banco Mundial

Anexo I:	Privatización (1 apéndice con 2 anexos)
II:	Reforma del Ministerio de Agricultura (12 apéndices)
III:	Investigación y Extensión (2 apéndices)

borrador

1. El sector agropecuario ha experimentado, durante la década pasada, la crisis más profunda de la economía salvadoreña. En el período 1978-86, el índice global de la producción agropecuaria per-cápita se redujo en 29 por ciento. Las importaciones de productos agrícolas han aumentado y las exportaciones han disminuido. En los primeros años de la crisis, 1978/79 a 1984/85 el balance neto del sector sufrió un decrecimiento de 234 millones de colones (promedio anual). Se aumentaron además, las importaciones concesionarias de productos básicos que compitieron deslealmente con los productores domésticos. Los efectos sociales de esos acontecimientos económicos han sido dramáticos, registrándose sobre todo en altos índices de desempleo y desnutrición.

2. El manejo de las políticas macroeconómicas especialmente la politica cambiaria, comercial y tributaría fue el principal causante del pobre desempeño del sector. Estas politicas incidieron negativamente sobre la estructura de precios agropecuarios reales y desprotegieron al sector. Diversos estudios trataron de cuantificar sus efectos. De 1978 a 1988, los precios agropecuarios reales cayeron en promedio en 42%. Las tres politicas combinadas condujeron a que la protección efectiva del sector agropecuario era de -25% en 1985, mientras que la protección del sector industrial era de +27%, en el mismo año.

3. Sumado al efecto de las políticas macroeconómicas, el efecto de las políticas sectoriales fue tambien negativo. Las políticas sectoriales del modelo de desarrollo implementado en la última década trajeron consigo un incremento de la intervención estatal directa en el sector, mediante la ejecución de reformas estructurales en las que este modelo se apoyaba. Se incrementaron las acciones de comercialización por parte del Estado, los subsidios, los controles de precios y las restricciones al comercio. Se implementó una reforma agraria que estatizó parte de las tierras afectadas, se nacionalizó la banca, se profundizaron las políticas de comercialización del Instituto Regulador de Abastecimientos (IRA) y se nacionalizó el comercio internacional del azúcar y del café. En general, las políticas sectoriales, contribuyeron también, a reducir la rentabilidad del sector y a desestimular la inversión en el agro.

4. El sector público agropecuario se adecuó a apoyar el proyecto de reforma agraria y en general el modelo intervencionista de la década pasada. Se realizaron tres reestructuraciones profundas en menos de diez años. Estos cambios dejaron al Ministerio de Agricultura y Ganadería desorganizado y descapitalizado de recursos tanto humanos como financieros. Sumado a esto, el financiamiento del conflicto armado que ha vivido el pais en la última década, y la crisis económica hicieron que se redujera el gasto público total en agricultura en 58%, en términos reales, de 1985 a 1990. Además, se redujo drásticamente la proporción del gasto dedicado a inversión. El presupuesto de inversión de las unidades

centralizadas se redujo en 43% en el mismo período. De los gastos de funcionamiento se incrementó la proporción dedicada al pago de remuneraciones y salarios de 88% en 1985 a 92% en 1990, dejando solamente un 8% para la operación del Ministerio.

5. La situación del personal es igualmente caótica. El Ministerio es grande en relación al personal que labora en él, pero muy débil en cuanto a su capacidad de ejecutar proyectos, transmitir nuevas tecnologías y en fin, para influir positivamente en el desempeño del sector. El personal está desigualmente distribuido de acuerdo a su calidad y formación. Existe un desbalance entre los técnicos, que son la minoría, y las personas que por su insuficiente y/o inapropiada formación están ubicadas en puestos burocráticos. Como ejemplo, en el Centro de Tecnología Agrícola (CENTA), institución encargada de la investigación y transferencia de tecnología, la relación de técnicos a personal administrativo es de 1 a 6.

6. En junio de 1989, al inicio de la administración del Presidente Alfredo Cristiani, existía un reconocimiento que la ventaja comparativa de El Salvador, aunque obscurecida por distorsiones, está en el sector agropecuario, por lo que, la reactivación de la economía, en el corto plazo, tendría que estar fundamentada en la reactivación del sector agropecuario. Sin embargo, también se tenía el convencimiento de que esa reactivación requería de cambios substanciales en la conducción de la política económica.

7. En este estado de cosas, el Gobierno del Presidente Cristiani, ha iniciado el Plan de Desarrollo Económico y Social 1989-94. El Plan tiene dos objetivos fundamentales: (i) crear las condiciones necesarias para alcanzar un desarrollo sostenido y (ii) mejorar el bienestar y los niveles de vida de la población, especialmente de la que vive en extrema pobreza, como el medio para alcanzar una paz duradera.

8. La estrategia de acción comprendió, en el corto plazo, un Programa de Estabilización apoyado por un acuerdo de stand-by con el Fondo Monetario Internacional, aprobado en agosto de 1990. El Programa produjo resultados positivos, mejores de los proyectados, a pesar del empeoramiento de las condiciones imperantes internas y externas. Además, en el mediano plazo, el Plan comprende un Programa de Reorientación Económica. Para ejecutar su programa de reformas, el Gobierno de El Salvador, solicitó la asistencia técnica y el apoyo financiero de Banco Mundial. La solicitud fue aprobada el 17 de enero de 1991, mediante la firma de la carta de entendimiento del Préstamo de Ajuste Estructural (SAL).

9. La implementación del Programa comprende el compromiso del Gobierno de ejecutar reformas en las siguientes áreas: (i) política comercial, (ii) administración pública, (iii) política monetaria y de tasas de interés, (iv) reformas del sector financiero, (v) reformas del sector agropecuario, y (vi) programas sociales.

10. Para el sector agropecuario existe el compromiso de implementar reformas en el area de políticas macroeconómicas, políticas sectoriales, reorientación de programas y proyectos. Estas reformas están contenidas en la Estrategia Sectorial Agropecuaria 1989-94 que es coherente y consistente con el Plan de Desarrollo Económico y Social 1989-94 y con los compromisos adquridos por el Gobierno con el Banco Mundial en el acuerdo del SAL. Las reformas deben estar apoyadas por un marco institucional eficiente y un marco legal consistentes con los objetivos generales. El exito de las reformas dependerá en gran medida de la capacidad que se tenga para reorientar y racionalizar el gasto público hacia usos más eficientes, por lo tanto, la reorientación del gasto se constituye en un objetivo primordial.

11. Las politicas más importantes de la Estrategia Sectorial Agropecuaria se señalan a continuación:

a) Política macroeconómica.

El objetivo es mantener una política macroeconómica sin distorsiones que no discrimine en contra de la agricultura. El Ministerio deberá velar constantemente por que se mantenga un tipo de cambio realista; una política comercial que proporcione niveles similares de protección entre sectores y entre productos y que tienda a eliminar las restricciones no arancelarias al comercio exterior; y una política tributaria que no dependa demasiado en gravámenes sobre los bienes de agroexportación. Estos tres instrumentos determinan la política de precios agropecuarios, la cual ha sido, en el pasado, sumamente desfavorable desde el punto de vista de los productores y ha conducido a ineficiencias en la asignación de los recursos económicos.

b) Política de precios de granos básicos y comercialización.

Con la nueva politica de precios de granos básicos se han eliminado los controles de precios y los precios de garantía. Se ha establecido el mecanismo de Bandas de Precios para el maíz y el arroz con una moderada protección arancelaria, congruente con la política arancelaria nacional. En el corto plazo, se establecerá para el sorgo. Se han eliminado la mayoría de restricciones al libre comercio y se busca tener una zona de libre comercio en toda el area Centroamericana. Se ha eliminado la intervención estatal directa en la comercialización de estos productos y se tiene un plan de privatización de las instalaciones de comercialización del IRA y del BFA.

c) Política de Investigación, Transferencia de Tecnología y Asistencia Técnica.

La política nacional de desarrollo tecnológico agropecuario, dirigirá los esfuerzos a identificar las prioridades de investigación del país en el corto, mediano y largo plazo, estableciendo, con el apoyo de los centros privados, el Sistema Nacional de Investigación.

La nueva política plantea el logro de una estructura de investigación eficiente y un programa de transferencia y asistencia técnica fortalecido, orientado fundamentalmente, a favor de los pequeños productores y, en cuanto a rubros, a los granos básicos, la ganadería y el subsector forestal. Una atención preferencial también será brindada a aquellas instituciones de carácter privado especializadas en la investigación y transferencia de tecnología para los productos tradicionales y no tradicionales de exportación.

La investigación dirigida a los pequeños productores, debe conducir a recomendaciones técnicas sencillas, de bajo costo y que induzcan al agricultor a utilizar los recursos disponibles en su medio.

Se ha reestablecido el servicio de extensión a traves de la metodología de Extensión Dirigida a Objetivos (EDO). El servicio está dirigido a pequeños y medianos productores a los cuales se les llevarán mensajes que incorporen tecnologías sencillas y fáciles de adoptar. El servicio incorpora a la mujer rural como productora.

El proceso de integración de la investigación y extensión se consolidará en el corto plazo, mediante la creación de una organización descentralizada y de derecho público fundamentada en la actual estructura del Centro de Tecnología Agrícola (CENTA). La creación de esta nueva institución constituye un componente fundamental de la nueva Política de Reforma Institucional, que contempla, además, la efectiva integración de las actividades de investigación, extensión y capacitación agrícola, ganadera y forestal.

d) Política de Riego

Es necesario lograr la mayor eficiencia posible en la operación y mantenimiento de la infraestructura ya existente, iniciando el proceso con una rehabilitación y mejora de la infraestructura de riego que está deteriorada o subutilizada. A su vez, se buscará que los gastos en infraestructura se financien por medio de un sistema tarifario que refleje el costo de suministro del recurso. Se impulsará una participación más activa de los usuarios individuales y de las asociaciones de regantes en la administración de la infraestructura hidráulica. La administración de los distritos de riego y avenamiento (que incluyen los costos de operación y el mantenimiento de los sistemas de riego) será transferida a los usuarios.

En materia de nuevas inversiones, la atención se concentrará en pequeños proyectos y microsistemas de riego. En el diseño definitivo y en la ejecución de esta política se buscará la participación activa de los usuarios y de las diferentes instancias públicas y privadas que tienen competencia con el uso del recurso agua, dado que su manejo tendrá un criterio nacional y de largo alcance.

e) Política Crediticia.

El Banco de Fomento Agropecuario de El Salvador (BFA) se especializará en las acciones que justifican su existencia, es decir, en el crédito de capitalización que permite ampliar la capacidad productiva y en el financiamiento a los pequeños y medianos agricultores, retirándose de las actividades extra bancarias como la importación de insumos agrícolas y la comercialización de bienes.

Las tasas de interés aplicables a los créditos del sector, se han igualado a las de la banca comercial, eliminando con ello el ineficiente subsidio que se otorgaba por está vía. Lo anterior implica que será necesario la reorganización de las instituciones estatales de crédito agropecuario a fin de asegurarle un crédito ágil, oportuno y con la suficiente cobertura (crédito de inversión) al productor, lo cual es más importante que el subsidio vía tasas de interés. Lo anterior implica una redefinición de la clientela de la banca de fomento estatal, de los plazos y una delimitación con respecto al papel de la banca comercial.

Por otra parte, se está estudiando la posibilidad de contar con los recursos crediticios necesarios para que los pequeños productores organizados, las cooperativas y los trabajadores públicos indemnizados puedan participar en la adquisición de la infraestructura de almacenamiento y transformación que será privatizada.

f) Política de Sanidad Agropecuaria

Con esta política se pretende reducir las pérdidas económicas derivadas de factores de índole fito y zoosanitario y formular y aplicar la normatividad legal para el control de calidad de los productos e insumos agropecuarios para fortalecer la política de promoción de exportaciones y apertura comercial.

impulsada a nivel global por el gobierno, en el entendido que para poder penetrar los mercados externos, es crucial el establecimiento de controles que permitan garantizar la calidad del producto nacional.

Se pretende actualizar el marco regulatorio sobre el uso de insumos agropecuarios; la adopción del Código Internacional de Conducta sobre el uso de plaguicidas; hacer efectivo el cumplimiento de la legislación fito-zoosanitaria, mediante el fortalecimiento institucional de la Dirección de Sanidad Agropecuaria. Además existe ya un acuerdo de armonización de sistemas regionales de sanidad agropecuaria.

g) Estrategia de Recuperación, Explotación Racional y Conservación de los Recursos Naturales y del Medio Ambiente.

El programa se enfocará en cuatro áreas de acción básicas:

i) Reorganizar el marco institucional para lo cual se ha comenzado por crear el Consejo Nacional del Medio Ambiente (CONAMA), del cual son miembros todos los Ministros de Estado, y su Secretaría Tecnica, cuyo objetivo principal es velar por la protección, mejora y conservación del medio ambiente. En congruencia con dicho objetivo, la tarea prioritaria de la secretaría técnica del CONAMA consistirá en diseñar la estrategia nacional de protección del medio ambiente y el programa de acción conjunta en estrecha colaboración y coordinación con organismos públicos, privados y organismos ambientalistas no gubernamentales.

ii) Revisar el marco legal; Una tarea urgente es la de revisar, actualizar y unificar toda la legislación concerniente al medio ambiente. Esto incluirá, las Leyes del Agua, Desechos Industriales y la Ley Forestal. El objetivo fundamental es establecer el código ambiental y su regulación, así como los mecanismos que serán utilizados para asegurar su cumplimiento.

iii) Promover la programas tendientes a resolver problemas fundamentales como la conservación del suelo, reforestación, recuperación de lagos, rios, espacios marinas, uso racional del agua, conservación de parques nacionales, etc.

iv) Desarrollar un programa de educación ecológicaos esfuerzos anteriormente descritos, se complementarán con un plan maestro sobre el uso correcto y la protección del medio ambiente, en cuya aplicación se buscará la participación de escolares, campesinos y público en general.

Como complemento a las cuatro áreas especificadas, se ha buscado el apoyo de organismos internacionales para que colaboren en la asesoría de políticas y estrategias ambientales y en la dotación de recursos para la rehabilitación y protección de zonas ecológicamente degradadas. A su vez, se diseñarán proyectos que permitan intercambiar una parte de la deuda externa del país por inversiones que contribuyan a la protección del medio ambiente.

h) Política de Reforma Institucional.

Reestructurar el sector público agropecuario para dotarlo de la capacidad de cumplir con los objetivos propuestos: velar porque se mantenga un marco de política que permita el desarrollo eficiente del sector, prestar servicios al pequeño y mediano productor, y velar constantemente por la recuperación, explotación racional y conservación de los recursos naturales y el medio ambiente. Dentro de la nueva concepción el MAG, debe ser un ente promotor del desarrollo agropecuario, normador y no interventor, para contribuir a la reactivación del sector y por consiguiente, a la erradicación de la extrema pobreza en el área rural.

La orientación general de la reestructuración del sector público agropecuario debe ser:

i. Reducir hasta lograr eliminar la intervención estatal directa que se ha dado en los diferentes mercados que afectan el desempeño del sector controlando el comercio exterior, los precios y los salarios, y otorgando líneas especiales de crédito a determinados productos en determinado tiempo.

ii. Modernizar el sector Público Agropecuario por medio del establecimiento de sistemas administrativos, contables y de personal. Además, es necesario llevar a cabo una consolidación real y financiera de las múltiples instituciones públicas, financieras y no financieras que están encargadas de las distintas tareas en el sector agropecuario. La consolidación real servirá para eliminar redundancias de programas y gastos, la consolidación financiera es necesaria para poder determinar el tamaño del déficit global del sector y reorientar el gasto hacia usos más productivos.

iii. Readecuar el tamaño del Sector Público Agropecuario, eliminar gradualmente las distorsiones salariales existentes y mejorar el nivel técnico académico del personal.

iv. Fortalecer la capacidad del Ministerio para analizar, formular, evaluar y proponer políticas macroeconomicas y sectoriales; recopilar y divulgar información pertinente al sector que facilite la toma de decisiones. Fortalecer las dependencias normativas como las encargadas de vigilar la explotación racional y la conservación de los recursos naturales, y el control fito y zoosanitario.

v. Fortalecer y orientar el quehacer de las dependencias descentralizadas como las encargadas de generar y transferir tecnología agropecuaria; brindar servicios de banca de fomento agropecuario; y de consolidación de la reforma agraria ejecutando políticas que inciden sobre los cambios en la estructura y régimen de tenencia de la tierra.

12. Al momento se ha avanzado mucho especialmente en lo que se refiere a los cambios que era necesario llevar a cabo en política macroeconómica y sectorial. Estos cambios, permitieron que el sector creciera en 7.4% en términos reales durante 1990 siendo el sector más dinámico de la economía en el mismo año. Casi nada se ha podido avanzar, en el campo institucional y legal. Para alcanzar un desarrollo sostenido, se hace necesario por un lado, ejecutar proyectos de inversión en áreas prioritarias como: investigación y transferencia de tecnología, sanidad agropecuaria, riego, recursos naturales y medio ambiente; y por otro, realizando los cambios institucionales y legales que permitan consolidar las reformas para lograr un crecimiento sustentable en el mediano y largo plazo para lograr mejorar el nivel de vida de la población rural.

13. En este contexto se ha solicitado un préstamo al Banco Mundial...

The World Bank
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL DEVELOPMENT ASSOCIATION

1818 H Street, N.W.
Washington, D.C. 20433
U.S.A.

(202) 477-1234
Cable Address: INTBAFRAD
Cable Address: INDEVAS

Washington, D.C., 4 de noviembre de 1991

DRAFT

Excelentísimo Sr. Ing. Antonio Cabrales
Ministro de Agricultura y Ganadería
Ministerio de Agricultura y Ganadería
San Salvador
El Salvador

Señor Ministro:

Tengo el agrado de dirigirme a Ud. para agradecerle la recepción de la cual fue objecto nuestra misión de evaluación del Proyecto de Reforma e Inversión Sectorial Agropecuario (PRISA) que visitó San Salvador del 30 de Septiembre al 11 de Octubre del corriente año. Desearía también confirmar el ayuda de memoria dejado por la misión y expresarle nuestra preocupación por la ausencia de parte de la información requerida por misiones anteriores, lo que impidió a la misión definir y dimensionar el componente de investigación y extensión agropecuaria. Cabe señalar que este retraso influenciará el ritmo de procesamiento y por lo tanto de desembolso de este propuesto préstamo.

Como le informó la misión antes de su partida, la misión y sus contrapartes del MAG y CENTA llegaron a un consenso en la definición del programa de trabajo de los próximos meses, que fué plasmado en el ayuda de memoria. Esperamos que el ímpetu logrado durante esta estrecha colaboración no decaerá y en este sentido nos alienta el reciente nombramiento al cargo de Coordinador del PRISA. Encomendaríamos que el Coordinador del PRISA recibiera todo el apoyo necesario para cumplir el calendario de trabajo convenido.

Queremos también informarle que el Banco no tendría objeción en financiar la construcción de una sede para el Ministerio, si se justificara que ésta sería una opción financieramente más ventajosa que, por ejemplo, el alquiler o la compra de un edificio. Le sugerimos realizar un estudio para comparar estas opciones. El Banco no estaría en medida, sin embargo, de financiar la compra o el alquiler de esta sede.

Finalmente, quisiera someter a su consideración una opción de asistencia técnica para el CENTA autónomo. Dado que se estima que en los primeros años de funcionamiento como ente autónomo, el CENTA carecerá de un plantel completo de personal calificado, sería una opción de asistencia técnica posible entrar en un convenio con una institución melliza de conocida reputación (un "twinning"), para que ésta reemplace temporariamente al personal en capacitación por un período definido. Este período podría variar entre 3 (período mínimo requerido antes de que se finalicen los primeros posgrados) a 6 años (años de duración del PRISA), dependiendo de las necesidades y modalidades de financiamiento de este "twinning". Se podría explorar si este convenio podría financiarse por un convenio bilateral, lo que creemos sería menos oneroso, o por el proyecto. Solicitamos su reacción ante esta opción, y recomendamos la discuta con el Sr. Ligocki, de larga trayectoria en el EMBRAPA, que llegará como consultor internacional el 11 de Noviembre de 1991 para asistir al CENTA en la elaboración de su microestructura y programa de trabajo. Ejemplos de instituciones "mellizas" del CENTA, que realizan investigación agropecuaria en zonas tropicales y sub-tropicales, que podrían ser candidatas a un acuerdo de este tipo serían el EMBRAPA en Brasil, INIFAP en México, y el ICA en Colombia.

Aprovecho la oportunidad para expresarle el testimonio de mi más distinguida consideración,

Hans Binswanger
Jefe de Division, Agricultura
Departamento II
Región de América Latina y el Caribe

Annex IV

The World Bank
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL DEVELOPMENT ASSOCIATION

1818 H Street, N.W.
Washington, D.C. 20433
U.S.A.

(202) 477-1234
Cable Address: INTBAFRAD
Cable Address: INDEVAS

Attachment II

Washington, D.C., 5 de noviembre de 1991

DRAFT

Excelentísima Sra. Lic. Mirna Liévano de Marques
Ministro de Planificación y Coordinación del Desarrollo Económico
Ministerio de Planificación y Coordinación del Desarrollo Económico
Casa Presidencial
San Salvador
El Salvador

Señora Ministro:

Tengo el agrado de dirigirme a Ud. para agradecer su cordial recibimiento y apoyo brindado a la misión de evaluación del Proyecto de Reforma e Inversión Sectorial Agropecuario (PRISA) que visitó El Salvador del 30 de Septiembre al 11 de Octubre de 1991. Me permito también remitirle el ayuda de memoria de la misión.

Quisiera reiterarle nuestra propuesta de transferir los activos del IRA en zonas de conflicto a otra institución, como la Comisión Nacional de Privatización, hasta que se mejoren sus posibilidades de venta. Esto facilitaría al proceso hacia la derogación de la Ley de Creación del IRA.

Aprovecho la ocasión para expresarle el testimonio de mi más alta y distinguida consideración,

Hans Binswanger,
Jefe de Division, Agricultura
Departamento II
Región América Latina y El Caribe

El Salvador

Programa de Reforma e Inversión Sectorial Agrícola, PRISA, (ES-0033)

**AYUDA MEMORIA DE MISION DE ORIENTACION III
(2 al 11 de octubre, 1.991)**

I. ANTECEDENTES

Una Misión del Banco Interamericano de Desarrollo (BID) visitó El Salvador entre las fechas indicadas, habiendo sido integrada por los siguientes miembros del equipo de proyecto: Srs. Fernando Villamizar (ENP/AGR, Jefe del Equipo), quien la presidió, Alfonso Blandón (ENP/AGR), Rodrigo Tamayo, Oficial de Operaciones, así como el Sr. Luis Oberti, Especialista Agrícola de la Representación del Banco en El Salvador. Adicionalmente se unió a la Misión el Sr. Luis Ampuero, del Centro de Programas y Proyectos de Inversión (CEPPI) del IICA, quien ha sido designado Coordinador de la Misión de Preparación de los tres componentes a cargo del BID.

La Misión coincidió durante su estadía con una Misión de Evaluación del Banco Mundial, lo cual permitió coordinar acciones principalmente entre el Componente de Privatización y el de Apoyo a la Comercialización Privada de Granos Básicos; al igual que entre la reorganización del MAG y la nueva estructura para la sanidad agropecuaria.

El propósito de la Misión era darle continuidad al proceso de seguimiento de los tres Componentes a cargo del BID, aprovechar su estadía para coordinar con los funcionarios del Banco Mundial lo pertinente al Programa PRISA y para alistar la Misión de Reconocimiento a ser realizada en el marco de preparación de proyectos del Convenio BID/IICA.

II. COMENTARIOS DETALLADOS SOBRE LOS COMPONENTES

A. Apoyo a la Comercialización Privada de Granos Básicos

Se recibieron comentarios de funcionarios de la Unidad de Banda de Precios respecto al Informe Final del Consultor Richard Graham, presentado el pasado 12 de julio; así como la información adicional sobre documentos preparados por Consultores de la FAO en el área de capacitación (Edgar Morales y Hugo Ramos) y el Servicio de Información de Precios (J. Alfonso Sell Cantalapiedra). La existencia de estos documentos, así como el resultado de los trabajos adicionales que ha realizado el Grupo de Transición, permiten a la Misión solicitar las siguientes acciones:

1. Ampliar y/o definir el marco legal del componente para aclarar la libertad de acción de las empresas propuestas para la comercialización de granos básicos. El Grupo de Transición, encargado de la preparación de este Componente, debe disponer de los servicios de un abogado que analice el impacto, de por lo menos los siguientes aspectos: (a) la legislación contra el acaparamiento; (b) los antecedentes y operación del certificado de depósito negociable; (c) los antecedentes y operación del bono de prenda; (d) el concepto de empresa mercantil, su conformación, requisitos para operar, su relación con asociaciones y cooperativas de productores.

2. Revisar y adaptar las recomendaciones de los consultores de FAO, bajo criterios de reducción del gasto público; considerándose prudencial mantener la asignación de personal incremental y el costo del equipo a niveles apropiados.

3. Determinar las fuentes del crédito para inversión en instalaciones de mercadeo y aclarar los mecanismos de acceso al crédito para capital de trabajo de las futuras empresas.

4. Precisar los objetivos y metas del componente, principalmente lo relativo al vínculo del mismo con el componente de privatización a cargo del Banco Mundial; así como con los programas financiados por la USAID y aquellos a cargo de la FAO. Esto es mas importante para el caso de la capacitación tanto en el país como en el exterior y su fecha de iniciación, siendo prudencial principiarlo desde el momento en que se identifiquen las asociaciones y cooperativas que pudieran ser eventualmente seleccionadas. En esta etapa la capacitación se orientaría a facilitar su organización, negociación y definición del perfil de capacitación en servicio.

B. <u>Rehabilitación de los Distritos de Riego</u>

1. La Misión tuvo conocimiento del avance en la preparación del componente. Por un lado se cuenta con los consultores financiados por el FOSEP para apoyar las acciones de la DRD y por otro lado se dispone de fondos de la AID para adelantar el proceso de titulación en el Distrito Atiocoyo.

Este avance permite proponer la conveniencia de condicionar la próxima Misión de Análisis a las siguientes medidas:

(a) disponer del "padrón de usuarios" para los Distritos de Riego. Esta condicionalidad sería la comprobación de que se han solucionado los conflictos de tenencia de tierra existentes en el Distrito.

(b) En forma complementaria con la condicionalidad anterior, haber tomado las medidas legales e institucionales sobre las "Asociaciones de Regantes" que serían beneficiarias de la transferencia de la administración de los actuales Distritos de Riego. La Misión fue informada de que un paso previo para el establecimiento de estas Asociaciones sería la derogación o reforma de las leyes de creación de los Distritos de Riego y Avenamiento de Atiocoyo y Zapotitan, decisión que requiere realizar consultas legales, con especialistas en la materia.

(c) Como complemento a la creación de las "Asociaciones de Regantes", se requiere que éstas tengan capacidad legal para planificar la operación, mantenimiento y conservación de las obras y para el cobro del 100% de las tarifas correspondientes. Así mismo, se deberán haber establecido las condiciones de cobro de las cuotas de amortización de las inversiones, ajustadas a las disposiciones legales pertinentes.

2. Proyecto Lempa-Acahuapa. La Misión fue informada del interés de las autoridades del Ministerio de Agricultura de plantear dentro de este componente el financiamiento complementario para cubrir los sobrecostos de las inversiones del Proyecto Lempa-Acahuapa que actualmente se están ejecutando con financiamiento parcial del BID (Préstamo 802/SF-ES). Los fondos adicionales serían destinados a la terminación de las obras de adecuación parcelaria. Estas obras han sido consideradas indispensables desde la aprobación del Préstamo para garantizar la pronta y eficiente utilización de los suelos y el agua del Distrito. Con base en la documentación pertinente, el BID confirmaría la posición definitiva sobre la ampliación del financiamiento para este Proyecto. A su vez se recomienda realizar las consultas con las Agencias correspondientes del Gobierno Salvadoreño, para modificar el monto solicitado.

C. Sanidad Animal y Vegetal

1. Sanidad Animal. La Misión tiene confirmación de la entrega del Informe del Componente de Sanidad Animal por el Consultor Carlos Franco, para finales de octubre 1991; una vez esté disponible se remitirá para su revisión e incorporación en el proceso de preparación del PRISA.

2. Sanidad Vegetal. El informe del Consultor Edward Stubbs ha sido revisado por la División de Defensa Agropecuaria quienes consideran que falta información para la preparación del Componente. Por esta razón se reconoció la necesidad de complementar este informe, incluyendo el costo de campañas fitosanitarias. Como parte del apoyo a estas labores, se ha previsto la participación del IICA/CEPPI (con fondos de la ATN/SF-3185--Convenio BID-IICA) en la preparación del documento del proyecto; además, esta actividad se vería respaldada por el Sr. Alberto Perdomo, de la Representación del IICA en El Salvador. Así mismo, se considera conveniente que la DDA aproveche las experiencias de la OIRSA, institución que estaría dispuesta a colaborar.

3. Como resultado de la reestructuración del MAG se traspasará parte del personal, instalaciones y equipos destinados a investigación y transferencia de tecnología del CDG al CENTA, y otra parte se integraría con la DDA. A fin de dar continuidad a los objetivos del programa a cargo del CDG, institución ejecutora de un Préstamo del BID (Préstamo 349/OC-ES) y por continuar vigente reiteramos la recomendación de la Ayuda Memoria de la Misión de Orientación de Diciembre 1990, que señalaba que: "Es indispensable estudiar cuidadosamente la incidencia de trasladar las instalaciones y/o equipos a otras dependencias del MAG, bajo la propuesta

reestructuración, toda vez que estas modificaciones pueden restarle capacidad a la Dirección de Sanidad Animal del Centro de Desarrollo Ganadero para participar en el PRISA".

4. Se debe dar prioridad a la terminación de los diseños arquitectónicos de este Componente, a fin de disponer durante la Misión de Análisis de una adecuada estimación de costos. Se entiende que los arquitectos del MAG están alistando una parte de esta actividad, esperándose que el MAG envíe al Banco una solicitud para la contratación de otro arquitecto que terminaría este trabajo, con cargo a los fondos disponibles del PPF .

III. OTROS ASPECTOS RELACIONADOS CON LA PREPARACION DEL PRISA

1. Con el propósito de revisar la etapa de implantación de recomendaciones de la Cooperación Técnica del Proyecto de Fortalecimiento Institucional (PFI), las autoridades del BID han programado una Misión de Revisión que se realizaría en el curso de las próximas semanas. Esta actividad permitirá aprobar los informes de la etapa en ejecución y definir las siguientes etapas del Proyecto. También permitirá la coordinación y/o cooperación con el Componente de Reforma y Fortalecimiento Institucional del MAG, a cargo del Banco Mundial.

2. Está previsto que la Misión indicada se complemente con la Misión de Reconocimiento IICA/BID, para configurar la fase final de preparación de los tres componentes a cargo del BID. Para esta nueva fase es indispensable contar con la documentación relacionada con los componentes, precisar sus objetivos y metas, la coordinación y vinculo de los mismos con los componentes a cargo del Banco Mundial y con programas financiados por la USAID y otras instituciones donantes. Esto va a asegurar los elementos necesarios para cumplir con el calendario de realizar la Misión de Análisis del Banco, programada oficialmente para la primera quincena del mes de diciembre.

3. La Misión destaca especialmente el cumplimiento de las condiciones que se han indicado en el componente de rehabilitación de los Distritos de Riego, las cuales conforman el paso critico en el proceso de preparación del PRISA.

IV. COMENTARIO FINAL

La Misión agradece la amplia colaboración de los funcionarios salvadoreños con quienes se revisaron los asuntos pendientes.

PERSONAS ENTREVISTADAS

Nombre	Entidad	Cargo
Ing. Salvador Urrutia	MAG	Gerente Operaciones
Lic. Mercedes LLort	OSPA	Directora Técnica.
Ing. Mario Zabaleta	MAG	Director Recursos Naturales
Ing. Julio Cruz	PRISA	Coordinador
Ing. Joaquín Florez	Pry.Lempa	Director
Ing. Alirio Mendoza	" "	Ingeniero
Lic. Aristides Magaña	DDA	Planificación
Lic Ma. Emma de Escobar	DDA	"
Lic. Ricardo Guevara	MAG	Unidad Banda de Precios
Ing. Mariano Olazabal	IICA	Representante
Ing. Alberto Perdomo	"	Técnico Sanidad Vegetal
Lic. José Louis	PFI	Coordinador
Lic. Julio Ramos Ch.		Consultor Riego
Ing. Eduardo Montes U.	RUTA	Coordinador Nacional RUTA/UNAT
Mr. Mike Wise	USAID	Jefe Programa Desarrollo Rural
Ing. Jose Tubino	FAO	Representante
Ing. Carlos E. Mate	OIRSA	Representante
Ing. Miguel A. Granillo	OIRSA	Experto Planificación
Ing. Armando Alas	OIRSA	Experto San. Animal
Ing. Norbelto E. Urbina	OIRSA	Experto San. Vegetal
DV. Julio E.Calderón	OIRSA	Experto San. Animal

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The World Bank

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Report No. P-5447-ES

REPORT AND RECOMMENDATION

OF THE

PRESIDENT OF THE

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

TO THE

EXECUTIVE DIRECTORS

ON A

PROPOSED STRUCTURAL ADJUSTMENT LOAN

IN AN AMOUNT EQUIVALENT TO US$75.0 MILLION

TO THE

REPUBLIC OF EL SALVADOR

JANUARY 17, 1991

CURRENCY EQUIVALENTS
(as of January 15, 1991)

Currency Unit	=	Colon (C)
US$ 1.0	=	C 8.08
C 1.0	=	US$ 0.12

FISCAL YEAR

January 1 to December 31, 1991

ABBREVIATIONS

ANDA	=	National Water and Sewage Administration
ANTEL	=	National Telecommunications Administration
BFA	=	Agricultural Development Bank
CABEI	=	Central American Bank for Economic Integration
CACM	=	Central American Common Market
CEL	=	Rio Lempa Electric Utility Company
CEPA	=	Autonomous Ports Commission
COPAL	=	Cooperative for cotton ginning, marketing and export
IDB	=	Inter-American Development Bank
INAZUCAR	=	National Sugar Institute
INCAFE	=	National Coffee Institute
IRA	=	Institute for regulation of food supplies
ISIC	=	Coffee Research Institute
ISSS	=	Salvadoran Social Security Institute
RUTA	=	Regional Unit for Technical Assistance
SIF	=	Social Investment Fund
SOE	=	Statement of Expenditures
TIBA	=	Basic lending rate (for loans maturing within 1 year)
TIBP	=	Basic deposit rate (for 180-day time deposits)
UNDP	=	United Nations Development Programme
USAID	=	United States Agency for International Development
VAT	=	Value-added Tax

EL SALVADOR

STRUCTURAL ADJUSTMENT LOAN

LOAN AND PROGRAM SUMMARY

Borrower:	Republic of El Salvador
Amount:	US$75.0 million equivalent
Executing Agency:	Government of El Salvador
Terms:	Repayment in 20 years, including five years of grace at the standard variable interest rate.
Description:	The proposed loan would support the Government's structural adjustment program, which is designed to (i) improve incentives to stimulate savings and investment in more efficient export oriented and import-substituting activities, (ii) increase tax enforcement capacity, (iii) improve the efficiency of financial intermediation, (iv) improve productivity in the agricultural sector, and (v) prevent a deterioration in the nutritional status of the poor during the adjustment process.
Project Benefits:	The adjustment program would promote export growth and diversification, a more efficient allocation of domestic resources, improved fiscal control and a reduction in absolute poverty. It also would improve El Salvador's creditworthiness, facilitating access to external finance needed for long-term sustainable growth.
Project Risks:	The principal risks are continued domestic political instability and potentially adverse developments in the international oil market. Two other risks are insufficient institutional capacity to carry out the complete program and inadequate external financing, should bilateral donors reduce their support.
Schedule of Disbursements:	The proceeds of the loan would be disbursed in three equal tranches of US$25 million equivalent each: the first tranche upon effectiveness (with retroactive financing of up to US$15 million), the second tranche after a satisfactory performance review around September 1991, and the third tranche after a satisfactory performance review to be held in the last quarter of CY92.
Appraisal Report:	This is a combined staff appraisal and President's Report

EL SALVADOR

STRUCTURAL ADJUSTMENT LOAN

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REPORT AND RECOMMENDATION OF THE PRESIDENT
OF THE
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
TO THE EXECUTIVE DIRECTORS ON
A PROPOSED STRUCTURAL ADJUSTMENT LOAN
IN AN AMOUNT EQUIVALENT TO US$75.0 MILLION
TO THE REPUBLIC OF EL SALVADOR

1. I submit the following report and recommendation on a proposed loan for the equivalent of US$75 million to the Republic of El Salvador. The loan would support a structural adjustment program aiming to achieve balanced and sustained economic growth and to reduce absolute poverty. The loan would have a term of 20 years, including 5 years of grace, with interest at the Bank's standard variable interest rates.

2. Between 1978 and 1985, El Salvador's real per-capita GDP dropped by 25% as a result of civil strife, capital flight, terms of trade shocks and inadequate economic policies. In October 1986, a severe earthquake struck the city of San Salvador, greatly damaging urban infrastructure and placing a heavy burden on public sector finances. Despite massive infusions of foreign aid and partial stabilization attempts, the economy did not recover from these shocks and continued to stagnate for the rest of the decade. By early 1989, serious balance of payments and fiscal disequilibria developed, and the authorities resorted to the accumulation of arrears with most external creditors, including the Bank, which suspended its disbursements to the country on April 18, 1989.

3. In June 1989, a new administration led by President Alfredo Cristiani assumed office and introduced a far-reaching economic reform program emphasizing the reactivation of growth and the reduction of absolute poverty as its top economic priorities, while initiating negotiations with the Farabundo Marti National Liberation Front in an attempt to achieve a peaceful solution to the decade-long civil conflict. Despite two severe setbacks -- a collapse of international coffee prices in June 1989 and a major urban guerrilla offensive in November 1989, the Government's economic program remained on course, attesting to the strong commitment to reform by El Salvador's policymakers. Soon after taking office, the Government also reinitiated debt service payments to the Bank and other creditors, clearing all overdue obligations to the Bank on January 31, 1990 and to the Inter-American Development Bank (IDB) in February 1990. The Board of the International Monetary Fund (IMF) approved an upper-tranche Stand-by program for El Salvador on August 27, 1990, and a Paris Club agreement was reached on September 17, 1990.

4. With the exception of a US$65 million Earthquake Reconstruction Loan approved on September 15, 1987, and modified on July 18, 1990, the Bank has not made any new loans to El Salvador since 1979. A Country Economic Memorandum on El Salvador (No. 7818-ES) was circulated to the Executive Directors in August 1989. The Government formally requested a SAL to support its stabilization and adjustment program during the 1989 Bank/Fund Annual Meetings.

PART I - THE ECONOMY

A. Background

5. With a current population of 5.2 million and a land surface of 21,000 square kilometers, El Salvador is one of the most densely populated countries in the Western Hemisphere. It has limited natural resources and no remaining agricultural frontier. In the 1960s and 1970s, rapid real GDP growth averaging 5.4% annually was made possible by favorable agricultural commodity prices, an expanding regional market for manufactured goods following the creation of the Central American Common Market and an accomodating international financial environment. Considerable improvements also took place in health, education and literacy standards. Nevertheless, by the end of the 1970s, El Salvador still remained a relatively poor country, with social indicators that continued to rank among the lowest in Latin America.

6. In 1979, El Salvador's simmering social and political tensions, exacerbated by an inflexible political system, erupted into an open civil war. At the same time, the external economic environment deteriorated sharply with the second oil price hike, a steep decline in world coffee prices, higher international interest rates and the contraction of the regional market for manufactured goods, as the other Central American trading partners experienced similar terms of trade shocks. These events led to severe macroeconomic imbalances, resulting in a drop of real GDP by 22% between 1978 and 1982. Economic stability was partially restored after 1982, but efforts to reactivate growth remained unsuccessful. In 1983-84, a stabilization program was carried out with IMF Stand-by support, leading to substantial reductions in the fiscal and balance of payments deficits. Fiscal retrenchment largely was achieved, however, through reductions in public investment and social sector expenditures, while the balance of payments gap was closed through more restrictive trade policies and increased external transfer inflows. This adjustment response did not augur well for future growth, which averaged less than 2% per annum for the rest of the decade.

7. A massive outflow of Salvadorean emigrants after 1980 (estimated at one million, or almost 20% of the population) helped relieve domestic population pressures and their remittances became an increasingly important credit item in the balance of payments. Private transfers, which represented less than 1% of GDP in 1980, have remained above 4% of GDP since 1986. Official grants also increased significantly, from less than 1% of GDP in 1980-81 to over 5% of GDP in 1986-89. A positive consequence of these inflows has been that El Salvador's total external debt burden remained relatively low compared to most other Latin American countries. (The total external debt reached close to US$1.8 billion in 1989, representing 33% of GDP, while total debt service represented 22% of exports (G&S) and 4% of GDP.) Despite this low debt burden, the inward-oriented interventionist policies of past administrations prevented a reactivation of economic growth and maintained the economy's vulnerability to destabilizing

shocks. In early 1989, a bad coffee harvest and expansionary fiscal policies led to a rapid decline in foreign exchange reserves and debt service to external and internal creditors was halted; by mid-year, total medium and long term external debt arrears reached US$165 million and disbursements from the Bank and IDB had been suspended.

8. The new Government led by President Alfredo Cristiani assumed office in June 1989 and introduced a comprehensive economic stabilization and structural adjustment program designed to create a more market-oriented and private sector led economy, capable of rapid sustained growth, while seeking to eliminate absolute poverty. The achievement of a negotiated end to the civil conflict also represented a top priority in the Government's policy agenda, and peace negotiations with the guerrilla forces began in September 1989. Soon after the program was introduced, however, the International Coffee Agreement collapsed, leading to a 45% fall in El Salvador's principal commodity export, and in November 1989, violence escalated, as the guerrillas launched a major armed offensive that resulted in considerable human and material losses. A further economic shock occurred in early 1990, when changing aid priorities and budgetary constraints prompted a US$ 50 million reduction in USAID's economic assistance to El Salvador. These events seriously disrupted the incipient stabilization process, but the Government's economic team remained in control and continued to pursue its reform program.

9. By December 31, 1989, the Government had succeeded in reducing the stock of outstanding medium and long term overdue obligations from US$ 165 million to US$ 109 million, with the intention of eliminating the remaining arrears by the end of 1990. Major economic reforms also were initiated: by mid-1990, the exchange rate was unified and floated, most non-tariff import barriers and price controls were eliminated and most tariff rates were reduced below a maximum of 35%, interest rates and public sector prices were raised, major tax reform legislation was passed through Congress and parastatal monopolies in the marketing of sugar, coffee and grains were abolished. An emergency social program was introduced to provide minimum incomes to the poor through a series of rural public works and municipal construction projects. Peace negotiations were resumed under United Nations auspices in April 1990, with six rounds of negotiations completed through November 1990. In August 1990, the IMF approved an upper-tranche Stand-by program for SDR 35.6 million, and in September 1990, a Paris Club agreement to reschedule US$135 million in outstanding arrears and upcoming obligations on favorable terms was concluded. Finally, on December 13, 1990, El Salvador became a signatory to the GATT.

B. Recent Economic Developments and Prospects

10. The economic policy measures taken by the Government since June 1989 have begun to yield important results: the Central Bank's index of economic activity points toward a significant reactivation of growth in 1990, with real GDP likely to increase by at least 2.5% (compared to growth rates of 1.6% and 1.1% in 1988-89). Agriculture and

commerce have been the main source of increased activity, with basic grains production heading toward a record harvest during the 1990-91 season. This reflects the relative price corrections induced by more flexible trade and exchange rate policies as well as favorable weather conditions. In real effective terms, the Colon has depreciated by 20% between December 1989 and November 1990. Exports have responded strongly to the trade measures: in the period from January to August 1990, the total value of merchandise exports increased by 11% compared to the same period in 1989, with the volume of sugar exports increasing by 88% and of coffee exports by 58% (which more than offsets the decline in international coffee prices). The value of non-traditional exports to countries outside Central America has been 60% higher over this period.

11. Merchandise imports also grew by 10% during the January-September 1990 period, however, so that the current account deficit (excluding grants) for the entire year may reach US$350 million (compared to US$465 million in 1989). The strong growth of imports is explained by the more liberalized trade regime and the faster than expected reactivation of economic growth. Nevertheless, the overall balance of payments situation has improved, as net international reserves have risen strongly during the second and third quarters of 1990, in conformance with the IMF Stand-by targets. The main cause for this improvement has been a substantial inflow of private capital and remittances, attracted by an improved business climate, tighter domestic credit policies and the liberalized exchange system.

12. The deceleration of inflation appears to have contributed to the improved confidence that motivated these inflows. The annual inflation rate fell from a peak of 30% in April 1990 to 20% in October. Furthermore, the annualized inflation rate during the six months ending in October 1990 has been about 10%. During that period, the floating Colon/US$ exchange rate rose by 5%, while the six-month commercial interest rate for colon deposits was maintained at 18%, yielding an annualized rate on the order of 8%-9% in dollar terms. The monetary aggregates, M-2 and M-3, grew by 24% and 25% over the last 12 months ending in September 1990, reversing the declining trend in real balances over the preceding three years. This process of disinflation resulted from the rigorous application of a restrictive monetary program, a tighter fiscal policy stance, less expansive public sector wage increases and an exceptional agricultural harvest.

13. The fiscal deficit declined significantly during the first nine months of 1990, partly as a result of the tax reforms introduced at the beginning of the year, but primarily through reduced spending. Current Central Government revenues increased by 22% during January-September 1990 relative to the revenues collected over the same period in 1989, or roughly equal to the average inflation rate prevailing over that period. In contrast, current Central Government spending increased by only 5.6% in nominal terms, while capital spending declined by 9.6%. This represents a 34% nominal decline of in the consolidated Central Government deficit (excluding grants) or a reduction of about 1.3% of

GDP. The rest of the nonfinancial public sector is expected to yield a small surplus of 0.1% of GDP. The authorities made important price adjustments during the year for services provided by the public sector enterprises, raising water and sewage service rates by 40% and 25%, telephone connection fees by 14%, and residential and commercial electricity rates by 45% and 30%. In October 1990, the Government responded to the current oil crisis by raising domestic consumer prices of oil and derivatives an average of 43%, corresponding to an average price of crude oil of US$31 per barrel. These deficit reducing measures should yield an overall non-financial public sector deficit of about 3.6% of GDP (compared to 5.9% in 1989), which is consistent with the 1990 Stand-by targets. The main concern in this area, however, is that tax revenues have remained below expected levels, so that the brunt of the adjustment was borne by further cuts in spending, which is already at very low levels.

14. In summary, the economy has stabilized considerably during 1990, with output growing above projected levels. In view of the ongoing Gulf crisis and still unsettled domestic conflict, this stability could be fragile, however. The economy's positive performance in 1990 was made possible by large inflows of private capital and remittances to finance the additional imports that helped sustain the higher output growth in a non-inflationary manner. A sudden revision of the public's exchange rate and inflationary expectations, due to unforeseen shocks, could lead to a rapid reversal of these flows. In the event of such a reversal, the authorities will have to be prepared to respond rapidly and decisively to prevent renewed destabilization. A major step in this direction was taken with the adoption of a unified, market-determined exchange system. Equally important will be the continued maintenance of sufficient fiscal and monetary control. The ability to maintain such control will depend critically on the Government's capacity to raise taxes and on allowing interest rates to adjust quickly in response to market pressures.

PART II - THE GOVERNMENT'S ADJUSTMENT PROGRAM

15. The stagnation of the Salvadorean economy throughout most of the 1980s was aggravated by adverse exogenous events, but the more fundamental factors were the widespread structural weaknesses of the economy and continuing civil strife. To reactivate economic growth, the Cristiani administration initiated a major stabilization and structural adjustment program in July 1989. This program aims to create a more liberalized, private-sector led economy and focuses on reforms in the external, fiscal, monetary, financial and agricultural sectors, with special attention on poverty alleviation.

A. The External Sector

16. As a small economy, El Salvador's best prospects for economic growth lie in the expansion of international trade. Yet during the 1980s, the economy became more closed: merchandise exports declined by about half in dollar terms between 1980 and 1989, and as a share of GDP, from 30% in the 1970s to less than 10% in 1989. Another key problem is the lack of export diversification: coffee accounts for over 50% of total merchandise exports, which has kept the economy highly vulnerable to international commodity price fluctuations. Despite the sharp decline in merchandise exports, imports rose slightly in dollar terms over 1980-89. This was made possible by increased transfer inflows as the economy increasingly relied on foreign assistance and the export of labor services to balance the current account.

Table I

Current Account of the Balance of Payments, 1980-89

	1980	1985	1986	1987	1988	1989
			(In US$ millions)			
Trade Balance	113.2	(266.2)	(180.0)	(403.2)	(398.1)	(664.8)
Merchandise Expts. (FOB)	1,075.3	695.1	754.9	590.9	608.8	496.5
o/w coffee	615.2	463.7	546.8	351.5	358.0	227.5
non-traditional 1	347.9	169.4	161.3	204.5	215.3	244.7
Merchandise Imports (IF)	962.1	961.3	934.9	994.1	1,006.9	1,161.3
Net Non-Factor Svcs.	(47.8)	7.0	29.0	92.0	63.0	82.0
Net Factor Income	(83.8)	(117.0)	(117.0)	(123.0)	(121.0)	(121.0)
o/w interest	(64.5)	(85.0)	(83.0)	(82.0)	(80.0)	(81.0)
Private Transfers	17.4	113.0	161.0	195.0	221.0	237.0
Curr.Acc.Bal. (before off. grants)	(1.0)	(263.2)	(107.0)	(239.2)	(235.1)	(466.8)
Official Grants	31.5	206.0	224.0	378.0	288.0	282.0
Curr.Acc.Bal. (after off. grants)	30.6	(57.2)	117.0	138.8	52.9	(184.8)
Memo:			(As % of current GDP)			
Merchandise Exports (FOB)	30.1	12.1	19.1	12.7	11.1	8.5
Interest Payments	(1.8)	(1.5)	(2.1)	(1.8)	(1.5)	(1.4)
Private Transfers	0.5	2.0	4.1	4.2	4.0	4.0
Official Grants	0.9	3.6	5.7	8.1	5.3	4.8
Curr.Acc.Bal. (after off. grants)	0.9	(1.0)	3.0	3.0	1.0	(3.2)

1/ Traditional exports consist of coffee, cotton, sugar and shrimp.

Source: Banco Central de Reserva .

17. The decline in exports largely resulted from the collapse of intra-Central American trade and the decline in commodity export prices. By maintaining high import barriers, however, El Salvador prevented the structural adjustments needed to reorient its exports from the regional market toward third countries and to diversify its extra-regional exports away from coffee. Tariffs and exchange controls represented the most important trade barriers, while quantitative restrictions and other non-tariff barriers have played a relatively minor role since 1987. Export taxes also have not been important, except for coffee, sugar and shrimp. In 1988, tariffs and other duties ranged from 1% to over 300%, with an unweighted-average ad-valorem rate of 37%. The highest rates were applied to final consumer goods, averaging 59%, while intermediate

and capital goods received 22%; see Table 2. The disparity in nominal protection rates led to extremely high effective protection rates, averaging over 100% for the manufacturing sector and rendering it uncompetitive in third markets. The cascading pattern of import duties also encouraged the use of capital inputs and intermediates at the expense of labor, which constitutes El Salvador's most abundant factor of production.

Table II

Structure of Tariffs and Other Import Duties.

(Percentages)

	1988 1/			September 1989 2/			April 1990 3/		
	Mean 4/ Weighted	Unweighted	St.Dev.	Mean Weighted	Unweighted	St.Dev.	Mean Weighted	Unweighted	St.Dev.
Total Economy	12.5	36.9	42.8	9.9	20.4	17.4	9.6	17.8	13.6
Agriculture	7.2	39.0	38.9	9.2	20.4	18.6	9.0	17.2	13.2
Mining	1.4	10.4	4.6	5.0	6.9	3.7	5.0	6.9	3.7
Manufacturing	14.6	37.2	43.2	10.6	20.6	17.4	10.3	18.0	13.7
Consumption	21.1	59.2	53.4	15.3	29.5	18.5	14.5	24.2	13.6
Intermediate	11.6	21.8	24.9	8.9	14.4	13.1	8.8	13.8	11.8
Capital	12.0	21.5	22.2	7.8	14.0	13.9	7.6	13.3	12.6

1/ Nominal protection rates granted through legal tariffs plus other duties. The highest combined duty was 365% and the lowest was 1% .
2/ In September 1989 the tariff ceiling was reduced to 50%, the tariff floor was raised to 5% and other duties were eliminated.
3/ The tariff ceiling was further reduced to 35% for tariff positions in categories 1 & 2.
4/ All weighted means are calculated using 1988 imports.

Source: World Bank staff calculations.

18. To reduce the distortions caused by the high level and dispersion of tariffs, the Government initiated a major trade reform in September 1989 by eliminating all non-tariff duties, reducing all tariffs to a maximum of 50% and raising the tariff floor to 5%, with the exception of wheat imports, which receive 1%. Also, the number of tariff categories was reduced from 25 to 7 rates. These reforms had the effect of reducing the unweighted average rate of nominal protection (derived from tariffs and other duties) from 37% to 20%. Equally important is the reduction in tariff dispersion; the standard deviation of rates fell from 43% to 17%. In April 1990, the tariff ceiling was further reduced to 35%, except for a limited number of luxury items (referred to in Annex 3 of the Central American Tariff Code), comprising less than 5% of all tariff positions. This had the effect of further reducing the unweighted average tariff rate to 18% and the standard deviation to 14%. To continue the process of trade liberalization, the Government has announced a schedule of annual adjustments to progressively unify tariff rates toward a tariff floor of 10% and a ceiling of 20%, to be reached by end-June 1993.

19. The anti-labor bias generated by the old tariff structure was aggravated by import duty exemptions, mainly granted for imported inputs and capital through a variety of incentive schemes intended to promote industry, non-traditional exports and selected agricultural sectors. These exemptions did little to prevent the stagnation of these sectors and represented a significant fiscal loss; although the import-weighted

rate of all duties averaged 12.5% in 1988, only 8.8% was actually collected. To remove this source of distortions and fiscal losses, the authorities eliminated most tariff exemptions (together with other tax exemptions) in the second semester of 1989, by abolishing the special incentive schemes for industry. In April 1990, the system of incentives for non-traditional exports also was abolished and replaced by a simpler system designed to resemble a drawback system. Under the new system, eligible exporters receive a cash payment equivalent to 8% of the FOB value of exports upon deposit of the foreign exchange receipts. (This 8% rate roughly corresponds to the average import content of non-traditional exports (40%), multiplied times the average tariff rate (20%) prevailing at the end of 1989.) The only major tariff exemptions remaining at the end of 1990 pertain to public sector imports. The Government recognizes that these exemptions run counter to its reform program, which relies heavily on private sector development, and intends to eliminate most of them by mid-1991.

20. With the recent tariff reforms, the Government also eliminated most quantitative restrictions applied for other than health and national security reasons: by mid-1990, only 62 tariff positions (out of 1700) were subject to import permit requirements (comprising about 11% of total 1989 merchandise imports) and 49 tariff positions required export permits (comprising 2.5% of total 1988 merchandise exports). About half of the imports and exports subject to these permits consist of agricultural products that are governed by PL-480 agreements with USAID. The Government intends to eliminate most permit requirements for products not covered by PL-480 agreements, such that by end-1992, at most 16 tariff positions (0.7% of 1989 imports) would require import permits and 4 tariff positions (0.1% of 1988 exports) would require export permits. With respect to those products ruled by PL-480 agreements, the government intends to seek USAID's approval to replace the import and export permits by a registration requirement.

21. In parallel with the trade barrier reductions in mid-1989, the Government also eliminated most price controls, which previously covered approximately 240 products. Currently, only seven groups of products are subject to price controls, comprising cement, wheat flour, instant coffee, edible oils, sugar, cotton seeds and oil derivatives.

22. Prior to July 1989, the authorities maintained a fixed exchange rate policy, coupled with exchange controls. Exchange controls, consisting of import licensing and prior deposit requirements, constituted the main non-tariff barrier to trade. In granting import licenses, the Central Bank established a system of foreign exchange allocation that favored imports of essential foodstuffs, medicines, raw materials and capital goods in declining order of priority. With manufactured goods last on the priority list, the system of exchange controls reinforced the distortions created by the tariff structure. Since mid-1989, the monetary authorities have progressively allowed the exchange rate to become more market-determined and have eliminated exchange controls. The exchange system was effectively unified in June 1990. Under the current system, export proceeds (except coffee) and

merchandise imports are transacted through the commercial banks, while other transactions take place through freely operating foreign exchange houses (Casas de Cambio), which were legalized in April 1990. Coffee export proceeds and official payments must be transacted through the Central Bank, which sets its rate as an average of the market-determined rates prevailing in the Casas de Cambio and commercial banks. Since June 1990, the spread between these two rates averaged less than 2%, and the Government intends to continue managing the exchange rate in a flexible and unified manner as stated in its Letter of Development Policy.

B. Public Finances

23. The fiscal deficit (before grants) of the consolidated non-financial public sector progressively deteriorated since 1987 to almost 6% of GDP in 1989. Mainly responsible for this deterioration has been the steady decline in tax revenues collected by the central government, from 13.3% of GDP in 1986 to 7.6% in 1989. This decline reflects two important structural weaknesses of the tax system: a heavy reliance on trade taxes, particularly on coffee export taxes, and a weak system of tax administration that facilitates evasion. During 1980-87, the share of coffee export tax revenues in total revenues averaged 23%, but ranged from 17% to 37%, reflecting the volatility of coffee prices and domestic coffee production. In 1989, coffee taxes declined to less than 6% of total tax revenues, due to a weather-related decline in production followed by a sharp drop in international coffee prices.

Table III

Consolidated Nonfinancial Public Sector, 1980-89

	1980	1986	1987	1988	1989
	(As % of current GDP)				
Current Revenue	14.5	15.9	13.6	12.1	10.1
Tax Revenue	10.8	13.3	10.8	9.2	7.6
Nontax Revenue	2.8	2.3	2.3	2.3	2.0
Op. Surplus of Pub. Ent.	0.8	0.3	0.5	0.6	0.5
Current Expenditure	14.7	14.5	13.7	12.5	11.7
Consumption	13.20	11.4	11.1	10.1	9.4
Interest	0.50	2.3	1.8	1.5	1.4
Transfers	1.0	0.8	0.8	0.9	0.9
Public Savings	(0.2)	1.4	(0.1)	(0.4)	(1.6)
Capital Revenue	0.1	0.1	0.1	0.0	0.0
Capital Exp. & Net Lending	7.8	5.9	2.8	3.9	4.3
Overall Deficit/Surplus	(8.0)	(4.4)	(2.8)	(4.3)	(5.9)
Official Grants	0.0	2.0	3.1	1.8	1.9
Net External Financing	2.3	1.3	0.8	1.0	1.6
Internal Financing	5.6	1.1	(1.1)	1.5	2.4
Banking System	4.8	(1.4)	0.2	(1.6)	3.3
Nonbank Financing	0.1	0.2	(0.1)	(0.3)	0.2
Floating Debt	2.5	3.9	0.0	1.0	1.0
Other	(1.9)	(1.6)	(1.2)	2.4	(2.1)

Source: Banco Central de Reserva and IMF.

24. The decline in coffee taxes accounts for a large portion of the recent fiscal revenue erosion. Also worrisome has been the erosion of direct taxes and the sales (Stamp) tax. Various factors have contributed to the government's inability to increase revenues from these last two sources, including (i) limited administrative and monitoring capacity, coupled with a high disparity in tax rates, (ii) inefficient tax enforcement, (iii) the proliferation of tax exemptions granted through various incentive schemes, and (iv) a long lag between the time when taxes fall due and are paid. The operating surplus of the public sector enterprises also have fallen during the latter half of the 1980s, mainly as a result of inadequate pricing policies, thereby also contributing to the weak fiscal situation, but not to the extent of the tax revenue declines.

Table IV

Central Government Revenue, 1980-89

	1980	1986	1987	1988	1989
	(As % of current GDP)				
Total Revenue	11.3	16.3	14.3	11.9	10.0
Tax Revenue	10.8	13.3	10.8	9.2	7.6
Direct Taxes	3.5	2.7	3.1	2.7	2.3
Income Taxes	2.6	2.2	2.4	2.0	1.8
Taxes on Foreign Trade	4.2	5.9	3.0	2.2	1.4
Import Taxes	1.1	1.0	1.1	0.8	1.0
Export Taxes	3.1	4.9	1.9	1.4	0.4
Taxes on Domestic Transactions	3.4	4.8	5.1	4.4	3.9
Stamp Tax	0.9	2.8	3.0	2.6	2.4
Other	(0.3)	(0.1)	(0.4)	(0.1)	--
Nontax Revenue	0.4	1.3	0.6	1.0	0.6
Capital Revenue	0.1	0.1	0.0	0.0	0.0
Foreign Grants	0.0	1.6	2.9	1.7	1.8

Source: Ministerio de Hacienda and Banco Central de Reserva.

25. With the decline in fiscal revenues, total expenditures of the nonfinancial public sector fell significantly, from over 20% of GDP in 1986 to 16% in 1988. The cutback in expenditures largely was achieved through a decline in public sector wages and through the squeezing of public investment. Public sector investment, which had averaged 11% of GDP during the early 1980s, fell to 4.4% during 1984-88, reaching a decade low of 2.3% in 1988. This investment decline represents a significant sacrifice of future growth.

26. Total employment in the central government fell by 7.6% from 1981 to 1988, while the public enterprises maintained their labor force more or less the same. The largest fall in public wage costs, however, occurred through a decline in real wages, which fell by about 58% during the same period. Despite the fall in real wages and public employment, however, the total wage bill increased as a share of total public current expenditures from 52% in 1980-83 to 57% in 1985-88, while the share spent on goods and services declined from 34% to 28%. Over this

period, wage differentials within the public sector have shrunk by about 50%. While this has mitigated the impact of the real wage decline on employees at the lower end of the wage scale, it has adversely affected the public sector's ability to retain qualified personnel.

27. The past decline in total spending also was accompanied by a significant shift in the allocation of resources toward national defense and public debt service and away from education, health and housing. In 1978-79 spending on national defense accounted for 9% of total expenditures and debt service accounted for 4%, while during 1986-87, these shares accounted for 20% and 21%. Over the same period, spending on infrastructure development fell from 19% to 9%, and on social programs from 40% to 24%, representing a 40% decline in real percapita social welfare outlays.

28. Public spending on the social sectors and infrastructure has fallen to extremely low levels, and further cuts would seriously jeopardize El Salvador's future growth prospects and efforts to alleviate poverty. The main fiscal adjustments, therefore, must be made on the revenue side, through increased tax collections. A strong effort also needs to be made, however, to reallocate existing public resources, both sectorally (toward targeted social services and investment) and functionally (toward goods and services and away from salaries), especially during the initial transition period when tax reforms are still being introduced.

29. To reverse the decline in tax revenues, the Government introduced a major package of tax reforms that became effective in early 1990. These reforms were aimed mainly at simplifying the tax system to reduce tax administration costs and raising the tax base. They included (i) a reduction in the dispersion of personal and corporate income tax rates, (ii) the elimination of low yielding excise taxes and export taxes for sugar and shrimp, (iii) the elimination of the legal bases for most tariff and tax exemptions, (iv) a reform of the coffee export tax structure, and (v) the unification of the sales to 5%. Preliminary evidence for 1990 shows that these measures have been successful in stopping the past tax erosion, with total tax revenues in 1990 estimated at 8.3% of GDP (compared to 7.6% in 1989). This increase fell short of initial expectations, however, largely on account of a weak performance in sales tax collections.

30. In view of this disappointing tax performance, the Government has recognized the need to quickly strengthen its tax enforcement capabilities. To achieve that objective, it has defined a short term program to (i) make the legal changes needed to abolish existing tax loopholes, raise penalties for tax evasion and charge interest on overdue tax payments, (ii) reorient tax audit procedures toward increasing the coverage of audited taxpayers and devoting fewer resources on the excessive scrutiny of individual cases, (iii) force the commercial banks to remit tax payments to the Treasury in a more timely manner and (iv) create a special task force within the Office of the Finance Minister that would be responsible for monitoring the tax

enforcement effort. These measures should lead to a significant improvement in tax collections from all sources, while improving the basis for introducing a value-added tax.

31. The Government intends to introduce a value-added tax to replace the existing sales tax by mid-1992. This change is expected to yield two major benefits: one is that the value-added tax has a far less distortionary impact on production and consumption incentives and the other is that it enhances the Government's ability to monitor taxpayers' declarations. In preparation of the VAT, the authorities have developed an action program to train and equip the personnel needed to administer the VAT and to expand the number of taxpayers registered for the sales tax. This program is being supported by technical assistance from IMF, IDB and USAID.

32. On the expenditure side, the Government is concerned about the past declines in public investment and social sector expenditures resulting from budgetary constraints. To help improve the allocation of investment expenditures, the Government completed a public investment review with technical assistance from UNDP in December 1990. To facilitate higher public investment, public savings were increased from -1.6% of GDP in 1989 to an estimated -0.1% in 1990, and a target of 1.7% has been incorporated into the 1991 ordinary public sector budget.

33. Two other weaknesses in fiscal policy to be addressed are (i) the Central Government's limited control over the budgets of decentralized public sector institutions and enterprises and (ii) the separation of the Central Government's ordinary budget from the extraordinary budget, which mainly comprises funds from USAID and finances most of the public investment program. To improve overall expenditure control, the Government has submitted to the National Assembly a draft law that would create a National Public Investment System, which subjects all public investment projects to a common evaluation and selection procedure and ranks these according to national priorities. This system is expected to yield a considerable improvement in public investment planning. Also, the Government intends to present a consolidated (ordinary + extraordinary) budget to the Legislative Assembly, starting with the budgeting exercise for fiscal year 1993, which should yield better insight into public expenditure patterns and, thus, improve the information basis for public spending decisions.

C. The Financial Sector

34. The success of the structural adjustment program, which aims to create a more open, less regulated and more private-sector-based economy, depends critically on the existence of a sufficiently flexible and competitive financial market. The process of structural reform calls for a major reallocation of resources within the economy that, in turn, requires adequate financial support for new investment opportunities created by the realignment of relative prices and incentives. In this context, a well-functioning financial system plays a crucial role in mobilizing, both domestic savings and external

capital, and in allocating those financial resources toward the most profitable activities.

35. During the past decade, El Salvador's financial sector has been extremely repressed and rendered incapable of fulfilling its intermediary role in the adjustment effort. Nine commercial banks, a mortgage bank and seven savings & loans associations represent the backbone of the financial system. All except the mortgage bank were nationalized in 1980 and placed under the control of the Central Bank. In recent years, the financial situation of these institutions deteriorated steadily, both because of bad management under state control and as a consequence of the deteriorating economy. The high operating costs of the commercial banks, which vary between 5% and 8% of total asset value, reflects their inefficient management, and in December 1989, between 30% and 40% of the total commercial bank loan portfolio was assessed as non-performing. (The privately-held mortgage bank faced the same problems and was intervened by the monetary authorities in October 1989.) The low quality of banking supervision in large part is responsible for the weak state of the banking system. The Superintendency of Banks currently constitutes a department within the Central Bank, without independent legal standing or resources, and does not have the capacity, either legal and material, to diagnose potential banking problems, regulate banking risks and enforce remedial actions.

36. Since the early 1980s, all commercial lending and deposit rates have been set by the Central Bank, often on the basis of political criteria rather than in response to market developments. This has led to negative real rates over prolonged periods, which discourages domestic financial savings and stimulates demand for non-productive assets. As a result, between 1986 and 1989, total bank deposits fell by almost 30% in real terms, while the velocity of M-2 increased by 25%. Since the Central Bank fixes all interest rates, there are no financial instruments through which it can accurately gauge overall market liquidity. Also, it has made the Central Bank a focus of interest group pressures, resulting in the proliferation of special credit lines with differentiated interest rates that hamper effective monetary management and distort the allocation of credit. In 1988, the credit granted through the Central Bank rediscount lines accounted for almost one-third of the total credit extended to the private sector through the banking system.

37. Monetary and Credit Policy Reform. The medium term economic program announced by the Cristiani Government includes the privatization of the banking system as one of its key objectives. Recognizing that the current system of interest rate controls and directed credit is incompatible with a well-functioning privately-owned banking system, the Government intends to progressively liberalize the financial market. The ultimate goal is to eliminate all interest rate controls, but the authorities feel that the liberalization process must take place gradually. The reasons for choosing a gradual approach are (i) the current fragility of the nationalized banks and savings & loans associations, (ii) the underdevelopment of financial markets, which have

grown accustomed to fixed rates over the last decade, and (iii) the need to spread out the fiscal costs of financial liberalization. Since the Government is simultaneously carrying out major stabilization measures, the authorities fear that too rapid a liberalization of interest rates could cause unnecessary disruption of economic activity and further weaken the commercial banks before they have been reformed and have adapted to the workings of a freer market.

38. A rapid interest rate liberalization could also hamper the stabilization process itself, by raising the fiscal costs of reform during the initial period when tax reforms are still underway: the total cost of recapitalizing the commercial banks, savings & loans associations and the Banco Hipotecario is estimated at 3.13 billion 1990 Colones, of which 720 million Colones are expected losses of the savings & loans associations, based on a 7 percentage point real interest rate increase. This total recapitalization represents 8% of GDP, which is to be financed through bonds issued by the Central Bank. Assuming that these bonds mature in 10 years and have a 3% real interest rate, then with zero inflation, the annual cost to the Central Bank would amount to 370 million colones or 0.9% of GDP. But if inflation were to remain at 15%, the real cost of servicing the debt would be front-loaded, amounting to 1.8% of GDP during the first year and 0.4% of GDP for the tenth year. By decontrolling interest rates more gradually in anticipation of declining inflation rates, the total real cost of restructuring the financial system remains the same, but the share borne by the Government, especially during the initial period, would be lower.

39. In this context, the Government has defined a three-part action plan of gradual financial market liberalization that encompasses (i) the progressive elimination of controls over different segments of the financial market, (ii) the application of a systematic interest rate adjustment rule to avoid negative real rates for those segments of the market that are not yet decontrolled, and (iii) a reduction in the Central Bank's financial intermediation role and provision of subsidized credit.

40. A first step to eliminate interest rate controls was taken in September 1990, when the Central Bank eliminated such controls on interbank loans. The Government intends to eliminate interest rate controls on commercial bank deposits and loans with maturities of more than one year by mid-1991, and on bank deposits with maturities of more than 180-days by mid-1992. In 1993, all remaining interest rate controls are to be eliminated.

41. During the transition period until all interest rate controls are eliminated, the Government intends to establish an interest rate band for the controlled segments of the market, such that banks will be free to set their deposit and lending rates within that band. The floor of the interest rate band will serve as a lower limit for the 180-day deposit rate (TIBP), while the ceiling of the band serves as an upper limit for lending rates on transaction with maturities up to one-year (TIBA). The Central Bank will review the interest rate floor at least

every semester, starting in January 1990, and adjust it if necessary so that TIBP would not be less than the past annual inflation rate. The floor would be at least equal to the past inflation rate plus one percentage point by the third quarter of 1991, and to the inflation rate plus two percentage points by the third quarter of 1992. (In view of the rapid decline of inflation during the second half of 1990, the Government may choose to define past inflation as the annualized inflation rate over the preceding six months in setting the interest rate floor during the first six months of 1991.) Beginning in January 1991, the ceiling of the interest rate band is to be set equal to the interest rate floor (TIBP) plus an intermediation margin of 4 percentage points. This intermediation margin is to be raised to 5 percentage points by the third quarter of 1991, and to 6 percentage points by the third quarter of 1992.

42. Since December 1989, the number of rediscount credit lines offered by the Central Bank, as well as the dispersion of interest rates charged, has decreased. The Government intends not to create any new lines financed from its own resources in addition to those that were in place on October 1, 1990. Furthermore, by mid-1991, all new credits extended by the Central Bank through its rediscount lines to intermediary institutions are to be made at an interest rate not less than the interest rate floor applicable to the 180-day deposit rate, while the lending rate to the final user will be subject to the same norms that apply to commercial loans. (Central Bank rediscount lines financed by foreign assistance loans or grants with specific provisions for onlending these funds at preferential rates may be exempt from this general rule.)

43. To facilitate a more competitive banking system, the Central Bank intends to reduce the required reserve ratio from the current level of 19% toward a target level of 15% by mid-1992 and to rely increasingly on open market operation for purposes of controlling liquidity. This measure has the added advantage of making the banks more attractive to potential buyers.

44. Institutional Reforms. The first steps to restructure the banking system were taken in the second half of 1989, when the government conducted various studies with external technical assistance to assess the solvency of the banking system and financial viability of each of the nationalized banks. Based on these assessments, the monetary authorities decided in February 1990 on a strategy to recapitalize six of the nine commercial banks (of which two are to be merged) and to liquidate the rest. In July 1990, the authorities began closing the banks to be liquidated and transferred their assets to the remaining banks. Finally, the Government prepared a package of three draft laws with assistance from the Bank and IDB that provide the basis for (i) recapitalizing the commercial banks and savings & loans associations, (ii) reforming the Banking Superintendency and (iii) privatizing the nationalized banks. This draft legislation was submitted to the National Assembly in October 1990 and approved in November 1990.

45. According to the draft law, the recapitalization of banks is to take place through a newly created fund, which will purchase the non-performing bank debts at their face value in exchange for existing bank debts to the Central Bank, and the remainder for tax-exempt Central Bank bonds with a variable rate (such that the net yield equals the 6-month deposit rate plus two percentage points) and a maturity of ten years. In recapitalizing the banks, the Government's objective is to raise each bank's net worth to at least 10% of the value of its total assets prior to being sold to the public. Although the Government acquires ownership of the non-performing portfolio, this portfolio will continue to be administered by the banks for a small commission. At the same time, the banks will be offered an incentive to recuperate the non-performing assets or transform these into performing assets, through a fee amounting to at least 10% of the amount recuperated. When a loan is converted into a performing asset, the bank acquires ownership in exchange for the counterpart bond emitted through the capitalization fund.

46. To promote widespread ownership, the law to privatize the banks gives small shareholders and banking employees the opportunity to purchase shares on a first-option basis for a period of 120 days after the bank has been offered for sale. Furthermore, small shareholders may have preferential access to credit for up to 100,000 Colones (or about US$ 12,500) for this purchase, using the shares as collateral. Another element in the law is the limitation on the percentage of shares in a bank or set of banks owned by any one person, which cannot exceed 5%. (A higher limit of 20% has been set for ownership by multilateral international institutions.) This limit was introduced to prevent excessive concentration of ownership, but may have the drawback of rendering bank ownership less attractive for potential investors. The Government's assessment is that the introduction of this limit has allowed a broader political consensus in favor of bank privatization, which outweighs the potential drawbacks of this restriction.

47. Under the new law, the Banking Superintendency obtains independent legal standing from the Central Bank, as well as financial independence. This represents a first institutional step to strengthen the Superintendency. To improve the Superintendency's capacity to carry out its supervisory, diagnostic and legal enforcement functions, the Government also has prepared an action plan to train personnel, purchase adequate equipment and review the operating procedures. To implement this plan, the Superintendent has submitted an official request for technical assistance to USAID, which has expressed interest in supporting these actions, and the IMF is providing assistance through a resident representative. (The adoption of this action plan and the identification of a financing source for technical assistance were conditions for Board Presentation of the SAL; see para. 93.)

48. The Government intends to have completed the recapitalization of at least two banks and initiated their sale by mid-1991. If these banks have not been privatized 18 months after the initial solicitation, a public auction will be held to speed up the sale. By the end of 1991,

the Government intends to have completed an action plan to recapitalize and privatize the savings & loans associations and the mortgage bank, to be implemented in 1992. The action plan to fortify the Banking Superintendency is to be implemented in early 1991.

D. Agricultural Pricing and Marketing

49. The coffee sector accounts for about one-third of El Salvador's agricultural GDP, generates over half of the country's merchandise exports and provides approximately 100,000 rural jobs. During the 1980s, coffee production declined on average by 2.3% per annum, mainly as a result of a substantial appreciation of the real exchange rate applicable to coffee, the decline in international coffee prices, an outdated export tax structure and the inefficient commercial operations of the Instituto del Cafe (INCAFE), the parastatal monopoly in charge of coffee marketing. Other cash crops also were subject to monopolized marketing, especially sugar (through the parastatal INAZUCAR) and cotton (through the producers' cooperative, COPAL). Guerrilla activity also had a disruptive effect on coffee production, but this was minor in comparison to the disruption to cotton production.

50. Domestic production of basic grains (maize, beans, rice, sorghum), which represents the main source of food in El Salvador, did not decline as much as the rest of agriculture during the 1980s, but its economic situation also deteriorated dramatically, with real domestic basic grains prices falling by about 50%. On the consumer's side, developments have been equally dismal; although grains imports increased by 40% from 1978-80 to 1984-86, total food availability decreased by 20% during that period. The main factors responsible for this deterioration are the appreciation of the exchange rate, a discriminatory tariff structure that maintained basic grains prices artificially low relative to manufactured products, incentive distortions caused through price controls and the inefficient marketing operations of the state-owned Instituto Regulador de Abastecimientos (IRA), which was primarily responsible for regulating the domestic supply of grains and stabilizing producer and consumer prices. The state agricultural development bank (BFA) also intervened as a buyer and seller in basic grains, but to a lesser extent than IRA.

51. The Government's policy reform program aims to reduce the role of the state in agricultural markets and to improve production incentives by eliminating the past policy discrimination against agriculture. In the coffee sector, three basic reforms have taken place: coffee exports are transacted at the same exchange rate as other sectors as of June 1990, while the coffee export tax structure was reformed and the parastatal coffee marketing monopoly was eliminated in December 1989. (The marketing monopolies of INAZUCAR and COPAL were also eliminated at the end of 1989.) The previous coffee export tax structure had been in place since the 1950s, which resulted in an increasing tax burden over time. The current tax structure consists of a straight 30% rate applied to the total export value in excess of US$45 per quintal (100 lbs.). Compared to the old tax system, the new one has

the advantages of lowering the average tax burden for the coffee producer, while incorporating a rising marginal tax schedule that stabilizes after-tax producer incomes, and being easier to administrate. The basic grains sector benefitted from a similar set of reforms: IRA ceased to intervene in the domestic grain market in 1989, domestic price controls were suspended and tariffs on grain imports were raised toward the average levels applicable to other imports. In the case of maize, a price band mechanism was introduced to stabilize its domestic price in dollar terms through a variable tariff structure yielding an average nominal protection rate of 20%. These reforms have significantly improved the incentives facing coffee and basic grains producers and contributed to the exceptional harvests expected for the 1990/91 season.

52. To avoid distorting producer prices through cheap food aid, the Government is seeking an agreement with USAID to ensure that all imported grains (including donations) will be subject to the same tariff and exchange rate regime as all other imports, with the exception of food reserved for specifically targetted lower income groups. As part of this agreement, the Government also is seeking to eliminate all import and export permit requirements on grains covered by PL-480 covenants. Another important step to be taken in this area is the divestiture of the assets (warehouses, mills, land) of the parastatal marketing companies, (IRA, INCAFE and INAZUCAR). Studies to divest the assets of IRA and ISIC (the parastatal coffee research institute) has been completed with assistance for USAID, and their assets are to be offered for sale by September 1991. At the same time, the Government intends to have completed the necessary preparations for divesting the assets of INCAFE, INAZUCAR and the marketing activities of BFA, by end-1991, and to initiate their sale by mid-1992.

E. Poverty Alleviation

53. A surprising feature of El Salvador's development record during the 1980s is that basic social indicators generally do not seem to have deteriorated much despite the economic and social crisis. For example, infant mortality fell from 74 per 1000 births in 1980 to 57/1000 in 1988 and life expectancy rose from 58 in 1975 to 61 in 1986. Nevertheless, El Salvador's social indicators continue to rank among the worst in Latin America and the incidence of poverty remains very high. Malnutrition among school age children is between 50% and 75% in the poorest departments of the country. In 1988, one-third of the country's urban population was estimated to live in extreme poverty (i.e., with incomes that barely suffice to purchase a standard food basket yielding 2,200 calories per day), while another third earn incomes of at most twice that amount. About 36% of the adult population is illiterate.

54. The poorest of the poor are concentrated in the rural areas. The rural/urban split of the population is approximately half and half, but 74% of all persons in the lowest quintile of the income distribution live in rural areas. The same uneven distribution is also observed in other social indicators; For example, illiteracy is 50% higher in rural than in urban areas and the shares of rural households without running

water is 72%, and with dirt floors is 80%, as compared to share of 62% and 32% for urban households. Among the rural poor, 70% of those in the poorest quintile are engaged in basic grains agriculture (primarily corn), while the rest are informally employed in industry (9%) and services (12%). Among the urban poor, 50% of those in the lowest income quintile are employed in services and commerce, 25% in industry and the rest in agriculture. While El Salvador's average real income per capita declined by a cumulative 17% between 1981 and 1989, the real incomes of the poor are likely to have declined even more, as minimum wages and basic grains prices did not keep pace with aggregate inflation.

55. On the consumers' side, the decline in real basic grains prices cushioned the impact of declining real incomes. It is estimated that the poorest half of the population spends about 70% of its income on food, with basic grains as the main item in their consumption basket. A reversal of the declining trend in grains pricies, therefore could worsen the real incomes of those poor groups not engaged in agriculture. On average, the rural poor can be expected to gain from rising agricultural prices, since most are directly or indirectly engaged in that sector, but the urban poor would be affected adversely by rising grains prices.

56. To reduce the incidence of absolute poverty, the Government has designed a set of measures as part of its structural adjustment program, with the aim of providing a safety net for the most vulnerable groups of society in the short term and of improving their human capital in the long term. As discussed below (Part III, Section C), the Government's adjustment program is expected to have an overall positive impact on poverty alleviation, primarily by raising the average incomes of the poorest members of society. To provide minimum incomes to the chronic poor and those adversely affected by the economic reforms, the Government had introduced several rural public works projects in the provinces of Oriente and Chalatenango and initiated locally managed construction projects in 239 rural and urban municipalities, both as part of a short term Social Emergency Program. The Government, with IDB assistance also has finalized preparations for introducing a three-year Social Investment Fund (SIF), as a more flexible mechanism for channeling donor funds toward urgently needed projects. The creation of the SIF was approved by the National Assembly on October 31, 1990, and will begin operations in early 1991, initially with domestic resources to be supplemented by external concessionary funds from the IDB and donors.

57. To improve the nutritional status of the most vulnerable groups, particularly children under 12 years and lactating mothers, the Government has already identified the target population groups to receive assistance. Following up on this initial step, three pilot projects, identified in a strategy report prepared jointly by RUTA, the World Food Program and Government staff, are to be introduced over the course of 1991 (MIPLAN, La Ayuda Alimentaria en El Salvador: Elementos para una Estrategia, October 10, 1990). These projects involve (i) the distribution of nutritionally fortified cookies to primary

schoolchildren, (ii) the distribution of weaning formula through health posts and (iii) the distribution of food coupons. The Government has finalized the preparations for the pilot project involving fortified cookies and will begin implementation when the current school year starts. If the pilot project proves sucessful, the project will be expanded by end-1991 to one-third of the 78 municipalities identified as having the worst incidence of malnutrition, and expanded to the rest of these municipalities by mid-1992. The other two pilot projects will be initiated in the latter half of 1991 and early 1992, and will follow the same expansion pattern if proven successful. Implementation of these nutrition projects will be closely monitored as part of the proposed SAL conditionality (paras. 93-95). The Government also hopes to phase out ongoing food-for-work programs, which have proven inefficient, and use those resources for cash-for-work programs and to supplement the preceding targetted nutrition programs. This step still requires the approval of the World Food Program, which donates the largest share of these resources.

58. To increase the human capital of the poor, the delivery of basic social services needs to be greatly improved, particularly in the health and education sectors. A critical bottleneck in this area has been the overall decline in public sector resources devoted to social sector services; from 3.3% of GDP on education and 1.5% on health in 1978 to shares of 2% and 0.7% in 1988 and an estimated 1.6% and 0.5% in 1989. The Government seeks to shift public expenditures toward these sectors, with special emphasis on the priority areas of primary health care and education, but it has only had limited success for far. The share of the 1991 budgeted expenditures devoted to health and education is 23.3% of the total budget, which is slightly above the 22.9% devoted to these sectors in 1989 but below the 25.5% budgeted for 1990, as a result of overall fiscal constraints. (The share budgeted for defense declined over those three years, from 24.3% in 1989, to 20.5% in 1990 and 17.82% for 1991.) The overall pattern of expenditures still remains unclear, however, for lack of adequate information on extraordinary budget expenditures. Also, a mere reorientation of resources toward the social sectors will have limited benefits if it is not accompanied by institutional improvements in the overly centralized line ministries that administer these resources. To address this problem, the Miguel Kast Foundation has assisted the Government in designing a plan to decentralize the functions of the Education Ministry (a similar plan is to be prepared for the Health Ministry). Following these initial steps, the Government intends to decentralize both ministries by shifting major management responsibilities for personnel, supplies, accounting and the monitoring of statistics to the regional level. This strategy is being designed in close cooperation with the Bank and its implementation is to begin in the second half of 1991, with the support of a proposed Bank Social Sector Rehabilitation Loan.

F. Medium Term Prospects and Financing Plan

59. El Salvador's economy has strong potential for achieving rapid growth over the next decade. This positive assessment is based on three fundamental factors: (i) the important policy reforms currently being implemented to improve the structure of incentives and raise productivity, (ii) the low external debt overhang, and (iii) the fact that current output levels are extremely low by historical standards. Until the domestic civil conflict is settled, however, this growth potential cannot be fully realized. The chances for a peaceful resolution of this conflict continue to be better now than they have been in the past, but the progress made so far in the negotiations has been slow. The Government's short run stabilization objectives, which aim to achieve single digit annual inflation by 1992, also will place a constraint on growth over the next two years.

60. The Government's recent and intended adjustment measures, nevertheless, will have a significant impact in the short run and in preparing the ground for faster growth when the political situation stabilizes. An indicative example is given by the strong response to improved incentives observed in the agricultural sector in 1990. This sector should continue to provide an important source of growth in the medium term. The announced trade policy and agricultural pricing reforms should help the recovery of key agricultural sectors from the past depressed levels and gradually encourage the exploitation of export opportunities for non-traditional agricultural products to replace the less dynamic traditional products.

61. The manufacturing sector represents one of the most promising sources of growth in the longer term, in view of El Salvador's proximity to the US market, highly competitive real wage levels and abundant labor supply, relative to land and other natural resources. The reduced anti-export and anti-labor bias resulting from the recent and intended trade policy reforms, should improve the international competitiveness of this sector considerably and encourage employment. Nevertheless, growth in this sector is likely to remain modest in the medium term, as investors may adopt a wait-and-see attitude with respect to future political developments and the permanence of the recently introduced policy reforms before committing significant amounts of capital.

62. The gradual liberalization of interest rates together with the strengthening of the banking system should have important productivity enhancing effects in the medium term, and render the economy less susceptible to destabilization through short term capital movements. Although private agents may be reluctant to rapidly increase investment until the uncertainties referred to above are resolved, the reduced distortions in the financial market should encourage a more efficient allocation of existing resources, thus raising productivity levels.

63. The oil price shock caused by the current Gulf crisis represents a key uncertainty for 1991, even though it did not have a major destabilizing impact in 1990. Prior to the Gulf crisis, oil and

derivatives imports were projected at US$ 100-110 million in 1990 and 1991. Based on revised oil price projections, the import bill is estimated to increase above the originally projected level only by about US$15 million in 1990, but by US$53 million in 1991, before declining again to pre-crisis projected levels. The figure for 1991 is highly tentative, however, and based on an oil price of US$29 per barrel of crude. For every US$1 increase in the annual average price of oil, El Salvador's import bill would rise by US$5 million or 0.1% of GDP. The increased import bill can be partly financed through the San Jose oil facility, whereby Venezuela and Mexico have agreed to extend medium term credit for up to 20% of their oil exports to Central America. Since less than 10% of El Salvador's existing external debt is at variable interest rates, the indirect impact of the oil shock on the debt servicing accounts of the balance of payments should remain small.

64. Internally, the Government passed through the higher oil price to consumers, thus avoiding any direct negative fiscal impact. The oil price rise is projected to generate a once-and-for-all increase of 5% in the domestic CPI, distributed over the course of the following 5 months, but should not reverse the underlying deflationary trend, as the authorities are expected to continue their tight fiscal and monetary policy stance.

65. Following the successful implementation of its reform program, the Government will have established a positive track record by 1993, by which time a peace settlement is expected to have been achieved. This should have a strong growth-boosting effect. Agriculture would experience an upswing, particularly in cotton, when lands left idle as a result of the civil conflict are brought back into production. A surge in manufacturing activity would be expected, as the private sector gains confidence, repatriates former flight capital and increases spending. The cessation of hostilities, moreover, will allow existing resources currently devoted to defense and damage repair to be reoriented toward more productive activities and needed infrastructure. Under this scenario, real GDP growth should rebound to the 5%-6% levels observed in earlier periods by the mid-1990s.

66. The 1990-95 financing requirements for this scenario are shown in Table 5, along with the likely sources. Projected financing through unidentified sources is small, partly as a result of the more flexible exchange rate management and adjustment policies pursued by the Government. Official funds remain the key financing source. USAID's Economic Support Fund grants are projected to fall from the 1989 levels, but its Development Assistance grants remain constant. The projections include a US$135 million rescheduling of outstanding arrears and upcoming payments on concessionary terms agreed to at the Paris Club in September 1990. This is expected to facilitate the rescheduling of an additional US$45 million of bilateral debts on similar terms, while other bilateral funds are expected to increase after a peace settlement is achieved. Multilateral lending is mainly expected for the IMF, IDB, CABEI and IBRD. Private financing remains small, with financial institutions and private non-guaranteed lending each projected to be

about US$10 million in 1993, and then growing in line with GDP. Conforming with the Government's policy of improving relations with its creditors, no financing through arrears is projected.

Table 5: El Salvador - Projected Financing Plan.
(US$ million)

	1988	1989	1990	1991	1992	1993	1994	1995
Gross Financing Requirements	-294	-672	-546	-507	-439	-414	-416	-387
Current Account a./	-235	-465	-346	-305	-251	-249	-258	-226
Amortization Payments	-122	-151	-140	-118	-117	-114	-119	-110
Buildup of reserves	64	-56	-60	-85	-71	-51	-39	-51
Sources	294	672	546	507	439	414	416	387
A. Official Grants	288	282	223	224	163	146	120	115
B. Net Direct Investment	0	0	-7	0	0	10	20	30
C. MLT Gross Disbursements	184	137	213	261	260	262	276	250
of which: IBRD	13	1	2	57	59	27	36	24
IDB	22	41	59	69	75	92	95	81
Net IMF Purchases	-5	-4	35	50	46	27	1	-3
Other Multilateral	62	29	30	19	27	23	21	21
Bilaterals	74	63	82	63	49	70	97	96
Suppliers	0	0	0	0	0	2	5	7
Private LT	18	8	4	4	2	21	22	22
D. Private ST Sources b./	-178	252	117	26	10	0	0	-10
E. Unidentified	0	0	-0	-3	6	-4	0	3
Memo Item:								
Accumulated DS Arrears c./	35	109	0	0	0	0	0	0

a./ Excludes official grants.
b./ Includes net short term, errors & omissions, refinancing and arrears.
c./ Assumed to be rescheduled in 1990.

Source: World Bank estimates.

67. El Salvador's weak creditworthiness position in the late 1980s was the result of poor policies and political instability, which led to a weak balance of payments position and the buildup of arrears. The adjustment measures taken by the Government since assuming office in July 1989 have helped to reduce the external financing gap. Further, the clearance of arrears to the Bank and the IDB in early 1990, agreement on an upper-tranche IMF program and a Paris Club rescheduling agreement also have enhanced the country's creditworthiness. The future creditworthiness of El Salvador will depend on the success of the authorities in closing the fiscal gap and, in particular, on their ability to expand the tax base. The adoption of a more flexible system of exchange rate management should result in increased remittance inflows through formal channels. The Government will need to generate the necessary fiscal surplus in domestic currency to tap these flows without excessive monetary expansion. The other critical factor determining the country's future creditworthiness is the ability of the authorities to end the civil conflict.

68. The country's external debt indicators will initially worsen, due to the real devaluation that has taken place, before improving. The ratio of total debt service to exports (G&S) is expected to fall to 18% by 1995, from 22% in 1988 and 31% in 1989, while the ratio of total debt to GDP remains around 39% during 1990-1995, before gradually declining. Since El Salvador's bilateral debt is mostly on concessional terms

(about 52% of total external debt is concessional) and commercial debt is small (less than 7% of total debt), the share of debt service to multilateral financial institutions in total debt service is projected to increase from 43% in 1989 to almost 60% in 1995, although the multilaterals' share in total debt increases more modestly, from 45% in 1989 to 51% in 1995. The Bank Group's share of total debt is projected to increase from 10% to 11% over 1989-95, while its share of debt service increases from 10% to 14%. However, debt service to the Bank Group as a share of total exports would be declining, from 3.2% in 1989 to 2.6% in 1995. As creditworthiness indicators improve after 1995, El Salvador should be able to finance transitory balance of payments gaps increasingly through commercial borrowing.

III. THE PROPOSED LOAN

A. General

69. The Structural Adjustment Loan is proposed in support of the Government's 1991-92 action program of economic adjustment and recovery. In preparation of the loan, an identification mission visited El Salvador in April 1990 and a pre-appraisal mission visited in August 1990. Appraisal took place in October 1990. Negotiations were held in Washington, D.C., during December 18-19, 1990. The delegation from El Salvador was headed by Minister Mirna Liévano de Marques, of the Ministry of Planning. The following section describes the components of the SAL program, which are summarized in Annex IV. Annex V contains the Government's Letter of Development Policy addressed to the Bank. The Supplementary Data Sheet is provided in Annex III.

70. The proposed loan of US$75 million equivalent would be disbursed in three equal tranches over a period of 18-24 months. Its objective is to facilitate the economic adjustments triggered by the policy actions that have already taken place since mid-1989 and to support the further policy actions intended during 1991. The SAL also is needed to help the Government overcome three important adverse developments during the last year that could derail the adjustment program. These are the decline in the price of coffee, the reduction in economic assistance from the United States and, most recently, the rise in international oil prices. These three factors have created an additional external financing gap of approximately US$140 million p.a. The Government's program is also being supported by the IMF, through an SDR 35.6 million upper-tranche Stand-by program, and by the IDB, through a US$60 million Global Multisectoral Credit Loan. The IMF program focuses primarily on aggregate macroeconomic performance issues and targets, while the IDB loan focuses on financial sector reforms. Close cooperation with the IMF and IDB has been essential to ensure the consistency of this operation.

71. The US$75 million equivalent loan would represent about US$7.2 per capita p.a., assuming it is disbursed over 2 years, and it would meet about 8% of El Salvador's gross external financing requirement for 1991-92. The loan size appears sufficient to help the authorities overcome the temporary payments imbalances occasioned by the recent reform measures that are beginning to take effect and by adverse external developments such as the fall in coffee prices, reduced U.S. economic aid and the current oil price hike. By signalling the Bank's strong support for the Government's promising program, the loan should help attract additional donor resources in the future.

B. Program to be Supported

72. The proposed SAL would support the Government's reform program and maintenance of a consistent macroeconomic policy framework, with special focus on trade policy, fiscal policy, monetary and financial sector reform, agricultural pricing policy and poverty alleviation measures. As a global condition for future tranche releases it is understood that the reform measures already taken would not be reversed and that the Government would make such policy adjustments as would be needed to maintain the stabilization program on track in response to unforeseen future developments.

Trade Reform Actions

73. El Salvador currently has the most liberal trade policy regime in Central America. Nevertheless, the authorities recognize the need to open the economy further and diversify its export base by eliminating remaining trade impediments and incentive distortions (paras. 18-20). As part of this process, El Salvador finalized negotiations to accede GATT and became a member in December 1990.

74. The Government adjusted all tariff rates within a range of 5%-35%, with the exception of tariffs on wheat imports. These still receive a tariff of 1%, which is to be raised to 5% by June 1991. Also, the Government announced a schedule of calenderized steps whereby the tariff range will be progressively reduced toward a maximum of 20% and a minimum rate of 10% to be reached by June 1993. According to this schedule, the tariff ceiling will be reduced to 30% in June 1991, to 25% in June 1992, and to 20% in June 1993, while the tariff floor will be raised to 7% in June 1992 and to 10% in June 1993. An exception will be made for textile, leather and shoe imports, whose tariffs will be adjusted according to the same schedule, but with a one year lag to allow a more gradual adjustment process. Also, the Government has presented to the Bank a schedule for eliminating the remaining import and export permit requirements that still apply for reasons other than internationally recognized health and security considerations. In accordance with this schedule, the Goverment further eliminated import permit requirements on 26 tariff positions (leaving 36 subject to permits; see para. 20) and export permit requirements on 6 tariff positions (leaving 43) in the fourth quarter of 1990. These steps constituted conditions for Board presentation of the loan.

75. Continued adjustment of tariff rates and further removal of export and import permits according to the Government's announced program will be conditions for release of the SAL's second and third tranches. Also, prior to second tranche release, all imports other than investment goods carried out by autonomous public sector institutions (which do not compete with private sector activities) would be subject to the same tariffs as private imports. The remaining exemptions are to be phased out once the Government has reviewed public sector pricing policies and public sector prices are more flexibly determined. By third tranche release, import permits should not be required for more than 16 tariff positions (not including 8 tariff positions covered by PL-480 agreements with USAID) and export permits would not be required for more than 4 tariff positions (not including 12 tariff positions where agreement with USAID is required); paras. 93-95. The Bank will be in contact with the Government and USAID to review the progress made in negotiations to eliminate permits on items imported under PL-480.

Public Finances

76. To ensure the sustainability of the Government's adjustment program, measures to improve the collection of taxes without raising the rates are critically needed (paras. 23-25). The Government has presented to the Bank a set of actions to improve tax enforcement and expand the base of registered taxpayers. These actions include (i) a directive sent to the commercial banks to remit tax payments to the Treasury in less than 2 weeks, (ii) the presentation of a list of laws to be changed to eliminate legal tax loopholes and to increase the penalties for tax evasion or late payment, and (iii) a decision to create a task force within the Office of the Finance Minister in charge of monitoring tax enforcement. The Government also has decided on an action plan for introducing a value-added tax to replace the sales tax by June 1992. This plan was elaborated with technical assistance from the IMF and USAID. The Bank will monitor the progress made in the implementation of both programs as a condition for second tranche disbursement. Prior to third tranche release, a value-added tax system should be operating in place of the sales tax.

77. The decline in public investment in recent years places a constraint on El Salvador's long term growth potential. To enable an adequate level of public investment expenditures without violating overall budget limitations, the Government needs to increase its public savings. The appraisal mission reviewed the 1991 Ordinary Budget sent to the Legislative Assembly in September 1990 and confirmed that it is consistent with a public savings target of 1.7% for 1991. Compliance with this savings target will be considered during the macroeconomic review process that will precede each future tranche release as a criterion for evaluating whether the overall reform program remains on track.

78. The Bank's assessment during appraisal of the loan was that the Finance Ministry's ability to ensure that the expenditure and savings targets of the total nonfinancial public sector could be met was

extremely limited due to lack of adequate information on spending commitments incurred through the extraordinary budget and for lack of jurisdiction over the decentralized public institutions. To improve this situation, the SAL would support the regular preparation of a consolidated budget, combining the ordinary and extraordinary budgets, to be presented to the Legislative Assembly, beginning with the fiscal budget for 1993. Presentation of such a budget is a condition for third tranche release.

Monetary Policy

79. To complement the Government's flexible exchange rate management, flexibility in interest rates and reduction in direct state intervention in the financial market are crucial for maintaining adequate macroeconomic control and enabling a well-functioning competitive financial system. Conforming with this objective, the Government intends to have eliminated all controls on commercial interest rates by January 1993. To facilitate the transition toward a completely liberalized system, the SAL would support the Government's program of gradual financial market liberalization, which focuses on (i) the progressive elimination of controls on different segments of the market, (ii) the establishment of a gradually widening interest rate band within which commercial interest rates are free to move, and (iii) the elimination of distortions through credit subsidization and high reserve requirements.

80. In September 1990, the Government eliminated interest rate controls on interbank loans, as a first step toward the overall elimination of interest rate controls. The elimination of controls on all commercial lending and deposit rates for operations with a maturity of more than one-year, together with a public announcement by the Government that all interest controls would be eliminated by 1993, would be a condition for second tranche disbursement. The elimination of controls on deposit rates with maturity of more than 180-days would be a condition for third tranche release.

81. The interest rate on 180-day deposits and the lending rate for credit transactions of up to one year are used as reference rates by the Central Bank and would be subject to a gradually widening interest rate band until 1993. As of January 1, 1990, the floor of this band was above the annualized inflation rate over the preceding six months (when the Government's deflationary program took effect), while the interest rate ceiling was 4 percentage points above the interest rate floor. The Government will review these rates with the Bank, using its interest rate adjustment schedule (described in para. 41) as a reference, and adjust them if necessary at least every semester, and more frequently if required by macroeconomic circumstances, taking into account capital movements, the evolution of real balances and other market indicators. Timely adjustment of interest rates as needed in response to changing market developments will be an important criterion in the Bank's assessment of (i) the overall macroeconomic policy framework that would precede each tranche release and (ii) whether the program is on track.

82. For a more efficient financial intermediation, it is important that credit subsidization be eliminated. As a condition for second tranche release, therefore, the interest rate charged by the Central Bank on its short term rediscount lines that depend on own resources should be not less than the interest floor, TIBP (paras. 41-42). The only exception would be credit rediscount lines financed with external assistance grants or loans, which carry specific provisions that these funds be onlent at preferential rates.

Financial Sector Institutional Reforms

83. On October 30, 1990, the Government submitted to Congress a package of draft laws to recapitalize and privatize the nationalized banks and savings & loans associations, and to reform the Banking Superintendency. These laws were approved by the Legislative Assembly in November 1990. A well-functioning banking system is a critical element of the structural adjustment program initiated by the Government, and the SAL would support the recapitalization of the banks and the rehabilitation of the Superintendency in conformance with these laws. Prior to Board Presentation of the SAL the Government issued the legal regulations needed to implement the law to recapitalize the Banks, which contains the following elements: each bank is to be recapitalized to raise its net worth to at least 10% of its asset value, the bonds issued to recapitalize the banks yield a variable rate equal to TIBP plus two percentage points and the banks will receive a commission to rehabilitate non-performing loans of at least 10% of the amount recuperated. Also, the Government has finalized an action program of staff training and equipment procurement to strengthen the newly independent Superintendency (para. 47), with technical assistance from the Fund and financing from USAID.

84. Since the public authorities are reducing their direct intervention in the financial system and intend to decontrol interest rates in 1993, the banks and Superintendency must be rehabilitated as soon as possible so that they may be in a position to perform satisfactorily in a more competitive environment (para. 48). Initiation of sale of at least two commercial banks, adequate progress in the implementation of the Superintendency's rehabilitation program and the completion of a plan to recapitalize and sell the savings & loans associations and the Banco Hipotecario are conditions for second tranche release, while the implementation of this last plan represents a condition for third tranche release.

Agriculture Sector

85. An important constraint on the agricultural sector has been the discriminatory treatment it received through the trade policies pursued by past governments. The Government is correcting this problem by incorporating the agricultural sector into the same trade and incentive regime applicable to other products. Much of the conditionality in this area, therefore, is already being addressed in the trade policy conditions for SAL disbursement (paras. 73-75). With

respect to basic grains, import and export permit requirements are to be eliminated for rice, sorghum and yellow maize as a condition for second tranche release. In the special case of white maize and beans, import permit requirements will be eliminated if an agreement is reached among the Central American countries to, either, adopt a uniform basic grains policy or permit the application of variable tariffs on intra-regional imports of basic grains, while export permits are to be eliminated once the Government's targetted nutrition programs (described in para. 57) are fully operating. With respect to products covered by PL-480 agreements, import and export permit requirements are to be eliminated by third tranche release, unless maintaining such requirements is part of the agreements.

86. The other important step in the agricultural sector supported by the SAL is the divestiture of assets of the parastatal marketing companies, whose monopoly rights already have been abolished and which now constitute a fiscal burden (paras. 51-52). As a condition for Board presentation, the Government has completed an action plan to reform IRA and sell its assets. The implementation of this plan, along with the completion of an action plan to reform and sell the assets of INAZUCAR, INCAFE and the marketing activities of BFA, are conditions for second tranche disbursement. Finally, inititating the sale of the assets of INAZUCAR, INCAFE and BFA's marketing activities constitutes a condition for third tranche disbursement.

Poverty Alleviation

87. The 3-year Social Investment Fund recently approved by the Legislature should serve as a safety net to mitigate the possible adverse impact of the structural adjustment program on the most vulnerable groups. The SIF is being supported through the IDB, while the SAL's conditionality would focus on three specifically targeted nutritional assistance programs and on public expenditures patterns in the education and health sectors (paras 57-58). Prior to Board presentation, the Government completed preparations for a pilot project to distribute nutritionally fortified cookies to schoolchildren, which is to begin in March 1991. Based on the pilot project results, the Government will expand the fortified cookies program to to about one-third of the 78 municipalities with the highest incidence of malnutrition and initiate a pilot project to distribute weaning formula through health posts by end-1991. The expansion of the cookies program to all 78 municipalities, the expansion of the weaning formula distribution program to one-third of these municipalities and the initiation of a pilot project to distribute food coupons to the poor would be conditions for third tranche disbursement.

88. The continuous decline in real public expenditures devoted to health and education threatens to constrain future growth by limiting human capital formation (para. 58). Fundamental reforms of the Ministries, needed to improve the delivery of primary health and basic education services, will be supported by a Bank Social Sector Rehabilitation Project that is scheduled to be presented to the Board in

CY91. At the same time, it is important that these sectors not be underfinanced. The Government will present a draft 1992 Budget for review with the Bank prior to submission to the National Assembly. Agreement with the Bank on the sectoral distribution of planned expenditures in the 1992 Budget, with special attention to basic health and primary education, would be a condition for second tranche release.

C. Poverty Impact

89. The Government's reform program is expected to contribute significantly toward reducing absolute poverty, even in the short run. Most important in this respect are the exchange rate and tariff policy reforms, which reduced the distortions in producer prices for basic grains, and the elimination of most price controls and IRA, which had represented major sources of inefficiency. As described earlier, three-fourths of the persons in the lowest income quintile live in rural areas and they are mainly engaged in basic grains agriculture. The improved incentive environment in this sector, which already appears to be bearing fruit in terms of higher production, is expected to be especially beneficial to rural incomes. The improved profitability of coffee production resulting from the exchange rate measures and export tax reductions also should benefit the poor, given that this sector is a major source of employment for low wage workers. The urban poor, on the other hand, may stand to lose from higher food prices. This problem, however, is being partly addressed by the creation of the Social Investment Fund and specifically targetted nutrition programs. These social sector actions are also expected to act as a safety net for poor urban workers who may be adversely affected by adjustments in the industrial sector as the level of protection is reduced. In the medium term, however, these workers should also experience an income gain through the unification of the tariff schedule, which reduces the bias against labor in favor of capital inputs.

90. The raising of the interest rate to reflect higher inflation and, eventually, the higher cost of capital in a capital-poor economy, should also benefit labor by raising incentives for producers to switch toward more labor-intensive techniques. This process would be reinforced by the creation of a less repressed, more competitive private banking system that would give smaller industries, which generally are more labor intensive and currently are rationed out of the financial markets, better access to credit markets.

91. The Government's tax reforms and the proposed introduction of the VAT render the legal tax structure less progressive. This is compensated, however, by the raising of the minimum taxable levels of income and wealth, which should benefit lower-middle income persons and small businesses. Marginal tax rates prior to the reforms were often unrealistically high, with the effect that they were largely evaded, rendering the nominal progressivity of the tax system meaningless. By bringing down those rates, eliminating tax exemptions and simultaneously strengthening tax enforcement, it is expected that more revenues will be collected from higher income groups. Those living in absolute poverty,

on the other hand, should remain unaffected by the income and wealth tax reforms, since they are generally not registered taxpayers. While the VAT is not progressive, it is less regressive than the sales tax, which it replaces, thus representing an improvement from the viewpoint of consumers.

92. Finally, it is worth noting that the short term stabilization efforts of the Government on balance should have a beneficial impact on poverty by virtue of the fact that the poor are more vulnerable to real income erosion through inflation than the relatively better off. Lower income groups generally hold a higher proportion of their wealth in money, given that they are less able, both materially and as a product of lesser education, to diversify their wealth into other productive assets. Also, the wages of low-skill workers in the informal sector are likely to be the least responsive to inflation. The groups that stand to lose as a result of the disinflationary measures introduced by the Government are medium income workers in the formal sector that may be laid off during the adjustment process.

D. Proposed Tranche Conditionality

93. The proposed loan would be disbursed in three equal tranches of US$25 million each. The first tranche would be disbursed upon effectiveness. There are no special conditions for effectiveness other than those specified under the General Conditions applicable to the Bank's Loan Agreement. Before presentation of the loan to the Executive Directors, the Government has taken the following actions:

(a) unified the exchange rate and adjusted all import tariff rates within a range of 5% and 35%, except for tariffs on wheat imports. Also, the Government has publicly announced a schedule of annual tariff adjustments, whereby all tariffs are to be brought within a range of 10% and 20% by June 1993 (except for textiles, leather and shoe imports, whose tariffs would lie in this range by June 1994). Finally, the Government has removed import and export permit requirements on 32 tariff items and presented the Bank with a schedule to remove most of the remaining permit requirements (para. 74);

(b) presented to the Bank a satisfactory action plan to improve tax enforcement and expand the base of registered taxpayers. Also, the authorities have adopted an action program satisfactory to the Bank to replace the sales tax by a value-added tax by June 1992 (para. 76);

(c) submitted to the Legislative Assembly an ordinary budget for 1991 that is consistent with a public savings target of 1.7% of GDP (para. 77);

(d) removed interest rate controls on interbank loans and established an interest rate band, within which commercial interest rates are free to move, and such that the interest rate floor is not less than the annualized inflation rate prevailing since June 1990 (paras. 80-81);

(e) submitted to Congress a package of laws enabling the recapitalization and privatization of the nationalized banks and savings & loan associations, as well as the reform of the Superintendency of Banks. The Government will have issued accompanying regulations defining the terms of the bank recapitalization that were satisfactory to the Bank and presented a plan to rehabilitate the Banking Superintendency, with technical assistance to be financed through USAID (para. 83);

(f) finalized an action plan to reform IRA and sell its assets (para. 86); and

(g) obtained legislative approval to establish the Social Investment Fund and set aside sufficient funds to initiate its operations in early 1991. Also, the Government will have finalized the preparations for a pilot project to distribute nutritionally fortified cookies to schoolchildren beginning with the commencement of the school year in March 1991 (para. 87);

94. Release of the second tranche (expected to take place in October-November 1991) would be contingent on satisfactory progress in the implementation of the Government's structural adjustment program, including the maintenance of a supportive macroeconomic framework, and fulfilling the following conditions:

(a) adjustment of import tariffs according to the announced schedule (as set out in the program, including raising the tariff on wheat to 5%), together with the elimination of import tariff exemptions for autonomous public sector institutions and enterprises, with the possible exception of certain (investment) goods agreed between the Government and the Bank that are imported by ANDA, ANTEL, CEL, CEPA and ISSS.(para.75);

(b) implementation of the action programs to improve tax enforcement and introduce a value-added tax (para. 76);

(c) public announcement by the Government that all commercial interest rates would be decontrolled by January 1993, elimination of interest rate controls on commercial bank loans and deposits with maturities of more than one year, and unification of all Central Bank rediscount rates on short term credit lines (excluding those credit lines financed by foreign assistance loans or grants with specific provisions for onlending at preferential rates) to a rate not less than the prevailing market rate on 180-day commercial bank deposits (para. 82);

(d) bringing to the market for sale at least two recapitalized commercial banks, having progressed in the implementation of the Superintendency's rehabilitation program and adoption of action plans to recapitalize and privatize the savings & loans associations and the Banco Hipotecario (para. 84);

(e) bringing the assets of IRA to the market for sale and adoption of action plans satisfactory to the Bank to divest the assets of INAZUCAR, INCAFE, and the marketing activities of BFA (para. 86); and

(f) agreement with the Bank on the 1992 fiscal budgetary allocations for the social sectors (with special attention to basic health and primary education) prior to submission of the Budget to the Legislative Assembly (para. 88).

95. Release of the third tranche (expected to take place in the fourth quarter of 1992) would also be contingent on continued progress in the implementation of the adjustment program, including the maintenance of a supportive macroeconomic framework, and fulfillment of the following conditions:

(a) elimination of all but 16 import permit requirements (excluding those that may be regulated by PL-480 agreements) and of all but 4 export permit requirements (excluding those that may be regulated by PL-480 agreements) (paras. 75, 85);

(b) putting into effect a value-added tax in place of the sales tax (para. 76);

(c) preparation of a consolidated budget for fiscal year 1993 and submission of such budget to Legislative Assembly (para. 78);

(d) elimination of interest rate controls on commercial bank deposits with maturity of more than 180 days (para. 80);

(e) commenced implementation of plan to restructure and privatize the savings & loans associations and the Banco Hipotecario, and of plans for divestiture of the assets of INAZUCAR, INCAFE and the marketing activities of BFA. Also, the Government will have ceased to hold a controlling shareholding in at least one commercial bank (paras. 83-84, 86); and

(f) based on the pilot project results to be reviewed with the Bank, the Government will have expanded the coverage of its nutritional assistance programs, namely the distribution of fortified cookies to schoolchildren and the distribution of weaning formula through health posts, as scheduled, and will have initiated a pilot project, satisfactory to the Bank, to distribute food coupons to the poor (para. 87).

E. Implementation Assistance

96. The adjustment program is being coordinated jointly by the Government's Economic Council, headed by the Minister of Planning and including the Ministers of Finance, Economy and Agriculture and the President of the Central Bank. The UNDP, USAID, IMF, IDB and the Bank-supported Regional Unit for Technical Assistance (RUTA) have been the main sources of financing and technical assistance support for strengthening the Government's program implementation capacity. The UNDP has been supportive of the preparation of the Government's public sector investment review, completed in December 1990. USAID currently is preparing with the Government a program to strengthen tax enforcement capacity (through the Programa de Mejoramiento y Modernization) and will be financing technical assistance to help the Government's program to rehabilitate the Banking Superintendency, liberalize interest rates and privatize the nationalized banks. USAID also has been active in helping the Government design a plan to divest the assets of IRA. IMF will be financing two long term consultants; one to assist in the areas of monetary management and banking superintendency reform, and another to help redesign the Central Government's accounting systems through the Finance Ministry. The IDB has been supporting the program to design a comprehensive taxpayers' registry (Registro Unico de Contribuyentes). Finally, RUTA has been assisting the Government in the area of agricultural sector reform, including the introduction of a market-oriented price band mechanism to stabilize basic grains prices, and in improving nutritional assistance, including the preparation of the strategy to introduce fortified cookies, weaning formula and food coupons.

F. Procurement, Disbursement and Auditing

97. Loan proceeds (US$75 million) would be used to finance the CIF cost of eligible imports by the public and private sectors. Ineligible imports comprise goods financed by other multilateral or bilateral sources, luxury goods and goods intended for military use. Retroactive financing of US$ 15 million (20% of loan total) is recommended for eligible imports made before the date of the agreement, but not before December 1, 1990.

98. Procurement will be carried out in accordance with the Bank's Procurement Guidelines. Imports by the public and private sectors estimated to cost more than US$ 3 million equivalent will be procured through simplified ICB procedures. Imports by the private sector, valued at less than US$ 3 million equivalent would be procured following established commercial practices. Public sector imports valued at less than US$ 3 million equivalent, would be procured following Government procurement practices.[1/] The Central Bank will carry out the screening process to ensure that all procurement conditions have been met. To

1/ A draft country procurement assessment is now under review and specific country procurement issues are being addressed.

assist with this work, the Department for Control of International Prices at the Central Bank, which has successfully monitored USAID programs, has been evaluated by the Bank and found to be satisfactory to oversee procurement for the duration of the loan. In addition, the Government has agreed to retain a procurement consultant, whose cost would be eligible for withdrawals from the Loan Account in an amount of up to US$30,000, to help with the processing and verification of documentation supporting withdrawal applications under this this loan.

99. Disbursements of each tranche would be made against import documentation received from the Central Bank, except for items from the standard negative list. The Central Bank will be responsible for the coordination and collection of relevant documentation and for preparing and submitting withdrawal applications under the loan. Disbursements against contracts valued less than US$ 1 million equivalent would be made on the basis of a Statement of Expenditures (SOE) to be submitted by the Central Bank, with the detailed documentation retained by the Central Bank for review by the Bank as required. Full documentation would be required for the approval of individual contracts exceeding US$ 1 million equivalent. Application for withdrawals will be consolidated and submitted in amounts not less than US$ 250,000 equivalent. Expenditures for goods procured under individual contracts valued at less than US$ 15,000 equivalent would not be eligible for financing under the loan. In addition to standard auditing covenants, an audit report would be submitted to the Bank no later than 90 days after the full disbursement of each tranche.

G. Cofinancing

100. Cofinancing possibilities have been explored with the Japanese Eximbank and OECF, but this did not result in a cofinancing commitment for this operation. The IDB has approved a US$60 million global multisectoral credit operation in December 1990 that complements the measures supported under the SAL and could provide the basis for IDB cofinancing of a future financial sector operation. As a consequence of the strong demand for aid among Eastern European economies, together with the advent of the Gulf crisis, cofinancing from Western European countries was not available for this operation. Among the non-US donor coummunity there has been only limited interest so far in providing additional economic aid to El Salvador. The Government has recognized this and has attempted to improve its international image by disseminating information about its economic and social program. A Consultative Group has been tentatively scheduled for Spring 1991.

H. Program Benefits and Risks

101. The main benefits of the Government's structural adjustment program are that it would (i) accelerate export growth and export diversification, thus reducing the country's vulnerability to external trade shocks, (ii) reduce direct state intervention in financial intermediation and in the productive sectors, enabling a more efficient allocation of resources, (iii) strengthen the public sector's fiscal

control, improving it's ability to deliver basic social services, and contribute significantly toward reducing absolute poverty. These measures would set the basis for sustained rapid growth and improve the country's creditworthiness, facilitating future access to external finance.

102. There are three potential risks to successful program implementation: insufficient Government capacity to carry out the complete program, inadequate external financing and a volatile political environment. The Government is firmly committed to moving away from state intervention and proceeding with a rapid program of deregulation and privatization and has already implemented major reform measures in the trade, finance and fiscal sectors. While legislative approval of further measures may prove more difficult with the approaching legislative elections in March 1991, it is unlikely that the momentum of the program would be slowed down significantly, especially since many of the major legislative steps needed for the reform program have already been taken. While further adverse developments in the oil market cannot be dismissed, to date the Government has responded in a correct manner to higher oil prices and we do not project major disruptions from this source.

103. The level and timeliness of external aid are critical elements for the program's success and are closely linked to a peace settlement and to bilateral donors' concerns about human rights. The increased number of claimants for donor resources (both within Central America and Eastern Europe) introduces additional uncertainty. New commitments, as well as disbursements of resources already committed to the country, have been contingent on improvements in the country's human rights record. A minor financing shortfall could be accomodated by scaling back growth targets, but a large scale withdrawal of international financial support could force the Government to abandon its liberalization and poverty alleviation efforts.

104. Finally, domestic political stability is essential for the successful implementation of the Government's ambitious structural adjustment program. Although recent political changes in Central America and the resumption of peace talks with the Farabundo Marti National Liberation Front have been promising, the situation remains volatile. As the peace negotiations center on the hard issues of reintegration of the guerillas and the future role of the army, the possibility of a breakdown of talks and resurgence of violence increases. Such a course of events would impair the program's prospects.

PART IV - COUNTRY ASSISTANCE STRATEGY AND BANK LENDING OPERATIONS

105. Between 1949 and 1979, El Salvador received 19 Bank loans and 4 IDA credits totalling US$235.6 million equivalent net of cancellations. Bank group lending initially focused on infrastructure development to support productive activities, with smaller amounts

devoted subsequently to the social sectors. Of total disbursements, power projects accounted for 42%, telecommunications for 18%, education for 18%, transport (roads) for 13% and urban development for 9%. An Earthquake Reconstruction Loan (US$65 million) was approved in September 1987, complemented by a Japanese Yen Grant Facility of Y1.5 billion. In addition to supporting physical reconstruction efforts, the Bank assisted the Government in designing an overall reconstruction strategy and in coordination of foreign emergency assistance. In July 1990, the Earthquake Reconstruction Project was modified to include financing for the rehabilitation of damaged and debilitated primary schools, especially in rural areas.

106. The Bank's country strategy for El Salvador focuses on medium term structural adjustment, but recognizes the need to assist the Government in overcoming important short term constraints. The program, which has been coordinated with the IMF and the IDB, concentrates on: (i) addressing key policy and structural issues through quick disbursing operations; (ii) complementing and supporting the structural adjustment process with operations in the social sectors to support the Government's objectives of eradicating absolute poverty and minimizing the impact of adjustment on the most vulnerable members of the population; (iii) developing a pipeline of project lending, particularly in the productive sectors; and (iv) assisting the Government to mobilize additional resources on terms as concessional as possible.

107. At the macroeconomic level, the Bank would provide adjustment support through two quick disbursing operations: this SAL and a financial sector loan. In the financial sector, the SAL aims to support the initial steps taken in the areas of interest rate liberalization and monetary policy reform, which prepare the ground for the creation of a well-functioning private banking system. Further financial sector reforms would be addressed in a subsequent sector loan. Similarly, the SAL supports critical reforms in the productive sectors, needed to generate sustained economic growth, and the reorientation public resources toward key social sectors and specially targetted nutrition programs to mitigate the impact of the adjustment measures on the poor. These policy reform efforts would be accompanied by medium term reforms in the social sectors to be supported by a Social Sector Rehabilitation Project, which is under preparation. The Social Sector Rehabilitation Project focuses on structural reforms in the ministries of Health and Education, as well as sectoral investments, to enable a more efficient delivery of basic social services.

108. Preparation has also begun on the design of an agriculture operation, which would follow up on the reforms in basic grains pricing and the divestiture of parastatals initiated under the SAL. This operation would be designed in parallel with an IDB-financed operation.

109. Bank involvement in infrastructure investment will be limited until there is a solution to the civil conflict. As a first step, a technical assistance loan for the energy sector is under preparation. Bank support would focus on improving pricing policies operational

efficiency, training needs and the preparation of feasibility studies. In addition to policy and project lending, the Bank would provide technical assistance in such areas as public sector management, public investment planning and financial management. The above strategy is conditional on the continued willingness and ability of the Government to carry out the adjustment effort. Performance will be monitored closely and the strategy adjusted as appropriate.

PART V - IBRD/IMF COLLABORATION

110. The Bank and IMF have worked in close cooperation with El Salvador during the preparation of the proposed SAL. On August 27, 1990, the IMF's Board of Directors approved a Stand-by arrangement for El Salvador of SDR 35.6 million. An IMF mid-term review mission visited El Salvador in November 1990 and reported that the adjustment program remained on track: all Stand-by performance criteria through September 1990 were observed. El Salvador's quota in the IMF is SDR89 million and its current obligations to the Fund consist entirely of outstanding Trust Fund loans amounting to SDR 0.13 million. We will continue to work closely with Fund staff on key issues as the economic program progresses.

PART VI - RECOMMENDATION

111. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Bank and recommend that the Executive Directors approve the proposed loan.

Barber B. Conable
President

Attachments

Washington, D.C.
January 17, 1991

EL SALVADOR - NATIONAL ACCOUNTS

ANNEX I
Attachment 1a
(Page 1 of 2)

1988 Per Capita GNP in US$: 950.0
Mid-1988 Population (mils.) 5.06

A. National Accounts (As % of current GDP)	1970	1975	1980	1985	1986	1987	1988	Pre. 1989	Projected 1990	1991	1992	1993	1994	1995
Gross Domestic Product m.p.	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Agriculture	28.4	23.0	27.8	18.2	20.2	14.0	13.9	..	..	..	..	..	..	..
Industry	23.3	24.9	20.7	21.9	20.5	22.7	22.5	..	..	..	..	..	..	..
(of which Manufacturing)	18.8	18.6	15.0	16.4	15.5	..	..	..	..	..	..	..	..	..
Services	48.2	52.1	51.5	59.9	59.3	63.3	63.6	..	..	..	..	..	..	..
Resource Balance	0.3	-5.1	0.9	-7.6	-3.2	-7.7	-6.5	-10.3	-10.6	-8.8	-7.5	-6.4	-5.8	-5.0
Exports of GNFS	25.0	33.2	34.2	22.3	26.0	17.9	15.8	13.0	16.8	17.4	18.5	19.6	20.8	22.0
Imports of GNFS	24.7	38.3	33.2	29.9	29.1	25.7	22.3	23.3	27.4	26.2	26.0	25.9	26.6	26.9
Total Expenditures	99.7	105.1	99.1	107.6	103.2	107.7	106.5	110.3	110.6	108.8	107.5	106.4	105.8	105.0
Total Consumption	86.8	83.0	85.8	96.7	89.9	94.9	93.7	94.0	98.5	95.8	94.5	93.3	92.3	91.0
Private Consumption	76.1	71.8	71.8	81.2	77.9	81.8	80.9	81.8	87.1	85.9	85.1	83.4	82.4	81.1
General Government	10.7	11.2	14.0	15.5	12.1	13.1	12.7	12.2	11.4	9.8	9.4	9.9	9.9	9.9
Gross Domestic Investment	12.9	22.1	13.3	10.8	13.3	12.8	12.8	16.3	12.1	13.0	13.0	13.1	13.5	14.0
Fixed Investment	11.6	23.0	13.6	12.0	13.3	13.5	12.5	13.1	12.1	13.0	13.0	13.1	13.5	14.0
Changes in Stocks	1.3	-0.9	-0.3	-1.2	0.0	-0.7	0.3	3.2	0.0	0.0	0.0	0.0	0.0	0.0
Gross Domestic Saving	13.2	17.0	14.2	3.3	10.1	5.1	6.3	6.0	1.5	4.2	5.5	6.7	7.7	9.0
Net Factor Income	-0.9	-2.3	-1.4	-3.5	-3.2	-1.6	-1.9	-1.7	-2.1	-2.2	-2.0	-2.1	-1.9	-1.8
Net Current Transfers	1.2	1.4	0.5	2.3	3.7	4.3	9.3	8.9	10.3	9.6	8.0	6.8	5.7	5.2
Gross National Saving	13.5	16.2	13.2	2.1	10.5	7.9	13.8	13.2	9.7	11.6	11.5	11.5	11.4	12.4

B. National Accounts Growth (Constant Prices)	Actual 70-75	75-80	80-84	1984	1985	1986	1987	1988	Pre. 1989	Projected 1990	1988-93	1993-98
Gross Domestic Product m.p.	5.5	1.0	-2.8	2.4	1.8	0.5	2.7	1.6	1.1	2.5	2.3	4.9
Agriculture	4.7	1.3	-2.8	3.3	-1.2	-3.0	2.1	-1.0	..	..	..	..
Industry	7.2	0.7	-3.7	0.6	4.0	2.6	4.3	3.5	..	..	..	..
(of which Manufacturing)	5.7	0.3	-4.0	1.3	3.7	2.5	3.0	..	..	..	..	..
Services	5.0	1.1	-2.4	2.6	2.6	1.5	2.4	2.1	..	..	..	..
Exports of GNFS	7.9	2.3	-5.3	-4.4	-3.9	-12.6	12.4	-9.3	-12.5	29.2	5.9	8.7
Imports of GNFS	6.6	2.7	-5.2	2.0	0.5	-2.8	0.4	-0.8	7.5	-3.3	1.6	5.7
Total Expenditures	5.2	1.1	-2.7	4.6	3.2	3.3	0.4	1.2	4.5	-2.1	1.5	4.4
Total Consumption	4.3	1.8	-2.4	4.8	4.4	1.0	1.1	1.7	0.3	1.9	1.2	4.1
Private Consumption	4.2	1.3	-3.3	4.8	3.9	0.3	0.6	1.5	1.0	3.5	1.9	3.9
General Government	5.2	5.5	2.2	4.8	6.8	3.7	3.0	2.5	-4.2	-9.1	-3.6	5.4
Gross Domestic Investment	10.8	-3.0	-5.0	3.0	-5.6	21.6	-4.2	15.6	34.6	-23.6	3.7	6.3
Fixed Investment	14.9	-4.0	-6.6	2.3	10.2	7.5	9.1	2.3	11.0	-5.0	4.2	6.3
Capacity to Import	3.3	6.2	-12.0	-5.0	-1.5	15.9	-19.9	-2.0	-15.3	6.1	2.8	10.6
Gross Domestic Income	4.4	2.0	-4.7	2.8	2.9	8.2	-5.5	1.7	0.7	-0.7	1.7	5.2
Gross National Income	4.3	2.0	-5.2	2.9	3.0	8.4	-5.8	2.2	0.8	-0.7	1.8	5.4
Gross National Product/a	5.4	1.0	-3.2	2.4	1.9	0.4	2.7	1.5	1.2	2.5	2.3	5.1
Gross Domestic Saving	5.1	2.9	-25.3	-22.8	-23.9	183.9	-55.4	-46.6	12.5	10.7	14.1	11.2
Net Current Transfers	..	..	..	..	..	..	..	-22.0	-1.1	-4.1	-7.5	-6.4
Gross National Saving	4.5	1.3	-27.0	-24.1	-34.7	300.8	-41.2	-29.2	5.7	2.4	-0.1	9.9

/a. Excludes current transfers

EL SALVADOR - NATIONAL ACCOUNTS [continued]

ANNEX I
Attachment 1a
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C. Price Indices (1980=100):	Actual 1980	1984	1985	1986	1987	1988	Growth 1970-75	1975-80	1980-88
Consumer Prices (IFS 64)	100.0	162.1	198.2	261.6	326.7	391.1	8.6	12.8	18.6
Implicit GDP Deflator	100.0	146.5	176.6	242.6	275.9	320.8	6.0	13.6	15.7
Implicit Expenditures Deflator	100.0	144.2	176.1	241.3	270.0	305.7	7.7	8.0	15.0

D. Other Indicators:	75-80	80-88	88-93	93-98
Growth Rates (% p.a.):				
Population (IFS 99z)	2.1	1.3	2.2	2.6
Labor Force	--	--	--	--
Gross Nat'l. Income p.c.	-1.3	-2.5	-0.2	2.6
Private Consumption p.c.	-0.8	-2.4	-0.3	0.7
Import Elasticity:				
Imports (G+NFS) / GDP(mp)	0.66	1.56	1.00	1.24
Marginal Savings Rates:				
GNS wrt. GNY	0.09	0.90	0.09	0.23
GDS wrt. GDY	0.19	0.84	0.07	0.24
ICOR (lagged):	-0.9	6.6	7.1	3.1

Share of Total Labor Force in:	1975	1980
Agriculture	49.4%	43.2%
Industry	--	--
Services	--	--
Total	100%	100%

E. National Accounts (1980 mln. Colones)	Actual 1980	1984	1985	1986	1987	1988	Pre. 1989	Projected 1990	1991	1992	1993	1994	1995
Gross Domestic Product m.p.	8,917	7,971	8,117	8,157	8,377	8,511	8,605	8,820	9,014	9,335	9,670	10,109	10,665
Agriculture	2,480	2,215	2,188	2,123	2,167	2,145	..	..	..	..	..	..	..
Industry	1,846	1,590	1,654	1,697	1,770	1,832	..	..	..	..	..	..	..
(of which Manufacturing)	1,339	1,135	1,178	1,207	1,243	..	..	..	..	..	..	..	..
Services	4,591	4,167	4,275	4,338	4,442	4,535	..	..	..	..	..	..	..
Resource Balance	82	55	(52)	(282)	(36)	(232)	(669)	(50)	(0)	39	78	126	214
Exports of GNFS	3,046	2,451	2,357	2,060	2,315	2,100	1,838	2,374	2,501	2,669	2,863	3,083	3,334
Imports of GNFS	2,964	2,396	2,409	2,342	2,351	2,332	2,507	2,424	2,501	2,630	2,785	2,957	3,119
Total Expenditures	8,835	7,915	8,170	8,439	8,475	8,744	9,274	8,870	9,014	9,296	9,592	9,983	10,451
Total Consumption	7,652	6,953	7,261	7,334	7,354	7,520	7,626	7,611	7,639	7,891	8,126	8,420	8,759
Private Consumption	6,405	5,591	5,807	5,826	5,801	5,928	6,101	6,225	6,420	6,688	6,803	7,045	7,312
General Government	1,247	1,361	1,454	1,508	1,553	1,592	1,525	1,386	1,219	1,203	1,323	1,375	1,447
Gross Domestic Investment	1,183	963	909	1,105	1,059	1,224	1,648	1,259	1,375	1,405	1,466	1,563	1,692
Fixed Investment	1,210	919	1,013	1,089	1,188	1,216	1,648	1,259	1,375	1,405	1,466	1,563	1,692
Changes in Stocks	(27)	44	(104)	16	(129)	9	0	0	0	0	0	0	0
Capacity to Import	3,046	1,826	1,799	2,086	1,671	1,737	1,447	1,414	1,488	1,697	1,929	2,147	2,419
Terms of Trade Adjustment	0	(625)	(557)	26	(644)	(363)	(391)	(960)	(1,013)	(972)	(935)	(935)	(915)
Gross Domestic Income	8,917	7,346	7,560	8,183	7,733	8,148	8,214	7,860	8,001	8,363	8,736	9,174	9,750
Gross National Income	8,789	7,086	7,297	7,912	7,457	7,995	8,069	7,712	7,840	8,217	8,578	9,021	9,600
Gross National Product	8,789	7,711	7,854	7,886	8,101	8,358	8,460	8,672	8,853	9,189	9,513	9,956	10,515
Gross Domestic Saving	1,265	393	299	849	379	629	588	249	362	472	610	754	991
Net Factor Income	(128)	(260)	(263)	(271)	(276)	(153)	(145)	(148)	(161)	(146)	(157)	(153)	(150)
Gross National Saving	1,181	335	219	877	516	475	443	101	201	326	452	601	841

obs: Preliminary and projected data are based on RMSM estimates.

EL SALVADOR - EXTERNAL TRADE

ANNEX I
Attachment 1b

A. Volume, Value and Prices	1980	1984	1985	1986	1987	1988	Pre. 1989	Projected 1990	1991	1992	1993	1994	1995
Merchandise Exports	Volume Index 1980=100												
Coffee	100.0	89.1	86.3	73.4	84.5	68.2	46.8	83.1	85.1	89.7	94.5	99.5	104.8
Cotton	100.0	10.1	45.3	11.6	5.1	0.7	1.5	2.0	1.6	1.7	3.7	8.0	17.6
Sugar	100.0	217.8	322.8	285.7	109.4	226.7	84.3	139.1	299.0	277.4	257.4	238.8	221.5
Shrimp	100.0	166.9	85.1	144.8	118.7	104.3	66.4	79.7	82.9	108.4	141.7	148.8	156.2
CACM & Other	100.0	65.5	51.4	33.9	39.2	41.3	45.5	49.0	51.4	54.6	59.7	67.0	75.1
Total Merch. Exports FOB	100.0	77.1	82.4	72.3	78.7	68.6	56.4	80.7	84.9	89.7	96.1	103.5	111.8
	Value-Current Prices (US$ millions)												
Coffee	615	450	464	547	352	358	227	256	294	357	412	476	549
Cotton	85	9	29	5	2	0	1	1	1	1	3	6	13
Sugar	13	26	23	25	12	19	13	22	39	35	30	26	22
Shrimp	13	20	10	17	21	16	10	12	13	17	23	24	26
CACM	..	157	96	91	120	140	161	170	192	208	229	256	289
Other	348	64	74	70	85	76	84	110	130	145	162	190	225
Total Merch. Exports FOB	1,074	726	695	755	591	609	496	571	668	764	859	978	1,125
Merchandise Imports	Volume Index 1980=100												
Food	100.0	100.7	90.5	76.0	79.3	52.8	56.2	56.9	52.0	53.3	55.4	57.6	60.2
Other Consumer Goods	100.0	130.4	167.0	85.7	99.4	379.8	440.8	452.9	445.7	465.3	498.4	534.2	558.4
Petroleum and Derivatives	100.0	99.3	103.2	61.9	71.6	53.2	47.7	48.8	49.5	50.6	52.4	54.3	56.7
Intermediate	100.0	128.7	122.7	107.8	105.0	103.6	118.5	118.5	111.4	114.1	118.6	123.3	128.9
Capital Goods	100.0	137.9	167.2	231.7	237.2	224.5	241.0	204.0	188.6	197.0	211.0	233.9	264.7
Total Merch. Imports CIF	100.0	117.2	117.2	111.0	107.5	104.8	116.1	112.7	107.3	110.8	116.8	124.1	132.1
	Value-Current Prices (Million $)												
Food	273	239	211	182	208	33	37	39	39	42	44	46	50
Other Consumer Goods	34	38	48	25	32	225	268	275	280	302	334	370	399
Petroleum & Derivatives	151	130	133	82	104	81	87	113	161	144	117	125	123
Intermediate	393	438	412	371	397	415	490	521	536	567	596	631	677
Capital Goods	111	132	158	225	252	253	280	251	255	275	298	336	391
Total Merch. Imports CIF	962	978	961	935	994	1,007	1,161	1,200	1,270	1,329	1,389	1,508	1,640
Terms of Trade Indices	Price Indices 1980=100												
Merchandise Exports	100.0	87.7	78.6	97.2	69.9	82.6	81.9	65.9	73.3	79.3	83.3	88.0	93.7
Merchandise Imports	100.0	86.7	85.3	87.6	96.2	99.9	104.0	110.7	123.1	124.7	123.6	126.4	129.1
Merchandise Terms of Trade	100.0	101.1	92.1	111.0	72.7	82.7	78.7	59.6	59.5	63.6	67.4	69.7	72.5

	B. As % of Total (current prices)							C.Growth Rates (%)(constant prices)				
Merchandise Exports	1970	1975	1980	1984	1988	1993	1998	70-75	75-80	80-88	88-93	93-98
Coffee	50.4	32.3	57.3	62.0	58.8	48.0	43.2	3.6	5.4	-4.7	6.7	5.3
Cotton	9.8	14.3	7.9	1.3	0.0	0.3	8.4	12.0	-7.1	-46.5	40.3	119.6
Sugar	3.0	15.4	1.2	3.6	3.2	3.5	0.9	20.7	-23.7	10.8	2.6	-10.5
Shrimp	2.2	2.0	1.2	2.8	2.6	2.6	1.9	0.0	-3.5	0.5	6.3	5.0
CACM	..	..	..	21.7	23.0	26.6	24.1	..	..	..	..	..
Other	34.6	36.0	32.4	8.8	12.4	18.9	21.4	9.8	1.7	-10.5	7.7	12.2
Total Merch. Exports FOB	100.0	100.0	100.0	100.0	100.0	100.0	100.0	8.8	-0.7	-4.6	7.0	9.1
Merchandise Imports												
Food	15.8	14.7	28.4	24.4	3.3	3.2	3.0	6.0	7.4	-7.7	1.0	5.0
Other Consumer Goods	12.2	6.6	3.5	3.9	22.3	24.1	23.0	-0.7	1.5	18.2	5.6	5.7
Petroleum & Derivatives	5.6	14.7	15.7	13.3	8.0	8.4	9.4	15.9	13.7	-7.6	-0.3	4.9
Intermediate	40.9	39.2	40.9	44.9	41.2	42.9	43.4	6.1	-1.5	0.4	2.7	5.0
Capital Goods	25.5	24.8	11.5	13.5	25.1	21.4	21.0	17.6	-14.4	10.6	-1.2	8.1
Total Merch. Imports CIF	100.0	100.0	100.0	100.0	100.0	100.0	100.0	7.7	-0.6	0.6	2.2	5.9

ANNEX I
Attachment 1c

EL SALVADOR - BALANCE OF PAYMENTS

(US$ Millions)

BALANCE OF PAYMENTS	1980	1984	1985	1986	1987	1988	Pre. 1989	Projected 1990	1991	1992	1993	1994	1995
A. Exports of Goods & NFS	1,214	894	922	976	837	865	761	859	996	1,117	1,237	1,387	1,572
1. Merchandise (FOB)	1,074	726	695	755	591	609	496	571	668	764	859	978	1,125
2. Non-Factor Services	140	168	227	221	246	257	265	287	328	354	378	409	447
B. Imports of Goods & NFS	1,235	1,217	1,250	1,175	1,198	1,220	1,364	1,402	1,497	1,569	1,641	1,775	1,927
2. Merchandise (CIF)	962	978	961	935	994	1,007	1,161	1,200	1,270	1,329	1,389	1,508	1,640
3. Non-Factor Services	273	239	289	240	204	213	202	202	226	240	252	267	286
C. Resource Balance	(21)	(323)	(328)	(199)	(361)	(354)	(602)	(543)	(501)	(451)	(403)	(388)	(355)
D. Net Factor Income	(64)	(101)	(93)	(135)	(72)	(102)	(100)	(108)	(128)	(120)	(131)	(130)	(131)
1. Factor Receipts	55	61	46	19	82	40	43	45	58	61	59	60	69
2. Factor Payments	119	162	139	154	154	142	143	153	187	181	190	190	200
(interest payments)	36	74	76	74	76	76	92	94	102	109	112	116	126
E. Net Current Transfers 1./	49	315	319	384	574	509	519	529	549	483	431	380	375
F. Current Account Balance	(36)	(109)	(102)	50	141	52	(183)	(123)	(81)	(88)	(103)	(138)	(111)
G. Long-Term Capital Inflow	206	273	314	78	(41)	67	(9)	30	93	96	131	175	173
1. Net Direct Investment	6	12	12	0	(50)	0	0	(7)	0	0	10	20	30
2. Official Capital Grants	0	0	0	0	0	0	0	0	0	0	0	0	0
3. Net LT Loans (DRS data)	100	127	18	(11)	1	67	(9)	38	93	96	121	155	143
a. Disbursements	135	257	157	126	120	189	142	178	211	213	235	275	253
b. Repayments	35	130	139	137	119	122	151	140	118	117	114	119	110
4. Other LT Inflows	100	134	283	89	8	0	0	0	0	0	0	0	0
H. Total Other Items (net)	(251)	(172)	(190)	(85)	(12)	(207)	182	67	(3)	16	(4)	0	(7)
1. Net Short Term Capital	32	15	(73)	(44)	1	0	0	0	0	10	0	0	(10)
2. Capital Flows N.E.I.	0	0	0	0	0	(0)	0	(0)	(3)	6	(4)	0	3
3. Errors and Omissions	(282)	(186)	(118)	(41)	(13)	(207)	182	67	0	0	0	0	0
I. Change in Net Reserves [() indicates increase]	81	7	(21)	(43)	(88)	64	(56)	(60)	(85)	(71)	(51)	(39)	(51)
1. Net Credit from the IMF	25	(55)	(27)	(54)	(37)	(5)	(4)	35	50	46	27	1	(3)
Shares of GDP (current US$):													
1. Resource Balance	-0.6%	-6.9%	-5.7%	-5.0%	-7.7%	-6.5%	-10.3%	-10.6%	-8.8%	-7.5%	-6.4%	-5.8%	-5.0%
2. MLT Interest Payments	1.0%	1.6%	1.3%	1.9%	1.6%	1.4%	1.6%	1.8%	1.8%	1.8%	1.8%	1.7%	1.8%
3. Current Account Balance	-1.0%	-2.3%	-1.8%	1.3%	3.0%	1.0%	-3.1%	-2.4%	-1.4%	-1.5%	-1.6%	-2.1%	-1.6%
4. LT Capital Inflow (line G)	5.8%	5.9%	5.5%	2.0%	-0.9%	1.2%	-0.2%	0.6%	1.6%	1.6%	2.1%	2.6%	2.4%
5. Net Credit from the IMF	0.7%	-1.2%	-0.5%	-1.4%	-0.8%	-0.1%	-0.1%	0.7%	0.9%	0.8%	0.4%	0.0%	-0.0%
Foreign Exchange Reserves:													
1. Int'l. Reserves (IFS 1ld)	77.5	165.8	179.6	169.7	186.1	..	..	..	..	..	..	..	..
2. Gold (nat. val., IFS 1and)	21.80	19.80	19.80	19.80	19.80	..	..	..	..	..	..	..	..
3. Gross Reserves	99.3	185.6	199.4	189.5	205.9	238.1	293.9	353.9	438.9	509.8	560.5	599.1	650.3
4. Net Res. in Months Imports	0.8	1.6	1.7	1.7	1.9	2.3	2.6	3.0	3.5	3.9	4.1	4.1	4.1
Exchange Rates (C/US$):													
1. Nom. Off. X-Rate (IFS ae)	2.5	2.5	2.5	5.0	5.0	5.0	5.0	..	..	..	..	..	..
2. Real Eff. X-Rate Base 1980	100.0	141.0	150.0	123.0	139.0	155.4	151.4	188.8	188.9	188.8	188.8	188.8	188.8
3. X-Rate for GDP Conversion	2.5	2.5	2.5	5.0	5.0	5.0	5.5	7.8	8.1	8.4	8.4	8.4	8.4
Memorandum Item:													
GDP (US$ Million)	3,567	4,663	5,732	3,953	4,628	5,473	5,860	5,116	5,713	6,032	6,322	6,667	7,158
GDP curr. mill.colones	8917	11657	14331	19763	23141	27366	32232	39645	46504	50854	53296	56203	60341

1./ Includes Official Capital Grants.

EL SALVADOR - EXTERNAL CAPITAL AND DEBT

(US$ Millions)

ANNEX I
Attachment 1d
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							Pre.	Projected					
A. Disbursements:	1980	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
1. Public & P.Guar. LT	135.0	256.7	157.3	126.0	119.8	189.5	141.7	333.0	237.2	213.3	225.3	264.2	241.5
Official Creditors	130.3	220.3	144.4	125.2	119.8	171.9	133.7	328.7	233.6	210.8	211.9	248.5	222.7
Multilateral	61.5	67.3	76.7	44.4	34.3	97.9	71.2	91.5	144.7	161.6	142.3	151.3	126.5
of which IBRD	10.4	11.0	14.1	3.4	3.4	13.4	0.6	2.0	57.1	59.5	27.2	35.9	24.0
of which IDA	2.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Bilateral a./	68.8	153.0	67.7	80.8	85.5	74.0	62.5	237.2	88.9	49.2	69.6	97.2	96.2
Private Creditors	4.7	36.4	12.9	0.8	0.0	17.6	8.0	4.3	3.6	2.5	13.4	15.7	18.7
Suppliers	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	2.0	4.7	7.4
Financial Markets	4.7	36.4	12.9	0.8	0.0	17.6	8.0	4.3	3.6	2.5	11.4	11.0	11.3
2. Private Non-Guar. LT	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	10.0	10.5	11.1
3. Total LT Disbursements	135.0	256.8	157.3	126.0	119.8	189.5	141.7	333.0	237.2	213.3	235.3	274.7	252.5
4. IMF Purchases	25.0	0.0	0.0	0.0	0.0	0.0	0.0	39.0	52.0	46.4	46.4	46.4	46.4
5. Net Short-Term Capital	0.0	8.0	0.0	8.0	0.0	0.0	0.0	0.0	0.0	10.0	10.0	10.0	0.0
6. Unidentified Sources	0	0	0	0	0	-0	0	-0	-3	6	-4	0	3
7. Total (all sources)	160.0	264.8	157.3	134.0	119.8	189.5	141.7	372.0	286.1	276.0	287.6	331.3	301.4
B. Repayments:													
1. Public & P.Guar. LT	17.2	122.1	128.9	115.8	105.7	107.2	135.8	126.2	105.0	107.9	109.9	115.8	105.4
Official Creditors	7.6	61.8	74.9	75.1	76.5	64.7	97.9	87.9	87.7	90.6	93.2	99.2	90.4
Multilateral	4.9	15.2	22.6	33.3	35.8	25.5	54.1	58.2	60.6	64.3	66.0	69.6	56.3
of which IBRD	2.9	5.1	8.3	7.2	8.1	10.7	11.9	12.4	12.2	12.0	16.1	16.6	17.2
of which IDA	0.1	0.4	0.3	0.6	0.5	0.5	0.4	0.4	0.5	0.5	0.5	0.5	0.6
Bilateral a./	2.7	46.6	52.3	41.8	40.7	39.2	43.8	29.7	27.1	26.3	27.2	29.6	34.1
Private Creditors	9.6	60.3	54.0	40.7	29.2	42.6	37.9	38.3	17.3	17.3	16.7	16.6	15.0
Suppliers	0.0	0.0	0.0	0.0	0.0	13.8	13.8	13.4	12.4	12.4	12.0	9.4	5.2
Financial Markets	9.6	60.3	54.0	40.7	29.2	28.8	24.1	24.9	4.9	4.9	4.7	7.2	9.8
2. Private Non-Guar. LT	17.9	7.5	10.0	20.8	13.5	15.0	15.0	14.0	13.0	9.0	4.0	3.5	5.1
3. Unidentified Sources	0	0	0	0	0	0	0	0	0	0	0	0	-1
4. Total LT Repayments	35.1	129.6	138.9	136.6	119.2	122.2	150.8	140.2	118.0	116.9	113.9	119.3	110.0
5. IMF Repurchases	0.0	55.1	27.0	53.8	40.4	5.3	4.3	4.3	2.1	0.0	19.5	45.5	49.2
6. Amortization Arrears	..	..	..	..	..	..	..	..	0.0	0.0	0.0	0.0	0.0
C. Interest:													
1. Public & P.Guar. LT	24.5	71.8	67.7	66.9	74.3	69.9	87.5	89.3	93.5	97.3	99.0	102.9	110.9
Official Creditors	22.4	46.0	53.0	59.3	64.6	53.3	72.6	78.1	86.1	91.5	94.3	98.8	106.5
Multilateral	11.2	21.5	30.5	36.4	38.5	32.7	48.1	49.4	52.1	56.3	57.8	58.7	62.1
of which IBRD	7.2	6.2	8.0	10.2	11.3	11.6	12.0	12.1	14.3	18.0	19.2	19.6	21.1
of which IDA	0.2	0.2	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Bilateral a./	11.2	24.5	22.5	22.9	26.1	20.6	24.5	28.7	33.9	35.2	36.5	40.1	44.4
Private Creditors	2.1	25.8	14.7	7.6	9.7	16.6	14.9	11.2	7.4	5.8	4.6	4.2	4.4
Suppliers	0.0	0.0	0.0	0.0	0.0	9.3	7.7	6.1	4.6	3.2	1.9	1.1	1.0
Financial Markets	2.1	25.8	14.7	7.6	9.7	7.3	7.2	5.1	2.8	2.6	2.7	3.0	3.4
2. Private Non-Guar. LT	11.0	2.5	8.0	7.3	1.9	5.6	4.4	3.3	2.2	1.2	0.9	1.1	1.8
3. Total LT Interest	35.5	74.3	75.7	74.2	76.2	75.4	91.9	92.5	95.6	98.5	99.8	104.1	112.7
4. IMF Service Charges	0.2	7.9	7.0	5.2	1.9	0.1	0.1	1.9	7.0	10.9	11.9	12.2	13.1
5. Interest Paid on ST Debt	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.5	0.8	0.7	0.4
6. Unidentified Sources	0	0	0	0	0	0	0	0	-0	0	0	-0	0
7. Total (all sources)	35.7	82.2	82.7	79.4	78.1	75.5	92.0	94.4	102.5	109.8	112.6	117.0	126.3
8. Interest Arrears	..	..	..	..	..	..	..	..	0.0	0.0	0.0	0.0	0.0
Memo: Tot. Arrears (Amort.+Int.):	..	..	..	..	6.0	29.0	70.0	-105.0	0.0	0.0	0.0	0.0	0.0

a./ Includes refinancing.

EL SALVADOR - EXTERNAL CAPITAL AND DEBT

(US$ Millions)

ANNEX I
Attachment 1d
(Page 2 of 2)

D. External Debt (DOD)	1980	1984	1985	1986	1987	1988	Pre. 1989	Projected 1990	1991	1992	1993	1994	1995
1. Public & P.Guar. LT	524	1,394	1,478	1,497	1,597	1,711	1,705	1,911	2,044	2,149	2,264	2,413	2,549
Official Creditors	512	1,201	1,328	1,386	1,517	1,561	1,585	1,825	1,971	2,092	2,210	2,359	2,492
Multilateral	283	519	631	689	754	777	794	827	911	1,009	1,085	1,167	1,237
of which IBRD	87	95	119	140	167	155	144	134	179	226	237	256	263
of which IDA	27	26	26	25	25	24	24	23	23	22	22	21	21
Bilateral a/	229	682	697	697	763	784	791	998	1,060	1,083	1,125	1,193	1,255
Private Creditors	12	193	150	111	81	150	120	86	72	58	54	53	57
Suppliers	0	0	0	0	0	81	67	54	41	29	19	14	17
Financial Markets	12	193	150	111	81	69	53	32	31	29	35	39	41
2. Private Non-Guar. LT	161	114	104	83	70	70	55	41	28	19	25	32	38
3. Total Long-Term DOD	685	1,508	1,582	1,580	1,667	1,781	1,760	1,952	2,072	2,168	2,289	2,445	2,587
4. IMF Credit	24	125	89	43	6	11	6	41	91	137	164	165	162
5. Short-Term Debt	220	102	82	90	89	0	0	0	0	10	10	10	0
6. Unidentified Sources	0	0	0	0	0	-0	0	0	-3	3	-1	-1	2
7. Total (all sources)	929	1,735	1,753	1,713	1,762	1,792	1,766	1,994	2,160	2,319	2,463	2,619	2,751
8. Accumulated Arrears	..	..	..	..	..	..	105	0	0	0	0	0	0
A. Interest	..	..	..	..	..	..	0	0	0	0	0	0	0
B. Amortization	..	..	..	..	..	..	70	-105	0	0	0	0	0
9. Total Debt + Acc. Arrears	929	1,735	1,753	1,713	1,762	1,792	1,871	1,994	2,160	2,319	2,463	2,619	2,751
Share of Public LT DOD:													
1. On Concessional Terms	49.9%	52.7%	56.4%	60.9%	61.1%	--	--	--	--	--	--	--	--
2. With Variable Int. Rates	3.9%	15.8%	11.5%	8.1%	5.7%	--	--	--	--	--	--	--	--
E. Bank and IDA Ratios													
1.IBRD to total LT DOD (line 3	12.7%	6.3%	7.5%	8.9%	10.0%	8.7%	8.2%	6.8%	8.6%	10.4%	10.4%	10.5%	10.2%
2.IDA to total LT DOD (line 3)	3.9%	1.7%	1.6%	1.6%	1.5%	1.4%	1.4%	1.2%	1.1%	1.0%	1.0%	0.9%	0.8%
4.IBRD to total LT DS (line 3)	14.3%	5.5%	7.6%	8.3%	9.9%	11.3%	9.8%	10.5%	12.4%	13.9%	16.5%	16.2%	17.2%
5.IDA to total LT DS (line 3)	0.4%	0.3%	0.2%	0.4%	0.4%	0.3%	0.2%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%
F. DOD-to-Exports G&S													
1. Long-Term Debt	54.0%	157.9%	163.4%	158.8%	181.4%	196.7%	218.7%	216.1%	196.5%	184.0%	176.6%	168.9%	157.7%
2. IMF Credit	1.9%	13.1%	9.2%	4.3%	0.6%	1.2%	0.8%	4.5%	8.6%	11.7%	12.7%	11.4%	9.9%
3. Short-Term Debt	17.3%	10.7%	8.5%	9.0%	9.7%	0.0%	0.0%	0.0%	0.0%	0.8%	0.8%	0.7%	0.0%
4. LT+IMF+ST DOD	73.2%	181.6%	181.1%	172.2%	191.7%	197.9%	219.5%	220.6%	205.1%	196.5%	190.1%	181.0%	167.6%
5. Total Debt + Arrears	73.2%	181.6%	181.1%	172.2%	191.7%	197.9%	232.5%	220.6%	204.8%	196.7%	190.0%	181.0%	167.7%
G. DOD-to-current GDP													
1. Long-Term Debt/GDP	19.2%	32.3%	27.6%	40.0%	36.0%	32.5%	30.0%	38.2%	36.3%	35.9%	36.2%	36.7%	36.1%
2. IMF Credit/GDP	0.7%	2.7%	1.6%	1.1%	0.1%	0.2%	0.1%	0.8%	1.6%	2.3%	2.6%	2.5%	2.3%
3. Short-Term Debt/GDP	6.2%	2.2%	1.4%	2.3%	1.9%	0.0%	0.0%	0.0%	0.0%	0.2%	0.2%	0.1%	0.0%
4. LT+IMF+ST DOD/GDP	26.0%	37.2%	30.6%	43.3%	38.1%	32.7%	30.1%	39.0%	37.9%	38.4%	39.0%	39.3%	38.4%
5. Total Debt + Arrears	26.0%	37.2%	30.6%	43.3%	38.1%	32.7%	31.9%	39.0%	37.8%	38.4%	39.0%	39.3%	38.4%
H. Debt Service/Exports G&S													
1. Public & Guaranteed LT	3.3%	20.3%	20.3%	18.4%	19.6%	19.6%	27.8%	23.8%	18.8%	17.4%	16.1%	15.1%	13.2%
2. Private Non-Guaranteed LT	2.3%	1.0%	1.9%	2.8%	1.7%	2.3%	2.4%	1.9%	1.4%	0.9%	0.4%	0.3%	0.4%
3. Total LT Debt Service	5.6%	21.4%	22.2%	21.2%	21.3%	21.8%	30.2%	25.8%	20.3%	18.3%	16.5%	15.4%	13.6%
4. IMF Repurchases+Serv.Chgs..	0.0%	6.6%	3.5%	5.9%	4.6%	0.6%	0.5%	0.7%	0.9%	0.9%	2.4%	4.0%	3.8%
5. Interest Only on ST Debt	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%	0.0%
6. Total (LT+IMF+ST Int.)	5.6%	28.0%	25.7%	27.1%	25.9%	22.4%	30.7%	26.4%	21.1%	19.2%	19.0%	19.5%	17.4%
I. Interest Burden Ratios													
1. Total Interest/current GDP	1.0%	1.8%	1.4%	2.0%	1.7%	1.4%	1.6%	1.8%	1.8%	1.8%	1.8%	1.8%	1.8%
2. Total Interest/Exports G&S	2.8%	8.6%	8.5%	8.0%	8.5%	8.3%	11.4%	10.4%	9.7%	9.3%	8.7%	8.1%	7.7%

a/ Includes Refinancing.

EL SALVADOR - PUBLIC FINANCE, MONEY AND CREDIT

ANNEX I
Attachment 1e

I. Consolidated NF Public Sector							Growth (%)		
As percent of Current GDP:	1980	1984	1985	1986	1987	1988	1980-86	1987	1988
A. Total Current Receipts	14.4	16.1	16.3	15.9	13.6	12.8	16.1	0.2	11.7
1. Tax Revenue 1/	10.8	11.5	12.1	13.3	10.8	10.4	18.2	-4.9	13.6
2. Non-Tax Current Receipts	2.8	3.4	3.3	2.3	2.3	1.5	10.5	17.1	-25.1
3. Op. Surplus of Pub. Ent.	0.8	1.2	0.9	0.3	0.5	1.0	-3.0	95.2	138.9
B. Total Current Expenditures	14.7	17.5	15.8	14.5	13.7	12.5	13.9	10.6	8.2
C. Current Budget Balance	-0.3	-1.4	0.5	1.4	-0.1	0.3	..	..	..
D. Capital Exp. & Net Lending	7.8	5.2	4.9	5.9	2.8	3.7	9.0	-44.4	55.3
E. Capital Revenue	0.1	0.1	1.0	0.1	0.1	0.0	14.2	17.1	-100.0
F. Overall Balance Financed by	-8.0	-6.5	-3.4	-4.4	-2.8	-3.4	..	..	..
1. Official Capital Grants	0.0	3.3	1.5	2.0	3.1	2.0	..	..	..
2. External Borrowing (net)	2.3	1.9	1.6	1.3	0.8	1.2	..	..	..
3. Domestic Financing	5.6	1.3	0.3	1.1	-1.1	0.2	..	..	..
G. GDP (mill. Colones)	8,917	11,657	14,331	19,763	23,141	27,366			

							Growth (%)		
II. Money and Credit	1980	1984	1985	1986	1987	1988	1980-86	1987	1988
A. In millions of colones:									
Money Supply (34)	1,429	1,830	2,306	2,758	2,762	2,996	11.6	0.1	8.5
Money + Quasi-Money (34+35)	2,564	4,235	5,374	6,905	7,371	8,219	18.0	6.7	11.5
Total Net Domestic Credit	3,868	5,818	6,966	7,457	8,290	9,110	11.6	11.2	9.9
To Government (net) (32an)	866	1,381	1,517	1,037	1,324	1,136	3.0	27.7	-14.2
To Official Entities (32b)	..	299	323	360	429	393	..	19.2	-8.4
To Private Sector (32d)	3,002	3,199	4,075	4,981	5,400	6,070	8.8	8.4	12.4
Net Foreign Assets (31n)	-816	-1134	-914	-1046	-282	-379	..	..	..
All Other Items (net)	(488)	(448)	(678)	493	(638)	(514)	..	..	..
B. Offsets to expansion of MQM :									
Net Foreign Assets	-596%	10%	19%	-9%	164%	-11%			
Credit to Government	279%	5%	12%	-31%	62%	-22%			
Credit to Official Entities	..	2%	2%	2%	15%	-4%			
Credit to Private Sector	436%	45%	77%	59%	90%	79%			
Net Other Assets & Liabilities	-19%	38%	-10%	78%	-230%	59%			
Increase in Money + Quasi-money	100%	100%	100%	100%	100%	100%			

1/ Includes contribuitions the social security institute (ISSS).

STATUS OF BANK GROUP OPERATIONS IN EL SALVADOR

A. STATEMENT OF BANK LOANS AND IDA CREDITS

(As of September 30, 1990)

Credit/ Loan No.	Fiscal Year	Borrower	Purpose	Amount in US$ million (less cancellation) Bank	IDA	Undisbursed
19 loans and 4 credits fully disbursed.				206.76	27.99	
Loan 2873-ESL	1988	El Salvador	Earthquake Reconstruction	65.00		56.64
Total				271.76	27.99	56.64
Of which has been repaid				113.77	4.42	
Total now held by Bank and IDA				157.99	23.57	
Amount Sold : 5.15						
Of which has been repaid: 5.15						
Total undisbursed				56.64	0.00	56.64

EBArevalo:LA2CO
File:ESL0990 (a1.o75)
November 2, 1990

EL SALVADOR

B. Statement of IFC Investments
As of September 30, 1990
(US$ Million)

Fiscal Year	Obligor	Type of Business	-----Original Approvals-------- Loan	Equity	Totals
1959	Industrias Textiles, S.A.	Textiles	0.14	0.00	0.14
1969	Hoteles de Centro America, S.A.	Tourism	0.60	0.33	0.93
	Total Gross Commitments		0.74	0.33	1.07
	Less Cancellations, Terminations, Repayments, and Sales		0.74	0.33	1.07
	Total Commitment Now Held by IFC		0.00	0.00	0.00

IFC In·.stments:ESL90
EBArev.: o:LA2C2
November 6, 1990

El Salvador - Structural Adjustment Loan

Supplementary Loan Data Sheet

Section I. Timetable of Key Events

(a) Time taken by the Country to prepare project: 12 months

(b) Project prepared by: Ministries of Planning, Finance, Economy, Agriculture, Health and Education, and the Central Bank.

(c) First Presentation to the Bank: September 1989

(d) Departure of Appraisal Mission: October 1990

(e) Completion of Negotiations: December 19, 1990

(f) Planned date for Effectiveness: March 1991

Section II: Special Bank Implementation Action:

None

Section III: Special Conditions:

Release of the second tranche would be contingent on satisfactory progress in the implementation of the Government's structural adjustment program, including the maintenance of a supportive macroeconomic framework, and fulfilling the following conditions:

(a) adjustment of import tariffs according to the announced schedule (as set out in the program, including raising the tariff on wheat to 5%), together with the elimination of import tariff exemptions for autonomous public sector institutions and enterprises, with the possible exception of certain (investment) goods agreed between the Government and the Bank that are imported by ANDA, ANTEL, CEL, CEPA and ISSS;

(b) implementation of the action programs to improve tax enforcement and introduce a value-added tax;

(c) public announcement by the Government that all commercial interest rates would be decontrolled by January 1993, elimination of interest rate controls on commercial bank loans and deposits with maturities of more than one year, and unification of all Central Bank rediscount rates on short term credit lines (excluding those credit lines financed by foreign assistance loans or grants with specific provisions for onlending at preferential rates) to a rate not less than the prevailing market rate on 180-day commercial bank deposits;

(d) bringing to the market for sale at least two nationalized commercial banks, having made progress in the implementation of the Superintendency's rehabilitation program and adoption of action plans to recapitalize and privatize the savings & loans associations and the Banco Hipotecario;

(e) bringing the assets of IRA to the market for sale and adoption of action plans to divest the assets of INAZUCAR, INCAFE, and the marketing activities of BFA; and

(f) agreement with the Bank on the 1992 fiscal budgetary allocations for the social sectors (with special attention to basic health and primary education) prior to submission of the Budget to the Legislative Assembly.

Release of the third tranche also would be contingent on continued progress in the implementation of the adjustment program, including the maintenance of a supportive macroeconomic framework, and fulfillment of the following conditions:

(a) elimination of all but 16 import permit requirements (excluding those that may be regulated by PL-480 agreements) and of all but 4 export permit requirements (excluding those that may be regulated by PL-480 agreements);

(b) putting into effect a value-added tax in place of the sales tax;

(c) preparation of a consolidated budget for fiscal year 1993 and submission of such budget to the Legislative Assembly;

(d) elimination of interest rate controls on commercial bank deposits with maturity of more than 180 days;

(e) commenced implementation of plan to restructure and privatize the savings & loans associations and the Banco Hipotecario, and of plans for divestiture of the assets of INAZUCAR, INCAFE and the marketing activities of BFA. Also, the Government will have ceased to hold a controlling shareholding in at least one commercial bank; and

(f) based on the pilot project results to be reviewed with the Bank, the Government will have expanded the coverage of its nutritional assistance programs, namely the distribution of fortified cookies to schoolchildren and the distribution of weaning formula through health posts, as scheduled, and will have initiated a pilot project, satisfactory to the Bank, to distribute food coupons to the poor.

EL SALVADOR: MATRIX OF ACTIONS

OBJECTIVES	ACTIONS ALREADY TAKEN	ACTIONS TO BE TAKEN FOR: BOARD PRESENTATION	SECOND TRANCHE RELEASE	THIRD TRANCHE RELEASE
Economic Stabilization and Adjustment.	Stand-by Agreement approved by the IMF in August 1990. Paris Club agreement to reschedule US$135 million reached in September 1990.	Maintenance of a Supportive Macroeconomic Framework.		
I. Trade & Exchange Rate Policy				
Promotion of trade expansion and efficient import substitution, and stimulation of relative demand for labor inputs versus capital.	Unification of exchange rate system. Unification of most tariffs to within a range of 5% and 35%, with a tariff ceiling on luxury items of 50%. Reduction in the number of tariff categories from over 20 to 7 rates. Elimination of domestic price controls for all but 7 product categories. Elimination of most tariff exemptions. Reform of export incentive law. Accession to GATT.	Unification of all import tariffs within a range of 5%-35% except on wheat. Public announcement of a tariff adjustment schedule where: the maximum tariff will be 30% by June 1991; the maximum tariff will be 25% and the minimum tariff will be 7% by June 1992; and maximum tariff will be 20% and the minimum tariff will be 10% by June 1993. These tariff floors and ceilings will apply for all products except textiles and shoes, whose tariffs will be adjusted according to the same schedule but with a one-year lag. Elimination of import and export permit requirements on 32 tariff positions.	Satisfactory progress in adjusting tariffs and eliminating import and export permit requirements according to announced schedule. Elimination of tariff exemptions for all imports (other than investment goods) by autonomous public sector institutions.	Satisfactory progress in trade reform. Elimination of import permit requirements on all but 16 tariff positions (excluding PL-480 items) and of export permit requirements on all but 4 tariff positions (excluding PL-480 items).

OBJECTIVES	ACTIONS ALREADY TAKEN	ACTIONS TO BE TAKEN FOR: BOARD PRESENTATION	SECOND TRANCHE RELEASE	THIRD TRANCHE RELEASE
II. Fiscal Policy				
Expansion of the tax base and rise in level of public sector savings, to reduce public sector deficit in a manner consistent with greater public sector efficiency and investment.	Simplification and rate unification of: personal and corporate income tax, sales tax, net wealth tax.	Preparation of action plan to strengthen tax enforcement and expand tax base.	Satisfactory progress in application of tax enforcement program and in expanding tax base.	
	Elimination of most laws granting tax exemptions.	Definition of a plan to introduce a value-added tax to replace the sales tax.	Satisfactory progress in preparations to introduce value-added tax.	Replacement of the sales tax by the VAT.
Strengthening of tax administration and improvement in the equity of taxation system.	Reform and reduction of coffee export tax, and elimination of other export taxes.	Legislative approval of the 1991 budget conforming with a public sector savings target of 1.7% of projected GDP.	Agreement with Bank on sectoral distribution of 1992 Budget. (See Section VI of Matrix).	Review of satisfactory compliance with savings target established for 1991.
	Merger of Finance Ministry Departments responsible for monitoring taxes on internal and external transactions.			Presentation to Legislature of a consolidated ordinary and extraordinary) budget.
	Increase in electricity, water, fuel, and transport rates toward remunerative levels.			

	ACTIONS ALREADY TAKEN		ACTIONS TO BE TAKEN FOR:	
OBJECTIVES		**BOARD PRESENTATION**	**SECOND TRANCHE RELEASE**	**THIRD TRANCHE RELEASE**
III. Interest Rate & Monetary Policy				
Gradual elimination of government controls on interest rates and the allocation of credit, and reduced reliance on coercive monetary policy instruments to permit a more efficient allocation of financial resources and provide a proper environment for a competitive private banking system.	Adjustment of interest rates by up to 5% in esponse to higher inflation. Reduction in dispersion of interest rates applied to Central Bank credit lines.	Elimination of interest rate controls on interbank markets. Established interest rate band within which banks are free to set deposit and lending rates. The floor (TIBP) of the interest band applies to deposits of 180-days maturity and the ceiling (TIBA) applies to loans with maturity of up to one year. Starting January 15, 1990. TIBP will be adjusted, if necessary, to be not less than the past inflation rate (defined as the annualized rate of change of CPI during the preceding six months). Simultaneously, TIBA will be set at no less than TIBP plus 4 percentage points. Both rates will be reviewed at least every semester, and adjusted sooner as dictated by macro-economic and sectoral developments.	Public announcement that all commercial bank interest rates will be decontrolled in January 1993. Elimination of commercial bank interest controls on deposits and loans with maturity of more than one year. Satisfactory review of interest rate policy, with reference to the agreed interest adjustment schedule. Non-creation of new selective credit lines (in addition to those prevailing as of October 1, 1990) financed with domestic resources. The total value of loans extended through these credit lines will not grow in excess of overall credit expansion target. Unification of all Central Bank rediscount rates to levels at least as high as 180 day deposit rate (TIBP), except credit lines financed with external resources.	Elimination of interest controls on deposits with maturity of more than 180 days. Satisfactory review of interest rate policy, with reference to the agreed interest adjustment schedule. Reduction of maximum commercial bank required reserve ratio to 15%.

OBJECTIVES	ACTIONS ALREADY TAKEN	ACTIONS TO BE TAKEN FOR: BOARD PRESENTATION	SECOND TRANCHE RELEASE	THIRD TRANCHE RELEASE
IV. Financial Sector Reform				
Restructuration of the bankrupt commercial banking system and creation of a more competitive private sector based banking system, complemented by a strengthened banking supervisory and legal framework, with the aim of enabling more efficient financial intermediation.	Completed assessment of loan portfolio of commercial banks.	Presentation to Congress of a set of laws to (i) recapitalize the commercial banks and Savings & Loans Associations; (ii) privatize the nationalized banks; and (iii) restructure the Banking Superintendency.	Implementation of mechanism to recapitalize the commercial banks, and initiation of sale of at least two banks.	Carry out privatization of banks according to law. The Government will have lost its position as controlling shareholder in at least one commercial bank.
	Intervention by monetary authorities of commercial banks identified as nonviable and merger of two banks.		Liquidation of inviable banks and transfer of their assets to those banks identified as viable.	
	Budgetary provisions made in 1990/91 monetary program for funds to recapitalize commercial banks.	Publication of directives to complement the law of recapitalization such that: (i) each bank will have capital/asset ratio of at least 10%; (ii) the total value of loan-loss reserves set aside for the commercial banks is at least 85% of the required amount estimated for June 30, 1990; (iii) the bonds issued to recapitalize the banks will carry a variable rate with a net yield not less than the 180-day deposit rate (TIBA) plus 2%; (iv) commercial banks will receive a commission of at least 10% of the amount of recuperated non-performing debt.	Completion of diagnostic study to restructure the Banco Hipotecario and the Savings & Loans Associations, and integrate them into the general regime governing the commercial banking system.	Implementation of plan to restructure and privatize the Banco Hipotecario and Savings & Loans Associations.
			Satisfactory progress in implementation of program to restructure the Banking Superintendency.	Satisfactory operation of a risk monitoring system at the Banking Superintendency.
		Definition of a program to rehabilitate and fortify the Superintendency and identification of TA financing source.		

OBJECTIVES	ACTIONS ALREADY TAKEN	ACTIONS TO BE TAKEN FOR: BOARD PRESENTATION	SECOND TRANCHE RELEASE	THIRD TRANCHE RELEASE
V. Agriculture Sector				
Elimination of direct government intervention in the market for basic grains to improve production incentives and reduce public sector operating losses. Elimination of price distortions favoring industry at the expense of agricultural sector.	De Facto, elimination of parastatal marketing monopolies in basic grains, coffee, cotton, and sugar.	Elimination of all price controls on basic grains at the retail and whole-sale level.	Bring assets of IRA to the point of sale.	Elimination of all import and export permit requirement for yellow maize, rice and sorghum.
	Reduction in IRA's labor force by 8% and studies completed to divest IRA's assets.	Definition of action plan to divest assets of IRA.	Preparation of program to strengthen the private marketing of basic grains. Definition of action plan to privatize the assets of INAZUCAR, INCAFE and marketing activities of BFA.	Initiate sale of assets.
VI. Social Sectors				
Provision of a temporary safety net for the poor who might be adversely affected by the adjustment program.	Identification of target population groups for delivery of nutritional assistance.	Approval by Legislature to establish Social Investment Fund.	Based on pilot project results, expand fortified cookie program to 1/3 of the 78 municipalities identified as vulnerable. Apply pilot project to distribute weaning formula in health post.	Expand fortified cookie program to remainder of the 78 municipalities. Based on pilot project results, expand distribution of weaning formula to one-third of 78 vulnerable municipalities. Apply pilot project to distribute food coupons.
Improvement in capacity to reallocate public resources in the Health and Education Sectors to ensure a better delivery of basic services.	Created special government department in charge of logistics to reduce bottlenecks in food distribution. Operation of regional pilot program decentralizing the functions of the Health Ministry. Completion of study by Miguel Kast Foundation to decentralize the functions of the Education Ministry.	Apply pilot project to distribute nutritionally fortified cookies at start of school year.	Agreement with Bank on sectoral distribution of budgetary expenditures in 1992 Budget (with special attention to Primary Health & Education), prior to submission to Assembly.	

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LETTER OF DEVELOPMENT POLICY

San Salvador, January 11 1991

Mr. Barber B. Conable
President
The World Bank
Washington, D.C. 20433

Dear Mr. Conable:

1. El Salvador's economic activity declined sharply in the early 1980s and the weak growth rates achieved during 1983-1989 -- despite massive aid from friendly countries -- were not sufficient to enable a recuperation to the levels reached in the 1970s. In effect, GDP contracted on average by 1.3 percent per annum during the past decade, in contrast to an average annual growth rate of 4.5 percent during the 1970s. This weak performance largely reflected the severe impact of the external crisis at the beginning of the decade, which manifested itself in a significant deterioration of the terms of trade, a higher cost of servicing the external debt and the collapse of the Central American Common Market. The Salvadorean economy was further weakened by the heavy damage to the country's infrastructure caused by the domestic armed conflict, unfavorable weather conditions that have persisted during the last years, a severe earthquake in 1986, which resulted in more than US$1,000 million in losses, and the three major reforms undertaken in 1980 -- the nationalization of the financial system and of the external marketing of coffee and sugar, and the agrarian reform -- whose economic costs were higher than expected.

2. Faulty economic policies and the lack of timely adjustments also contributed significantly to the economic crisis experienced during the 1980s. After many decades of stable domestic prices, the rate of inflation reached 31.9 percent in 1985, then fell to 18.2 percent in 1988 and rebounded to 23.5 percent in 1989. At the same time, open unemployment remained at approximately 10 percent, while almost half of the economically active population remained employed in the informal sector and approximately one million workers emigrated to foreign countries. The public sector incurred large deficits, primarily on account of a marked contraction in real revenues due to (i) an increasingly deficient tax administration and (ii) infrequent and insufficient adjustments in the pricing of public services. The financing of the non-financial public sector absorbed an increasing share of domestic resources, displacing the private sector and placing increased pressures on domestic prices and the balance of payments. In addition, these high deficits limited the public sector's ability to support economic activity. Even though the Central Bank maintained strict control over the expansion of credit, interest rates were highly negative and the money supply declined in real terms, with detrimental effects on the Balance of Payments. The effects of the devaluation of the Colon at the beginning of 1986 were

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rapidly annulled by the high rate of domestic inflation and the lack of a consistent macroeconomic management. The Current Account deficit rose to more than 8 percent of GDP in 1989 (excluding official transfers equivalent to almost 5 percent of GDP), while the value of merchandise exports, which declined continuously during the decade, fell to the lowest level since 1975.

3. Confronted by this crisis situation, the administration of President Alfredo Cristiani on June 1, 1989, introduced the Plan of Economic and Social Development 1989-94. This Plan has two fundamental objectives: (i) to create the conditions needed for strong sustainable growth and (ii) to raise the welfare and standard of living of the population, especially of those that live in extreme poverty, as the means of achieving a lasting social peace. The Plan's action strategy encompasses a short-term Stabilization Program (June 1989 - December 1990), accompanied by a set of measures and compensatory social actions to alleviate the adjustment burden of the most vulnerable segments of the population. For the medium term (1990 - 1994), the Plan comprises a Program of Economic Reorientation, which aims to establish an economic system that is more open to the rest of the world and more competitive, and in which all Salvadoreans participate within a democratic framework.

4. The central objective of the Stabilization Program is to reduce the high economic imbalances and to reestablish a structure of relative prices that conforms to market conditions that would provide the basis for economic reactivation. In the execution of its Stabilization Program, the Government of El Salvador has demonstrated its firm commitment to pursue this objective. The policy measures and actions taken through the end of October 1990 include:

a) Liberalization and unification of the exchange rate and the authorization of foreign exchange houses (Casas de Cambio).

b) Establishment of an import tariff range of 5 percent and 35 percent, with the exception of a ceiling of 50 percent for luxury items included in Annex III of the Central American Tariff Code, and reduction in the number of import tariff rates from 25 to 7.

c) Establishment of a price-band mechanism for maize.

d) Elimination of most quantitative restrictions and price controls, except on seven products (i.e., sugar, instant coffee, cement, oil derivatives, edible oils and fats, wheat flour and cotton seed).

e) Introduction of fiscal and administrative measures to encourage export growth and carrying out of negotiations to accede GATT.

f) Introduction of fiscal reforms to raise revenues, adjustment of prices for public services and actions oriented to reduce costs and improve the operating efficiency of public enterprises.

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g) Elimination of various laws that had granted tax and tariff exemptions and other privileges to particular economic activities.

h) Simplification of the complex system for the allocation of credit and raising of interest rates by up to 5 percentage points in reponse to higher inflation.

i) initiation of a program to privatize the financial system and presentation to the Legislative Assembly of: a draft law to rehabilitate the Banks, a draft law to strengthen the Superintendency of the Financial System and a draft law for the privatization of the Banks and Savings & Loans Associations.

j) Elimination of the monopoly powers enjoyed by parastatal institutions in the marketing of coffee and sugar, and the monopoly and monopsony powers of the Cotton Cooperative (COPAL).

k) Strengthening and reorientation of various social programs so that these could serve to cushion the impact of the Stabilization Program. Furthermore, introduction of compensatory actions through employment programs, targetted subsidies, food for work programs, increases in minimum wages and raising of the minimum levels of taxable income.

l) Creation of the Social Investment Fund (FIS), with initial funding from the Inter-American Development Bank (IDB), the United States Agency for International Development (USAID), the United Nations Development Programme (UNDP) and resources from the Government of El Salvador.

m) Initiation of institutional reforms in the sectors of education and health, for which further tecnical assistance from the World Bank is expected.

5. The Stabilization Program is supported by the IMF through a stand-by agreement approved in August of last year. It has produced positive results, which are better than had been projected and have materialized sooner than anticipated, despite the adverse conditions that emerged during this period, such as (i) the fall of international coffee prices, resulting in an annual loss of more than US$100 million, (ii) the reduction by US$50 million in the balance of payments support program with USAID, (iii) the urban guerrilla offensive, which led to a loss of approximately US$100 million and, most recently, (iv) the rise in petroleum prices due to the Gulf crisis, which could represent an additional balance of payments burden of between US$70 million and US$100 million per year. Among the most important results achieved in 1990 are the following:

a) Economic activity has rebounded vigorously, with GDP expected to grow by 3 percent -- a rate not achieved since 1978.

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b) The inflation rate reached 12.9 percent during the first nine months of the year and was likely to fall below the target of 15 to 18 percent set for the year. Unfortunately, as a result of the oil price rise, inflation reached 19.3 percent at the end of the year.

c) The public sector deficit has been substantially reduced through a strong increase in revenues and the limitation of public expenditures resulting from a more austere policy stance of the Government.

d) The trade balance deficit also has been reduced despite the fall of coffee prices in the international market. Consequently, the current account deficit will be below the deficit in 1989 and the growth of international reserves will exceed the target of US$40 million.

e) In September, an agreement was reached with the Paris Club to reschedule US$138.8 million in external debts and external arreas were reduced as scheduled in the Government's program. In addition, agreement was reached to refinance debts with Mexico and Venezuela.

6. In the context of the Plan of Economic and Social Development and conforming with the Stabilization Program, the Government of El Salvador began implementing the Program of Economic Reorientation toward the end of 1989, and with increasing vigor in 1990. The Government of El Salvador needs the technical assistance and financial support of the World Bank to help with the execution of its reform program in the areas of (i) trade and commercial policy, (ii) public sector administration, (iii) monetary and interest rate policy, (iv) financial sector reform, (v) agricultural sector reform and (vi) social sector programs. We, therefore, hereby request a Structural Adjustment Loan (SAL) for a period of two years and for an amount equivalent to US$75 million. The principal components of the program and the operational steps to execute these are summarized below and described briefly in the attached matrix.

A. Adjustment Measures in Trade and Exchange Rate Policy

7. The Plan of Economic and Social Development of the Government of El Salvador considers an outward oriented policy approach as a fundamental prerequisite for achieving sustained growth over time. The aim of this policy approach is to generate a more dynamic base for the country's export base and to establish better conditions to stimulate foreign investment. In this manner we hope to expand existing markets and penetrate new markets, improve the levels of employment and obtain a more diversified base of production for goods and services.

8. **Exchange rate policy**. In view of the critical external situation, commercial banks were authorized to operate in the foreign exchange market in mid-1989, and approximately 80 percent of all transactions were transferred to that segment of the market. As a result of this liberalization of the exchange system, the Colon depreciated from 5 Colones per US Dollar in the official market in June 1989 to an average rate of 6.5 Colones per US Dollar in the banking market in December of that year, while the rates quoted in the black market were around 6.7 Colones per US Dollar. This process of liberalization continued and by mid 1990, all external transactions, except for some of the public sector, were carried

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out in the banking market. Furthermore, in April 1990, the Legislative Assembly approved the Foreign Exchange Houses Law (Ley de Casas de Cambio), giving the market greater transparency and flexibility. By the end of October 1990, the Central Reserve Bank (BCR) had approved more than 50 requests for establishing foreign exchange houses, which legalized and absorbed the black market; at that time, the exchange rate stood at 8.02 Colones per US Dollar in the banking market and at 8.13 Colones per US Dollar in the foreign exchange houses, i.e., margin of only 1.4 percent. In conformance with its Plan of Economic and Social Development, the Government of El Salvador will continue to maintain an exchange rate system with a unified rate that is freely determined by the market.

9. **Tariff Policy**. With the aim of facilitating a more open economy, stimulating exports and promoting an efficient substitution of imports, the Government has adopted a program of tariff adjustments and elimination of exemptions. The import tariff system, which initially included 25 different rates between 1 percent and 290 percent, was replaced by a system with only 7 rates in a range of 5 percent to 50 percent in September 1989. In April 1990, the range of tariffs again was reduced to between 5 percent and 35 percent, except for goods included in the Annex III of the Central American Tariff Code (which remained within the range of 35 percent and 50 percent), wheat (which has a tariff of 1 percent) and imports carried out under the PL-480 program (which are exempt from tariffs). The Legislative Assembly approved a modification to the law in December 1990, such that the goods included in the Annex III of the Central American Tariff Code also are within the general range of 5 and 35 percent. The tariff on wheat will be adjusted to 5 percent by June 30, 1991; and the Government of El Salvador will negotiate with USAID a mechanism whereby the imports carried out under the PL-480 program will be subject to the same tariff treatment as other goods, so as to avoid distortions. According to the tariff adjustment program and as agreed by the Economic Council of the Government of El Salvador, the dispersion of tariffs will be reduced further, such that the general tariff range will be adjusted to a floor of 5 percent and a ceiling of 30 percent in June 1991, to 7 percent and 25 percent in June 1992, and to 10 percent and 20 percent in June 1993.

10. **Commercial Policy**. In conformance with the economic liberalization program, practically all non-tariff restrictions were eliminated in 1989 and a one-stop window (CENTREX) was established for the processing of export documents, reducing the waiting time to less than one day. The Ministries of Agriculture and of Economy have taken steps to eliminate the remaining import and export permit requirements, except those that need to remain for reasons of health or security that are internationally recognized, and for white maize and beans, due to supply shortage problems and given that these two grains constitute the main nutritional base of the Salvadorean people. Also, the Government has successfully concluded negotiations to incorporate El Salvador into the General Agreement of Tariffs and Trade (GATT).

11. **External Trade Legal Regulatory Framework**. To complement the preceding policy changes and with the aim of stimulating exports, absorb new technologies, and attract foreign investment, the domestic legal framework has been revised to provide foreign and domestic investors better guarantees, without endangering the country's resources. In this area, the Legislative Assembly approved the Law of Export Reactivation (Ley de Reactivacion de las Exportaciones) and the Law of Free Zones and Fiscal Areas (Ley de Zonas Francas y Recintos Fiscales) on March 15, 1990, both of

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which complements the Law to Promote and Guarantee Foreign Investment (Ley de Fomento y Garantía de la Inversión Extranjera) that had been approved on April 28, 1988.

12. **Tariff Exemptions**. In conformance with the tariff policy reforms, most fiscal and tariff exemptions were removed during the second half of 1989 and the system of revenue collections was strengthened. Tariff exemptions for public enterprises imports are expected to be eliminated before September 30, 1991.

13. **Pricing Policies**. With the aim of liberalizing the market and stimulating healthy competition, most quantitative restrictions and price controls were removed during the second half of 1989 (except for 7 products). In line with the overall liberalization policy and taking care to safeguard consumers' rights, the Government will make necessary revisions to the Law of Commercialization and Price Regulation (Ley de Comercializacion y Regulacion de Precios) in the context of the draft law of Quality, Weights and Measures (Ley de Calidad, Pesos y Medidas), which will be presented to the Legislative Assembly before September 30, 1991.

B. Policies to Modernize Public Sector Administration

14. El Salvador's public sector expanded strongly during the 1980s, carrying out both norming and service functions, as well as adopting a more interventionist stance in the productive sectors. Since the beginning of President Cristiani's administration, the Government has sought to change the role of the public sector, to transform it into a more efficient and dynamic entity in conformance with a market oriented economy. Considering that the success of the Program of Economic Reorientation in large part depends on a significant improvement in public sector finances, the Government is carrying out a process of modernization by taking measures aimed, on one hand, at raising revenues and, on the other, at containing expenditures within limits consistent with its revised and more limited role.

15. **Revenue Policies**. Fiscal reforms are being taken in this area with the objective of establishing a new tax system that has a broader tax base, is more equitable and more neutral in its impact on incentives, and would permit a significant increase in tax collections, which are among the lowest in Latin America. With the aim of simplifying the tax system and rendering it more efficient, a series of specific taxes with low yields and high administrative costs were eliminated. To expand the tax base, while reducing tax-induced distortions, a large part of the previously existing exemptions were abolished. Similarly, the prices of services provided by public sector enterprises were adjusted.

16. **Expenditure Policies**. In this area, a policy of greater austerity and administrative integrity has been introduced. Mechanisms have been adopted to promote a more efficient utilization of public sector resources -- such as the National System of Public Investment -- and sectoral policies are being restructured and reoriented to provide a greater and more efficient allocation of resources toward the social sectors. The internal debt of the Central Government and Autonomous Public Institutions has been renegotiated.

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17. **Tax Collection**. Through an expanded tax base, strengthened tax administrations and improvement in tax equity, the Government is seeking to raise the level of tax revenues, as the primary means of generating greater public savings and reducing the fiscal deficit. With this objective, the Ministry of Finance will make a major effort to increase tax revenues through the following administrative reforms, which will be implemented before January 31, 1991:

    a) specific measures to increase the number of taxpayers registered for the Sales Tax;

    b) modifications to the norms that facilitate or stimulate tax evasion and tax avoidance;

    c) definition of policies and programs to improve tax enforcement, with an emphasis on expanding the tax auditing process;

    d) measures to limit the recourse to tax loopholes that erode the tax base;

    e) actions to coordinate the process of tax declarations and tax payments;

    f) actions to improve the control over the transfer of taxes paid through the banking system;

    g) diagnosis and reform of operating and control methods used by the Customs Office to reduce evasion; and

    h) Measures to strengthen the supervision capacity of the Office of the Minister of Finance over the Office of Internal Tax Administration, Treasury, Customs Office and General Accounting Office.

    Furthermore, the Ministry of Finance intends to define a program before January 31, 1991, to replace the Sales Tax by another tax that avoids the distortions caused by the cascading nature of the Sales Tax and that is easier to enforce. It is hoped that this new tax will be introduced in place of the Sales Tax prior to July 1, 1992.

18. **Public Savings**. As stipulated in its Plan of Economic and Social Development, the Government of El Salvador is committed to raise public savings. Its target is to increase the savings of the non-financial public sector to 1.7 percent of GDP in 1991 (including the extraordinary budget) and to no less than 2 percent of GDP in 1992. To achieve these targets, the Program for the Modernization and Improvement of Public Finances (PMM) is being designed with technical and financial assistance from USAID.

19. **Budgetary Policies**. As part of the structural reform process, the General Budget of the Nation is to be transformed into a more dynamic tool in the conduct of economic and social policy, to (i) achieve

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a more efficient allocation of the State's resources through more careful financial programming in all public entities; (ii) promote higher public savings, thereby also ensuring greater monetary stability and reducing pressures on the Balance of Payments; and (iii) encouraging human capital development, through subsidies specifically targetted to the poorest members of society. In the area of budgeting, the Minister of Finance is committed to:

a) define by January 31, 1991, an action plan to strengthen control over the decentralized public institutions and public sector enterprises, so that these will comply with the savings targets established for 1991 and 1992;

b) establish by January 31, 1991, and in conjunction with the Ministry of Planning, proceedings to coordinate the design and execution of the Ordinary and Extraordinary Budgets, with the goal of preparing a unified budget for the Central Government by mid-1992; and

c) apply, as of January 1, 1991, in conjunction with the Ministry of Planning, the norms and procedures established in the Law of the National System of Public Investment, with the aim of ensuring that the investments carried out by the institutions of the non-financial public sector satisfy minimum quality and efficiency criteria.

20. **Privatization Program**. The Plan of Economic and Social Development considers the privatization of public enterprises as fundamental in giving the State a more market oriented role. This process is essential for establishing a clear delineation between the functions of the state and those that are best carried out by the private sector. Among the actions to be taken are the following:

a) creation of a Privatization Commission encompassing public and private sector representatives;

b) finalization of studies and preparatory plans to transfer the assets of the Basic Grains Regulatory Agency (IRA) by January 31, 1991. As an interim step toward the sale the IRA's assets, a program to fortify the private sector marketing of basic grains is to be prepared by September 30, 1991, and implemented as of that date. The sale of assets of IRA and the transfer of the marketing activities of the Banco de Fomento Agropecuario (BFA) are to be implemented according to this action plan by October 31, 1992;

c) definition of an action plan to privatize the assets of the National Institutes of Coffee (INCAFE) and of Sugar (INAZUCAR) by September 30, 1991, and execution of this plan by October 31, 1992; and

d) carrying out the privatization program for the financial system as described below in Part D.

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C. Monetary and Interest Rate Policies

21. In the context of the Government's Plan of Economic and Social Development, monetary and interest rate policies must aim to maintain monetary stability, stimulate domestic savings, encourage efficient resource mobilization and allocation, and support the functioning of competitive, solvent and efficient financial system. During the transition period from a state-owned to a privately owned financial system, the monetary authorities are committed to maintain positive real interest rates, while progressively reducing the state's control over the allocation of credit until the market is completely decontrolled and establishing an environment that is conducive to the development of a private and competitive financial system.

22. **Interest Rate Policy**. To attain the objectives outlined in the preceding paragraph, the basic deposit rate (TIBP, to be defined as the minimum rate of interest on time deposits with maturity of up to 180 days) and the basic lending rate (TIBA, to be defined as the maximum rate of interest on credits with maturities of up to one year) will be reviewed and adjusted if necessary in accordance with the following calendarized schedule:

a) Beginning on January 15, 1991, interest rates will be subjected to a review process on a semester basis, or more frequently if required by changing market developments, such that TIBP will be adjusted in line with the annualized inflation rate prevailing over the preceding six months, while TIBA will be adjusted to maintain a differential of at least 4 percentage points above TIBP (i.e., TIBP plus 4 percentage points), with an exception made for agricultural credits and loans for housing with a sales price of less than 60,000 Colones. Furthermore, interest controls on the interbank lending market will be eliminated.

b) By September 30, 1991, the adjustment formula for interest rates will be revised, such that TIBP will not be below the rate of inflation during the last 12 months plus 1 percentage point, while TIBA will be adjusted to raise the differential to TIBP by at least 5 percentage points (i.e., TIBP plus 5 percentage points). Furthermore, the monetary authorities are committed to (i) liberate deposit and lending rates for operations with maturities of more than one year, (ii) announce publicly that all interest rates will be liberalized as of January 1993, and (iii) unify all rediscount rates for financial intermediaries to a level that is at least as high as TIBP, while subjecting the placement of such rediscounted loans to the same general norms applicable to other loans. The only exception to this last rule will be for credits to small farmers and the reformed agricultural sector, small entrepreneurs and loans financed through external resources, whose donors insist that these be onlent on preferential terms.

c) By October 31, 1992, the interest rate adjustment formula will be revised such that TIBP will be equal to the 12 month inflation rate plus two percentage points, while TIBA will be adjusted to ensure a differential of at least 6 percentage points above TIBP (i.e., TIBP plus 6 percentage points). Furthermore, interest rates on deposits with maturity of more than 180 days will be liberalized.

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23. **Monetary Policy** will be made compatible with external resource flows and domestic financing requirements in harmony with the objectives of domestic price stabilization and economic growth. Conforming with the overall policy of financial liberalization, the Central Reserve Bank of El Salvador (BCR) will not create new special lines of credit financed from domestic resources (in addition to those that existed on October 1, 1990). Furthermore, the legal minimum (non-interest bearing) reserve requirement of the commercial banks and the Banco Hipotecario will be reduced to 15 percent by October 31, 1992.

D. Financial Sector Reforms

24. In accordance with the privatization policies of the Government's Plan of Economic and Social Development and with the aim of restructuring the banking system, which a year ago was bankrupt, a process has been initiated to privatize the state-owned banks. The objective of this process is to improve the efficiency of financial intermediation.

25. **Privatization of the Financial System**. In the context of the program of privatization of the Commercial Banks and Savings & Loans Associations, and the strengthening of the Superintendency of the Financial System, the Government of El Salvador will have carried out the actions described below.

a) By January 31, 1991,

- The Legislative Assembly will have approved the following laws: the Ley de Saneamiento y Fortalecimiento de los Bancos Comerciales y de las Asociaciones de Ahorro y Prestamo (AAP) and the Ley de Privatizacion de los Bancos Comerciales y AAP.

- The Legislative Assembly will have approved the law to restructure the Superintendency of the Financial System.

- The BCR will have defined in a precise manner a financial package to recapitalize the banks with the aim of raising their net asset value as defined by the Fondo Operativo in accordance to the Ley de Instituciones de Credito y Organizaciones Auxiliares (LICOA).

- The BCR will have prepared regulations to guide the application of the Ley de Saneamiento y Fortalecimiento de los Bancos Comerciales y AAP.

- The monetary authorities will have defined a program, including a source of financing, to improve and strengthen the Superintendency of the Financial System.

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b) By September 30, 1991,

- The mechanism to recapitalize the commercial banks will have been implemented and the sale of assets of at least two recapitalized banks will have been initiated.

- The liquidation of banks previously identified as non-viable, and the transfer of their assets to the viable banks, will have been carried out.

- The studies to restructure the Banco Hipotecario and the Savings & Loans Associations, and incorporate them into the general framework governing the commercial banks, will have been completed under the supervision of the BCR.

- The monetary authorities will have made progress in implementing the program to restructure the Superintendency of the Financial System.

c) By October 31, 1992,

- The BCR will have implemented an auction mechanism to sell the shares of banks, as provided for by law.

- The monetary authorities will have begun implementation of the plan to restructure and privatize the Banco Hypotecario and Savings & Loans Associations.

- A risk monitoring system will have been implemented at the Superintendency of the Financial system.

E. Agricultural Sector Reforms

26. The agricultural sector is the most important sector of the Salvadoran economy, representing approximately 23 percent of GDP and 40 percent of total employment. The agricultural policies of the Government have been oriented toward: (i) eliminating the distoritions in relative prices that discriminated against the agricultural sector in favor of other sectors, (ii) strengthening the private marketing of basic grains and (iii) achieving the recovery, conservation and rational exploitation of the country's natural resources and environment, (iv) promote a more secure system of land ownership, (v) strengthen and reorient research and extension services, and (iv) abolish the monopoly power of the state in the marketing of coffee and sugar and of the monopoly and monopsony powers of the Cotton Cooperative (COPAL).

27. **Agricultural pricing and tariff rate policies**. Conforming with the general policy of liberalizing domestic prices and in an effort to stimulate agricultural sector activity, the Government of El Salvador

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will have (i) eliminated all price controls on basic grains at both the retail and wholesale level, (ii) implemented a price band mechanism for rice imports, with the aim of ensuring greater price stability, and (iii) adjusted the import tariffs for rice, soybeans, wheat flour and corn gluten to 20 percent, by January 31, 1991. The tariff on wheat imports will have been raised from 1 percent to 5 percent by June 30, 1991.

28. To complement the preceding measures, a price band mechanism will be implemented for sorghum by the end of September 1991. Also, over the course of 1991-92, the Government will continue to eliminate the remaining import and export permit requirements (used for other than health and security reasons) according to a specific calendar of actions, with the exception of permit requirements for white maize and beans.

F. Programs for the Social Sectors

29. **Social Compensation**. Programs of stabilization and structural adjustment impose social costs that generally are borne by the most vulnerable groups in society. Therefore, since the beginning of this administration, the Government of El Salvador has initiated a set of social compensatory programs. Through these programs and other measures of a compensatory character, the provision of services to the neediest groups has been improved. At the same time, the Legislative Assembly has approved the creation of the Social Investment Fund, which initiated its activities in October 1990.

30. **Reform in the Traditional Social Sectors**. The Government is seeking to improve the quality, coverage and efficiency of its social services through the introduction of structural reforms in the traditional institutions. In this context and parallel to the SAL negotiations, the Government has initiated a dialogue with the World Bank on a Project for the Strengthening of the Social Sectors, which emphasizes the areas of education and health. The execution of this Project is expected to begin in mid-1991.

31. **Nutrition**. Parallel to the social compensatory programs, the Government of El Salvador intends to introduce a pilot project to distribute nutritionally fortified cookies (ICAP) at the beginning of the school year (February 1991), and to expand their distribution to one-third of the 78 poorest municipalities (out of a total of 262 municipalities) by September 30, 1991. Based on the initial results of this project, the distribution of fortified cookies would be expanded to the remaining two-thirds of the 78 municipalities by October 31, 1992. Also, the authorities are committed to introduce a pilot project to distribute weaning formula by September 30, 1991, and to expand its distribution coverage, based on the pilot project results, by October 31, 1992. Finally, by October 31, 1992, the Government of El Salvador intends to have completed the design and to have initiated execution of a pilot project for the distribution of food coupons to the poor.

MINISTERIO DE PLANIFICACION
Y COORDINACION DEL DESARROLLO
ECONOMICO Y SOCIAL

G. Conclusion

32. The Plan of Economic and Social Development 1989-1994 outlines the actions and policies needed for achieving the objectives of sustained economic growth and an improvement in the standards of living of all Salvadorans. During the first 18 months of its administration, the Government led by President Cristiani has demonstrated its committment and political will to execute the Stabilization Program and initiate structural reforms, despite extremely difficult conditions. To ensure a successful completion of this Program, however, adequate financial and technical assistance from the international community are needed. In this context, the World Bank's support, both through its direct assistance and indirect assistance in the mobilization of additional external resources, is fundamentally important. In its search to bring about a peaceful solution to the domestic conflict, the Government of El Salvador has established a process of permanent dialogue, with the help of United Nations intermediation. For that peace to be lasting and to help strenghten our democratic processes, it is necessary to begin now by creating the economic and social conditions needed to reduce the levels of poverty and the inequality of opportunity that still prevail in Salvadoran society.

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GRENADA

THE ROLE OF STATE-OWNED ENTERPRISE IN GRENADA

One of the most frequently discussed topics among economists and development strategists in Grenada, as in most other countries of the developing world, is the role of the state in the ownership and management of commercial enterprise. Among the many questions one hears on this issue are the following:

- o What role do state-owned enterprises (SOEs) play in the Grenadian economy?
- o How does Grenada compare with other Caribbean nations, and with other developing nations throughout the world, in terms of state control of productive enterprise?
- o What has been the general impact of government ownership of enterprises on economic and social development in the developing world? What has been the impact of state corporations in Grenada?

The purpose of this article is to respond to these questions and to provide some factual information on the government's role in the Grenadian economy. Much of the information for this article was provided by the Management Analysis Center from Cambridge, Massachusetts, a firm of international public sector specialists which has provided consulting assistance in state enterprise strategy to a variety of governments throughout the world and which, since March of this year, has been assisting the Government of Grenada in this area.

Role of SOEs in the Developing World

While government-owned commercial enterprises have been around since the days of the Roman Empire, the most pronounced growth of these enterprises in the non-Socialist developing world has taken place during the past 25 years. For example:

- o In Brazil, more than three-quarters of the nation's 600 publicly-owned companies have been established since 1960.
- o Between 1960 and 1975, the number of state enterprises in Tanzania grew by 700%—from 50 to 400.
- o In Mexico, the number of SOEs grew from 180 to over 500 in the twenty years between 1960 and 1980.

Similar trends in state enterprise emergence are seen in numerous other developing nations--most notably India, Pakistan, Indonesia, Egypt, Turkey, Bangladesh, and the majority of countries in Africa and Latin America. In the Caribbean, state-owned enterprises have become most prevalent in Guyana, Jamaica, Trinidad and, since 1979, in Grenada.

How prominent a role do SOEs play in their respective economies? The following figures illustrate the degree to which state enterprise has come to dominate the economies of many developing nations:

- o In Venezuela and Brazil, the ten largest companies in the country are government owned.

- In Egypt, state enterprises account for an estimated 80% of the value of the nation's total industrial output.

- In Turkey, there are more than 150 government companies employing more than 700,000 people.

- In Peru, government-owned enterprise accounts for about 20% of Gross Domestic Product (GDP) and nearly 50% of total national investment.

- In Jamaica, the government owns more than 100 companies which, together, account for nearly one-quarter of the country's GDP.

- In Trinidad, a special ministry has been created just to oversee the activities of the nation's 60 state-owned companies.

Why have developing nations chosen to embrace state enterprises to this extent? The reasons are numerous and vary considerably from country to country. The three principal motives have usually been:

- Rapid industrialization. Upon gaining independence, many former colonial nations embarked upon a programme of "overnight" industrial modernization, and it was felt that the best way to accomplish this was through government investment. To a large extent, this motive was fostered by the major international lending agencies such as the World Bank, which made billions of dollars of credit available to state-owned enterprises on relatively easy terms—particularly in the "infrastructure" industries such as mining, energy, transport, and utilities.

- Employment preservation. When a private enterprise fails, the government frequently takes it over in order to preserve the jobs it represents.

- Idealogical motives. Countries often purchase or confiscate foreign and domestic private enterprises for what are essentially political reasons—to gain governmental control over an "essential industry," to expel foreign companies, or to disenfranchise wealthy local interests.

State Enterprise Performance: A Balance Sheet

How well have state enterprises performed over the years? To what extent have they lived up to the high expectations that were once set for them as "engines of development" and as guiding forces of the "commanding heights" of the economy?

The record on SOEs is very mixed on a worldwide basis, but it is fair to conclude that the overall result in most countries has tended to be more negative than positive. A few countries have managed their state enterprise sectors to great advantage—most notably India and Brazil, where state enterprises form the backbone of heavy manufacturing and high-technology industry and where some SOEs (such as the Hindustan Machine Tool Company, Petrobras, and Embraer) compete on an international basis. In South Korea and Taiwan, state enterprises established in key strategic industries following the Second World War today form the foundation of what are among the world's most flourishing private sector economies.

Unfortunately, the record is not as positive in most of the other developing nations in which public enterprise has been a primary strategy for economic development. Some cases in point:

- A study of 64 SOEs in 24 developing countries during the 1960s revealed that, when depreciation and interest payments were included in the financial statements, these enterprises had a combined loss equal to 15% of their revenues.

- In 1984, Mexican non-petroleum state enterprises registered a combined annual loss of nearly US $800 million.

- In Argentina, accumulated losses of the state enterprise sector in 1983 totaled US $1,700 million and the total indebtedness of these enterprises was the equivalent of 23% of the nation's GDP.

- In Brazil, government-owned enterprises own nearly 65% of the country's total foreign debt.

In addition to these statistics, examples of poor individual company performance abound in both the developed and developing worlds:

- In Japan, the National Railway loses almost US $20 million a day.

- In Liberia, the state-owned petroleum refinery lost more in one year than it took in as revenues.

- In Argentina, the National Petroleum Company's losses in 1982 were so severe—US $3,700 million—that in 1983 it ranked at the top of the list of losses recorded by any company in the world, public or private.

What are the costs to the nation of poor state enterprise performance? In terms of pure financial costs, they include direct monetary subsidies (a cost to the public treasury), foregone taxes and duties (also a public treasury cost), and the cost to the public of the domestic and overseas borrowing that the enterprise incurs. This "public borrowing cost" is particularly significant in the developing world. According to the World Bank, in 1980 non-financial SOEs accounted for 28% of all Eurocurrency borrowing and were responsible for 40% or more of total public sector borrowing in Bolivia, Guinea, Senegal, Bangladesh, and Indonesia. In a sample of 27 developing nations in the late 1970s, the combination of subsidies and public sector lending to state-owned enterprises averaged more than 3% of total GDP.

Thus, financial pressures created by SOEs represent both real and opportunity costs to the nation—opportunity costs in the sense that every dollar of borrowed funds to finance a state-enterprise's operations means a dollar less of borrowing capacity to finance other public sector projects in health, education, public services, etc. Consider, for example, the following World Bank hypotheses:

- An improvement of 10% in the financial performance of Tanzania's SOEs would be enough to finance all that country's annual spending on health.

- A similar 10% financial improvement of Malian state enterprises would generate resources equivalent to two-thirds the country's yearly education budget.

- A 5% increase in revenues of Zambia's manufacturing holding company would free resources equivalent to almost 90% of government spending on education, and several times its annual public health budget.

State-Owned Enterprise: A Fresh Look

As the public indebtedness of many developing nations has mounted dramatically during the past few years, governments all over the world have taken a fresh look at their state enterprise "portfolios" with an eye toward assessing the overall public costs and benefits of these enterprises. To this end, government leaders are taking a hard look at each of the companies under government ownership and are asking questions such as:

- How much is this enterprise actually costing the public treasury each year?

- Is the public cost justified by the public benefits of the enterprise?

- Does the enterprise provide public services as efficiently and as cost effectively as would be the case if the enterprise were privately operated?

- Is government ownership of the enterprise justified from the standpoint of "national security" or "strategic importance"? Has the purpose of the enterprise changed from its original mandate?

- Can government "control" over the enterprise be achieved through partial state ownership, through regulation, or through some means other than full government ownership?

As a result of considering these kinds of questions, and from the thorough probing and analysis to which many state enterprise sectors are currently being subjected, there has been a considerable movement in the direction of "privatization" of state enterprise in many countries. The term "privatization," to most students of state enterprise reform, refers to a variety of actions designed to make these enterprises more self-sufficient and market-responsive—in essence, to help them operate more like private enterprises even if they remain under government ownership. Among these privatization alternatives are the following:

- Divestiture: Under this form of privatization, government-owned shares are sold to private interests. Complete divestiture refers to the sale of 100% of the government shares; partial divestiture refers to the sale of only a portion of the shares, resulting in a joint public-private venture in which the government can be either a majority or a minority partner.

- Leasing: Under this alternative, the government retains ownership of the shares in the company but agrees to lease the facilities (land, building, manufacturing equipment, etc.) to a private concern for an agreed-upon yearly rental fee.

- o Management Contract: In this case, the government retains ownership but turns over the management control of the enterprise to a private entity, which collects a fee for its services—usually based on an incentive arrangement in which the fee is enhanced if the management contractor's performance meets or exceeds certain agreed-upon targets.

- o Market Mechanisms: This alternative—the least dramatic of the various forms of privatization—puts the state enterprise on more of a competitive footing by eliminating whatever monopoly positions it might enjoy, by introducing market-driven costs and prices into the enterprise, and by reducing government assistance and regulation to a minimum.

During the past five years, spurred by the international debt crisis and given incentives from the major donor nations and international lending agencies, many developing nations have taken significant steps to reduce the government's role in their economies. A major component of this strategy has been the privatization of state-owned enterprises. Some examples of this trend include:

- o In Venezuela, the capital city of Caracas has privatized garbage collection by contracting this function out to a private operator.

- o Jamaica has leased some of the government-owned hotels to private hotel operators and has arranged a long-term management contract to operate its deficit-ridden sugar factories.

- o The government of Uganda has sold a 49% interest in the major government-owned sugar and tea companies to their original private owners.

- o Since 1982, Bangladesh has divested nearly 100 state-owned jute, textile, chemical, and engineering firms.

- o Pakistan has divested some 2,000 small flour, rice, and cotton mills.

- o In Sri Lanka, seven government-owned textile mills have been placed under private management contracts.

- o In Brazil, 17 state companies in a variety of industries have been placed on the market, and another 75 companies are targeted for sale during the coming year.

- o In Zaire, 10 agribusiness concerns have been divested, and another two have been placed under private management agreements.

- o In Jamaica, the Kingston public bus company has been closed and its routes have been leased to private bus operators.

In addition, in several countries, enterprises whose public costs are so great and whose public benefits are so limited have been liquidated: the Ivory Coast has closed 16 government companies since 1980, Brazil dissolved 10 in 1982, and the Liberian government has decided to close the deficit-prone petroleum refinery alluded to earlier. Even in South Korea, where state enterprise has fared much better than in most countries, the government has chosen to liquidate two government fertilizer companies in view of the ability of existing private sector companies to adequately supply the market.

State-Owned Enterprise In Grenada

Grenada's experience with its SOEs mirrors that of many developing countries. For example, its SOEs were founded for many of the same reasons--as a function of national policy, an attempt to preserve employment or an attempt to industrialize more quickly. Similar also has been the mixed but generally poor performance of Grenada's SOEs, many of which are a financial drag on the national treasury and which do not provide commensurate benefit or economic well being. And as with other developing nations, many of the circumstances which led to establishing Grenada's SOEs have changed or have been reassessed, putting into question the advisability of continued state-ownership over the wide variety of enterprises.

Last year, Grenada's SOEs generated revenues of EC $50.5 million. However, the very high costs associated with their operations left net profits of only EC $.5 million. This profit provided the government a return on its investment of less than 1/3 of 1%. Although this return is already extremely small, it is misleading in that profits are highly concentrated among only four of the SOEs. If these four were removed from calculations, the government would have a net loss of almost EC $1.5 million.

Looking at those firms which produced profits, (only 38% of all the SOEs), two important observations should be made. First, while these firms generated a dollar profit, they provided a very poor return on the government's investment. For example, the largest dollar profit contributor had a return on investment of less than 2%. This is to say that while some SOEs produced annual operating results that were positive, the results were not as positive as they should or could be. Secondly, it is not clear that those SOEs which had net profits last year will continue to do so. For example, one firm that was profitable last year is currently running at a loss of several hundred thousand dollars because it is now required to pay interest on a loan.

More than half of Grenada's SOEs did not have net profits. Their operating losses last year totaled almost EC $2 million, roughly equivalent to 10% of the government's anticipated expenditures on education in 1985.

Grenadian SOEs have returned very little in the way of profits, and at the same time, they have absorbed a great deal of the government's resources. In addition to an EC $60 million investment in SOEs, the government has since 1982 spent EC $6 million on these enterprises for equipment, operating grants, and so on. The opportunity cost of this EC $6 million is very high, as the sum is equivalent to 40% of the government's projected 1985 expenditures on national health services, or 30% of projected 1985 education expenditures. Tying up EC $60 million of the government's capital in SOE's is also costly, as it is equivalent to 75% of the government's capital expenditures for the nation last year. This investment is even more significant given that 1984 capital expenditures were almost entirely donor financed.

It is clear that the capital and financial repercussions of SOE performance are great. Interestingly, employment is not of an equivalent magnitude. In total, only 1,500 are employed in SOEs, or approximately 4% of the available Grenadian workforce. Thus, while an improvement in the operations and health of these enterprises could expand employment, the impact would likely be small.

In light of this performance, the government has decided to review the role of state enterprises in meeting national economic objectives. As is the case with many nations, Grenada is evaluating which enterprises require government control or involvement, such as those which serve public policy and provide a public good. The government will attempt to help improve these enterprises that must be retained as public corporations so that they operate more profitably. For those enterprises where it is costly to continue state-ownership without commensurate benefit, the government will introduce private sector forces to make them perform efficiently and effectively; these steps could include the sale of an enterprise. In opening these enterprises to private sector forces, the government is sensitive to understanding the resulting impact on the economy and most importantly on employment.

To assist the government in its task of reviewing the appropriate role of state enterprises, a Working Group headed by Mr. Nick Braithwaite, and comprised of representatives from the private sector, government and labor, has been assembled to oversee a thorough evaluation of Grenada's SOEs. The evaluation will include an investigation of each enterprise with regard to its purpose, financial viability, operations, market position, competitive position and relationship with the government. This work is intended to help the government consider options for changing a given enterprise's operations or its ownership; the ultimate aim is to improve enterprise performance, reduce the drain on the national treasury and at the same time protect employment opportunities.

The Working Group will review the evaluations and options in light of the government's economic goals and policy, and will make recommendations to the Prime Minister and the Cabinet. This effort will allow the government to develop a strategy to address the pressing needs of improving SOE performance and of defining the appropriate involvement of the government. These recommendations are expected to be made to the Prime Minister at the end of this month.

(Draft Report)

AN ASSESSMENT OF THE CURRENT DIVESTITURE PROGRAM IN GRENADA, WITH RECOMMENDATIONS ON A STRATEGIC APPROACH FOR THE FUTURE

March, 1985

Presented to:

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A. INTRODUCTION

The following report was prepared by Donald E. Shay, Vice President of Management Analysis Center, Inc. (MAC) and Jeff Coburn, Vice President of Gray-Judson and Professional Associate of MAC. It is based on a two and one-half day visit to Barbados and Grenada, at the invitation of James Holtaway, Mission Director of AID/RDOC. The purpose of the visit was to assess the current status of Grenada's divestment effort, to identify obstacles to this effort, and to recommend ways in which the privatization of state-owned companies can proceed more smoothly and more expeditiously in the future.

As a backdrop to this brief analysis, it should be noted that the privatization of state-owned companies is a relatively new phenomenon in the world economy. Although a few large-scale privatization efforts have taken place in the past--most notably in Japan in the late 1800s and in Chile in the 1960s--it has only been during the last five years that privatization has been seriously contemplated in most countries. To date, the only extensive privatization program that has met with any real success has been that of Great Britain, which in six years has sold some 15 companies valued at roughly $5 billion.

In no other country has any extensive privatization or divestment of government-owned companies taken place, despite many public pronouncements supporting such programs and pledging action and government commitment to this end. To be sure, some countries such as Bangladesh, Brazil, Pakistan, Jamaica, and Senegal have sold, leased, or contracted out the management of a few small companies, but in most cases these actions have barely made a dent in the total state enterprise portfolio. This relative inactivity has been particularly notable in the developing world, which for the past several years has been under heavy pressure from the international lending community to reverse the state's dominant role in the national economy. Even in those countries where the divestment of state enterprise has been a written condition for obtaining international budget support loans, almost no success has been achieved in this regard, and several countries currently stand in violation of these agreements.

Within the developing world, many factors contribute to this lack of privatization success, despite what may be a genuine commitment on the part of the government to undertake a privatization program. Political opposition within the government, the fear of adverse public reaction, reluctance to relinquish government control over some types of companies, the dearth or local private capital, the hesitancy to permit large-scale foreign investment, the concern over the impact of divestment on employment, and the lack of any experience or history to go by in planning and implementing such a program—these are all serious impediments to successful privatization on any meaningful scale within the developing world.

In contemplating divestiture, Grenada faces all of these economic, social, and political barriers. Indeed, because of its recent history, the sensitivity to divestiture may be even more acute than elsewhere. For Grenada, as for most of the countries of the developing world, divestiture is still an untested experiment which is unlikely to be embraced wholeheartedly until some of the roadblocks are lessened, the risks reduced, and confidence in the process enhanced.

It is within this economic and political context that we present the report which appears below. MAC's experience with this issue over the past few years in countries such as Peru, Jamaica, and Panama—and the recent experience of developing countries worldwide—lead us to conclude that privatization, while do-able, must proceed according to a plan, a timetable, and a process which is realistic given each country's unique situation. Most importantly, the lessons of the past years dictate that for effective, large-scale privatization to occur, it must be predicated on a genuine commitment by the country's leadership, and not as a result of an imposed solution from the outside. The few countries which have exhibited success in privatizing state enterprise have done so because they genuinely wanted to, and not because they were coerced to do so.

B. OBSERVATIONS

1. No strategy currently exists for guiding and controlling the divestiture process. At present, neither AID nor the government of Grenada has a clearly spelled out strategy—a "game plan"—which the divestiture effort can follow. Other than the somewhat loosely-worded language in the loan agreement and a vaguely-worded "letter of intent" from the Grenadian government, there is no clear plan which sets forth the specific goals of the program, the timetable for its execution, and the

detailed decisionmaking process and implementation procedures under which it will operate. Until the divestiture program is grounded on a solid strategic framework, it is likely to remain a "best efforts" exercise, without a roadmap by which to control the effort or to measure its progress.

2. There appears to be little "ownership" of the divestiture program by the government of Grenada. Rightly or wrongly, the current government feels it is being held to an agreement made by its predecessor government, and is therefore not very committed to carrying it out. Most importantly, the current agreement appears to have been largely imposed from the outside, by USAID; as a result, it has apparently never gained the genuine endorsement of the government of Grenada or its people.

3. AID and the government of Grenada are speaking two different languages on the divestiture issue, and the current "discussion" is heavily ideological in nature. In his meeting with us, ~~Laurie Wilson~~ GOG
officials made it clear that certain members of the Prime Minister's Cabinet are ideologically opposed to the notion of selling government companies to private investors, and that Prime Minister Blaize must somehow neutralize this opposition before forging ahead with a real privatization program. By the same token, AID is perceived to be equally unreasonable from an ideological standpoint in its insistence on the quick sale of numerous companies from the Grenadian state enterprise portfolio. Until the two parties arrive at a common language about this issue, and have a "shared vision" of the problem based on facts and hard data, it will be difficult--if not impossible—to arrive at a mutually agreed upon plan of action which both parties "own" and to which both are committed.

An example of this "two languages" phenomenon is the different notion on the part of both AID and the GOG as to what actions should be undertaken within the overall effort. For its part, AID uses the term "divestiture" to refer exclusively to the sale of government-held companies to private investors. On the other hand, the Grenadian government views this term as encompassing a wider variety of actions to de-nationalize these companies—including leasing, management contracting, partial sale, joint ventures, and regulatory decontrol.[1] Such misunderstanding can contribute to the lack of a common perception of the problem, and therefore can stand in the way of progress toward a solution.

4. AID/W and USAID/RDOC do not always appear to be speaking the same language on the privatization issue. In the same way that USAID/RDOC and the GOG are viewing privatization through different glasses, so also do USAID/RDOC and AID/W. Within the larger AID network, there appears to be no "shared vision" as to what kinds of actions constitute privatization (e.g. does leasing "count"?), how extensive a program should be expected and at what pace the effort should proceed. Before USAID/RDOC and the Government of Grenada can be expected to reach a common understanding about a privatization program, it is essential that AID reach a common understanding within itself as to a definition of and approach to the problem.

5. Any extensive program to reform the state enterprise sector must be constructed on a foundation of public credibility and awareness. This foundation, in turn, must rest on facts and hard information about the nature of the public enterprise problem in Grenada and, in particular, the overall net impact of these enterprises on the national economy and on the efficient delivery of essential public services.

6. The case for privatization has not been effectively made either within the Government of Grenada or to the general public. Unlike the case of Jamaica, where the local independent press has done an effective job of building a public case for privatization, in Grenada no such effort has been made either by the local media or by the government itself. This is particularly important in light of the intense public relations campaign conducted by the previous administration in support of state

[1] Normally, the term "privatization" refers to the broad range of denationalization alternatives, with "divestiture" being only one of these options.

control over the economy. Several people interviewed felt that even the average educated Grenadian was probably not aware of the issues and problems surrounding state-owned enterprises (e.g. the extent of government ownership of the economy and the total effect of these enterprises on the economy). ~~Dr. Wilson~~ Some officials even intimated that some members of his own government lacked a complete picture of the problem.

7. At present, no administrative apparatus exists to carry out a privatization program. Even if there were a genuine desire on the part of the Grenadian government to undertake an extensive privatization effort, and even if a strategy existed to go along with it, there is no administrative mechanism or decisionmaking process to put such a program into action. The present responsibility for implementation appears to rest with Laurie Wilson, although we saw no evidence of any structure or process within the Ministry of Finance to actually manage the complex accounting, legal, financial, and analytical tasks which go into such a program. In addition, there are no established procedures or guidelines which specify who in the upper echelon of the Grenadian government should be vested with the authority to decide policy and to approve actual privatization proposals. Experience in other countries shows that if all of these details are left to the ultimate authority—the head of state--it is likely to become mired in political quicksand, and any hope of a smooth, consistent, and expeditious program will soon be lost.

8. An extensive privatization effort in Grenada will probably take longer than AID is presently willing to accept. If there are 20-25 companies which can be categorized as legitimate candidates for privatization, privatizing even half of these enterprises could take several years or more, even with a clear "game plan" and strategy. By contrast, AID seems to be thinking of time frames of months—or perhaps a year or two at the most—and this we believe is unrealistic considering the circumstances which presently exist in Grenada.

9. There is a genuine interest in the notion of a planned approach to privatization in Grenada. With the possible exception of one or two

people, everyone we interviewed expressed the need to develop a strategy for privatization in Grenada, and a detailed "game plan" to follow in carrying out the strategy. In this regard, it was generally felt that spending some "up front" time on planning and strategy formulation—and in getting the two parties more together in terms of a shared vision and common understanding of the problem--would be a worthwhile investment of time and effort, provided the time involved wasn't too long (most people seemed to feel that 3-6 months would be sufficient).

10. <u>Whatever the process and strategy that is eventually developed, the decisionmaking process on privatization will be highly political, particularly at the outset.</u> Getting the government of Grenada to view the privatization effort through logical glasses is probably unrealistic—at least until there is some initial experience to demonstrate to the political leadership that this process will not backfire as is now feared. Indeed, there are some genuine political considerations which AID and others involved in the process must be aware of—particularly the employment question in a country which is presently experiencing a 35% unemployment rate.

11. <u>The approach which is eventually arrived at must be tailored to the needs and realities of Grenada, and must not be imposed from the outside or borrowed from the experience of another country.</u> Ideally, the process of dialogue that should take place during the planning and strategy development phase should result in a "Grenada-ized" approach that fits the realities and exigencies of the local situation.

C. RECOMMENDATIONS

1. <u>Begin with a clean slate.</u> The current agreement appears to be at an impasse. AID is withholding the final \$2 milllion tranche pending action on this matter. For its part, the Government of Grenada appears to resent this position, seems reluctant to acknowledge ~~unwilling to honor~~ the promises of the predecessor government, and is likely to continue dragging its feet on any further action.

Given the new situation—a new government, a new mission director, and possibly a new view of the problem and its solution—it is a propitious moment to begin the process anew with a new agreement which is mutually arrived at and which is based on a fresh approach which has more likelihood of getting results.

2. Develop a privatization strategy for Grenada and a concrete plan to carry it out. A strategic plan must be fashioned which is acceptable to both parties—AID and the government of Grenada. To gain this level of acceptance and commitment, the plan must be the result of genuine participation by both parties in its formulation, with possible assistance from outside advisors as facilitators.

3. Make an effective public case for privatization. Based on the extensive data and information which already exists on Grenadian state companies, and with the help of the numerous consulting reports which have been prepared in recent months on this issue (Singh, IMF, etc.), an inventory should be drawn up of precisely what is contained in the public enterprise portfolio, what condition each of these enterprises is in, and which enterprises would be likely candidates for which forms of privatization. In addition, a public "balance sheet" should be prepared listing the benefits and detriments of the state enterprise sector *in toto*, including the net operating income, the total accumulated indebtedness, and the annual fiscal commitment by the Treasury in the form of transfers or subsidies. As mentioned earlier, establishing an objective factual case is essential to the strategy and will serve as the foundation for the new dialogue based on hard data, objective facts, and concrete information—rather than ideology and rhetoric—about state enterprises and their effect in Grenada.

4. Communicate the case effectively. Once the facts-based case is established, it should be communicated both within the Grenadian government—particularly within the cabinet ranks and among legislators—and to the wider public through broadcast and print media and by means of speeches by senior government officials. This will serve to

deflate some of the rhetoric on this controversial issue and should serve to lay a foundation of credibility for an eventual privatization effort.

5. Manage AID/W's expectations. If the Grenadian privatization program (and other similar efforts in the English-speaking Caribbean) are to succeed, AID itself must develop more of a "shared vision" as to its strategy and expectations vis-a-vis privatization. To this end, we believe it would be useful for advisors who are thoroughly familiar with the privatization planning and implementation process to make their experience known to senior AID officials, including the AID Administrator. This might be accomplished by means of a brief, half-day "workshop" on this topic, in which the practical experiences of different countries would be shared, AID's approach reviewed within the larger socio-political context, and concrete proposals made as to how the current AID strategy might be modified to yield a greater probability of success in the future.

6. Encourage a range of privatization alternatives. While divestiture—the actual sale of ownership—may be the most desirable outcome, it is not always the most likely to occur, at least not in the near term. In those cases where complete divestiture is not realistic—for whatever reasons and however illogical these reasons may appear—we recommend the adoption of other privatization means which, while short of sale, at least accomplish some of the same ends (and may pave the way for eventual divestiture at a later date). These alternative forms of privatization include:

- o Partial sale
- o Joint ventures
- o Management contracts
- o Leasing of assets
- o Relaxation of government regulations and controls
- o Stronger performance incentives
- o Greater fiscal self-reliance.

In addition, in those cases where <u>no</u> form of immediate privatization is likely to occur, and which nonetheless need upgrading, AID should consider supporting advisory services to enhance the efficiency and operational performance of these companies through organizational restructuring, systems development, and management training.

7. <u>Establish an administrative mechanism for implementing the program.</u> Once the strategy has been defined and the implementation plan laid out, an administrative unit within the government of Grenada must be identified to carry out the detailed program on a day-to-day basis. Ideally, this unit should be either housed within or tied to an existing governmental body, such as a ministry. To the greatest possible extent, it should be comprised of existing personnel, thus minimizing the need to add to the government payroll.

   Once the unit has been identified and structured, the administrative "rules of the game"—the process which the privatization program will follow—must be defined. This includes the definition of lines of authority, decisionmaking responsibility for different types of decisions, the approval process for signing off on decisions, and the procedures to be used for valuation of assets, updating accounting records, clearing title to the property, transferring the equity shares to the administrative unit, identifying potential buyers/lessors, and the scores of related details which go into the privatization of government companies.

   In addition to identifying the administrative coordination unit within the government of Grenada, it would also be advisable to identify someone within USAID/RDSOC to be in charge of supervising and monitoring the process from AID's standpoint. This individual should be someone within USAID who is familiar with the business world, who is knowledgable about the privatization strategy for Grenada, and who is sensitive to the socio-political realities in Grenada. Ideally, this person should also enjoy the type of relationship with the Grenadian government which would permit him to attend strategy meetings as an equal and trusted partner. The type of relationship which exists between the respective GOG and AID "administrative managers" will be crucial to the quality of dialogue and interaction throughout implementation and therefore will be a key factor in the overall success of the program.

8. Segregate the agricultural enterprises from the rest and treat them separately, under a separate strategy and implementation plan. Many of the issues surrounding the agro-enterprises are highly charged and complex (e.g., sale of government-owned lands; foreign ownership in agriculture; the restructuring of the MNIB; the policy aspects of food pricing; etc.). We suspect that the "solution" to the agribusiness portfolio will require a more "wholistic" approach than the simple divestiture or leasing, and will therefore have to follow a different process based on different goals and assumptions.

As a final note to the recommendations made above, it is important to emphasize that the process by which the privatization strategy is created is as important as the content of the strategy itself. If the strategy is imposed by AID, it will probably not be implemented. Similarly, if the strategy is prepared entirely by outside consultants, no matter how much they might know about the process and regardless of how good the strategy is, it will falter during implementation from the lack of genuine commitment to it. Only through a genuine interactive and participative process between the two principals—AID and the GOG—with the assistance of knowledgable outsiders as advisors and facilitators, can an appropriate process be developed.

D. PROPOSED WORKPLAN

(To be developed at meeting of 3/26/85)

GUATEMALA

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: December 20, 1991

TO: Sunita Kikeri, CECPS

FROM: Ronald E. Myers, LA2C2 REM

EXTENSION: 38774

SUBJECT: Guatemala: Draft Privatization Laws

As we discussed the other day I would be most interested in receiving reactions to the attached draft privatization laws which are to be introduced to the Guatemalan Congress early next year. Apparently a two-thirds majority vote is required for any privatization, therefore one of the drafts is a blanket authorization law which seeks the broadest possible support. With its passage a Privatization Commission would handle specific privatizations/sales/demonopolizations over the next few years. The second draft involves concessions for highway construction. Thank you.

92E0258 December 6, 1991
Spanish (Guatemala)
LA2C2 DRJB:ecw

THE CONGRESS OF THE REPUBLIC OF GUATEMALA,

Considering that the policy of the present Government is to make participation by the State in national economic activity more efficient and to transform Guatemala into a country of owners, and that these are aims which require the Government to create opportunities for new investors, provide equal access to ownership and foster growth of a local capital market;

Considering that the State has engaged in economic activities involving the creation of assets and services which for the most part have not only not produced the anticipated benefits but on the contrary have generated high opportunity costs for the community, have acted as a brake on the economy by increasing the country's fiscal deficit and its external and domestic debt, and, by diverting resources to non-priority activities, have caused the State to become deficient in carrying out those functions which fall to it alone;

Considering that there are public sector activities which, by constitutional mandate, can and should be left to private individuals, thereby paving the way for broader-based delivery of services, chiefly in those arenas where the State is acting as entrepreneur;

Considering that Article 130 of the Constitution of the Republic prohibits monopolies and privileges, and that the State is required to set limits on enterprises which, to the detriment of the national economy, take over or tend to take over production in one or more branches of industry or a single industrial or agricultural activity;

Considering that Article 130 of the Constitution of the Republic also provides that the State shall protect the market economy system and prevent the formation of associations tending to undermine the free play of the market or to cause damage to consumers;

And considering that Article 124 of the Constitution of the Republic provides that assets in the public domain may be disposed of only in the manner set by the laws in force, which shall set the limits and formalities governing any such disposal and its financial objectives, and that should no laws exist which regulate the liquidation and disposal of public assets adequately, then they shall be enacted;

THEREFORE,

on the basis of the foregoing and under the terms of Article 171 (a) of the Constitution of the Republic,

NOW DECREES THE FOLLOWING

DEMONOPOLIZATION AND PRIVATIZATION ACT

CHAPTER I

General Principles

Article 1: The term "privatization" shall be understood to mean the process whereby the role of the State and its participation in economic activity is redefined through demonopolization, deregulation, restructuring, liquidation or transfer to individuals or bodies corporate of the ownership or management of State assets and services.

Article 2: All other legislative instruments are hereby rescinded which allow or are conducive to monopolistic, regulatory or restrictive practices of any type with regard to the delivery, production or sale of any services, goods, products or related byproducts.

Also rescinded hereby are all privileges conferred on government entities or agencies, whether autonomous, semi-autonomous or direct dependencies of the Executive Branch, or on entities or enterprises in which the State holds any type of investment interest.

Article 3: In order to allow implementation of the above provisions, the Executive Branch is hereby vested with the power to proceed with privatization of State agencies or enterprises, whether autonomous or semi-autonomous, and of entities or enterprises in which the State holds any type of investment interest, and to engage in all such actions as may be necessary for that purpose, subject only to constitutional law.

Article 4: The National Privatization Commission (hereinafter referred to simply as the Commission) is hereby created as an auxiliary organ of the Executive Branch, answerable to the President of the Republic. This Commission, whose members shall be appointed by Executive Order, shall have the following powers and responsibilities:

(a) To administer, plan, execute and supervise the privatization process.

(b) To recommend to the Executive for its approval which enterprises, assets and services should be restructured, liquidated or transferred, and in what order of priority.

(c) To appoint and dismiss the general manager of the Commission and the deputy managers responsible for specific restructuring operations.

(d) To contract for the services of technical advisers to assist with execution of the privatization process.

(e) To inform the Executive of the full and partial results of each privatization operation.

(f) To work in conjunction with the Ethics Commission, the creation of which is provided for in Article 6 hereof.

(g) To formulate its own Regulations within a period of 30 days from the date of promulgation of this Act, submitting them for ratification by the Executive Branch through the Ministry of the Economy.

(h) To oversee the performance of all privatization agreements, recruiting the necessary personnel for this purpose.

Article 5: The members of the Commission shall be individuals who, in the opinion of the Executive Branch, are of recognized integrity, professional ability, and status. There shall be five members from the public sector, five other members who are private individuals, and four alternate members (two from the public sector and two private individuals). In each case, the term of office shall be five years, renewable.

Article 6: The Ethics Commission is hereby created, to remain in existence for the duration of the privatization process. Its members shall be appointed by Executive Order, and its powers and responsibilities shall be the following:

(a) To work in conjunction with the Commission.

(b) To scrutinize each of the privatization activities referred to in Article 1 hereof, and ensure that they are conducted with absolute legality and transparency.

(c) To issue reports on the matters within its competence throughout the privatization process. These shall be presented within the periods allowed by the Commission, and if not issued within such periods shall be assumed to be favorable.

(d) To formulate its own Regulations within the 30 days following the date of promulgation of this Act, submitting them for ratification by the Executive Branch through the Office of the Attorney General.

Article 7: The Ethics Commission shall be made up of one representative of the Office of the Attorney General, one representative of the Office of the Comptroller General, and four private individuals who in the opinion of the Executive Branch are of recognized integrity, professional ability, and status. When a particular case requires it, the Ethics Commission should also include one representative of the Office of the Superintendent of Banks.

Article 8: The members of the Commission shall give their services free of charge, while the services of the members of the Ethics Commission shall entitle them to the corresponding fees and allowances, which shall be set and paid by the Executive.

CHAPTER II

Successful Bidders and Licensees

Article 9: Successful bidders for the transfer of State assets and services, as well as licensees of works and services, may be either individuals or bodies corporate, Guatemalan or foreign, and shall be fully subject to the taxation and legal systems of Guatemala.

CHAPTER III

Administration of Resources

Article 10: The required part of the receipts from the transfer or restructuring of real or personal property assets, and from the restructuring or liquidation of State entities or enterprises, shall be set aside in each case for the creation of a fund, to be administered by the Commission, from which the operating costs of the privatization process shall be covered. Initially, or whenever necessary, the Executive shall contribute monetary resources to supplement this fund. In addition, the fund may also mobilize grants and lines of credit and contract for loans or other means of financing for its own use. To this end, the Commission may open accounts in any financial institutions in the country.

In respect of any contract entered into, the Commission, as an integral part of the Executive Branch, shall be exempt from payment of all classes of taxes, fees and like charges, without exception. Likewise, individuals or bodies corporate who or which sell assets or services shall not be liable for payment of taxes on negotiations or contracts effected with the Commission.

Article 11: The resources generated by the transfer or restructuring of real or personal property assets, and by the restructuring or liquidation of State entities or enterprises, shall, after assessment and deduction of operating costs, be remitted directly to the Ministry of Public Finances for deposit in a general expenditure account. These resources shall be employed in meeting the country's domestic and external debt and in funding investment projects, in accordance with national budgetary priorities.

Article 12: Within the first 90 calendar days of each anniversary of the promulgation of this Act, the Commission shall provide the Executive with an annual report on the use made of the resources generated through the privatization process.

Article 13: On completion of the privatization process, the Commission shall provide the Ethics Commission with a full accounting of the fund created under the terms of Article 9 hereof and shall request either the temporary suspension of its functions or its dissolution.

CHAPTER IV

Transfer of Real or Personal Property

Article 14: The process which shall be followed in transferring State-owned real or personal property to individuals and bodies corporate shall consist of the steps now enumerated:

(a) The Commission shall recommend and the Executive shall approve the State-owned [real and] personal property assets which are to be transferred.

(b) The Commission shall instruct external auditors to draw up an inventory of and value the real or personal property assets in question.

(c) The real or personal property assets in question shall be put up for sale at public auction, notice of which shall be published in the Official Bulletin and other widely circulated daily publications.

(d) Sale arrangements shall adhere solely to the provisions contained in the Code of Civil and Mercantile Procedures, Decree-Law 107.

CHAPTER V

Restructuring of State Entities

Article 15: The procedure to be followed in restructuring State-owned entities or enterprises shall consist essentially of the steps now enumerated:

(a) The Commission, once study of the matter has been completed and the Ethics Commission has issued its report, shall recommend to the Executive, and the latter shall approve, the State-owned entities or enterprises which are to be restructured and the order of priority for doing so.

(b) The Executive Branch, within a non-extendible period of 30 days from the date of the recommendation, shall issue an Order approving restructuring. Should such Order not be issued within that period, it shall be assumed that restructuring is approved and the Commission shall forthwith send notification of approval to be published in the Official Bulletin, to take effect on the day following its publication.

(c) The general manager of the Commission shall instruct external auditors to draw up an inventory of and value the State-owned entities or enterprises approved for restructuring.

(d) State-owned enterprises for which such approval is given under the terms of paras. (a) and (b) above shall be restructured as stock corporations. To this end, the Executive Branch, without prior proceedings, shall effect the restructuring by executing a public deed before the Government Notary. Execution of this document shall simultaneously effect delivery of all the assets, rights and obligations of the entity thus restructured, except for such shares of stock as the State is to hold.

(e) The certified copy of said public deed shall be filed with the Commercial Registrar, after which the procedure stipulated in the Commercial Code for the formation of a new corporation shall be followed.

(f) The law creating the State entity shall be rescinded on the date of provisional registration of the new corporation, but recision shall become final only when the new corporation is inscribed definitively in the Commercial Register.

(g) The right to administer the affairs of the new corporation shall be vested temporarily in the Commission. Accordingly, the Commission shall appoint the provisional managerial body, which shall be modified as shares are progressively sold. For every 10% of shares sold, the Commission shall call a general meeting of stockholders for the purpose of effecting modifications in the organization of the managerial body.

(h) Unsubscribed shares of stock in corporations created as a result of restructuring shall be offered for sale by the Executive Branch on the stock exchange or at monthly public auctions.[1] As long as the shares remain the property of the State, the rights attaching to them, except proprietary rights, shall remain in abeyance.

In all cases of restructuring or privatization, and especially in the electric power, transportation and communications fields, it shall be the ongoing policy of the Government to promote the free market system and free competition. Participation by the State shall be limited exclusively to those cases in which the private sector is not providing the services required by the population (within the meaning of Article 118 of the Constitution of the Republic), but only for as long as such circumstances prevail.

CHAPTER VI

Licenses

Article 16: In cases in which legal impediments exist to transfer of ownership, management of the assets, entities or services in question may be restructured or placed under license, in accordance with the procedures specified in the Commission's Regulations as ratified by the Executive Branch. Should these Regulations be amended, such amendments shall have no effect on previously granted licenses, unless the licensee voluntarily and explicitly

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1/ Translator's Note: As the first two sentences of this subparagraph are poorly drafted in the original, their meaning as rendered here is by no means certain.

informs the competent authority that he accepts the new provisions in their entirety.

Article 17: The Executive Branch is hereby vested with the power to enter into whatever licensing contracts the Commission may recommend as necessary for the operation of public services by individuals or bodies corporate. The maximum duration of any license shall be 30 years, with an extension of up to 5 years in cases of *force majeure* or act of God. Licensees shall provide the service in question on their own account, at their own risk and in accordance with the stipulations and conditions incorporated in the licensing contract.

CHAPTER VII

Liquidation

Article 18: In the case of liquidations, the principal steps in the required procedure shall be as follows:

(a) The Commission shall recommend and the Executive shall approve the enterprises or entities which are to be liquidated and in what order.

(b) The President of the Republic shall issue the Order for liquidation, which shall prescribe the period of time in which the operation is to be completed. In no circumstances may such period exceed the limits set in the Commercial Code for private-sector corporations.

(c) Once a liquidation is completed, the legislation, as amended, creating the State entity or enterprise in question shall automatically be rescinded.

Article 19: This Act shall take effect ....

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TOLL-ROAD LICENSING LAW

Article 1: The Executive Branch, acting through the Ministry of Communications, Transportation and Public Works, is hereby authorized to enter into licensing contracts for the operation of public-service roads.

Article 2: Licensing contracts for the operation of public-service roads shall be entered into with individuals or bodies corporate so that they, on their own account and at their own risk, may build, rebuild, rehabilitate, improve and maintain roads, subject to the terms of the particular contract in each case, and so that they may collect tolls from road users.

Article 3: The maximum licensing period shall be 30 years from the date of approval of the contract by Executive Order. The specific period in each case shall be commensurate with the amount and scale of the investment.

The period may be extended for up to five years in cases of *force majeure* or act of God.

Article 4: Licenses shall be awarded through the public competitive procurement procedures specified in the Purchasing and Contracts Act, and the award in each case shall be approved by Executive Order.

Article 5: The obligations of the licensee shall be to:

(a) Conserve all assets and components in accordance with the provisions of the licensing contract in question.

(b) Provide continuous service, with users enjoying the right to such service features as are stipulated in the licensing contract.

(c) Ensure smooth and efficient conditions of service.

(d) Take responsibility for damages caused to the State or to third parties as a consequence of exploitation of the license.

(e) Ensure that assets, structures, facilities and toll collection equipment revert to the State on completion of the licensing period in good operating condition and free of all encumbrances.

(f) Permit such audits to be carried out as the competent authorities of the Ministry of Communications, Transportation and Public Works or the Office of the Comptroller General of the Republic may regard as necessary, at the intervals and in the manner specified in the contract.

(g) Take responsibility, except in cases of *force majeure*, and in all instances up to the insured amount, for the loss or deterioration of assets which the State delivers to the licensee for exploitation of the license.

(h) Such other contractual obligations as the parties stipulate in the licensing contract.

Article 6: The obligations of the State shall be to:

(a) Obtain the necessary right of way, which shall become the property of the State. In each instance, the licensee shall pay whatever indemnities may be associated with obtaining right of way.

(b) Take over the road for reasons of public utility, indemnifying the licensee for the value of works carried out and facilities created on a basis commensurate with recovery of his investment. The following shall be considered reasons of public utility:

- failure on the part of the licensee to fulfil any of his contractual obligations;

- an increase in tolls imposed by the licensee without the corresponding authorization;

- the consequences of *force majeure* or act of God, duly verified.

(c) Review authorized tariffs every six months or whenever the adjustment factor of the cost overrun formula increases by more than 5%.

(d) Oversee execution of the licensing arrangements until it expires.

(e) Verify that only tolls as authorized by the Ministry of Communications, Transportation and Public Works are being collected.

(f) Carry out external audits at the intervals and in the manner stipulated in the contract.

(g) Re-grant the license on its expiry provided no other interested parties participate in the competitive procurement proceedings.

Article 7: The licensee is prohibited from:

(a) Transferring, ceding, encumbering or disposing of his rights as licensee without prior authorization from the Ministry of Communications, Transportation and Public Works.

(b) Changing the tolls authorized by the Ministry of Communications, Transportation and Public Works as required under the terms of the licensing contract.

Article 8: The licensee, as surety for performance of his obligations, shall on account of the State set up a deposit or provide the guarantees which the contract prescribes, commensurate with the amount and scope of the investment.

Article 9: The Ministry of Communications, Transportation and Public Works shall authorize the maximum rates at which the tolls payable by road users may be levied. Such ceilings may be adjusted only in the manner provided for in Article 6 (c) hereof.

Article 10: Vehicles operated in the course of their duties by the national police, Treasury and army of Guatemala, as well as hospital, Red Cross and Social Security Institute ambulances, and firefighting vehicles shall be exempt from payment of road tolls.

Article 11: A license shall become null and void in the following cases:

(a) on expiry of its period of duration;

(b) on being rescinded, in the circumstances specified in the particular contract;

(c) on being revoked, by Executive Order, in instances of non-performance as defined in the contract, unless such revocation is appealed or is disallowed by an administrative law tribunal;

(d) for failure on the part of the licensee to provide road services within the periods expressly stipulated in the contract and in the implementing regulations to this Law.

Article 12: The implementing regulations to this Law shall be issued within the 30 days following its promulgation.

Article 13: This decree shall come into effect immediately after its publication in the Official Bulletin.

"LEY PARA LA EXPLOTACION POR CONCESION DE CARRETERAS"

Artículo 1o. Se faculta al Organismo Ejecutivo para que a través del Ministerio de Comunicaciones, Transporte y Obras Públicas, celebre contratos de concesión para la explotación del servicio público de carreteras.

Artículo 2o. Los contratos de concesión para la explotación del servicio público de carreteras se celebrarán con las personas individuales o jurídicas, para que por su cuenta y riesgo, puedan construír, reconstruír, rehabilitar, mejorar y mantener las carreteras, con sujeción a lo contratado mediante el cobro de una cuota a los usuarios.

Artículo 3o. El plazo máximo de la concesión será de 30 años contados a partir de la fecha de aprobación del contrato en Acuerdo Gubernativo. El plazo será calculado en cada caso, de acuerdo con la cuantía e importancia de la inversión. El plazo podrá prorrogarse hasta por cinco años en caso de fuerza mayor o caso fortuito.

Artículo 4o. La concesión se adjudicará siguiendo el procedimiento de licitación determinado en la Ley de Compras y Contrataciones, y la adjudicación deberá aprobarse por medio de Acuerdo Gubernativo.

Artículo 5o. Son obligaciones del concesionario:

a) La conservación de todos los bienes y elementos conforme al contrato de concesión celebrado.

b) Prestar el servicio con la continuidad convenida, teniendo derecho los usuarios a utilizarlo en las condiciones establecidas en el contrato de concesión.

c) Velar por el orden del servicio y de su eficacia.

d) Responder por daños y perjuicios que ocasione al Estado o a terceros como consecuencia de la explotación de la concesión.

e) Revertir los bienes, las contrucciones e instalaciones y equipo de control de cobro al Estado, al vencimiento del plazo de la concesión, en condiciones de funcionamiento adecuado y libres de todo gravamen.

f) Permitir la práctica de las auditorías que la autoridad competente del Ministerio de Comunicaciones, Transporte y Obras Públicas o la Contraloría General de Cuentas de la Nación consideren necesarias, en la época y forma establecidas en el contrato.

g) Responder, salvo causas de fuerza mayor, y en todo caso hasta por el monto de lo asegurado por la pérdida o deterior de los bienes que el Estado le entregue para la explotación de la concesión; y

h) Las demás obligaciones contractuales que las partes estipulen en el contrato de concesión.

Artículo 6o. Son obligaciones del Estado:

a) Obtener el derecho de vía, que pasará a propiedad del Estado. En todo caso el concesionario deberá cubrir la indemnización que corresponda a dicha obtención de vía.

b) Rescatar el servicio por causas de utilidad pública, indemnizando al concesionario, el valor de las obras e instalaciones, tomando en consideración la recuperación de su inversión. Se consideran causas de utilidad pública las siguientes:

- Por incumplimiento del concesionario de cualquiera de sus obligaciones contractuales.

- Cuando el concesionario sin la autorización correspondiente aumentare las tarifas; y,

- Por causas de fuerza mayor y caso fortuito debidamente comprobados.

c) Revisar semestralmente las tarifas autorizadas, o cada vez que el factor de ajuste de la fórmula de sobrecostos se incremente en más de un 5%.

d) Supervisar la ejecución de la concesión hasta su vencimiento.

e) Velar porque se cobren las tarifas autorizadas por el Ministerio de Comunicaciones, Transporte y Obras Públicas.

f) Efectuar auditorías externas en la época y forma establecidas en el contrato.

g) En caso de vencerse el plazo de la concesión, dar nuevamente en concesión las carreteras, salvo que no hubieren interesados al momento de la respectiva licitación.

Artículo 7o. Se prohíbe al concesionario:

a) Transferir, ceder, gravar o enajenar sus derechos como concesionario, sin la previa autorización del Ministerio de Comunicaciones, Transporte y Obras Públicas.

b) Alterar las cuotas autorizadas por el Ministerio de Comunicaciones, Transporte y Obras Públicas conforme al contrato de concesión.

Artículo 8o. El concesionario, para garantizar el cumplimiento de sus obligaciones constituirá a favor del Estado un depósito u otorgará la garantía que se le fije en el contrato, de acuerdo con la cuantía e importancia de la inversión.

Artículo 9o. El Ministerio de Comunicaciones, Transporte y Obras Públicas autorizará las tarifas máximas para el cobro de la cuota que el usuario debe pagar por el uso de las carreteras, la que deberá ser revisada de acuerdo al Artículo 6o., inciso c).

Artículo 10o. Están exentos del pago por servicio público de carreteras los vehículos utilizados en el ejercicio de sus funciones por la Policía Nacional, Policía de Hacienda, el Ejército de Guatemala, las ambulancias de los hospitales nacionales, las ambulancias de la Cruz Roja Guatemalteca, las ambulancias del Instituto Guatemalteco de Seguridad Social -IGSS- y los Bomberos.

Artículo 11o. La concesión se extingue en los siguientes casos:

a) Por cumplimiento del plazo.

b) Por rescisión en los casos que se establezcan en el contrato respectivo.

c) Por revocación, en Acuerdo Gubernativo, en los casos de incumplimiento establecidos en el contrato, siempre y cuando dicha revocación no sea impugnada, o en su caso, no sea revocada por el Tribunal de lo Contencioso Administrativo.

d) Por incumplimiento del concesionario en realizar sus prestaciones dentro los plazos expresamente establecidos en el contrato y en el Reglamento.

Artículo 12o. Dentro de los 30 días siguientes de la publicación de esta ley deberá emitirse el Reglamento de la misma.

Artículo 13o. El presente decreto empezará a regir inmediatamente después de su publicación en el Diario Oficial.

EL CONGRESO DE LA REPUBLICA

CONSIDERANDO

Que es política del actual gobierno hacer más eficiente la participación del Estado en la actividad económica y transformar a Guatemala en un país de propietarios, para lo cual debe dar oportunidad a nuevos inversionistas, democratizar la propiedad y estimular el crecimiento de un mercado local de capitales.

CONSIDERANDO

Que el Estado ha desarrollado actividades económicas en la producción de bienes y servicios que en su mayoría no sólo no han generado los beneficios esperados, sino que, al contrario, han representado un alto costo de oportunidad para la comunidad y un freno para la economía al causar incrementos en el déficit fiscal y en la deuda externa e interna del país, y al desviar recursos a actividades no prioritarias ha realizado deficientemente las funciones indelegables que son de su competencia.

CONSIDERANDO

Que existen actividades del sector público que pueden y deben, de acuerdo al mandato constitucional, ser absorbidas por los particulares, propiciando con ello una ampliación en la prestación de los servicios, principalmente en aquellos donde el Estado está actuando como empresario.

CONSIDERANDO

Que el artículo 130 de la Constitución Política de la República de Guatemala prohibe los monopolios y privilegios, y que el Estado debe limitar las empresas que absorban o tiendan a absorber, en perjuicio de la economía nacional, la producción en uno o más ramos industriales o de una misma actividad industrial o agropecuaria.

CONSIDERANDO

Que de igual forma el artículo 130 de la Constitución Política de la República de Guatemala establece que el Estado debe proteger la economía de mercado e impedir las asociaciones que tiendan a destruir la libertad del mercado o a perjudicar a los consumidores.

CONSIDERANDO

Que el artículo 124 de la Constitución Política de la República de Guatemala establece que los bienes nacionales sólo podrán ser enajenados en la forma que determine la ley, la cual fijará las limitaciones y formalidades a que deba sujetarse la operación y sus objetivos fiscales. Si no existe una ley que regule adecuadamente la liquidación y enajenación de bienes del Estado, ésta debe crearse.

POR TANTO

Con fundamento en lo considerado y en el artículo 171, inciso a) de la Constitución Política de la República de Guatemala

DECRETA

La siguiente

LEY GENERAL DE DESMONOPOLIZACION Y PRIVATIZACION

CAPITULO I

Principios Generales

Artículo 1o. Se entiende por privatización el proceso mediante el cual se redefine el papel del Estado, reorientando su participación en la actividad económica con la desmonopolización, desregulación, transformación, liquidación o transferencia a personas individuales y jurídicas de la propiedad o administración de bienes y servicios del Estado.

Artículo 2o. Se derogan todas aquellas disposiciones que otorguen o propicien calidades monopolísticas, regulatorias o restrictivas de cualquier índole relativas a la prestación, producción o venta de cualquier servicio, mercancía, producto o subproducto que se deriven de las mismas.

También se derogan todos los privilegios establecidos a favor de las entidades o empresas del Estado, sean estas autónomas, semiautónomas o dependencias directas del Organismo Ejecutvo y de todas aquellas entidades o empresas en las que el Estado tenga participación a cualquier título.

Artículo 3o. Se faculta al Organismo Ejecutivo para que, en cumplimiento con lo antes dispuesto, pueda proceder a la privatización de las entidades o empresas del Estado, sean estas autónomas o semiautónomas y de todas aquellas entidades o empresas en las que el Estado tenga participación a cualquier título, y para que realice todos los actos que para ello sean necesarios, teniendo como única limitación el ordenamiento de las normas constitucionales.

Artículo 4o. Se crea la Comisión Nacional para la Privatización (en adelante también referida simplemente como la Comisión) como órgano auxiliar del Organismo Ejecutivo, dependiente del Presidente de la República. Esta comisión será nombrada por medio de acuerdo gubernativo y tendrá las atribuciones siguientes:

a) Administrar, planificar, ejecutar y supervisar el proceso.

b) Recomendar al Ejecutivo para su aprobación qué empresas, bienes y servicios deben transformarse, liquidarse o transferirse y en qué orden de prioridad.

c) Nombrar y remover al Gerente de la Comisión y a los Subgerentes encargados de cada una de las transformaciones.

d) Contratar los servicios de asesores técnicos que contribuyan al desarrollo del proceso de privatización.

e) Informar al Ejecutivo sobre los resultados totales y parciales de cada proceso de privatización.

f) Trabajar coordinadamente con la Comisión de Probidad, la cual se refiere en el artículo 6o. de esta ley.

g) Elaborar su propio reglamento interno en el plazo de treinta días, a partir de la fecha de emisión de esta ley. Este reglamento será ratificado por el Organismo Ejecutivo por conducto del Ministerio de Economía.

h) Velar por los acuerdos de ejecución del proceso y contratar al personal necesario para tal fin.

Artículo 5o. La Comisión estará integrada por personas que a juicio del Organismo Ejecutivo sean de reconocida honorabilidad, capacidad profesional y prestigio. Quedará conformada con cinco (5) miembros por el sector público y cinco (5) particulares, y contará con cuatro (4) miembros suplentes: dos (2) miembros por el sector público y dos (2) particulares, todos los que durarán en sus funciones cinco años prorrogables.

Artículo 6o. Se crea la Comisión de Probidad, la cual tendrá carácter permanente, mientras dure el proceso de privatización. Será nombrada por medio de acuerdo gubernativo y tendrá, entre otras, las siguientes atribuciones:

a) Trabajar coordinadamente con la Comisión.

b) Fiscalizar cada una de las actividades de privatización mencionadas en el artículo primero de esta ley, y velar porque las mismas se efectúen con absoluta legalidad y transparencia.

c) Emitir dictámenes de su competencia a lo largo del proceso de privatización, los cuales deberán ser presentados en los plazos acordados con la Comisión. Si en los plazos acordados no se emitieran los dictámenes referidos se presumirá que los mismos son favorables.

d) Elaborar su propio reglamento interno en el plazo de treinta días, a partir de la fecha de emisión de esta ley. Este reglamento será ratificado por el Organismo Ejecutivo por conducto del Ministerio Público.

Artículo 7o. La Comisión de Probidad estará integrada por un representante del Ministerio Público, un representante de la Contraloría de Cuentas y por cuatro (4) particulares que a juicio del Organismo Ejecutivo sean de reconocida honorabilidad, capacidad profesional y prestigio. Cuando el caso lo requiera, la Comisión de Probidad también deberá incluir un representante de la Superintendencia de Bancos.

Artículo 8o. Los miembros de la Comisión prestarán sus servicios ad honorem y los miembros de la Comisión de Probidad devengarán por sus servicios las prestaciones u honorarios correspondientes, los cuales serán fijados y pagados por el Ejecutivo.

CAPITULO II

De los adjudicatarios y concesionarios

Artículo 9o. Tanto los adjudicatarios en la transferencia de bienes y servicios del Estado como los concesionarios de obras y servicios podrán ser, indistintamente, personas individuales o jurídicas, guatemaltecas o extranjeras, y quedarán sujetas en todo el sistema tributario y legal del país.

CAPITULO III

Del manejo de los recursos

Artículo 10o. Del producto de la transferencia o tranformación de bienes muebles o inmuebles, y de la transformación o liquidación de las entidades o empresas del Estado, se destinará lo que cada caso requiera para la creación de un fondo, administrado por la Comisión, el cual se utilizará para cubrir los gastos de operación del proceso de privatización. Inicialmente, o cuando sea necesario, el Ejecutivo aportará recursos monetarios para complementar este fondo. Adicionalmente el fondo podrá captar, con carácter privativo, recursos de donaciones, líneas de crédito, convenios u otras fuentes de recursos monetarios. Para este fin la Comisión podrá abrir cuentas en cualquiera de las instituciones financieras del país.

En toda contratación que se realice, la Comisión como parte integrante del Organismo Ejecutivo estará exenta del pago de toda clase de impuestos, arbitrios y contribuciones, sin excepción alguna. Así mismo las personas que vendan bienes o servicios no estarán afectos al pago de impuestos en la negociación o contratación que realice con la Comisión.

Artículo 11o. Los recursos generados por la transferencia o transformación de bienes muebles o inmuebles, y por la transformación o liquidación de entidades o empresas del Estado, una vez presupuestados y deducidos los gastos de operación, se trasladarán directamente al Ministerio de Finanzas Públicas a cuenta del fondo común. Los mismos serán destinados para atender, de acuerdo a las prioridades presupuestarias nacionales, el pago de la deuda interna y externa del país, así como proyectos de inversión.

Artículo 12o. La Comisión deberá rendir al Ejecutivo, durante los primeros 90 días calendario a partir del aniversario de la emisión de esta ley, informes anuales de la utilización de los recursos generados en el proceso.

Artículo 13o. Al final del proceso, la Comisión presentará a la Comisión de Probidad la liquidación total del fondo creado según artículo 9o. de esta ley y solicitará la disolución de sus funciones temporal o definitivamente.

CAPITULO IV

De la transferencia de bienes muebles o inmuebles

Artículo 14o. El procedimiento que deberá seguirse para la transferencia de bienes muebles o inmuebles del Estado a personas individuales y jurídicas es el siguiente:

a) La Comisión recomendará al Ejecutivo para su aprobación los bienes muebles del Estado que deben transferirse.

b) La Comisión contratará los servicios de auditorias externas para llevar a cabo el inventario y el avalúo de los bienes muebles o inmuebles en cuestión.

c) Los bienes muebles o inmuebles en cuestión se sacarán a la venta en pública subasta, cuyo anuncio se publicará en el Diario Oficial y en otros diarios de mayor circulación.

d) Los procedimientos de venta deberán regirse únicamente por lo establecido en el Código Procesal Civil y Mercantil, Decreto Ley 107.

CAPITULO V

De la transformación de las entidades estatales

Artículo 15o. Para la transformación de las entidades o empresas del Estado, el procedimiento será, en sus aspectos fundamentales, el siguiente:

a) La Comisión, luego del estudio del caso y con el dictamen emitido por la Comisión de Probidad, recomendará al Ejecutivo para su aprobación las entidades o empresas del Estado que deben transformarse y el orden de prioridad.

b) El Organismo Ejecutivo emitirá el acuerdo de aprobación de la transformación correspondiente en el plazo improrrogable de treinta (30) días a partir de la recomendación. Si en este plazo no se emitiera dicho acuerdo se presumirá que la transformación queda aprobada y sin más trámite la Comisión lo enviará a publicar en el Diario Oficial, iniciando su vigencia al día siguiente de su publicación.

c) El Gerente de la Comisión contratará los servicios de auditorías externas para llevar a cabo el inventario y avalúo de las entidades o empresas estatales que van a transformarse.

d) Las empresas del Estado que se aprueben según incisos a) y b) anteriores, se tranformarán en sociedades anónimas. Para el efecto el Organismo Ejecutivo formalizará la transformación sin trámite previo en escritura pública ante los oficios del Escribano de Gobierno. Al otorgarse la escritura se aportarán de forma simultánea todos los bienes, derechos y obligaciones de la entidad transformada, con excepción de aquellas acciones que el Estado debe ejercitar.

e) Se presentará el testimonio de la escritura de sociedad en el Registro Mercantil, debiéndose seguir el procedimiento establecido en el Código de Comercio para la constitución de una nueva sociedad.

f) La ley de creación de la entidad estatal quedará derogada a partir de la fecha de inscripción provisional de la sociedad transformada, y la derogación sólo quedará firme siempre que la nueva sociedad se inscriba definitivamente en el Registro Mercantil.

g) Los derechos administrativos de la nueva sociedad quedarán temporalmente en la Comisión. Para el efecto, la Comisión designará al órgano de administración provisional, el cual se modificará en la medida en que las acciones sean vendidas. Por cada diez por ciento (10%) de acciones vendidas, la Comisión convocará a asamblea general para modificar la organización de la administración.

h) Las acciones de las sociedades anónimas que surjan de la transformación de las bolsas de valores, las acciones en que consista el capital. Si éstas no se lograran vender en su totalidad, el Organismo Ejecutivo deberá sacarlas a la venta sucesivamente en la bolsa de valores o cada mes en subasta pública. Mientras las acciones permanezcan en propiedad del Estado, éstas mantendrán sus derechos en suspenso, salvo los derechos patrimoniales.

En todos los casos de transformación o privatización y especialmente en materia de electricidad, transporte y comunicaciones, se establece como política permanente del gobierno el sistema de libre mercado y libre competencia, y se limita la participación del Estado exclusivamente para aquellos casos en que los particulares no presten los servicios que la población necesite (de acuerdo con el contexto del artículo 118 de la Constitución Política de la República) y únicamente mientras dure tal circunstancia.

CAPITULO VI

De la concesión

Artículo 16o. En los casos en que existan impedimentos legales para transferir la propiedad, se podrá transformar o dar en concesión la administración de los bienes, entidades o servicios de que se trate, de acuerdo al procedimiento que se establezca en el reglamento, que a propuesta de la Comisión emita el Organismo Ejecutivo. Cuando el reglamento antes mencionado sufra modificaciones, éstas no tendrán efecto sobre concesiones otorgadas con anterioridad salvo que el concesionario acepte voluntariamente y en forma explícita ante la autoridad competente la totalidad de las nuevas disposiciones.

Artículo 17o. Se faculta al Organismo Ejecutivo para que, conforme a las recomendaciones de la Comisión, celebre los contratos de concesión que sean necesarios para la explotación de servicios públicos por personas naturales o jurídicas. El plazo máximo de las concesiones será de treinta años, prorrogables hasta por cinco años en caso de fuerza mayor o caso fortuito. Los concesionarios prestarán el servicio de que se trate bajo su cuenta y riesgo, y conforme a las estipulaciones y condiciones del contrato respectivo.

CAPITULO VII

De la liquidación

Artículo 18o. En el caso de liquidaciones, el procedimiento será, en sus aspectos fundamentales, el siguiente:

a) La Comisión recomendará al Ejecutivo para su aprobación qué empresas o entidades deben liquidarse y en qué orden.

b) El Presidente de la República dictará el acuerdo de liquidación y en él fijará el plazo en que deberá efectuarse la misma. Este plazo nunca será mayor que el que señala el Código de Comercio para las sociedades mercantiles privadas.

c) Al concluir las liquidaciones quedarán automáticamente derogadas las respectivas leyes de creación y sus modificaciones relativas a las entidades o empresas del Estado de que se trate.

Artículo 19o. La presente ley entrará en vigor ...

THE WORLD BANK/IFC/MIGA
OFFICE MEMORANDUM

S. Kikeri
Stuart

DATE: September 19, 1991

TO: Mr. Marko Voljc, Division Chief, LA2C2

FROM: Ronald E. Myers, Country Officer, LA2C2 REM

EXTENSION: 38774

SUBJECT: GUATEMALA: Back-to-Office Report

1. I visited Guatemala September 9-13 to learn about the Government of Guatemala's (GOG) plans regarding privatization, discuss issues related to resuming normal relations with the Bank, and review the status of preparations for the pending SAL Pre-Appraisal mission. I met with the ministers of finance and economy, the Secretary General of Planning, President of the Bank of Guatemala, other officials in the BOG and finance ministry, and representatives of the private sector, IDB, and USAID. You participated in several of those meetings.

Overall Impressions on SAL Preparations

2. After a joint meeting with the Central Bank President and Minister of Public Finance in which you headed the IBRD side, I continue to believe the GOG is committed to restoring relations with the Bank and pursuing a medium term adjustment strategy. Macroeconomic policy implementation remains good with regard to the fiscal deficit, inflation, and international reserves. They responded to specific issues mentioned in the July Aide Memoire and agreed readily to your request to provide a letter covering the same topics. In the absence of specifics, they reported that progress is being made in the development of major adjustments in fiscal, trade, and public sector restructuring policies. They noted the warning that failure to meet the Bank's conditions regarding the SIF project would require inclusion of a social component of the SAL, most likely delaying its approval. The authorities seemed genuinely embarrassed about the breach in the arrears ceiling and anxious to move ahead with SAL preparations. They noted the suggestion that the country may want to seek a Consultative Group meeting in Paris, and that a joint meeting in the spring with other countries of the region would require significant preparatory work which should begin soon.

3. The private sector representatives seemed very supportive of the economic team. Several praised the recent decision of the President to establish diplomatic relations with Belize as a courageous and pragmatic step to end a festering and ultimately no-win issue. This action underscores statements to us by the ministers of finance and economy that the Government wants to focus its attention on fundamental problems affecting the country. That being said, the Pre-Appraisal mission will have to obtain more details on concrete plans with regard to key policy areas if we are to meet a March Board date.

Privatization

4. Juan Luis Miron, Minister of Economy, chaired a meeting with members of the Privatization Commission to outline progress achieved to date and plans with regard to privatization. The Commission, named by the President in March and composed of private sector representatives in addition to the Minister, has drafted legislation, conducted confidential public opinion polls to determine likely areas of support and opposition, visited Mexico and Venezuela (the latter this week) to study those countries' experiences, and designed an action plan and first year budget for a Privatization Unit. Privatization would include sale of shares in the market, private sale, liquidation, or management contracts/lease. Once a firm is targeted for privatization a special outside team would enter the firm to work with existing management as it oversees preparations for the sale/liquidation. Commission members did not reveal their priorities amongst state owned companies identified for privatization, although INDE, EEGSA, GUATEL, and state banks were all mentioned as possibilities.

5. President Serrano reportedly supports the Commission's effort, which is now focussing on political strategy issues. According to the Commission's lawyers, a two-thirds majority vote of Congress is needed to authorize a privatization. The Committee wants a one time blanket authorization (permitting a multi-year privatization effort) before congressional elections early next year. However an intense lobbying effort is needed and the Congress would not likely appropriate resources to the Privatization Commission for such an effort. In a recent development, the President has established a new commission on the energy crisis which includes the Privatization Commission, and serious thought is being given to trying to turn the public's frustration with the power outages into support for privatizing INDE/EEGSA and kicking off the privatization program. The Minister indicated that the new head of INDE/EEGSA strongly supports a much greater private sector role in energy production and that following the recent tariff increases there is increased interest being expressed in private sector co-generation projects. (Luis Luzuriaga and Hernan Campero are visiting Guatemala next week to review the electricity problem, look at prospects for revising/restarting the suspended Fifth Power Loan, and meet with interested ministers including Miron. Luzuriaga will also participate in a timely conference on power sector restructuring presented by USAID.)

6. During the meeting the Minister specifically asked 1) whether the Bank could in some manner provide "seed" money to the Commission to finance a public relations campaign necessary to obtain a favorable Congressional vote, 2) the Bank's advice on how to handle/finance labor retrenchment in targeted firms, 3) the treatment of Bank debt held by targeted firms, and 4) ways to prejudge the extent of (and attract) foreign and domestic investor interest in privatization. He indicated there would be political drawbacks to using bilateral or private sector resources for seed money.

7. I told the Commission that the Bank has provided TA money and specific loans to support privatization. With regard to the seed money, perhaps TA resources could be arranged on a retroactive basis using the UNDP if that agency agreed, arrears are cleared and the SAL is approved. I

promised to review possible options with Bank experts, as well as the other questions he raised, and convey the information ASAP. They responded very favorably to the suggestion they meet with IFC representatives. (Messrs. Freeman and McCordick of IFC will see Miron and possibly the Commission the week of September 23.) In conclusion I told Miron that the upcoming Pre-Appraisal mission would be interested in reviewing further progress in privatization, particularly with regard to a specific action plan to be included in the SAL. In a separate meeting with a member of the Commission I was told that with or without Bank seed money the administration will push ahead with privatization. I am not sure whether Miron can deliver a privatization program given the press of other economic issues and the two thirds congressional vote required; nevertheless, I am impressed with the calibre of Commission members, the extent of work accomplished so far, and their anger at, and commitment to alleviate, energy, telecommunication, and other public sector bottlenecks hurting the economy. Miron hinted that President Serrano may raise the issue of Bank support for privatization during his Washington visit early next month.

Electricity Shortages

8. A major problem facing the country is an electricity shortage provoked by inadequate rainfall this rainy season, but also attributable to inadequate power sector tariffs, management, investments, and maintenance. Daily rolling power outages of seven hours are affecting businesses and residents, with traffic jams, accidents, and deaths reported in the press. As the problem will likely last for some time, firms are investing in generators. The political debate appears intense, with blame given to the current and past administrations, the weather, the public sector, and unions. The recent 47 percent tariff increase has been denounced as unjust given the lack of service. We indicated the Bank's willingness to provide technical assistance, which was accepted by Messrs. Linares and Aitkenhead (simultaneous to a request to Ricardo Halperin by the Minister of Energy and Mines - see para.5).

Trade Reform

9. Minister Miron said that Guatemala, Honduras, and El Salvador may announce soon a common external tariff regime of three levels - 5, 10, and 20 percent with "immediate" implementation. He said that Guatemala must catch up to El Salvador in terms of trade liberalization. Intense discussions on bilateral trade arrangements are continuing with Venezuela, Colombia, and Mexico (although the Mexicans are going slow due to their focus on the FTA). Miron has spoken to USTR Hills requesting the same trade treatment for Guatemala as achieved by Mexico.

Arrears Clearance

10. The senior members of the economic team reiterated their intention to keep arrears to the Bank at or below $91 million and to clear the arrears as soon as possible. They attributed the breaching of the ceiling the previous week to bureaucratic delays in transferring domestic

currency just being received under the stabilization bonds legislation for payment to the Bank. They indicated that a payment would be made shortly. The USAID mission is hopeful that the US Congress will not object by a September 25 deadline to its plans to earmark $50 million to arrears clearance -- as of today no significant objections have been received.

Reactivation of Loans

11. I discussed with the MOF officers our intention to send an expert to prepare a Country Procurement Assessment Report. They indicated their desire to assist this effort, provided me a copy of the current procurement law, and asked that the expert contact them as soon as possible to facilitate preparation of other material. They welcomed the plan to conduct subsequently procurement and disbursement seminars. They asked whether the Bank would finance these seminars as they said had been done in the past. I said we would look into the issue, but that some contribution from the GOG may be appropriate.

cc: Messrs/Mmes.: Steckhan, Knotter (LA2DR), Ground, Tuncer, Van Trotsenburg (LA2C2), Halperin, Luzuriaga, Campero, Dianderas (LA2IE), Hamann, de St. Antoine (LA2HR), Quintanilla (LATTF), Trabucco (LACVP), Sugar (LOAEL), Nellis (CECPS), Freeman, McCordick (CL1D1)

GUYANA

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: April 30, 1991

TO: Mr. Moeen A. Qureshi

FROM: S. Shahid Husain

EXTENSION: 39001

SUBJECT: GUYANA - Second Structural Adjustment Credit (CR 2168-0-GUA) - Second Tranche Release and Increase of Credit Amount

1. Attached is a draft Memorandum (a) advising the Board of progress on the structural adjustment program and release of the second tranche, and (b) seeking the Board's approval, on a no-objection basis, to increase the Credit amount. The draft amendment to the Credit Agreement effecting the increase is also attached.

2. The Guyana program continues to be implemented under very difficult circumstances. Unusually heavy rains disrupted production in the critically important mining and agricultural sectors in the first half of 1990, and because of Guyana's heavy dependence on imported oil, the Gulf crisis had a highly negative impact on the economy and balance-of-payments in the second half of the year. Nevertheless, the Government persevered with the program and took strong fiscal measures in response to the negative exogenous factors. Slippages did occur in some important policy areas, particularly in movement towards exchange rate unification. But the delays were brief. On February 22, 1991 the Government unified the exchange rate and on March 1, 1991 took a series of other measures (described in the attached memorandum) which met, and in a number of cases surpassed, the requirements for second tranche release.

3. With regard to the IMF, a letter of intent requesting a waiver for non-observance of performance criteria for September and December 1990, and an extension of the Stand-by arrangement through December 31, 1991, was approved by its Executive Directors on April 24, 1991. The Fund has disbursed the next tranche (SDR 12.1 million) under its ESAF and stand-by arrangement.

4. As you know, the Board has been advised, through a Memorandum (R60-223) dated November 16, 1990, that Guyana is among the countries most seriously affected by the oil price increase caused by the Gulf crisis. Annex I of that Memorandum states that "in Guyana ... the current lending program to Guyana would be expanded to include a supplement to a structural adjustment credit ... to help mitigate the balance-of-payments effects of the Gulf crisis". The attached memorandum analyzes the impact of the oil price increase on Guyana and proposes the specific IDA response. Based on the incremental cost of oil imports and the loss of export earnings incurred by the bauxite industry, it is proposed to increase the SAC Credit of SDR 59.8 million by SDR 13.2 million and to add this amount to the second tranche.

5. Your approval is, therefore, requested to (1) release the second tranche of the Credit, and (2) send the attached Memorandum notifying the Board of the release of the said tranche and seeking approval for increasing the Credit amount and adding such increase to the second tranche.

6. The draft Memorandum has been cleared by the Departments concerned.

Attachment: Draft Memorandum for Notification to the ~~Board of~~ Second Tranche Release

cc: Messrs./Mmes. Grilli, Ray (EASDR); Thalwitz (PRESV); Stern (FINSV); Isenman (PRDDR); Linn (CECDR) (2 copies); Sengamalay, Sugar (LOAEL); Aiyer (LACVP); Selowsky (o/r), Fleisig (LACCE); Quijano (LACSA); Segura (LATDR); Loh, Garcia-Zamor, Vasiliades (LA3DR); Flood, Sokol, Codippily, Taylor-Lewis (LA3C2); Chaudhry (LATPS); Collell, Abbott (LEGLA); LAC Files, Black Book, Chron File

From: The President May , 1991

GUYANA - Second Structural Adjustment Credit
(Credit 2168-0 GUA)
(1) Progress of Reform Program and
Notification of Release of Second Tranche;
(2) Proposed Increase in Credit Amount

1. This memorandum is submitted to the Executive Directors for two purposes: first, to report on the progress achieved under the economic reform program supported by the above Credit and to advise of the release of the second tranche; and second, to seek approval under the Gulf Assistance Program to increase the above Credit by SDR 13.2 million and add such amount to the second tranche.

2. A Structural Adjustment Credit (SAC) for an amount of SDR 59.8 (US$78 million equivalent) was approved on June 28, 1990 and the Credit Agreement was signed on July 13, 1990. The Credit became effective on August 29, 1990. The Credit is being cofinanced by the Caribbean Development Bank (US$42 million) and Germany (US$6 million). The first tranche of the SAC SDR 38.3 (US$53 million) was fully disbursed in September 1990. The Caribbean Development Bank disbursed US$32 million equivalent, and Germany disbursed the full amount of its loan during 1990.

3. As provided in Section 3.01 of the Development Credit Agreement, discussions were held with the authorities during October 1990 and January 1991 on the progress achieved in carrying out the economic recovery program assisted by the Credit. Part I of this memorandum summarizes recent economic developments and the progress achieved in complying with the conditions for the credit's second tranche release. Based on satisfactory progress towards achievement of the objectives of the program and the Government's compliance with the conditions for second tranche release including, in a number of areas, actions exceeding the requirements for the release, the Government of Guyana has been advised of the availability of the second tranche of SDR 11.5 million.

Distribution:

Executive Directors and Alternates
President
President's Council
Vice Presidents, Bank, IFC and MIGA
Directors and Department Heads, Bank, IFC and MIGA

Questions on this document
may be referred to
Mr. Hilarian Codippily
(Extension 38684)

4. As described in the Memorandum to the Board (R90-223) dated November 16, 1990, Guyana is among the countries most seriously affected by the oil price increase caused by the Gulf crisis. Part II of this memorandum describes the impact of the oil price increase on the Guyanese economy, the measures taken by the Government in response to the crisis, and the proposed IDA support under the Gulf Assistance Program to help offset its impact.

PART I. STATUS OF STRUCTURAL ADJUSTMENT PROGRAM AND COMPLIANCE WITH CONDITIONS FOR THE RELEASE OF THE SECOND TRANCHE OF THE CREDIT

Summary of Recent Economic Developments

5. The Government of Guyana is continuing to implement its Economic Recovery Program (ERP) under difficult conditions. Over the past year, the economy experienced a number of set-backs stemming from exogenous factors. Unusually heavy rains (February to July 1990) had a devastating effect on Guyana's principal productive and export sectors -- bauxite, sugar and rice. The resulting flooding of the bauxite mining areas led to closure of the mines for protracted periods, while the inundation of agricultural lands severely impeded sugar and rice production. Agricultural production was further constrained by the intrusion of saline water into prime agricultural lands, following extensive breaches in the protective coastal sea wall. The performance of the key productive sectors was also adversely affected by an increasing shortage of skilled manpower, resulting from the continued emigration of Guyanese nationals. In addition, the shortage of working capital for the private sector continued to constrain production. In the aftermath of the above adverse developments, real GDP, which had been projected to increase by 3 percent in 1990, instead declined by about 3.5 percent. Notwithstanding the above difficulties and some slippages in policy implementation, the Government demonstrated its resolve to keep the program on track and was successful in remaining current in its debt service payments to the International Monetary Fund, the World Bank and the Caribbean Development Bank.

6. As regards the external account, the shortfall in external receipts amounted to US$60 million relative to the program target. The shortage of foreign exchange, in particular, was reflected in the legalized free market (cambio) exchange rate which rose to over G$100 per US$ as against a projected G$62 per US dollar for the second half of 1990 and an official exchange rate of G$45 per US dollar since June 1990. Other contributory factors to the increase in the cambio rate included: increased purchases of foreign exchange at the cambio rate by public corporations in accordance with the program objective of moving more transactions from the official market to the cambio market, and delays in implementing further monetary policy measures including a flexible interest rate policy.

7. Meanwhile, public finances in the second half of 1990 came under severe pressure owing to the increasing spread between the cambio and the official exchange rates, the sharp rise in fuel costs, an overall rate of

inflation about double that projected and the export shortfall. The authorities responded to the situation by sharply compressing central government expenditure, including the wage bill, keeping the latter within the nominal limits that had been set, and in increasing tax collections. As a result, the primary current account surplus (i.e. excluding interest payments) of the Central Government amounted to about 3% of GDP compared to a program target of breaking even, offsetting a part of the shortfall that occurred in the bauxite, sugar and other state enterprises. The primary current account surplus of the non-financial public sector stood at 17% of GDP compared to a target of 22% of GDP. As public sector investment outlays attained only 90% of the amounts programmed, the overall deficit of the nonfinancial public sector rose to 58% of GDP or slightly above the program's limit of 55% of GDP.

8. While the Government thus took strong measures in the fiscal area, the difficulties experienced by the program led the Guyanese authorities to defer some other policy actions expected in December 1990, particularly the movement of the official exchange rate to within 15% of the cambio rate and further improvements in pricing policy. The deferral, however, was brief as on February 20, 1991 the Administration announced in Parliament measures which brought the program fully back on track, and in a number of areas went beyond the reforms originally contemplated. These measures represent another major step in correcting relative prices and in increasing public savings to reduce Guyana's imbalances. The main elements of the reforms, most of which were implemented between February 21 and March 1, 1991, were: (a) unification of the exchange rate and the adoption thereafter of a floating exchange rate; (b) linking of sugar and petroleum price movements to market-related factors and the freeing up of all other remaining commodity and transport price controls; (c) the adoption of fiscal measures amounting to about 8 percentage points of GDP; and (d) the tightening of credit policies and periodic adjustment of the interest rates in line with price movements.

Status of Program With The Fund

9. A Fund mission visited Guyana during January 1991 to review the ESAF and stand-by arrangement and negotiate the economic program for 1991. The mission noted that most of the performance criteria for September 1990 and some for December 1990, relating mainly to limits on net domestic and external borrowing, reduction in the stock of domestic public debt, and increases in gross international reserves were not met. However, the Government's response (para. 7) to the exogenous shocks was sufficiently strong that the formal targets, other than the target on reduction of the stock of domestic public debt, would still have been met had it not been for a delay in the receipt of proceeds from the divestment of the Guyana Telecommunications Corporation. (This divestment was completed and the sales proceeds were received in January 1991.) Considering that the performance shortfalls were partly due to exogenous factors, that the Guyanese authorities took corrective actions first in the form of expenditure controls and tax collections and subsequently in all other areas of the program, the Executive Directors of the Fund approved on April 24, 1991, a proposal to accept the Government's request to waive nonobservance of performance criteria for September and December 1990 and to extend the stand-by arrangement through December 31, 1991. Most of the key measures agreed under the 1991 program are included in the package of reforms

implemented between February 21 and March 1, 1991 (para. 8). Accordingly the Guyana dollar in the official exchange market was adjusted to G$101.75 per US dollar, the level that prevailed in the cambio market. The authorities intend to maintain an official exchange market--limited to bauxite and sugar exports on the receipts side and fuel and sugar imports and official external debt service payments on the expenditure side--in which the rate will be adjusted weekly and determined as a weighted average of the exchange rates prevailing in the cambio market during the previous week. Transactions in the cambio market will continue to be conducted freely with no restrictions on access.

10. In the fiscal area, the agreed measures include: (a) actions to increase central government revenue by about 4 percentage points of GDP in 1991, including inter alia, an increase in the travel tax, a 15% levy on rice exports to the EEC (to capture at least 50% of the difference between the preferential price and the world market price, as called for under the arrangement with the EEC), elimination of the subsidy on the sale of sugar, modification of the personal income, consumption and withholding (on interest earnings) taxes, and a tightening of tax administration (the IDB is supporting the Government's efforts to improve tax administration and tax collections by providing technical assistance and a grant of US$4.2 million); (b) cost reducing measures in the bauxite corporation (GUYMINE) amounting to about 2 percentage points of GDP; and (c) an average wage increase in the public sector limited to 50% above the December 1990 levels, as against a projected inflation rate of 65% for 1991.

11. As regards monetary policy the authorities have agreed to establish competitive bidding for treasury bills by June 30, 1991. In the interim effective February 28, 1991, the authorities raised the bank rate from 30% to 32.5% and the treasury bill rate from 28.75% to 31.25% respectively. The authorities intend to review administered interest rates at end May 1991, in the light of price movements. In addition the authorities have increased the reserve requirements and liquid asset ratios applicable to commercial bank deposits.

<u>Status of Compliance with Tranche Release Conditions</u>

A. <u>Macroeconomic Framework</u>

12. The actions taken to comply with the specific conditions governing the release of the second tranche of the Credit are set out below.

13. TRANCHE RELEASE CONDITION as per Schedule 1, paragraph 4(b)(ii) of Development Credit Agreement: REQUIRED ACTION: <u>that the macroeconomic framework of the Borrower, including international competitiveness is consistent with the objectives of the Program</u>. COMPLIANCE: <u>Satisfactory</u>. The adoption of the measures described in paras. 7-11 above provides adequate assurances that the macroeconomic framework for Guyana, including international competitiveness, is consistent with the structural adjustment program.

B. Domestic Pricing

14. TRANCHE RELEASE CONDITION NO. 1(a): Rice Pricing. REQUIRED ACTION: the Borrower shall have taken measures satisfactory to the Association, to put into effect pricing policies which adequately reflect the international price of equivalent grades of rice calculated at an exchange rate acceptable to the Association. COMPLIANCE: Full. The objective of this condition was that, so long as rice continued to be a price-controlled item, its domestic price should adequately reflect the international price of rice. However, the Government has surpassed the requirements of this condition by lifting controls on the domestic price of rice effective March 1, 1991. Moreover, exporters can now convert their foreign receipts at the cambio exchange rate.

15. TRANCHE RELEASE CONDITION NO. 1(b): Sugar Pricing. REQUIRED ACTION: in the case of sugar, the Borrower shall have established domestic wholesale prices at levels sufficient to cover the c.i.f. - Georgetown price as well as the other acquisition costs of imported sugar. COMPLIANCE: Full. The Government has raised the price at which the Guyana Sugar Corporation (GUYSUCO) sells imported sugar to the wholesaler from G$7.70 per pound to G$21.91 per pound. At this price, the Government recovers the c.i.f. cost of imported sugar, all acquisition costs and the import duty, thus fulfilling the second tranche condition.

16. TRANCHE RELEASE CONDITION NO. 1(c): Electricity Tariffs. REQUIRED ACTION: in the case of electricity, the Borrower shall have set tariffs to cover the full cost of operations including fuel, other consumable items, all maintenance costs, wages, overhead, interest and depreciation. COMPLIANCE: Satisfactory. Effective April 1, 1991, the authorities have implemented a new tariff structure averaging around G$10.85 per kwh--representing a 95% increase from the previous average tariff rate of about G$5.57 per kwh. The new tariff structure covers the full cost of operations of the Guyana Electricity Corporation (GEC) including fuel, other consumables, all maintenance costs, wages, overheads, interest and depreciation, based on the February 21, 1991 exchange rate G$101.75 per US dollar. A further tariff increase has been planned for July 1991, to cover any further increase in the cost of operations.

17. TRANCHE RELEASE CONDITION NO. 1(d): Petroleum Product Pricing. REQUIRED ACTION: in the case of petroleum products, the Borrower shall have set prices (except for kerosene) to cover the c.i.f. - Georgetown price and local acquisition costs, including depreciation. COMPLIANCE: Full. During September-December 1990, the Government passed through the cost increases in petroleum products (except for kerosene) resulting from the Gulf crisis (see para. 32). With the adoption of a unified exchange rate, the prices of all petroleum products, except for kerosene, have been increased by 70 to 100% thus ensuring a full pass-through of the effects of the exchange rate adjustment and achieving the cost recovery required to fulfill the tranche release condition.

18. TRANCHE RELEASE CONDITION NO. 1(e): Public Transport Fares. REQUIRED ACTION: in the case of public transportation, the Borrower shall

have put into effect fares adequate to cover all operating costs. For purposes of this clause "operating costs" mean all costs related to the operation of motor vehicles and overhead, including the cost of fuel and oil consumption, wages, insurance, license fee and taxes, maintenance costs, depreciation and interest. COMPLIANCE: Full. The authorities have liberalized effective March 1, 1991, the fares applicable to all passenger transport for the public consisting of some 2,400 privately owned mini-buses and about 7,000 private hire-cars. By eliminating all price controls on passenger transport, performance has in effect exceeded that called for in the second tranche release condition.

C. Expansion Program for Electricity Supply

19. TRANCHE RELEASE CONDITION NO. 2: Expansion Program for Electricity Supply. REQUIRED ACTION: that the Borrower has completed the preparation of a least-cost expansion program for electricity supply for Fiscal Years 1990 through 1999. COMPLIANCE: Satisfactory. A draft report on the least-cost electricity supply expansion program prepared by the GEC's consultants was reviewed by Bank staff in October 1990. Comments made by Bank staff consisted of suggestions relating to: reductions in the proposed capacity build-up considering the country's financial constraints, a widening of supply options including the possibility of a transmission line from Venezuela and/or, electricity generation from sugar cane bagasse, the conduct of a sensitivity analysis of the program with respect to oil prices, provision of a breakdown of demand forecasts by consumer groups, and the inclusion of GEC's financial projections. The suggestions made by Bank staff have been accepted by the Government and are being incorporated in the program.

D. Trade Policy

20. TRANCHE RELEASE CONDITION NO. 3(a): Prohibited Imports. REQUIRED ACTION: reducing the number of categories of items which are on the prohibited list of imports (except for non-processed meat, poultry, fruit and processed fruit items) by at least half. COMPLIANCE: Full. The Government has removed all but two categories of imports from the prohibited list of imports, i.e., the only remaining items on the prohibited list are meat and jellies. This represents a movement well beyond the second tranche condition, which could have been satisfied by removing 16 categories of items and leaving 20 categories (16 plus the excepted four) on the prohibited list.

21. TRANCHE RELEASE CONDITION NO. 3((b): Import Licensing. REQUIRED ACTION: implementing a system to grant import licenses automatically for all import transactions within two working days from receipt of the respective import license application when no Government provision of foreign exchange is required and to process within seven working days all other import license applications. COMPLIANCE: Full. Applications which require no foreign exchange from the Bank of Guyana are now processed within two working days and all other license applications are processed within seven working days. The latter has been made possible through the elimination of the requirement of the Bank of Guyana approval prior to the issue of the license.

E. Central Government Reforms

22. TRANCHE RELEASE CONDITION NO. 4: Civil Service Reforms. REQUIRED ACTION: that the Borrower has commissioned management audits of the civil service based on the findings of the Public Sector Review (PSR), under terms of reference and a timetable satisfactory to the Association. COMPLIANCE: Full. Phase I of the Public Service Review (PSR) consisting of a global review of the structure of the civil service carried out by a team of British consultants, with UK/ODA assistance, was completed as of mid-1990. This study has, inter alia, recommended the streamlining of the existing structure of the civil service consisting of 18 ministries into a simplified structure consisting of 10 ministries and the Office of the President. The Government has decided to implement this recommendation starting about mid-1991. Phase II of the PSR consists of more intensively focussed management audits of the structures of newly proposed ministries designed to identify further measures for streamlining them, including inter alia, elimination of overlapping functions and non-critical vacancies. The authorities have commissioned management audits for the new ministries taking into account the comments made by Bank staff on the terms of reference. These management audits commenced in February 1991 and are to be completed within an agreed timetable of about six months.

23. TRANCHE RELEASE CONDITION NO. 5. Transfers to Public Enterprises. REQUIRED ACTION: that the Borrower has ended all central government current transfers to public enterprises beginning with the FY90 budget except for the Guyana Electricity Corporation and for maintenance expenditures of public enterprises to be divested pursuant to clause 6 below. COMPLIANCE: Full. In 1990, there were no transfers to public enterprises except to the GEC. Transfers to GEC amounted to about G$413 million equivalent to 9% of central government current revenues, primarily reflecting GEC's continuing low level of sales and collections, attributable in large part to a history of its failure to provide satisfactory service.

F. Public Enterprise Divestment

24. TRANCHE RELEASE CONDITION NO. 6. Public Enterprise Reform. REQUIRED ACTION: that the Borrower has put into effect an action program, satisfactory to the Association, for carrying out a corporate strategy, satisfactory to the Association, for the enterprises supervised by PCS. COMPLIANCE: Satisfactory. The agreed action program called for substantial strengthening of the Divestment Unit in the Public Corporations Secretariat (PCS) and for carrying out divestment activities according to an agreed quarterly timetable. The Divestment Unit is now adequately staffed and operational. It has successfully carried out divestment activities for the enterprises mentioned below and is in the process of contracting the services of an accounting firm to complete similar activities for the remaining enterprises included in the program. A legal advisor has also been selected. Two staff members of the Unit have attended overseas training program and a study tour and other in-house training is proposed for the remaining staff over the next few months.

25. The divestment program for 1990 called for firm offers by the Government for sale of or other divestment options for nine enterprises. All nine were offered for sale. Of these, two enterprises (Sijan Palace and Guyana Nichimo Company) have been sold outright. Also trawlers belonging to the Guyana Fisheries Corporation were sold while its major onshore operations were leased, and four mills belonging to the Guyana Rice Milling and Marketing Authority were sold while leasing options for the other two mills were explored. Of the remaining five, three enterprises1/ are now expected to be sold before June 1991, after delays caused by low price offers. Divestment plans for the remaining two enterprises (National Paints, Soap and Detergents) are to be modified because of insufficient interest on the part of potential buyers. The Government may seek other options (for example, joint ventures, or leasing) as against outright sales of these enterprises. Bank staff also reviewed progress on divestment of five other enterprises not included in the original action plan. Of these enterprises, so far one has been sold.2/ Separate from the PCS divestment program, the Government has been actively negotiating the sale of majority ownership in the electric power company (GEC) to a foreign company and is actively negotiating with foreign firms for the establishment of joint ventures for the bauxite and sugar enterprises.

G. Public Enterprise Monitoring

26. TRANCHE RELEASE CONDITION NO. 7. Public Enterprise Monitoring. REQUIRED ACTION: that the Borrower has established operating procedures and auditing systems, satisfactory to the Association, for monitoring the financial performance of GUYMINE, GUYSUCO and the enterprises supervised by the PCS and for monitoring transfers from those enterprises to the Central Government. COMPLIANCE: Satisfactory. Monthly reporting procedures have been established for GUYMINE, GUYSUCO and the enterprises supervised by the PCS. The authorities have also established auditing systems in the form of a reconciliation of accounts between the Accountant General's office and the PCS and an examination of accounts by the President's office in the case of GUYMINE and GUYSUCO.

27. Financial transfers from GUYMINE and GUYSUCO are being monitored by the Monitoring and Coordinating Agency (MCA). A monitoring system for ensuring systematic transfers from the enterprises supervised by the PCS is also in place. Since October 1990, the PCS has introduced a system whereby individual corporations supervised by it are to pay targeted amounts of

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1/ The three enterprises are: Guyana National Trading Corporation (GNTC) (partial divestment), Quality Foods, and Guyana Transport Services Limited (GTSL) (partial divestment).

2/ After the formulation of the Divestment Strategy Statement, the Government decided to divest the following enterprises supervised by PCS: Guyana Telecommunication Corporation (GTC), Guyana Airways Corporation (GAC), Sanata Textiles, Guyana National Engineering Corporation (GNEC), and the Livestock Industrial Development Company (LIDCO). The sale of 80% of GTC's equity to a U.S. company was completed in January 1991.

dividends and special transfers for a given quarter before the end of that quarter. Transfer targets are estimated by the PCS on the corporations' actuals for two months and projections for the third month and communicated to the corporations before the end of the quarter. Previously, dividends and special transfers for any given quarter were based solely on actuals and paid by corporations only in the following quarter. The new system is being further refined to ensure accuracy of data received from those enterprises by PCS for the purpose of developing quarterly targets for the transfers from the enterprises. A quarterly review process has also been established between the PCS and the Accountant General's Office to cross-check whether the amount of transfers reported by individual enterprises to PCS reconcile with those actually received by the Accountant General. Furthermore, late payments and default payments on transfers are being reviewed since the last quarter of 1990, by the Monitoring Subcommittee of the Cabinet to expedite payment by the corporations.

H. Public Sector Investment Program (PSIP)

28. TRANCHE RELEASE CONDITION NO. 8: Public Sector Investment Program (PSIP). REQUIRED ACTION: that the Borrower has formulated a three-year rolling PSIP satisfactory to the Association. COMPLIANCE: Satisfactory. The PSIP for the period 1990-92, as currently formulated, is generally consistent with Guyana's macroeconomic framework in terms of composition, size and financing. The PSIP's emphasis is on infrastructure and support to the productive sectors. Accordingly, a significant share of the PSIP (22% in 1991) has been allocated to economic infrastructure including repairs and rehabilitation of the sea wall, and the rehabilitation of the electricity supply system and the road network. In the case of the productive sectors, the Government intends to divest the two most important export industries -- bauxite and sugar. Pending the divestment of these industries, 39% of the PSIP has been allocated to the rehabilitation of these sectors. Unless this is done, it is unlikely that the assets of these two industries, which are severely run-down, could be brought to a level which would attract foreign investment. Finally, a significant share of the PSIP (12% in 1991) has been allocated to social infrastructure covering education, health, housing and community services.

29. The 1990-92 PSIP is about US$295 million, of which US$224 million would be externally financed, over the three years. The 1991 PSIP amounts to US$96 million of which US$68 million would be financed from external sources. The PSIP for 1992, in its present form, envisages a slight increase in expenditures to about US$101 million. Depending on the progress made by the divestment program, especially in electricity, sugar and mining, the total amount and composition of the 1992 PSIP could change.

30. The similar level of capital expenditures in 1991 (US$96 million) and 1990 (US$97.6 million) is the result of the lack of local counterpart resources which slows down disbursement of external financing. The same is true of the 1992 PSIP. Although the composition and focus of the PSIP has been substantially improved, it still contains ongoing programs that are years past their scheduled completion date, have substantial cost overruns, and have not achieved their original objectives. The Government needs to continue

reviewing the PSIP with a view to reformulating, scaling-down or eliminating such programs which no longer make economic sense as currently designed. Over the medium term the project priorities in the PSIP need to be determined on the basis of adequate sector work. However, strengthening of the PSIP will be possible only with the cooperation of the international donor community which will have to be willing to revise or cancel existing agreements and to finance a greater share of local costs of projects and some recurrent costs.

31. TRANCHE RELEASE CONDITION NO. 9. Institutional Arrangements. REQUIRED ACTION: that the Borrower has implemented institutional arrangements, satisfactory to the Association, for strengthening the capacity of the SPS to provide guidelines on project preparation to line ministries and government agencies and to evaluate and monitor projects included in the PSIP. COMPLIANCE: Full. The Government has filled all five positions for planners in the Project Cycle Unit of the State Planning Secretariat (SPS) with qualified personnel and has thus complied with the second tranche condition.

PART II. PROPOSED INCREASE OF SECOND TRANCHE TO OFFSET EFFECTS OF THE GULF CRISIS

32. Guyana was one of the countries most seriously affected by the oil price shock resulting from the Gulf crisis, because of its heavy dependence on imported oil for its bauxite industry, internal transportation and domestic cooking. Fuel imports during 1990, comprising gasoline, kerosene, diesel, fuel oil, aviation gas and LPG, amounted to US$78 million or 31% of merchandise imports. The prices of these items rose sharply during September-December 1990 in relation to the January-August average and was highest for kerosene (62%), followed by gasoline (52%) and was lowest for fuel oil (28%). These price increases were passed through to the consumer during September to December 1990, except for kerosene which is used for domestic cooking by low income families, and for which 60% of the increased cost was passed through. The additional cost incurred by Guyana in importing these items during September-December 1990, using the January-August 1990 average price of each product as a benchmark, is estimated at approximately US$10 million while the increase during January-February 1991 is estimated at US$2.5 million. This additional cost increase of US$12.5 million, was not envisaged at the time the program was formulated. This cost increase also led to compression in the volume of imports and thus to an increase in the pent-up demand for critical imported inputs.

33. The bauxite industry in particular was seriously affected by the oil price rise, as it came at a time when the rains had stopped and the industry was poised to try to make up for the production shortfall that had occurred during February to July 1990. During September to December 1990, the volume of monthly fuel imports dropped by 21% while during January-February 1991, it dropped by 43%, in substantial part owing to the lack of funds necessary to pay for the more expensive petroleum products. The loss of export earnings caused by the volume cut back in fuel imports by the bauxite industry is estimated at US$5.5 million. There were most likely cutbacks in import volumes also in other sectors, and they may have been substantial, as

the bauxite industry consumes about 25% of petroleum imports. Rice milling and manufacturing industry which depend on power supply based on imported fuel also experienced production losses at a time when the incentive framework became more favorable to these sectors. It has not been possible, however, to quantify export losses in these and other sectors.

34. Thus, the impact of the Gulf crisis in terms of the incremental costs to the economy of fuel imports, as well as export losses sustained only by the bauxite industry is estimated at US$18 million. Additional IDA financing in this amount is proposed under the Gulf Assistance Program. Unless such additional resources are provided to help offset the impact of the Gulf crisis, strains on the balance of payments would continue to aggravate the pent-up demand for imports and consequently weaken growth prospects of the economy and jeopardize the success of Guyana's structural adjustment program.

PART III: RECOMMENDATION

35. I recommend that the Executive Directors approve under the Gulf Assistance Program an increase of SDR 13.2 million, or approximately US$18 million equivalent, in the Second Structural Adjustment Credit (2168-GUA) of July 13, 1990, to offset the incremental cost of fuel imports incurred by Guyana during September 1990 to February 1991 and the loss of export earnings by the bauxite industry. I also recommend that this increase be made available to Guyana as part of the second tranche of the Credit referred to above. In the absence of objections (which should be communicated to the Vice-President and Secretary or Deputy Secretary by close of business on May __, 1991), these amendments will be deemed approved, to be so recorded in the minutes of a subsequent meeting of the Executive Directors, and the legal documents will be modified accordingly.

Barber B. Conable
President

IMF Blue Sheet - Nov. 16

from Quito that Catholic officials said the church would buy $28M of Ecuador's foreign debt to help Indian groups buy their land. The government has authorized the debt buy-back on secondary markets.

GERMANY WOULD SEND FOOD AID TO USSR IF CRISIS DEVELOPS THIS WINTER, WP, pA1, reported.

Stuart - pls. check.

U.S. INVESTORS BUY MAJORITY STAKES IN GUYANA'S ELECTRICITY, TELEPHONE COMPANIES, JOC, p3A, reported from Kingston.

IADB APPROVES $300M LOAM FOR VENEZUELAN ECONOMIC REFORM, TO BE

MATCHED BY IBRD CREDIT, AP-DJ reported from Washington.

600,000 PERUVIAN CIVIL SERVANTS STRIKE FOR HIGHER WAGES, EFE reported from Lima.

SUDAN FACES NEW FAMINE, NYT, pA3, reported from El Obeid, Sudan.

U.S. LEGISLATORS WARN KENYA RIGHTS RECORD ENDANGERS AID, NYT, pA10, reported.

RUSSIA, OTHER REPUBLICS, SEEN IMPORTING GRAIN DIRECTLY, Reuters reported from Moscow. See also WSJ, pC12.
Nairobi.

U.S. HAS MUCH AT RISK IF GATT TALKS FAIL, NYT, pD12, reported from Washington.

OIL PRICE GOOD FOR FEW LATIN AMERICAN COUNTRIES, WSJ, pA7D, reported from Rio de Janeiro.
CHINA SAYS RENMINDI TO BE DEVALUED 17.1% TO 5.667 PER DOLLAR, Reuters reported from Beijing.

SPAIN'S CENTRAL BANK GOVERNOR SAYS MONETARY POLICY TO REMAIN TIGHT. AP-DJ reported from Madrid that Spain's Central Bank Governor Mariano Rubio told reporters Thursday monetary policy would remain tight as long as the rate of inflation remained around its current annual level of 7%.

International Development Association

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FOR EXECUTIVE DIRECTORS' MEETING

For consideration on
Thursday, June 28, 1990

IDA/R90-106

FROM: Vice President and Secretary

June 11, 1990

GUYANA: Second Structural Adjustment Credit

1. Attached is the President's Report and Recommendation (P-5140-GUA) on a proposed Second Structural Adjustment Credit to the Cooperative Republic of Guyana.

2. A report entitled "Guyana: A Proposal for Economic Recovery" (6501-GUA) was distributed on January 12, 1987.

3. A draft Development Credit Agreement between Guyana and the Association is available on request from the Secretary's Department Documents Office (X80213).

4. Questions on these documents should be referred to Mr. Codippily (X38684).

Distribution:

Executive Directors and Alternates
President
Senior Vice Presidents
Senior Management Council
Vice Presidents, IFC and MIGA
Directors and Department Heads, Bank, IFC and MIGA

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The World Bank

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Report No. P-5140-GUA

REPORT AND RECOMMENDATION

OF THE

PRESIDENT OF THE

INTERNATIONAL DEVELOPMENT ASSOCIATION

TO THE

EXECUTIVE DIRECTORS

ON A

PROPOSED

SECOND STRUCTURAL ADJUSTMENT CREDIT

OF SDR 59.8 MILLION

TO

THE COOPERATIVE REPUBLIC OF GUYANA

JUNE 7, 1990

CURRENCY EQUIVALENTS

Currency Unit: Guyana Dollar (G$)

The Guyana dollar floated with the pound sterling from July 1972 to October 1975, when the Government announced its linkage to the US dollar at G$2.55 = US$1.00. A new rate of G$3.00 = US$1.00 was established on June 1, 1981. On January 11, 1984, it was adjusted to G$3.75 = US$1.00. The average exchange rates for the period 1984-89 are set out below.

Annual Average

1984	US$1.00 = G$3.832	G$1.00 = US$0.261
1985	US$1.00 = G$4.252	G$1.00 = US$0.235
1986	US$1.00 = G$4.272	G$1.00 = US$0.235
1987	US$1.00 = G$9.756	G$1.00 = US$0.103
1988	US$1.00 = G$10.000	G$1.00 = US$0.100
1989		
January-March	US$1.00 = G$10.00	G$1.00 - US$0.100
April-December	US$1.00 = G$33.00	G$1.00 = US$0.030

GOVERNMENT OF GUYANA FISCAL YEAR

January 1 - December 31

ABBREVIATIONS

CARICOM	Caribbean Community
CDB	Caribbean Development Bank
CET	Common External Tariff
CFF	Compensatory Financing Facility
CGCED	Caribbean Group for Cooperation in Economic Development
CIF	Cost, Insurance and Freight
EDC	Export Development Corporation
EC	European Community
EIB	European Investment Bank
GDP	Gross Domestic Product
GNP	Gross National Product
GEC	Guyana Electricity Corporation
GNEA	Guyana National Energy Authority
GNEC	Guyana National Engineering Corporation
GNTC	Guyana National Trading Corporation
GPC	Guyana Pharmaceutical Corporation
GRG	Guyana Rice Group
GRMMA	Guyana Rice Milling and Marketing Authority
GTC	Guyana Telecommunications Corporation
GUYMINE	Guyana Mining Enterprise Ltd.
GUYSUCO	Guyana Sugar Corporation
IBRD	International Bank for Reconstruction and Development
ICB	International Competitive Bidding
IDA	International Development Association
IDB	Inter-American Development Bank
IMF	International Monetary Fund
MIGA	Multilateral Investment Guarantee Agency
PCS	Public Corporations Secretariat
PSIP	Public Sector Investment Program
QRs	Quantitative Restrictions
SAC	Structural Adjustment Credit
TAC	Technical Assistance Credit

GUYANA

SECOND STRUCTURAL ADJUSTMENT CREDIT

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COOPERATIVE REPUBLIC OF GUYANA

SECOND STRUCTURAL ADJUSTMENT CREDIT

CREDIT AND PROGRAM SUMMARY

Borrower:	Cooperative Republic of Guyana.
Beneficiary:	Cooperative Republic of Guyana.
Amount:	SDR 59.8 million (US$78.0 million equivalent).
Terms:	Standard IDA terms with a maturity of 40 years, including a grace period of 10 years.
Cofinancing:	The proposed Credit would be cofinanced by the Caribbean Development Bank (US$42 million), and the Federal Republic of Germany (US$6 million).
Program Description:	The proposed Second Structural Adjustment Credit (SAC) would support the Government's economic recovery program. The aim of the program is to create viable and stable economic conditions conducive to restoring a higher and sustained rate of economic growth. Specifically, the proposed credit will support a reform program encompassing: (i) the improvement of the incentive framework through reforms in domestic pricing, trade policies, and private sector investment procedures; (ii) improvement of public sector finances through the elimination of central government transfers to public enterprises, streamlining the civil service, increasing revenue transferred by public enterprises to the Central Government and divestment programs for selected public enterprises; and (iii) the formulation of a realistic public sector investment program consistent with the macroeconomic framework in terms of size, composition and financing and with the country's implementation capacity.
Estimated Disbursements:	The proceeds of the proposed credit would be disbursed in three tranches: the first of US$50.0 million equivalent upon credit effectiveness, the second of US$15 million equivalent and third of US$13 million equivalent each following satisfactory reviews of program compliance. The reviews are expected to take place within six and fifteen months after effectiveness.

Benefits

The main benefits will be: (i) financing of critical imports needed to help restore economic growth; (ii) the gradual improvement in the standard of living of the population through sustained economic growth; and (iii) providing the basis for increased support to Guyana by other donors.

Risks:

The major risks affecting the success of the program are: (i) the possibility that the Government's commitment to the program of reforms may be eroded because of political opposition to adjustment and to market-oriented policies; (ii) the severity of the adjustment program which may depress the economy to such an extent that the conditions needed to produce a supply response may take a long time to materialize; (iii) lack of implementation capacity and skilled manpower to carry out the reforms; (iv) total breakdown of the already deficient power supply and a further deterioration in infrastructure services which may constrain a supply response; (v) failure of domestic and foreign investment to respond to the new incentive framework; (vi) unexpected adverse developments in the world economic environment or weather conditions; and (vii) failure of donors to provide sufficient net balance of payments flows in a timely fashion.

Factors that may reduce the program risks include: (i) a number of policies outlined in the PFP which have been already implemented; in particular, actions have been taken on the exchange rate, fiscal, monetary and incomes policy reforms negotiated with the IMF, and active negotiations are under way to establish joint ventures, divest and/or obtain management contracts for major public enterprises; (ii) the provision of technical assistance to strengthen the Government's implementation capacity and preparation by the Inter-American Development Bank of a power sector rehabilitation program; and (iii) the Government's commitment to the program has been supported by pledges of financial assistance from the donor community through the Support Group for Guyana and the

Caribbean Group for Cooperation in Economic Development.

Appraisal Report: None.

Map: IBRD No. 11683R1

INTERNATIONAL DEVELOPMENT ASSOCIATION
REPORT AND RECOMMENDATION OF THE PRESIDENT
TO THE EXECUTIVE DIRECTORS ON A
PROPOSED SECOND STRUCTURAL ADJUSTMENT CREDIT
TO THE COOPERATIVE REPUBLIC OF GUYANA

1. I submit the following report and recommendation on a proposed Second Structural Adjustment Credit (SAC) in the amount of SDR 59.8 million (US$78.0 million equivalent)[1] in support of the Government's economic recovery program (ERP). The credit would be on standard IDA terms with 40 years' maturity including a grace period of 10 years. In support of the program, cofinancing is also being considered by the Caribbean Development Bank (US$42 million equivalent) and the Federal Republic of Germany (US$6 million equivalent).

2. The proposed SAC would be the first operation in Guyana since 1986. Because of the status of Guyana's overdue payments to the Bank, disbursement on all Bank loans and IDA credits to Guyana were suspended on August 15, 1986. On December 15, 1986, the Bank placed Guyana's overdue account in non-accrual status.

3. The Government, with the assistance of Bank and Fund staff prepared a Policy Framework Paper (PFP) in 1988 which outlined the Government's proposed measures for addressing economic problems over the medium term, including the normalization of relations with its external creditors. In July 1988, the Bank, through its leadership in the Caribbean Group for Cooperation in Economic Development (CGCED), began efforts to mobilize the necessary financial resources to support Guyana's proposed medium-term adjustment program. In early November 1988, the Fund-sponsored Support Group for Guyana was established under the chairmanship of Canada. The Support Group has led the external resource mobilization effort since that time.

PART I - THE ECONOMY

4. An economic report entitled "Guyana: A Proposal for Economic Recovery" (Report No. 6501-GUA) was distributed to the Executive Directors on January 8, 1987. The Guyana PFP was reviewed by the Committee of the Whole of the Bank on July 12, 1988. An updated PFP will be distributed shortly to the Executive Directors for review by the Committee of the Whole on the same date as the Executive Directors' consideration of the proposed SAC. The following paragraphs incorporate the most recent information obtained by the post-appraisal mission for the proposed SAC that visited the country in April 1990. Annex I contains the key economic indicators.

Background

5. Guyana's economy is based mainly on the production and export of bauxite, sugar and rice. The greater part of the agricultural activity is

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1/ Includes SDR 2.6 million (US$3.4 million equivalent) from IDA reflows.

concentrated along the coastal belt of the country (where most of the population resides), whereas the extensive mineral and timber resources within the densely tropical hinterland -- with the exception of bauxite mining -- remain largely unexploited. Because of the country's topography and the uneven distribution of its small population, Guyana's infrastructural needs are substantial on a per capita basis. Guyana's population, estimated at 756,000 in mid-1988, has been declining in recent years as a result of a low birth rate and continuous emigration. Economic activity has been retarded, however, by a difficult physical environment, sharp fluctuations in output stemming from the vulnerability of the economy to exogenous factors such as weather and fluctuations in international prices and demand, and the Government's failure to address economic issues adequately. Guyana's per capita GNP of US$410 in 1988 was the second lowest in the Western Hemisphere (only slightly higher than US$360 in Haiti).

6. After independence in 1966, the development strategy had been to increase the participation of the public sector in economic activity and to promote producer, consumer and marketing activities in the public sector. The Government expanded state-owned enterprises, created new state-owned financial institutions and nationalized the country's bauxite/alumina and sugar industries. The Government progressively became the main employer and now controls over 80% of the recorded import and export trade. The growing role of the public sector is reflected in the increase in its share of gross domestic capital formation from 40% in 1968 to 85% in 1988.

Economic Performance

7. Economic performance in the 1970s and 1980s raises basic issues regarding the public sector's capacity to play an active and expanding role in the development of the country. The rapid expansion of the public sector involvement in the economy over the past 15 years was accompanied by the stagnation of private investment, both domestic and foreign, and the emergence of a parallel economy. Economic performance during the 1970s was mixed. During the first half of the decade, GDP grew by about 4% per annum in real terms as a result of favorable prices for Guyana's major export commodities and the rapid growth in government expenditures. Unlike many other developing countries, the rapid increases in oil prices during 1973-74 were only slightly disruptive in the short term, as they were offset by a boom in the price of sugar in 1974-75. The terms of trade for Guyana improved by approximately 30% during 1970-75. National per capita income increased by about 6% per annum, resulting in a rapid expansion in consumption and investment (5% and 10% per annum, respectively). Much of the growth occurred in the public sector, which utilized the windfall associated with sugar to expand both central government consumption and investment expenditures. On the other hand, the period 1975-80, characterized by an expanding public sector role, witnessed a period of economic decline as a result of the fall in sugar prices, the weakening in the demand for Guyana's main exports, and the reduced output in the two main export commodities (bauxite and sugar). The terms of trade fell by over 30% during 1975-80, wiping out the gains enjoyed in the first half of the decade. Moreover, the level of domestic expenditure was not adjusted promptly with undesirable implications for the balance of payments. During 1975-80, the resource gap averaged 12% of GDP compared to less than 2% during 1971-75.

8. Guyana's real gross domestic product decreased at an average annual rate of 6% during 1981-83 as output in virtually all sectors fell, with commodity-producing sectors exhibiting particularly sharp declines. This downturn resulted from the closure of some bauxite production facilities owing to weak external demand, and the curtailment of imported inputs for the other sectors. Economic growth averaged only about 1% per year in 1984-87, and was not adequate to offset the decreases in the preceding years. The level of recorded output in 1987 was thus some 15% below that of 1980 and 20% below that of 1976. Throughout most of the period 1981-87, Guyana's principal export commodities (bauxite, sugar and rice), accounting for about a quarter of GDP, encountered a number of technical, organizational and financial problems and adverse weather conditions. The resulting decline and subsequent stagnation of production was compounded by weak external demand and falling world market prices for these commodities, which account for about 80% of Guyana's merchandise export earnings. Reduced foreign exchange earnings cut into the country's capacity to import inputs needed for production purposes. Consequently, input shortages led to considerable capacity underutilization (up to 60%), raising costs of production and further reducing the profitability of production.

9. The public sector finances deteriorated markedly during 1981-86. A steady erosion of the Central Government's revenue base, as a consequence of both the decline in real economic activity and the growth of a parallel economy, coupled with growing expenditures (especially interest payments) led to widening current account deficits which increased from 15% of GDP in 1981 to 40% in 1986. Similarly, the financial performance of the rest of the public sector deteriorated, partly as a result of the continued underutilization of capacity. The public sector's overall deficit deteriorated from 43% of GDP in 1981 to 52% in 1986. However, following the adoption of reforms in a number of public enterprises, the financial position of the public enterprises improved somewhat -- leading to an overall public sector deficit equivalent to 36% of GDP in 1987.

10. Guyana's external trade and payments situation remained extremely weak during 1981-87. Total export earnings declined steadily through 1983, and while they picked up a little during 1984-87, it was not sufficient to avert a continued deterioration of the balance of payments. The currency devaluation of 32% in 1984 failed to yield a devaluation in real terms. The main source of financing for the balance of payments was the accumulation of external payments arrears as Guyana was unable to meet its external payments obligations. The Government devalued the currency once again, by 56% in January 1987. But its effects were eroded by the persistence of large fiscal deficits and monetary expansion which triggered further price increases in 1987; consequently, no devaluation in real terms was achieved.

11. The 1984-87 period was marked by a low level of aggregate resource availability, an increasing divergence between the investment and savings rates especially of the public sector and, correspondingly, an increasing dependence on payments arrears to finance domestic expenditures. The Government took a number of measures to increase output and exports and reduce Guyana's imbalances. The scope of domestic price controls was reduced, public sector prices were increased to reflect the devaluations

and special efforts were made to rehabilitate the bauxite and sugar industries. A number of public enterprises were reorganized and restructured. Measures were also taken to curb central government spending. Although these measures were in the appropriate direction, they were insufficient to deal with the severity of the country's problems.

Government Response to the Crisis

12. Since July 1988, the Government has taken a number of steps to implement policies outlined in the PFP. In early August, price controls were removed from all remaining items[2] except for petroleum products, transportation, rice, sugar and a few other essential items. Import prohibitions were also removed on all items, except for food products[3] on grounds of the national objective of food security through self-sufficiency. In addition, and in compliance with the PFP, the licensing of "no funds" imports, i.e., those not involving the use of official foreign exchange, was liberalized beginning September 1, 1988, so as to allow private individuals to import without licenses, items for their own use. In the fiscal area, some measures to raise tax revenues were implemented in 1988, including the Fiscal Enactment (Amendment) Bill of 1988 and the Consumption Tax (Amendment) Order of 1988. Also, actions have been taken to close down two loss-making public enterprises; the Glass Factory has been closed down and the Public Transportation Corporation is in the process of being closed down. These actions, in part, helped the Public Corporations Secretariat (PCS, formerly GUYSTAC) group of 27 public enterprises to increase its overall surplus from 1% of GDP in 1987 to 4.5% of GDP in 1988. Also, in July 1988, the Government issued a document setting out the incentives available to the private sector and in August 1988, Guyana joined MIGA.

13. The economy, however, witnessed a setback in 1988, with real GDP declining by about 3%. This was largely attributable to heavy rains which affected sugar production and bauxite mining and a fall in rice production owing to the blast disease. However, better management of public enterprises enabled the Government to reduce the overall public sector deficit to 33% of GDP in 1988. Guyana's public sector external debt stood at about US$1,777 million (equivalent to 683% of exports) as of end December 1988, of which external payments arrears amounted to US$1,141 million (438% of exports). The debt service obligations (including arrears) in 1988 amounted to 83% of exports while the scheduled interest payments amounted to 37% of exports.[4]

2/ These include mild steel, welding electrodes, agricultural machinery, horticultural tools, bicycle spares, tires and tubes, spares for grain milling machinery, soap, detergents, matches and edible oil.

3/ These food categories include meat, fish, poultry, vegetables, fruits, processed meat and fish, beet sugar, confectionary pastries and jams.

4/ As in the PFP, all magnitudes relating to the external account are expressed as shares of exports of goods and non-factor services. A meaningful analysis of time trends in relation to nominal GDP is precluded by wide disparities in the impact of a series of major nominal devaluations upon the estimation of external account magnitudes and nominal GDP.

14. Following agreement on the PFP, the Government initiated discussions with the Fund in late 1988 about a possible program to support its Economic Recovery Program. Negotiations on a Fund-monitored economic program for 1989 were concluded in February 1989 and the program was endorsed by the Fund Board in April 1989. As part of this program, the Guyana dollar was devalued at the beginning of the second quarter of 1989 from G$10 per US$ to G$33 per US$ (230% in G$ terms). Following the devaluation, the prices of controlled items were adjusted as follows: sugar (producer price) - 225%; rice (producer price) - 125%; gasoline/diesel - 200%; transportation - 100%; cooking gas - 175%. Interest rates were also increased, with the bank rate rising from 15% to 35%. As part of the same policy package, the public sector nominal wage increase was limited only to 20%. The devaluation led to an increase in prices, as measured by the official consumer price index, of 40% in April 1989.

15. The program eased some of the long-standing price distortions in the goods markets (for the above products) and in the foreign exchange market. The parallel rate (for foreign exchange) came down from G$60 per US$ prior to April 1989 to G$48 per US$ after the devaluation--owing to a sizable reduction in purchasing power and in domestic liquidity. But the cut in real wages of at least 25% combined with increased transportation costs affected the supply of labor and led to strikes, absenteeism, resignations and out-migration. In the two major export industries, i.e., sugar and bauxite, strikes resulted in a net foreign exchange loss of about US$20 million. This loss together with the fact that disbursements of commodity assistance during 1989 amounted to only US$27 million compared to US$41 million envisaged in the program were the major reasons for a disappointing economic performance in 1989 (discussed further in paras. 45-47).

Key Adjustment Issues

16. Macroeconomic Issues. Guyana continues to face major structural imbalances. These stem from the failure to correct, until recently, an overvalued exchange rate and price distortions. Guyana's economic problems are also attributable to an over-extended and inefficient public sector, responsible for a significant deterioration of public finances. At the same time, the lack of a clear role for the private sector also dampened economic activity. The country's capital stock has deteriorated and the state of disrepair of physical infrastructure has resulted in serious bottlenecks. The decline in the standard of living over the years has led to an exodus of qualified personnel and to a shortage of skilled labor and experienced managers. Thus, major weaknesses in management and project implementation remain in the public sector and there is a need to continue Government's efforts to divest activities and to evolve a more efficient public sector.

17. Sectoral Issues. A number of sectoral issues need to be addressed in order to increase output, raise export earnings and promote a recovery of the economy. In this regard, agriculture which currently accounts for about 25% of GDP and over 45% of total merchandise exports requires special focus since it is expected to continue to generate a substantial portion of Guyana's net foreign earnings over the medium-term and to remain the

mainstay of the economy for the foreseeable future. Specific issues to be addressed within the sector include: (a) measures to further improve performance in the sugar subsector through cost reduction, rationalization of milling capacity, organizational improvement, maintenance of adequate crop (ratoon) renewal as well as measures to sustain proposed export targets by meeting the rehabilitation and new investment needs of the sector; (b) the continued provision of incentives (mainly pricing, including access to foreign exchange), input supplies (fertilizers, herbicides and pesticides) and the maintenance of adequate research, extension services and water management to facilitate increased productivity and production in the rice sector; and (c) the provision of adequate infrastructural and marketing support to facilitate increased production of rice and other crops, as well as increased production in the fishery and forestry subsectors. In the mining sector, major efforts are required to address the rehabilitation needs of the bauxite industry which had accounted for about 35% of merchandise exports and about 6% of GDP. In the manufacturing sector, policies are needed to promote growth of primarily the nontraditional manufacturing sector which accounted for less than 10% of GDP in 1987-88. These include the continued implementation of an appropriate exchange rate regime, further deregulation of the economy, and the provision of incentives and infrastructural support.

18. Guyana's quest for medium-term growth, however, is expected to be difficult owing to its heavy dependence on its three traditional export sectors, highly vulnerable to fluctuations in international prices and demand. On the other hand, lead time is needed to develop nontraditional sectors. While the bauxite sector is affected by obsolete plant and equipment and weak financial performance--both of which adversely affect production efficiency--it continues to have a high potential for increased export earnings owing to the buoyant market for calcined bauxite, the market for which is shared only with China. At the same time, potential exists for the development of nontraditional sectors in agriculture (e.g. fruits, vegetables and dairy products), manufacturing (clothing, footwear, beverages and furniture), mining (gold and diamonds) and forestry. The speedy and efficient development of these sectors will require maintenance of export competitiveness and participation by the indigenous private sector together with foreign investors--which in turn would depend upon a fundamental restructuring of the macroeconomic policy framework to provide incentives to expand production and exports. The Government is fully committed to the implementation of the policy reforms set out in the PFP as the only means of moving the economy out of 15 years of cumulative deterioration and placing it on a sustainable growth path. A clear sign of the change in approach are the initiatives taken recently to establish joint ventures, divest and/or negotiate management contracts with foreign firms for the bauxite, sugar, electric power, air transport, and telecommunications sectors, and a number of other public enterprises (para. 23). Given the Government's commitment, the chances of success of a structural adjustment program will depend in substantial measure on whether the necessary external financial support can be mobilized and the necessary technical assistance can be secured.

PART II - COUNTRY STRATEGIES AND BANK GROUP OPERATIONS

A. THE GOVERNMENT'S MEDIUM-TERM ADJUSTMENT PROGRAM

19. The main objectives of the Government's ERP are set out in a Letter of Development Policies (Annex V). These objectives are to: restore economic growth and later increase it above historical levels over the medium term; eliminate internal and external imbalances; incorporate the parallel economy into the official economy; and normalize Guyana's financial relations with its external creditors. To attain these objectives, the Government has given the highest priority to the restoration of incentives through a realistic exchange rate regime, removal of remaining price distortions, trade liberalization, and promotion of private sector development. It gives high priority also to the improvement of the public sector finances through a streamlining of the civil service, generating surpluses from public enterprises and a selective divestment program. Rehabilitation of the basic infrastructure, critical to an increase in exports and private investment, is to be emphasized through the launching of a public sector investment program (PSIP) consistent with a viable macroeconomic framework. Finally, in order to protect groups that are particularly vulnerable during the adjustment process and to maintain public support for the economic recovery program, a social impact amelioration program (SIMAP) is to be implemented in parallel with the medium-term adjustment program.

20. An exchange rate regime is being implemented to help ensure external competitiveness and protect the balance of payments. The exchange rate will be reviewed periodically with a view to progressively eliminating the divergence between the official rate and the free market exchange rate. To guarantee exporters a minimum of foreign exchange for importation requirements, the Bank of Guyana had established foreign exchange retention schemes that allow selected exporters to retain a certain percentage of their export proceeds depending upon the availability of adequate foreign exchange at the Bank of Guyana. The retention schemes will be gradually eliminated as more foreign exchange becomes available for meeting all bona fide payments.

21. In order to support private investment, new measures will be instituted to reduce the processing time for the approval of fiscal incentives for new projects. There are also good prospects for promoting increased production of mineral deposits (notably gold and diamonds), for which appropriate policy incentives such as tax holidays, exemptions from consumption tax and accelerated depreciation allowances are being provided in order to encourage the required private sector investments.

22. The Government will adopt fiscal policies aimed at reducing the overall public sector deficit, consistent with a sustainable balance of payments position over the medium term and also, increased public sector savings. Measures to increase revenues include improving of tax administration and broadening the tax base, adopting a program to address deficiencies in the application and administration of consumption taxes, and reducing import duty exemptions. The objective is to enhance revenue, minimize disincentives, improve resource allocation and help incorporate the parallel economy into the official economy. Measures to reduce

expenditures include the close monitoring by sector of recurrent expenditures on supplies and materials; the termination of transfers to public enterprises, except to the Guyana Electricity Corporation and for maintenance expenditures of public enterprises to be fully divested (during the period in which assets are valued, tenders are called and analyzed and the sale is negotiated); the restraining of increases in public sector wages and salaries; and the strengthening of budgeting, monitoring and fiscal reporting procedures. The reduction of central government expenditure is also to be achieved through rationalization measures including the elimination of overlapping functions and non-critical vacancies in the civil service.

23. A corporate strategy has been developed for the enterprises under the Public Corporations Secretariat (PCS) with a view to determining which enterprises will be kept within the Government's control and which should be divested. Altogether 12 enterprises have been identified for divestment and options include closure, total or partial sale to the private sector, joint venture arrangements, or leasing contracts. A Policy Group chaired by the President has been set up to guide the divestment process and a Divestment Unit staffed with lawyers, financial analysts and economists has been set up to carry out the technical work needed for divestment. In the case of the Guyana Sugar Corporation (GUYSUCO), separate accounting and management systems will be established and foreign investment will be sought for both its sugar and non-sugar production activities. In order to derive policy recommendations, the problems and prospects for private sector rice exports will be reviewed by the Government with assistance from the Inter-American Development Bank. Meanwhile, the Government has already taken a number of steps to improve the bauxite industry including the securing of a European Development Fund Loan to rehabilitate the industry and discussions with Reynolds International of United States and Alcan of Canada about possible joint ventures. In February 1989, Reynolds International signed an agreement with the Government to commence mining, marketing and sales of bauxite. The initial capital investment is estimated at US$25 million. Discussions are also under way with Bookers of United Kingdom to obtain management assistance for the sugar industry and with British Airport Services Group, to run the country's international airport. In addition the Government has sought foreign equity participation in Guyana Airways and the Guyana Electricity Corporation. Also, discussions are in progress with a US company on the sale of 80% of the Government's equity in the Guyana Telecommunications Corporation.

24. The Government will review annually during 1990-92 the size and composition of the rolling three-year Public Sector Investment Program (PSIP) to ensure its consistency with the objectives of the economic recovery program, projected domestic and foreign resource availability and implementation capacity. Particular attention will be given to adequate costing of projects and the timing of project disbursements as well as to the economic criteria for admission of new projects. The State Planning Secretariat will be adequately staffed to provide guidelines for project preparation to the line ministries and government agencies and for evaluation and monitoring of projects. Additionally, the management of external aid coordination and resource mobilization will be strengthened at the Ministry of Finance to maintain continuous contact with donors and to accelerate the internal processing of loans and grants, and disbursement requests.

25. The above-mentioned initiatives signal a fundamental change in economic management -- from one based on state intervention and controls towards a market-oriented economy with a much greater role for the private sector. In sum, the Government has given the highest priority to the restoration of incentives through a movement towards a realistic exchange rate regime, removal of price distortions, trade liberalization, promotion of private, local and foreign investment and divestment of public enterprises. However, this change of direction is constrained by the lack of balance of payments support to finance imported inputs needed to restore economic growth and the lack of investment resources for complementary infrastructure.

B. BANK GROUP ASSISTANCE STRATEGY AND OPERATIONS

Past Assistance

26. The first Bank loan to the then British Guyana was made in 1961 for an agricultural credit project and was repaid in full. Since independence in 1966, Guyana has received, net of cancellations, US$76.2 million in loans from the Bank and US$44.8 million in credits from IDA, covering twenty development projects and programs. These include assistance in the highways, power, education, agriculture, livestock, and petroleum sectors; a sea defense project; a structural adjustment loan/credit; and two technical assistance projects. A Bauxite Industry Technical Assistance Project in an amount of SDR 6.6 million (Credit 1729-GUA) was approved August 5, 1986 but is not yet signed because of Guyana's arrears situation with the Bank.

27. Earlier Bank Group operations in Guyana were aimed at strengthening both the physical and social infrastructure as well as governmental institutions. The Bank Group has also supported the Government's economic program through a Structural Adjustment Loan (1948-GUA) for US$14 million, a Structural Adjustment Credit (1098-GUA) for US$8 million and an associated Second Technical Assistance Loan (1949-GUA) for US$1.5 million, all of which were approved by the Board on February 3, 1981. An IMF Extended Fund Facility (EFF) was also approved in 1981. Guyana's performance under the first year of the IMF Extended Fund Facility and the Bank's SAL fell short of the targets set. In mid-1982, the Fund arrangement was terminated. The structural adjustments envisaged under the Bank's program also did not materialize because of the slow rate at which planned policies were implemented. Partly as a result of the slow and ad hoc implementation of policies formulated, economic performance continued to deteriorate. An evaluation of the performance of the adjustment program (OED Report No. 6119 of March 25, 1986) focused on two weaknesses: the lack of government commitment to the basic policy thrust of the program and the lack of institutional capacity to implement the program. Other problems were the inclusion of too many conditions, the unrealistic time frame for carrying out a number of actions, and the lack of specificity in the conditionality set out in the program. Deadlines were attached to a wide range of detailed actions of varying importance, most of which required periodic reporting. According to the evaluation, the program was rushed through without sufficient appreciation of the need to have the proposals under the program fully considered within the Government. The

proposed SAC, which focuses on supply side macroeconomic conditions rather than detailed sectoral ones, has been developed with the Government over the past 18 months and the Government is fully committed to its implementation. As described below (para.34) the proposed Technical Assistance Credit seeks to address the issue of implementation capacity.

Proposed Bank Group Assistance Strategy

28. While the Fund-monitored program currently under implementation will help reduce internal and external imbalances, such efforts will not be sustainable unless the economy can resume growth above historical levels. This would require a significant improvement in the supply side conditions needed for economic growth, balance of payments support to meet increased import needs, and technical and management skills to implement the program. The run-down state of the country's physical infrastructure also calls for a major rehabilitation effort, including new investments to promote economic growth. There is a need also to address the social cost of adjustment and its potentially negative effects if its impact is not cushioned.

29. Accordingly, the main elements of the Bank Group country assistance strategy are to: (a) complement the Fund's stabilization program by focusing the proposed SAC on the improvement of incentives and public sector reforms; (b) assist the Government, through the provision of technical assistance, to ensure that the financial assistance being made available for the rehabilitation of the productive sectors and infrastructure is efficiently used; (c) support the rehabilitation of the bauxite sector; (d) assist in the rehabilitation of the social infrastructure; (e) design an economic and sector work program with further emphasis on the incentive framework, infrastructure rehabilitation and development, public sector management, agriculture development and mining; and (f) through the Caribbean Group for Cooperation in Economic Development to help Guyana mobilize the external resources to support infrastructure rehabilitation and other objectives of the PSIP.

30. Consistent with the above strategy, and taking into account planned lending activities of other agencies and IDA resource constraints, the proposed lending program in the near term is expected to include the proposed SAC and related proposed Technical Assistance Credit, in addition to (i) a possible bauxite rehabilitation project on IBRD terms which, because of creditworthiness considerations, would be processed as an "enclave-type" operation, and (ii) a proposed social sector project, with emphasis on possible improvements in rural health delivery systems. Support for infrastructure rehabilitation (power, roads, water supply, sea defenses, flood control and drainage) is expected to be provided by IDB, EEC and CDB, for agriculture and education principally by IDB, and for industry by EIB.

31. The Bank Group has also been assisting the Government's efforts to mobilize external resources for its Social Impact Amelioration Program (SIMAP). A Special Donors Meeting of the CGCED was held on July 10, 1989 to seek support for the SIMAP estimated at US$10 million and engendered expressions of donor support particularly from the IDB and UN agencies.

Resumption of Previously Approved Projects

32. The liquidation of Guyana's arrears with the Bank will permit a resumption of disbursements under the Petroleum Exploration Promotion Project (Credit 1208-GUA) and Upper Demerara Forestry Project (Supplementary Credit--Credit 1555-GUA). The Petroleum project, in the amount of SDR 1.7 million (US$2.0 million equivalent), was made in November, 1982 to help finance the Government's efforts to establish blocks of potential oil-bearing areas for leasing to interested companies for oil exploration, including the provision of specialist consultant services and other technical assistance to the Government, a vehicle and laboratory equipment and materials. As of March 31, 1990 the undisbursed balance of the Credit amounted to US$1.1 million. The Supplementary Credit for the Upper Demerara Forestry Project, in the amount of SDR 8.7 million (US$8.8 million equivalent), was made in March 1985 to help finance cost overruns relating to the procurement of logging equipment and vehicles, sawmill equipment, and construction of housing and community facilities and additional components financed under the Upper Demerara Forestry Project (Loan No. 1623-GUA). As of March 31, 1990, the undisbursed amount under this Credit was US$3.7 million. Implementation of both the Petroleum and Forestry projects has continued albeit at a very slow pace because of limited government resources. Bank missions will visit Guyana as soon as possible to review progress and to determine the amounts eligible for reimbursement under each credit following the lifting of suspension of disbursements. It is expected that both projects will be closed during FY91.

33. The liquidation of Guyana's arrears will also enable the signing of the Credit (1729-GUA) for the Bauxite Industry Technical Assistance Project, amounting to SDR 6.6 million (US$8.5 million equivalent), which was approved by the Executive Directors in August 1986. The project would provide the basis for assessing the medium- to long-term economic and financial viability of the bauxite industry and assist, as appropriate, in the preparation of a full scale rehabilitation project. The Government Agencies involved, the Bauxite Industry Development Company (BIDCO) and Guyana Mining Enterprise Ltd. (GUYMINE) have been financing out of their own resources, a number of expenditures relating to the implementation of the project. The expenditures incurred have been made substantially in accordance with the Association Procurement Guidelines on the understanding that they would qualify for reimbursement under the above Credit. It is estimated that around US$3.0 million equivalent have already been incurred in reimbursable expenditures. As US$0.8 million equivalent is the limit of retroactive financing permitted under the draft Development Credit Agreement, it is proposed that this limit be increased to US$3.0 million to allow reimbursement of eligible expenditures already incurred in project implementation. Utilization of the US$5.5 million equivalent balance of credit proceeds will be determined after a review with Government of the most appropriate use of these resources to support the divestment program for the bauxite sector. The Executive Directors will be informed of the proposed revised project content.

The Proposed Technical Assistance Credit

34. The shortage of professional and technical manpower continues to impede the operational as well as the development activities of the public sector. Even basic information needed for macroeconomic management such as

the national accounting data base remains extremely weak, in large part, owing to the lack of personnel to collect, compile and analyze key economic data. The lack of professional manpower has also adversely affected the formulation of effective economic policies and the development and monitoring of the PSIP. Shortages are most acute in the fields of economics, engineering, accountancy and industrial management, as reflected by the large number of unfilled vacancies in the public service. Guyana's economic recovery program would crucially depend upon developing a "critical mass" of higher level manpower through increased incentives, training and technical assistance, and attracting Guyanese professionals abroad for short periods. IDA will help address some of these issues through the Technical Assistance Credit (TAC) also being presented to you today. The TAC both complements the SAC and forms a part of a broader technical assistance program formulated with assistance from the UNDP.

C. EXTERNAL FINANCING AND BURDEN SHARING

35. Guyana's lack of a track record or commercial ties with traditional and new Caribbean area donors have made it difficult to obtain financial resources from abroad. Also, the amount of support required for the ERP (See Table 1) is clearly without precedent and its mobilization has proven difficult. Moreover, substantial financial assistance from the donor community will be required well beyond the program period.

Table 1: GROSS EXTERNAL FINANCING AND BURDEN SHARING, 1990-91
(US$ million)

	1990	1991	1990-91
TOTAL	766.0	126.4	892.4
Multilateral	226.0	66.1	292.1
o/w: Bank 1/	69.5	16.8	86.3
Fund	117.5	27.3	144.8
Other	39.0	22.0	61.0
Bilateral and others (incl. rescheduling)	540.0	60.3	600.3
TOTAL	100.0	100.0	100.0
Multilateral	29.5	52.3	32.7
o/W: Bank	9.1	13.3	9.7
Fund	15.3	21.6	16.2
Other	5.1	17.4	6.8
Bilateral and others (incl. rescheduling)	70.5	47.7	67.3

1/ Includes project financing. See Table 2.

Source: Annex I.

36. The aggregate financing for the three years period is based on current assumptions of export receipts and a projected large increase in imports, both related to the recovery of the sugar and bauxite sectors. The trade deficit is thus projected to increase from an annual average of US$17 million in 1988-89 to some US$67 million per year during 1990-92.

37. The above trade balance projection is sensitive to unexpected developments in the prices and volume of bauxite and sugar. A 10% drop in export volume or price of bauxite would worsen the trade deficit by about US$10 million while the same outcome in either price or export volume of sugar would worsen it by US$8 million per year.

38. In 1989, Guyana's actual debt service (as opposed to scheduled debt service which was much higher) was about US$42 million or 17% of export earnings. The actual debt service is projected to average around 30% during 1990-92. Barring a major unexpected favorable development affecting the trade balance, the debt servicing capacity of the country will depend, particularly in 1990-91, on timely official assistance made available on concessional terms.

39. Taking into account the repayment of arrears due to the Bank (about US$57 million by mid-June 1990), and debt service obligations, the expected pattern of disbursements would be as follows:

Table 2: WORLD BANK NET DISBURSEMENTS AND TRANSFERS TO GUYANA, 1990-91
(US$ millions)

	1990	1991	Total
Inflows			
IDA SAC	65.0	13.0	78.0
IDA TAC	0.5	1.8	2.3
Ongoing Operations	1.0	-	1.0
Bauxite TA	3.0	2.0	5.0
Total	69.5	16.8	86.3
Outflows			
Arrears	57.0	-	57.0
Debt Service	6.8	11.0	17.8
of which:			
Principal	3.8	6.0	9.8
Interest	3.0	5.0	8.0
Total	63.8	11.0	74.8
Net Disbursements	8.7	10.8	19.5
Net Transfers	5.7	5.8	11.5

Source: Proposed Lending Program.

PART III - THE FUND PROGRAMS FOR 1989 AND 1990

40. The essential policy components of the Fund-monitored economic reform program for 1989 were:

41. Exchange Rate Policy. Following the adjustment of the official exchange rate system which took place in April 1989, the Government was required to implement a flexible exchange rate policy to help ensure external competitiveness and protect the balance of payments. A mechanism for triggering adjustments in the exchange rate was to be reviewed periodically and, if necessary, adjusted to maintain it within a 15% margin from the parallel exchange rate. In addition, adjustments to the official exchange rate were expected to take into account domestic nominal wages and prices in relation to those of Guyana's main trading partners and competitors, and of developments in international reserves in relation to the program's targets.

42. Fiscal Policy. The Government was required to undertake fiscal policies that would aim at reducing the overall public sector deficit from US$140 million in 1988 (33% of GDP) to US$95 million in 1989 (37% of GDP),[5] consistent with a sustainable balance of payments position over the medium term, and increased public sector savings. Measures to increase revenues included the improvement of tax administration and broadening of the tax base by restructuring and extending excise and consumption taxes, and reducing tax exemptions. The objective was to enhance revenue, minimize disincentives, improve resource allocation and help incorporate the parallel economy into the official economy. Measures to reduce expenditures included: the close monitoring by sector of recurrent funding requirements for supplies and materials to seek further savings; the termination of transfers to public corporations except to the Guyana Electricity Corporation; the restraining of increases in public sector wages and salaries; and the strengthening of budgeting, monitoring and fiscal reporting procedures.

43. Monetary Policy. In line with these fiscal policies designed to reduce the public sector deficit, the Fund-monitored monetary policies were designed to ensure consistency with the program's targets for inflation and the balance of payments deficit. The Bank of Guyana was required to limit credit expansion consistent with an increase in net foreign assets of US$4 million during the last nine months of 1989 and with an increase of currency in circulation of 27%. The excess liquidity already frozen will be converted into medium-term debentures so that potential inflationary pressures would be deflected while the economy is undergoing liberalization.

44. Incomes Policy. In order to increase employment, protect external competitiveness and help reduce inflation, the Government was required to implement a restrained wage policy. Nominal wages were expected to remain

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5/ The deficit as a proportion of the GDP is higher in 1989 owing a much higher multiplier (3 fold) of the foreign component in public investment measured in local currency.

unchanged unless the Guyana dollar was further devalued. Merit increases were permitted on the basis of productivity increases and the overall financial situation of the public sector, and wages in the private sector were expected to continue to be freely determined with the exception of some non-unionized workers.

Economic Performance and Financial Targets - 1989

45. The extent of the adjustment effected under the Fund-monitored program led to strikes in the sugar and bauxite sectors which have impacted adversely on economic performance vis-a-vis the projected outcome. Bauxite production dropped to about 1.3 million tons (target: 1.76 million tons) and sugar to about 164,000 tons (target: 200,000 tons). Persistent shortages in electricity supply compounded the problem through its damaging effects on the rice and other productive sectors. Rice production reached an estimated 143,000 tons (target: 162,000 tons). As a result of these production losses, the downturn in production in other sectors and associated losses in the service sectors, real GDP declined by about 3.3% during 1989 (target: 5% growth). This setback in economic performance also impacted very seriously on public finances and the balance of payments during 1989 as described below.

46. Public Finances: The overall deficit of the nonfinancial public sector reached 48% of GDP in 1989 compared to a target of 37% of GDP in the Fund-monitored program for 1989. This deviation in performance is largely the result of the sharp drop in real GDP and a much wider central government current account deficit (31% of GDP) compared to the deficit (21% of GDP) envisaged in the program. The windfall gains envisaged from the devaluation did not materialize, owing to major production shortfalls (para. 44) and consequently revenue performance remained weak during 1989. While the operating surpluses of the two enterprises in the sugar and bauxite sectors deteriorated severely relative to the program, the performance of most of the other enterprises relative to the program was also poor owing to the lack of foreign exchange to obtain essential inputs. Consequently, the programmed large transfers from the public enterprises did not take place. This, in turn, led to a much weaker central government revenue performance than programmed. Furthermore, the Sugar Corporation bore the cost of an unprogrammed subsidy on the domestic sales of imported sugar needed to meet the shortfall in production mentioned above. Although the Government's non-wage current expenditure remained significantly below the program level, this only partly offset the reduction in revenue and a further 20% wage increase granted outside the program in August 1989 with a view to averting further strikes in the bauxite and sugar industries.

47. Balance of Payments: The current account deficit for 1989 (accrual basis) is now estimated at 60% of projected exports of goods and nonfactor services, compared to 48% of programmed exports of goods and nonfactor services reflecting in part strike losses amounting to US$20 million. The deterioration in the external account was compounded by slippages in the implementation of commodity assistance from bilateral sources amounting to US$14 million. Net merchandise exports declined from an original target of US$260 million to US$198 million. Consequently, the foreign exchange situation remained extremely difficult. A major compression of non-project imports of about US$50 million from the original target became a serious impediment to growth in 1989.

48. Dialogue with the Fund: The above-mentioned deviations were reviewed by the Fund staff and the authorities before and during September 1989. The Fund staff advised the authorities about the need to take additional fiscal actions plus legalizing the parallel market rate for foreign exchange (including moving all official transactions to it, except for those of the highly sensitive sugar and petroleum companies). On the fiscal side, the Government took the additional measures discussed with the Fund staff. First, it raised the retail price of sugar from G$2.90 per lb. to G$6.20 per lb. equivalent to US cents 19 per lb.--the price at which sugar was imported in October/November 1989. Second, it implemented a tax on diesel and gasoline equivalent to US cents 30 per imperial gallon effective from November 1, 1989. The Government also enacted the Dealers in Foreign Currency (Licensing) Act of 1989 to legalize the parallel market for foreign exchange. As of April 1990, 15 Exchange Houses (or Cambios) were in operation.

The Fund Program - 1990

49. The main elements of the proposed Fund program for 1990, to be supported by an ESAF (US$106 million) and a Standby (US$64 million) are:

Exchange Rate Policy

(a) adjustment of the exchange rate in stages to achieve a full unification of the rate by March 31, 1991;

(b) shifting of more transactions to the newly legalized parallel market for foreign exchange; and

(c) adjustment in the prices of controlled items to allow for the pass-through of changes in the exchange rate.

Fiscal Policy

(a) an increase in the primary current account surplus of the public sector from 18% of GDP in 1989 to 22% of GDP in 1990 and to 30% of GDP in 1991;

(b) establishment of a sales tax by December 1990;

(c) elimination of exemptions from consumption taxes on fuel enjoyed by fishing trawlers and aviation fuel for domestic flights;

(d) elimination of exemptions from consumption tax and import-duty granted to imports of agricultural, forestry and mining equipment;

(e) restraints on non interest current expenditure of the Central Government.

Monetary Policy

(a) a progressive movement towards a more market-oriented approach to monetary control centered on the auctioning of treasury bills and on the development of secondary markets for treasury bills and government securities;

(b) the establishment of a monetary policy unit at the Bank of Guyana principally to: help determine and implement credit targets; improve coordination between monetary and public debt management policies; and monitor credit developments in the financial systems;

(c) implementation of a market determined interest rate policy taking into account developments in wages, prices and the exchange rate which aims at holding interest rates positive in real terms;

(d) an increase in the rediscount rate on treasury bills;

(e) extending the freeze on excess liquidity; and

(f) increasing the charge for non-compliance (by Commercial Banks) with liquid assets and reserve requirements.

PART IV - THE PROPOSED STRUCTURAL ADJUSTMENT PROGRAM

50. The proposed SAC would support the Government's economic recovery program. The aim of the program is to create viable and stable economic conditions conducive to restoring a higher and sustained rate of economic growth. The proposed SAC comprises the following components:

> The Incentive Framework. Reforms in domestic pricing, trade policy, private sector investment climate, within the context of a sound macroeconomic framework, conducive to growth and investment.

> Public Sector Finances. Elimination of central government transfers to public enterprises (PEs), streamlining of the civil service, increasing transfers from PEs to the Central Government, and divestment programs for selected PEs.

> The Public Sector Investment Program (PSIP). Formulation of a realistic PSIP consistent with the macroeconomic framework and with the country's implementation capacity.

A. THE INCENTIVE FRAMEWORK

51. While Guyana's poor export performance had originated from adverse external factors, it was also aggravated by an erosion of the incentive framework stemming from the failure to correct an overvalued exchange rate, price distortions, and the lack of a clear role for the private sector. To expand exports, the proposed sequencing of actions in the SAC is to first maintain international competitiveness, second to relax import licensing procedures and reduce QRs and finally, after achieving the fiscal targets under the program and strengthening the public sector's savings capacity, to begin rationalizing the consumption tax structure. The devaluation of the Guyana dollar in April 1989 and June 1990 seek to produce a supply response through producer incentives in the form of higher margins in local currency.

Domestic Pricing

52. After maintaining for several years a domestic pricing policy of keeping fixed prices for a number of consumer goods, the Government freed the prices of a number of items in 1988, but the prices of sugar, petroleum products, rice, public utilities services, and public transportation remained controlled and in some cases unchanged. This policy has had several undesirable effects, including lack of incentives to private producers, excessive and indiscriminate consumption subsidies, illegal trade, and weakening of public enterprise finances from resulting subsidies.

53. The price of rice has been based essentially on domestic costs; international price trends are not explicitly featured in the pricing formula. Consequently, price signals to rice farmers do not reflect economic efficiency considerations. Rice exporters also are constrained by a number of factors such as the shortage of credit and farm inputs, restrictions on sale to CARICOM countries and excessive regulation. But

the absence of Bank operations or studies on the rice sector has impeded our ability to develop appropriate proposals for resolving these problems. Given the importance of the rice sector, a study on the sectoral issues would be essential. Sugar pricing is also based on domestic production costs, except for the recent price adjustment (para. 47) to cover the cost of imported sugar. Since sugar imports for domestic consumption is likely to continue for the next two years, its pricing needs to reflect the c.i.f. cost as well as other acquisition costs.

54. In the case of electricity, price adjustments have been hampered by the severe shortages in supply. The Guyana Electricity Corporation (GEC) is currently able to supply only about 16 MW of power supply out of a maximum demand of about 35 MW in the Demerara Integrated System (DIS). While plans are under way to rehabilitate the system with IDB assistance, the GEC is in the process of securing consultancy services for formulating a least-cost expansion program, from which a long-run marginal cost estimate of producing electricity could be derived. In these circumstances and as an interim measure, a feasible solution would be to ensure the adequacy of electricity prices to cover the full cost of operations. Thereafter, the Government needs to develop a least-cost expansion program (LCEP), which will provide the information for setting of tariffs based on long-run marginal costs (LRMC).

55. As regards water supply, cost recovery in the sector remains extremely poor. The Georgetown City Council which serves the largest segment of Guyana's population, recovers only 65% of the operational cost. Poor cost recovery has led to central government transfers, amounting to about G$2 million in 1988 or 0.1% of total revenue. Cost recovery is impeded by a severely deteriorated water supply system which provides neither the quantity nor quality of water required. In the absence of water meters, costs are recovered on the basis of a percentage charge on the property value. Plant rehabilitation and the installation of water meters would take time, and need to be implemented within a sector development plan. In the case of public transportation, fares were raised to cover operational costs during April 1989, but the principle of covering full operational costs needs to be maintained.

56. Action Program. During negotiations, agreement was reached on:

(i) putting into effect pricing policies on rice which will reflect the international price of equivalent grades of rice calculated at an exchange rate acceptable to IDA;

(ii) setting the domestic price of sugar to cover the c.i.f. Georgetown and other acquisition costs of imported sugar;

(iv) setting of electricity tariffs to cover the full cost of operations including depreciation and on developing a 10-year least cost expansion program which will provide the information for setting of electricity tariffs based on long-run marginal costs;

(v) developing a plan to rehabilitate the Georgetown Water Supply System;

(vi) setting petroleum product prices (except kerosene used extensively by low-income groups) to cover the c.i.f. price and local costs including depreciation; and

(vii) setting public transportation fares to cover operating costs, including depreciation.

57. Prior to second tranche release, the Government will:

(i) implement changes in rice, sugar, electricity and petroleum prices as well as public transportation fares in accordance with pricing formulas described in para. 56 above; and

(ii) complete the preparation of a least cost expansion program for electricity supply for 1990-99.

58. Conditions for the third tranche release will be:

(i) the completion of a study and initiation of an IDA-agreed action program for improving private sector rice exports;

(ii) preparation of an electricity tariff schedule for all categories of services with rates equal to at least the long-run marginal costs and a schedule for implementation satisfactory to IDA; and

(iii) completion and review with IDA of the Master Plan to rehabilitate the Georgetown Water Supply System.

Trade Policy

59. The trade regime in Guyana has only a few remaining distortions since the Government has taken a number of actions set out in the PFP during the past two years. Since October 1, 1988, no licenses are required and no import tariffs are applicable for imports of CARICOM origin. In addition, the licensing of "no funds" imports, i.e., those not involving the use of official foreign exchange was liberalized so as to allow private individuals to import without licenses from non-CARICOM sources, items for their own use. Import duties are also in line with the CARICOM common external tariff (CET) and unlike other Caribbean countries no stamp duties or other import charges are levied. The remaining issues relate to the prohibited or negative list of imports and some import duty exemptions. Regarding the former, agreement was reached with the Government during the PFP discussions in 1988 to remove all items on the prohibited list except for 36 categories of food, on grounds of food security. The prohibited list (applicable only to non-CARICOM countries) now comprises only 146 tariff items out of a total of 2,285 tariff items. These items mainly comprise meat, poultry, fish, vegetables and some fruits which are produced locally. The list also contains some processed food items (e.g., canned fish and meat, processed fruits, etc.). Food processing accounts for 92 out of a total of 550 registered manufacturing units. But the absence of survey data precludes an assessment of the production coverage of these food items which form the prohibited list of imports. Although the reduction of the prohibited list to a relatively small size (6.4% of a total of 2285) is a significant achievement, further reductions are needed

from the standpoint of improving the efficiency of domestic production and generating revenues from import duties levied on these items. In the case of import duty exemptions, the problem is that these are granted in an ad hoc manner--leading to loss of revenue and reportedly to an inequitable treatment of importers.

60. Action Program. During negotiations, agreement was reached on the removal of the remaining items on the prohibited list, except for four categories of food items (out of 36), representing locally produced basic foods consumed by the low-income population i.e., non-processed meats, poultry, fruit and processed fruit items. Prior to second tranche release, the Government will:

(i) ensure that import licenses are: issued automatically by the Ministry of Trade within two working days for all applications not requiring government foreign exchange; and processed within seven days for all applications requiring foreign exchange from the Bank of Guyana (excluding items in the prohibited list); and

(ii) remove 16 categories of items from the prohibited list.

61. Prior to third tranche release, the Government will:

(i) remove the remaining 16 categories of items to be removed from the prohibited list of imports; and

(ii) begin implementation of an IDA-agreed program to reduce import duty exemptions.

Other Incentives

62. Another disincentive for private sector activity concerns the consumption taxes levied on domestic and imported goods. In cases where a high consumption tax has been imposed on imported goods subject to high tariffs, the burden on importers and consequently on domestic consumers is excessive. Although the consumption tax applies to both domestic producers and importers, in the case of the former the tax is calculated after the mark-up (often in the range of 30-40% to cover overheads and interest), and for the latter, before the mark-up. This procedure leads to higher consumption tax payments by domestic producers vis-a-vis importers and consequently renders them less competitive vis-a-vis importers. Also, these high tax rates encourage tax evasion. Some cascading of the consumption tax on domestic production takes place where producers source their inputs from local suppliers. Cascading of consumption taxes also takes place when imports of packaging materials and machinery spares are subject to consumption taxes. Furthermore, there are instances of wide disparities in the consumption tax rates applied to close substitutes--thus distorting production choices. These issues would be studied and recommendations for improvement would be developed with financing from the TAC.

63. Action Program. Prior to third tranche release, based upon the results of a study on consumption taxes in accordance with terms of reference satisfactory to IDA, the Government would adopt a program satisfactory to IDA to address deficiencies in the application and administration of consumption taxes.

Private Sector Investment Procedures

64. Private sector investment has also been hampered by the lack of a well-defined investment code. The Government sought to address this problem by issuing a document in July 1988, entitled "Guyana Investment Policy" which sets out the incentives available to the private sector and includes policies covering the ownership and security of investments, regulations controlling foreign payments and transfers, the legal framework for businesses operating in Guyana and the norms to which investors should conform. The same document also identifies the Guyana Manufacturing and Industrial Development Agency (GUYMIDA) as the one-stop agency for investors. Notwithstanding these steps, the general perception in the private sector is that the investment policy paper is not fully operational because of the length of processing time.

65. Action Program. The Government has instituted new procedures to reduce the average processing time for the consideration and decision on fiscal incentives for new projects from ten weeks to five weeks, by increasing the frequency of the Fiscal Incentives Committee (FIC) meetings held at GUYMIDA and shortening the time within and between core steps. These include: reviews by the relevant sector ministry; discussion of the project at the FIC; and formal approval of fiscal incentives by the Minister of Finance.

B. PUBLIC SECTOR FINANCES

Central Government

66. The Central Government's overall deficit declined from around 52% of GDP in 1986-87 to 37% of GDP in 1988, reflecting the combined result of reduced current and capital outlays, and a strengthening of current revenue which had deteriorated in 1987. Although the current balance in 1988 registered the lowest deficit relative to GDP since 1983, it still exceeded 27% of GDP. The improvement in revenue reflected high tax payments particularly from the public enterprises, following the 1987 devaluation, and the payment by GUYSUCO of the sugar levy for 1987. Other taxes rose much more moderately, reflecting weaknesses both in the tax system and its administration. On the expenditure side, years of excessive overall deficits, and a resulting accumulated debt service burden, has contributed to persistently high deficits evidenced by the 40 to 50% share of (scheduled) interest payments in total expenditure of the Central Government over the last five years. In 1988, interest payments on the debt was the largest expenditure item in the budget, followed by personnel emoluments. Together these two expenditure categories, which were equivalent to 46% of GDP, accounted for almost 58% of the Central Government's total expenditure and 69% of current expenditure, while current transfers added a further 7% of GDP to government expenditure and the deficit.

67. A much stronger revenue performance as well as expenditure restraint will be needed to significantly improve the Government's financial position. Nevertheless, given the present tax system, including its narrow tax base, its high nominal rates, and the possibilities for obtaining exemptions or avoiding tax liability, most of the strengthening

of the revenue side, at least in the initial phase, is expected to reflect improvements in the performance of the public enterprises (see paras. 71-75 below) and resultant tax and dividend payments to the Central Government.

68. Restraint on the expenditure side has been exercised in a manner consistent with the need to increase public investment and allow for adequate maintenance. First, some savings are expected to be generated from the improvement in the performance of the public enterprises, which will result in the elimination of the need for current transfers from the Government to most of the public enterprises. Second, a policy of wage restraint in 1989 has already substantially reduced the wage bill, to about 27% of current revenue in 1989 from around 40% in 1986-87. However, this wage bill could rise sharply, if a large number of currently unfilled jobs were to be filled. Furthermore, the high vacancy rates, and the preferential wages offered by some government offices have led to a bidding away of staff from some essential offices, which cannot offer competitive salaries, thus putting pressure on the wage bill without improving the overall staffing in the Government. Given the very large vacancy rates with which government offices have been working for a number of years, there is an urgent need for a streamlining of the civil service system to establish critical positions, eliminate duplicating and redundant jobs, and establish pay scales in a systematic fashion in accordance with overall government priorities. To avoid a return to the present situation, a systematic and continuous review of the civil service would be needed--a function which falls within the purview of the Management Services Division (MSD) of the Ministry of Public Administration. However, the MSD is not adequately staffed to carry out its responsibilities, particularly to review the civil service and recommend the elimination of overlapping functions and noncritical vacancies. This issue is being addressed through assistance for the public service review presently being provided by the UK Overseas Development Administration.

69. Action Program. During negotiations, agreement was reached on:

(i) carrying out a public service review (PSR) with a view to identifying overlapping functions and non-critical vacancies in the civil service (i.e., positions not directly related to output growth); and

(ii) ending all central government current transfers to public enterprises from 1990 budget onwards, except for the Guyana Electricity Corporation and for maintenance expenditures of public enterprises to be fully divested.

70. Prior to second tranche release, the Government will commission management audits of the civil service based on the findings of the PSR, under terms of reference satisfactory to IDA. Prior to third tranche release, the Government will begin implementing a program satisfactory to IDA, to eliminate any overlapping functions and noncritical vacancies identified in the management audits.

Public Enterprises

71. The three traditional sectors of the economy, i.e., bauxite, sugar and rice are dominated by the Guyana Mining Enterprise Limited (GUYMINE),

the Guyana Sugar Corporation (GUYSUCO) and the Guyana Rice Group (GRG). Although there have been improvements in the financial performance of these enterprises since 1980, their financial structures remain extremely weak. The debt/equity ratio for GUYMINE stood at 4.7:1 in 1987, while that for GUYSUCO stood at 3.6:1 for 1986 and the net worth of GRG's largest entity, the Guyana Rice Milling and Marketing Authority (GRMMA) was negative in 1987. Furthermore, the enterprises supervised by the Public Corporations Secretariat (PCS) known earlier as the GUYSTAC group, have been performed poorly in the early 1980s, but have shown a marked improvement after 1985. The combined operating balance of the public enterprises turned from a deficit prior to and including 1985 into large operating surpluses in both 1987 and 1988, reflecting improvements in their financial position after the devaluation in 1987. This enabled the corporations to make substantial tax and dividend contributions to the Government, especially in 1988, where these payments amounted to 8.7% of GDP. With an estimated combined operating surplus of 18.6% of GDP in 1989, it is estimated that their tax and dividend payments to the Central Government reached 12.8% of GDP in 1989, equivalent to 9.5% of their current revenue.

72. The financial performance of GUYSUCO and GUYMINE, as the two major exporting public enterprises, was expected to improve substantially in 1989 as a result of the devaluation, and account for most of the initially projected significant improvement in the operating surplus of the public enterprises. Following two years when these two enterprises registered only small combined operating cash surpluses, their targeted combined operating surplus in 1989 was equivalent to 42.4% of GDP. However, recent estimates indicate that a combined surplus for the two enterprises was about 15% of GDP, compared to 5.2% of GDP in 1988. These deviations reflect production losses as a result of extended strikes, a more appreciated exchange rate than targeted, the cost of unprogrammed sugar imports for domestic consumption, domestic sugar sales at subsidized prices, and a different cost and demand response than anticipated to the devaluation of the Guyana dollar. Although the PCS group reached a somewhat higher than programmed cash operating surplus, it compensated for only a small portion of the shortfall in GUYSUCO and GUYMINE. The result has been a major downward movement in the combined operating surplus of the public enterprises for 1989 from a targeted 46.5% of GDP to an estimated 19% of GDP.

73. Rationalization of the operations of GUYMINE and GUYSUCO as well as those in the PCS group is urgently needed, to improve their efficiency and ensuring, inter alia, that they make significant contributions to the Government in the form of taxes, transfers and dividends. Some rationalization of the enterprises has already taken place such as the closing of certain loss-making enterprises and the rehabilitation of others, and progress has been made towards improving their financial performance and efficiency, but these efforts need to be further consolidated. For GUYMINE, as already mentioned, negotiations are in progress with Reynolds International of the U.S. and Alcan of Canada for the establishment of joint ventures. In addition, the PCS has already identified twelve enterprises for divestment, and the Government has set up a Policy Group chaired by the President and a Divestment Unit to implement the divestment program (para. 23). A corporate strategy statement for the PCS group already prepared needs to be implemented. In GUYSUCO, sugar operations are hampered by a lack of capital, while the corporation is expanding its activities into non-sugar areas. GUYSUCO needs to establish

a strategy to attract foreign capital to help increase sugar production, and to provide separate accounting and management systems for non-sugar activities and to attract private investment for these activities. Discussions are under way with Bookers of United Kingdom to obtain management assistance for the sugar industry (para. 23). Another enterprise which needs major rehabilitation is the Guyana Electricity Corporation (GEC), whose daily shutdowns continue to impair both public and private sector operations. The IDB is developing a program for rehabilitating GEC.

74. Action Program. During negotiations, agreement was reached on a strategy statement committing GUYSUCO to seek foreign capital to improve sugar production and to set up separate accounting and management systems and attract private investment (foreign or local) for its non-sugar activities, i.e., rice production, other grain production, dairy and livestock development, aquaculture and orchard development.

75. The second tranche will be conditional upon:

(i) putting into effect an action program and a schedule for implementing the corporate strategy for the PCS group; and

(ii) establishing operating procedures and auditing systems satisfactory to IDA to monitor the financial performance of GUYMINE, GUYSUCO, the PCS Group and transfers of targeted amounts from these enterprises to the Central Government.

C. PUBLIC SECTOR INVESTMENT PROGRAM

76. The long period of economic decline and consequently inadequate asset maintenance has resulted in badly deteriorated infrastructure services. Accordingly, the major focus of the public sector investment program will be the rehabilitation of basic infrastructure that is critical for supporting the program's objectives of increasing exports and private investment. An urgent task is to restore electricity supply to required levels. At present the main Demerara-Berbice system can supply only about 16 megawatts at most, as against a maximum demand of 35 megawatts.

77. The composition of the PSIP largely reflects ongoing projects dominated by a few major projects to rehabilitate electricity supply, the bauxite industry, sugar and rice sectors and water supply. As regards new projects, in the absence of a well-developed pipeline of technically sound and economically viable projects, there is a tendency for the PSIP to include projects which are at the most advanced stage of preparation rather than necessarily those of the highest priority. Moreover, there is also a tendency to include in the PSIP projects of a large size relative to domestic and foreign resource availability and some times beyond the country's implementation capacity. There is, thus, a need to design the PSIP consistent with the macroeconomic framework in terms of size, composition and financing. Procedures need to be developed to institute a pre-investment review system to ensure that individual project proposals are linked with agreed macroeconomic and sector strategies; and that stringent tests of economic viability and technical and environmental feasibility are applied. A three-year rolling core PSIP and a reserve list of projects needs to be put in place, and a monitoring system introduced.

78. Action Program. Agreement has been reached with the Government on:

(i) the size and composition of the three-year PSIP (1990-92), to bring it in line with projected domestic and foreign resource availability;

(ii) modalities including the type of information required, criteria for admission of new projects, and timing for reviews of the PSIP (in the context of a rolling three-year framework);

(iii) institutional arrangements--principally the staffing in the State Planning Secretariat for providing guidelines on project preparation to line ministries and government agencies, and for evaluation and monitoring of projects; and

(iv) improvement of external aid coordination through the services of an advisor (financed by the TAC) to the Ministry of Finance to maintain continuous contact with donors and to facilitate procurement and disbursement of funds provided by bilateral and multilateral donors.

79. Prior to second tranche release, the Government will implement the institutional arrangements to strengthen the State Planning Secretariat and the Bank would review the rolling PSIP and ensure progress satisfactory to IDA.

80. Prior to third-tranche release the Government would update the rolling PSIP in a manner satisfactory to IDA.

D. SOCIAL SECTOR PROGRAMS

81. Economic decline in Guyana over the past 15 years has led to the dilapidated state of much of the economic and social infrastructure, with widespread and substantial reductions in living standards and the provision of social services. Although the successful implementation of the structural adjustment program should help reverse this decline in the long run, some aspects of the program could impose additional stress on certain segments of the population. The groups of people particularly vulnerable to the effects of the ERP include the rural and urban poor, the unemployed and underemployed as well as the retired elderly. Their real incomes and hence their standard of living are bound to fall in the short run. Another vulnerable group would be those laid off as part of the rationalization of the Central Government and public enterprises. In order to protect groups which are particularly vulnerable during the adjustment process, and engender public support for the ERP, a social sector program (SIMAP) has been developed. At the Special Donors Meeting held on July 10, 1989, expressions of support amounted to nearly US$6 million of the US$10 million sought.

PART V - MEDIUM-TERM PROSPECTS, CREDITWORTHINESS AND EXTERNAL CAPITAL REQUIREMENTS

82. Predicated on the timely availability of the projected financial inflows and implementation of the ERP to address the above-mentioned adjustment issues, projections have been prepared which show that the economy could recover from its currently estimated decline of 3.3% in real GDP in 1989, achieve real GDP growth about 2.9% in 1990, and 4.6% in 1991. In 1992-94, real GDP growth is projected to average about 3.5% per year. The projected GDP growth in the short term would depend largely on using existing underutilized capacity for bauxite, sugar, rice, timber, and manufactured exports. Over the medium term, sugar production is expected to stabilize at levels compatible with Guyana's export quota to the EEC and the United States. If, on the other hand, financial inflows are lower than projected and constrain the imports of essential inputs, a much lower GDP growth rate would be inevitable. Investment during 1990-92 is projected at around 34% of GDP, reflecting the execution of externally financed projects to rehabilitate infrastructure.[6] Domestic savings are projected to remain at around 24% of GDP during 1990-92. Benefits from these savings and investments, however, will largely accrue beyond the program period 1990-92. Per capita consumption is projected to increase at 2.6% per year in real terms during 1990-92 reflecting the increased resource balance in 1990 financed from external sources. The primary current account balance (before interest payments) of the non-financial public sector will improve from 18% of GDP in 1989 to 22% of GDP in 1990 and to about 30% of GDP in 1991. However, the overall public sector deficit will increase from 48% of GDP in 1989 to about 54% of GDP in 1990, owing to increased payments of interest, increased capital expenditures and the impact of the devaluation upon the foreign component of the PSIP, before dropping to 41% of GDP in 1991. Based on the successful implementation of the stabilization measures and the fact that capital expenditures will be financed almost entirely from external resources in 1990 and largely from such resources in 1991, the annual rate of inflation is projected to decline from 90% in 1989 to about 30% in 1991.

83. Exports are projected to recover at an average annual rate of about 9% in real terms during 1990-92, with a significant recovery in 1990, reflecting the improvement in competitiveness, the timely availability of inputs, and barring any work stoppages. Exports of high value calcined bauxite are projected to increase from 417,000 tons in 1988 to 480,000 tons in 1991. Exports of sugar are projected to increase from 147,000 tons in 1988 to 193,000 tons in 1991. Exports of rice are projected to increase from 62,000 tons in 1988 to 77,000 in 1991. These export targets are considered to be within achievable ranges since sugar production averaged

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6/ Total investment as a proportion of GDP is relatively high because it is dominated by public investment (which has a foreign component of 72%) needed to rehabilitate productive infrastructure, deteriorated over the past two decades.

200,000 tons in 1983-86, calcined bauxite output averaged 545,000 tons in 1984-85 and rice exports peaked at 105,000 tons in 1978. Imports are projected to grow at an average annual rate of about 10% in real terms in 1990-92 based on the assumption that projected external financial inflows would be forthcoming. The increase in imports in 1990 largely reflects capital goods imports for rehabilitation projects in the bauxite and sugar industries and other infrastructure projects. The trade deficit is projected to increase from an annual average of US$17 million in 1988-89 to some US$67 million per year during the program period 1990-92. Beyond the program period, the trade deficit is projected to decline gradually, reaching about US$25 million in 1996. A better performance of the trade balance is not considered feasible during the program period, both because of the initial narrow base of Guyana's exports and the need to increase imports to restore and expand productive capacity. Likewise, the external current account deficit is projected to increase from an annual average of US$37 million in 1988-89 to about US$150 million per year during the program period 1990-92. The current account deficit is not projected to decline vis-a-vis the trade balance, because of projected interest payments (cash basis) averaging US$43 million during 1993-96.

84. Guyana's cumulative external current account deficit during 1990-92 is projected at about US$451 million (cash basis). However, with scheduled amortization (including repurchases to the Fund), and the need to start building up gross international reserves, Guyana's financing requirements for the period January 1990-December 1992, are estimated at around US$784 million--a sizable amount in relation to Guyana's population of 0.75 million. This gap consists mainly of US$303 million for project financing,[7] and about US$482 million for balance of payments support. The amount for balance of payments support includes US$229 million needed to clear arrears, to the Fund (US$142 million), Bank (US$57 million) and the Caribbean Development Bank (US$30 million). A large part of the external assistance has been secured through the Support Group for Guyana. As noted in Annex I(a), the financing plan to support the ERP is in place.

85. The financing program for 1990-92 would permit reasonable progress toward the objectives mentioned above. Essential import levels could be maintained, arrears could be eliminated during 1990, and existing and expected rescheduled debt service obligations fulfilled. However, given the country's small economic base (GNP per capita of US$410 in 1988), the excessively large debt (US$2,500 per capita) and the time required for substantial economic growth to take place, the burden of existing debt obligations and expected rescheduled ones is substantially above the country's future debt service capacity. Thus, substantial debt relief will continue to be required for the country during the 1990s. Particularly cautious economic and financial management will continue to be essential beyond 1991 in order to complete the adjustment process. The servicing of external debt obligations has become an increasing burden for Guyana since the mid-1970s with declining export receipts and increased interest and amortization liabilities. Prospects of achieving viability in the external accounts would appear possible over the longer term provided that: (i) the authorities continue to undertake prompt actions to advance the process of structural adjustment, and that official assistance continues to be made available on highly concessional terms in the amounts required; and (ii)

7/ For 1990-91, project-related external financing is estimated at US$199 million, of which donor commitments exist for US$161 million.

continued reschedulings are put in place and further debt relief is obtained. Nevertheless, the situation will at best constitute a "tight fit" over the short to medium term and, in the absence of a major unexpected improvement in the terms of trade, it is highly unlikely that dependence on balance of payments assistance can be eliminated before the mid- to late 1990s. The balance of payments constraint on Guyana's growth is such that, should the external net capital inflows fall significantly below projected levels, the country would have to significantly reduce its growth rate below that included in these projections, thus affecting its debt servicing capacity.

86. The initial responses by Guyana's creditors with regard to the issue of debt rescheduling has been positive. Trinidad and Tobago, the largest creditor (holding US$412 million, or over 20% of Guyana's total debt), has agreed to provide a very substantial interest payment relief (no interest payments until 1991; applicable interest rate reduced by about 1/3; 10-year repayment, after a 10-year grace period). Likewise, the Caribbean Multilateral Clearing Facility which ceased to operate in 1983, because of Guyana's arrears, has agreed to a similar arrangement to be applied to a debt of US$146.5 million accumulated as at the end of 1988. Paris Club creditors also rescheduled debts amounting to US$195 million at its meeting held on May 23, 1989. On an exceptional basis, Guyana received "Venice terms" i.e., rescheduling over 20 years, including a grace period of 10 years. The Fund's contribution would amount to 266% of quota equivalent to SDR 131 million (US$170 million). Moreover, some donors (the United States and the United Kingdom) have recently indicated their willingness to consider Toronto terms for debt rescheduling. This would be very important to help reduce the above mentioned risks.

87. Disbursements from IDA during 1990 and 1991 are shown on page 13 above in Table 2. Because of the need to make debt service payments, the Bank Group's net disbursement during 1990 (the first year) would amount to a US$8.7 million. But during 1990-91, the net disbursements would amount to about US$19.5 million translating to a net transfer of US$11.5 million. In the case of the Fund, at 266% of quota, the net transfer during 1990-93 would be marginally positive. The CDB's net disbursements including project financing for 1990-91 would amount to a positive US$3 million.

PART VI - CREDIT FEATURES

Credit Amount and Cofinancing

88. The proposed IDA credit in support of the SAC would be US$78.0 million equivalent, to be disbursed in three tranches: the first one of US$50 million, and two of US$15 million and US$13 million respectively, depending on compliance with agreed policy conditionality. The first tranche of the credit is expected to be disbursed within one month following Board approval, assuming rapid compliance with routine conditions of effectiveness. The second and third tranches are expected to be disbursed within six and fifteen months after effectiveness, following compliance with respective tranche conditions. The SAC would be cofinanced by the CDB (US$42 million) and the Federal Republic of Germany (US$6 million). These, together with the IDA credit would total US$126 million representing the foreign exchange component of the program.

Procurement and Disbursement

89. The proposed credit would finance the CIF cost of eligible imports, excluding alcoholic beverages, tobacco and tobacco products, sugar, luxury goods products, military and hazardous and other goods specifically prohibited in a negative list. Imports under existing contracts for the supply of certain goods such as fertilizers, petroleum products, and commodities would be eligible for IDA financing provided that they were not procured from a single source or under bilateral trade agreements, unless otherwise agreed by IDA. Currently, the major imports and their orders of magnitude per year are: petroleum products (US$79 million), fertilizers (US$10 million), spares for GUYMINE (US$12 million), and spares for the sugar and rice industries (US$15 million) which together constitute over half of non-project imports. CIDA would be financing almost the entirety of fertilizer imports and ODA (UK) and the Inter-American Development Bank would be financing a large proportion of spares for the sugar and rice industries under their respective lines of credit. Consequently, of the major import items only petroleum products and GUYMINE spares are potentially eligible for IDA financing.

90. IDA review of public procurement procedures in Guyana conducted in 1989 revealed that for large capital purchases or national projects, procurement is usually carried out through international competitive bidding (ICB) while local competitive bidding (LCB) is used primarily for smaller-scale construction or works projects. All central government procurement fall within the purview of the Central Tender Board (CTB); public corporations (e.g., GUYMINE, GUYSUCO) and statutory bodies have their own tender boards. The procurement procedures are generally consistent with Bank procurement policy. Established importers such as GUYMINE, GUYSUCO, etc., have over the years developed and depended on long established trading links with certain key suppliers. Although in many cases formal requests for price quotations are not issued, these companies consistently review prices by seeking competitive bids on an on-going basis in an effort to ensure optimal pricing to the extent possible. A survey of private sector procurement practices determined that some private trading companies follow the practice of obtaining competitive price quotations. However, in many instances, suppliers do not find it worthwhile to send bids and consequently importers are forced to obtain supplies from a single source. Also, due to foreign exchange availability constraints, many importers - particularly those who do not have systematic access to foreign exchange - deal solely with those foreign suppliers who are willing to provide credit terms, frequently at a high premium.

91. A more difficult issue concerns the low value of IDA eligible imports per month and its implications for retroactive financing. A recent procurement mission to Guyana explored the possibilities for financing imports, but its conclusion was that IDA could finance only about US$7 million a month. The main problem is the very depressed state of the economy, with recorded non-project imports running at about US$190 million annually. About 15% of petroleum imports are financed by a term credit from Venezuela, fertilizers are financed by CIDA and spare parts by UK, ODA, OPEC, IDB and suppliers. Private sector imports are almost all financed through the parallel market, with the result that recorded private sector imports for 1989 amounted to only US$24 million. Moreover, the extreme scarcity of foreign exchange that prevails means that, with the

exception of petroleum, eligible imports by both the public and the private sectors cannot be planned on a regular basis. Thus, it is impossible to predict the amount of most import items in any given month. As a review of purchase prices for petroleum products indicates that they are competitive, they would represent eligible imports, and IDA could finance about US$5.0 million a month. A rough estimate as to other public and private sector imports that IDA could finance amounts to US$2.0 million a month. Guyana is faced with the need to repay a bridge loan from BIS by mid-September 1990. It will need to receive import financing of an amount equivalent to the full US$50 million first tranche of the IDA resources if Guyana is to be able to free up foreign exchange resources needed for repayment of the BIS loan. Since IDA credit effectiveness is expected in late July, and IDA will be able to finance only about US$7 million of imports a month, this implies a need for US$43 million in retroactive financing, or 55% of the proposed US$78 million SAC. While well beyond normal guidelines for structural adjustment operations, we believe that such amount of retroactive financing, to cover eligible transactions dating to SAC appraisal (June 1989), is justified in this case, as the implementation of the Economic Recovery Program being supported by the proposed SAC and IMF arrangements began with the major devaluation and related actions in April 1989 and has been underway ever since. But Board presentations of the proposed IDA and IMF operations, originally scheduled for the latter part of 1989 were substantially delayed, in large measure because of delays in arranging the external finance necessary to support the program.

92. For the proposed credit, the following procedures will apply:

(a) Contracts for general imports to cost the equivalent of US$2 million or more shall be awarded on the basis of simplified ICB procedures; this would include all purchases of petroleum products; and

(b) for all imports to cost under US$2 million equivalent: (i) public sector agencies and companies will follow their normal competitive bidding procedures acceptable to IDA; and (ii) private sector companies could follow their own established commercial practices, provided that price quotations from eligible suppliers from at least two countries could be sought, except where direct contracting is permitted under the circumstances described under para. 3.5 of IDA procurement guidelines.

Assurances were obtained at negotiations that the above procurement procedures will be followed under the credit.

93. The Bank of Guyana (BOG) would administer the credit and would be responsible for the collection and maintenance of relevant documentation under the credit, ensuring that only purchases that meet the agreed procurement procedures are included in withdrawal applications. To assist with this work, a qualified procurement agent to be financed from the Technical Assistance Credit would be retained for the duration of the credit. Disbursements would be made against statements of expenditure (SOEs), except for contracts valued at US$2 million or more, for which disbursements would be made against full documentation. The minimum value for each SOE submitted would be US$100,000 equivalent and detailed documentation evidencing expenditures would be retained by BOG and made available for the required audit and also for supervision by the Bank.

Expenditures for goods procured under individual contracts valued at less than US$50,000 equivalent would not be eligible for financing under the credit.

Benefits and Risks

94. Benefits. The main benefits of the government program will be the gradual improvement in the standard of living of the population through the restoration and maintenance of higher and sustained economic growth. The program's success should strengthen the confidence of external donors and investors in Guyana's growth, balance of payments and employment prospects. The credit itself will help alleviate the current shortage of imported inputs and intermediate goods that constrains capacity utilization and export competitiveness. The financing program would permit reasonable progress toward meeting the Government's longer term macroeconomic objectives. Essential import levels would be maintained, arrears would be eliminated and debt service obligations would be fulfilled.

95. Risks. The major risk of the policy reform program relates to the possibilities of setbacks in macroeconomic policy that would produce a stoppage or a reversal by the Government in implementing the medium-term adjustment program. Specifically, the risks are: (i) Lack of political sustainability. While the Government now seems committed to the program, its commitment may be eroded because of political opposition resulting from the political and social cost of adjusting to the new incentives and the low level of net flows in the program. (ii) The severity of the adjustment program which may cause drastic cuts in real incomes and labor strikes and depress the economy to such an extent that conditions to produce a supply response may take a longer time; (iii) Lack of implementation capacity and of skilled manpower which could adversely affect the projected supply response. (iv) A total breakdown of the already deficient power supply and of the significantly deteriorated transport infrastructure could occur. (v) Failure of domestic or foreign investment to respond to the new incentive climate. (vi) Unexpected adverse developments in the world economic environment (sharp fall in world commodity prices and demand for Guyana's exports, or sharp increases in petroleum prices) and in weather conditions; and (vii) the failure of donors to provide net balance of payments flows on a timely basis which would cause Guyana's export performance to fall short of the projections. The bauxite sector in particular would be adversely affected if spare parts and machinery to be financed through the EDF/SYSMIN loan are delayed.

96. While the above risks are substantial and will not be eliminated over the medium term, there are, factors that will help to mitigate them. First and most importantly, the Government has acknowledged that it has no choice but to tackle the developmental issues head on. The Government has already demonstrated its commitment to economic reform through the major devaluation of its currency and price pass-throughs in April 1989 (para. 14). It has also shown a commitment to undertake a medium-term program of structural reform--by eliminating most trade restrictions, taking measures to increase revenues and reduce current expenditures, making interest rates positive in real terms, initiating a rationalization of the public sector, increasing the pace of divestment, and increasing the role of the private sector in the economy. Second, the Government is committed to maintaining export competitiveness. The implementation of this policy includes the continuous review of the level of the real exchange rate. The recent

legalization of the parallel market for foreign exchange and the movement of some transactions to this market indicates commitment to this policy. Third, the program gives priority to the rehabilitation of existing productive capacity and infrastructure through the provision of imports of inputs and raw materials required for export production. This should give a boost to exports, domestic production and employment. In the area of electrical power generating capacity, there is a critical 15-20 MW shortage which could adversely affect production and exports. The Inter-American Development Bank is actively considering financing for this purpose. Fourth, support through a highly focussed TAC should strengthen from the outset implementation capacity and also technical work required where there is a dearth of local expertise. Fifth, Bank assistance in the preparation of a program to cushion the social impact of adjustment which met with a positive response from the donors at the Special Donors Meeting of the CGCED held in July 1989. The IDB has taken a lead role in this area, although important issues, particularly the need for assurances of adequate autonomy for the administering agency, need to be resolved to enable IDB financing to go forward. Finally, a significant effort to diversify exports should reduce the adverse effects on export performance of changes in the international economic environment and in the prices of Guyana's traditional exports and of petroleum.

97. Effects on the Environment. The environmental situation in Guyana reflects the relatively low state of the country's industrial development. Ninety percent of the population live on the coastal fringe with 30% living in five urban centers. As such, human impacts tend to be concentrated in these areas with the provision of potable water and sewerage and solid waste disposal being primary concerns. Sufficient cleared land for expansion of the country's primary exports, rice and sugar, and local food needs are available as acreage under cultivation and output has declined in recent years. The population in the country's large interior is scattered in small settlements involved in various exploitative industries such as forestry, mining and livestock. Direct impacts from these populations are generally localized to their immediate areas with mining and forestry activities having the most long-term impact.

98. Major environmental issues revolve around current and future resource development practices. The increase in gold and diamond dredge mining activities on streams in the interior can be expected to have cumulative impact on the rivers. In addition, the release of mercury into the streams can affect fish supply to the indigenous population. These issues are now being addressed by the relevant government agencies. Bauxite mining is relatively well controlled and although no efforts are currently made to remove overburden or clean smokestack pollutants, no broad environmental damages are occurring as a result of these activities. The country's forest industry is quite small given the size of the forested area. Exploration of new forest and mining areas will probably increase following the completion of the Brazilian-financed 175-mile road from Letham to Kurupukari and the subsequent completion to Mabura Hill. While greatly enhancing prospects for the development of Guyana's interior, the road has the possibility of affecting negatively wildlife and other biological resources in the area it traverses. Regulations and programs are being prepared by the Government to control the environmental impact of the road.

PART VII - RECOMMENDATION

99. I am satisfied that the proposed credit would comply with the Articles of Agreement of the Association and recommend that the Executive Directors approve the proposed credit.

100. Because of the time elapsed since Board approval of Credit 1729-GUA (Bauxite Industry Technical Assistance Project), I also recommend that the Executive Directors approve an increase to retroactive financing approved under such credit in an amount equivalent to US$3.0 million.

Barber B. Conable
President

Attachments

Washington, D.C.
June 7, 1990

Table 1: GUYANA - KEY INDICATORS, 1985-1996

	Actual				Est.	Projections				
Key Indicators	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
GDP Growth Rate	0.0	0.2	0.7	-2.6	-3.3	2.9	4.6	3.1	3.5	4.0
Per Capita GDP Growth Rate	-2.2	-0.8	-0.3	-3.6	-4.3	1.9	3.5	2.0	2.4	2.9
Consumption/Capita Growth Rate	7.7	10.1	-14.4	-16.6	-7.7	15.3	-4.1	-3.4	3.7	2.8
Actual Debt Serv.(in US$) 1/ 3/	31.7	38.2	31.7	31.9	42.3	78.6	102.9	101.0	111.3	115.1
Actual Debt Service/XGNFS 2/ 3/	13.2	15.8	11.6	12.4	17.3	30.0	32.7	29.0	27.7	23.0
Gross Investment/GDP (1985 pr.)	27.9	26.7	28.5	33.4	32.8	33.8	33.3	34.7	34.6	34.3
Domestic Savings/GDP 4/	10.0	0.0	14.2	25.7	28.4	18.9	24.9	28.9	25.3	25.4
Public Investment/GDP	24.9	24.3	18.5	26.2	25.9	27.1	29.5	27.2	26.9	26.7
Ratio of Public/Private Invest.	8.6	10.0	1.9	3.7	3.8	4.0	7.8	3.6	3.5	3.5
C. Govt. Revenues/GDP	39.4	45.8	33.6	40.1	37.5	41.5	46.0	48.7	48.4	48.2
C. Govt. Curr. Expend./GDP 5/	-75.4	-85.1	-70.6	-67.4	-73.2	-57.0	-65.5	-66.5	-66.0	-65.5
Curr.Acct.Def.(-) or Sur.(+)/GDP	-36.0	-39.3	-37.0	-27.3	-35.7	-15.5	-19.5	-17.8	-17.6	-17.3
Export Growth Rate (XGNFS)	0.7	-8.3	-2.5	-7.8	-6.0	7.1	20.1	10.7	15.5	8.8
Import Growth Rate (MGNFS)	13.9	2.6	-10.7	-13.8	8.2	27.4	2.1	9.0	8.7	5.9
Current Account (in US$) 3/	-111.3	-141.3	-119.6	-100.5	-64.6	-251.8	-103.6	-95.7	-83.5	-73.7
Current Account/XGNFS 3/	-45.2	-57.3	-42.4	-38.6	-26.4	-96.1	-32.8	-27.5	-20.8	-16.8

1/ Debt rescheduling has been projected only up to 1992.

2/ All magnitudes relating to the external account (as in the case of PFP), are expressed as shares of exports of goods and nonfactor services. A meaningful analysis of time trends in relation to nominal GDP is precluded by: a) the underestimation of GDP in the context of a growing parallel economy, and b) wide disparities in the impact of a series of major devaluation of external accounts magnitude and the nominal GDP.

3/ Actual debt service reflects payments in cash. It also reflects projected payments in cash for future years. Data on scheduled debt service are presently being prepared by the IMF staff and will be included in the PFP to be distributed shortly to the Executive Directors.

4/ Guyana's weak economic data base precludes a meaningful quantification of public and private savings consistent with national accounting concepts.

5/ Includes interest on public debt (external and domestic). Interest amounted to 32.5% of GDP in 1988.

Table 2: GUYANA: BALANCE OF PAYMENTS a/
(US$ million)

	Est. b/	Projected b/						
	1989	1990	1991	1992	1993	1994	1995	1996
A Exports of Goods & NFS	244.6	261.9	314.6	348.3	402.3	437.7	472.6	501.0
1. Merchandise (FOB)	197.5	217.7	266.1	299.1	336.1	366.7	396.4	419.2
2. Non-Factor Services	47.1	44.2	48.5	49.2	66.2	71.0	76.2	81.8
B Imports of Goods & NFS	301.5	384.0	392.1	427.5	464.5	492.0	520.3	552.2
1. Merchandise (CIF)	232.2	312.6	317.2	354.5	374.5	396.4	418.6	444.0
2. Non-Factor Services	69.3	71.4	74.9	73.0	90.0	95.6	101.7	108.2
C Resource Balance	-56.9	-122.1	-77.5	-79.2	-62.3	-54.3	-47.7	-51.2
D Net Factor Income	-14.7	-135.4	-36.5	-37.5	-40.1	-40.9	-37.1	-45.1
1. Factor Receipts	0.3	0.6	1.2	1.6	2.1	2.4	2.7	2.8
2. Factor Payments	15.0	32.6	37.7	39.1	42.2	43.3	39.8	47.9
3. Interest arrears (IFIs)	..	103.4	..	..	..	..	..	..
E Private Transfers	7.0	5.7	10.4	21.0	18.9	21.5	24.5	26.6
F Current Account Balance	-64.6	-251.8	-103.6	-95.7	-83.5	-73.7	-60.3	-69.7
G Long-Term Capital Inflow	16.4	-61.4	60.4	40.3	22.7	22.7	45.5	51.7
1. Direct Investment	5.2	10.0	17.0	20.0	8.0	8.0	8.0	8.0
2. Official Capital Grants	6.9	3.0	3.2	3.8	5.4	5.5	5.7	5.9
3. Net MLT Loans	-0.2	-77.2	31.7	14.8	7.6	7.3	29.8	35.3
a. Disbursements	27.1	93.7	81.8	61.6	65.6	67.1	71.4	73.2
b. Repayments	27.3	44.9	50.1	46.8	58.0	59.8	41.6	37.9
c. Arrears (IFIs)	..	126.0	..	..	..	..	..	..
4. Other MLT Flows (net)	4.5	2.8	8.5	1.7	1.7	1.9	2.0	2.5
Total Other Items (Net)	-14.5	0.0	-15.1	-15.2	-11.1	-11.7	-12.8	-13.7
1. Net Short Term Capital	0.0	0.0	-15.1	-15.2	-11.1	-11.7	-12.8	-13.7
2. Errors and Omissions	-14.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
I Overall Balance	-62.7	-313.2	-58.3	-70.6	-71.9	-62.7	-27.6	-31.7

a / These figures are based on projections of actual debt service payments as opposed to scheduled debt service payments. Balance of payments information on an accrual basis through 1992, reflecting scheduled debt service payments, are presently being prepared by IMF staff. They will be included in the PFP to be distributed shortly to the Executive Directors.

b / As of June 5, 1990.

Table 2: GUYANA: BALANCE OF PAYMENTS (contd.)
(US$ million)

	Est.	Projected						
	1989	1990	1991	1992	1993	1994	1995	1996
J Financing	62.7	313.2	58.3	70.6	70.7	60.9	26.3	30.5
Change in Net Int'l. Reserves	-4.8	-9.1	-14.3	-10.0	-5.0	-5.0	-3.0	-2.0
Change in Arrears	-742.4	-425.6	-32.9	10.1	53.7	47.0	9.5	15.5
Financing from IFIs	0.0	222.0	68.0	35.5	0.0	0.0	0.0	0.0
Exceptional Financing	809.9	525.9	37.5	35.0	22.0	18.9	19.8	17.0
Rescheduling	783.0	452.0	21.0	19.0	0.0	0.0	0.0	0.0
Bilaterals and others	26.9	73.9	16.5	16.0	22.0	18.9	19.8	17.0
K Financing Gap	0.0	0.0	0.0	0.0	1.2	1.8	1.3	1.2
L Shares of Exports of Goods and NFS								
1. Resource Balance	-23.3	-46.6	-24.6	-22.7	-15.5	-12.4	-10.1	-10.2
2. Total Interest Payments	-6.0	-51.7	-11.6	-10.8	-10.0	-9.4	-7.9	-9.0
3. Current Account Balance	-26.4	-96.2	-32.9	-27.5	-20.8	-16.8	-12.8	-13.9
4. MLT Capital Inflow	-0.1	-28.8	10.1	4.2	1.8	3.1	7.8	9.1
M Foreign Exchange Reserves:								
1. Int'l Reserves (Net)	-114.4	-94.9	-117.7	-136.9	-84.2	-55.0	-36.2	-17.8
2. Gross Reserves	11.3	20.4	34.7	44.7	49.7	54.7	57.7	59.7
3. Gr. Res. in Mths. of Imports	0.6	0.8	1.3	1.5	1.6	1.7	1.7	1.6

GUYANA - EXTERNAL CAPITAL AND DEBT

(US$ millions at Current Prices)

	Est. 1989	Projected 1990	1991	1992	1993	1994	1995	1996
A. Disbursements								
1. Public & Publicly Guar. LT	56.4	269.1	141.7	99.3	95.0	94.2	97.4	96.4
Official Creditors	51.9	258.0	134.9	92.2	87.8	87.0	90.2	89.2
Multilateral	0.0	162.5	100.5	74.1	55.6	57.1	59.4	61.2
o/w World Bank	0.0	66.2	13.2	0.2	0.0	0.0	0.0	0.0
Bilateral	51.9	95.5	34.4	18.1	32.2	29.9	30.8	28.0
Private Creditors	4.5	11.1	6.8	7.1	7.2	7.2	7.2	7.2
Suppliers	4.5	8.4	6.8	7.1	7.2	7.2	7.2	7.2
Financial Markets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Others a/	0.0	2.7	0.0	0.0	0.0	0.0	0.0	0.0
2. Private Non-Guar. LT	2.1	5.4	1.0	0.1	0.1	0.1	0.1	0.1
3. Total LT Disbursements	58.5	274.5	142.7	99.4	95.1	94.3	97.5	96.5
4. IMF Purchases	0.0	117.5	32.1	23.0	0.0	0.0	0.0	0.0
5. Net Short-Term Capital	0.0	0.0	-15.1	-15.2	-11.1	-11.9	-12.8	-13.7
6. Total incl. IMF & Net ST	58.5	392.0	159.7	107.2	84.0	82.4	84.7	82.8
B. Repayments b/								
1. Public & Publicly Guar. LT	15.7	161.8	43.8	41.3	32.9	28.6	26.1	25.1
Official Creditors	7.4	144.0	28.2	28.3	26.8	24.1	23.1	21.9
Multilateral	5.6	18.7	28.2	28.3	16.8	15.4	15.5	15.1
o/w World Bank	1.5	5.6	8.8	8.7	6.3	5.5	5.7	5.6
Arrears to IFIs	..	125.3	..	..	..	..	..	..
Bilateral	1.8	0.0	0.0	0.0	10.0	8.7	7.6	6.8
Private Creditors	8.3	17.8	15.6	13.0	6.1	4.5	3.0	3.2
Suppliers	0.8	14.8	12.7	10.1	3.2	1.6	0.1	0.2
Financial Markets	7.5	0.9	0.0	0.0	0.0	0.0	0.0	0.0
Other a/	0.0	2.1	2.9	2.9	2.9	2.9	2.9	3.0
2. Private Non-Guar. LT	11.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0
3. Total LT Repayments	27.3	161.8	43.8	41.3	32.9	28.6	26.1	25.1
4. IMF Repurchases	0.0	8.4	9.4	7.1	25.1	31.2	15.5	12.8
C. Interest								
1. Public & Publicly Guar. LT	8.1	113.8	9.3	9.1	7.4	6.5	5.8	5.5
Official Creditors	6.5	109.3	5.5	5.9	5.4	5.2	5.0	4.8
Multilateral	5.0	5.2	5.5	5.9	5.4	5.2	5.0	4.8
o/w World Bank	0.5	1.2	2.0	1.9	1.8	1.6	1.5	1.4
Arrears to IFIs	..	104.1	..	..	..	..	..	..
Bilateral	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Private Creditors	1.5	4.5	3.8	3.2	2.0	1.3	0.8	0.7
Suppliers	0.4	3.7	3.2	2.5	1.3	0.6	0.1	0.0
Financial Markets	1.1	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Other a/	0.0	0.5	0.6	0.7	0.7	0.7	0.7	0.7
2. Private Non-Guar. LT	3.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
3. Total LT Interest	11.3	113.8	9.3	9.1	7.4	6.5	5.8	5.2
4. IMF Service Charges	0.0	1.8	2.1	1.5	5.5	6.9	3.4	2.8
5. Interest on ST Debt	3.8	21.9	26.3	28.5	29.3	29.9	30.6	39.9
7. Total incl. IMF & Net ST	15.1	137.5	37.7	39.1	42.2	43.3	39.8	47.9

a / Refers to nationalization.

GUYANA - EXTERNAL CAPITAL AND DEBT (continued)

(US$ millions at Current Prices)

	Est.	Projected						
	1989	1990	1991	1992	1993	1994	1995	1996
D. Debt Service/Exports b_/								
1. Public & Publicly Guar. LT	9.7	105.2	16.9	14.5	10.0	8.0	6.8	6.1
2. Private Non-Guar. LT	6.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
3. Total LT Debt Service	15.8	105.2	16.9	14.5	10.0	8.0	6.8	6.0
4. IMF Repurchases+Serv.Chgs.	0.0	3.9	3.7	2.5	7.6	8.7	4.0	3.1
5. Interest only on ST Debt	1.6	8.4	12.2	12.0	10.0	9.5	9.2	10.7
6. Total (LT+IMF+ST+ Int.)	17.3	117.5	32.7	29.0	27.7	23.0	19.9	19.9
I. Interest Burden Ratios								
2. Total Interest/Exports b_/	6.2	52.5	12.0	11.2	10.5	9.9	8.4	9.6

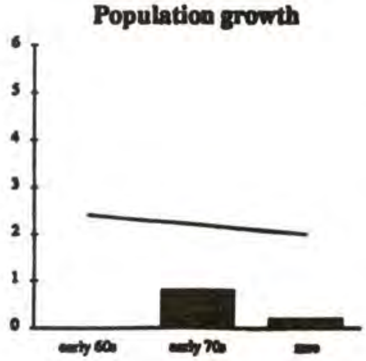
a / Includes debt service of newly disbursed funds.
b / Ratio to "Exports" with latter defined to include merchandise and non factor services.

Social Indicators of Development, 1989

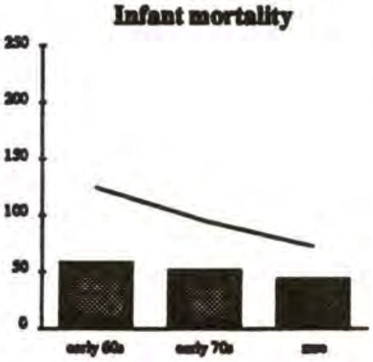
Guyana

	Unit of measure	25-30 years ago	15-20 years ago	Most recent estimate (mre)	Same region / income group: Latin America, Caribbean	Same region / income group: Low-income	Next higher income group
HUMAN RESOURCES							
Size, growth, structure of population							
Total population (mre = 1988)	millions	..	0.73	0.80	416	2,881	629
14 and under	% of pop.	..	43.8	35.4	36.9	35.4	38.3
15-64	"	..	52.8	60.2	58.6	60.2	57.4
Age dependency ratio	unit	1.06	0.89	0.65	0.71	0.66	0.74
Percentage in urban areas	% of pop.	29.2	29.6	33.4	72.6	34.2	56.1
Females per 100 males							
Urban	number	..	101	..	104	..	..
Rural	"	..	101	..	..	..	..
Population growth rate	annual %	..	0.8	0.2	2.0	2.0	2.2
Urban	"	..	1.0	2.2	3.2	3.7	3.5
Urban/rural growth differential	difference	..	0.2	2.7	3.7	2.2	2.5
Projected population: 2000	millions	..	..	0.77	516	3,625	805
Stationary population	"	..	..	0.85	..	..	..
Determinants of population growth							
Fertility							
Crude birth rate	per thou. pop.	37.4	32.8	27.1	28.7	30.4	31.5
Total fertility rate	births per woman	5.58	4.15	3.06	3.59	3.89	4.08
Contraceptive prevalence	% of women 15-49	..	35.0	..	..	57.4	..
Child (0-4) / woman (15-49) ratios							
Urban	per 100 women	..	63	..	..	..	..
Rural	"	..	63	..	..	..	..
Mortality							
Crude death rate	per thou. pop.	8.1	8.1	7.0	7.5	10.0	8.6
Infant mortality rate	per thou. live births	58.0	51.8	43.9	54.2	72.6	59.1
Under 5 mortality rate	"	..	..	56.0	65.0	174.8	96.5
Life expectancy at birth: overall	years	61.9	65.4	66.1	66.4	61.4	63.8
female	"	64.1	67.9	68.8	69.2	62.3	66.1
Labor force (15-64)							
Total labor force	millions	0.19	0.24	0.37	146	1,343	232
Agriculture	% of labor force	35.0	29.3	..	..	..	..
Industry	"	27.9	27.1	..	..	..	..
Female	"	19.8	22.8	24.9	26.6	36.0	31.2
Females per 100 males							
Urban	number	..	103	..	106	..	..
Rural	"	..	103	..	88	..	..
Participation rate: overall	% of labor force	28.9	30.6	36.3	35.0	49.2	39.0
female	"	11.4	13.9	18.1	18.5	34.9	23.5
Educational attainment of labor force							
School years completed: overall	years	..	..	6.8	..	..	..
male	"	..	..	..	..	..	..
NATURAL RESOURCES							
Area	thou. sq. km	215	215	215	20,396	36,997	17,083
Density	pop. per sq. km	..	3	4	20	76	36
Agricultural land	% of land area	6.3	6.4	8.0	36.3	36.1	38.3
Agricultural density	pop. per sq. km	..	53	46	55	211	94
Forests and woodland	thou. sq. km	182	182	164	9,776	9,154	5,449
Deforestation rate (net)	annual %	0.0	0.0	0.0	-0.5	-0.3	-0.7
Access to safe water	% of pop.	..	84.0	82.0	73.2	..	..
Urban	"	..	100.0	100.0	83.5	73.4	76.7
Rural	"	..	75.0	65.0	52.7	..	46.3

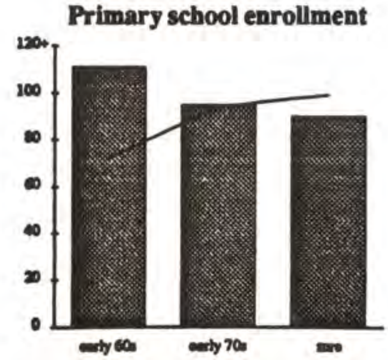
Population growth



Infant mortality



Primary school enrollment



■ Guyana — Low-income

Social Indicators of Development, 1989

Guyana

	Unit of measure	25-30 years ago	15-20 years ago	Most recent estimate (mre)	Same region / income group: Latin America, Caribbean	Same region / income group: Low-income	Next higher income group
INCOME AND POVERTY							
Income							
GNP per capita (mre = 1988)	US$	..	640	410	1,940	310	1,270
Total household income							
Share to top 10% of households	% of income	..	..	..	..	..	..
Share to top 20% of households	"	..	..	..	..	..	..
Share to bottom 40% of households	"	..	..	..	..	..	..
Share to bottom 20% of households	"	..	..	..	..	..	..
Poverty							
Absolute poverty income: urban	US$ per person	..	..	..	..	..	..
rural	"	..	..	..	..	..	..
Pop. in absolute poverty: urban	% of pop.	..	..	..	..	..	..
rural	"	..	..	..	..	..	..
Prevalence of malnutrition (under 5)	% of age group	..	32.1	..	..	..	..
EXPENDITURE							
Food	% of GDP	..	..	..	..	..	..
Staples	"	..	..	..	..	..	..
Meat, fish, milk, cheese, eggs	"	..	..	..	..	..	..
Cereal imports	thou. metric tonnes	43	62	53	17,643	27,738	36,712
Food aid in cereals	"	..	0	65	..	7,122	7,851
Food production per capita	1979-81=100	113.1	102.0	77.6	100.7	116.4	97.0
Share of agriculture in GDP	% of GDP	24.1	31.1	29.2	11.7	33.0	16.0
Daily calorie supply	calories per person	2,276	2,298	2,484	2,704	2,392	2,767
Daily protein supply	grams per person	56	56	60	69	57	70
Housing	% of GDP	..	..	..	..	..	..
Average household size	persons per household	..	5	..	..	..	..
Urban	"	..	..	..	..	..	..
Fixed investment: housing	% of GDP	..	..	..	..	..	..
Fuel and power	% of GDP	..	..	..	..	..	..
Energy consumption per capita	kg of oil equivalent	..	819.9	585.0	974.1	323.7	886.3
Households with electricity							
Urban	% of households	..	..	..	..	..	..
Rural	"	..	..	..	..	..	..
Transport and communication	% of GDP	..	..	..	..	..	..
Population per passenger car	persons	..	28	..	16	..	27
Fixed investment: transport equipment	% of GDP	..	..	..	..	..	..
Total road length	km	..	..	..	..	..	..
Population per telephone	persons	..	35	24	11	..	16
INVESTMENT IN HUMAN CAPITAL							
Medical care	% of GDP	..	..	..	..	..	..
Population per: physician	persons	..	4,000	6,220	933	1,462	1,547
nurse	"	..	..	885	875	1,746	..
hospital bed	"	..	200	300	..	756	..
Access to health care	% of pop.	..	..	88.8	..	..	..
Immunized (under 12 months): measles	% of age group	..	..	52.0	52.7	43.4	62.6
DPT	"	..	..	67.0	62.4	41.3	64.7
Oral Rehydration Therapy use (under 5)	% of cases	..	..	9.8	33.6	21.6	28.2
Education	% of GDP	..	..	..	..	..	..
Gross enrollment ratios							
Primary: total	% of school-age group	111.0	95.0	90.0	108.1	99.3	106.8
female	"	110.0	95.0	99.0	105.2	87.8	101.3
Secondary: total	"	53.0	54.0	55.0	48.8	33.4	52.0
female	"	50.0	55.0	62.0	52.7	26.1	51.8
Tertiary: science/engineering	% of tertiary students	27.3	31.3	17.4	..	..	..
Pupil-teacher ratio: primary	pupils per teacher	26	32	37	26	10	28
secondary	"	28	21	19	..	19	18
Pupils reaching grade 4	% of cohort	..	..	..	66.3	..	81.0
Repeater rate: primary	% of total enrollment	..	8.4	3.5	17.9	..	8.0
Illiteracy rate: overall	% of pop. (age 15+)	..	..	4.1	16.7	43.3	26.2
female	% of females (age 15+)	..	..	5.2	19.0	56.5	32.5
Newspaper circulation	per thou. pop.	..	..	88.8	81.2	20.4	79.3

Source: World Bank International Economics Department, September 1989.

TABLE 1

GUYANA: TOTAL FINANCING REQUIREMENTS

(In millions of U.S. dollars)

	1989	1990	1991	1992	1990-92
Trade balance	-27.2	-94.9	-51.1	-55.4	-201.4
Net services and transfers (excluding interest)	-2.5	-18.5	-12.8	1.0	-30.3
Increase in gross international reserves	-4.8	-9.1	-14.3	-10.0	-33.4
Leads and lags	0.0	1.3	-6.1	-1.8	-6.6
Subtotal	-34.5	-121.2	-84.3	-66.2	-271.7
Current debt service payments 1/	-42.3	-78.6	-102.9	-101.0	-282.5
IMF	-6.1	-10.2	-11.5	-8.6	-30.3
World Bank	-2.0	-6.8	-11.3	-11.2	-29.3
CDB	-0.1	-3.2	-5.0	-5.1	-13.3
Others (except rescheduled debt and new debt)	-33.1	-36.5	-48.8	-47.6	-132.9
Rescheduled Debt and Debt Subject to Rescheduling	-1.0	-19.1	-22.9	-23.3	-65.3
New debt	0.0	-2.8	-3.4	-5.2	-11.4
Arrears to the IFIs (June 1989)	0.0	-229.4	0.0	0.0	-229.4
IMF	0.0	-141.9	0.0	0.0	-141.9
World Bank	0.0	-57.0	0.0	0.0	-57.0
CDB	0.0	-30.5	0.0	0.0	-30.5
Total Financing Gap 2/	-76.8	-429.2	-187.2	-167.2	-783.6

1/ Net of amounts rescheduled or subject to rescheduling.

2/ Net of rescheduling.

TABLE 2

ANNEX I(a)
Page 2 of 2

GUYANA: IDENTIFIED FINANCING SOURCES

(In millions of US dollars)

	1989	1990	1991	1992	1990-92
Total Financing Requirement	76.8	429.2	187.2	167.2	783.6
(Reschedulings)	(783.0)	(452.0)	(21.0)	(19.0)	(492.2)
Project financing	60.2	106.6	92.2	104.5	303.3
Trade Credits & Others	-10.3	-1.6	0.0	0.0	-1.6
Required BOP Suppport	26.9	324.2	95.0	62.7	481.9
Financing from the IFIs 1/	0.0	222.0	68.1	35.5	325.6
IMF 2/	0.0	117.5	32.1	23.0	172.6
World Bank 3/	0.0	66.0	13.0	0.0	79.0
CDB	0.0	33.5	6.0	2.5	42.0
IDB	0.0	5.0	17.0	10.0	32.0
Identified bilateral sources	26.9	73.9	16.5	16.0	106.4
Other Sources of Finance	0.0	28.3	10.4	11.2	49.9
Sale of Public Enterprises	0.0	20.0	0.0	0.0	20.0
VIF Deposits	0	8.3	10.4	11.2	29.9
Financing Gap	0.0	0.0	0.0	0.0	0.0

1/ Bridge financing of US S229.4 million would be required to clear arrears of the IFIs as of end June 1990. A portion of the bridge equivalent to US $178 million would be repaid from the IFI disbursements July-Sept. 1990. The residual portion of the bridge will be funded from bilateral commitments.

2/ Equivalent to 266 percent of quota, with a mix of ESAF and general resources over the three-year period, with disbursements starting from 1990.

3/ The disbursement in 1990 assumes the total of first and second tranche releases of US$50 million and US$15 million respectively. It also includes US$1 million of retroactive disbursement from IDA project loans as BOP financing.

STATUS OF BANK GROUP OPERATIONS IN GUYANA

A. Statement of Bank Loans and IDA Credits as of March 31, 1990

Loan/Cr. Number	Fiscal Year	Borrower	Purpose		US$ Million Amount (Less Cancellation) Bank	IDA	Undisbursed
12 loans and 7 credits have been fully disbursed:					76.2	27.0	
of which SECALs, SALs and Program Loans a/							
1098-GUA	81	Guyana	Structural Adjustment			8.0	
1948-GUA	81	Guyana	Structural Adjustment		14.0		
			Subtotal		14.0	8.0	
1268-GUA	82	Gyana	Petroleum Exploration Promotion			2.0	1.1
1555-GUA	85	Guyana	Upper Demerara Forestry (Supplemental Credit)			8.8	3.7
1729-GUA b/	87	Guyana	Bauxite Industry Tech. Assist.			7.0	8.5
			Total (Net of Cancellations)		76.2	44.8	
			of which has been repaid		14.2	1.2	
			Total Held by Bank and IDA c/		62.0	43.6	----
			Amount Sold	0.8			
			of which has been repaid	0.8			
			Total Undisbursed d/				13.3

a/ Approved during or after FY80.
b/ Credit has not yet been signed.
c/ Book value (IBRD Current Value $82.4m; IDA Current Value $47.9m -- difference due to fluctuation in SDR/US$ exchange rate. Converted at rate prevailing at March 31, 1990).
d/ Current Value converted at SRD/US$ exchange rate prevailing at March 31, 1990.

B. Statement of IFC Investments as of March 31, 1990

Investment Number	Fiscal Year	Borrower	Type of Business	US$ Million Equity	Loan	Total	Total Held by IFC	Total Undisbursed
-	-	-	-	-	-	-	-	-

GUYANA: STRUCTURAL ADJUSTMENT CREDIT

SUPPLEMENTARY LOAN DATA SHEET

Section I - Timetable of Key Events

(a) The Government has with the assistance of Bank and IMF staff prepared a Policy Framework Paper (PFP) which outlines the Government's proposed measures for addressing economic problems over the medium term. The Guyana PFP was reviewed by the Committee of the Whole of the Bank and by the IMF Board in July 1988. Since July 1988, the Bank, through its leadership in the Consultative Group for Caribbean Economic Development (CGCED), has been engaged in mobilizing the necessary financial resources to support Guyana's proposed medium-term adjustment program. These efforts have been augmented through the Support Group for Guyana, chaired by Canada, formed in late November 1988.

(b)	Preappraisal mission	November 1988
(c)	Appraisal mission	May 1989
(d)	Post-Appraisal mission	April 1990
(e)	Completion of negotiations	May 1990
(f)	Planned date of effectiveness	July 1990

Section II - Special Bank Implementation Actions

The Government's wide-ranging efforts at structural adjustment have stretched the implementation capacity of an already weak institutional structure. The steady outmigration of professional, technical and managerial personnel has aggravated the situation. To ensure timely implementation of the credit conditions, IDA will provide technical support under a parallel Technical Assistance Credit (TAC).

Section III - Special Conditions

Effectiveness of the credit, which will permit use of the first tranche of US$50.0 million equivalent, is subject to no special conditions over and above the several policy measure's that were adopted prior to Board presentation. Release of the second and third tranches of US$15.0 million and US$13 million respectively would be contingent upon significant and satisfactory progress made by the Government in implementing the structural adjustment program, notably in complying with the following specific conditions for each tranche release.

Conditions for Release of Second Tranche

Macroeconomic Framework

Favorable Bank assessment of the macroeconomic framework, including international competitiveness.

Domestic Pricing

(a) Implementation of pricing policies in rice, sugar, electricity, petroleum and public transportation as per formulas agreed with IDA; and

(b) Complete the preparation of a least cost expansion program for electricity supply for 1990-99.

Trade Policy

(a) Import licenses will be issued automatically by the Ministry of Trade for all transactions within two working days for all applications not requiring government foreign exchange and import licenses will be processed within seven working days for applications requiring foreign exchange from the Bank of Guyana (excluding those in the prohibited list);

(b) One-half of the items from the prohibited list except for non-processed meat, poultry, fruit and fruit preservatives will have been removed.

Central Government

(a) Commission management audits of the civil service based on the findings of the public service review, under terms of reference satisfactory to IDA.

Current Transfers

(a) End all central government transfers to public enterprises from the 1990 budget onwards except for the Guyana Electricity Corporation and for maintenance expenditures of public enterprises to be fully divested.

Public Enterprises

(a) PCS: Put into effect an action program and schedule for carrying out the corporate strategy for the PCS group: and

(b) Operating procedures and auditing systems satisfactory to IDA to be established to monitor the financial performance of GUYMINE, GUYSUCO and PCS, and transfer of targeted amounts to these enterprises to the Central Government.

PSIP

(a) Review of rolling PSIP satisfactory to IDA: and

(b) Implementation of institutional arrangements satisfactory to IDA, for strengthening the capacity of the State Planning Secretariat by filling all vacancies for planners in the Project Cycle Unit to provide guidelines on project preparation to line ministries and government agencies and to evaluate and monitor projects included in the PSIP.

Conditions for Release of Third Tranche

Macroeconomic Framework

Favorable Bank assessment of the macroeconomic framework, including international competitiveness.

Domestic Pricing

(a) Complete study and initiate an IDA-agreed action program for improving private sector rice exports;

(b) Prepare an electricity tariff schedule for all categories of services with rates equal to at least the long-run marginal costs on the basis of an externally financed least-cost expansion program and a schedule for implementation satisfactory to IDA; and

(c) Complete and review with IDA the Master Plan to rehabilitate the Georgetown Water Supply system.

Trade Policy

(a) Remaining items to be removed from the prohibited list of imports will have been removed except for non-processed meat, poultry, fruit and processed fruit items; and

(b) Begin implementation of an IDA-agreed program to reduce import duty exemptions, except those required by regional and other international agreements or those intended to provide fiscal incentives for new investments in the form of exemptions up to five years renewable once for the same period thereafter.

Other Incentives

(a) Completed a study on consumption taxes in accordance with terms of reference satisfactory to the Association, and adopted a program satisfactory to IDA to address deficiencies in the application and administration of consumption taxes identified in such study.

Central Government

(a) Begin implementing a program satisfactory to IDA, to eliminate any overlapping functions and noncritical vacancies identified in the management audits.

PSIP

(a) Review of rolling PSIP satisfactory to IDA.

GUYANA - STRUCTURAL ADJUSMENT CREDIT

COVERAGE OF IMF AND BANK PROGRAMS

Macroeconomic stabilization	-	IMF would take the lead through exchange rate, fiscal, monetary and wage policy reforms. IDA would make an assessment of macroeconomic policies taking into account the findings of the IMF.
Restoration of incentives and strengthening of competition to promote economic growth	-	IDA's proposed SAC includes domestic pricing, trade policy (import licensing, QRs, tariffs and export pricing) and procedural reforms designed to complement the producer incentives generated by an appropriate exchange rate regime. The Government/IMF program also includes some components of trade policy (import licensing and review of QRs). IMF program includes the passthrough of price increases following the devaluation. IDA's main concern, however, would be to ensure that domestic pricing provides adequate producer incentives needed for medium-term growth.
Reduction of public sector deficit	-	IMF: fiscal policy reforms under the program will be complemented by the proposed SAC through conditionality on central government employment, elimination of current transfers to public enterprises and resource mobilization and divestment targets for public enterprises.
Rehabilitation of economic infrastructure	-	IDA: the public sector investment program (PSIP) to be agreed under the proposed SAC will assign high priority to investments needed to rehabilitate economic infrastructure. The PSIP will also include a few projects to rehabilitate social infrastructure.
Institutional strengthening	-	IDA's proposed TAC will help strengthen the central ministries and departments through advisors and training and thereby assist in the implementation of the SAC and IMF's program.
Alleviation of the social impact	-	IDA's proposed operation in the social sectors will help address the social cost of adjustment.

IN REPLYING QUOTE DATE
HEREOF AND NO..........

- 49 -

MINISTRY OF FINANCE,
P.O. BOX 757,
Main & Urquhart Streets,
Georgetown,
Guyana.

June 4, 1990

Mr. Barber B. Conable
President
World Bank
1818 H Street, N.W.
Washington, D.C. 20433

Dear Mr. Conable:

GUYANA: Government Policy Statement on Structural Adjustment

1. The Government of the Co-operative Republic of Guyana requests from the International Development Association (IDA) a Structural Adjustment Credit (credit) to support its economic recovery programme over the medium term.

2. The main objectives of the Government's programme are to: restore economic growth over the medium term; eliminate internal and external imbalances; incorporate the parallel economy into the official economy; and normalize Guyana's financial relations with external creditors. The attainment of these objectives will require the restoration of incentives through a realistic exchange rate regime, removal of price distortions, sequential trade liberalization, promotion of private sector development, and improvement of the public sector finances through streamlining the civil service, increased generation of surpluses from public enterprises and the implementation of a divestment programme. In addition, rehabilitation of basic infrastructure will be critical for supporting increased exports and private investment. Thus, the financing and implementation of a public sector investment programme (PSIP) consistent with the macroeconomic framework will be essential. The implementation of a Social Impact Amelioration Programme is desirable in order to protect groups that are particularly vulnerable to the adjustment measures and in order to maintain public support for the economic recovery programme.

Recent Economic Developments

3. As you may be aware, Guyana's economy is based mainly on the production and exports of bauxite, sugar and rice. Extensive mineral and timber resources remain unexploited partly because of underdeveloped infrastructure. Given the country's topography and the uneven distribution of its relatively small population, the cost of meeting Guyana's infrastructural needs are substantial on a per capita basis. Furthermore, economic activity has been constrained by a difficult physical environment, sharp fluctuations in output stemming from the vulnerability of the economy to exogenous factors, and weak economic management.

4. Economic performance during the 1970s was mixed. During the first half of the decade, GDP grew by about 4% per annum in real terms as a result of the rapid growth in Government expenditures and favorable prices for Guyana's major export commodities. Per capita income increased by about 6% per annum, resulting from a rapid expansion in consumption and investment and the period was characterized by a rapid expansion of the public sector, made possible by the windfall gains associated with sugar production. This was followed by economic decline as a result of the fall in sugar prices, the weakening in the demand for Guyana's main exports, and reduced output notably in the case of sugar and bauxite during the period 1975-80 . As a result, the terms of trade fell by over 30% during 1975-80, wiping out the gains achieved in the first half of the decade.

5. Guyana's real gross domestic product decreased at an average annual rate of 6% during 1981-83. Following a turnaround in 1984, however, economic growth averaged about 1% per year in 1984-87, but was not sufficient to offset the decreases in preceding years. The level of recorded output in 1987 was thus some 15% below that of 1980. Throughout most of the period 1981-87, Guyana's principal productive sectors which had hitherto accounted for about one third of GDP, and 80% of merchandise exports, encountered a number of technical, organizational and financial problems and in the case of sugar and rice, adverse weather conditions. Reduced foreign exchange earnings cut into the country's capacity to acquire imported inputs and led to considerable capacity under-utilization, raising unit costs of production and further reducing financial profitability of various operations.

6. Despite the modest upturn in production during 1984-87, the period was marked by a low level of aggregate resource availability, an increasing divergence between the investment and savings rates especially of the public sector and, correspondingly, an increasing dependence on foreign borrowing. The public sector finances deteriorated markedly during 1981-86, although a reversal of this trend occurred in 1987.

7. Guyana's external trade and payments situation remained extremely weak during 1981-87. As a result, the balance of payments deteriorated and Guyana was unable to meet its external payments obligations. In 1988, the economy witnessed a further setback, with real GDP declining by about 3%. As of December 1988, Guyana's total external debt stood at about US$1.8 billion, equivalent to 670% of exports.

The Government's Response

8. During 1984-88, the Government took a number of measures relating to the exchange rate regime and the public sector operations aimed at increasing output and exports and reducing imbalances. Although these measures were in the right direction, they did not produce the desired results given the severity of the country's economic problems. Guyana's export volume remains below the levels of the mid-1970s while imports continue to be compressed. In addition, the capital stock of the economy continues to deteriorate and the state of disrepair of physical infrastructure has resulted in serious bottlenecks which impair increases in production. The period has also witnessed a decline in the standard of living which has led to an exodus of managerial, professional and technical

personnel and thus to a shortage of skills at all levels. Meanwhile, major weaknesses continue to exist in the public sector and need to be addressed.

9. In mid-1988, the Government, with the assistance of the World Bank and IMF staff, prepared a Policy Framework Paper (PFP) which outlined the Government's proposals for addressing the problems of the economy over the medium term. In early August 1988, price controls were removed from a number of items except for petroleum products, public transportation, rice, sugar and a few other essential commodities. Import prohibitions were also removed on all items except for food products, on grounds of the national objective of food security through self-sufficiency. In addition, the licensing of "no funds" imports, i.e., those not involving the use of official foreign exchange, was liberalized beginning September 1, 1988. In the fiscal area, some measures to raise tax revenues were implemented; Guyana Timbers Limited was sold in early 1989, and actions were taken to close down one loss-making public enterprise. In July 1988, the Government issued a document setting out the incentives available to the private sector and in August 1988, Guyana joined MIGA. On the sectoral front, the Government has taken a number of steps to improve the bauxite industry, including securing a European Development Fund Loan to rehabilitate the industry, and discussions with Reynolds International of United States of America and ALCAN of Canada about possible joint ventures. In February 1989, Reynolds International signed an agreement with the Government to commence mining, marketing and sales of bauxite. Discussions are also underway with Booker Tate of United Kingdom to obtain management assistance for the sugar industry while the operation of Guyana's international airport has been contracted with British Airport Services Group. Also, discussions are in progress with a US company on the sale of 80% of the Government's equity in the Guyana Telecommunications Corporation.

The Stabilization Program

10. The essential components of the Government's stabilization program include further reforms in exchange rate regime as well as in fiscal, monetary and income policies. Following a significant devaluation of March 31, 1989 (230% in G$ terms), the prices of controlled items were adjusted in order to pass through the effects of the devaluation. The program initially called for the implementation of a flexible exchange rate policy to help ensure external competitiveness and protect the balance of payments. However, considering the difficult industrial relations conditions that resulted from the 1989 devaluation, and the less than expected flow of external resources, the Government decided not to adjust further the official exchange rate despite the prevalence of a large margin relative to the parallel rate (50%). Instead, the Government enacted the Dealers in Foreign Currency (Licensing) Act of 1989 which legalized a large volume of transactions in the parallel market. At the same time, the Government moved a number of items to the newly legalized market. As of April 1990, 15 Exchange Houses (or cambios) were in operation. The Government intends to move more items to the cambio market and to unify the exchange rate system, in stages, by March 31, 1991. To guarantee exporters a minimum of foreign exchange for importation requirements, the Bank of Guyana had established foreign exchange retention schemes that allow selected exporters to retain a certain percentage of export proceeds. However, with the eventual unification of the official exchange rate system and the liberalization of exchange restrictions, the retention

schemes will be abolished. Thereafter, foreign exchange for all payments will be provided on the basis of availability.

11. The Government will undertake fiscal policies aimed at reducing the overall public sector deficit, consistent with a sustainable balance of payments position and increased public sector savings over the medium term. Measures to increase revenues include the improvement of tax administration and a broadening of the tax base, addressing deficiencies in the application and administration of consumption taxes, and reducing tax exemptions. The objective is to enhance revenue, minimize disincentives, improve resource allocation and incorporate the parallel economy into the official economy. Measures to reduce expenditures will include: the close monitoring by sector of recurrent funding requirements on supplies and materials to seek further savings; the termination of transfers to public corporations, except to the Guyana Electricity Corporation; the restraining of increases in public sector wages and salaries; and the strengthening of budgeting, monitoring and fiscal reporting procedures.

12. The prime interest rate was increased from 15% to 35%, but was reduced to 30% as of April, 1990. It will be maintained at a positive real level, taking into account the expected domestic inflation and interest rates in the international market. The Government will abstain from from establishing selective credit policies.

13. To protect external competitiveness and help reduce inflation a restrained wage policy will be implemented. The increase in nominal wages would not exceed the domestic inflation rate in 1990-91. Merit increases will be based on productivity increases and the overall financial situation of each public sector enterprise. Wages in the private sector, with the exception of that of some non-unionized workers, would continue to be freely determined.

The Structural Adjustment Programme

14. The structural adjustment programme aims to improve the incentive framework for private sector development, reducing the public sector deficits and implementing a realistic and viable public sector investment programme (PSIP), all of which are designed to improve the supply side conditions needed for sustainable economic growth.

15. The reforms to restore an adequate incentive framework include domestic pricing, trade policy and improved fiscal incentive procedures. All prices except for those relating to rice, sugar, electricity, petroleum and public transportation will be maintained free of controls during and beyond the programme period. New pricing mechanisms will be implemented according to the following criteria: the domestic prices of rice will reflect the international prices at the recently legalized market exchange rate; the domestic price of sugar will be set to cover the c.i.f. and other aquisition costs of imported sugar; information from the ongoing study to formulate a least-cost expansion programme will be used to develop rates for the sale of electricity equal to at least the long-run marginal cost and will be put into effect in the context of the implementation of the power sector expansion programme; petroleum product prices will be set to cover all foreign and local costs; and public transportation fares will be set to cover all operating costs including depreciation.

16. With respect to trade policy, import licenses will be issued within two working days for all applications not requiring government foreign exchange; and processed within seven days for all applications requiring foreign exchange from the Bank of Guyana (excluding items in the prohibited list). The list of prohibited imports will be reviewed with a view to progressively reducing the list and eliminating all such prohibited items by September 1991, except for non-processed meat, poultry, fruit and processed fruit items. The Government has also decided to eliminate import duty exemptions, except those required by regional and other international agreements or those intended to provide fiscal incentives for new investments in the form of exemptions up to five years renewable once for the same period thereafter. As regards other incentives, the Government has decided to study the existing consumption tax structure and to adopt a program to address deficiencies in the application and administration of consumption taxes identified in such study, subject to the revenue requirements to meet the Central Government's current balance targets.

17. In order to support private investment, procedures have been streamlined to reduce the average processing time from 10 weeks to 5 weeks for consideration and decisions on fiscal incentives for new projects.

18. A reduction in the Central Government non-interest current expenditure in real terms will be achieved through further streamlining, following the implementation of the recommendations of the public service review, currently under way.

19. As regards the Central Government budget, from 1990 and onwards, no transfers to the public enterprises (PEs) will be made, with the possible exceptions of the Guyana Electricity Corporation, and maintenance expenditures for those enterprises to be divested. In addition, no new PEs will be established during 1990-92 except for those resulting from the rationalization process as defined in the strategy statements of GUYSUCO and the PCS group of enterprises and/or joint ventures of private or foreign firms with existing PEs. Nonviable public corporations will continue to be closed or divested. Operating procedures and auditing systems to monitor the financial performance of the PEs are being instituted. The payment of taxes, dividends and transfers from PEs to the Central Government will be enforced. In general, the above mentioned actions will be aimed at improving the primary current account balance (before interest payments) of the non-financial public sector from 18% of GDP in 1989 to 22% of GDP in 1990 and to about 30% of GDP in 1991. However, the overall public sector deficit will increase from 48% of GDP in 1989 to about 54% of GDP in 1990, owing to increased interest payments, increased capital expenditure and the impact of the devaluation upon the foreign component of the PSIP, but will be reduced to 41% of GDP in 1991.

20. A corporate strategy has been developed for the enterprises under the Public Corporations Secretariat with a view to determining which enterprises will be kept within the Government's control and which should be offered for joint ventures or for outright sale to the private sector. An action program and an implementation schedule have been established and will be carried out. In the case of the Guyana Sugar Corporation (GUYSUCO), the Government and Booker PLC of United Kingdom plan to develop during 1990 a detailed agreement which will: (a) make arrangements for Booker Tate to provide management services and technical assistance to

GUYSUCO; and (b) make possible a range of investments through equity and loans, including the conversion into equity of the Government's debt to Booker. In regard to GUYSUCO's non-sugar activities, separate accounting and management will be implemented and joint ventures will be sought.

21. The size and composition of the PSIP for 1990-92 will be reviewed periodically to ensure its consistency with the stated objectives of the program, projected domestic and foreign resources availability and implementation capacity. Special attention will be given to the adequate costing of projects to project disbursements and to the economic and social criteria for the inclusion of new projects. The State Planning Secretariat will be adequately staffed to provide guidelines for project preparation to the line ministries and government agencies and for evaluation and monitoring of projects. Additionally, the management of external aid will be strengthened through the services of an advisor at the Office of Budget in the Ministry of Finance to facilitate procurement and disbursement of funds provided by bilateral and multilateral donors.

The Social Impact of Adjustment

22. Donor assistance for the Social Impact Amelioration Programme (SIMAP) has, so far, remained well below the levels of support indicated at the Special Donors Meeting of July 1989. The Government remains convinced of the need for urgent assistance in cushioning the most vulnerable groups from the adverse consequences of the adjustment and proposes to explore the possibility of assistance from a wider range of potential donors. In this regard, it has strengthened its internal arrangements. A SIMAP Coordinating Committee has been established. This Committee is chaired by the Ministry of Culture and Social Development (MCSD) and includes representation from the Ministry of Finance and the State Planning Secretariat. The Committee and the related agencies are promoting local community and NGO participation in the design and implementation of suitable projects. In addition, the MCSD has been staffed to support the implementation of programmes.

23. In view of the measures being taken, the Government of the Co-operative Republic of Guyana would appreciate your favorable consideration of its request for the provision of a Structural Adjustment Credit. We thank you for your efforts through the Consultative Group for Cooperation in Economic Development and through participation in the Guyana Support Group to raise the external financing required to support the Government's economic recovery programme. We look forward to a continuing exchange of ideas with IDA and the World Bank and to the opportunity to discuss on a continuous basis the progress made in implementing the above reforms.

Yours Sincerely,

Carl B. Greenidge, M.P.
Minister of Finance.

GUYANA: STRUCTURAL ADJUSTMENT CREDIT

THE SOCIAL IMPACT AMELIORATION PROJECTS

1. SIMAP projects are designed initially as short-term interventions of 6 to 24 months, with a funding ceiling of US$10 million. However, if funds are available, some projects would be extended, particularly those that develop human resources (nutrition, health and training) and facilitate increased household incomes.

2. To solicit projects, the SIMAP Coordinating Committee (SCC) distributed preparation guidelines to central Ministries, agencies, Towns and Regions. Hundreds of project proposals were received and reviewed by the SCC. Those selected balance proposals needs and geographical distribution over the five Towns and ten Regions including the hinterland areas inhabited by native Amerindians. Community and NGO participation in project generation and implementation is being promoted. Unless otherwise noted, projects will be managed by central, regional and local governments. Some government projects will be contracted to private firms, especially infrastructure rehabilitation and construction.

3. Labor intensive employment schemes in infrastructure rehabilitation and development constitute 68% of total program costs. Work will be mainly manual, using spades, pickaxes, shovels and hired tractors and trailers to restore and extend neglected social and physical infrastructure. Several employment projects aim to improve sanitation and the environment. Other projects would develop aim to improve sanitation and the environment. Other projects would develop human capital through nutrition (16% of total project costs), training (14%) and health (1%). The status of project readiness varies; some could begin implementation immediately, while others could within a few months.

GUYANA: STRUCTURAL ADJUSTMENT CREDIT

SUMMARY OF TECHNICAL ASSISTANCE

1. This Annex summarizes the technical assistance to be provided under a separate Technical Assistance Credit (TAC) to assist the Government in:

(i) implementing the adjustment measures under the proposed SAC; and

(ii) implementing a social impact amelioration program (SIMAP) to cushion the social cost of adjustment.

2. Project Objectives. The TAC will ensure that government policymakers have the knowledge and expertise required to attain SAC objectives: (i) improvements in the incentive framework, (ii) public sector reform, (iii) improved public sector investment, (iv) amelioration of the social impacts of adjustment, and (v) improved macroeconomic management. The TAC will strengthen the public sector agencies responsible for implementing the SAC by providing special studies and highly-skilled professionals; equipment including vehicles and training will also be provided to ensure that agencies develop improved management and analytic capacity to ensure a smooth transition at the project's end.

3. Project Description. The project will support the Statistical Bureau and several offices in the Ministry of Finance (MOF), Ministry of Culture and Social Development (MCSD), State Planning Secretariat (SPS), Public Corporations Secretariat (PCS). The Monitoring and Coordinating Unit (MCA) in the Ministry of Finance has the responsibility for coordinating, advising and overseeing the provision of project-funded assistance to other government offices critical for the attainment of SAC policy conditions.

4. The project will provide technical assistance in the form of short-term and long-term consultants to work with local staff, equipment, vehicles, special studies, and training. Technical assistance will be provided to improve the incentive framework through the funding of special studies on consumption taxes. Public sector reform will be supported by improving financial monitoring and divestment activities of the State Planning Secretariat and the Public Corporations Secretariat. The Public Sector Investment Program will be strengthened by improving the evaluation and planning capacity of the Project Cycle Unit in the SPS, responsible for formulating the PSIP. In addition, the TAC will improve the expeditious use of external aid through assistance to the Division of Multilateral Financial Institutions in the MOF, responsible for aid coordination, the Bank of Guyana, and the Ministry of Trade and Tourism. Implementation of the emergency SIMAP program will be assisted by helping the Ministry of Culture and Social Development and SPS to improve target efficiency of SIMAP programs. Almost all technical assistance provided under the TAC will contribute to macroeconomic management. In addition to the assistance listed above, the project will improve the overall coordination of macreconomic policy advice provided by the MCA and improve macroeconomic information provided by the Statistical Bureau.

5. The Policy Framework Paper agreed by the Government of Guyana, the IMF, and the Bank stipulated the adoption of a number of adjustment measures prior to Board presentation of the SAC. Implementation of these measures requires technical assistance for improvement in public sector management capacity. To provide this technical assistance prior to TAC effectiveness, the UNDP has agreed to a bridging operation in which it fills several high level consulting positions, anticipated under the TAC, using terms of reference agreed to by the Government and the Bank. The TAC will fund those positions retroactively.

6. The total cost of the project is estimated at about US$3.1 million, of which US$3.0 million will be provided under the IDA credit. The terms of reference (TOR) for the consultants were agreed during negotiations and are available in the Project File. The consultants will be selected in accordance with Bank guidelines. Contracting of the consultants will be handled by the MCA on behalf of the Government.

Long-term Consultant Positions to be Provided by the Technical Assistance Credit in Support of the Structural Adjustment Credit

7. Macroeconomic advisor to the head of the Monitoring and Coordinating Unit (MCA) located in the Ministry of Finance. This advisor will have overall responsibility for assessing macroeconomic trends in the economy, improving coordination of macroeconomic information and providing analyses and policy advice to the Ministry of Finance. In addition, the advisor will collaborate with other government agencies to ensure implementation of the Government's Economic Recovery Program.

8. Advisor to the State Planning Secretariat on formulation and monitoring of the Public Sector Investment Program to ensure consistency in terms of size and composition to the Borrower's macroeconomic framework, objectives and funding.

9. Advisor to the State Planning Secretariat on financial and operational monitoring of public enterprises and monitoring corporate development strategy of the independent public enterprises.

10. Advisor to the Public Corporation Secretariat on corporate development strategy, including divestment, and financial monitoring of the enterprises under the PCS.

11. Advisor to the Project Cycle Unit of the SPS to strengthen its capacity to do economic evaluation and cost analysis of proposed investment projects.

12. Advisor to the Ministry of Finance, Bank of Guyana and the Ministry of Trade and Tourism on coordination of multilateral and bilateral external finance and disbursement, to be located in the Division of Multilateral Financial Institutions under the Office of the Budget. This individual will have responsibility for facilitating procurement and disbursement of lines of credit provided by bilateral and multilateral donors for project finance and balance of payments support.

Short-Term Consultant position to be provided by the Technical Assistance Credit in Support of the Structural Adjustment Credit

A. Incentive Framework

13. Analysis of the consumption tax structure to identify deficiencies in its application and administration and develop recommendations to address such deficiencies.

B. Macroeconomic Management

14. Provision of a procurement agent to ensure compliance with Bank Group guidelines and preparation of needed documentation for draw down of the SAC.

C. Social Sector Program

15. Assist the State Planning Secretariat and the Ministry of Culture and Social Development in analyzing the distribution effects of the Economic Recovery Program and the target efficiency of SIMAP and other social programs in ameliorating the effects and make recommendations for measures to improve target efficiency.

GUYANA - STRUCTURAL ADJUSTMENT CREDIT

POLICY MATRIX

Policy Areas	Actions Taken by the Government as of end 1989	Actions Taken Prior to Board Presentation	Actions to be Taken Prior to Second Tranche Release	Actions to be Taken Prior to Third Tranche Release
Macroeconomic Framework				
Guyana continues to face major macroeconomic imbalances. These stem largely from an inappropriate mix of exchange rate fiscal, monetary and wage policies.	In April 1989, Guyana began implementing an IMF-monitored program which included a major devaluation (230% in G$ terms), price pass throughs, interest rate adjustments, public expenditure controls and wage restraint. Legislation was also enacted in late 1989 to legalize a large volume of transactions in the parallel market through exchange houses or cambios.	Favorable Bank assessment of the macroeconomic framework, including international competitiveness.	Favorable Bank assessment of the macroeconomic framework, including international competitiveness.	Favorable Bank assessment of the macroeconomic framework, including international competitiveness.
Incentive Framework The incentive framework has been eroded by the failure to correct an overvalued exchange rate, price distortions and the lack of a clear role for the private sector.	In early August 1988, price controls were removed from a number of items, except for petroleum products, transportation, rice, sugar and a few other essential items. Import prohibitions were also removed on all items except for food products, on grounds of the national objective of food security through self-sufficiency as agreed in the PFP. In addition, and in compliance with the PFP, the licensing of "no funds" imports, i.e., those not involving the use of official foreign exchange, was liberalized beginning September 1, 1988, so as to allow private individuals to import without licenses, items for their own use. Also, in July 1988, the Government issued a document setting out the incentives available to the private sector.	**Domestic Pricing** (a) Agreement to put into effect pricing policies on rice which will reflect the international price of equivalent grades of rice calcuated at an exchange rate acceptable to the Association; (b) Agreement to set the domestic wholesale price of sugar to cover the c.i.f. Georgetown and other acquisition costs of imported sugar including handling, transportation, and storage costs;	**Domestic Pricing** (a) Implementation of pricing policies in rice, sugar, electricity, petroleum and public transportation as per formulas agreed with IDA;	**Domestic Pricing** (a) Complete study and initiate an IDA-agreed action program for improving private sector rice exports.

GUYANA - STRUCTURAL ADJUSTMENT CREDIT

POLICY MATRIX

Policy Areas	Actions Taken by the Government as of end 1989	Actions Taken Prior to Board Presentation	Actions to be Taken Prior to Second Tranche Release	Actions to be Taken Prior to Third Tranche Release
		(c) Agreement on setting electricity tariffs to cover the full cost of operations including depreciation. Agreement to be reached on developing a 10-year least cost expansion program which will provide the information for setting of electricity tariffs based on long-run marginal costs; (d) Agreement on developing a plan to rehabilitate the Georgetown Water Supply System; (e) Agreement on petroleum product prices (except kerosene) to cover c.i.f. price and local acquisition costs including depreciation; (f) Agreement on public transportation prices to cover operating costs, including depreciation.	(b) Complete the preparation of a least cost expansion program for electricity supply for 1990-99.	(b) Prepare an electricity tariff schedule for all categories of services with rates equal to at least the long-run marginal cost calculated on the basis of an externally financed least-cost expansion program and a schedule for implementation satisfactory to IDA. (c) Complete and review with IDA the Master Plan to rehabilitate the Georgetown Water Supply system.
		Trade Policy	**Trade Policy**	**Trade Policy**
		(a) Agree that the remaining items on the prohibited list will be removed, with the exception of non-processed meat, poultry, fruit and processed fruit items.	(a) Import licenses will be issued automatically by the Ministry of Trade for all transactions within two working days for all applications not requiring government foreign exchange and import licenses will be processed within seven working days for applications requiring foreign exchange from the Bank of Guyana excluding those in the prohibited list; (b) one-half of the items from the prohibited list except for non-processed meat, poultry, fruit and processed fruit items will have been removed.	(a) Remaining items to be removed from the prohibited list of imports will have been removed except for non-processed meat, poultry, fruit and processed fruit items.

GUYANA - STRUCTURAL ADJUSTMENT CREDIT

POLICY MATRIX

Policy Areas	Actions Taken by the Government as of end 1989	Actions Taken Prior to Board Presentation	Actions to be Taken Prior to Second Tranche Release	Actions to be Taken Prior to Third Tranche Release
				(b) Begin implementation of an IDA agreed program to reduce import duty exemptions, except those required by regional and other international agreements or those intended to provide fiscal incentives for new investments in the form of exemptions up to five years renewable once for the same period thereafter.
				Other Incentives
				(a) Completed a study on consumption taxes in accordance with terms of reference satisfactory to the Association, and adopted a program satisfactory to IDA to address deficiencies in the application and administration of consumption taxes identified in such study.
		Procedural Reforms		
		(a) The Government will streamline procedures to reduce the average processing time for the consideration and decision on fiscal incentives for new projects from ten weeks to five weeks by increasing te frequency of the Fiscal Incentives Committee (FIC) meeting held at GUYMIDA, and shortening the time within and between core steps which include: review by the relevant sector ministry; discussion of the project at the FIC;		

GUYANA - STRUCTURAL ADJUSTMENT CREDIT

POLICY MATRIX

Policy Areas	Actions Taken by the Government as of end 1989	Actions Taken Prior to Board Presentation	Actions to be Taken Prior to Second Tranche Release	Actions to be Taken Prior to Third Tranche Release
		and formal approval of fiscal incentives by the Ministry of Finance. A specific processing schedule would be agreed upon.		
Public Sector Reforms Guyana's economic problems also stem largely from an over-extended and inefficient public sector responsible for a significant deterioration of public finances. The public sector consists of the central government, the National Insurance service and about 33 public enterprises. Together they employ a total of about 75,000 persons--nearly 40% of them in the Central Government and the balance in public enterprises and financial institutions. The Central Government deficit stood at an unsustainable level of 27% of GDP in 1988. This is largely attributable to interest payments, the sluggish growth of revenues, owing to recent declines in real economic activity, the growth of the parallel economy (which is outside the revenue collecting system) and current transfers to public enterprises.	In the fiscal area, some measures to raise tax revenues were implemented in 1988, including the Fiscal Enactment (Amendment) Bill 1988 and the Consumption Tax (Amendment) Order 1988 (para. 42 of PFP). Also, actions have been taken to close down two loss-making public enterprises; the Glass Factory has been closed down and the Public Transportation Corporation is in the process of being closed down. These actions, in part, helped the GUYSTAC group of 27 public enterprises (in the areas of agriculture, industry, trading, transportation and utilities) to increase its overall surplus from 1% of GDP in 1987 to 4.5% of GDP in 1988. On the sectoral front, the Government has taken a number of steps to improve the Bauxite industry including the securing of a SYSMIN intervention to rehabilitate the industry, and discussions with Reynolds (USA) and ALCAN (Canada) about possible joint ventures.	**Central Government** (a) A public service review (PSR) will be undertaken with a view to identifying overlapping functions and noncritical vacancies in the civil service (i.e., positions not directly related to output growth); (b) Agreement on ending all Central Government transfers to public enterprises from the 1990 budget onwards, except for the Guyana Electricity Corporation and for maintenance expenditures of public enterprises to be fully divested.	**Central Government** (a) Commissioned management audits of the civil service based on the findings of the PSR, under terms of reference satisfactory to the Association; **Current Transfers** (a) End all central government current transfers to public enterprises from the 1990 budget onwards except for the Guyana Electricity Corporation and for maintenance expenditures of public enterprises to be fully divested.	**Central Government** (a) Begin implementing a program satisfactory to the Association, to eliminate any overlapping functions and noncritical vacancies identified in the management audits.

GUYANA - STRUCTURAL ADJUSTMENT CREDIT

POLICY MATRIX

Policy Areas	Actions Taken by the Government as of end 1989	Actions Taken Prior to Board Presentation	Actions to be Taken Prior to Second Tranche Release	Actions to be Taken Prior to Third Tranche Release
		Public Enterprises	Public Enterprises	
The three traditional sectors of the economy, i.e. bauxite, sugar and rice are dominated by the Guyana Mining Enterprise Limited (GUYMINE), and Guyana Sugar Corporation (GUYSUCO) and the Guyana Rice Group (GRG). Together they account for about 30% of GDP and 83% of total merchandise exports. Their financial structures remain extremely weak, and thus hampering their operational efficiency.		(a) GUYSUCO: Agree on a strategy statement and timetable for setting up separate accounting and management and attracting private investment for sugar production and for non-sugar activities, i.e. rice production, dairy development, aquaculture and orchard development; (b) PCS: Agree on a corporate strategy for the PCS group with a view to determining which enterprises should be kept within the Government's control to meet strategic/social objectives and which should be offered for joint ventures or for outright sale to the private sector;	(a) PCS: Put into effect an action program and schedule for carrying out the corporate strategy for the PCS group; (b) Operating procedures and auditing systems satisfactory to IDA to be established to monitor the financial performance of GUYMINE, GUYSUCO, PCS, and transfers of targeted amounts from these enterprises to the Central Government.	

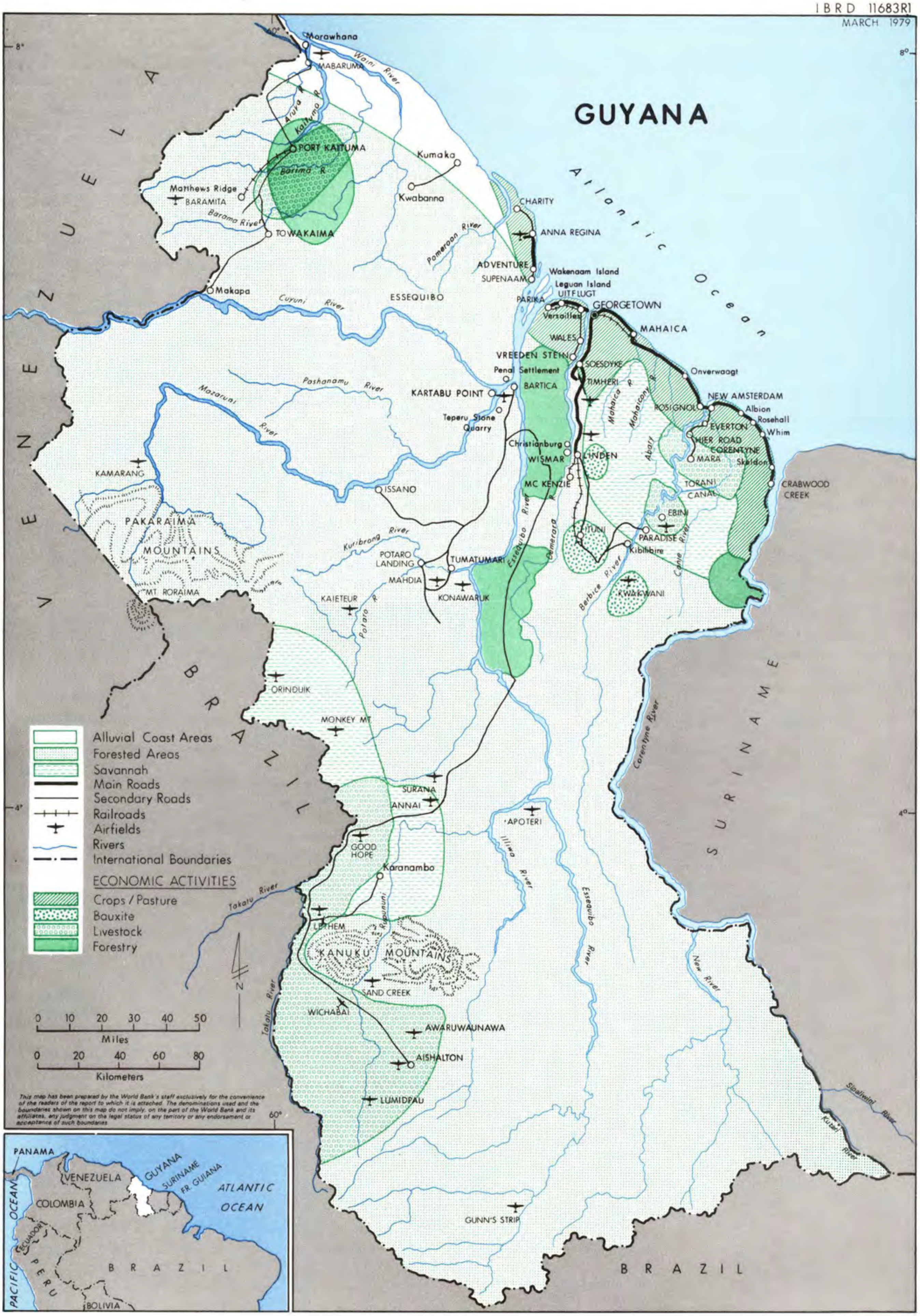
GUYANA - STRUCTURAL ADJUSTMENT CREDIT

POLICY MATRIX

Policy Areas	Actions Taken by the Government as of end 1989	Actions Taken Prior to Board Presentation	Actions to be Taken Prior to Second Tranche Release	Actions to be Taken Prior to Third Tranche Release
Public Sector Investment Program (PSIP)		PSIP	PSIP	PSIP
The long period of economic decline and consequently inadequate asset maintenance has resulted in poor condition in the infrastructure services. Therefore, the major focus of the PSIP will be the rehabilitation of basic infrastructure that is critical for supporting the program's objectives of increasing exports and private investment. The most urgent task is to restore electricity supply to required levels.		(a) Agreement on and review during 1990-92 of the size and composition of the three-year rolling PSIP, to bring it in line with projected domestic and foreign resource availability; (b) Agreement on modalities including the type of information, economic criteria for admission of new projects and timing for reviews of the PSIP (in the context of a rolling three-year framework); (c) Agreement on institutional arrangements -- principally the staffing in the State Planning Secretariat -- for providing guidelines on project preparation to line ministries and government agencies and for evaluation and monitoring of projects; (d) Improvement of external aid coordination through the services of an advisor to the Ministry of Finance to maintain continuous contact with donors and to facilitate procurement and disbursement of funds provided by bilateral and multilateral donors.	(a) Review of rolling PSIP satisfactory to IDA; (b) Implementation of institutional arrangements satisfactory to IDA, for strengthening the capacity of the State Planning Secretariat by filling all vacancies for planners in the Project Cycle Unit to provide guidelines on project preparation to line ministries and government agencies and to evaluate and monitor projects included in the PSIP.	(a) Review of rolling PSIP satisfactory to IDA.

IBRD 11683R1

MARCH 1979



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REPORT AND RECOMMENDATION

OF THE

PRESIDENT OF THE

INTERNATIONAL DEVELOPMENT ASSOCIATION

TO THE

EXECUTIVE DIRECTORS

ON A

PROPOSED

SECOND STRUCTURAL ADJUSTMENT CREDIT

OF SDR 59.8 MILLION

TO

THE COOPERATIVE REPUBLIC OF GUYANA

JUNE 7, 1990

CURRENCY EQUIVALENTS

Currency Unit: Guyana Dollar (G$)

The Guyana dollar floated with the pound sterling from July 1972 to October 1975, when the Government announced its linkage to the US dollar at G$2.55 = US$1.00. A new rate of G$3.00 = US$1.00 was established on June 1, 1981. On January 11, 1984, it was adjusted to G$3.75 = US$1.00. The average exchange rates for the period 1984-89 are set out below.

Annual Average

1984	US$1.00 = G$3.832	G$1.00 = US$0.261
1985	US$1.00 = G$4.252	G$1.00 = US$0.235
1986	US$1.00 = G$4.272	G$1.00 = US$0.235
1987	US$1.00 = G$9.756	G$1.00 = US$0.103
1988	US$1.00 = G$10.000	G$1.00 = US$0.100
1989		
January-March	US$1.00 = G$10.00	G$1.00 - US$0.100
April-December	US$1.00 = G$33.00	G$1.00 = US$0.030

GOVERNMENT OF GUYANA FISCAL YEAR

January 1 - December 31

ABBREVIATIONS

CARICOM	Caribbean Community
CDB	Caribbean Development Bank
CET	Common External Tariff
CFF	Compensatory Financing Facility
CGCED	Caribbean Group for Cooperation in Economic Development
CIF	Cost, Insurance and Freight
EDC	Export Development Corporation
EC	European Community
EIB	European Investment Bank
GDP	Gross Domestic Product
GNP	Gross National Product
GEC	Guyana Electricity Corporation
GNEA	Guyana National Energy Authority
GNEC	Guyana National Engineering Corporation
GNTC	Guyana National Trading Corporation
GPC	Guyana Pharmaceutical Corporation
GRG	Guyana Rice Group
GRMMA	Guyana Rice Milling and Marketing Authority
GTC	Guyana Telecommunications Corporation
GUYMINE	Guyana Mining Enterprise Ltd.
GUYSUCO	Guyana Sugar Corporation
IBRD	International Bank for Reconstruction and Development
ICB	International Competitive Bidding
IDA	International Development Association
IDB	Inter-American Development Bank
IMF	International Monetary Fund
MIGA	Multilateral Investment Guarantee Agency
PCS	Public Corporations Secretariat
PSIP	Public Sector Investment Program
QRs	Quantitative Restrictions
SAC	Structural Adjustment Credit
TAC	Technical Assistance Credit

GUYANA

SECOND STRUCTURAL ADJUSTMENT CREDIT

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ANNEXES

COOPERATIVE REPUBLIC OF GUYANA

SECOND STRUCTURAL ADJUSTMENT CREDIT

CREDIT AND PROGRAM SUMMARY

Borrower:	Cooperative Republic of Guyana.
Beneficiary:	Cooperative Republic of Guyana.
Amount:	SDR 59.8 million (US$78.0 million equivalent).
Terms:	Standard IDA terms with a maturity of 40 years, including a grace period of 10 years.
Cofinancing:	The proposed Credit would be cofinanced by the Caribbean Development Bank (US$42 million), and the Federal Republic of Germany (US$6 million).
Program Description:	The proposed Second Structural Adjustment Credit (SAC) would support the Government's economic recovery program. The aim of the program is to create viable and stable economic conditions conducive to restoring a higher and sustained rate of economic growth. Specifically, the proposed credit will support a reform program encompassing: (i) the improvement of the incentive framework through reforms in domestic pricing, trade policies, and private sector investment procedures; (ii) improvement of public sector finances through the elimination of central government transfers to public enterprises, streamlining the civil service, increasing revenue transferred by public enterprises to the Central Government and divestment programs for selected public enterprises; and (iii) the formulation of a realistic public sector investment program consistent with the macroeconomic framework in terms of size, composition and financing and with the country's implementation capacity.
Estimated Disbursements:	The proceeds of the proposed credit would be disbursed in three tranches: the first of US$50.0 million equivalent upon credit effectiveness, the second of US$15 million equivalent and third of US$13 million equivalent each following satisfactory reviews of program compliance. The reviews are expected to take place within six and fifteen months after effectiveness.

Benefits

The main benefits will be: (i) financing of critical imports needed to help restore economic growth; (ii) the gradual improvement in the standard of living of the population through sustained economic growth; and (iii) providing the basis for increased support to Guyana by other donors.

Risks:

The major risks affecting the success of the program are: (i) the possibility that the Government's commitment to the program of reforms may be eroded because of political opposition to adjustment and to market-oriented policies; (ii) the severity of the adjustment program which may depress the economy to such an extent that the conditions needed to produce a supply response may take a long time to materialize; (iii) lack of implementation capacity and skilled manpower to carry out the reforms; (iv) total breakdown of the already deficient power supply and a further deterioration in infrastructure services which may constrain a supply response; (v) failure of domestic and foreign investment to respond to the new incentive framework; (vi) unexpected adverse developments in the world economic environment or weather conditions; and (vii) failure of donors to provide sufficient net balance of payments flows in a timely fashion.

Factors that may reduce the program risks include: (i) a number of policies outlined in the PFP which have been already implemented; in particular, actions have been taken on the exchange rate, fiscal, monetary and incomes policy reforms negotiated with the IMF, and active negotiations are under way to establish joint ventures, divest and/or obtain management contracts for major public enterprises; (ii) the provision of technical assistance to strengthen the Government's implementation capacity and preparation by the Inter-American Development Bank of a power sector rehabilitation program; and (iii) the Government's commitment to the program has been supported by pledges of financial assistance from the donor community through the Support Group for Guyana and the

Caribbean Group for Cooperation **in Economic** Development.

Appraisal Report: None.

Map: IBRD No. 11683R1

INTERNATIONAL DEVELOPMENT ASSOCIATION
REPORT AND RECOMMENDATION OF THE PRESIDENT
TO THE EXECUTIVE DIRECTORS ON A
PROPOSED SECOND STRUCTURAL ADJUSTMENT CREDIT
TO THE COOPERATIVE REPUBLIC OF GUYANA

1. I submit the following report and recommendation on a proposed Second Structural Adjustment Credit (SAC) in the amount of SDR 59.8 million (US$78.0 million equivalent)[1] in support of the Government's economic recovery program (ERP). The credit would be on standard IDA terms with 40 years' maturity including a grace period of 10 years. In support of the program, cofinancing is also being considered by the Caribbean Development Bank (US$42 million equivalent) and the Federal Republic of Germany (US$6 million equivalent).

2. The proposed SAC would be the first operation in Guyana since 1986. Because of the status of Guyana's overdue payments to the Bank, disbursement on all Bank loans and IDA credits to Guyana were suspended on August 15, 1986. On December 15, 1986, the Bank placed Guyana's overdue account in non-accrual status.

3. The Government, with the assistance of Bank and Fund staff prepared a Policy Framework Paper (PFP) in 1988 which outlined the Government's proposed measures for addressing economic problems over the medium term, including the normalization of relations with its external creditors. In July 1988, the Bank, through its leadership in the Caribbean Group for Cooperation in Economic Development (CGCED), began efforts to mobilize the necessary financial resources to support Guyana's proposed medium-term adjustment program. In early November 1988, the Fund-sponsored Support Group for Guyana was established under the chairmanship of Canada. The Support Group has led the external resource mobilization effort since that time.

PART I - THE ECONOMY

4. An economic report entitled "Guyana: A Proposal for Economic Recovery" (Report No. 6501-GUA) was distributed to the Executive Directors on January 8, 1987. The Guyana PFP was reviewed by the Committee of the Whole of the Bank on July 12, 1988. An updated PFP will be distributed shortly to the Executive Directors for review by the Committee of the Whole on the same date as the Executive Directors' consideration of the proposed SAC. The following paragraphs incorporate the most recent information obtained by the post-appraisal mission for the proposed SAC that visited the country in April 1990. Annex I contains the key economic indicators.

Background

5. Guyana's economy is based mainly on the production and export of bauxite, sugar and rice. The greater part of the agricultural activity is

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1/ Includes SDR 2.6 million (US$3.4 million equivalent) from IDA reflows.

concentrated along the coastal belt of the country (where most of the population resides), whereas the extensive mineral and timber resources within the densely tropical hinterland -- with the exception of bauxite mining -- remain largely unexploited. Because of the country's topography and the uneven distribution of its small population, Guyana's infrastructural needs are substantial on a per capita basis. Guyana's population, estimated at 756,000 in mid-1988, has been declining in recent years as a result of a low birth rate and continuous emigration. Economic activity has been retarded, however, by a difficult physical environment, sharp fluctuations in output stemming from the vulnerability of the economy to exogenous factors such as weather and fluctuations in international prices and demand, and the Government's failure to address economic issues adequately. Guyana's per capita GNP of US$410 in 1988 was the second lowest in the Western Hemisphere (only slightly higher than US$360 in Haiti).

6. After independence in 1966, the development strategy had been to increase the participation of the public sector in economic activity and to promote producer, consumer and marketing activities in the public sector. The Government expanded state-owned enterprises, created new state-owned financial institutions and nationalized the country's bauxite/alumina and sugar industries. The Government progressively became the main employer and now controls over 80% of the recorded import and export trade. The growing role of the public sector is reflected in the increase in its share of gross domestic capital formation from 40% in 1968 to 85% in 1988.

Economic Performance

7. Economic performance in the 1970s and 1980s raises basic issues regarding the public sector's capacity to play an active and expanding role in the development of the country. The rapid expansion of the public sector involvement in the economy over the past 15 years was accompanied by the stagnation of private investment, both domestic and foreign, and the emergence of a parallel economy. Economic performance during the 1970s was mixed. During the first half of the decade, GDP grew by about 4% per annum in real terms as a result of favorable prices for Guyana's major export commodities and the rapid growth in government expenditures. Unlike many other developing countries, the rapid increases in oil prices during 1973-74 were only slightly disruptive in the short term, as they were offset by a boom in the price of sugar in 1974-75. The terms of trade for Guyana improved by approximately 30% during 1970-75. National per capita income increased by about 6% per annum, resulting in a rapid expansion in consumption and investment (5% and 10% per annum, respectively). Much of the growth occurred in the public sector, which utilized the windfall associated with sugar to expand both central government consumption and investment expenditures. On the other hand, the period 1975-80, characterized by an expanding public sector role, witnessed a period of economic decline as a result of the fall in sugar prices, the weakening in the demand for Guyana's main exports, and the reduced output in the two main export commodities (bauxite and sugar). The terms of trade fell by over 30% during 1975-80, wiping out the gains enjoyed in the first half of the decade. Moreover, the level of domestic expenditure was not adjusted promptly with undesirable implications for the balance of payments. During 1975-80, the resource gap averaged 12% of GDP compared to less than 2% during 1971-75.

8. Guyana's real gross domestic product decreased at an average annual rate of 6% during 1981-83 as output in virtually all sectors fell, with commodity-producing sectors exhibiting particularly sharp declines. This downturn resulted from the closure of some bauxite production facilities owing to weak external demand, and the curtailment of imported inputs for the other sectors. Economic growth averaged only about 1% per year in 1984-87, and was not adequate to offset the decreases in the preceding years. The level of recorded output in 1987 was thus some 15% below that of 1980 and 20% below that of 1976. Throughout most of the period 1981-87, Guyana's principal export commodities (bauxite, sugar and rice), accounting for about a quarter of GDP, encountered a number of technical, organizational and financial problems and adverse weather conditions. The resulting decline and subsequent stagnation of production was compounded by weak external demand and falling world market prices for these commodities, which account for about 80% of Guyana's merchandise export earnings. Reduced foreign exchange earnings cut into the country's capacity to import inputs needed for production purposes. Consequently, input shortages led to considerable capacity underutilization (up to 60%), raising costs of production and further reducing the profitability of production.

9. The public sector finances deteriorated markedly during 1981-86. A steady erosion of the Central Government's revenue base, as a consequence of both the decline in real economic activity and the growth of a parallel economy, coupled with growing expenditures (especially interest payments) led to widening current account deficits which increased from 15% of GDP in 1981 to 40% in 1986. Similarly, the financial performance of the rest of the public sector deteriorated, partly as a result of the continued underutilization of capacity. The public sector's overall deficit deteriorated from 43% of GDP in 1981 to 52% in 1986. However, following the adoption of reforms in a number of public enterprises, the financial position of the public enterprises improved somewhat -- leading to an overall public sector deficit equivalent to 36% of GDP in 1987.

10. Guyana's external trade and payments situation remained extremely weak during 1981-87. Total export earnings declined steadily through 1983, and while they picked up a little during 1984-87, it was not sufficient to avert a continued deterioration of the balance of payments. The currency devaluation of 32% in 1984 failed to yield a devaluation in real terms. The main source of financing for the balance of payments was the accumulation of external payments arrears as Guyana was unable to meet its external payments obligations. The Government devalued the currency once again, by 56% in January 1987. But its effects were eroded by the persistence of large fiscal deficits and monetary expansion which triggered further price increases in 1987; consequently, no devaluation in real terms was achieved.

11. The 1984-87 period was marked by a low level of aggregate resource availability, an increasing divergence between the investment and savings rates especially of the public sector and, correspondingly, an increasing dependence on payments arrears to finance domestic expenditures. The Government took a number of measures to increase output and exports and reduce Guyana's imbalances. The scope of domestic price controls was reduced, public sector prices were increased to reflect the devaluations

and special efforts were made to rehabilitate the bauxite and sugar industries. A number of public enterprises were reorganized and restructured. Measures were also taken to curb central government spending. Although these measures were in the appropriate direction, they were insufficient to deal with the severity of the country's problems.

Government Response to the Crisis

12. Since July 1988, the Government has taken a number of steps to implement policies outlined in the PFP. In early August, price controls were removed from all remaining items[2] except for petroleum products, transportation, rice, sugar and a few other essential items. Import prohibitions were also removed on all items, except for food products[3] on grounds of the national objective of food security through self-sufficiency. In addition, and in compliance with the PFP, the licensing of "no funds" imports, i.e., those not involving the use of official foreign exchange, was liberalized beginning September 1, 1988, so as to allow private individuals to import without licenses, items for their own use. In the fiscal area, some measures to raise tax revenues were implemented in 1988, including the Fiscal Enactment (Amendment) Bill of 1988 and the Consumption Tax (Amendment) Order of 1988. Also, actions have been taken to close down two loss-making public enterprises; the Glass Factory has been closed down and the Public Transportation Corporation is in the process of being closed down. These actions, in part, helped the Public Corporations Secretariat (PCS, formerly GUYSTAC) group of 27 public enterprises to increase its overall surplus from 1% of GDP in 1987 to 4.5% of GDP in 1988. Also, in July 1988, the Government issued a document setting out the incentives available to the private sector and in August 1988, Guyana joined MIGA.

13. The economy, however, witnessed a setback in 1988, with real GDP declining by about 3%. This was largely attributable to heavy rains which affected sugar production and bauxite mining and a fall in rice production owing to the blast disease. However, better management of public enterprises enabled the Government to reduce the overall public sector deficit to 33% of GDP in 1988. Guyana's public sector external debt stood at about US$1,777 million (equivalent to 683% of exports) as of end December 1988, of which external payments arrears amounted to US$1,141 million (438% of exports). The debt service obligations (including arrears) in 1988 amounted to 83% of exports while the scheduled interest payments amounted to 37% of exports.[4]

2/ These include mild steel, welding electrodes, agricultural machinery, horticultural tools, bicycle spares, tires and tubes, spares for grain milling machinery, soap, detergents, matches and edible oil.

3/ These food categories include meat, fish, poultry, vegetables, fruits, processed meat and fish, beet sugar, confectionary pastries and jams.

4/ As in the PFP, all magnitudes relating to the external account are expressed as shares of exports of goods and non-factor services. A meaningful analysis of time trends in relation to nominal GDP is precluded by wide disparities in the impact of a series of major nominal devaluations upon the estimation of external account magnitudes and nominal GDP.

14. Following agreement on the PFP, the Government initiated discussions with the Fund in late 1988 about a possible program to support its Economic Recovery Program. Negotiations on a Fund-monitored economic program for 1989 were concluded in February 1989 and the program was endorsed by the Fund Board in April 1989. As part of this program, the Guyana dollar was devalued at the beginning of the second quarter of 1989 from G$10 per US$ to G$33 per US$ (230% in G$ terms). Following the devaluation, the prices of controlled items were adjusted as follows: sugar (producer price) - 225%; rice (producer price) - 125%; gasoline/diesel - 200%; transportation - 100%; cooking gas - 175%. Interest rates were also increased, with the bank rate rising from 15% to 35%. As part of the same policy package, the public sector nominal wage increase was limited only to 20%. The devaluation led to an increase in prices, as measured by the official consumer price index, of 40% in April 1989.

15. The program eased some of the long-standing price distortions in the goods markets (for the above products) and in the foreign exchange market. The parallel rate (for foreign exchange) came down from G$60 per US$ prior to April 1989 to G$48 per US$ after the devaluation--owing to a sizable reduction in purchasing power and in domestic liquidity. But the cut in real wages of at least 25% combined with increased transportation costs affected the supply of labor and led to strikes, absenteeism, resignations and out-migration. In the two major export industries, i.e., sugar and bauxite, strikes resulted in a net foreign exchange loss of about US$20 million. This loss together with the fact that disbursements of commodity assistance during 1989 amounted to only US$27 million compared to US$41 million envisaged in the program were the major reasons for a disappointing economic performance in 1989 (discussed further in paras. 45-47).

Key Adjustment Issues

16. Macroeconomic Issues. Guyana continues to face major structural imbalances. These stem from the failure to correct, until recently, an overvalued exchange rate and price distortions. Guyana's economic problems are also attributable to an over-extended and inefficient public sector, responsible for a significant deterioration of public finances. At the same time, the lack of a clear role for the private sector also dampened economic activity. The country's capital stock has deteriorated and the state of disrepair of physical infrastructure has resulted in serious bottlenecks. The decline in the standard of living over the years has led to an exodus of qualified personnel and to a shortage of skilled labor and experienced managers. Thus, major weaknesses in management and project implementation remain in the public sector and there is a need to continue Government's efforts to divest activities and to evolve a more efficient public sector.

17. Sectoral Issues. A number of sectoral issues need to be addressed in order to increase output, raise export earnings and promote a recovery of the economy. In this regard, agriculture which currently accounts for about 25% of GDP and over 45% of total merchandise exports requires special focus since it is expected to continue to generate a substantial portion of Guyana's net foreign earnings over the medium-term and to remain the

mainstay of the economy for the foreseeable future. Specific issues to be addressed within the sector include: (a) measures to further improve performance in the sugar subsector through cost reduction, rationalization of milling capacity, organizational improvement, maintenance of adequate crop (ratoon) renewal as well as measures to sustain proposed export targets by meeting the rehabilitation and new investment needs of the sector; (b) the continued provision of incentives (mainly pricing, including access to foreign exchange), input supplies (fertilizers, herbicides and pesticides) and the maintenance of adequate research, extension services and water management to facilitate increased productivity and production in the rice sector; and (c) the provision of adequate infrastructural and marketing support to facilitate increased production of rice and other crops, as well as increased production in the fishery and forestry subsectors. In the mining sector, major efforts are required to address the rehabilitation needs of the bauxite industry which had accounted for about 35% of merchandise exports and about 6% of GDP. In the manufacturing sector, policies are needed to promote growth of primarily the nontraditional manufacturing sector which accounted for less than 10% of GDP in 1987-88. These include the continued implementation of an appropriate exchange rate regime, further deregulation of the economy, and the provision of incentives and infrastructural support.

18. Guyana's quest for medium-term growth, however, is expected to be difficult owing to its heavy dependence on its three traditional export sectors, highly vulnerable to fluctuations in international prices and demand. On the other hand, lead time is needed to develop nontraditional sectors. While the bauxite sector is affected by obsolete plant and equipment and weak financial performance--both of which adversely affect production efficiency--it continues to have a high potential for increased export earnings owing to the buoyant market for calcined bauxite, the market for which is shared only with China. At the same time, potential exists for the development of nontraditional sectors in agriculture (e.g. fruits, vegetables and dairy products), manufacturing (clothing, footwear, beverages and furniture), mining (gold and diamonds) and forestry. The speedy and efficient development of these sectors will require maintenance of export competitiveness and participation by the indigenous private sector together with foreign investors--which in turn would depend upon a fundamental restructuring of the macroeconomic policy framework to provide incentives to expand production and exports. The Government is fully committed to the implementation of the policy reforms set out in the PFP as the only means of moving the economy out of 15 years of cumulative deterioration and placing it on a sustainable growth path. A clear sign of the change in approach are the initiatives taken recently to establish joint ventures, divest and/or negotiate management contracts with foreign firms for the bauxite, sugar, electric power, air transport, and telecommunications sectors, and a number of other public enterprises (para. 23). Given the Government's commitment, the chances of success of a structural adjustment program will depend in substantial measure on whether the necessary external financial support can be mobilized and the necessary technical assistance can be secured.

PART II - COUNTRY STRATEGIES AND BANK GROUP OPERATIONS

A. THE GOVERNMENT'S MEDIUM-TERM ADJUSTMENT PROGRAM

19. The main objectives of the Government's ERP are set out in a Letter of Development Policies (Annex V). These objectives are to: restore economic growth and later increase it above historical levels over the medium term; eliminate internal and external imbalances; incorporate the parallel economy into the official economy; and normalize Guyana's financial relations with its external creditors. To attain these objectives, the Government has given the highest priority to the restoration of incentives through a realistic exchange rate regime, removal of remaining price distortions, trade liberalization, and promotion of private sector development. It gives high priority also to the improvement of the public sector finances through a streamlining of the civil service, generating surpluses from public enterprises and a selective divestment program. Rehabilitation of the basic infrastructure, critical to an increase in exports and private investment, is to be emphasized through the launching of a public sector investment program (PSIP) consistent with a viable macroeconomic framework. Finally, in order to protect groups that are particularly vulnerable during the adjustment process and to maintain public support for the economic recovery program, a social impact amelioration program (SIMAP) is to be implemented in parallel with the medium-term adjustment program.

20. An exchange rate regime is being implemented to help ensure external competitiveness and protect the balance of payments. The exchange rate will be reviewed periodically with a view to progressively eliminating the divergence between the official rate and the free market exchange rate. To guarantee exporters a minimum of foreign exchange for importation requirements, the Bank of Guyana had established foreign exchange retention schemes that allow selected exporters to retain a certain percentage of their export proceeds depending upon the availability of adequate foreign exchange at the Bank of Guyana. The retention schemes will be gradually eliminated as more foreign exchange becomes available for meeting all bona fide payments.

21. In order to support private investment, new measures will be instituted to reduce the processing time for the approval of fiscal incentives for new projects. There are also good prospects for promoting increased production of mineral deposits (notably gold and diamonds), for which appropriate policy incentives such as tax holidays, exemptions from consumption tax and accelerated depreciation allowances are being provided in order to encourage the required private sector investments.

22. The Government will adopt fiscal policies aimed at reducing the overall public sector deficit, consistent with a sustainable balance of payments position over the medium term and also, increased public sector savings. Measures to increase revenues include improving of tax administration and broadening the tax base, adopting a program to address deficiencies in the application and administration of consumption taxes, and reducing import duty exemptions. The objective is to enhance revenue, minimize disincentives, improve resource allocation and help incorporate the parallel economy into the official economy. Measures to reduce

expenditures include the close monitoring by sector of recurrent expenditures on supplies and materials; the termination of transfers to public enterprises, except to the Guyana Electricity Corporation and for maintenance expenditures of public enterprises to be fully divested (during the period in which assets are valued, tenders are called and analyzed and the sale is negotiated); the restraining of increases in public sector wages and salaries; and the strengthening of budgeting, monitoring and fiscal reporting procedures. The reduction of central government expenditure is also to be achieved through rationalization measures including the elimination of overlapping functions and non-critical vacancies in the civil service.

23. A corporate strategy has been developed for the enterprises under the Public Corporations Secretariat (PCS) with a view to determining which enterprises will be kept within the Government's control and which should be divested. Altogether 12 enterprises have been identified for divestment and options include closure, total or partial sale to the private sector, joint venture arrangements, or leasing contracts. A Policy Group chaired by the President has been set up to guide the divestment process and a Divestment Unit staffed with lawyers, financial analysts and economists has been set up to carry out the technical work needed for divestment. In the case of the Guyana Sugar Corporation (GUYSUCO), separate accounting and management systems will be established and foreign investment will be sought for both its sugar and non-sugar production activities. In order to derive policy recommendations, the problems and prospects for private sector rice exports will be reviewed by the Government with assistance from the Inter-American Development Bank. Meanwhile, the Government has already taken a number of steps to improve the bauxite industry including the securing of a European Development Fund Loan to rehabilitate the industry and discussions with Reynolds International of United States and Alcan of Canada about possible joint ventures. In February 1989, Reynolds International signed an agreement with the Government to commence mining, marketing and sales of bauxite. The initial capital investment is estimated at US$25 million. Discussions are also under way with Bookers of United Kingdom to obtain management assistance for the sugar industry and with British Airport Services Group, to run the country's international airport. In addition the Government has sought foreign equity participation in Guyana Airways and the Guyana Electricity Corporation. Also, discussions are in progress with a US company on the sale of 80% of the Government's equity in the Guyana Telecommunications Corporation.

24. The Government will review annually during 1990-92 the size and composition of the rolling three-year Public Sector Investment Program (PSIP) to ensure its consistency with the objectives of the economic recovery program, projected domestic and foreign resource availability and implementation capacity. Particular attention will be given to adequate costing of projects and the timing of project disbursements as well as to the economic criteria for admission of new projects. The State Planning Secretariat will be adequately staffed to provide guidelines for project preparation to the line ministries and government agencies and for evaluation and monitoring of projects. Additionally, the management of external aid coordination and resource mobilization will be strengthened at the Ministry of Finance to maintain continuous contact with donors and to accelerate the internal processing of loans and grants, and disbursement requests.

25. The above-mentioned initiatives signal a fundamental change in economic management -- from one based on state intervention and controls towards a market-oriented economy with a much greater role for the private sector. In sum, the Government has given the highest priority to the restoration of incentives through a movement towards a realistic exchange rate regime, removal of price distortions, trade liberalization, promotion of private, local and foreign investment and divestment of public enterprises. However, this change of direction is constrained by the lack of balance of payments support to finance imported inputs needed to restore economic growth and the lack of investment resources for complementary infrastructure.

B. BANK GROUP ASSISTANCE STRATEGY AND OPERATIONS

Past Assistance

26. The first Bank loan to the then British Guyana was made in 1961 for an agricultural credit project and was repaid in full. Since independence in 1966, Guyana has received, net of cancellations, US$76.2 million in loans from the Bank and US$44.8 million in credits from IDA, covering twenty development projects and programs. These include assistance in the highways, power, education, agriculture, livestock, and petroleum sectors; a sea defense project; a structural adjustment loan/credit; and two technical assistance projects. A Bauxite Industry Technical Assistance Project in an amount of SDR 6.6 million (Credit 1729-GUA) was approved August 5, 1986 but is not yet signed because of Guyana's arrears situation with the Bank.

27. Earlier Bank Group operations in Guyana were aimed at strengthening both the physical and social infrastructure as well as governmental institutions. The Bank Group has also supported the Government's economic program through a Structural Adjustment Loan (1948-GUA) for US$14 million, a Structural Adjustment Credit (1098-GUA) for US$8 million and an associated Second Technical Assistance Loan (1949-GUA) for US$1.5 million, all of which were approved by the Board on February 3, 1981. An IMF Extended Fund Facility (EFF) was also approved in 1981. Guyana's performance under the first year of the IMF Extended Fund Facility and the Bank's SAL fell short of the targets set. In mid-1982, the Fund arrangement was terminated. The structural adjustments envisaged under the Bank's program also did not materialize because of the slow rate at which planned policies were implemented. Partly as a result of the slow and ad hoc implementation of policies formulated, economic performance continued to deteriorate. An evaluation of the performance of the adjustment program (OED Report No. 6119 of March 25, 1986) focused on two weaknesses: the lack of government commitment to the basic policy thrust of the program and the lack of institutional capacity to implement the program. Other problems were the inclusion of too many conditions, the unrealistic time frame for carrying out a number of actions, and the lack of specificity in the conditionality set out in the program. Deadlines were attached to a wide range of detailed actions of varying importance, most of which required periodic reporting. According to the evaluation, the program was rushed through without sufficient appreciation of the need to have the proposals under the program fully considered within the Government. The

proposed SAC, which focuses on supply side macroeconomic conditions rather than detailed sectoral ones, has been developed with the Government over the past 18 months and the Government is fully committed to its implementation. As described below (para.34) the proposed Technical Assistance Credit seeks to address the issue of implementation capacity.

Proposed Bank Group Assistance Strategy

28. While the Fund-monitored program currently under implementation will help reduce internal and external imbalances, such efforts will not be sustainable unless the economy can resume growth above historical levels. This would require a significant improvement in the supply side conditions needed for economic growth, balance of payments support to meet increased import needs, and technical and management skills to implement the program. The run-down state of the country's physical infrastructure also calls for a major rehabilitation effort, including new investments to promote economic growth. There is a need also to address the social cost of adjustment and its potentially negative effects if its impact is not cushioned.

29. Accordingly, the main elements of the Bank Group country assistance strategy are to: (a) complement the Fund's stabilization program by focusing the proposed SAC on the improvement of incentives and public sector reforms; (b) assist the Government, through the provision of technical assistance, to ensure that the financial assistance being made available for the rehabilitation of the productive sectors and infrastructure is efficiently used; (c) support the rehabilitation of the bauxite sector; (d) assist in the rehabilitation of the social infrastructure; (e) design an economic and sector work program with further emphasis on the incentive framework, infrastructure rehabilitation and development, public sector management, agriculture development and mining; and (f) through the Caribbean Group for Cooperation in Economic Development to help Guyana mobilize the external resources to support infrastructure rehabilitation and other objectives of the PSIP.

30. Consistent with the above strategy, and taking into account planned lending activities of other agencies and IDA resource constraints, the proposed lending program in the near term is expected to include the proposed SAC and related proposed Technical Assistance Credit, in addition to (i) a possible bauxite rehabilitation project on IBRD terms which, because of creditworthiness considerations, would be processed as an "enclave-type" operation, and (ii) a proposed social sector project, with emphasis on possible improvements in rural health delivery systems. Support for infrastructure rehabilitation (power, roads, water supply, sea defenses, flood control and drainage) is expected to be provided by IDB, EEC and CDB, for agriculture and education principally by IDB, and for industry by EIB.

31. The Bank Group has also been assisting the Government's efforts to mobilize external resources for its Social Impact Amelioration Program (SIMAP). A Special Donors Meeting of the CGCED was held on July 10, 1989 to seek support for the SIMAP estimated at US$10 million and engendered expressions of donor support particularly from the IDB and UN agencies.

Resumption of Previously Approved Projects

32. The liquidation of Guyana's arrears with the Bank will permit a resumption of disbursements under the Petroleum Exploration Promotion Project (Credit 1208-GUA) and Upper Demerara Forestry Project (Supplementary Credit--Credit 1555-GUA). The Petroleum project, in the amount of SDR 1.7 million (US$2.0 million equivalent), was made in November, 1982 to help finance the Government's efforts to establish blocks of potential oil-bearing areas for leasing to interested companies for oil exploration, including the provision of specialist consultant services and other technical assistance to the Government, a vehicle and laboratory equipment and materials. As of March 31, 1990 the undisbursed balance of the Credit amounted to US$1.1 million. The Supplementary Credit for the Upper Demerara Forestry Project, in the amount of SDR 8.7 million (US$8.8 million equivalent), was made in March 1985 to help finance cost overruns relating to the procurement of logging equipment and vehicles, sawmill equipment, and construction of housing and community facilities and additional components financed under the Upper Demerara Forestry Project (Loan No. 1623-GUA). As of March 31, 1990, the undisbursed amount under this Credit was US$3.7 million. Implementation of both the Petroleum and Forestry projects has continued albeit at a very slow pace because of limited government resources. Bank missions will visit Guyana as soon as possible to review progress and to determine the amounts eligible for reimbursement under each credit following the lifting of suspension of disbursements. It is expected that both projects will be closed during FY91.

33. The liquidation of Guyana's arrears will also enable the signing of the Credit (1729-GUA) for the Bauxite Industry Technical Assistance Project, amounting to SDR 6.6 million (US$8.5 million equivalent), which was approved by the Executive Directors in August 1986. The project would provide the basis for assessing the medium- to long-term economic and financial viability of the bauxite industry and assist, as appropriate, in the preparation of a full scale rehabilitation project. The Government Agencies involved, the Bauxite Industry Development Company (BIDCO) and Guyana Mining Enterprise Ltd. (GUYMINE) have been financing out of their own resources, a number of expenditures relating to the implementation of the project. The expenditures incurred have been made substantially in accordance with the Association Procurement Guidelines on the understanding that they would qualify for reimbursement under the above Credit. It is estimated that around US$3.0 million equivalent have already been incurred in reimbursable expenditures. As US$0.8 million equivalent is the limit of retroactive financing permitted under the draft Development Credit Agreement, it is proposed that this limit be increased to US$3.0 million to allow reimbursement of eligible expenditures already incurred in project implementation. Utilization of the US$5.5 million equivalent balance of credit proceeds will be determined after a review with Government of the most appropriate use of these resources to support the divestment program for the bauxite sector. The Executive Directors will be informed of the proposed revised project content.

The Proposed Technical Assistance Credit

34. The shortage of professional and technical manpower continues to impede the operational as well as the development activities of the public sector. Even basic information needed for macroeconomic management such as

the national accounting data base remains extremely weak, in large part, owing to the lack of personnel to collect, compile and analyze key economic data. The lack of professional manpower has also adversely affected the formulation of effective economic policies and the development and monitoring of the PSIP. Shortages are most acute in the fields of economics, engineering, accountancy and industrial management, as reflected by the large number of unfilled vacancies in the public service. Guyana's economic recovery program would crucially depend upon developing a "critical mass" of higher level manpower through increased incentives, training and technical assistance, and attracting Guyanese professionals abroad for short periods. IDA will help address some of these issues through the Technical Assistance Credit (TAC) also being presented to you today. The TAC both complements the SAC and forms a part of a broader technical assistance program formulated with assistance from the UNDP.

C. EXTERNAL FINANCING AND BURDEN SHARING

35. Guyana's lack of a track record or commercial ties with traditional and new Caribbean area donors have made it difficult to obtain financial resources from abroad. Also, the amount of support required for the ERP (See Table 1) is clearly without precedent and its mobilization has proven difficult. Moreover, substantial financial assistance from the donor community will be required well beyond the program period.

Table 1: GROSS EXTERNAL FINANCING AND BURDEN SHARING, 1990-91
(US$ million)

	1990	1991	1990-91
TOTAL	766.0	126.4	892.4
Multilateral	226.0	66.1	292.1
o/w: Bank 1/	69.5	16.8	86.3
Fund	117.5	27.3	144.8
Other	39.0	22.0	61.0
Bilateral and others (incl. rescheduling)	540.0	60.3	600.3
TOTAL	100.0	100.0	100.0
Multilateral	29.5	52.3	32.7
o/W: Bank	9.1	13.3	9.7
Fund	15.3	21.6	16.2
Other	5.1	17.4	6.8
Bilateral and others (incl. rescheduling)	70.5	47.7	67.3

1/ Includes project financing. See Table 2.

Source: Annex I.

36. The aggregate financing for the three years period is based on current assumptions of export receipts and a projected large increase in imports, both related to the recovery of the sugar and bauxite sectors. The trade deficit is thus projected to increase from an annual average of US$17 million in 1988-89 to some US$67 million per year during 1990-92.

37. The above trade balance projection is sensitive to unexpected developments in the prices and volume of bauxite and sugar. A 10% drop in export volume or price of bauxite would worsen the trade deficit by about US$10 million while the same outcome in either price or export volume of sugar would worsen it by US$8 million per year.

38. In 1989, Guyana's actual debt service (as opposed to scheduled debt service which was much higher) was about US$42 million or 17% of export earnings. The actual debt service is projected to average around 30% during 1990-92. Barring a major unexpected favorable development affecting the trade balance, the debt servicing capacity of the country will depend, particularly in 1990-91, on timely official assistance made available on concessional terms.

39. Taking into account the repayment of arrears due to the Bank (about US$57 million by mid-June 1990), and debt service obligations, the expected pattern of disbursements would be as follows:

Table 2: WORLD BANK NET DISBURSEMENTS AND TRANSFERS TO GUYANA, 1990-91
(US$ millions)

	1990	1991	Total
Inflows			
IDA SAC	65.0	13.0	78.0
IDA TAC	0.5	1.8	2.3
Ongoing Operations	1.0	-	1.0
Bauxite TA	3.0	2.0	5.0
Total	69.5	16.8	86.3
Outflows			
Arrears	57.0	-	57.0
Debt Service	6.8	11.0	17.8
of which:			
Principal	3.8	6.0	9.8
Interest	3.0	5.0	8.0
Total	63.8	11.0	74.8
Net Disbursements	8.7	10.8	19.5
Net Transfers	5.7	5.8	11.5

Source: Proposed Lending Program.

PART III - THE FUND PROGRAMS FOR 1989 AND 1990

40. The essential policy components of the Fund-monitored economic reform program for 1989 were:

41. Exchange Rate Policy. Following the adjustment of the official exchange rate system which took place in April 1989, the Government was required to implement a flexible exchange rate policy to help ensure external competitiveness and protect the balance of payments. A mechanism for triggering adjustments in the exchange rate was to be reviewed periodically and, if necessary, adjusted to maintain it within a 15% margin from the parallel exchange rate. In addition, adjustments to the official exchange rate were expected to take into account domestic nominal wages and prices in relation to those of Guyana's main trading partners and competitors, and of developments in international reserves in relation to the program's targets.

42. Fiscal Policy. The Government was required to undertake fiscal policies that would aim at reducing the overall public sector deficit from US$140 million in 1988 (33% of GDP) to US$95 million in 1989 (37% of GDP),[5] consistent with a sustainable balance of payments position over the medium term, and increased public sector savings. Measures to increase revenues included the improvement of tax administration and broadening of the tax base by restructuring and extending excise and consumption taxes, and reducing tax exemptions. The objective was to enhance revenue, minimize disincentives, improve resource allocation and help incorporate the parallel economy into the official economy. Measures to reduce expenditures included: the close monitoring by sector of recurrent funding requirements for supplies and materials to seek further savings; the termination of transfers to public corporations except to the Guyana Electricity Corporation; the restraining of increases in public sector wages and salaries; and the strengthening of budgeting, monitoring and fiscal reporting procedures.

43. Monetary Policy. In line with these fiscal policies designed to reduce the public sector deficit, the Fund-monitored monetary policies were designed to ensure consistency with the program's targets for inflation and the balance of payments deficit. The Bank of Guyana was required to limit credit expansion consistent with an increase in net foreign assets of US$4 million during the last nine months of 1989 and with an increase of currency in circulation of 27%. The excess liquidity already frozen will be converted into medium-term debentures so that potential inflationary pressures would be deflected while the economy is undergoing liberalization.

44. Incomes Policy. In order to increase employment, protect external competitiveness and help reduce inflation, the Government was required to implement a restrained wage policy. Nominal wages were expected to remain

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5/ The deficit as a proportion of the GDP is higher in 1989 owing a much higher multiplier (3 fold) of the foreign component in public investment measured in local currency.

unchanged unless the Guyana dollar was further devalued. Merit increases were permitted on the basis of productivity increases and the overall financial situation of the public sector, and wages in the private sector were expected to continue to be freely determined with the exception of some non-unionized workers.

Economic Performance and Financial Targets - 1989

45. The extent of the adjustment effected under the Fund-monitored program led to strikes in the sugar and bauxite sectors which have impacted adversely on economic performance vis-a-vis the projected outcome. Bauxite production dropped to about 1.3 million tons (target: 1.76 million tons) and sugar to about 164,000 tons (target: 200,000 tons). Persistent shortages in electricity supply compounded the problem through its damaging effects on the rice and other productive sectors. Rice production reached an estimated 143,000 tons (target: 162,000 tons). As a result of these production losses, the downturn in production in other sectors and associated losses in the service sectors, real GDP declined by about 3.3% during 1989 (target: 5% growth). This setback in economic performance also impacted very seriously on public finances and the balance of payments during 1989 as described below.

46. Public Finances: The overall deficit of the nonfinancial public sector reached 48% of GDP in 1989 compared to a target of 37% of GDP in the Fund-monitored program for 1989. This deviation in performance is largely the result of the sharp drop in real GDP and a much wider central government current account deficit (31% of GDP) compared to the deficit (21% of GDP) envisaged in the program. The windfall gains envisaged from the devaluation did not materialize, owing to major production shortfalls (para. 44) and consequently revenue performance remained weak during 1989. While the operating surpluses of the two enterprises in the sugar and bauxite sectors deteriorated severely relative to the program, the performance of most of the other enterprises relative to the program was also poor owing to the lack of foreign exchange to obtain essential inputs. Consequently, the programmed large transfers from the public enterprises did not take place. This, in turn, led to a much weaker central government revenue performance than programmed. Furthermore, the Sugar Corporation bore the cost of an unprogrammed subsidy on the domestic sales of imported sugar needed to meet the shortfall in production mentioned above. Although the Government's non-wage current expenditure remained significantly below the program level, this only partly offset the reduction in revenue and a further 20% wage increase granted outside the program in August 1989 with a view to averting further strikes in the bauxite and sugar industries.

47. Balance of Payments: The current account deficit for 1989 (accrual basis) is now estimated at 60% of projected exports of goods and nonfactor services, compared to 48% of programmed exports of goods and nonfactor services reflecting in part strike losses amounting to US$20 million. The deterioration in the external account was compounded by slippages in the implementation of commodity assistance from bilateral sources amounting to US$14 million. Net merchandise exports declined from an original target of US$260 million to US$198 million. Consequently, the foreign exchange situation remained extremely difficult. A major compression of non-project imports of about US$50 million from the original target became a serious impediment to growth in 1989.

48. Dialogue with the Fund: The above-mentioned deviations were reviewed by the Fund staff and the authorities before and during September 1989. The Fund staff advised the authorities about the need to take additional fiscal actions plus legalizing the parallel market rate for foreign exchange (including moving all official transactions to it, except for those of the highly sensitive sugar and petroleum companies). On the fiscal side, the Government took the additional measures discussed with the Fund staff. First, it raised the retail price of sugar from G$2.90 per lb. to G$6.20 per lb. equivalent to US cents 19 per lb.--the price at which sugar was imported in October/November 1989. Second, it implemented a tax on diesel and gasoline equivalent to US cents 30 per imperial gallon effective from November 1, 1989. The Government also enacted the Dealers in Foreign Currency (Licensing) Act of 1989 to legalize the parallel market for foreign exchange. As of April 1990, 15 Exchange Houses (or Cambios) were in operation.

The Fund Program - 1990

49. The main elements of the proposed Fund program for 1990, to be supported by an ESAF (US$106 million) and a Standby (US$64 million) are:

Exchange Rate Policy

(a) adjustment of the exchange rate in stages to achieve a full unification of the rate by March 31, 1991;

(b) shifting of more transactions to the newly legalized parallel market for foreign exchange; and

(c) adjustment in the prices of controlled items to allow for the pass-through of changes in the exchange rate.

Fiscal Policy

(a) an increase in the primary current account surplus of the public sector from 18% of GDP in 1989 to 22% of GDP in 1990 and to 30% of GDP in 1991;

(b) establishment of a sales tax by December 1990;

(c) elimination of exemptions from consumption taxes on fuel enjoyed by fishing trawlers and aviation fuel for domestic flights;

(d) elimination of exemptions from consumption tax and import-duty granted to imports of agricultural, forestry and mining equipment;

(e) restraints on non interest current expenditure of the Central Government.

Monetary Policy

(a) a progressive movement towards a more market-oriented approach to monetary control centered on the auctioning of treasury bills and on the development of secondary markets for treasury bills and government securities;

(b) the establishment of a monetary policy unit at the Bank of Guyana principally to: help determine and implement credit targets; improve coordination between monetary and public debt management policies; and monitor credit developments in the financial systems;

(c) implementation of a market determined interest rate policy taking into account developments in wages, prices and the exchange rate which aims at holding interest rates positive in real terms;

(d) an increase in the rediscount rate on treasury bills;

(e) extending the freeze on excess liquidity; and

(f) increasing the charge for non-compliance (by Commercial Banks) with liquid assets and reserve requirements.

PART IV - THE PROPOSED STRUCTURAL ADJUSTMENT PROGRAM

50. The proposed SAC would support the Government's economic recovery program. The aim of the program is to create viable and stable economic conditions conducive to restoring a higher and sustained rate of economic growth. The proposed SAC comprises the following components:

> The Incentive Framework. Reforms in domestic pricing, trade policy, private sector investment climate, within the context of a sound macroeconomic framework, conducive to growth and investment.
>
> Public Sector Finances. Elimination of central government transfers to public enterprises (PEs), streamlining of the civil service, increasing transfers from PEs to the Central Government, and divestment programs for selected PEs.
>
> The Public Sector Investment Program (PSIP). Formulation of a realistic PSIP consistent with the macroeconomic framework and with the country's implementation capacity.

A. THE INCENTIVE FRAMEWORK

51. While Guyana's poor export performance had originated from adverse external factors, it was also aggravated by an erosion of the incentive framework stemming from the failure to correct an overvalued exchange rate, price distortions, and the lack of a clear role for the private sector. To expand exports, the proposed sequencing of actions in the SAC is to first maintain international competitiveness, second to relax import licensing procedures and reduce QRs and finally, after achieving the fiscal targets under the program and strengthening the public sector's savings capacity, to begin rationalizing the consumption tax structure. The devaluation of the Guyana dollar in April 1989 and June 1990 seek to produce a supply response through producer incentives in the form of higher margins in local currency.

Domestic Pricing

52. After maintaining for several years a domestic pricing policy of keeping fixed prices for a number of consumer goods, the Government freed the prices of a number of items in 1988, but the prices of sugar, petroleum products, rice, public utilities services, and public transportation remained controlled and in some cases unchanged. This policy has had several undesirable effects, including lack of incentives to private producers, excessive and indiscriminate consumption subsidies, illegal trade, and weakening of public enterprise finances from resulting subsidies.

53. The price of rice has been based essentially on domestic costs; international price trends are not explicitly featured in the pricing formula. Consequently, price signals to rice farmers do not reflect economic efficiency considerations. Rice exporters also are constrained by a number of factors such as the shortage of credit and farm inputs, restrictions on sale to CARICOM countries and excessive regulation. But

the absence of Bank operations or studies on the rice sector has impeded our ability to develop appropriate proposals for resolving these problems. Given the importance of the rice sector, a study on the sectoral issues would be essential. Sugar pricing is also based on domestic production costs, except for the recent price adjustment (para. 47) to cover the cost of imported sugar. Since sugar imports for domestic consumption is likely to continue for the next two years, its pricing needs to reflect the c.i.f. cost as well as other acquisition costs.

54. In the case of electricity, price adjustments have been hampered by the severe shortages in supply. The Guyana Electricity Corporation (GEC) is currently able to supply only about 16 MW of power supply out of a maximum demand of about 35 MW in the Demerara Integrated System (DIS). While plans are under way to rehabilitate the system with IDB assistance, the GEC is in the process of securing consultancy services for formulating a least-cost expansion program, from which a long-run marginal cost estimate of producing electricity could be derived. In these circumstances and as an interim measure, a feasible solution would be to ensure the adequacy of electricity prices to cover the full cost of operations. Thereafter, the Government needs to develop a least-cost expansion program (LCEP), which will provide the information for setting of tariffs based on long-run marginal costs (LRMC).

55. As regards water supply, cost recovery in the sector remains extremely poor. The Georgetown City Council which serves the largest segment of Guyana's population, recovers only 65% of the operational cost. Poor cost recovery has led to central government transfers, amounting to about G$2 million in 1988 or 0.1% of total revenue. Cost recovery is impeded by a severely deteriorated water supply system which provides neither the quantity nor quality of water required. In the absence of water meters, costs are recovered on the basis of a percentage charge on the property value. Plant rehabilitation and the installation of water meters would take time, and need to be implemented within a sector development plan. In the case of public transportation, fares were raised to cover operational costs during April 1989, but the principle of covering full operational costs needs to be maintained.

56. Action Program. During negotiations, agreement was reached on:

(i) putting into effect pricing policies on rice which will reflect the international price of equivalent grades of rice calculated at an exchange rate acceptable to IDA;

(ii) setting the domestic price of sugar to cover the c.i.f. Georgetown and other acquisition costs of imported sugar;

(iv) setting of electricity tariffs to cover the full cost of operations including depreciation and on developing a 10-year least cost expansion program which will provide the information for setting of electricity tariffs based on long-run marginal costs;

(v) developing a plan to rehabilitate the Georgetown Water Supply System;

(vi) setting petroleum product prices (except kerosene used extensively by low-income groups) to cover the c.i.f. price and local costs including depreciation; and

(vii) setting public transportation fares to cover operating costs, including depreciation.

57. Prior to second tranche release, the Government will:

(i) implement changes in rice, sugar, electricity and petroleum prices as well as public transportation fares in accordance with pricing formulas described in para. 56 above; and

(ii) complete the preparation of a least cost expansion program for electricity supply for 1990-99.

58. Conditions for the third tranche release will be:

(i) the completion of a study and initiation of an IDA-agreed action program for improving private sector rice exports;

(ii) preparation of an electricity tariff schedule for all categories of services with rates equal to at least the long-run marginal costs and a schedule for implementation satisfactory to IDA; and

(iii) completion and review with IDA of the Master Plan to rehabilitate the Georgetown Water Supply System.

Trade Policy

59. The trade regime in Guyana has only a few remaining distortions since the Government has taken a number of actions set out in the PFP during the past two years. Since October 1, 1988, no licenses are required and no import tariffs are applicable for imports of CARICOM origin. In addition, the licensing of "no funds" imports, i.e., those not involving the use of official foreign exchange was liberalized so as to allow private individuals to import without licenses from non-CARICOM sources, items for their own use. Import duties are also in line with the CARICOM common external tariff (CET) and unlike other Caribbean countries no stamp duties or other import charges are levied. The remaining issues relate to the prohibited or negative list of imports and some import duty exemptions. Regarding the former, agreement was reached with the Government during the PFP discussions in 1988 to remove all items on the prohibited list except for 36 categories of food, on grounds of food security. The prohibited list (applicable only to non-CARICOM countries) now comprises only 146 tariff items out of a total of 2,285 tariff items. These items mainly comprise meat, poultry, fish, vegetables and some fruits which are produced locally. The list also contains some processed food items (e.g., canned fish and meat, processed fruits, etc.). Food processing accounts for 92 out of a total of 550 registered manufacturing units. But the absence of survey data precludes an assessment of the production coverage of these food items which form the prohibited list of imports. Although the reduction of the prohibited list to a relatively small size (6.4% of a total of 2285) is a significant achievement, further reductions are needed

from the standpoint of improving the efficiency of domestic production and generating revenues from import duties levied on these items. In the case of import duty exemptions, the problem is that these are granted in an ad hoc manner--leading to loss of revenue and reportedly to an inequitable treatment of importers.

60. Action Program. During negotiations, agreement was reached on the removal of the remaining items on the prohibited list, except for four categories of food items (out of 36), representing locally produced basic foods consumed by the low-income population i.e., non-processed meats, poultry, fruit and processed fruit items. Prior to second tranche release, the Government will:

(i) ensure that import licenses are: issued automatically by the Ministry of Trade within two working days for all applications not requiring government foreign exchange; and processed within seven days for all applications requiring foreign exchange from the Bank of Guyana (excluding items in the prohibited list); and

(ii) remove 16 categories of items from the prohibited list.

61. Prior to third tranche release, the Government will:

(i) remove the remaining 16 categories of items to be removed from the prohibited list of imports; and

(ii) begin implementation of an IDA-agreed program to reduce import duty exemptions.

Other Incentives

62. Another disincentive for private sector activity concerns the consumption taxes levied on domestic and imported goods. In cases where a high consumption tax has been imposed on imported goods subject to high tariffs, the burden on importers and consequently on domestic consumers is excessive. Although the consumption tax applies to both domestic producers and importers, in the case of the former the tax is calculated after the mark-up (often in the range of 30-40% to cover overheads and interest), and for the latter, before the mark-up. This procedure leads to higher consumption tax payments by domestic producers vis-a-vis importers and consequently renders them less competitive vis-a-vis importers. Also, these high tax rates encourage tax evasion. Some cascading of the consumption tax on domestic production takes place where producers source their inputs from local suppliers. Cascading of consumption taxes also takes place when imports of packaging materials and machinery spares are subject to consumption taxes. Furthermore, there are instances of wide disparities in the consumption tax rates applied to close substitutes--thus distorting production choices. These issues would be studied and recommendations for improvement would be developed with financing from the TAC.

63. Action Program. Prior to third tranche release, based upon the results of a study on consumption taxes in accordance with terms of reference satisfactory to IDA, the Government would adopt a program satisfactory to IDA to address deficiencies in the application and administration of consumption taxes.

Private Sector Investment Procedures

64. Private sector investment has also been hampered by the lack of a well-defined investment code. The Government sought to address this problem by issuing a document in July 1988, entitled "Guyana Investment Policy" which sets out the incentives available to the private sector and includes policies covering the ownership and security of investments, regulations controlling foreign payments and transfers, the legal framework for businesses operating in Guyana and the norms to which investors should conform. The same document also identifies the Guyana Manufacturing and Industrial Development Agency (GUYMIDA) as the one-stop agency for investors. Notwithstanding these steps, the general perception in the private sector is that the investment policy paper is not fully operational because of the length of processing time.

65. Action Program. The Government has instituted new procedures to reduce the average processing time for the consideration and decision on fiscal incentives for new projects from ten weeks to five weeks, by increasing the frequency of the Fiscal Incentives Committee (FIC) meetings held at GUYMIDA and shortening the time within and between core steps. These include: reviews by the relevant sector ministry; discussion of the project at the FIC; and formal approval of fiscal incentives by the Minister of Finance.

B. PUBLIC SECTOR FINANCES

Central Government

66. The Central Government's overall deficit declined from around 52% of GDP in 1986-87 to 37% of GDP in 1988, reflecting the combined result of reduced current and capital outlays, and a strengthening of current revenue which had deteriorated in 1987. Although the current balance in 1988 registered the lowest deficit relative to GDP since 1983, it still exceeded 27% of GDP. The improvement in revenue reflected high tax payments particularly from the public enterprises, following the 1987 devaluation, and the payment by GUYSUCO of the sugar levy for 1987. Other taxes rose much more moderately, reflecting weaknesses both in the tax system and its administration. On the expenditure side, years of excessive overall deficits, and a resulting accumulated debt service burden, has contributed to persistently high deficits evidenced by the 40 to 50% share of (scheduled) interest payments in total expenditure of the Central Government over the last five years. In 1988, interest payments on the debt was the largest expenditure item in the budget, followed by personnel emoluments. Together these two expenditure categories, which were equivalent to 46% of GDP, accounted for almost 58% of the Central Government's total expenditure and 69% of current expenditure, while current transfers added a further 7% of GDP to government expenditure and the deficit.

67. A much stronger revenue performance as well as expenditure restraint will be needed to significantly improve the Government's financial position. Nevertheless, given the present tax system, including its narrow tax base, its high nominal rates, and the possibilities for obtaining exemptions or avoiding tax liability, most of the strengthening

of the revenue side, at least in the initial phase, is expected to reflect improvements in the performance of the public enterprises (see paras. 71-75 below) and resultant tax and dividend payments to the Central Government.

68. Restraint on the expenditure side has been exercised in a manner consistent with the need to increase public investment and allow for adequate maintenance. First, some savings are expected to be generated from the improvement in the performance of the public enterprises, which will result in the elimination of the need for current transfers from the Government to most of the public enterprises. Second, a policy of wage restraint in 1989 has already substantially reduced the wage bill, to about 27% of current revenue in 1989 from around 40% in 1986-87. However, this wage bill could rise sharply, if a large number of currently unfilled jobs were to be filled. Furthermore, the high vacancy rates, and the preferential wages offered by some government offices have led to a bidding away of staff from some essential offices, which cannot offer competitive salaries, thus putting pressure on the wage bill without improving the overall staffing in the Government. Given the very large vacancy rates with which government offices have been working for a number of years, there is an urgent need for a streamlining of the civil service system to establish critical positions, eliminate duplicating and redundant jobs, and establish pay scales in a systematic fashion in accordance with overall government priorities. To avoid a return to the present situation, a systematic and continuous review of the civil service would be needed--a function which falls within the purview of the Management Services Division (MSD) of the Ministry of Public Administration. However, the MSD is not adequately staffed to carry out its responsibilities, particularly to review the civil service and recommend the elimination of overlapping functions and noncritical vacancies. This issue is being addressed through assistance for the public service review presently being provided by the UK Overseas Development Administration.

69. Action Program. During negotiations, agreement was reached on:

(i) carrying out a public service review (PSR) with a view to identifying overlapping functions and non-critical vacancies in the civil service (i.e., positions not directly related to output growth); and

(ii) ending all central government current transfers to public enterprises from 1990 budget onwards, except for the Guyana Electricity Corporation and for maintenance expenditures of public enterprises to be fully divested.

70. Prior to second tranche release, the Government will commission management audits of the civil service based on the findings of the PSR, under terms of reference satisfactory to IDA. Prior to third tranche release, the Government will begin implementing a program satisfactory to IDA, to eliminate any overlapping functions and noncritical vacancies identified in the management audits.

Public Enterprises

71. The three traditional sectors of the economy, i.e., bauxite, sugar and rice are dominated by the Guyana Mining Enterprise Limited (GUYMINE),

the Guyana Sugar Corporation (GUYSUCO) and the Guyana Rice Group (GRG). Although there have been improvements in the financial performance of these enterprises since 1980, their financial structures remain extremely weak. The debt/equity ratio for GUYMINE stood at 4.7:1 in 1987, while that for GUYSUCO stood at 3.6:1 for 1986 and the net worth of GRG's largest entity, the Guyana Rice Milling and Marketing Authority (GRMMA) was negative in 1987. Furthermore, the enterprises supervised by the Public Corporations Secretariat (PCS) known earlier as the GUYSTAC group, have been performed poorly in the early 1980s, but have shown a marked improvement after 1985. The combined operating balance of the public enterprises turned from a deficit prior to and including 1985 into large operating surpluses in both 1987 and 1988, reflecting improvements in their financial position after the devaluation in 1987. This enabled the corporations to make substantial tax and dividend contributions to the Government, especially in 1988, where these payments amounted to 8.7% of GDP. With an estimated combined operating surplus of 18.6% of GDP in 1989, it is estimated that their tax and dividend payments to the Central Government reached 12.8% of GDP in 1989, equivalent to 9.5% of their current revenue.

72. The financial performance of GUYSUCO and GUYMINE, as the two major exporting public enterprises, was expected to improve substantially in 1989 as a result of the devaluation, and account for most of the initially projected significant improvement in the operating surplus of the public enterprises. Following two years when these two enterprises registered only small combined operating cash surpluses, their targeted combined operating surplus in 1989 was equivalent to 42.4% of GDP. However, recent estimates indicate that a combined surplus for the two enterprises was about 15% of GDP, compared to 5.2% of GDP in 1988. These deviations reflect production losses as a result of extended strikes, a more appreciated exchange rate than targeted, the cost of unprogrammed sugar imports for domestic consumption, domestic sugar sales at subsidized prices, and a different cost and demand response than anticipated to the devaluation of the Guyana dollar. Although the PCS group reached a somewhat higher than programmed cash operating surplus, it compensated for only a small portion of the shortfall in GUYSUCO and GUYMINE. The result has been a major downward movement in the combined operating surplus of the public enterprises for 1989 from a targeted 46.5% of GDP to an estimated 19% of GDP.

73. Rationalization of the operations of GUYMINE and GUYSUCO as well as those in the PCS group is urgently needed, to improve their efficiency and ensuring, inter alia, that they make significant contributions to the Government in the form of taxes, transfers and dividends. Some rationalization of the enterprises has already taken place such as the closing of certain loss-making enterprises and the rehabilitation of others, and progress has been made towards improving their financial performance and efficiency, but these efforts need to be further consolidated. For GUYMINE, as already mentioned, negotiations are in progress with Reynolds International of the U.S. and Alcan of Canada for the establishment of joint ventures. In addition, the PCS has already identified twelve enterprises for divestment, and the Government has set up a Policy Group chaired by the President and a Divestment Unit to implement the divestment program (para. 23). A corporate strategy statement for the PCS group already prepared needs to be implemented. In GUYSUCO, sugar operations are hampered by a lack of capital, while the corporation is expanding its activities into non-sugar areas. GUYSUCO needs to establish

a strategy to attract foreign capital to help increase sugar production, and to provide separate accounting and management systems for non-sugar activities and to attract private investment for these activities. Discussions are under way with Bookers of United Kingdom to obtain management assistance for the sugar industry (para. 23). Another enterprise which needs major rehabilitation is the Guyana Electricity Corporation (GEC), whose daily shutdowns continue to impair both public and private sector operations. The IDB is developing a program for rehabilitating GEC.

74. Action Program. During negotiations, agreement was reached on a strategy statement committing GUYSUCO to seek foreign capital to improve sugar production and to set up separate accounting and management systems and attract private investment (foreign or local) for its non-sugar activities, i.e., rice production, other grain production, dairy and livestock development, aquaculture and orchard development.

75. The second tranche will be conditional upon:

(i) putting into effect an action program and a schedule for implementing the corporate strategy for the PCS group; and

(ii) establishing operating procedures and auditing systems satisfactory to IDA to monitor the financial performance of GUYMINE, GUYSUCO, the PCS Group and transfers of targeted amounts from these enterprises to the Central Government.

C. PUBLIC SECTOR INVESTMENT PROGRAM

76. The long period of economic decline and consequently inadequate asset maintenance has resulted in badly deteriorated infrastructure services. Accordingly, the major focus of the public sector investment program will be the rehabilitation of basic infrastructure that is critical for supporting the program's objectives of increasing exports and private investment. An urgent task is to restore electricity supply to required levels. At present the main Demerara-Berbice system can supply only about 16 megawatts at most, as against a maximum demand of 35 megawatts.

77. The composition of the PSIP largely reflects ongoing projects dominated by a few major projects to rehabilitate electricity supply, the bauxite industry, sugar and rice sectors and water supply. As regards new projects, in the absence of a well-developed pipeline of technically sound and economically viable projects, there is a tendency for the PSIP to include projects which are at the most advanced stage of preparation rather than necessarily those of the highest priority. Moreover, there is also a tendency to include in the PSIP projects of a large size relative to domestic and foreign resource availability and some times beyond the country's implementation capacity. There is, thus, a need to design the PSIP consistent with the macroeconomic framework in terms of size, composition and financing. Procedures need to be developed to institute a pre-investment review system to ensure that individual project proposals are linked with agreed macroeconomic and sector strategies; and that stringent tests of economic viability and technical and environmental feasibility are applied. A three-year rolling core PSIP and a reserve list of projects needs to be put in place, and a monitoring system introduced.

78. Action Program. Agreement has been reached with the Government on:

(i) the size and composition of the three-year PSIP (1990-92), to bring it in line with projected domestic and foreign resource availability;

(ii) modalities including the type of information required, criteria for admission of new projects, and timing for reviews of the PSIP (in the context of a rolling three-year framework);

(iii) institutional arrangements--principally the staffing in the State Planning Secretariat for providing guidelines on project preparation to line ministries and government agencies, and for evaluation and monitoring of projects; and

(iv) improvement of external aid coordination through the services of an advisor (financed by the TAC) to the Ministry of Finance to maintain continuous contact with donors and to facilitate procurement and disbursement of funds provided by bilateral and multilateral donors.

79. Prior to second tranche release, the Government will implement the institutional arrangements to strengthen the State Planning Secretariat and the Bank would review the rolling PSIP and ensure progress satisfactory to IDA.

80. Prior to third-tranche release the Government would update the rolling PSIP in a manner satisfactory to IDA.

D. SOCIAL SECTOR PROGRAMS

81. Economic decline in Guyana over the past 15 years has led to the dilapidated state of much of the economic and social infrastructure, with widespread and substantial reductions in living standards and the provision of social services. Although the successful implementation of the structural adjustment program should help reverse this decline in the long run, some aspects of the program could impose additional stress on certain segments of the population. The groups of people particularly vulnerable to the effects of the ERP include the rural and urban poor, the unemployed and underemployed as well as the retired elderly. Their real incomes and hence their standard of living are bound to fall in the short run. Another vulnerable group would be those laid off as part of the rationalization of the Central Government and public enterprises. In order to protect groups which are particularly vulnerable during the adjustment process, and engender public support for the ERP, a social sector program (SIMAP) has been developed. At the Special Donors Meeting held on July 10, 1989, expressions of support amounted to nearly US$6 million of the US$10 million sought.

PART V - MEDIUM-TERM PROSPECTS, CREDITWORTHINESS AND EXTERNAL CAPITAL REQUIREMENTS

82. Predicated on the timely availability of the projected financial inflows and implementation of the ERP to address the above-mentioned adjustment issues, projections have been prepared which show that the economy could recover from its currently estimated decline of 3.3% in real GDP in 1989, achieve real GDP growth about 2.9% in 1990, and 4.6% in 1991. In 1992-94, real GDP growth is projected to average about 3.5% per year. The projected GDP growth in the short term would depend largely on using existing underutilized capacity for bauxite, sugar, rice, timber, and manufactured exports. Over the medium term, sugar production is expected to stabilize at levels compatible with Guyana's export quota to the EEC and the United States. If, on the other hand, financial inflows are lower than projected and constrain the imports of essential inputs, a much lower GDP growth rate would be inevitable. Investment during 1990-92 is projected at around 34% of GDP, reflecting the execution of externally financed projects to rehabilitate infrastructure.[6] Domestic savings are projected to remain at around 24% of GDP during 1990-92. Benefits from these savings and investments, however, will largely accrue beyond the program period 1990-92. Per capita consumption is projected to increase at 2.6% per year in real terms during 1990-92 reflecting the increased resource balance in 1990 financed from external sources. The primary current account balance (before interest payments) of the non-financial public sector will improve from 18% of GDP in 1989 to 22% of GDP in 1990 and to about 30% of GDP in 1991. However, the overall public sector deficit will increase from 48% of GDP in 1989 to about 54% of GDP in 1990, owing to increased payments of interest, increased capital expenditures and the impact of the devaluation upon the foreign component of the PSIP, before dropping to 41% of GDP in 1991. Based on the successful implementation of the stabilization measures and the fact that capital expenditures will be financed almost entirely from external resources in 1990 and largely from such resources in 1991, the annual rate of inflation is projected to decline from 90% in 1989 to about 30% in 1991.

83. Exports are projected to recover at an average annual rate of about 9% in real terms during 1990-92, with a significant recovery in 1990, reflecting the improvement in competitiveness, the timely availability of inputs, and barring any work stoppages. Exports of high value calcined bauxite are projected to increase from 417,000 tons in 1988 to 480,000 tons in 1991. Exports of sugar are projected to increase from 147,000 tons in 1988 to 193,000 tons in 1991. Exports of rice are projected to increase from 62,000 tons in 1988 to 77,000 in 1991. These export targets are considered to be within achievable ranges since sugar production averaged

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6/ Total investment as a proportion of GDP is relatively high because it is dominated by public investment (which has a foreign component of 72%) needed to rehabilitate productive infrastructure, deteriorated over the past two decades.

200,000 tons in 1983-86, calcined bauxite output averaged 545,000 tons in 1984-85 and rice exports peaked at 105,000 tons in 1978. Imports are projected to grow at an average annual rate of about 10% in real terms in 1990-92 based on the assumption that projected external financial inflows would be forthcoming. The increase in imports in 1990 largely reflects capital goods imports for rehabilitation projects in the bauxite and sugar industries and other infrastructure projects. The trade deficit is projected to increase from an annual average of US$17 million in 1988-89 to some US$67 million per year during the program period 1990-92. Beyond the program period, the trade deficit is projected to decline gradually, reaching about US$25 million in 1996. A better performance of the trade balance is not considered feasible during the program period, both because of the initial narrow base of Guyana's exports and the need to increase imports to restore and expand productive capacity. Likewise, the external current account deficit is projected to increase from an annual average of US$37 million in 1988-89 to about US$150 million per year during the program period 1990-92. The current account deficit is not projected to decline vis-a-vis the trade balance, because of projected interest payments (cash basis) averaging US$43 million during 1993-96.

84. Guyana's cumulative external current account deficit during 1990-92 is projected at about US$451 million (cash basis). However, with scheduled amortization (including repurchases to the Fund), and the need to start building up gross international reserves, Guyana's financing requirements for the period January 1990-December 1992, are estimated at around US$784 million--a sizable amount in relation to Guyana's population of 0.75 million. This gap consists mainly of US$303 million for project financing,[7] and about US$482 million for balance of payments support. The amount for balance of payments support includes US$229 million needed to clear arrears, to the Fund (US$142 million), Bank (US$57 million) and the Caribbean Development Bank (US$30 million). A large part of the external assistance has been secured through the Support Group for Guyana. As noted in Annex I(a), the financing plan to support the ERP is in place.

85. The financing program for 1990-92 would permit reasonable progress toward the objectives mentioned above. Essential import levels could be maintained, arrears could be eliminated during 1990, and existing and expected rescheduled debt service obligations fulfilled. However, given the country's small economic base (GNP per capita of US$410 in 1988), the excessively large debt (US$2,500 per capita) and the time required for substantial economic growth to take place, the burden of existing debt obligations and expected rescheduled ones is substantially above the country's future debt service capacity. Thus, substantial debt relief will continue to be required for the country during the 1990s. Particularly cautious economic and financial management will continue to be essential beyond 1991 in order to complete the adjustment process. The servicing of external debt obligations has become an increasing burden for Guyana since the mid-1970s with declining export receipts and increased interest and amortization liabilities. Prospects of achieving viability in the external accounts would appear possible over the longer term provided that: (i) the authorities continue to undertake prompt actions to advance the process of structural adjustment, and that official assistance continues to be made available on highly concessional terms in the amounts required; and (ii)

7/ For 1990-91, project-related external financing is estimated at US$199 million, of which donor commitments exist for US$161 million.

continued reschedulings are put in place and further debt relief is obtained. Nevertheless, the situation will at best constitute a "tight fit" over the short to medium term and, in the absence of a major unexpected improvement in the terms of trade, it is highly unlikely that dependence on balance of payments assistance can be eliminated before the mid- to late 1990s. The balance of payments constraint on Guyana's growth is such that, should the external net capital inflows fall significantly below projected levels, the country would have to significantly reduce its growth rate below that included in these projections, thus affecting its debt servicing capacity.

86. The initial responses by Guyana's creditors with regard to the issue of debt rescheduling has been positive. Trinidad and Tobago, the largest creditor (holding US$412 million, or over 20% of Guyana's total debt), has agreed to provide a very substantial interest payment relief (no interest payments until 1991; applicable interest rate reduced by about 1/3; 10-year repayment, after a 10-year grace period). Likewise, the Caribbean Multilateral Clearing Facility which ceased to operate in 1983, because of Guyana's arrears, has agreed to a similar arrangement to be applied to a debt of US$146.5 million accumulated as at the end of 1988. Paris Club creditors also rescheduled debts amounting to US$195 million at its meeting held on May 23, 1989. On an exceptional basis, Guyana received "Venice terms" i.e., rescheduling over 20 years, including a grace period of 10 years. The Fund's contribution would amount to 266% of quota equivalent to SDR 131 million (US$170 million). Moreover, some donors (the United States and the United Kingdom) have recently indicated their willingness to consider Toronto terms for debt rescheduling. This would be very important to help reduce the above mentioned risks.

87. Disbursements from IDA during 1990 and 1991 are shown on page 13 above in Table 2. Because of the need to make debt service payments, the Bank Group's net disbursement during 1990 (the first year) would amount to a US$8.7 million. But during 1990-91, the net disbursements would amount to about US$19.5 million translating to a net transfer of US$11.5 million. In the case of the Fund, at 266% of quota, the net transfer during 1990-93 would be marginally positive. The CDB's net disbursements including project financing for 1990-91 would amount to a positive US$3 million.

PART VI - CREDIT FEATURES

Credit Amount and Cofinancing

88. The proposed IDA credit in support of the SAC would be US$78.0 million equivalent, to be disbursed in three tranches: the first one of US$50 million, and two of US$15 million and US$13 million respectively, depending on compliance with agreed policy conditionality. The first tranche of the credit is expected to be disbursed within one month following Board approval, assuming rapid compliance with routine conditions of effectiveness. The second and third tranches are expected to be disbursed within six and fifteen months after effectiveness, following compliance with respective tranche conditions. The SAC would be cofinanced by the CDB (US$42 million) and the Federal Republic of Germany (US$6 million). These, together with the IDA credit would total US$126 million representing the foreign exchange component of the program.

Procurement and Disbursement

89. The proposed credit would finance the CIF cost of eligible imports, excluding alcoholic beverages, tobacco and tobacco products, sugar, luxury goods products, military and hazardous and other goods specifically prohibited in a negative list. Imports under existing contracts for the supply of certain goods such as fertilizers, petroleum products, and commodities would be eligible for IDA financing provided that they were not procured from a single source or under bilateral trade agreements, unless otherwise agreed by IDA. Currently, the major imports and their orders of magnitude per year are: petroleum products (US$79 million), fertilizers (US$10 million), spares for GUYMINE (US$12 million), and spares for the sugar and rice industries (US$15 million) which together constitute over half of non-project imports. CIDA would be financing almost the entirety of fertilizer imports and ODA (UK) and the Inter-American Development Bank would be financing a large proportion of spares for the sugar and rice industries under their respective lines of credit. Consequently, of the major import items only petroleum products and GUYMINE spares are potentially eligible for IDA financing.

90. IDA review of public procurement procedures in Guyana conducted in 1989 revealed that for large capital purchases or national projects, procurement is usually carried out through international competitive bidding (ICB) while local competitive bidding (LCB) is used primarily for smaller-scale construction or works projects. All central government procurement fall within the purview of the Central Tender Board (CTB); public corporations (e.g., GUYMINE, GUYSUCO) and statutory bodies have their own tender boards. The procurement procedures are generally consistent with Bank procurement policy. Established importers such as GUYMINE, GUYSUCO, etc., have over the years developed and depended on long established trading links with certain key suppliers. Although in many cases formal requests for price quotations are not issued, these companies consistently review prices by seeking competitive bids on an on-going basis in an effort to ensure optimal pricing to the extent possible. A survey of private sector procurement practices determined that some private trading companies follow the practice of obtaining competitive price quotations. However, in many instances, suppliers do not find it worthwhile to send bids and consequently importers are forced to obtain supplies from a single source. Also, due to foreign exchange availability constraints, many importers - particularly those who do not have systematic access to foreign exchange - deal solely with those foreign suppliers who are willing to provide credit terms, frequently at a high premium.

91. A more difficult issue concerns the low value of IDA eligible imports per month and its implications for retroactive financing. A recent procurement mission to Guyana explored the possibilities for financing imports, but its conclusion was that IDA could finance only about US$7 million a month. The main problem is the very depressed state of the economy, with recorded non-project imports running at about US$190 million annually. About 15% of petroleum imports are financed by a term credit from Venezuela, fertilizers are financed by CIDA and spare parts by UK, ODA, OPEC, IDB and suppliers. Private sector imports are almost all financed through the parallel market, with the result that recorded private sector imports for 1989 amounted to only US$24 million. Moreover, the extreme scarcity of foreign exchange that prevails means that, with the

exception of petroleum, eligible imports by both the public and the private sectors cannot be planned on a regular basis. Thus, it is impossible to predict the amount of most import items in any given month. As a review of purchase prices for petroleum products indicates that they are competitive, they would represent eligible imports, and IDA could finance about US$5.0 million a month. A rough estimate as to other public and private sector imports that IDA could finance amounts to US$2.0 million a month. Guyana is faced with the need to repay a bridge loan from BIS by mid-September 1990. It will need to receive import financing of an amount equivalent to the full US$50 million first tranche of the IDA resources if Guyana is to be able to free up foreign exchange resources needed for repayment of the BIS loan. Since IDA credit effectiveness is expected in late July, and IDA will be able to finance only about US$7 million of imports a month, this implies a need for US$43 million in retroactive financing, or 55% of the proposed US$78 million SAC. While well beyond normal guidelines for structural adjustment operations, we believe that such amount of retroactive financing, to cover eligible transactions dating to SAC appraisal (June 1989), is justified in this case, as the implementation of the Economic Recovery Program being supported by the proposed SAC and IMF arrangements began with the major devaluation and related actions in April 1989 and has been underway ever since. But Board presentations of the proposed IDA and IMF operations, originally scheduled for the latter part of 1989 were substantially delayed, in large measure because of delays in arranging the external finance necessary to support the program.

92. For the proposed credit, the following procedures will apply:

(a) Contracts for general imports to cost the equivalent of US$2 million or more shall be awarded on the basis of simplified ICB procedures; this would include all purchases of petroleum products; and

(b) for all imports to cost under US$2 million equivalent: (i) public sector agencies and companies will follow their normal competitive bidding procedures acceptable to IDA; and (ii) private sector companies could follow their own established commercial practices, provided that price quotations from eligible suppliers from at least two countries could be sought, except where direct contracting is permitted under the circumstances described under para. 3.5 of IDA procurement guidelines.

Assurances were obtained at negotiations that the above procurement procedures will be followed under the credit.

93. The Bank of Guyana (BOG) would administer the credit and would be responsible for the collection and maintenance of relevant documentation under the credit, ensuring that only purchases that meet the agreed procurement procedures are included in withdrawal applications. To assist with this work, a qualified procurement agent to be financed from the Technical Assistance Credit would be retained for the duration of the credit. Disbursements would be made against statements of expenditure (SOEs), except for contracts valued at US$2 million or more, for which disbursements would be made against full documentation. The minimum value for each SOE submitted would be US$100,000 equivalent and detailed documentation evidencing expenditures would be retained by BOG and made available for the required audit and also for supervision by the Bank.

Expenditures for goods procured under individual contracts valued at less than US$50,000 equivalent would not be eligible for financing under the credit.

Benefits and Risks

94. Benefits. The main benefits of the government program will be the gradual improvement in the standard of living of the population through the restoration and maintenance of higher and sustained economic growth. The program's success should strengthen the confidence of external donors and investors in Guyana's growth, balance of payments and employment prospects. The credit itself will help alleviate the current shortage of imported inputs and intermediate goods that constrains capacity utilization and export competitiveness. The financing program would permit reasonable progress toward meeting the Government's longer term macroeconomic objectives. Essential import levels would be maintained, arrears would be eliminated and debt service obligations would be fulfilled.

95. Risks. The major risk of the policy reform program relates to the possibilities of setbacks in macroeconomic policy that would produce a stoppage or a reversal by the Government in implementing the medium-term adjustment program. Specifically, the risks are: (i) Lack of political sustainability. While the Government now seems committed to the program, its commitment may be eroded because of political opposition resulting from the political and social cost of adjusting to the new incentives and the low level of net flows in the program. (ii) The severity of the adjustment program which may cause drastic cuts in real incomes and labor strikes and depress the economy to such an extent that conditions to produce a supply response may take a longer time; (iii) Lack of implementation capacity and of skilled manpower which could adversely affect the projected supply response. (iv) A total breakdown of the already deficient power supply and of the significantly deteriorated transport infrastructure could occur. (v) Failure of domestic or foreign investment to respond to the new incentive climate. (vi) Unexpected adverse developments in the world economic environment (sharp fall in world commodity prices and demand for Guyana's exports, or sharp increases in petroleum prices) and in weather conditions; and (vii) the failure of donors to provide net balance of payments flows on a timely basis which would cause Guyana's export performance to fall short of the projections. The bauxite sector in particular would be adversely affected if spare parts and machinery to be financed through the EDF/SYSMIN loan are delayed.

96. While the above risks are substantial and will not be eliminated over the medium term, there are, factors that will help to mitigate them. First and most importantly, the Government has acknowledged that it has no choice but to tackle the developmental issues head on. The Government has already demonstrated its commitment to economic reform through the major devaluation of its currency and price pass-throughs in April 1989 (para. 14). It has also shown a commitment to undertake a medium-term program of structural reform--by eliminating most trade restrictions, taking measures to increase revenues and reduce current expenditures, making interest rates positive in real terms, initiating a rationalization of the public sector, increasing the pace of divestment, and increasing the role of the private sector in the economy. Second, the Government is committed to maintaining export competitiveness. The implementation of this policy includes the continuous review of the level of the real exchange rate. The recent

legalization of the parallel market for foreign exchange and the movement of some transactions to this market indicates commitment to this policy. Third, the program gives priority to the rehabilitation of existing productive capacity and infrastructure through the provision of imports of inputs and raw materials required for export production. This should give a boost to exports, domestic production and employment. In the area of electrical power generating capacity, there is a critical 15-20 MW shortage which could adversely affect production and exports. The Inter-American Development Bank is actively considering financing for this purpose. Fourth, support through a highly focussed TAC should strengthen from the outset implementation capacity and also technical work required where there is a dearth of local expertise. Fifth, Bank assistance in the preparation of a program to cushion the social impact of adjustment which met with a positive response from the donors at the Special Donors Meeting of the CGCED held in July 1989. The IDB has taken a lead role in this area, although important issues, particularly the need for assurances of adequate autonomy for the administering agency, need to be resolved to enable IDB financing to go forward. Finally, a significant effort to diversify exports should reduce the adverse effects on export performance of changes in the international economic environment and in the prices of Guyana's traditional exports and of petroleum.

97. Effects on the Environment. The environmental situation in Guyana reflects the relatively low state of the country's industrial development. Ninety percent of the population live on the coastal fringe with 30% living in five urban centers. As such, human impacts tend to be concentrated in these areas with the provision of potable water and sewerage and solid waste disposal being primary concerns. Sufficient cleared land for expansion of the country's primary exports, rice and sugar, and local food needs are available as acreage under cultivation and output has declined in recent years. The population in the country's large interior is scattered in small settlements involved in various exploitative industries such as forestry, mining and livestock. Direct impacts from these populations are generally localized to their immediate areas with mining and forestry activities having the most long-term impact.

98. Major environmental issues revolve around current and future resource development practices. The increase in gold and diamond dredge mining activities on streams in the interior can be expected to have cumulative impact on the rivers. In addition, the release of mercury into the streams can affect fish supply to the indigenous population. These issues are now being addressed by the relevant government agencies. Bauxite mining is relatively well controlled and although no efforts are currently made to remove overburden or clean smokestack pollutants, no broad environmental damages are occurring as a result of these activities. The country's forest industry is quite small given the size of the forested area. Exploration of new forest and mining areas will probably increase following the completion of the Brazilian-financed 175-mile road from Letham to Kurupukari and the subsequent completion to Mabura Hill. While greatly enhancing prospects for the development of Guyana's interior, the road has the possibility of affecting negatively wildlife and other biological resources in the area it traverses. Regulations and programs are being prepared by the Government to control the environmental impact of the road.

PART VII - RECOMMENDATION

99. I am satisfied that the proposed credit would comply with the Articles of Agreement of the Association and recommend that the Executive Directors approve the proposed credit.

100. Because of the time elapsed since Board approval of Credit 1729-GUA (Bauxite Industry Technical Assistance Project), I also recommend that the Executive Directors approve an increase to retroactive financing approved under such credit in an amount equivalent to US$3.0 million.

Barber B. Conable
President

Attachments

Washington, D.C.
June 7, 1990

Table 1: GUYANA - KEY INDICATORS, 1985-1996

	Actual				Est.	Projections				
Key Indicators	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
GDP Growth Rate	0.0	0.2	0.7	-2.6	-3.3	2.9	4.6	3.1	3.5	4.0
Per Capita GDP Growth Rate	-2.2	-0.8	-0.3	-3.6	-4.3	1.9	3.5	2.0	2.4	2.9
Consumption/Capita Growth Rate	7.7	10.1	-14.4	-16.6	-7.7	15.3	-4.1	-3.4	3.7	2.8
Actual Debt Serv.(in US$) 1/ 3/	31.7	38.2	31.7	31.9	42.3	78.6	102.9	101.0	111.3	115.1
Actual Debt Service/XGNFS 2/ 3/	13.2	15.8	11.6	12.4	17.3	30.0	32.7	29.0	27.7	23.0
Gross Investment/GDP (1985 pr.)	27.9	26.7	28.5	33.4	32.8	33.8	33.3	34.7	34.6	34.3
Domestic Savings/GDP 4/	10.0	0.0	14.2	25.7	28.4	18.9	24.9	28.9	25.3	25.4
Public Investment/GDP	24.9	24.3	18.5	26.2	25.9	27.1	29.5	27.2	26.9	26.7
Ratio of Public/Private Invest.	8.6	10.0	1.9	3.7	3.8	4.0	7.8	3.6	3.5	3.5
C. Govt. Revenues/GDP	39.4	45.8	33.6	40.1	37.5	41.5	46.0	48.7	48.4	48.2
C. Govt. Curr. Expend./GDP 5/	-75.4	-85.1	-70.6	-67.4	-73.2	-57.0	-65.5	-66.5	-66.0	-65.5
Curr.Acct.Def.(-) or Sur.(+)/GDP	-36.0	-39.3	-37.0	-27.3	-35.7	-15.5	-19.5	-17.8	-17.6	-17.3
Export Growth Rate (XGNFS)	0.7	-8.3	-2.5	-7.8	-6.0	7.1	20.1	10.7	15.5	8.8
Import Growth Rate (MGNFS)	13.9	2.6	-10.7	-13.8	8.2	27.4	2.1	9.0	8.7	5.9
Current Account (in US$) 3/	-111.3	-141.3	-119.6	-100.5	-64.6	-251.8	-103.6	-95.7	-83.5	-73.7
Current Account/XGNFS 3/	-45.2	-57.3	-42.4	-38.6	-26.4	-96.1	-32.8	-27.5	-20.8	-16.8

1/ Debt rescheduling has been projected only up to 1992.

2/ All magnitudes relating to the external account (as in the case of PFP), are expressed as shares of exports of goods and nonfactor services. A meaningful analysis of time trends in relation to nominal GDP is precluded by: a) the underestimation of GDP in the context of a growing parallel economy, and b) wide disparities in the impact of a series of major devaluation of external accounts magnitude and the nominal GDP.

3/ Actual debt service reflects payments in cash. It also reflects projected payments in cash for future years. Data on scheduled debt service are presently being prepared by the IMF staff and will be included in the PFP to be distributed shortly to the Executive Directors.

4/ Guyana's weak economic data base precludes a meaningful quantification of public and private savings consistent with national accounting concepts.

5/ Includes interest on public debt (external and domestic). Interest amounted to 32.5% of GDP in 1988.

Table 2: GUYANA: BALANCE OF PAYMENTS a/
(US$ million)

		Est. b/	Projected b/						
		1989	1990	1991	1992	1993	1994	1995	1996
A	Exports of Goods & NFS	244.6	261.9	314.6	348.3	402.3	437.7	472.6	501.0
	1. Merchandise (FOB)	197.5	217.7	266.1	299.1	336.1	366.7	396.4	419.2
	2. Non-Factor Services	47.1	44.2	48.5	49.2	66.2	71.0	76.2	81.8
B	Imports of Goods & NFS	301.5	384.0	392.1	427.5	464.5	492.0	520.3	552.2
	1. Merchandise (CIF)	232.2	312.6	317.2	354.5	374.5	396.4	418.6	444.0
	2. Non-Factor Services	69.3	71.4	74.9	73.0	90.0	95.6	101.7	108.2
C	Resource Balance	-56.9	-122.1	-77.5	-79.2	-62.3	-54.3	-47.7	-51.2
D	Net Factor Income	-14.7	-135.4	-36.5	-37.5	-40.1	-40.9	-37.1	-45.1
	1. Factor Receipts	0.3	0.6	1.2	1.6	2.1	2.4	2.7	2.8
	2. Factor Payments	15.0	32.6	37.7	39.1	42.2	43.3	39.8	47.9
	3. Interest arrears (IFIs)	..	103.4	..	..	..	..	..	..
E	Private Transfers	7.0	5.7	10.4	21.0	18.9	21.5	24.5	26.6
F	Current Account Balance	-64.6	-251.8	-103.6	-95.7	-83.5	-73.7	-60.3	-69.7
G	Long-Term Capital Inflow	16.4	-61.4	60.4	40.3	22.7	22.7	45.5	51.7
	1. Direct Investment	5.2	10.0	17.0	20.0	8.0	8.0	8.0	8.0
	2. Official Capital Grants	6.9	3.0	3.2	3.8	5.4	5.5	5.7	5.9
	3. Net MLT Loans	-0.2	-77.2	31.7	14.8	7.6	7.3	29.8	35.3
	a. Disbursements	27.1	93.7	81.8	61.6	65.6	67.1	71.4	73.2
	b. Repayments	27.3	44.9	50.1	46.8	58.0	59.8	41.6	37.9
	c. Arrears (IFIs)	..	126.0	..	..	..	..	..	..
	4. Other MLT Flows (net)	4.5	2.8	8.5	1.7	1.7	1.9	2.0	2.5
	Total Other Items (Net)	-14.5	0.0	-15.1	-15.2	-11.1	-11.7	-12.8	-13.7
	1. Net Short Term Capital	0.0	0.0	-15.1	-15.2	-11.1	-11.7	-12.8	-13.7
	2. Errors and Omissions	-14.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
I	Overall Balance	-62.7	-313.2	-58.3	-70.6	-71.9	-62.7	-27.6	-31.7

a / These figures are based on projections of actual debt service payments as opposed to scheduled debt service payments. Balance of payments information on an accrual basis through 1992, reflecting scheduled debt service payments, are presently being prepared by IMF staff. They will be included in the PFP to be distributed shortly to the Executive Directors.

b / As of June 5, 1990.

Table 2: GUYANA: BALANCE OF PAYMENTS (contd.)
(US$ million)

	Est.	Projected						
	1989	1990	1991	1992	1993	1994	1995	1996
J Financing	62.7	313.2	58.3	70.6	70.7	60.9	26.3	30.5
Change in Net Int'l. Reserves	-4.8	-9.1	-14.3	-10.0	-5.0	-5.0	-3.0	-2.0
Change in Arrears	-742.4	-425.6	-32.9	10.1	53.7	47.0	9.5	15.5
Financing from IFIs	0.0	222.0	68.0	35.5	0.0	0.0	0.0	0.0
Exceptional Financing	809.9	525.9	37.5	35.0	22.0	18.9	19.8	17.0
Rescheduling	783.0	452.0	21.0	19.0	0.0	0.0	0.0	0.0
Bilaterals and others	26.9	73.9	16.5	16.0	22.0	18.9	19.8	17.0
K Financing Gap	0.0	0.0	0.0	0.0	1.2	1.8	1.3	1.2
L Shares of Exports of Goods and NFS								
1. Resource Balance	-23.3	-46.6	-24.6	-22.7	-15.5	-12.4	-10.1	-10.2
2. Total Interest Payments	-6.0	-51.7	-11.6	-10.8	-10.0	-9.4	-7.9	-9.0
3. Current Account Balance	-26.4	-96.2	-32.9	-27.5	-20.8	-16.8	-12.8	-13.9
4. MLT Capital Inflow	-0.1	-28.8	10.1	4.2	1.8	3.1	7.8	9.1
M Foreign Exchange Reserves:								
1. Int'l Reserves (Net)	-114.4	-94.9	-117.7	-136.9	-84.2	-55.0	-36.2	-17.8
2. Gross Reserves	11.3	20.4	34.7	44.7	49.7	54.7	57.7	59.7
3. Gr. Res. in Mths. of Imports	0.6	0.8	1.3	1.5	1.6	1.7	1.7	1.6

GUYANA - EXTERNAL CAPITAL AND DEBT

(US$ millions at Current Prices)

	Est.	Projected						
	1989	1990	1991	1992	1993	1994	1995	1996
A. Disbursements								
1. Public & Publicly Guar. LT	56.4	269.1	141.7	99.3	95.0	94.2	97.4	96.4
Official Creditors	51.9	258.0	134.9	92.2	87.8	87.0	90.2	89.2
Multilateral	0.0	162.5	100.5	74.1	55.6	57.1	59.4	61.2
o/w World Bank	0.0	66.2	13.2	0.2	0.0	0.0	0.0	0.0
Bilateral	51.9	95.5	34.4	18.1	32.2	29.9	30.8	28.0
Private Creditors	4.5	11.1	6.8	7.1	7.2	7.2	7.2	7.2
Suppliers	4.5	8.4	6.8	7.1	7.2	7.2	7.2	7.2
Financial Markets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Others a/	0.0	2.7	0.0	0.0	0.0	0.0	0.0	0.0
2. Private Non-Guar. LT	2.1	5.4	1.0	0.1	0.1	0.1	0.1	0.1
3. Total LT Disbursements	58.5	274.5	142.7	99.4	95.1	94.3	97.5	96.5
4. IMF Purchases	0.0	117.5	32.1	23.0	0.0	0.0	0.0	0.0
5. Net Short-Term Capital	0.0	0.0	-15.1	-15.2	-11.1	-11.9	-12.8	-13.7
6. Total incl. IMF & Net ST	58.5	392.0	159.7	107.2	84.0	82.4	84.7	82.8
B. Repayments b/								
1. Public & Publicly Guar. LT	15.7	161.8	43.8	41.3	32.9	28.6	26.1	25.1
Official Creditors	7.4	144.0	28.2	28.3	26.8	24.1	23.1	21.9
Multilateral	5.6	18.7	28.2	28.3	16.8	15.4	15.5	15.1
o/w World Bank	1.5	5.6	8.8	8.7	6.3	5.5	5.7	5.6
Arrears to IFIs	..	125.3	..	..	..	..	..	..
Bilateral	1.8	0.0	0.0	0.0	10.0	8.7	7.6	6.8
Private Creditors	8.3	17.8	15.6	13.0	6.1	4.5	3.0	3.2
Suppliers	0.8	14.8	12.7	10.1	3.2	1.6	0.1	0.2
Financial Markets	7.5	0.9	0.0	0.0	0.0	0.0	0.0	0.0
Other a/	0.0	2.1	2.9	2.9	2.9	2.9	2.9	3.0
2. Private Non-Guar. LT	11.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0
3. Total LT Repayments	27.3	161.8	43.8	41.3	32.9	28.6	26.1	25.1
4. IMF Repurchases	0.0	8.4	9.4	7.1	25.1	31.2	15.5	12.8
C. Interest								
1. Public & Publicly Guar. LT	8.1	113.8	9.3	9.1	7.4	6.5	5.8	5.5
Official Creditors	6.5	109.3	5.5	5.9	5.4	5.2	5.0	4.8
Multilateral	6.0	5.2	5.5	5.9	5.4	5.2	5.0	4.8
o/w World Bank	0.5	1.2	2.0	1.9	1.8	1.6	1.5	1.4
Arrears to IFIs	..	104.1	..	..	..	..	..	..
Bilateral	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Private Creditors	1.5	4.5	3.8	3.2	2.0	1.3	0.8	0.7
Suppliers	0.4	3.7	3.2	2.5	1.3	0.6	0.1	0.0
Financial Markets	1.1	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Other a/	0.0	0.5	0.6	0.7	0.7	0.7	0.7	0.7
2. Private Non-Guar. LT	3.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
3. Total LT Interest	11.3	113.8	9.3	9.1	7.4	6.5	5.8	5.2
4. IMF Service Charges	0.0	1.8	2.1	1.5	5.5	6.9	3.4	2.8
5. Interest on ST Debt	3.8	21.9	26.3	28.5	29.3	29.9	30.6	39.9
7. Total incl. IMF & Net ST	15.1	137.5	37.7	39.1	42.2	43.3	39.8	47.9

a / Refers to nationalization.

GUYANA - EXTERNAL CAPITAL AND DEBT (continued)

(US$ millions at Current Prices)

	Est.	Projected						
	1989	1990	1991	1992	1993	1994	1995	1996
D. Debt Service/Exports b /								
1. Public & Publicly Guar. LT	9.7	105.2	16.9	14.5	10.0	8.0	6.8	6.1
2. Private Non-Guar. LT	6.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
3. Total LT Debt Service	15.8	105.2	16.9	14.5	10.0	8.0	6.8	6.0
4. IMF Repurchases+Serv.Chgs.	0.0	3.9	3.7	2.5	7.6	8.7	4.0	3.1
5. Interest only on ST Debt	1.6	8.4	12.2	12.0	10.0	9.5	9.2	10.7
6. Total (LT+IMF+ST+ Int.)	17.3	117.5	32.7	29.0	27.7	23.0	19.9	19.9
I. Interest Burden Ratios								
2. Total Interest/Exports b /	6.2	52.5	12.0	11.2	10.5	9.9	8.4	9.6

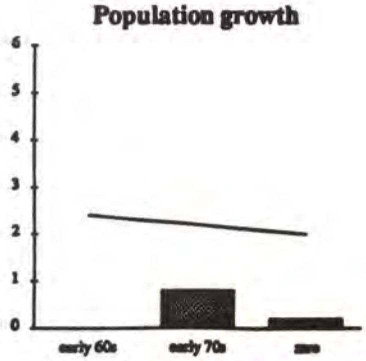
a / Includes debt service of newly disbursed funds.
b / Ratio to "Exports" with latter defined to include merchandise and non factor services.

Social Indicators of Development, 1989

Guyana

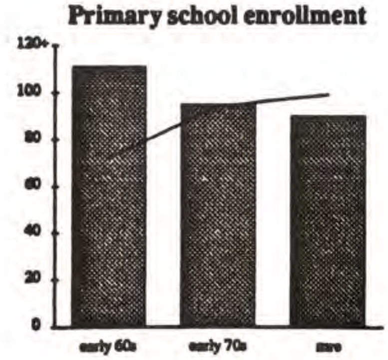
	Unit of measure	25-30 years ago	15-20 years ago	Most recent estimate (mre)	Same region / income group: Latin America, Caribbean	Same region / income group: Low-income	Next higher income group
HUMAN RESOURCES							
Size, growth, structure of population							
Total population (mre = 1988)	millions	..	0.73	0.80	416	2,881	629
14 and under	% of pop.	..	43.8	35.4	36.9	35.4	38.3
15-64	"	..	52.8	60.2	58.6	60.2	57.4
Age dependency ratio	unit	1.06	0.89	0.65	0.71	0.66	0.74
Percentage in urban areas	% of pop.	29.2	29.6	33.4	72.6	34.2	56.1
Females per 100 males							
Urban	number	..	101	..	104	..	..
Rural	"	..	101	..	..	..	..
Population growth rate	annual %	..	0.8	0.2	2.0	2.0	2.2
Urban	"	..	1.0	2.2	3.2	3.7	3.5
Urban/rural growth differential	difference	..	0.2	2.7	3.7	2.2	2.5
Projected population: 2000	millions	..	..	0.77	516	3,625	805
Stationary population	"	..	..	0.85	..	..	..
Determinants of population growth							
Fertility							
Crude birth rate	per thou. pop.	37.4	32.8	27.1	28.7	30.4	31.5
Total fertility rate	births per woman	5.58	4.15	3.06	3.59	3.89	4.08
Contraceptive prevalence	% of women 15-49	..	35.0	..	..	57.4	..
Child (0-4) / woman (15-49) ratios							
Urban	per 100 women	..	63	..	..	..	..
Rural	"	..	63	..	..	..	..
Mortality							
Crude death rate	per thou. pop.	8.1	8.1	7.0	7.5	10.0	8.6
Infant mortality rate	per thou. live births	58.0	51.8	43.9	54.2	72.6	59.1
Under 5 mortality rate	"	..	..	56.0	65.0	174.8	96.5
Life expectancy at birth: overall	years	61.9	65.4	66.1	66.4	61.4	63.8
female	"	64.1	67.9	68.8	69.2	62.3	66.1
Labor force (15-64)							
Total labor force	millions	0.19	0.24	0.37	146	1,343	232
Agriculture	% of labor force	35.0	29.3	..	..	..	..
Industry	"	27.9	27.1	..	..	..	..
Female	"	19.8	22.8	24.9	26.6	36.0	31.2
Females per 100 males							
Urban	number	..	103	..	106	..	..
Rural	"	..	103	..	88	..	..
Participation rate: overall	% of labor force	28.9	30.6	36.3	35.0	49.2	39.0
female	"	11.4	13.9	18.1	18.5	34.9	23.5
Educational attainment of labor force							
School years completed: overall	years	..	..	6.8	..	..	..
male	"	..	..	..	..	..	..
NATURAL RESOURCES							
Area	thou. sq. km	215	215	215	20,396	36,997	17,083
Density	pop. per sq. km	..	3	4	20	76	36
Agricultural land	% of land area	6.3	6.4	8.0	36.3	36.1	38.3
Agricultural density	pop. per sq. km	..	53	46	55	211	94
Forests and woodland	thou. sq. km	182	182	164	9,776	9,154	5,449
Deforestation rate (net)	annual %	0.0	0.0	0.0	-0.5	-0.3	-0.7
Access to safe water	% of pop.	..	84.0	82.0	73.2	..	..
Urban	"	..	100.0	100.0	83.5	73.4	76.7
Rural	"	..	75.0	65.0	52.7	..	46.3

Population growth



Infant mortality

Primary school enrollment



■ Guyana __ Low-income

Social Indicators of Development, 1989

Guyana

	Unit of measure	25-30 years ago	15-20 years ago	Most recent estimate (mre)	Same region / income group: Latin America, Caribbean	Same region / income group: Low-income	Next higher income group
INCOME AND POVERTY							
Income							
GNP per capita (mre = 1988)	US$	..	640	410	1,940	310	1,270
Total household income							
Share to top 10% of households	% of income	..	..	..	..	..	..
Share to top 20% of households	"	..	..	..	..	..	..
Share to bottom 40% of households	"	..	..	..	..	..	..
Share to bottom 20% of households	"	..	..	..	..	..	..
Poverty							
Absolute poverty income: urban	US$ per person	..	..	..	..	..	..
rural	"	..	..	..	..	..	..
Pop. in absolute poverty: urban	% of pop.	..	..	..	..	..	..
rural	"	..	..	..	..	..	..
Prevalence of malnutrition (under 5)	% of age group	..	32.1	..	..	..	..
EXPENDITURE							
Food	% of GDP	..	..	..	..	..	..
Staples	"	..	..	..	..	..	..
Meat, fish, milk, cheese, eggs	"	..	..	..	..	..	..
Cereal imports	thou. metric tonnes	43	62	53	17,643	27,738	36,712
Food aid in cereals	"	..	0	65	..	7,122	7,851
Food production per capita	1979-81=100	113.1	102.0	77.6	100.7	116.4	97.0
Share of agriculture in GDP	% of GDP	24.1	31.1	29.2	11.7	33.0	16.0
Daily calorie supply	calories per person	2,276	2,298	2,484	2,704	2,392	2,767
Daily protein supply	grams per person	56	56	60	69	57	70
Housing	% of GDP	..	..	..	..	..	..
Average household size	persons per household	..	5	..	..	..	..
Urban	"	..	..	..	..	..	..
Fixed investment: housing	% of GDP	..	..	..	..	..	..
Fuel and power	% of GDP	..	..	..	..	..	..
Energy consumption per capita	kg of oil equivalent	..	819.9	585.0	974.1	323.7	886.3
Households with electricity							
Urban	% of households	..	..	..	..	..	..
Rural	"	..	..	..	..	..	..
Transport and communication	% of GDP	..	..	..	..	..	..
Population per passenger car	persons	..	28	..	16	..	27
Fixed investment: transport equipment	% of GDP	..	..	..	..	..	..
Total road length	km	..	..	..	..	..	..
Population per telephone	persons	..	35	24	11	..	16
INVESTMENT IN HUMAN CAPITAL							
Medical care	% of GDP	..	..	..	..	..	..
Population per: physician	persons	..	4,000	6,220	933	1,462	1,547
nurse	"	..	..	885	875	1,746	..
hospital bed	"	..	200	300	..	756	..
Access to health care	% of pop.	..	..	88.8	..	..	..
Immunized (under 12 months): measles	% of age group	..	..	52.0	52.7	43.4	62.6
DPT	"	..	..	67.0	62.4	41.3	64.7
Oral Rehydration Therapy use (under 5)	% of cases	..	..	9.8	33.6	21.6	28.2
Education	% of GDP	..	..	..	..	..	..
Gross enrollment ratios							
Primary: total	% of school-age group	111.0	95.0	90.0	108.1	99.3	106.8
female	"	110.0	95.0	99.0	105.2	87.8	101.3
Secondary: total	"	53.0	54.0	55.0	48.8	33.4	52.0
female	"	50.0	55.0	62.0	52.7	26.1	51.8
Tertiary: science/engineering	% of tertiary students	27.3	31.3	17.4	..	..	..
Pupil-teacher ratio: primary	pupils per teacher	26	32	37	26	10	28
secondary	"	28	21	19	..	19	18
Pupils reaching grade 4	% of cohort	..	..	..	66.3	..	81.0
Repeater rate: primary	% of total enrollment	..	8.4	3.5	17.9	..	8.0
Illiteracy rate: overall	% of pop. (age 15+)	..	..	4.1	16.7	43.3	26.2
female	% of females (age 15+)	..	..	5.2	19.0	56.5	32.5
Newspaper circulation	per thou. pop.	..	..	88.8	81.2	20.4	79.3

Source: World Bank International Economics Department, September 1989.

TABLE 1

GUYANA: TOTAL FINANCING REQUIREMENTS

(In millions of U.S. dollars)

	1989	1990	1991	1992	1990-92
Trade balance	-27.2	-94.9	-51.1	-55.4	-201.4
Net services and transfers (excluding interest)	-2.5	-18.5	-12.8	1.0	-30.3
Increase in gross international reserves	-4.8	-9.1	-14.3	-10.0	-33.4
Leads and lags	0.0	1.3	-6.1	-1.8	-6.6
Subtotal	-34.5	-121.2	-84.3	-66.2	-271.7
Current debt service payments 1/	-42.3	-78.6	-102.9	-101.0	-282.5
IMF	-6.1	-10.2	-11.5	-8.6	-30.3
World Bank	-2.0	-6.8	-11.3	-11.2	-29.3
CDB	-0.1	-3.2	-5.0	-5.1	-13.3
Others (except rescheduled debt and new debt)	-33.1	-36.5	-48.8	-47.6	-132.9
Rescheduled Debt and Debt Subject to Rescheduling	-1.0	-19.1	-22.9	-23.3	-65.3
New debt	0.0	-2.8	-3.4	-5.2	-11.4
Arrears to the IFIs (June 1989)	0.0	-229.4	0.0	0.0	-229.4
IMF	0.0	-141.9	0.0	0.0	-141.9
World Bank	0.0	-57.0	0.0	0.0	-57.0
CDB	0.0	-30.5	0.0	0.0	-30.5
Total Financing Gap 2/	-76.8	-429.2	-187.2	-167.2	-783.6

1/ Net of amounts rescheduled or subject to rescheduling.

2/ Net of rescheduling.

TABLE 2

GUYANA: IDENTIFIED FINANCING SOURCES

(In millions of US dollars)

	1989	1990	1991	1992	1990-92
Total Financing Requirement	76.8	429.2	187.2	167.2	783.6
(Reschedulings)	(783.0)	(452.0)	(21.0)	(19.0)	(492.2)
Project financing	60.2	106.6	92.2	104.5	303.3
Trade Credits & Others	-10.3	-1.6	0.0	0.0	-1.6
Required BOP Suppport	26.9	324.2	95.0	62.7	481.9
Financing from the IFIs 1/	0.0	222.0	68.1	35.5	325.6
IMF 2/	0.0	117.5	32.1	23.0	172.6
World Bank 3/	0.0	66.0	13.0	0.0	79.0
CDB	0.0	33.5	6.0	2.5	42.0
IDB	0.0	5.0	17.0	10.0	32.0
Identified bilateral sources	26.9	73.9	16.5	16.0	106.4
Other Sources of Finance	0.0	28.3	10.4	11.2	49.9
Sale of Public Enterprises	0.0	20.0	0.0	0.0	20.0
VIF Deposits	0	8.3	10.4	11.2	29.9
Financing Gap	0.0	0.0	0.0	0.0	0.0

1/ Bridge financing of US S229.4 million would be required to clear arrears of the IFIs as of end June 1990. A portion of the bridge equivalent to US $178 million would be repaid from the IFI disbursements July-Sept. 1990. The residual portion of the bridge will be funded from bilateral commitments.

2/ Equivalent to 266 percent of quota, with a mix of ESAF and general resources over the three-year period, with disbursements starting from 1990.

3/ The disbursement in 1990 assumes the total of first and second tranche releases of US$50 million and US$15 million respectively. It also includes US$1 million of retroactive disbursement from IDA project loans as BOP financing.

STATUS OF BANK GROUP OPERATIONS IN GUYANA

A. Statement of Bank Loans and IDA Credits as of March 31, 1990

Loan/Cr. Number	Fiscal Year	Borrower	Purpose		US$ Million Amount (Less Cancellation) Bank	IDA	Undisbursed
12 loans and 7 credits have been fully disbursed:					76.2	27.0	
of which SECALs, SALs and Program Loans a/							
1098-GUA	81	Guyana	Structural Adjustment			8.0	
1948-GUA	81	Guyana	Structural Adjustment		14.0		
			Subtotal		14.0	8.0	
1208-GUA	82	Gyana	Petroleum Exploration Promotion			2.0	1.1
1555-GUA	85	Guyana	Upper Demerara Forestry (Supplemental Credit)			8.8	3.7
1729-GUA b/	87	Guyana	Bauxite Industry Tech. Assist.			7.0	8.5
			Total (Net of Cancellations)		76.2	44.8	
			of which has been repaid		14.2	1.2	
			Total Held by Bank and IDA c/		62.0	43.6	
			Amount Sold	0.8			
			of which has been repaid	0.8			
			Total Undisbursed d/				13.3

a/ Approved during or after FY80.
b/ Credit has not yet been signed.
c/ Book value (IBRD Current Value $82.4m; IDA Current Value $47.9m -- difference due to fluctuation in SDR/US$ exchange rate. Converted at rate prevailing at March 31, 1990).
d/ Current Value converted at SRD/US$ exchange rate prevailing at March 31, 1990.

B. Statement of IFC Investments as of March 31, 1990

Investment Number	Fiscal Year	Borrower	Type of Business	US$ Million Equity	Loan	Total	Total Held by IFC	Total Undisbursed
-	-	-	-	-	-	-	-	-

GUYANA: STRUCTURAL ADJUSTMENT CREDIT

SUPPLEMENTARY LOAN DATA SHEET

Section I - Timetable of Key Events

(a) The Government has with the assistance of Bank and IMF staff prepared a Policy Framework Paper (PFP) which outlines the Government's proposed measures for addressing economic problems over the medium term. The Guyana PFP was reviewed by the Committee of the Whole of the Bank and by the IMF Board in July 1988. Since July 1988, the Bank, through its leadership in the Consultative Group for Caribbean Economic Development (CGCED), has been engaged in mobilizing the necessary financial resources to support Guyana's proposed medium-term adjustment program. These efforts have been augmented through the Support Group for Guyana, chaired by Canada, formed in late November 1988.

(b)	Preappraisal mission	November 1988
(c)	Appraisal mission	May 1989
(d)	Post-Appraisal mission	April 1990
(e)	Completion of negotiations	May 1990
(f)	Planned date of effectiveness	July 1990

Section II - Special Bank Implementation Actions

The Government's wide-ranging efforts at structural adjustment have stretched the implementation capacity of an already weak institutional structure. The steady outmigration of professional, technical and managerial personnel has aggravated the situation. To ensure timely implementation of the credit conditions, IDA will provide technical support under a parallel Technical Assistance Credit (TAC).

Section III - Special Conditions

Effectiveness of the credit, which will permit use of the first tranche of US$50.0 million equivalent, is subject to no special conditions over and above the several policy measures that were adopted prior to Board presentation. Release of the second and third tranches of US$15.0 million and US$13 million respectively would be contingent upon significant and satisfactory progress made by the Government in implementing the structural adjustment program, notably in complying with the following specific conditions for each tranche release.

Conditions for Release of Second Tranche

Macroeconomic Framework

Favorable Bank assessment of the macroeconomic framework, including international competitiveness.

Domestic Pricing

(a) Implementation of pricing policies in rice, sugar, electricity, petroleum and public transportation as per formulas agreed with IDA; and

(b) Complete the preparation of a least cost expansion program for electricity supply for 1990-99.

Trade Policy

(a) Import licenses will be issued automatically by the Ministry of Trade for all transactions within two working days for all applications not requiring government foreign exchange and import licenses will be processed within seven working days for applications requiring foreign exchange from the Bank of Guyana (excluding those in the prohibited list);

(b) One-half of the items from the prohibited list except for non-processed meat, poultry, fruit and fruit preservatives will have been removed.

Central Government

(a) Commission management audits of the civil service based on the findings of the public service review, under terms of reference satisfactory to IDA.

Current Transfers

(a) End all central government transfers to public enterprises from the 1990 budget onwards except for the Guyana Electricity Corporation and for maintenance expenditures of public enterprises to be fully divested.

Public Enterprises

(a) PCS: Put into effect an action program and schedule for carrying out the corporate strategy for the PCS group: and

(b) Operating procedures and auditing systems satisfactory to IDA to be established to monitor the financial performance of GUYMINE, GUYSUCO and PCS, and transfer of targeted amounts to these enterprises to the Central Government.

PSIP

(a) Review of rolling PSIP satisfactory to IDA: and

(b) Implementation of institutional arrangements satisfactory to IDA, for strengthening the capacity of the State Planning Secretariat by filling all vacancies for planners in the Project Cycle Unit to provide guidelines on project preparation to line ministries and government agencies and to evaluate and monitor projects included in the PSIP.

Conditions for Release of Third Tranche

Macroeconomic Framework

Favorable Bank assessment of the macroeconomic framework, including international competitiveness.

Domestic Pricing

(a) Complete study and initiate an IDA-agreed action program for improving private sector rice exports;

(b) Prepare an electricity tariff schedule for all categories of services with rates equal to at least the long-run marginal costs on the basis of an externally financed least-cost expansion program and a schedule for implementation satisfactory to IDA; and

(c) Complete and review with IDA the Master Plan to rehabilitate the Georgetown Water Supply system.

Trade Policy

(a) Remaining items to be removed from the prohibited list of imports will have been removed except for non-processed meat, poultry, fruit and processed fruit items; and

(b) Begin implementation of an IDA-agreed program to reduce import duty exemptions, except those required by regional and other international agreements or those intended to provide fiscal incentives for new investments in the form of exemptions up to five years renewable once for the same period thereafter.

Other Incentives

(a) Completed a study on consumption taxes in accordance with terms of reference satisfactory to the Association, and adopted a program satisfactory to IDA to address deficiencies in the application and administration of consumption taxes identified in such study.

Central Government

(a) Begin implementing a program satisfactory to IDA, to eliminate any overlapping functions and noncritical vacancies identified in the management audits.

PSIP

(a) Review of rolling PSIP satisfactory to IDA.

GUYANA - STRUCTURAL ADJUSMENT CREDIT

COVERAGE OF IMF AND BANK PROGRAMS

Macroeconomic stabilization	-	IMF would take the lead through exchange rate, fiscal, monetary and wage policy reforms. IDA would make an assessment of macroeconomic policies taking into account the findings of the IMF.
Restoration of incentives and strengthening of competition to promote economic growth	-	IDA's proposed SAC includes domestic pricing, trade policy (import licensing, QRs, tariffs and export pricing) and procedural reforms designed to complement the producer incentives generated by an appropriate exchange rate regime. The Government/IMF program also includes some components of trade policy (import licensing and review of QRs). IMF program includes the passthrough of price increases following the devaluation. IDA's main concern, however, would be to ensure that domestic pricing provides adequate producer incentives needed for medium-term growth.
Reduction of public sector deficit	-	IMF: fiscal policy reforms under the program will be complemented by the proposed SAC through conditionality on central government employment, elimination of current transfers to public enterprises and resource mobilization and divestment targets for public enterprises.
Rehabilitation of economic infrastructure	-	IDA: the public sector investment program (PSIP) to be agreed under the proposed SAC will assign high priority to investments needed to rehabilitate economic infrastructure. The PSIP will also include a few projects to rehabilitate social infrastructure.
Institutional strengthening	-	IDA's proposed TAC will help strengthen the central ministries and departments through advisors and training and thereby assist in the implementation of the SAC and IMF's program.
Alleviation of the social impact	-	IDA's proposed operation in the social sectors will help address the social cost of adjustment.

MINISTRY OF FINANCE,
P.O. BOX 757,
Main & Urquhart Streets,
Georgetown,
Guyana.

June 4, 1990

Mr. Barber B. Conable
President
World Bank
1818 H Street, N.W.
Washington, D.C. 20433

Dear Mr. Conable:

GUYANA: Government Policy Statement on Structural Adjustment

1. The Government of the Co-operative Republic of Guyana requests from the International Development Association (IDA) a Structural Adjustment Credit (credit) to support its economic recovery programme over the medium term.

2. The main objectives of the Government's programme are to: restore economic growth over the medium term; eliminate internal and external imbalances; incorporate the parallel economy into the official economy; and normalize Guyana's financial relations with external creditors. The attainment of these objectives will require the restoration of incentives through a realistic exchange rate regime, removal of price distortions, sequential trade liberalization, promotion of private sector development, and improvement of the public sector finances through streamlining the civil service, increased generation of surpluses from public enterprises and the implementation of a divestment programme. In addition, rehabilitation of basic infrastructure will be critical for supporting increased exports and private investment. Thus, the financing and implementation of a public sector investment programme (PSIP) consistent with the macroeconomic framework will be essential. The implementation of a Social Impact Amelioration Programme is desirable in order to protect groups that are particularly vulnerable to the adjustment measures and in order to maintain public support for the economic recovery programme.

Recent Economic Developments

3. As you may be aware, Guyana's economy is based mainly on the production and exports of bauxite, sugar and rice. Extensive mineral and timber resources remain unexploited partly because of underdeveloped infrastructure. Given the country's topography and the uneven distribution of its relatively small population, the cost of meeting Guyana's infrastructural needs are substantial on a per capita basis. Furthermore, economic activity has been constrained by a difficult physical environment, sharp fluctuations in output stemming from the vulnerability of the economy to exogenous factors, and weak economic management.

4. Economic performance during the 1970s was mixed. During the first half of the decade, GDP grew by about 4% per annum in real terms as a result of the rapid growth in Government expenditures and favorable prices for Guyana's major export commodities. Per capita income increased by about 6% per annum, resulting from a rapid expansion in consumption and investment and the period was characterized by a rapid expansion of the public sector, made possible by the windfall gains associated with sugar production. This was followed by economic decline as a result of the fall in sugar prices, the weakening in the demand for Guyana's main exports, and reduced output notably in the case of sugar and bauxite during the period 1975-80 . As a result, the terms of trade fell by over 30% during 1975-80, wiping out the gains achieved in the first half of the decade.

5. Guyana's real gross domestic product decreased at an average annual rate of 6% during 1981-83. Following a turnaround in 1984, however, economic growth averaged about 1% per year in 1984-87, but was not sufficient to offset the decreases in preceding years. The level of recorded output in 1987 was thus some 15% below that of 1980. Throughout most of the period 1981-87, Guyana's principal productive sectors which had hitherto accounted for about one third of GDP, and 80% of merchandise exports, encountered a number of technical, organizational and financial problems and in the case of sugar and rice, adverse weather conditions. Reduced foreign exchange earnings cut into the country's capacity to acquire imported inputs and led to considerable capacity under-utilization, raising unit costs of production and further reducing financial profitability of various operations.

6. Despite the modest upturn in production during 1984-87, the period was marked by a low level of aggregate resource availability, an increasing divergence between the investment and savings rates especially of the public sector and, correspondingly, an increasing dependence on foreign borrowing. The public sector finances deteriorated markedly during 1981-86, although a reversal of this trend occurred in 1987.

7. Guyana's external trade and payments situation remained extremely weak during 1981-87. As a result, the balance of payments deteriorated and Guyana was unable to meet its external payments obligations. In 1988, the economy witnessed a further setback, with real GDP declining by about 3%. As of December 1988, Guyana's total external debt stood at about US$1.8 billion, equivalent to 670% of exports.

The Government's Response

8. During 1984-88, the Government took a number of measures relating to the exchange rate regime and the public sector operations aimed at increasing output and exports and reducing imbalances. Although these measures were in the right direction, they did not produce the desired results given the severity of the country's economic problems. Guyana's export volume remains below the levels of the mid-1970s while imports continue to be compressed. In addition, the capital stock of the economy continues to deteriorate and the state of disrepair of physical infrastructure has resulted in serious bottlenecks which impair increases in production. The period has also witnessed a decline in the standard of living which has led to an exodus of managerial, professional and technical

personnel and thus to a shortage of skills at all levels. Meanwhile, major weaknesses continue to exist in the public sector and need to be addressed.

9. In mid-1988, the Government, with the assistance of the World Bank and IMF staff, prepared a Policy Framework Paper (PFP) which outlined the Government's proposals for addressing the problems of the economy over the medium term. In early August 1988, price controls were removed from a number of items except for petroleum products, public transportation, rice, sugar and a few other essential commodities. Import prohibitions were also removed on all items except for food products, on grounds of the national objective of food security through self-sufficiency. In addition, the licensing of "no funds" imports, i.e., those not involving the use of official foreign exchange, was liberalized beginning September 1, 1988. In the fiscal area, some measures to raise tax revenues were implemented; Guyana Timbers Limited was sold in early 1989, and actions were taken to close down one loss-making public enterprise. In July 1988, the Government issued a document setting out the incentives available to the private sector and in August 1988, Guyana joined MIGA. On the sectoral front, the Government has taken a number of steps to improve the bauxite industry, including securing a European Development Fund Loan to rehabilitate the industry, and discussions with Reynolds International of United States of America and ALCAN of Canada about possible joint ventures. In February 1989, Reynolds International signed an agreement with the Government to commence mining, marketing and sales of bauxite. Discussions are also underway with Booker Tate of United Kingdom to obtain management assistance for the sugar industry while the operation of Guyana's international airport has been contracted with British Airport Services Group. Also, discussions are in progress with a US company on the sale of 80% of the Government's equity in the Guyana Telecommunications Corporation.

The Stabilization Program

10. The essential components of the Government's stabilization program include further reforms in exchange rate regime as well as in fiscal, monetary and income policies. Following a significant devaluation of March 31, 1989 (230% in G$ terms), the prices of controlled items were adjusted in order to pass through the effects of the devaluation. The program initially called for the implementation of a flexible exchange rate policy to help ensure external competitiveness and protect the balance of payments. However, considering the difficult industrial relations conditions that resulted from the 1989 devaluation, and the less than expected flow of external resources, the Government decided not to adjust further the official exchange rate despite the prevalence of a large margin relative to the parallel rate (50%). Instead, the Government enacted the Dealers in Foreign Currency (Licensing) Act of 1989 which legalized a large volume of transactions in the parallel market. At the same time, the Government moved a number of items to the newly legalized market. As of April 1990, 15 Exchange Houses (or cambios) were in operation. The Government intends to move more items to the cambio market and to unify the exchange rate system, in stages, by March 31, 1991. To guarantee exporters a minimum of foreign exchange for importation requirements, the Bank of Guyana had established foreign exchange retention schemes that allow selected exporters to retain a certain percentage of export proceeds. However, with the eventual unification of the official exchange rate system and the liberalization of exchange restrictions, the retention

schemes will be abolished. Thereafter, foreign exchange for all payments will be provided on the basis of availability.

11. The Government will undertake fiscal policies aimed at reducing the overall public sector deficit, consistent with a sustainable balance of payments position and increased public sector savings over the medium term. Measures to increase revenues include the improvement of tax administration and a broadening of the tax base, addressing deficiencies in the application and administration of consumption taxes, and reducing tax exemptions. The objective is to enhance revenue, minimize disincentives, improve resource allocation and incorporate the parallel economy into the official economy. Measures to reduce expenditures will include: the close monitoring by sector of recurrent funding requirements on supplies and materials to seek further savings; the termination of transfers to public corporations, except to the Guyana Electricity Corporation; the restraining of increases in public sector wages and salaries; and the strengthening of budgeting, monitoring and fiscal reporting procedures.

12. The prime interest rate was increased from 15% to 35%, but was reduced to 30% as of April, 1990. It will be maintained at a positive real level, taking into account the expected domestic inflation and interest rates in the international market. The Government will abstain from from establishing selective credit policies.

13. To protect external competitiveness and help reduce inflation a restrained wage policy will be implemented. The increase in nominal wages would not exceed the domestic inflation rate in 1990-91. Merit increases will be based on productivity increases and the overall financial situation of each public sector enterprise. Wages in the private sector, with the exception of that of some non-unionized workers, would continue to be freely determined.

The Structural Adjustment Programme

14. The structural adjustment programme aims to improve the incentive framework for private sector development, reducing the public sector deficits and implementing a realistic and viable public sector investment programme (PSIP), all of which are designed to improve the supply side conditions needed for sustainable economic growth.

15. The reforms to restore an adequate incentive framework include domestic pricing, trade policy and improved fiscal incentive procedures. All prices except for those relating to rice, sugar, electricity, petroleum and public transportation will be maintained free of controls during and beyond the programme period. New pricing mechanisms will be implemented according to the following criteria: the domestic prices of rice will reflect the international prices at the recently legalized market exchange rate; the domestic price of sugar will be set to cover the c.i.f. and other aquisition costs of imported sugar; information from the ongoing study to formulate a least-cost expansion programme will be used to develop rates for the sale of electricity equal to at least the long-run marginal cost and will be put into effect in the context of the implementation of the power sector expansion programme; petroleum product prices will be set to cover all foreign and local costs; and public transportation fares will be set to cover all operating costs including depreciation.

16. With respect to trade policy, import licenses will be issued within two working days for all applications not requiring government foreign exchange; and processed within seven days for all applications requiring foreign exchange from the Bank of Guyana (excluding items in the prohibited list). The list of prohibited imports will be reviewed with a view to progressively reducing the list and eliminating all such prohibited items by September 1991, except for non-processed meat, poultry, fruit and processed fruit items. The Government has also decided to eliminate import duty exemptions, except those required by regional and other international agreements or those intended to provide fiscal incentives for new investments in the form of exemptions up to five years renewable once for the same period thereafter. As regards other incentives, the Government has decided to study the existing consumption tax structure and to adopt a program to address deficiencies in the application and administration of consumption taxes identified in such study, subject to the revenue requirements to meet the Central Government's current balance targets.

17. In order to support private investment, procedures have been streamlined to reduce the average processing time from 10 weeks to 5 weeks for consideration and decisions on fiscal incentives for new projects.

18. A reduction in the Central Government non-interest current expenditure in real terms will be achieved through further streamlining, following the implementation of the recommendations of the public service review, currently under way.

19. As regards the Central Government budget, from 1990 and onwards, no transfers to the public enterprises (PEs) will be made, with the possible exceptions of the Guyana Electricity Corporation, and maintenance expenditures for those enterprises to be divested. In addition, no new PEs will be established during 1990-92 except for those resulting from the rationalization process as defined in the strategy statements of GUYSUCO and the PCS group of enterprises and/or joint ventures of private or foreign firms with existing PEs. Nonviable public corporations will continue to be closed or divested. Operating procedures and auditing systems to monitor the financial performance of the PEs are being instituted. The payment of taxes, dividends and transfers from PEs to the Central Government will be enforced. In general, the above mentioned actions will be aimed at improving the primary current account balance (before interest payments) of the non-financial public sector from 18% of GDP in 1989 to 22% of GDP in 1990 and to about 30% of GDP in 1991. However, the overall public sector deficit will increase from 48% of GDP in 1989 to about 54% of GDP in 1990, owing to increased interest payments, increased capital expenditure and the impact of the devaluation upon the foreign component of the PSIP, but will be reduced to 41% of GDP in 1991.

20. A corporate strategy has been developed for the enterprises under the Public Corporations Secretariat with a view to determining which enterprises will be kept within the Government's control and which should be offered for joint ventures or for outright sale to the private sector. An action program and an implementation schedule have been established and will be carried out. In the case of the Guyana Sugar Corporation (GUYSUCO), the Government and Booker PLC of United Kingdom plan to develop during 1990 a detailed agreement which will: (a) make arrangements for Booker Tate to provide management services and technical assistance to

GUYSUCO; and (b) make possible a range of investments through equity and loans, including the conversion into equity of the Government's debt to Booker. In regard to GUYSUCO's non-sugar activities, separate accounting and management will be implemented and joint ventures will be sought.

21. The size and composition of the PSIP for 1990-92 will be reviewed periodically to ensure its consistency with the stated objectives of the program, projected domestic and foreign resources availability and implementation capacity. Special attention will be given to the adequate costing of projects to project disbursements and to the economic and social criteria for the inclusion of new projects. The State Planning Secretariat will be adequately staffed to provide guidelines for project preparation to the line ministries and government agencies and for evaluation and monitoring of projects. Additionally, the management of external aid will be strengthened through the services of an advisor at the Office of Budget in the Ministry of Finance to facilitate procurement and disbursement of funds provided by bilateral and multilateral donors.

The Social Impact of Adjustment

22. Donor assistance for the Social Impact Amelioration Programme (SIMAP) has, so far, remained well below the levels of support indicated at the Special Donors Meeting of July 1989. The Government remains convinced of the need for urgent assistance in cushioning the most vulnerable groups from the adverse consequences of the adjustment and proposes to explore the possibility of assistance from a wider range of potential donors. In this regard, it has strengthened its internal arrangements. A SIMAP Coordinating Committee has been established. This Committee is chaired by the Ministry of Culture and Social Development (MCSD) and includes representation from the Ministry of Finance and the State Planning Secretariat. The Committee and the related agencies are promoting local community and NGO participation in the design and implementation of suitable projects. In addition, the MCSD has been staffed to support the implementation of programmes.

23. In view of the measures being taken, the Government of the Co-operative Republic of Guyana would appreciate your favorable consideration of its request for the provision of a Structural Adjustment Credit. We thank you for your efforts through the Consultative Group for Cooperation in Economic Development and through participation in the Guyana Support Group to raise the external financing required to support the Government's economic recovery programme. We look forward to a continuing exchange of ideas with IDA and the World Bank and to the opportunity to discuss on a continuous basis the progress made in implementing the above reforms.

Yours sincerely,

Carl B. Greenidge, M.P.
Minister of Finance.

GUYANA: STRUCTURAL ADJUSTMENT CREDIT

THE SOCIAL IMPACT AMELIORATION PROJECTS

1. SIMAP projects are designed initially as short-term interventions of 6 to 24 months, with a funding ceiling of US$10 million. However, if funds are available, some projects would be extended, particularly those that develop human resources (nutrition, health and training) and facilitate increased household incomes.

2. To solicit projects, the SIMAP Coordinating Committee (SCC) distributed preparation guidelines to central Ministries, agencies, Towns and Regions. Hundreds of project proposals were received and reviewed by the SCC. Those selected balance proposals needs and geographical distribution over the five Towns and ten Regions including the hinterland areas inhabited by native Amerindians. Community and NGO participation in project generation and implementation is being promoted. Unless otherwise noted, projects will be managed by central, regional and local governments. Some government projects will be contracted to private firms, especially infrastructure rehabilitation and construction.

3. Labor intensive employment schemes in infrastructure rehabilitation and development constitute 68% of total program costs. Work will be mainly manual, using spades, pickaxes, shovels and hired tractors and trailers to restore and extend neglected social and physical infrastructure. Several employment projects aim to improve sanitation and the environment. Other projects would develop aim to improve sanitation and the environment. Other projects would develop human capital through nutrition (16% of total project costs), training (14%) and health (1%). The status of project readiness varies; some could begin implementation immediately, while others could within a few months.

GUYANA: STRUCTURAL ADJUSTMENT CREDIT

SUMMARY OF TECHNICAL ASSISTANCE

1. This Annex summarizes the technical assistance to be provided under a separate Technical Assistance Credit (TAC) to assist the Government in:

(i) implementing the adjustment measures under the proposed SAC; and

(ii) implementing a social impact amelioration program (SIMAP) to cushion the social cost of adjustment.

2. Project Objectives. The TAC will ensure that government policymakers have the knowledge and expertise required to attain SAC objectives: (i) improvements in the incentive framework, (ii) public sector reform, (iii) improved public sector investment, (iv) amelioration of the social impacts of adjustment, and (v) improved macroeconomic management. The TAC will strengthen the public sector agencies responsible for implementing the SAC by providing special studies and highly-skilled professionals; equipment including vehicles and training will also be provided to ensure that agencies develop improved management and analytic capacity to ensure a smooth transition at the project's end.

3. Project Description. The project will support the Statistical Bureau and several offices in the Ministry of Finance (MOF), Ministry of Culture and Social Development (MCSD), State Planning Secretariat (SPS), Public Corporations Secretariat (PCS). The Monitoring and Coordinating Unit (MCA) in the Ministry of Finance has the responsibility for coordinating, advising and overseeing the provision of project-funded assistance to other government offices critical for the attainment of SAC policy conditions.

4. The project will provide technical assistance in the form of short-term and long-term consultants to work with local staff, equipment, vehicles, special studies, and training. Technical assistance will be provided to improve the incentive framework through the funding of special studies on consumption taxes. Public sector reform will be supported by improving financial monitoring and divestment activities of the State Planning Secretariat and the Public Corporations Secretariat. The Public Sector Investment Program will be strengthened by improving the evaluation and planning capacity of the Project Cycle Unit in the SPS, responsible for formulating the PSIP. In addition, the TAC will improve the expeditious use of external aid through assistance to the Division of Multilateral Financial Institutions in the MOF, responsible for aid coordination, the Bank of Guyana, and the Ministry of Trade and Tourism. Implementation of the emergency SIMAP program will be assisted by helping the Ministry of Culture and Social Development and SPS to improve target efficiency of SIMAP programs. Almost all technical assistance provided under the TAC will contribute to macroeconomic management. In addition to the assistance listed above, the project will improve the overall coordination of macreconomic policy advice provided by the MCA and improve macroeconomic information provided by the Statistical Bureau.

5. The Policy Framework Paper agreed by the Government of Guyana, the IMF, and the Bank stipulated the adoption of a number of adjustment measures prior to Board presentation of the SAC. Implementation of these measures requires technical assistance for improvement in public sector management capacity. To provide this technical assistance prior to TAC effectiveness, the UNDP has agreed to a bridging operation in which it fills several high level consulting positions, anticipated under the TAC, using terms of reference agreed to by the Government and the Bank. The TAC will fund those positions retroactively.

6. The total cost of the project is estimated at about US$3.1 million, of which US$3.0 million will be provided under the IDA credit. The terms of reference (TOR) for the consultants were agreed during negotiations and are available in the Project File. The consultants will be selected in accordance with Bank guidelines. Contracting of the consultants will be handled by the MCA on behalf of the Government.

Long-term Consultant Positions to be Provided by the Technical Assistance Credit in Support of the Structural Adjustment Credit

7. Macroeconomic advisor to the head of the Monitoring and Coordinating Unit (MCA) located in the Ministry of Finance. This advisor will have overall responsibility for assessing macroeconomic trends in the economy, improving coordination of macroeconomic information and providing analyses and policy advice to the Ministry of Finance. In addition, the advisor will collaborate with other government agencies to ensure implementation of the Government's Economic Recovery Program.

8. Advisor to the State Planning Secretariat on formulation and monitoring of the Public Sector Investment Program to ensure consistency in terms of size and composition to the Borrower's macroeconomic framework, objectives and funding.

9. Advisor to the State Planning Secretariat on financial and operational monitoring of public enterprises and monitoring corporate development strategy of the independent public enterprises.

10. Advisor to the Public Corporation Secretariat on corporate development strategy, including divestment, and financial monitoring of the enterprises under the PCS.

11. Advisor to the Project Cycle Unit of the SPS to strengthen its capacity to do economic evaluation and cost analysis of proposed investment projects.

12. Advisor to the Ministry of Finance, Bank of Guyana and the Ministry of Trade and Tourism on coordination of multilateral and bilateral external finance and disbursement, to be located in the Division of Multilateral Financial Institutions under the Office of the Budget. This individual will have responsibility for facilitating procurement and disbursement of lines of credit provided by bilateral and multilateral donors for project finance and balance of payments support.

Short-Term Consultant position to be provided by the Technical Assistance Credit in Support of the Structural Adjustment Credit

A. Incentive Framework

13. Analysis of the consumption tax structure to identify deficiencies in its application and administration and develop recommendations to address such deficiencies.

B. Macroeconomic Management

14. Provision of a procurement agent to ensure compliance with Bank Group guidelines and preparation of needed documentation for draw down of the SAC.

C. Social Sector Program

15. Assist the State Planning Secretariat and the Ministry of Culture and Social Development in analyzing the distribution effects of the Economic Recovery Program and the target efficiency of SIMAP and other social programs in ameliorating the effects and make recommendations for measures to improve target efficiency.

GUYANA - STRUCTURAL ADJUSTMENT CREDIT

POLICY MATRIX

Policy Areas	Actions Taken by the Government as of end 1989	Actions Taken Prior to Board Presentation	Actions to be Taken Prior to Second Tranche Release	Actions to be Taken Prior to Third Tranche Release
Macroeconomic Framework				
Guyana continues to face major macroeconomic imbalances. These stem largely from an inappropriate mix of exchange rate fiscal, monetary and wage policies.	In April 1989, Guyana began implementing an IMF-monitored program which included a major devaluation (230% in G$ terms), price pass throughs, interest rate adjustments, public expenditure controls and wage restraint. Legislation was also enacted in late 1989 to legalize a large volume of transactions in the parallel market through exchange houses or cambios.	Favorable Bank assessment of the macroeconomic framework, including international competitiveness.	Favorable Bank assessment of the macroeconomic framework, including international competitiveness.	Favorable Bank assessment of the macroeconomic framework, including international competitiveness.
Incentive Framework	In early August 1988, price controls were removed from a number of items, except for petroleum products, transportation, rice, sugar and a few other essential items. Import prohibitions were also removed on all items except for food products, on grounds of the national objective of food security through self-sufficiency as agreed in the PFP. In addition, and in compliance with the PFP, the licensing of "no funds" imports, i.e., those not involving the use of official foreign exchange, was liberalized beginning September 1, 1988, so as to allow private individuals to import without licenses, items for their own use. Also, in July 1988, the Government issued a document setting out the incentives available to the private sector.	**Domestic Pricing** (a) Agreement to put into effect pricing policies on rice which will reflect the international price of equivalent grades of rice calcuated at an exchange rate acceptable to the Association; (b) Agreement to set the domestic wholesale price of sugar to cover the c.i.f. Georgetown and other acquisition costs of imported sugar including handling, transportation, and storage costs;	**Domestic Pricing** (a) Implementation of pricing policies in rice, sugar, electricity, petroleum and public transportation as per formulas agreed with IDA;	**Domestic Pricing** (a) Complete study and initiate an IDA-agreed action program for improving private sector rice exports.
The incentive framework has been eroded by the failure to correct an overvalued exchange rate, price distortions and the lack of a clear role for the private sector.				

GUYANA - STRUCTURAL ADJUSTMENT CREDIT

POLICY MATRIX

Policy Areas	Actions Taken by the Government as of end 1989	Actions Taken Prior to Board Presentation	Actions to be Taken Prior to Second Tranche Release	Actions to be Taken Prior to Third Tranche Release
		(c) Agreement on setting electricity tariffs to cover the full cost of operations including depreciation. Agreement to be reached on developing a 10-year least cost expansion program which will provide the information for setting of electricity tariffs based on long-run marginal costs; (d) Agreement on developing a plan to rehabilitate the Georgetown Water Supply System; (e) Agreement on petroleum product prices (except kerosene) to cover c.i.f. price and local acquisition costs including depreciation; (f) Agreement on public transportation prices to cover operating costs, including depreciation.	(b) Complete the preparation of a least cost expansion program for electricity supply for 1990-99.	(b) Prepare an electricity tariff schedule for all categories of services with rates equal to at least the long-run marginal cost calculated on the basis of an externally financed least-cost expansion program and a schedule for implementation satisfactory to IDA. (c) Complete and review with IDA the Master Plan to rehabilitate the Georgetown Water Supply system.
		Trade Policy	**Trade Policy**	**Trade Policy**
		(a) Agree that the remaining items on the prohibited list will be removed, with the exception of non-processed meat, poultry, fruit and processed fruit items.	(a) Import licenses will be issued automatically by the Ministry of Trade for all transactions within two working days for all applications not requiring government foreign exchange and import licenses will be processed within seven working days for applications requiring foreign exchange from the Bank of Guyana excluding those in the prohibited list; (b) one-half of the items from the prohibited list except for non-processed meat, poultry, fruit and processed fruit items will have been removed.	(a) Remaining items to be removed from the prohibited list of imports will have been removed except for non-processed meat, poultry, fruit and processed fruit items.

GUYANA - STRUCTURAL ADJUSTMENT CREDIT

POLICY MATRIX

Policy Areas	Actions Taken by the Government as of end 1989	Actions Taken Prior to Board Presentation	Actions to be Taken Prior to Second Tranche Release	Actions to be Taken Prior to Third Tranche Release
				(b) Begin implementation of an IDA agreed program to reduce import duty exemptions, except those required by regional and other international agreements or those intended to provide fiscal incentives for new investments in the form of exemptions up to five years renewable once for the same period thereafter.
				Other Incentives (a) Completed a study on consumption taxes in accordance with terms of reference satisfactory to the Association, and adopted a program satisfactory to IDA to address deficiencies in the application and administration of consumption taxes identified in such study.
		Procedural Reforms (a) The Government will streamline procedures to reduce the average processing time for the consideration and decision on fiscal incentives for new projects from ten weeks to five weeks by increasing to frequency of the Fiscal Incentives Committee (FIC) meeting held at GUYMIDA, and shortening the time within and between core steps which include: review by the relevant sector ministry; discussion of the project at the FIC;		

GUYANA - STRUCTURAL ADJUSTMENT CREDIT

POLICY MATRIX

Policy Areas	Actions Taken by the Government as of end 1989	Actions Taken Prior to Board Presentation	Actions to be Taken Prior to Second Tranche Release	Actions to be Taken Prior to Third Tranche Release
		and formal approval of fiscal incentives by the Ministry of Finance. A specific processing schedule would be agreed upon.		
Public Sector Reforms Guyana's economic problems also stem largely from an over-extended and inefficient public sector responsible for a significant deterioration of public finances. The public sector consists of the central government, the National Insurance service and about 33 public enterprises. Together they employ a total of about 75,000 persons--nearly 40% of them in the Central Government and the balance in public enterprises and financial institutions. The Central Government deficit stood at an unsustainable level of 27% of GDP in 1988. This is largely attributable to interest payments, the sluggish growth of revenues, owing to recent declines in real economic activity, the growth of the parallel economy (which is outside the revenue collecting system) and current transfers to public enterprises.	In the fiscal area, some measures to raise tax revenues were implemented in 1988, including the Fiscal Enactment (Amendment) Bill 1988 and the Consumption Tax (Amendment) Order 1988 (para. 42 of PFP). Also, actions have been taken to close down two loss-making public enterprises; the Glass Factory has been closed down and the Public Transportation Corporation is in the process of being closed down. These actions, in part, helped the GUYSTAC group of 27 public enterprises (in the areas of agriculture, industry, trading, transportation and utilities) to increase its overall surplus from 1% of GDP in 1987 to 4.5% of GDP in 1988. On the sectoral front, the Government has taken a number of steps to improve the Bauxite industry including the securing of a SYSMIN intervention to rehabilitate the industry, and discussions with Reynolds (USA) and ALCAN (Canada) about possible joint ventures.	Central Government (a) A public service review (PSR) will be undertaken with a view to identifying overlapping functions and noncritical vacancies in the civil service (i.e., positions not directly related to output growth); (b) Agreement on ending all Central Government transfers to public enterprises from the 1990 budget onwards, except for the Guyana Electricity Corporation and for maintenance expenditures of public enterprises to be fully divested.	Central Government (a) Commissioned management audits of the civil service based on the findings of the PSR, under terms of reference satisfactory to the Association; Current Transfers (a) End all central government current transfers to public enterprises from the 1990 budget onwards except for the Guyana Electricity Corporation and for maintenance expenditures of public enterprises to be fully divested.	Central Government (a) Begin implementing a program satisfactory to the Association, to eliminate any overlapping functions and noncritical vacancies identified in the management audits.

GUYANA - STRUCTURAL ADJUSTMENT CREDIT

POLICY MATRIX

Policy Areas	Actions Taken by the Government as of end 1989	Actions Taken Prior to Board Presentation	Actions to be Taken Prior to Second Tranche Release	Actions to be Taken Prior to Third Tranche Release
		Public Enterprises	Public Enterprises	
The three traditional sectors of the economy, i.e. bauxite, sugar and rice are dominated by the Guyana Mining Enterprise Limited (GUYMINE), and Guyana Sugar Corporation (GUYSUCO) and the Guyana Rice Group (GRG). Together they account for about 30% of GDP and 83% of total merchandise exports. Their financial structures remain extremely weak, and thus hampering their operational efficiency.		(a) GUYSUCO: Agree on a strategy statement and timetable for setting up separate accounting and management and attracting private investment for sugar production and for non-sugar activities, i.e. rice production, dairy development, aquaculture and orchard development; (b) PCS: Agree on a corporate strategy for the PCS group with a view to determining which enterprises should be kept within the Government's control to meet strategic/social objectives and which should be offered for joint ventures or for outright sale to the private sector;	(a) PCS: Put into effect an action program and schedule for carrying out the corporate strategy for the PCS group; (b) Operating procedures and auditing systems satisfactory to IDA to be established to monitor the financial performance of GUYMINE, GUYSUCO, PCS, and transfers of targeted amounts from these enterprises to the Central Government.	

GUYANA - STRUCTURAL ADJUSTMENT CREDIT

POLICY MATRIX

Policy Areas	Actions Taken by the Government as of end 1989	Actions Taken Prior to Board Presentation	Actions to be Taken Prior to Second Tranche Release	Actions to be Taken Prior to Third Tranche Release
Public Sector Investment Program (PSIP) The long period of economic decline and consequently inadequate asset maintenance has resulted in poor condition in the infrastructure services. Therefore, the major focus of the PSIP will be the rehabilitation of basic infrastructure that is critical for supporting the program's objectives of increasing exports and private investment. The most urgent task is to restore electricity supply to required levels.		PSIP (a) Agreement on and review during 1990-92 of the size and composition of the three-year rolling PSIP, to bring it in line with projected domestic and foreign resource availability; (b) Agreement on modalities including the type of information, economic criteria for admission of new projects and timing for reviews of the PSIP (in the context of a rolling three-year framework); (c) Agreement on institutional arrangements -- principally the staffing in the State Planning Secretariat -- for providing guidelines on project preparation to line ministries and government agencies and for evaluation and monitoring of projects; (d) Improvement of external aid coordination through the services of an advisor to the Ministry of Finance to maintain continuous contact with donors and to facilitate procurement and disbursement of funds provided by bilateral and multilateral donors.	PSIP (a) Review of rolling PSIP satisfactory to IDA; (b) Implementation of institutional arrangements satisfactory to IDA, for strengthening the capacity of the State Planning Secretariat by filling all vacancies for planners in the Project Cycle Unit to provide guidelines on project preparation to line ministries and government agencies and to evaluate and monitor projects included in the PSIP.	PSIP (a) Review of rolling PSIP satisfactory to IDA.

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MARCH 1979

HAITI

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Report No. P-4411-HA

REPORT AND RECOMMENDATION

OF THE

PRESIDENT OF THE

INTERNATIONAL DEVELOPMENT ASSOCIATION

TO THE

EXECUTIVE DIRECTORS

ON A

PROPOSED DEVELOPMENT CREDIT

OF SDR 32.8 MILLION (US$ 40.0 MILLION EQUIVALENT)

TO THE

REPUBLIC OF HAITI

FOR AN

ECONOMIC RECOVERY PROGRAM

FEBRUARY 9, 1987

CURRENCY EQUIVALENTS

Currency Unit = Gourde (G)
G 1.00 = US$0.20
US$1.00 = G 5.00

The Gourde has been pegged to the U.S. Dollar since 1919 at this rate.

WEIGHTS AND MEASURES

Metric System

FISCAL YEAR

October 1 - September 30

This report uses FY for fiscal year. Thus FY87 refers to the period from October 1, 1986 to September 30, 1987.

ABBREVIATIONS

BCA	Bureau de Credit Agricole (Agricultural Credit Bureau)
BNDAI	Banque Nationale de Developpement Agricole et Industriel (National Agricultural and Industrial Development Bank)
CNG	Conseil National de Gouvernement (National Government Council)
CPNAP	Commissariat a la Promotion Nationale et a l'Administration Publique (planning agency)
ENAOL	Enterprise Nationale des Oleagineux (vegetable oil factory)
FDI	Fonds de Developpement Industriel (Industrial Development Fund)
IDB	Inter-American Development Bank
IMF	International Monetary Fund
SOE	Statement of Expenditure
UNDP	United Nations Development Programme
USN	Usine Sucriere du Nord (sugar mill)
USND	Usine Sucriere Nationale de Darbonne (sugar mill)

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OCT 17 2022

WBG ARCHIVES

HAITI

ECONOMIC RECOVERY PROGRAM

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HAITI

ECONOMIC RECOVERY PROGRAM

Credit and Program Summary

Borrower: Republic of Haiti.

Amount: IDA credit of SDR 32.8 million (US$40 million equivalent).

Terms: Standard IDA.

Description: The proposed credit would finance general imports in support of the Government's Economic Recovery Program, set out in its Letter of Recovery Policy, designed to reform public finances and economic policies, stimulate economic growth and establish conditions from which retrogression to the inappropriate policies of the past would be difficult. Measures include macroeconomic stabilization and the improvement of resource allocation through reform of taxes, public expenditure, public enterprises, competition and industrial incentives, and agricultural pricing and credit. The program is also being supported by an arrangement under the IMF's Structural Adjustment Facility, the policy framework paper for which was jointly prepared by the Government, the IMF and IDA.

Benefits: Restored confidence, improved resource allocation, and improved consumer welfare, particularly of the poorest Haitians.

Risks: Political instability and public sector wage demands could weaken the Government's ability to maintain fiscal discipline; influential protected manufacturers could resist trade regime reforms; and the Government that will take office in February 1988 could reverse the policy reforms. These risks would be reduced through tranching, the provision of technical assistance, and broad support and close monitoring, not only by IDA but also by the IMF and the donor community.

Estimated Disbursements:	**FY87**	**FY88**
(US$ million)	20.0	20.0

Appraisal Report: None.

Map: IBRD 17094R

INTERNATIONAL DEVELOPMENT ASSOCIATION

REPORT AND RECOMMENDATION OF THE PRESIDENT TO THE EXECUTIVE DIRECTORS ON A PROPOSED DEVELOPMENT CREDIT TO THE REPUBLIC OF HAITI FOR AN ECONOMIC RECOVERY PROGRAM

1. I submit the following report and recommendation on a proposed development credit to the Republic of Haiti for SDR 32.8 million (US$40.0 million equivalent) on standard IDA terms. The proposed credit would support the Government's Economic Recovery Program.

PART I - THE ECONOMY

2. The assessment of the Haitian economy in this report is based largely on three documents already distributed to the Executive Directors and on the work of the appraisal mission (September/October 1986) for the proposed credit. Haiti: Policy Proposals for Growth (5601-HA) was distributed on June 18, 1985 and Haiti: Public Expenditure Review (6113-HA) on October 5, 1986. The joint Government/IDA/IMF Policy Framework Paper for an IMF Structural Adjustment Facility arrangement was discussed by the Committee of the Whole on November 18, 1986. All three were also made available to the members of the Caribbean Group for Cooperation in Economic Development, whose Haiti Subgroup met in November 1986. Annex I presents economic data.

A. Main Features

3. Haiti is a small, densely populated, predominantly rural, and open economy. Its 5.4 million people occupy 28,000 square kilometers, the western end of the island of Hispaniola, and are among the poorest in the world. Absolute poverty in Haiti is unmatched in the Western Hemisphere. Life expectancy at birth is only 53 years, the infant mortality rate is about 120 per 1,000 live births, over 25 percent of children suffer from second or third degree malnutrition and 27 percent die before the age of five; about 65 percent of adult Haitians are illiterate. Economic and social conditions improved in the 1970s, but the economy stagnated during the 1980s, unemployment increased, and real per capita income fell; in 1985, it averaged US$350 (Atlas basis), and half the labor force is unemployed or underemployed.

4. Three quarters of the population live in the rural areas, and ultimately depend on agriculture, historically the principal productive sector. Since the early 1970s, however, the volume and value of agricultural output, including exports, have increased little. Physical production per capita has fallen steadily as relentless population pressure

has forced peasants to cultivate ever more marginal hillside land. Strenuous family planning efforts, largely by non-governmental organizations, have yet to show results. Only about 20 percent of the rugged, mountainous terrain is considered cultivable; nonetheless, about 30 percent is actually cultivated. The average farm size is below 1.1 hectares. This shortage of land, coupled with insecurity of tenure and the demand for wood and charcoal for energy, has generated a vicious circle of deforestation and soil erosion that has further intensified the shortage. Declining rural incomes have led to substantial rural-urban and international migration. The total population is growing at 1.8 percent per annum, net of emigration of 0.5 percent, while the urban population is expanding by four percent.

5. Past public policies in agriculture exacerbated the scarcity of land and the pressure of population. A million people on the hillsides depend on coffee, the major cash crop, expansion of which has been discouraged by an export tax. Reduced from 26 percent in the early 1980s, this tax was still about 22 percent in FY86, representing half the price received by the producers. Producer prices for foodgrains were increased to well above world prices by import restrictions. This fostered the cultivation of maize on the hillsides instead of coffee and worsened soil erosion. Cotton production was also discouraged by a producer price below the import parity price. Public agricultural investment and credit programs were occasionally targeted more to social relief than to stimulating either growth in productivity, output and employment or effective soil conservation. On the plains, where agricultural potential is much greater than on the hillsides, irrigation systems lack operating and maintenance finance, and are silting up from the erosion on the hills; much State and private land is unexploited; and peasants practice highly risk-averse production patterns.

6. These agricultural problems have resulted in Haiti's increasing dependence on imported staples to satisfy basic food requirements. In FY85, food imports accounted for about 24 percent of all official merchandise imports, compared to 20 percent ten years earlier. Substantial and increasing quantities of contraband food, particularly rice, maize and sugar, are also entering the country.

7. In recent decades, output and employment have shifted toward urban activity, largely as a result of a scarcity of cultivable land and the establishment in the 1970s of a labor-intensive, export assembly industry. Agriculture now accounts for only one third of GDP compared with one half in the early 1950s. Gross national savings are very low, averaging only about five percent of GDP since FY80. This deficiency of savings, which is particularly marked in agriculture, leaves the economy reliant on external savings in the form of concessional aid to attain levels of investment consistent with sustained growth. The economy has become much more open; by 1980, the total value of exports and imports of goods and services had risen to about 50 percent of GDP.

8. Despite the expansion of manufacturing for export, the external payments position is weak; the export base remains narrow, leaving Haiti vulnerable to exogenous shocks. The assembly industry produces a very limited range of products--electronics, clothing, and sporting goods--yet accounts for over 50 percent of all exports; external factors, such as the 1980-83 world recession and the shakeout in the North American computer industry have contributed to the recent slowdown in this subsector. Coffee, which accounts for about 25 percent of exports, is particularly vulnerable to world price fluctuations and to hurricanes. Tourism has virtually ceased as a result of publicity concerning AIDS and the only bauxite mine closed in 1982, when deposits were exhausted.

9. In the second half of the 1970s, economic growth, averaging 4.5 percent per annum, allowed for some improvement in real per capita income. A basic physical infrastructure was established and education and health received attention, virtually for the first time since the 1930s. Prudent financial policies were pursued and foreign development assistance was substantial. The economy was virtually on a dollar standard, with the Gourde remaining at a fixed parity of five to the U.S. dollar, and prices were relatively stable. These conditions helped engender private sector confidence and promoted the continued rapid expansion of the export assembly industry, largely based on Haitian entrepreneurial talent. Although it has enjoyed tax holidays and other investment incentives, this subsector's primary advantage has been the freely determined structure of wages in Haiti. Until recently it was the fastest growing assembly industry in the Caribbean Basin; over 50,000 jobs were created by 1980. In contrast, the private industrial subsector producing for the domestic market, which grew quickly in the early 1970s behind high walls of protection, quickly saturated this market and has stagnated for almost 10 years. There is little scope for this domestic subsector to expand into export markets without major restructuring.

B. Developments, FY80-85

10. From FY80-85 the public sector expanded its influence in the economy through higher rates of taxation, even higher levels of public expenditure--the control and allocation of which was seriously deficient--and an increase in the number of public enterprises. Waste and inefficiency became endemic. Extrabudgetary expenditures rose disturbingly, as did the level of corruption. New and inefficient public industrial enterprises were formed, resulting in real resource losses equivalent to almost four percent of GDP each year. Too much spending went to salaries and non-development purposes, not enough to non-salary operating costs; too little went for development, and the returns on public investment were very low or even negative. Transfers from the Treasury to the investment budget were partly diverted to meet salary payments in ministries without development functions, reducing the availability of counterpart funds for aid-financed projects. Per capita public spending on health declined by 45

percent from FY80-86. The overall public sector deficit before grants averaged over 10 percent a year (6.5 percent after grants). Public savings dropped to less than one percent of GDP on average and recourse to nonconcessional financing, mostly Central Bank credit, increased to more than three percent of GDP on average. This in turn exerted heavy pressure on the balance of payments; official net reserves declined at an annual rate of US$22 million and had fallen to minus US$93 million by the end of FY85. Gross reserves had declined to less than three weeks' import coverage. Payments arrears accumulated and a parallel foreign exchange market developed, with the Gourde selling at a discount which at times exceeded 20 percent.

11. The confidence of the Haitian people, the private sector and the international aid donor community was eroded and the economy declined by an average of 0.6 percent per year from FY81-86, compared to the growth of the late 1970s. Per capita incomes in FY86 were 15 percent below those in FY80. There was increasing immiseration in the rural areas and emigration--the "boat people"--increased. Starting in April 1984, there was intermittent civil unrest. The assembly industry stagnated since 1983. Employment in this subsector peaked at about 60,000 jobs but is estimated to have declined by around 10 percent since, mainly in response to political uncertainty and civil unrest. Donors expressed concern over inappropriate public investments, the lack of overall public investment priorities, and poor policies in agriculture and industry. In the absence of a major overhaul of public investment, foreign aid declined from seven to five percent of GDP from FY83-85 and several donors allocated their aid away from the public sector toward non-governmental organizations.

12. The Government's increased revenue demands on the domestic economy in the 1980s were met through rent-seeking pricing policies by public industrial enterprises that enjoyed trade monopolies. Together with the intensification of import restrictions and of private production and importing monopolies, this inflated prices for basic consumer goods to well above world levels. The annual increase in consumer prices averaged eight percent in FY80-86, double that of Haiti's main trading partners. An outright ban on the importation of specific consumption items was first introduced in 1981 and then replaced by an administered system of import licensing after 1982. Both trade restrictions and pricing policies created price distortions with neighboring countries, and encouraged contraband in imported consumption goods.

PART II - THE GOVERNMENT'S ECONOMIC RECOVERY PROGRAM, FY86-88

A. Political Background

13. Coming to power in 1957, President Francois Duvalier closed the economy, conducted an effective reign of terror, and ended all hope of progress until his death in 1971. His son and successor, Jean-Claude, began a limited modernization process. The economy became more open, foreign aid

began to flow, and emigrants returned from the diaspora. The initial response of the economy was positive; by the late 1970s, as noted, it was growing at about 4.5 percent per annum.

14. The economic stagnation of the early 1980s, however, led to increasing political discontent. By late 1985, civil unrest was widespread and the economy was deteriorating rapidly; by early 1986, the situation was unsustainable. The political system changed dramatically on February 7 with the sudden departure from Haiti of President Duvalier. A provisional National Government Council (CNG) came to power, pledged to hold elections and promote economic recovery. Civil calm was largely restored within a few months, although occasional disturbances continue. An electoral calendar has been established and so far followed; presidential elections are scheduled for November 1987, with a new Government taking office on February 7, 1988.

B. Overall Strategy

15. The Government's intentions for the Haitian economy are set out in its Letter of Recovery Policy (Annex IV): to reform public finances and economic policies in order to hand over a viable, growing economy to its elected successor and to establish conditions from which retrogression to the inappropriate policies of the past would be difficult. The essence of the program is to reduce the exploitation of the average Haitian, long impoverished by high consumer prices set to expropriate economic rents to benefit former regimes. An attempt is thus being made to end the past system of privilege and monopoly. These actions are also intended to lead to more sustained economic expansion; the overall target of the Economic Recovery Program is GDP growth of at least 4.5 percent a year through improved exports and agricultural performance. This target is to be promoted both directly by the removal of impediments to efficient resource allocation, and indirectly by the impetus to higher capital inflows that these policies should generate. Central to this strategy is the need to rebuild the confidence of Haitian workers, farmers and investors, on the one hand, and foreign investors and aid donors, on the other.

16. The policy measures to achieve the Government's objectives are, first, macroeconomic stabilization and, second, the improvement of resource allocation through reform of taxes, public expenditure, public enterprises, competition and industrial incentives, and agricultural pricing and credit. These are discussed in subsequent sections of Part II; reform of the trade regime is a principal vehicle for many of them. The public sector's scope is to be reduced, and it is to be made more efficient. In addition, the Government is working to reduce external obstacles to Haitian exports. In September 1986 it successfully negotiated a major increase in the United States' import quota for Haitian textiles. If the new U.S. import ceilings are achieved, Haiti's export assembly industry could expand its output by some 45 percent and create 10-12,000 new jobs.

17. The present Government's Economic Recovery Program will not, of course, resolve Haiti's many severe development problems. This will take much more time than the short life of this Government, as it well recognizes. Thus its program is designed to pave the way for future development.

18. A longer term development strategy will have to be based on Haiti's people; the country has few natural resources. Haiti's comparative advantage lies in the development of urban industrial, export-oriented production; its internationally competitive wage structure has already led to the establishment of the export assembly subsector, the most dynamic element of the economy. A development strategy based on human resources implies major investments in human capital, through improved education and health. It also implies raising agricultural productivity, production and employment, as the bulk of the Haitian people will continue to depend on agriculture for at least another generation. This in turn will necessitate alleviating the pressure of population on the land through the introduction of effective family planning and through migration from the hillsides to the plains and cities. The development of urban industry and of agriculture on the plains will require major improvements in Haiti's physical infrastructure--especially its urban capital stock, its export facilities and services, and its irrigation systems--and in its deteriorating natural environment.

C. Macroeconomic Stabilization

19. **Performance in FY86.** The public sector's financial position improved significantly in FY86. The year began in October 1985 with approval of a budget that called for a reduction in the overall public sector deficit (after grants) from 4.0 percent of GDP in FY85 to 1.7 percent; Central Bank financing was to be limited to 0.4 percent of GDP, compared with 2.2 percent in FY85 and 3.5 percent in FY84. When the present Government came to power in February 1986, the deficit and financing plan were broadly on track. The composition of expenditure, however, was noticeably different from that budgeted as sound budgetary procedures were being ignored.

20. The Government took drastic steps to redress the budgetary situation. From February on, both expenditures and taxes were cut and a balanced budget was maintained, except for concessional financing. Many wasteful current expenditures and unjustified "development" projects, equivalent to some three percent of GDP on an annual basis, were eliminated. About half of the savings were reallocated to priority sectors (health, education, agriculture and internal security). The rest enabled excise taxes to be reduced on basic consumption items such as flour, sugar, vegetable oil, and petroleum products, and certain taxes, previously earmarked for special projects of the previous regime, to be eliminated. In total, current and development expenditure came to only 17 percent of GDP compared to the 23 percent foreseen in the previous Government's budget.

21. As a result, Haiti's financial situation improved substantially. In FY86 the public sector was able to make net repayments on its external commercial debt and to reduce the stock of debt to the domestic banking

system. The overall public sector deficit before grants was 5.2 percent of GDP, compared to 7.5 percent in FY85; the deficit after grants was 1.0 percent of GDP. The reduction of the public sector deficit was accompanied by a marked improvement in the balance of payments. The current account deficit narrowed by two percent of GDP to 4.8 percent in FY86 and, after six years of deficits, the overall balance of payments registered a surplus of over US$20 million. The discount on the Gourde on the parallel foreign exchange market fell back sharply after July 1986 to about 5-7 percent. Inflationary pressures have also ended; the consumer price index fell by four percent from February to September 1986.

22. **Objectives.** The Government recognizes that without continued stabilization, the other elements of the recovery program will be ineffectual. It aims to reduce further its outstanding stock of nonconcessional debt, both external and to the domestic banking system; to generate overall balance of payments surpluses equivalent to almost 1.5 percent of GDP in FY87 and close to one percent in each of the following two years; and to keep inflation below about four percent, as in Haiti's main trading partners. The centerpiece of this effort is fiscal policy. The overall deficit (after grants) is expected to increase in FY87 to 1.8 percent of GDP from the low of 1.0 percent in FY86 and to remain close to this level in the following two years as higher levels of concessional financing are sustained. Assuming a favorable response of donors to its Economic Recovery Program, the Government will limit the overall public sector deficit, before grants, to about seven percent of GDP. The anticipated level of grants and concessional aid will more than finance this deficit, permitting the reduction of nonconcessional debt. Haiti's nonconcessional debt and liabilities to the IMF should decline sharply, falling by US$27 million or 16 percent in FY87 and by similar percentages in the following two years. The Government and the monetary authorities do not intend to contract or guarantee any nonconcessional external credit within the 1-12 year maturity range, other than the refinancing of arrears.

23. This fiscal stance will set a sound basis for monetary and credit policy by facilitating a reduction in the stock of Central Bank credit to the public sector. This in turn should allow an expansion in credit to the private sector without either jeopardizing the inflation objective or placing pressure on the balance of payments.

24. **Program for FY87.** In line with these broad objectives, the Government has established a continued stabilization program for FY87, supported by an IMF Structural Adjustment Facility arrangement which includes quarterly benchmarks for Treasury receipts and outlays, net financing of the public sector, and credit.

25. This program projects Treasury revenue at 10.2 percent of GDP, compared with actual collections of 11.5 percent in FY86. A similarly cautious approach has been followed in making budgetary provision for outlays financed with external cash grants. Although expectations are that these may be as high as G 180 million, for programming purposes grant disbursements have been set at G 140 million. The budget places a limit on Treasury expenditures of 11 percent of GDP, permitting it to run a surplus of G 40 million, which will be used to reduce Government debt to the Central Bank. The public enterprises are expected to make net repayments to the domestic banking system and reduce somewhat their indebtedness to external

commercial creditors. The overall public sector surplus (after grants) is to rise to G 60 million, from G 48 million in FY86. Including public investment, overall public expenditure should recover to about 20 percent of GDP.

26. The Central Bank and the state-owned National Credit Bank will be subject to ceilings on their net domestic assets and on credit extended to the private sector. As a result, the Central Bank's net credit to the public sector will be reduced by two percent, while commercial bank credit to the private sector is projected to increase by 14 percent. The program also calls for an overall balance of payments surplus of US$32 million which will allow some reconstitution of net international reserves. External arrears, which stood at US$14 million at the beginning of the fiscal year, will be rescheduled or settled with cash payments by its end. By December 31, 1986, all first quarter benchmarks had been achieved.

D. Tax Reform

27. Despite measures to overcome their sluggishness, including a value added tax introduced in FY83, tax revenues remained low, at around 10 percent of GDP, through FY85. Besides Haiti's poverty, several factors accounted for this. First, exemptions increased as part of industrial investment and export promotion. This increased the difficulty of assessing and collecting income taxes and customs duties. Second, the structure of these taxes was too complex with unrealistically high marginal rates. Third, taxes on agricultural exports, notably coffee, reduced farmers' incentives to expand output. Fourth, too much reliance was placed on a vast array of excises, fees and charges which depressed the buoyancy of the system. Fifth, and above all, evasion and fraud were increasingly widespread, largely reflecting the common perception that taxes were used to finance inappropriate public expenditures.

28. Starting in February 1986, the new Government embarked on a program of far-reaching reforms aimed at improving the equity of the tax system and increasing its responsiveness to economic growth. The Government believes that evasion can be reduced by broadening the tax base, lowering rates and managing public finances in a transparent manner. The FY86 reform measures were relatively modest while more important ones were being prepared. As noted, excise taxes on consumption goods were reduced and certain taxes, mainly ancillary taxes on wages, previously earmarked for special projects of the previous regime, were eliminated. The revenue loss from these latter sources, estimated tentatively at G 70 million, represented a benefit for wage earners in Port-au-Prince and the other main towns. In addition, a variable excise tax was imposed on petroleum products to capture the difference between import costs and the domestic fixed prices. Finally, as discussed in Part II.G, quotas on 76 imported goods were replaced with ad valorem tariffs.

29. More fundamental measures were adopted in early FY87. The export tax on coffee was reduced from 22 to 10 percent and other export taxes on cocoa and sisal were eliminated. The Government intends to eliminate the coffee export tax when overall revenue and expenditure performance has improved sufficiently. Also effective in early FY87, the income tax system

was simplified, with fewer tax brackets, fewer exemptions, lower marginal rates, a greater degree of consistency between the treatment of individuals and corporations, and improved collection procedures, the latter including the dismissal of non-performing staff from the internal revenue service. Administrative procedures are also being improved, in particular by systematic cross-checks between income, value-added and trade taxes. In the longer run, the Government intends to replace most excise taxes by the value added tax. Finally, the Government implemented in early FY87 a further round of import quota and tariff changes, replacing quotas and specific tariffs with ad valorem tariffs, and intends to improve customs valuation and enforcement procedures.

E. Public Expenditure

30. From a development perspective, there were two major resource allocation and expenditure control problems of the central Government before FY86. First, the four development-oriented ministries--agriculture, public works, education and health--suffered from inadequate non-salary operating funds. Agricultural extension workers could not get to the fields, irrigation systems were not properly maintained, schools were without furniture and books, and public health clinics without drugs. Since the internal efficiency of these ministries was low, the returns to existing private and public investments in their areas of responsibility were much lower than expected. The four ministries at the same time spent too much on salaries. They had recruited too many unskilled employees, largely for social or political reasons, and found it difficult to attract the skilled staff they needed because of relatively low salary scales compared to other parts of the Government. Fraudulent wage payments were also a serious problem, especially in education and health.

31. Second, the size and composition of the public investment program has been determined more by the availability of externally packaged and aided projects than by careful consideration by the Government of national priorities and domestic resources likely to be available as counterpart funds for these projects. The availability of foreign funds was consistently overestimated. In addition, local resources earmarked for investment included too many socially-oriented projects with low economic returns in terms of their contribution to output and exports; many represented disguised salary support. Shortages of local counterpart funds were therefore common during project implementation. Overall implementation of past programs never exceeded 70 percent of that forecast. During the first half of the 1980s, the public investment program also included inappropriate, resource-losing public industrial enterprises, as discussed in the next section. Among justified projects, too many suffered from insufficient technical design and poor implementation. In agriculture, public investments were not accompanied by necessary pricing and structural changes.

32. Reflecting these two problems was a complex system of planning, budgeting, monitoring and disbursing public investment, which provided numerous opportunities to divert funds. The situation regarding current expenditure was little better.

33. The present Government has embarked on a widespread program of reforms designed to begin to tackle these problems. Its aim is to manage public finances transparently, to reallocate current expenditure toward development-oriented ministries and the non-wage needs of development projects, while concentrating public investment on the consolidation and rehabilitation of existing and ongoing investments. These objectives are modest but well chosen, given the limited life of this Government. By February 1988, it should have achieved substantial results by comparison with the past, but much will remain to be done, especially in the complex and difficult areas of rationalizing public employment and establishing efficient procedures for planning, budgeting, disbursing and monitoring public expenditure.

34. **FY86 Reforms.** After February 1986, Treasury expenditure, which is mostly current, was cut from an average monthly level of G 111 million to G 84 million. Expenditure for the political support of the former regime was eliminated; audits of several ministries and agencies identified wasteful expenditures. The public investment program was severely pruned; preliminary estimates indicate that only about 60 percent of the G 1,113 million forecast in October 1985 was actually implemented. In August 1986, the former Ministry of Planning was replaced with a more streamlined National Promotion and Public Service Commission (CPNAP), charged with improving the public investment program and, together with the Ministry of Economy and Finance, with examining development projects' recurrent financial needs. Finally, toward the end of the fiscal year, the salary question was addressed. First, wage payments were controlled in the education sector to eliminate fraud; the Government intends to extend this review to health and other sectors once the necessary staff and procedures can be put in place. Second, untaxed fringe benefits were eliminated.

35. During the last four months of FY86, the Government allowed Treasury expenditure to rise again to an average monthly rate of about G 100 million. The G 16 million increase on the average of the previous four months was intended to be used both for sorely needed salary increases and for operating supplies in the education and health sectors. This intention was, however, defeated. After teachers' and health workers' salaries were raised, Government employees elsewhere went on strike for commensurate increases. The end result was that the G 16 million was almost fully allocated to raising salaries, not only in education and health, where the functional need was greatest, but also in the armed forces and the departments of customs, internal revenue, agriculture, interior and justice. Very little was left for the purchase of operating supplies in education and health. The effect on the Government's wage bill was permanent. Resolving this problem is not feasible in the short term, however. The Government is considering establishing a mechanism at the highest political level to develop a policy to rationalize the public wage bill and public employment.

36. **FY87 Treasury Budget.** The Treasury budget for FY87 includes a complete allocation of expenditures, abandoning the practice of reserving large sums for unspecified programs; unallocated expenditures comprised almost one fifth of the FY86 budget. There will be no extrabudgetary Treasury spending and no transfers to public enterprises. The auditing program is continuing, including audits of both the Ministry of the Economy and Finance and of the Central Bank. Public sector accounting will be

improved by monthly reconciliations of the accounts of the Ministry of Finance and the Central Bank. The current Treasury budget (i.e. excluding debt service and transfers to investment) more adequately reflects the non-wage recurrent needs of development projects, particularly in education and health. These two sectors' share of total current expenditure has increased from 19 percent in FY86 to 32 percent. A lesser increase is provided for agriculture because of administrative constraints. Table 1 compares the FY86 and FY87 current budgets.

Table 1: TREASURY BUDGETS, FY86 AND FY87
(G million at current prices)

Ministry or Agency	FY86 Budget	FY87 Budget	Percentage Change
Education	98.3	161.6	64
Health	89.5	144.4	61
Agriculture	37.5	42.2	13
Public Works	77.3	78.0	1
Armed Forces	96.3	142.0	48
Other	589.6	385.1	-35
Current expenditure	988.5	953.3	-4
Debt service	324.4	236.7	-27
Transfer to investment	136.0	100.0	-27
Treasury expenditure	1,448.9	1,290.0	-11

Source: Ministry of the Economy and Finance.

37. The FY87 budget establishes a limit of G 676 million on wage payments to civil servants, compared to last year's G 561 million. This increase not only reflects salary increases but also the reclassification of remuneration previously included in other budget categories or paid outside budgetary channels. The official figure for central Government employment in early FY86 was 32,400; the actual figure may well have been over 50,000, however. The Government intends to review the staffing levels of all ministries and agencies; streamlining has already occurred at the Ministry of Economy and Finance, the internal revenue service and at CPNAP.

38. **FY87 Public Investment Program.** The size and composition of the FY87 public investment program were determined by the needs to meet the local counterpart requirements of projects and to consolidate and rehabilitate existing and ongoing investments. Unfortunately, the process began late and was rather disorderly. The attempt to do better than in the past was, however, genuine and by and large effective. The overall public investment program is estimated at G 1,140 million, to be financed by public savings (G 280 million) and concessional external aid (G 860 million). Likely disbursements of project aid are still overestimated. However, considering both the increased level of overall public savings because of untied aid for budgetary support and improvements in project preparation and administration, actual disbursements may well result in an overall implementation rate of about 80 percent, or between G 900-950 million, consistent with the Government's macroeconomic stabilization target of a

public sector deficit before grants of about seven percent. Table 2 summarizes the sectoral composition and financing of the program and compares it with that for FY86.

Table 2: PUBLIC INVESTMENT PROGRAM, FY86 AND FY87
(percentage shares)

	FY86 Program	FY87 Program
Total Program Cost (G million)	1,113	1,140
Financing		
Public savings	25.5	24.5
Concessional external aid	74.5	75.5
Sectoral Composition		
Agriculture	18.5	21.2
Industry, including mining	11.9	4.8
Electric power	15.0	12.7
Transportation a/	10.5	12.2
Telecommunications	5.6	11.2
Urban development	5.4	6.5
Water supply	6.0	4.8
Education	5.8	7.1
Health	10.5	9.6
Other sectors	10.8	9.9
Implementation Rate (percent)	60.3 (est.)	80.0 (proj.)

Sources: CPNAP; Annex VI.

a/ Excludes proposed Cap Haitien airport project (para. 39)

39. Details on the sectoral composition of the program and the largest projects are given in Annex VI. In brief, agricultural projects concentrate on irrigation rehabilitation (including where necessary protection of associated watersheds), feeder roads and input delivery. Soil conservation and reforestation are maintained at financially sustainable levels and increasingly linked to treecrop rehabilitation or expansion. There are no new irrigation projects in the program. Similarly, there are no investments to expand the capacity of public industrial enterprises, although there are some productivity enhancing investments at the public flour mill and cement factory. Projects to benefit industry are those which improve the physical infrastructure and public utilities serving the private sector. The transport data exclude a proposal to construct an international airport at Cap Haitien. This would represent at most two percent of public investment in FY87. No cost estimation or feasibility analysis has been carried out for this project, which has not yet started. The Government does not, however, intend to use any funds for this project other than those available to the National Airport Authority from one third of a G 75 user charge levied on air passengers, about G 5 million per year; no external concessional or commercial financing will be used. Development expenditure

in the social sectors is concentrated heavily on the completion of ongoing projects in education, training and health, and on urban development and water supply.

40. On the financing side, Treasury development expenditures are almost exclusively devoted to meeting the counterpart fund requirements of foreign aided projects. All projects are financed exclusively with concessional external aid. The program is by and large appropriate for Haiti's development needs. In addition to this program, the Government has presented to external donors a list of 26 new projects proposed for external financing of G 217 million (US$43 million). These modest projects are within Haiti's absorptive capacity and will be added to the program as financing is secured.

41. The Government intends also to continue to strengthen the planning, budgeting and disbursing of public expenditure through improved procedures. These will include the elimination of fraudulent wage payments at the Ministry of Public Health and Population, the improvement of recurrent budgeting at the Ministry of National Education, and the preparation of the public investment program for FY88. This last will be based on a joint review with IDA staff of actual progress made in the first nine months of FY87 and of preliminary proposals for FY88, and will start much earlier than has previously been the custom.

F. Public Enterprises

42. Policy toward public enterprises has undergone a radical change. There were in early 1986 five major public industrial enterprises: Entreprise Nationale des Oleagineux (ENAOL), a vegetable oil mill; two sugar mills, Usine Sucriere Nationale de Darbonne (USND) and Usine Sucriere du Nord (USN); Ciment d'Haiti, a cement plant; and La Minoterie, a flour mill. All five used to enjoy trade privileges which, in each case, protected grossly inefficient operations and enabled financial procedures inconsistent with sound business practices. Annual real resource losses were equivalent to almost four percent of GDP during FY82-85, a period in which the Haitian economy never grew by more than one per cent per year. In addition, the two sugar mills and the vegetable oil mill incurred heavy financial losses. To stem and eventually reverse this economic and financial waste, the Government has combined the closure and restructuring of enterprises with market liberalization and the introduction of financial monitoring.

43. **ENAOL.** This enterprise, which produced semi-refined vegetable oil from oilseeds by crushing and solvent extraction, was never economic. Since beginning operations in 1981, it had a negative balance of payments impact of about US$16 million each year. The scale of the crushing and solvent extraction was too small to be economic; the plant also carried out second stage refining to fully refined oil, a process already amply catered for in Haiti through the existence of six other private refiners.

44. The mill was accordingly closed on July 31, 1986. The approximately 300 employees were offered either generous severance pay or the option to form a private cooperative to run the factory; about 60

percent opted for the former, each receiving about nine months' salary. The remainder, including most of ENAOL's previous managers, will lease the plant from the Government for 25 years at a nominal rent. If the cooperative is to survive, it will have to adapt to a highly competitive market environment: the Government has pledged not to grant it any subsidies, privileges or loan guarantees. Moreover, the market for vegetable oils has been liberalized: ENAOL's import monopoly was dissolved with the company itself; licencing requirements for importation have been eliminated, and a tariff of 20 percent has been imposed on vegetable oil imports.

45. **USND and USN.** Until mid-1986, Haiti had four operating sugar mills, two private and two public. The two latter, USND and USN, operated at a loss despite the high price of US$0.24 per lb paid for raw sugar at the factory gate and the low price of US$13 per ton paid for cane. If prices and costs are adjusted to reflect long term international values, then neither mill is economically viable even under highly favorable assumptions concerning raw material supply and efficiency. USND was built directly by the state in 1982; the equipment was supplied on a turnkey basis at prices well above those prevailing on world markets. Capacity utilization has been low because of insufficient cane supply, while operating costs were inflated by a labor force of about 700, some four times as many as required to run the plant.

46. The USND mill was therefore closed in July 1986. The 700 factory employees were, like those at ENAOL, offered the choice between indemnization and the formation of a cooperative to run the mill; all opted for the former, again receiving about nine months' salary. The plant would in any case have required between G 10-20 million of expenditure on rehabilitation and maintenance to reopen and could not have been operated for the FY87 harvest. Farmers in the surrounding Leogane plain, who previously supplied the mill, can either sell their cane to the small artisanal "guildives", which use it to manufacture cane spirit, or to one of the private mills which used to purchase cane from the area before USND's establishment. This mill has both the necessary capacity and logistic support to absorb the Leogane crop. The Government is actively encouraging the planting of alternative crops, principally rice and vegetables, in the Leogane plain to supply the nearby Port-au-Prince market.

47. The case of USN is more complex, since the plant is located in the north of the country, far from the main market and where technically and economically viable alternatives to cane are difficult to identify. Several thousand families depend for their livelihood on supplying or working for the mill. The Government will undertake a study of alternatives to cane, including improvements in watershed and erosion control which they might imply. In the meantime, to identify ways in which mill operating expenses might be reduced, the Government has ordered an independent audit of the company.

48. **Ciment d'Haiti.** This company, 90 percent Government-owned, supplies most of Haiti's current consumption of cement, about 250,000 metric tons per year. Until recently, a licence was required to import cement and a

specific tariff of G 300 per metric ton was levied, equivalent to over 100 percent ad valorem at current CIF prices. This gave the company a de facto monopoly on the production and legal importation of clinker, cement and by-products. The company was exceedingly inefficient: annual operating expenditures, net of taxes, were about US$83 per metric ton, some 66 percent higher than the estimated landed cost of imported bagged cement. There were two main reasons for these high costs. First, personnel costs, at some US$17 per metric ton, were over twice industry standards. This was due both to excessive employment and high wages and salaries. The plant employed in September 1986 about 380 persons on a regular basis, plus a similar number of "temporary" workers, as against efficient industry standards of about 200. It paid unskilled workers more than twice what they would have earned in the private sector, while some managerial staff earned extremely high salaries. Second, energy consumption was high due mainly to the plant's antiquated power generating equipment. New equipment, which may take up to a year to order and install, will still only reduce costs by about US$8 per metric ton.

49. Options under consideration for Ciment d'Haiti include partial divestiture, and switching from the local production of clinker to its importation. The Government has approached IFC about the former. The latter would imply additional investments in storage and handling facilities, and perhaps also in port works, which would have to be subjected to detailed engineering studies. For any option for the plant's continued existence to be economic, it is essential to reduce personnel and administration costs, which amount to about 25 percent of total operating expenditures, and to subject the factory to competition from imports. As a first step, personnel were reduced by 120 by the end of January 1987, and a detailed plan to reduce the company's wage bill has been prepared in connection with an independent financial and management audit. Second, the cement market has been liberalized. Import licencing requirements have been lifted and a tariff of 33 percent placed on imports of bagged and bulk cement.

50. **La Minoterie**, the Government-owned flour mill, has a monopoly over both the importation of wheat and the legal sale of wheat flour, except for specialized products directly imported by bakeries. Wheat cannot be grown in Haiti's climate. The mill has an effective capacity of about 2.8 million 100-lb bags of flour a year. Production has remained near this figure in recent years. La Minoterie has been financially profitable, but only because of a controlled price for wheat flour more than twice border parity. La Minoterie's declared operating costs appear to be about 52 percent above the border price for imported flour. However, while there are undoubtedly major operating inefficiencies and considerable overstaffing--employment of some 1,200 in September 1986 was over ten times industry standards--the cost data on which this analysis was based is unreliable. A recent audit was unable to verify the company's financial statements, partly due to the non-observance of standard accounting practices, but mainly due to significant abuses. Large sums, in some cases totalling several million U.S. dollars, had been siphoned off from the company; moreover, cash management and purchasing and sales procedures were maintained in a deliberately disorganized fashion to facilitate the misappropriation of funds. Despite this, there is no doubt the mill could be run more efficiently and economically in either the public or the private sector.

51. Privatization is under consideration, among other options. The Government changed the management team in October 1986 and separated the Board and the management. The new team, pledged to restructure the company, has engaged consultants to implement the key recommendations of the audit, including the preparation of a plan for wage bill reduction, the consolidation and reorganization of cash and bank accounts, the establishment of a cost accounting system, and the reform of purchase, production and sales procedures. By the end of January 1987, the wage bill at the mill had been reduced by some seven percent.

52. In addition the Government has liberalized the wheat flour market by revoking La Minoterie's monopoly on wheat imports. Import competition will encourage efficiency and facilitate continued supply of the market when demand increases above La Minoterie's current capacity.

53. **Financial Monitoring.** To improve its financial monitoring of all public enterprises, the Government has established a unit in the Ministry of Economy and Finance to review the enterprises' budgets, financial results and the execution of their programmed investments. All public enterprises will also be subject to regular, independent, external auditing. The objective of this more systematic financial monitoring is not to increase state interference in the day-to-day management of the enterprises, but rather to enable the state, as the shareholder, to ensure that the enterprises' operations are consistent with the wider aims of economic policy.

G. Competition and Industrial Incentives

54. The dynamic export assembly subsector grew up without protection, though with tax holidays and other incentives. There has, however, been little linkage between it and the rest of the economy, except through wages, partly because Haitian local industry has been so inefficient that its products are not competitive as intermediate inputs to the assembly subsector.

55. Starting more than 15 years ago, however, import-substitution policies followed by balance of payments constraints led to progressively higher tariffs and barriers to trade as well as to discretionary fiscal incentives for investment. The resulting trade regime created an incentive structure for industry producing for the local market that deterred competition, efficient production and exports. It also led to high domestic prices for many basic consumption items. There were export taxes on agricultural products, import quotas and licenses, high import tariffs, an overly complex and inefficient Customs system and staff, and a complicated administrative structure facing any investor, exporter or provider of services to exporters. The arbitrary operation of the system provided further major disincentives to the establishment of efficient exporting industries. Industrial firms tended to rely on rents from the narrow, protected domestic market rather than investing to correct inefficiencies

and compete in the international marketplace. As a result, local industrial production is stagnant with excess capacity, obsolete equipment and low quality products sold at high prices. Tariffs as high as 180 percent combined with quantitative restrictions on imports resulted in effective protection levels averaging about 100 percent, with more than 10 percent of industrial production enjoying effective protection of over 300 percent.

56. Until mid-1986, more than 100 goods, most produced locally, were subject to import quotas and licencing. In addition, 25 were subject to price controls fixed by the Ministry of Commerce, mostly for monopolistic markets such as milk, soap, matches and fish. Import prohibitions affected several products, such as tomato paste, used cars and used newspapers. De facto import monopolies were enjoyed by the public industrial enterprises for vegetable oil, cement, sugar and flour. More than a dozen petty taxes were also levied on imports by the Customs service, each yielding less than G 500,000 per annum.

57. The Investment Code, revised and simplified in 1985, guarantees various domestic tax holidays and tariff exemptions on imported inputs or equipment to encourage new investments. As with the trade regime, these incentives did not stimulate the development of efficient industries but rather increased the protection of existing firms at the expense of fiscal revenues, consumer prices and the unemployed. While the assembly industry created over 40,000 jobs since 1975, local industrial employment stagnated at around 25,000.

58. The wide range of customs regimes could not be controlled by a weak Customs administration, already burdened with complex import documentation and procedures and afflicted by widespread corruption. Actual collected import duties bore only a coincidental resemblance to official rates. Total collections in FY86 corresponded to 12.5 percent of dutiable imports. As tariff rates rose, contraband increased; it is now virtually endemic.

59. To lower prices, reverse past distortions and stimulate the economy, the Government embarked in July 1986 on a thorough program to liberalize trade, stimulate competition and revise the incentive structure. Its objective is a stable, neutral incentive system to channel resources toward competitive rather than rent-seeking activities. The narrow domestic market means that industrial expansion has to be driven by exports. The Government is thus progressively reducing the average level of effective protection and harmonizing its distribution across sectors through various reforms. Lower tariffs will also be easier to collect than the previous complex system.

60. **Quantitative Restrictions.** In July 1986, the Government reduced the number of products subject to licensing, quotas or prohibitions from 111 to 35. In December 1986, it abrogated the import licensing and quota law. No import monopoly remains in effect. Two products are restricted for sanitary reasons: used newspapers and used clothes. A new import licensing law, without formal ceilings, was introduced for seven agricultural products: rice, maize, millet, beans, sugar, chicken parts and porkmeat parts.

61. **Tariffs.** The quantitative restrictions removed in July 1986 were replaced by ad valorem tariffs averaging about 20 percent with a maximum of 40 percent. At the same time, specific tariffs were replaced with ad valorem ones or ad valorem tariffs were lowered for approximately 300 of the 2,000 tariff positions. In February 1987, following the abrogation of the remaining quantitative restrictions, the Government implemented a complete revision of the entire tariff structure. All specific tariffs were replaced with ad valorem ones. With five exceptions (rice, maize, millet, flour and petroleum), rates range between 0 and 40 percent. Their application takes into account the ending of quantitative restrictions. Exemptions allowed by the Investment Code will be ended by December 1987. Medical supplies and agricultural imports are exempted.

62. The cascading of the rates followed a physical input/output rule rather than the necessities of the existing industrial base to avoid as far as possible ex ante negative protection or sectoral biases. Consumer and final goods are subject to a maximum rate of 30 percent whereas equipment, raw materials and some inputs are subject to 10 percent. A 5 percent rate was used to provide a little protection to locally produced essential intermediate goods (such as packaging, cans, and metal working) without overburdening downstream industries. The targeted average tariff rate is 20 percent.

63. The level of effective protection for existing firms has been drastically reduced by these measures from an average of over 100 percent to below 40 percent; 95 percent of industrial firms now have less than 60 percent effective protection. The state of Haitian trade statistics and customs data and the prevalence of contraband make it impossible to predict accurately the likely impact of the trade regime changes on either the balance of payments or fiscal revenues. Insofar as lower protection should discourage contraband, however, both recorded imports and fiscal revenues may well increase.

64. In addition to these major changes, the Government is streamlining the various Customs procedures and rationalizing petty taxes on trade. Import notifications are now processed quickly and automatically at the Ministry of Commerce and Industry. Customs clearance procedures are being simplified. Further institutional strengthening of the Customs will, however, be necessary. An administrative charge of one percent of CIF value has been extended to all imports except pharmaceuticals and petroleum to cover the costs of an independent, foreign firm that is responsible for import verification. Petty taxes on imports and exports will be eliminated by the end of FY87. The maximum tariff for imports from non-GATT countries is being reviewed.

65. **Investment Code.** The Government intends to revise the Investment Code to harmonize with the above measures. In particular, general exemptions of import duties will no longer be available and existing ones will be progressively eliminated. Eligibility criteria will be neutral in terms of sector, years in business, value added content and market share.

66. **Price Controls.** The Ministry of Commerce and Industry has eliminated its price control office. Price controls remain in effect for very few products, notably sugarcane, sugar and petroleum products.

67. **Export Promotion.** The Government is also reducing the bias against exports. Taxes on agricultural exports are being progressively reduced (Part II.H). In addition to the revised Investment Code, the Government intends to implement an endorsable drawback system by the end of 1987 to reduce anti-export bias. Export promotion is being stepped up and, as noted, a new textile agreement has been reached with the United States.

68. **Restructuring Assistance.** The Government is making available both technical and financial assistance to industrial firms that wish to restructure to operate in the new incentive environment. The Industrial Development Fund (FDI) has been charged with this responsibility; a program of technical assistance has already begun, offering diagnostic surveys to enterprises to advise on priority areas for restructuring and following this up with detailed consulting services and credit to finance new investments.

H. Agriculture

69. The stagnation of agriculture, its declining ability to satisfy minimum nutrition requirements, and the loss of non-renewable natural resources (Part I), are major preoccupations of the Government. Half the mountain land, which accounts for 60 percent of Haiti's total area, has a slope greater than 40° and is suitable ecologically only for forest cover. Nevertheless, much of the forest has been removed for energy and to permit cultivation. Farm technologies are rudimentary. The topography, small size and scattered location of most farm plots offer little scope for mechanization. Investments such as reforestation and terracing are logistically difficult, because of the priority given by farmers to food crops, the insecurity of tenure in many places, and the sheer immensity of the erosion problem. The lowland plains represent about 15 percent of the total land area; 90,000 ha are irrigated. Most systems are in disrepair, however, as a result of inadequate operation and maintenance. Watershed protection is virtually nonexistent, leading to the siltation of irrigation channels after heavy rains.

70. Overcoming Haiti's agricultural crisis will take much time and investment. Reforms should aim at increasing productivity, production and exports; improving nutrition; preserving non-renewable resources; increasing fiscal revenues; and improving equity. The present Government has made a determined start in addressing problems of pricing, policy-induced rents and deficient public services to agriculture. Much remains to be done, however, for many years to come.

71. **Pricing.** Prices have been affected by four major Government interventions: (a) prices and tax levels established at food processing plants for wheat, sugar and vegetable oils (Part II.F); (b) export taxes; (c) quantitative import restrictions and tariffs; and (d) administered

farmgate prices for sugarcane and cotton. Their combined effects have been to tax agricultural producers--mostly in coffee, sugarcane and cotton--and consumers--mostly in sugar, wheat flour, rice and vegetable oils.

72. Despite coffee's comparative advantage over maize and sorghum, it has been subject to an export tax of around 25 percent of FOB prices. Prices of maize, sorghum, rice and wheat flour have hovered in recent years at some 20-30 percent above import prices because controls resulted in negligible imports of the first three while La Minoterie required high flour prices for financial viability and the extraction of rents. By August 1986, farmgate prices for maize were around 100 percent higher than CIF import prices, 30 percent for rice and 40 percent for wheat flour. These policies--of "supporting" grain and flour prices above world levels and suppressing coffee prices below world levels--have had negative results. In the competition for scarce hillside land, many farmers have replaced their coffee trees with maize and sorghum, exacerbating soil erosion.

73. The previous Government made a hesitant effort to deal with the coffee export tax, reducing it to about 22 percent by 1985. It also eliminated the 5 percent export tax on essential oils in 1985. The present Government has moved more forcefully, reducing the coffee export tax to 10 percent, and eliminating the export taxes on cocoa (6%) and sisal fibre (G 1.25 per 100 kg). Provided overall revenue and expenditure performance remain satisfactory, the Government intends to eliminate entirely the coffee export tax by the end of FY87.

74. The Government reduced the excise tax on wheat flour in February 1986, has permitted wheat flour imports, and has replaced import quotas with import licensing restricted to seven products: rice, maize, millet, beans, sugar, chicken parts and porkmeat parts. Even before this, domestic grain prices fell substantially in the second half of 1986, following the unprecedented decline in international prices (and pervasive contraband) and possibly the strengthening of the Gourde on the parallel foreign exchange market. The Government also intends to free the producer price of cotton.

75. **Policy-induced rents.** Past Government policies for State lands created rents for a privileged few, rather than capturing them for the fisc. Substantial areas of public lands were leased at nominal rates to influential individuals, who in turn subleased them to small farmers or sold the lease rights, both at market rates. The law provides that annual rents on State lands are to be assessed at six percent of the fair market land value. Yet most primary leases have been assessed at G 15-60 per ha, compared to fair market rental assessments of G 250-2,000. The Government is thus foregoing some G 100-200 million per annum in revenues. The Government intends during FY87 to introduce a scheme to raise rents on all new and renewed leases according to the fair market value of the land.

76. **Credit.** Only 10-15 percent of the rural population has access to institutional credit. Past primary sources have been the Agricultural Credit Bureau (BCA), which lends mainly to smallholders, and the National Bank for Agricultural and Industrial Development (BNDAI), which has been

geared to medium and large farmers engaged in capital-intensive production, notably of irrigated rice.

77. The loan portfolios of both credit agencies have deteriorated. According to a recent audit, BCA had 6,470 borrowers in August 1986, many associations each averaging 10 farmers, and a portfolio of G 52 million, 50 percent in arrears. An audit of BNDAI is also underway; arrears on its portfolio rose from around 45 percent in mid-1985 to 70 percent a year later. Most of BCA's and BNDAI's arrears are considered uncollectable. During FY87, the Government intends to close BNDAI and will, with assistance from the Inter-American Development Bank, establish a new agricultural credit bank, to include BNDAI's performing agricultural portfolio.

I. Economic, Environmental and Social Impact

78. **Economic Impact.** The Government's Economic Recovery Program, especially the elimination of financial imbalances and price distortions, is having its intended effects. As discussed above, the public sector's affairs are now more transparently managed, it has reduced its stock of nonconcessional debt, the balance of payments is running an overall surplus, the discount on the Gourde on the parallel foreign exchange market has declined significantly, and consumer prices have dropped. Assembly industry exports, which fell in the second quarter of FY86, have picked up again. Confidence is returning and should continue to increase, so long as there is reasonable political stability. The endorsement of the program by external donors and the IMF has also provided a powerful boost to confidence, stimulating private investment and aid flows.

79. Resources have been freed by the reduced burden of public enterprises and the more effective management of a leaner public sector. In the medium term, the public investment program should yield higher returns, though time and major reforms are still needed. The elimination of the coffee and other export taxes, the raising of rentals on State lands, and the reorganization of credit should help to sustain agricultural growth. Furthermore, as commerce becomes less attractive relative to production--as trade liberalization reduces opportunities for rent-seeking activities--Haitian industrial entrepreneurs can be expected to produce more efficiently for export or to supply the export assembly industries. Above all, the consumer will benefit from the reduction of economic rents and the fall in prices of basic consumption goods.

80. Haiti's economic prospects, like those of most small countries, also depend heavily on two external factors: market access and international prices for its exports, and the flow of concessional aid. While the first is largely beyond the Government's control, the second is directly linked to the policies it pursues, as the experience of the early 1980s demonstrated. Table 3 summarizes projections of economic indicators through FY90 for two cases, with and without the Economic Recovery Program; uncertainty about political developments after February 1988 necessarily makes them very tentative after FY88.

Table 3: ECONOMIC PROJECTIONS WITH AND WITHOUT RECOVERY PROGRAM
(percent)

	Average Annual Growth Rate (% at constant prices)				Share of GDP at Market Prices (% at current prices)				
	FY76-81	FY81-86	FY86-90 With Program	FY86-90 Without Program	FY76	FY81	FY86 (est.)	FY90 With Program	FY90 Without Program
Gross Domestic Product	3.4	-0.6	4.6	-0.8	100.0	100.0	100.0	100.0	100.0
Agriculture	0.8	-1.6	5.5	-0.7	38.4	33.8	32.1	33.2	32.2
Industry	6.2	0.2	5.1	-1.0	19.4	22.2	23.0	23.4	22.8
Other	4.3	-0.2	3.7	-0.8	42.2	44.0	44.9	43.4	45.0
Consumption	3.9	-1.2	4.4	0.6	93.1	98.3	93.9	93.7	100.1
Gross Domestic Investment	6.3	-3.7	13.9	-3.1	15.8	16.9	12.1	17.0	11.0
Public	9.7	-9.8	15.4	-1.4	9.5	11.9	6.2	9.1	6.0
Private	0.1	-4.8	12.4	-5.0	6.3	5.0	5.9	7.9	5.0
Exports of GNFS	3.2	0.1	4.4	0.9	16.8	16.8	13.8	13.7	14.6
Coffee	4.9	-0.3	7.1	4.7	5.0	2.2	2.6	2.1	2.3
Other Agricultural Goods	..	..	2.7	0.5	2.5	2.0	1.5	1.4	1.6
Assembly Industry	..	..	6.2	-	2.8	5.4	5.8	5.6	5.3
Imports of GNFS	6.8	-4.4	9.5	5.3	-25.7	-32.0	-20.3	-24.4	-25.7
Gross National Savings	-32.2	-7.8	14.5	-69.2	6.1	0.7	4.9	7.2	0.6
Balance of Payments									
Current Account					-6.5	-11.8	-4.8	-5.8	-6.6
Public Sector Deficit a/					-7.6	-12.9	-5.2	-6.0	-10.0
Debt Service/GDP									
Including IMF					1.2	1.7	3.4	1.3	1.6
Excluding IMF					1.2	1.4	2.3	1.0	1.2
Debt Service/Exports of Goods & NFS									
Including IMF					6.9	9.9	24.4	11.0	12.5
Excluding IMF					6.9	8.4	16.4	8.2	9.3

a/ Before grants.

12-Dec-86

81. **The <u>With Program</u>** case assumes improved allocative efficiency and the restoration of confidence among both the private sector and Haiti's external aid donors; details of the projection are included in Annex I. Macroeconomic stabilization would remain effective and GDP could grow at an average annual rate of 4.6 percent in FY86-90. Lower input and consumer prices resulting from the reform of the trade regime would stimulate the economy while domestic industry would restructure in line with the new incentives and would, by the end of the period, start to increase its exports. Subsequent growth would be fueled by new investment, restoring investment's share of GDP to the level of the early 1980s but with a much greater proportion coming from the private sector. Public investment could rise from about six to about nine percent of GDP, financed by increased aid flows, and would become more efficient, being focused on the rehabilitation and expansion of the existing capital stock; the neglect of maintenance would slowly be overcome with the provision of more adequate recurrent funding. By FY90, the public sector deficit before aid could be about six percent of GDP, financed entirely with concessional aid.

82. Export growth and foreign aid would finance the increased imports resulting from increased investment and trade liberalization. The current account deficit would widen slightly from the artificially low FY86 level but could be easily financed by foreign aid. Reserves would begin to increase and should turn positive during FY87 for the first time since FY80. Assembly industry exports could expand by over six percent per annum in FY86-90 due to restored confidence and the new textile agreement with the United States. Coffee production would ride the peak of its agronomic cycle in FY87 and FY88, benefiting also from relatively high world prices, and the reduction and elimination of the coffee export tax would promote replanting and sustained export growth averaging seven percent per annum.

83. **The <u>Without Program</u>** case, by contrast, would be characterized after FY87 by a return to the ineffective policies and zero growth of the early 1980s. This is not likely in FY87 because of the anticipated coffee crop and the relatively high levels of aid promised at a November 1986 meeting of the Haiti Subgroup of the Caribbean Group for Cooperation in Economic Development. Despite good coffee yields and prices in FY87, agricultural production would well fall because price disincentives would remain and rehabilitation of neglected irrigation systems would not occur. Local industry would continue to stagnate in the small protected domestic market, and assembly industry confidence would likely flag. Public investment and non-wage recurrent spending could very well be crowded out by popular pressure for public sector wage and employment increases. Increased public sector employment would become an obstacle to more effective public administration and would offset restructuring efforts at public enterprises, which would again become a major drain on the economy. The public sector deficit would widen, perhaps to 10 percent of GDP, and external concessional aid would be inadequate to finance it because policy-based external aid, which accounts for some 30 percent of projected aid inflows in the With Program case, would be lost and project aid disbursements would lag. The deficit would be financed by Central Bank credit which would lead anew to financial disequilibrium, inflation and a loss of confidence. Private investment could drop back to the very low level of FY81. While exports would stagnate, imports would continue to increase, likely provoking

a balance of payments crisis and the continued loss of reserves. Such a collapse of the Economic Recovery Program would not only leave the economy in recession, it would undermine the basis for future growth.

84. Neither case considers the exchange rate. The Government considers it of paramount importance to maintain the fixed parity of five Gourdes to the U.S. dollar. In the transition to new democratic institutions the Government judges that the preservation of this rate provides a firm anchor for fiscal and monetary policy in the immediate future. Moreover, in the late 1970s this fixed exchange rate regime, together with the pursuit of prudent fiscal and credit policies, created a climate of confidence which led to the establishment of the assembly industry. For several years beginning in 1979, the link with U.S. dollar led the Gourde to appreciate in real effective terms against the currencies of Haiti's main trading partners. This had little effect on Haiti's export performance because the domestic wage structure remained largely market-determined and highly competitive. Recently, as noted, real wages have increased as prices have fallen, without affecting Haiti's international competitiveness. Indeed, aside from protection, the principal obstacle to expanded exports has been market access, a situation now improved with the new U.S. textile agreement. Moreover, the recent depreciation of the dollar against other major currencies has brought about a decline in the real effective value of the Gourde of over 10 percent during the last 12 months, offsetting to an important extent the earlier rise. However, the Government recognizes that its commitment to trade liberalization while maintaining a stable exchange rate implies the maintenance of demand management policies to avoid excessive growth in imports.

85. **Environmental Impact.** The reduction and ultimate elimination of the coffee export tax should increase the incentives for hill farmers to maintain and replant soil-binding coffee trees and decrease those to grow crops like maize that contribute to erosion. This shift in relative prices will be complemented with several programs, financed with external aid, to improve coffee yields and promote reforestation.

86. **Social Impact.** The immediate adverse social consequences from the program affect the employees of public enterprises that are shut or restructured, and for some employees of private industrial firms that may not prove viable once protection is reduced. These direct consequences will be more than offset by resulting benefits to Haitians as a whole, especially the very poorest members of the society.

87. Severance pay of about nine months salary has been provided to employees of the ENAOL and USND factories. According to a recent study, less than a dozen of the approximately 200 industrial firms producing for the local market (averaging 90 employees each) may find it difficult to survive the reforms of the trade regime. These are largely firms whose products are not economic in the Haitian context, such as milk processing, metal working and packaging. Technical and financial assistance would be available to facilitate the restructuring of the vast majority of firms that are not at present competitive internationally but have the potential to be so.

88. Against these negative social consequences, there are five major social benefits from the Economic Recovery Program. First, real resources equivalent to some two percent of GDP are being released by the reform of public enterprises for investment in productive activities and the creation of productive employment. Second, the reform of these enterprises, the reduction of excise taxes, and the reform of the trade regime have already lowered the cost of living for the Haitian consumer, particularly the poorest, without hurting farmers, especially as prices of basic consumption goods fell; the retail price of vegetable oil has dropped by 40 percent since February 1986 and that of flour by 11 percent. Decreases may also be anticipated in the price of cement and hence in the cost of construction. Lower consumer prices not only improve welfare, especially of the very poorest, they raise real wages and so reduce the pressure to increase wages and help maintain Haiti's international competitiveness. Third, small scale industrial enterprises now stand to benefit from the advantages, such as low tariffs on inputs, that larger firms have enjoyed in the past; the trade reform thus eliminates many monopolies and barriers to entry. Fourth, the program should increase the income of over a million people who depend on coffee as their principal cash crop and should result in the encouragement of new directions for farmers locked into the vicious poverty circle of sugarcane production. Fifth, equity will be improved by the reform of the income tax, especially by stepped-up collection efforts and by the capturing of former private rents through the trade regime reforms and the raising of State land rents toward market levels.

PART III - THE PROPOSED OPERATION

A. History

89. The proposed operation would support the Government's Economic Recovery Program. It was prepared during an intensive dialogue with the Government since May 1986, based on IDA's economic, public expenditure and agricultural reports. Preparation of some public enterprise and agricultural pricing components benefited greatly from earlier work during 1985 on a possible agricultural sector operation, much of the proposed policy content of which is now included in the present operation. Appraisal was completed in October 1986 and negotiations were concluded on January 28, 1987. The Haitian delegation was led by Mr. Leslie Delatour, Minister of Economy and Finance. Annex III is a supplementary credit data sheet.

B. Relationship to the Government's Program

90. The proposed operation would support measures taken by the Government during FY86 and early FY87 and to be implemented during FY87 and early FY88. Actions taken so far reflect understandings reached with the Government during IDA's continuing policy dialogue. Certain components of the Government's program have our approval but are best directly supported

by others with more specialized monitoring capability, e.g. the IMF in the case of tax reform. The specific actions supported by the proposed credit were reviewed in detail during appraisal and are summarized in Annex V.

91. Actions already taken include macroeconomic stabilization measures and those listed below:

Public Expenditure

(a) Elimination of wasteful special projects to provide political support to the previous regime, and the ending of reserved budgetary sums for unidentified purposes;

(b) Increased recurrent spending on agriculture, education and health;

(c) Improvements in the FY86 public investment program, including the elimination of unproductive projects with little or no investment content;

(d) Preparation of an improved public investment program for FY87, including (i) a list of 26 projects submitted to donors for possible financing, and (ii) agreement not to use any resources for a possible Cap Haitien airport project other than one third of those accruing to the National Airport Authority from the departure tax.

Public Enterprises

(e) Closure and formal dissolution of ENAOL and replacement of its import monopoly and of the quota on vegetable oil with a 20 percent tariff;

(f) Closure of USND;

(g) Policy not to extend any subsidies, privileges or loan guarantees to any private cooperatives or companies that may run the former plants of ENAOL and USND;

(h) Audits, management changes and commencement of programs to reduce fixed costs and improve cost competitiveness at La Minoterie and Ciment d'Haiti;

(i) Removal of Ciment d'Haiti's import monopolies and of quota and licence requirements to import cement and their replacement with a 33 percent tariff;

(j) Removal of La Minoterie's wheat flour import monopoly and replacement of flour import quota with a 50% tariff;

(k) Ending of subsidies to public enterprises;

(l) New organic law of the Ministry of Finance includes financial monitoring of public enterprises.

Competition and Industrial Incentives

(m) Elimination of all import monopoly rights, all import quotas, and most import licenses and regulations (except for sanitary reasons on used clothes and newspapers and licensing of rice, millet, maize, beans, chicken parts and pork meat parts);

(n) Law establishing new tariff structure, ending all specific tariffs and introducing a structure with an average tariff of about 20 percent and a maximum of 40 percent, with four exceptions;

(o) Extension of one percent administrative charge to cover all imports except pharmaceuticals and petroleum products.

Agriculture

(p) Reduction of export tax on coffee from 22 to 10 percent;

(q) Elimination of export taxes on sisal and cocoa; and

(r) Audit of BNDAI.

92. In addition to maintaining the above actions in place, the following measures which are expected to be taken during FY87 and early FY88 would, together with continued satisfactory macroeconomic stabilization, be conditions of release of the second tranche of the proposed credit:

Public Expenditure

(a) Preparation of a satisfactory public investment program for FY88.

(b) Improvements in recurrent budgeting for education;

(c) Completion of ongoing audits of the Ministry of Finance and the Central Bank;

Public Enterprises

(d) Implementation of auditors' recommendations and further improvements in cost competitiveness at Ciment d'Haiti and La Minoterie;

Competition and Industrial Incentives

(e) Elimination of petty taxes on imports and exports;

Agriculture

(f) Elimination of coffee export tax;[1]

(g) Dissolution of BNDAI and legal establishment of a new agricultural credit bank; and

(h) Preparation and implementation of a program to raise rentals on State lands.

C. Associated Technical Assistance

93. A proposed Technical Assistance Project would complement the proposed operation. Annex V also sets out its proposed relationship to the Government's program. The major component would be the provision of technical assistance through FDI to industrial firms that wish to restructure to meet the new incentives that the reforms to the trade regime will bring about (para. 68). This is already underway with financing from the Project Preparation Facility, and will continue after the Technical Assistance Project through a proposed Industrial Restructuring Project. In addition, the proposed Technical Assistance Project would provide modest technical assistance for macroeconomic management; the programming, control and monitoring of public expenditure, including the wage bill and the public investment program; the financial monitoring of the public enterprises; the restructuring of Ciment d'Haiti; the design and implementation of a trade drawback system; the design and implementation of a system to increase rents on State lands; a study of alternatives to sugarcane production in the area around the USN sugar mill; and a review and development of preliminary policy and investment proposals to arrest the alarming rate of degradation of Haiti's natural environment. In addition to strengthening Haitian institutions, the project's results would also help the Government meet the second tranche conditions of the proposed operation and define programs which could be supported by future IDA lending.

D. Benefits and Risks

94. The main benefits of the proposed operation are the financing of imports and the support of the Government's Economic Recovery Program discussed in Part II: the improved allocation of resources, the resumption of sustained economic growth, the improved welfare of the mass of Haitians, including farmers, through lower prices, and the restoration of confidence.

1/ IDA will assess the Government's fiscal situation prior to release of the second tranche to ascertain that this reduction is feasible. If it is not, this condition will be waived.

95. There are three principal risks. Chief among them is the implication for fiscal discipline of the relatively fragile political situation; some continued instability is almost inevitable. Popular expectations were that the February 1986 change of regime would lead to a very rapid improvement in living standards. While modest improvements are occurring, there is a risk that unrealistic and hence unfulfilled expectations could translate into unmanageable civil disorder, given the lack of societal structures, particularly in the run-up to the November 1987 elections. This could weaken the fragile confidence that is now beginning to return. Further, the Government might not, under such circumstances, be able to contain expenditure, especially the public sector wage bill, and reform public enterprises as it has until now.

96. The second risk is that influential protected manufacturers might successfully resist the full introduction of the trade regime reforms. This is not very likely as the existence of contraband means that they already face increased competition, and less than a dozen firms are likely to suffer severely from the reforms. It should be directly mitigated also by the technical and financial assistance that will be made available for industrial restructuring, by the existence of a progressive element among industrialists which is vocal in its support for reform, and by consumer support for lower prices. The third risk is that the policy reforms might be reversed by the new Government that should take office in February 1988.

97. These risks should not be exaggerated, however. The Government has so far shown itself resolutely determined to reform economic policies, and the Haitian people expect this. Moreover, the risks should be reduced through tranching, through the proposed provision of technical assistance, and through broad support and close monitoring of the Government's program by the IMF and the donor community as well as by IDA.

E. Credit Size and Tranching

98. The proposed credit of SDR 32.8 million (US$40.0 million) would be disbursed in two equal tranches, the first upon effectiveness in April 1987. The specific conditions for release of the second tranche are listed in paragraph 92. A second tranche review is forecast no later than September 30, 1987 with tranche release no later than October 31, 1987. Each tranche would cover about five percent of Haiti's merchandise imports in the relevant fiscal year.

F. Disbursement, Procurement, Accounts and Auditing

99. **Disbursement.** The proposed credit would finance goods imported by the private and public sectors into Haiti from eligible countries and

territories. Excluded would be goods financed by other sources and a specific list including military and para-military items, alcoholic beverages, tobacco, precious stones and jewelry, gold and nuclear reactors and parts. Proceeds of the credit would be disbursed based on satisfactory evidence of (a) physical entry of the imports into the country; (b) actual payment in foreign exchange for such imports; and (c) evidence that the quantities imported match the invoiced amount. This evidence would be compiled by an independent inspection company already in place in Haiti (para. 64).

100. Since retroactive financing to November 1, 1986 of SDR 16.4 million (US$20.0 million) corresponding to the first tranche is proposed, a revolving fund would not be necessary as claims would be made on a reimbursement basis for payments already made. Only contracts with a minimum value of US$10,000 equivalent would be eligible for financing. Disbursements would be made on the basis of Statements of Expenditure (SOEs), duly certified by a specialized inspection company satisfactory to IDA, and authorized by the borrower, responsible for the submission of withdrawal applications to IDA. A minimum value in US dollars equivalent will be established for SOEs submitted. Detailed documentation evidencing expenditures would be retained by the borrower and made readily available for inspection by IDA staff and the required audit process.

101. **Procurement.** Procurement of general imports by both the private and the public sectors would use international competitive bidding in accordance with IDA guidelines. Exceptions would be for contracts valued below US$3.0 million and for petroleum products. Procurement of imports by the private sector in the case of contracts valued below US$3.0 million would be made following regular commercial practices. Procurement of imports by the public sector in the case of contracts valued below US$3.0 million would be on the basis of comparisons of written quotations solicited from a list of three suppliers eligible under IDA guidelines. Procurement of petroleum products would be carried out either under bilateral arrangements based on prevailing market prices, or on the spot market through direct negotiations in accordance with local practices.

102. **Accounts and Auditing.** The Ministry of the Economy and Finance would maintain records of all transactions under the credit in accordance with sound accounting practices. Not later than four months after the end of each Haitian fiscal year, all accounts would be audited by independent auditors acceptable to IDA. Audit reports would include a separate opinion with regard to the claims submitted to IDA on the basis of the SOEs and state whether such claims have been effected in accordance with the credit agreement.

G. Monitoring

103. The progress of the Government's Economic Recovery Program, of the measures supported by the proposed operation, and of the linked Technical Assistance Project would be closely monitored through regular supervision, including continued close cooperation with the IMF and with other aid donors. Specific supervision would determine compliance with the conditions for release of the second tranche.

PART IV - BANK GROUP OPERATIONS AND STRATEGY

104. **Operations.** Since beginning operations in Haiti in 1956, the Bank Group has extended one loan and 23 credits totalling US$ 279.0 million equivalent and IFC has made one investment (US$1.5 million). As of September 30, 1986, the total of credits outstanding was US$271.4 million equivalent, of which US$62.0 million equivalent was undisbursed. Annex II summarizes Bank Group operations in Haiti as of September 30, 1986. Since then, a US$20.0 million equivalent credit for a transport project has also been extended. The Bank Group has financed projects in transport (7), power (4), education (4), rural development (2), agricultural rehabilitation (1), industrial credit (1), ports (1), water supply (1) and urban development (1). A pilot project in forestry is also underway. Some of these projects have enjoyed cofinancing or parallel financing from the aid agencies of Canada, France, Germany, and Switzerland. IFC's investment is for an integrated poultry project.

105. Overall, project implementation and disbursement performance are satisfactory. However, a lack of counterpart funds has in the past delayed IDA disbursements. The establishment of revolving funds in recent projects has improved this. IDA is in addition carefully monitoring Haiti's absorptive capacity for external assistance, with particular attention to projects' local cost counterpart financing requirements.

106. The Bank also chairs the Caribbean Group for Cooperation in Economic Development, whose Haiti Subgroup provides a framework for cooperation among donors.

107. **Strategy.** Within the last two years, IDA has prepared an economic memorandum, an agricultural sector study and a public expenditure review. These documents identify the major obstacles to economic recovery and the specific actions needed to achieve and sustain financial stabilization, reduce resource losses, increase agricultural and industrial production and exports, save foreign exchange, meet the infrastructure and training needs of agriculture and industry, increase the efficiency of public institutions and, for the longer term, improve basic education. A population, health and nutrition sector report is currently under preparation.

108. The present Government's Economic Recovery Program, described in Part II, follows closely the principal recommendations of the three recent reports, all of which were submitted to the new authorities. Consequently, IDA's program, in close collaboration with the IMF and with other donors through the CGCED, aims at supporting the Government's Economic Recovery Program with both policy-based operations and investment project credits.

109. Indeed, since May 1986, IDA has been involved in an intensive policy dialogue with the Haitian authorities which has led to four operations now underway or proposed to provide specific support for the Economic Recovery Program:

(a) The Government prepared jointly with IMF and IDA staff a Policy Framework Paper to underpin an IMF Structural Adjustment Facility Arrangement that was approved by the Executive Board of the Fund in December 1986. The paper was discussed by IDA's Executive Directors meeting as the Committee of the Whole on November 18, 1986.

(b) The proposed Economic Recovery Operation.

(c) The proposed Technical Assistance Project.

(d) A proposed Industrial Restructuring Project, scheduled for Board presentation in IDA FY88, which would provide financial and technical assistance to industrial firms which need to restructure or invest to operate under the new set of incentives that the reforms to the trade regime described in Part II will establish.

110. IDA would maintain an active policy dialogue with the Government through monitoring the proposed Economic Recovery Operation and supervising the proposed Technical Assistance Project. Further policy-based operations are envisaged as long as an appropriate policy framework remains in place. Future investment credits now under preparation include electric power and water supply projects.

111. IDA's share in Haiti's external debt disbursed and outstanding is estimated at 38 percent as of September 30, 1986. This is high only because grants constitute a very large share of the external assistance Haiti has received. IDA's share of external public debt service was about five percent in FY86.

PART V - RELATIONS WITH THE IMF AND WITH OTHER DONORS

112. **IMF.** Haiti has been a member of the IMF since September 1953 under Article VIII status. Its current quota is SDR 44.1 million. In December 1986 the Executive Board of the Fund approved a three-year structural adjustment arrangement, and the first annual arrangement thereunder, under the Structural Adjustment Facility. The macroeconomic stabilization and structural reform program that this supports was described in Part II; the IMF will monitor particularly closely the implementation of the stabilization program. IDA and IMF staff will continue their close cooperation while monitoring the Government's Economic Recovery Program. There are no ongoing Stand-by arrangements; the last was approved in November 1982. Haiti made a purchase under the Compensatory Financing Facility in 1981. As of December 31, 1986, total Fund credit outstanding was SDR 54.7 million, or 124 percent of quota, and Trust Fund loan disbursements totalled SDR 18.6 million, of which SDR 9.3 million is outstanding. A resident representative has been stationed in Port-au-Prince since 1972. The last Article IV consultations were held during September 1986 and were concluded in December 1986. An IMF expert on bank supervision

and credit control is presently on assignment at the Central Bank; a tax administration adviser has been assigned since early 1987 to assist the Government to implement the income tax and customs tariff reforms.

113. **Other Donors.** Many public and private aid agencies are active in Haiti. With the proposed credit, IDA disbursements would amount to about 25 percent of total aid flows to Haiti in FY87. Among the most important agencies are the Inter-American Development Bank, the United States (about 50 percent of disbursements), France, the Federal Republic of Germany, Japan, Canada, and the United Nations Development Programme (UNDP). All are members of the Haiti donors Subgroup of the Caribbean Group for Cooperation in Economic Development. At its meeting in November 1986, donors announced their support for the Government's Economic Recovery Program and also substantial increases in their intended levels of financial support for Haiti. In addition, the Government presented a list of 26 projects proposed for external financing, drawn up with the assistance of UNDP and IDA staff. This list also formed the basis of the UN Secretary-General's appeal for Haiti in October 1986. Direct donor assistance for the Government's Economic Recovery Program includes the United States' Economic Support Fund grants, which are policy-based operations supporting many of the same reforms as the IMF Structural Adjustment Facility Arrangement and the proposed IDA Economic Recovery Operation. Other support is detailed in Annex V.

PART VI - RECOMMENDATION

114. I am satisfied that the proposed Development Credit would comply with the Articles of Agreement of the Association and recommend that the Executive Directors approve it.

Barber B. Conable
President

Attachments

Washington, D. C.
February 9, 1987

HAITI: ECONOMIC INDICATORS AND PROJECTIONS

	Amount (US$ million) FY86 (est.)	Average Annual Growth Rate (% at constant prices) FY76-81	FY81-86	FY86-90 (projected)	Share of GDP at Market Prices (% at current prices) FY76	FY81	FY86 (est.)	FY90 (proj.)
National Accounts								
Gross Domestic Product	2147.0	3.4	-0.6	4.6	100.0	99.7	100.0	100.0
Indirect Taxes	85.9	6.0	-3.0	4.6	4.0	4.2	4.0	4.0
Agriculture	689.2	100.8	-1.6	5.5	38.4	33.8	32.1	32.1
Industry	493.8	6.2	0.2	5.1	19.4	22.2	23.0	23.0
Other	878.1	4.1	0.1	3.6	38.2	39.5	40.9	40.9
Consumption	2025.6	3.9	-1.2	4.4	93.1	98.3	93.9	93.9
Gross Domestic Investment	259.7	6.3	-3.7	13.9	15.8	16.9	12.1	12.1
Exports of GNFS	297.1	3.2	0.1	4.4	16.8	16.8	13.8	13.8
Imports of GNFS	435.4	6.8	-4.4	9.5	-25.7	-32.0	-20.3	-20.3
Gross National Savings	107.4	-32.2	-7.8	14.5	6.1	0.7	4.9	7.2
External Trade								
Merchandise Exports	212.3	..	..	5.9	12.7	10.7	9.9	9.1
Coffee	54.9	..	..	7.1	5.0	2.2	2.6	2.1
Other Agricultural Exports	33.2	..	..	2.7	2.5	2.0	1.5	1.4
Assembly Industry	124.2	..	..	6.2	2.8	5.4	5.8	5.6
Minerals	-	..	..	-	2.4	1.1	-	-
Merchandise Imports	245.1	..	..	9.6	-18.7	-21.4	-11.4	-13.0

Prices	FY81	FY82	FY83	FY84	FY85	FY86 (est.)	FY87	FY88	FY89	FY90
							----------(projected)----------			
GDP Deflator (1986=100)	67.0	69.7	75.9	84.3	88.8	100.0	104.0	108.2	112.5	117.0
Consumer Price Index (1986=100)	67.0	72.5	78.6	84.9	92.1	100.0				
Export Price Index (1986=100)	84.2	80.8	87.0	91.1	92.9	100.0	98.6	99.2	101.3	103.4
Import Price Index (1986=100)	86.8	91.9	93.8	100.1	101.4	100.0	96.1	95.1	95.2	94.7
Terms of Trade Index (1986=100)	96.9	87.9	92.8	91.0	91.6	100.0	102.6	104.3	106.4	109.2

Public Finance	Public Sector FY86 (est.)	Public Sector As % of GDP FY80	FY86 (est.)	FY90 (proj.)	Central Government FY86 (est.)	Central Government As % of GDP FY80	FY86 (est.)	FY90 (proj.)
Current Receipts a/	1989.1	14.9	18.5	14.8	1129.0	9.5	10.5	11.5
Current Expenditure	1885.0	14.7	17.6	11.7	1237.0	10.1	11.5	9.4
Current Surplus	104.1	0.2	1.0	3.1	-108.0	-0.6	-1.0	2.1
Capital Expenditure	661.1	8.2	6.2	9.1	529.6	6.5	4.9	8.1
Foreign Financing b/	594.2	5.0	5.5	6.0	528.5	4.2	4.9	6.0

a/ Central Government Current Receipts includes transfers from public enterprises.
b/ Includes foreign grants.

09-Dec-86

HAITI: ECONOMIC INDICATORS AND PROJECTIONS
(percent)

Population: 5.4 million (1986)
GNP per Capita: US$350 (1985, Atlas methodology)

	FY80	FY81	FY82	FY83	FY84	FY85	FY86 (est.)	FY87	FY88	FY89	FY90
								---------(projected)----------			
GDP Growth Rate	7.6	-2.8	-3.4	0.8	0.3	1.1	-1.4	4.5	5.0	4.5	4.5
GDY Growth Rate	7.9	-3.0	-5.4	2.0	-0.2	1.3	0.2	4.9	5.2	4.8	4.9
GDY per capita Growth Rate	6.4	-4.4	-6.8	0.2	-1.9	-0.5	-1.6	3.0	3.4	2.9	3.0
Consumption per capita Growth Rate	10.9	-1.9	-11.1	0.4	-3.9	0.8	-0.2	3.1	2.8	1.8	2.7
Consumer Price Growth	18.0	8.2	8.2	8.4	8.0	8.4	8.5	4.0	4.0	4.0	4.0
Debt (including IMF)											
Debt Service (US$ million)	20.5	24.5	18.8	18.7	24.4	38.7	72.5	62.9	52.7	43.5	39.9
Debt Service/Exports of G&NFS	6.5	9.9	6.4	6.6	7.7	12.7	24.4	20.5	16.3	12.6	11.0
Debt Service/GDP	1.4	1.7	1.3	1.1	1.3	2.0	3.4	2.7	2.1	1.6	1.3
DOD/GDP	18.2	27.1	31.3	32.3	31.9	31.5	29.4	29.2	28.5	28.1	27.5
Debt (excluding IMF)											
Debt Service (US$ million)	20.5	20.8	15.0	14.1	17.6	20.2	48.7	35.0	29.2	28.8	30.0
Debt Service/Exports of G&NFS	6.5	8.4	5.1	4.9	5.6	6.6	16.4	11.4	9.0	8.4	8.2
Debt Service/GDP	1.4	1.4	1.0	0.9	1.0	1.0	2.3	1.5	1.1	1.0	1.0
Gross Domestic Investment/GDP	16.9	16.9	16.6	16.3	15.9	14.6	12.1	14.6	16.3	17.0	17.0
Gross Domestic Savings/GDP	8.1	1.7	6.1	6.0	6.9	6.0	5.6	5.6	6.2	7.3	7.6
Gross National Savings/GDP	7.0	0.7	5.0	4.5	5.8	5.3	4.9	5.0	5.7	6.8	7.2
Public Investment/GDP	8.2	11.9	9.8	10.4	11.2	8.5	6.2	8.0	9.1	9.1	9.1
Public Savings/GDP	0.2	-0.9	0.6	1.2	0.6	1.0	1.0	1.2	1.9	2.3	3.1
Private Investment/GDP	8.8	5.0	6.8	5.9	4.7	6.1	5.9	6.6	7.2	7.9	7.9
Private Savings/GDP	6.8	1.7	4.4	3.4	5.2	4.2	4.0	3.8	3.8	4.5	4.1
Ratio of Public to Private Investment	0.9	2.4	1.5	1.8	2.4	1.4	1.0	1.2	1.3	1.2	1.2
Government Revenue/GDP	9.5	8.9	10.1	10.4	10.1	11.6	10.5	10.2	10.9	11.5	11.5
Government Expenditure/GDP	16.6	21.2	20.4	18.7	19.9	19.2	16.5	16.4	17.1	17.5	17.5
Public Sector Deficit/GDP a/	-7.9	-12.9	-9.2	-9.2	-10.6	-7.5	-5.2	-6.8	-7.2	-6.8	-6.0
Exports G&NFS Growth Rate b/	66.6	-42.1	22.7	-9.5	6.2	-6.0	-9.2	4.8	5.0	3.8	3.9
Exports of G&NFS/GDP	21.6	16.8	19.7	17.5	17.5	15.7	13.8	13.9	13.9	13.8	13.7
Imports of G&NFS Growth Rate b/	60.0	-24.0	-11.4	0.5	-0.9	-4.0	-5.7	19.5	11.1	3.7	4.5
Imports of G&NFS/GDP	30.5	32.0	29.9	27.9	26.5	24.2	20.3	23.2	24.5	24.4	24.4
Current Account (US$ million)	-93.5	-174.7	-118.1	-151.6	-139.0	-130.7	-102.2	-153.1	-179.3	-177.0	-175.8
Current Account/GDP	-6.4	-11.8	-8.0	-9.3	-7.7	-6.8	-4.8	-6.6	-7.0	-6.4	-5.8
Terms of Trade Index (1986=100)	99.8	96.9	87.9	92.8	91.0	91.6	100.0	102.6	104.3	106.4	109.2

a/ Before grants.
b/ In volume terms.

09-Dec-86

HAITI: BALANCE OF PAYMENTS, EXTERNAL CAPITAL AND DEBT
(US$ million at current prices)

	FY80	FY81	FY82	FY83	FY84	FY85	FY86 (est.)	FY87	FY88	FY89	FY90
								---------(projected)-----------			
Current Account Balance	-93.5	-174.7	-118.1	-151.6	-139.0	-133.7	-105.3	-154	-179	-177	-176
Exports of Goods, NFS	316.1	248.6	293.0	285.5	317.3	302.4	294.0	303	320	340	360
of which: Coffee	90.9	33.1	35.9	52.5	54.0	48.0	55.0	54	56	59	63
Assembly Industry	77.2	79.6	98.9	100.4	124.7	126.6	121.0	130	141	153	165
Imports of Goods, NFS	-445.7	-473.4	-444.0	-455.1	-481.5	-469.6	-435.4	-498	-546	-567	-590
Factor Income	-15.9	-14.7	-16.8	-24.5	-19.8	-14.6	-14.0	-14	-13	-13	-13
Net Private Transfers	52.0	64.8	49.7	42.5	45.0	48.1	50.1	54	59	63	66
Capital Account Balance	80.3	119.6	104.6	139.6	118.6	119.5	128.4	276	258	254	247
Net Official Transfers (Grants)	33.4	66.1	69.2	69.3	78.2	87.3	117.2	163	155	153	153
Official Capital MLT	65.2	102.0	30.3	75.9	55.3	22.7	22.7	113	103	101	94
of which: Amortization	-11.5	-10.7	-16.1	-13.6	-13.8	-5.7	-6.8	23	17	17	18
Other Official Capital	3.2	1.7	-	-	-8.1	13.6	-10.0	-	-	-	-
Private Capital & Errors & Ommissions	-21.5	-50.2	5.1	-5.6	-6.8	-4.1	-1.5	-	-	-	-
Overall Balance	-13.2	-55.1	-13.5	-12.0	-20.4	-14.2	23.1	122	79	77	71
Net IMF Purchases (decrease = -)	..	17.5	12.1	22.3	21.8	-9.4	-18.8	-23	-20	-13	-9
Changes in Arrears (decrease = -)	-	20.5	0.4	-12.2	-6.3	9.6	5.0	-15	-	-	-
Other Reserve Changes (increase= -)	13.2	17.1	1.0	1.9	4.9	14.1	-9.3	-38	-25	-31	-27
Official Reserve Level (net)	32.5	-2.0	-20.8	-58.0	-74.0	-92.9	-75.9	60	85	115	142
Off. Res. as Months' Imports (gross)	-1.1	-0.5	-1.0	-0.7	-0.7	-0.5	-0.6	1.8	1.6	1.1	0.7

Exchange Rate (since 1919)	Public External Debt (US$ m.)	Public Debt Service Ratio (%)	IDA Lending, Sept. 30, 1986 (US$ m.)
US$ 1.00 = G 5.00	9/30/86: 631 (Including IMF)	FY86: 24.7 (Including IMF)	Oustanding and Disbursed 209.3
G 1.00 = US$ 0.20	555 (Excluding IMF)	16.6 (Excluding IMF)	Undisbursed 62.0
			Outstanding incl. Undis. b/ 271.4

a/ Including IMF.
b/ Total does not equal sum because of SDR exchange rate changes.

29-Oct-86

THE STATUS OF BANK GROUP OPERATIONS IN HAITI

A. STATEMENT OF BANK LOANS AND IDA CREDITS [a]

(as of September 30, 1986)

Credit Number	Fiscal Year	Borrower	Purpose	Amount in US$ million (Less cancellation) Bank	IDA	Undisbursed
One loan and 12 credits have been fully disbursed				2.6	124.2	
1131-HA	1981	Republic of Haiti	Industrial Credit		7.0	0.4
1220-HA	1982	Republic of Haiti	Highways VI		14.0	3.3
1257-HA	1982	Republic of Haiti	Forestry		4.0	2.5
1281-HA	1982	Republic of Haiti	Power III		26.0	1.4
1305-HA	1983	Republic of Haiti	Education III		9.0	1.4
1338-HA	1983	Republic of Haiti	Urban Development		21.0 b/	14.7
1410-HA	1984	Republic of Haiti	Rural Development II		19.1	9.5
1527-HA	1985	Republic of Haiti	Fourth Power		22.1	18.2
1592-HA	1985	Republic of Haiti	Fourth Education and Training		10.0	10.6 c/
	TOTAL			2.6	256.4	
	of which has been repaid			2.6		
	TOTAL now held by Bank and IDA				271.4 c/	
	Amount sold		0.6			
	of which has been repaid		0.6			
	TOTAL undisbursed					62.0

a/ In addition, a credit of US$20.0 million for a Seventh Transport Project was approved by the Board on February 3, 1987.

b/ Includes US$13.0 million Special Fund.

c/ Difference due to SDR exchange rate.

HAITI

B. STATEMENT OF IFC INVESTMENTS
(as of September 30, 1986)

Investment Number	Fiscal Year	Obligor	Type of Business	Loan	Equity	Total
				------US$ Million----		
620-HA	1982	Promoteurs et Investisseurs Associes, S. A.	Integrated Poultry	1.35	0.15	1.50
Total Gross Commitments				1.35	0.15	1.50
Less cancellations, repayment, and sales				0.06	-	0.06
Total commitments now held by IFC				1.29	0.15	1.44
Total Undisbursed				0.75	0.04	0.79

HAITI

ECONOMIC RECOVERY OPERATION

SUPPLEMENTARY CREDIT DATA SHEET

I. TIMETABLE OF KEY EVENTS

(a) Preparation:	
Initial request for IDA credit:	May 1986
Identification mission:	July 1986
IMF-IDA Policy Framework mission:	September 1986
(b) Appraisal mission:	September/October 1986
(c) Negotiations:	January 1987
(d) Planned effectiveness:	April 1987

II. SPECIAL IDA IMPLEMENTATION ACTION

None.

III. CONDITIONS OF DISBURSEMENT OF THE SECOND TRANCHE

Conditions of release of the second tranche of the proposed credit would include the continued implementation of actions already taken (para. 91), continued satisfactory macroeconomic stabilization, and the actions discussed in para. 92.

REPUBLIQUE D'HAITI
MINISTERE
DE L'ECONOMIE ET DES FINANCES

GOVERNMENT'S LETTER OF RECOVERY POLICY

Le Ministre

No. SEC - 141

PORT-AU-PRINCE, LE 30 janvier 1987

Mr. Barber B. Conable
President
International Development Association
Washington, D.C.
U.S.A.

Dear Mr. Conable:

The Government of Haiti requests an Economic Recovery Credit from the International Development Association to support its program of development policy reforms detailed in this letter.

The provisional Government which came to power in February 1986 has scheduled elections for November 1987, with the then elected Government taking office in February 1988. The present Government is reforming public finances and development policies to stimulate economic recovery, to hand over a viable, growing economy to its successor. It intends therefore to maintain in force all actions so far taken and to be taken.

The Government's program seeks to promote economic expansion through export-led growth and improved agricultural performance. These objectives are being fostered both directly by the removal of impediments to efficient resource allocation and indirectly by the impetus to higher capital inflows that such policies should generate. Central to our strategy is the need to rebuild the confidence of Haitian workers, farmers and investors as well as the external aid donors.

Macro-economic management and stabilization

Our medium-term macro-economic objectives are (a) to generate a real GDP growth rate of at least 4.5% per year; (b) to reduce inflation to the level of our main trading partners, currently estimated at some 4% per year: and (c) to achieve an overall balance of payments surplus equivalent to almost 1.5% of GDP in FY87 and close to 1% in each of FY88 and FY89, so as to permit the strengthening of official net international reserves and some replenishment of the Central Bank's gross foreign assets.

After February 1986, the Government took drastic steps during the rest of FY86 to redress the budgetary position. Wasteful current expenditures and unjustified development projects, including special projects of the former regime, were eliminated, and resources were reallocated to agriculture, education, health and the armed forces. The cut in current expenditure amounted to more than 3% of GDP on an annual basis, of which about half was reallocated to priority sectors in the form of wage increases and sorely needed non-wage expenditure. The other half was used to reduce excise taxes on basic consumption items such as petroleum products, sugar and flour. Severe pruning of the FY86 development program resulted in a 60% implementation rate compared to original expenditure forecasts. In total, current and development expenditure came to only 17% of GDP compared to the 23% foreseen in the previous Government's budget estimates.

As a result, Haiti's financial position improved substantially. In FY86, the public sector made net repayments to the domestic banking system and reduced its foreign commercial debt. The balance of payments recorded a substantial overall surplus of US$23 million compared to a US$14 million deficit the previous year. Prices dropped by 4% from February to September 1986, the end of the fiscal year. The discount on the Gourde on the parallel market for foreign exchange declined from over 20% to 5-7%. However, the economy remained in recession.

The Government continues to exercise fiscal restraint in FY87. As in FY86, its main objective is no Central Bank financing of the public sector. In the FY87 budget, Treasury receipts and expenditures are both set at G1290 million and the public investment program amounts to G1140 million. Assuming an 80% implementation rate of this program, which would be a significant improvement on the past, overall public expenditure should recover to about 20% of GDP with corresponding foreign exchange requirements covered by external aid. Estimated Treasury receipts of G1290 million include agreed upon disbursements from the IMF's Structural Adjustment Facility and USAID's Economic Support Fund. Treasury Gourde expenditures include a G100 million transfer to the public investment program, which is financed in its entirety by this transfer, the internal cash generation of public enterprises and disbursements of concessional external aid. The overall public sector deficit (before aid) will be held to about 7% of GDP in FY87 and beyond, well below the average level of recent years. This deficit will be more than offset by external aid, enabling the non-financial public sector as a whole to reduce its indebtedness to the domestic banking system and foreign commercial creditors. This in turn will permit an expansion in credit to the private sector without risking either our inflation or balance of payments objectives. Any increase in expenditure above these levels will be met by a corresponding and equal increase in public receipts from nonbank sources; similarly, any shortfall in receipts will be offset by an equal decrease in expenditure so that the level of nonconcessional debt can still be reduced.

Tax Reform

The Government is continuing in FY87 to implement the program of tax reform begun in FY86, which aims at irreversibly improving the equity of the tax system as well as at increasing its elasticity and buoyancy. The Government believes that by broadening the tax base and lowering rates the current high levels of evasion can be reduced. In FY86 ancillary taxes on wages were eliminated and a variable excise tax was imposed on petroleum imports. Effective in early FY87, the export tax on coffee was reduced to 10% and other export taxes were eliminated, a new corporate and personal income tax decree was enacted simplifying the rate structure, clarifying the tax base and strengthening collection procedures. Administrative procedures will be improved in particular by facilitating cross-checks between income, value added and trade taxes. Starting in FY87, the value added tax will be more stringently enforced in order to reverse the recent slowdown in collection. In the long run, this tax should replace most excise taxes, already a number of excise taxes have been eliminated or reduced. Steps are also being taken to improve both tax and customs revenue collection.

Public Expenditure

The budgeting and control of current Treasury expenditure are being reinforced progressively, as competent staff can be assigned to these tasks. Significant diversions of public funds to fraudulent or wasteful uses have been stopped, the effort in this direction will be firmly maintained. At the same time the systematic reallocation of resources to priority areas is being pursued. The recurrent needs of past development projects are being more adequately met than in the past. A start has been made to reduce the excessive share of wages in current expenditure. Fraud in wage payments is being reduced with significant savings for the Treasury. The Government will in FY87 limit staff levels and wage increases in ministries and other public bodies. In addition, the Government is carrying out an extensive series of audits of ministries, public agencies and public enterprises, including of the Ministry of Finance and the Central Bank.

Following the establishment of the Commissariat a la Promotion Nationale et a l'Administration Publique in August 1986, public investment is being both improved and expanded. Our objective is to ensure that priority ongoing projects are completed, that counterpart fund requirements and the recurrent needs of development projects are adequately provided for, and, more generally, to improve the quality of public investments. Allocations to agricultural development projects favor irrigation rehabilitation (including where necessary protection of associated watersheds), feeder roads and input delivery. Soil conservation and reforestation are maintained at financially sustainable levels and increasingly linked to treecrop rehabilitation or expansion. For industry, public investments are concentrated on restructuring the public industrial enterprises which remain and, especially, on improving the physical infrastructure and public utilities serving private industries. Development expenditure in social sectors is concentrated heavily on education, training, health and urban development. Less useful social projects have been curtailed drastically. On the financing side, Treasury transfers are almost exclusively devoted to meeting the counterpart fund requirements of foreign aided projects. Should the proposed Cap Haitien airport project go ahead, we will finance it only out of the proceeds of one-third of the passenger departure tax that accrues to the National Airport Authoritv and will not apply any foreign grants or incur any external indebtedness to its construction. All other new projects are being financed exclusively with concessional external aid. We intend to maintain this pattern of public investment expenditure in the future, in close consultation with IDA and the members of the Caribbean Group for Cooperation in Economic Development.

The Government, with assistance from UNDP and IDA, prepared a list of 26 small new projects, the total cost estimated at US$43 million. These projects, which concentrate on productive employment generation in the short term, were submitted to aid donors at the November 1986 meeting of the Haiti Subgroup of the Caribbean Group for Cooperation in Economic Development. They will be included in the public development program as and when they receive firm financing commitments from donors.

Public Enterprises

The Government is fully cognizant of the need to reverse previous policies toward public enterprises which led to substantial losses, not only in terms of fiscal revenue but also of real economic resources, amounting to almost 4 percent of GDP each year from FY80-85. Yet the economy declined over this period. No new public industrial enterprises will be established and investments at existing ones will be confined to those necessary for restructuring. The Government will continue its policy of not subsidizing public enterprises.

To stem losses, the Government has adopted a policy of market liberalization, closures and restructuring of the public industrial enterprises and is taking measures to improve financial monitoring and performance evaluation of all public enterprises. In accordance with this new policy, all import monopolies and licensing requirements affecting all products except sugar imported or manufactured by public enterprises have been removed and import tariffs placed on the products concerned. Most public enterprises are also being externally audited. The vegetable oil mill, ENAOL, and one of the two publicly owned sugar mills, USND, ceased operating in July 1986; neither will be operated as a public enterprise. In both cases, the employees were given the option of forming a private cooperative to operate the plants or to accept an indemnity. At USND, all workers opted for an indemnity. This plant will therefore be offered for sale or lease to the private sector; it will not operate during FY87. Alternative arrangements have been made for cane growers to supply one of the two private sector mills. At the same time, alternatives to cane production in the Leogane plain are being developed and encouraged. ENAOL has been dissolved and a cooperative formed by about 30 percent of the previous employees to run the plant. No subsidies, public credit, loans, loan guarantees, protection or market privileges of any kind will be extended to any cooperative or private enterprise which may run either the former ENAOL or USND plants.

At Ciment d'Haiti, a cement factory, and La Minoterie, a flour mill, major restructuring measures will be undertaken, in addition to the market reforms, in order to make these two enterprises more efficient and competitive. During FY87, these will include substantial reductions in excess staff and wages, especially in the upper echelons, regular external auditing and, in the case of La Minoterie, improvements in accounting and management procedures following the key recommendations of a recent external audit.

During FY87, the Government will in addition conduct external audits of TELECO, the telecommunications company, and of USN, the second public sugar mill. Alternatives to sugar cane production in the area surrounding the latter will also be examined.

Trade Regime

Starting more than fifteen years ago, import substitution policies, balance of payments constraints and fiscal revenue requirements progressively led to high taxes and barriers to trade and to discretionary fiscal incentives for investment. Protection for local producers made exporting relatively less attractive; measures included high import tariffs, quantitative restrictions on imports, import licensing, import monopolies and prohibitions and price controls. As discussed below, taxes on agricultural exports further deterred exporting. In addition to these consequences for production, domestic prices were kept high, placing a heavy burden on the Haitian consumer.

The Government is reversing these trends. The narrowness of the local market means that industrial expansion can only occur through exporting and through increased demand as a result of lower domestic prices. Both imply increased efficiency and competition. The Government has therefore adopted a major program to reform the trade regime and stimulate efficiency through a revised incentive structure. The objective is to reduce the average level of effective protection below 40%, harmonize its distribution across sectors, and lead to a more stable and neutral environment which will stimulate investment in efficient production rather than rent-seeking activities. The local cost of goods will be reduced in the process, as it will through a thorough revision of tariffs on products not produced in Haiti.

To reach these objectives the Government is progressively eliminating all export taxes, has ended all but one import monopoly (sugar), has abrogated completely the law imposing import quotas and licensing requirements for industrial products, has limited import prohibitions to only two products for sanitary reasons, has eliminated quotas for all products but retained import licensing for seven agricultural products, and has started to implement a major tariff reform to replace all specific tariffs with ad valorem ones and to reduce the levels of nominal tariffs. Tariffs range between 0 and 40%, the majority between 10 and 30%. Medical supplies and agricultural imports are exempt. The average level of effective protection has been drastically reduced from over 100 to about 40%. The new tariff will be fully in effect by December 1987.

In addition to these measures, the Government is reviewing the tariff structure for imports from non-GATT countries and has extended the 1% minimum administrative charge to all imports except pharmaceuticals and petroleum. During FY87, we shall also eliminate petty taxes on both imports and exports and revise the Investment Code to harmonize it with the above measures. We intend to introduce an endorsable drawback system to place production for both the local and export markets on the same footing. We further intend to improve the operation of the Customs.

The Government intends to provide financial and technical assistance to industrial enterprises restructuring in viable ways to operate in the new business environment. Finally export promotion measures are being stepped up. We have also recently negotiated a significant expansion in Haiti's quotas for imports of textiles into the United States which should greatly benefit our textile industry.

Agriculture

The agricultural sector, which contains the vast majority of our people, is in a state of crisis. The volume of agricultural production has increased little, if at all, in recent years, while the real value of agricultural exports has declined sharply. Production per capita has also fallen and the Government is increasingly concerned about deteriorating levels of nutrition for some segments of the population. At the same time, increasing population pressure on the land, insecure land tenure and felling of forests for fuel and construction, have resulted in soil erosion and environmental degradation of catastrophic proportions.

The causes of these discouraging phenomena are rooted in history and are socio-economically complex. They point to basic structural distortions and to an absence of proper technical support. The Government plans to refocus production toward those products and technologies for which Haiti has a comparative advantage, thereby increasing productivity, production and exports. Our strategy for this is one of improved production incentives, investment programs and technical support. The Government intends also to maintain efforts to address the pervasive problems of deteriorating non-renewable resources and nutrition levels.

Trade in agricultural products is being liberalized. First, we have reduced the export tax on coffee to 10% and intend to eliminate it once overall revenue or expenditure performance permits; all other export taxes on agricultural products--on cocoa, essential oils and sisal--have been abolished. Second, all imports of agricultural inputs are to be admitted free of restrictions and duties. Third, it is also our intention to free the producer price of cotton in order to revive cotton production.

The Government intends as soon as possible to establish a new agricultural development bank to replace BNDAI and BCA, the two existing credit institutions. Following a recently completed audit, BNDAI will be dissolved before the end of FY87. By that date, we will also establish a system setting rents on State lands related to market value.

Sincerely,

Delatour

Leslie Delatour
Minister of the Economy and Finance

THE GOVERNMENT'S PROGRAM AND THE PROPOSED OPERATION

Sector and Policy Area	Issues and Objectives	Measures Taken	Future Actions	Related IDA, IMF and Donor Support
		[* = Supported by the Proposed Operation]		
MACROECONOMIC STABILIZATION				
a. Overall performance	Need to maintain satisfactory macro framework in which to implement policy reforms; past policies led to economic stagnation, inflation and balance of payments problems	FY86 resulted in reduced inflation and overall balance of payments surplus *Agreement with IMF and IDA on policy framework for IMF Structural Adjustment Facility has targets of 4.5% real growth, inflation at level of trading partners, and overall balance of payments surplus of about 2% of GDP in FY87	*Continued satisfactory performance	IDA TA to provide macro consulting services IMF Structural Adjustment Facility approved Dec 86 Proposed U.S. Economic Support Fund grant for FY87 to be contingent on appropriate macro framework as agreed with IMF and IDA
b. Fiscal policy	Inadequately controlled and extra-budgetary spending led to fiscal deficits	Public sector deficit reduced in FY86	Overall public sector deficit before grants to be held to about 7% of GDP in FY87-89	
c. Monetary policy	Past fiscal deficit financed largely with Central Bank credit; excess liquidity spilled over into balance of payments	Public sector's stock of nonconcessional debt reduced in FY86	Further reduction in public sector's stock of non-concessional debt in FY87	IMF TA banking adviser at Central Bank
TAX REFORM	System lacked buoyancy and equity with high excise taxes on basic consumption items and extensive income tax evasion. Objective is to improve collections, buoyancy and equity	Reduction of excise taxes Variable excise tax placed on petroleum products Elimination of taxes ear-marked for special projects Reform of income tax	Improved collection and systematic cross-checking among income and value added taxes	IMF TA tax administration adviser at Ministry of Finance

THE GOVERNMENT'S PROGRAM AND THE PROPOSED OPERATION

Sector and Policy Area	Issues and Objectives	Measures Taken	Future Actions	Related IDA, IMF and Donor Support
		[* = Supported by the Proposed Operation]		
PUBLIC EXPENDITURE				
a. Recurrent	Past spending dominated by wages, poorly controlled, and not oriented enough to development and non-wage needs. Much past expenditure wasteful, inefficient and for special political purposes. Objective is to control spending and reorient it to priority purposes	*Elimination of wasteful special political projects *Ending of reserved budgetary sums for unidentified purposes Reduction of fraudulent wage payments, especially in education *Increased recurrent spending on agriculture, education and health	Improvements to wage payment control in health and to *recurrent budgeting in education Completion of further audits, *including of the Ministry of Finance and of the Central Bank	IDA TA for programming, control and monitoring of public expenditure, including wage bill IDA Education IV project includes TA to improve education budgeting and control USAID financed audits of several ministries and agencies
b. Public Investment	Past program included inappropriate and uneconomic enterprises, and diffused over too many uncompleted and unproductive projects; project selection poor and returns low. Quality of program is to be improved by limiting number of projects and completing priority ongoing ones	*FY86 program improved, with elimination of unproductive projects with little or no investment content *FY87 program is relatively sound, including list of 26 small new projects for donor financing and agreement not to use resources other than from airport tax for Cap Haitien airport	*Preparation of a satisfactory program for FY88	IDA TA for programming, control and monitoring of program and for project selection UNDP assisted preparation of list of 26 projects World Bank chaired Nov 86 Caribbean Group for Cooperation in Economic Development meeting of Haiti Subgroup

THE GOVERNMENT'S PROGRAM AND THE PROPOSED OPERATION

Sector and Policy Area	Issues and Objectives	Measures Taken	Future Actions	Related IDA, IMF and Donor Support
		[* = Supported by the Proposed Operation]		
PUBLIC ENTERPRISES				
a. Agro-industrial and industrial enterprises	Inappropriate, inefficient and uneconomic enterprises operating with privileged and monopoly status led to real resource losses, fiscal losses and high consumer prices for basic items. Objective is to stem these losses and lower prices	*Ending of subsidies to public enterprises	Audits of several public enterprises	USAID financing several of the audits
		*Closure and dissolution of ENAOL vegetable oil plant and replacement of its import monopoly and quota on imports with 20% tariff		
		*Closure of USND sugar mill		IDA TA to finance study of alternatives to sugarcane in area surrounding the second public sugar mill, USN
		*Decision not to extend any subsidies, privileges or loan guarantees to any private companies or cooperatives that may run the former ENAOL and USND plants		
		*Audits, management changes and commencement of programs to improve cost competitiveness at La Minoterie and Ciment d'Haiti	*Implementation of auditors' recommendations and further improvements in cost competitiveness at La Minoterie and Ciment d'Haiti	IDA TA for Ciment d'Haiti power and other advice CCCE considering financing new power generator for Ciment d'Haiti
		*Replacement of La Minoterie's monopoly on flour imports with tariff.		
		*Removal of Ciment d'Haiti's import monopolies and of quota and licence requirements to import cement and their replacement with 30% tariff		
b. Financial monitoring	Inadequate past monitoring of public enterprises	*New organic law of the Ministry of Finance includes financial monitoring of public enterprises		IDA TA to assist Ministry of Finance monitoring

THE GOVERNMENT'S PROGRAM AND THE PROPOSED OPERATION

Sector and Policy Area	Issues and Objectives	Measures Taken [* = Supported by the Proposed Operation]	Future Actions	Related IDA, IMF and Donor Support
COMPETITION AND INDUSTRIAL INCENTIVES				
a. Trade regime	High protection of domestic market led to uncompetitive local production, high consumer prices and anti-export bias. Objective is to reduce nominal and effective protection on local market to reduce consumer prices and increase relative profitability of exports	*Elimination of all import monopoly rights, all import quotas, and most import licenses and regulations (except for sanitary reasons on used clothes and newspapers and licensing of rice, sorghum, maize, beans, chicken parts and pork meat parts)		IDA TA to support technical assistance for firms restructuring Proposed IDA Industrial Restructuring credit to finance firms restructuring
		*New tariff structure, ending all specific tariffs, and introducing a structure with an average tariff of about 20% and a maximum of 40%, with a few exceptions, and including transitional measures for products made in Haiti through December 1987	Introduce drawback system	
		*Extension of 1% administrative charge to all imports except pharmaceuticals and petroleum products	*Elimination of petty taxes on exports and imports	
b. Fiscal incentives	Past system of discretionary tax exemptions led to privileged status for some firms. Objective is to harmonize treatment across sectors and firms		Revisions to the Investment Code and its uniform application	IDA TA to assist introduction of drawback scheme

THE GOVERNMENT'S PROGRAM AND THE PROPOSED OPERATION

Sector and Policy Area	Issues and Objectives	Measures Taken	Future Actions	Related IDA, IMF and Donor Support
		[* = Supported by the Proposed Operation]		
AGRICULTURE				
a. Pricing	Prices and taxes at food processing plants, export taxes, import quotas and tariffs, and administered prices have set incentives which diverge from comparative advantage, deterring output and export expansion, and inducing soil erosion. Objective is to reverse this by shifting relative producer prices	*Export tax on coffee reduced from 22 to 10% *Elimination of export taxes sisal and cocoa *Replacement of import monopoly on flour with tariffs	*Elimination of coffee export tax if overall revenue and expenditure performance permit	USAID and French aid support coffee development projects IDA TA to review environmental degradation and develop policy and investment proposals
b. Policy-induced rents	Production discouraged by low rents on State lands, permitting intermediaries to extract high economic rents from subtenants. Objective is to raise rents to market levels		*Preparation and implementation of program to raise rents on State lands	IDA TA to assist design and implementation of system to raise rents
c. Credit	Access to credit has been very limited and credit agencies portfolios are heavily in arrears, largely uncollectable loans. Objective is to improve access to and efficiency of credit system	*Audit BNDAI	*Dissolution of BNDAI and legal establishment of a new agricultural credit bank	IDB considering supporting new credit bank

PUBLIC INVESTMENT PROGRAM, FY87

1. The overall program is estimated by the Government at G 1,140 million. Historically, however, implementation has averaged about 70 percent; in FY86 it was only 60 percent. For FY87, a rate of about 80 percent, or G 900-950 million, would seem feasible, considering the increased availability of untied aid to the current budget and improvements in program preparation. This total excludes a list of 26 new projects, requiring commitments of G 217 million (US$43 million) that was presented to external donors for possible financing in late 1986. It also excludes the proposed Cap Haitien international airport.

2. The four tables in this annex present the program by sector and source of financing; by sector and type of investment; by executing agency and source of financing; and also the 34 largest projects which account for 71 percent of the total program in financial terms. Sectoral highlights are presented below.

3. **Agriculture.** Expenditure reforms cannot produce results in agriculture if they are not accompanied by pricing and structural changes. Especially important are an increase in non-salary operating funds, now partially built into the FY87 current Treasury Budget, and major improvements in the management of staff resources at the Ministry of Agriculture as well as in project preparation, selection and implementation. These measures, while fully agreed by the Government, will take time to implement.

4. The share of agriculture in the total public investment program is thus increased moderately compared to FY86 because of management and other constraints. The program, which amounts to G 241.9 million, focuses on irrigation system rehabilitation, rainfed agriculture development, feeder roads (which also appear under transportation) and input delivery to farmers. There are no new irrigation projects. Soil conservation and reforestation are kept at financially sustainable levels and increasingly linked to treecrop rehabilitation and watershed protection. Pre-investment studies amount to G 18.1 million and support activities (mostly salaries) are kept at G 5.7 million.

5. The FY87 agricultural program is satisfactory as a transitional, consolidation effort out of past errors in agriculture. It cannot, however, be considered satisfactory when viewed against the considerable potential for growth and export of agriculture in Haiti, especially under irrigation. As the Government's reforms of agricultural pricing, credit and management are carried out, the sector should be able to absorb substantially higher levels of public investment.

6. **Industry.** The FY87 industrial program is sharply reduced both in absolute and relative terms compared to FY86. The Government has disengaged itself from ill-advised public industrial enterprises. The FY87 program

covers modernization and rebalancing investments at La Minoterie and Ciment d'Haiti (G 7.5 and G 15.0 million, respectively), as well as the construction of an industrial park aided by IDB (G 25 million).

7. **Electric Power.** With G 20 million for pre-investment studies and G 6.0 million for managerial strengthening, the G 145.2 million electric power program in FY87 is reasonable and well balanced. Electricite d'Haiti (EdH), while competently run, needs to reduce the number of employees per customer but achieving this agreed objective is slowed by social sensitivity in a country where unemployment and underemployment are extremely acute problems.

8. **Transportation.** The road transport program (G 91.0 million) is mainly devoted to feeder road construction and to main road rehabilitation. Improvements at the Port-au-Prince airport (G 28.0 million) are justified. The National Port Authority (G 16.0 million) will improve security at the Port-au-Prince harbor, complete minor works at Cap Haitien and construct two cabotage ports. The total transportation program thus amounts to G 139.4 million and contains only well justified projects. The road to Jeremie is still at the technical design stage.

9. **Telecommunications.** The bulk of the telecommunications program (G 127.3 million) is to introduce digital exchanges to the Port-au-Prince telephone network and improve the telex service. The cost of this equipment is high by international standards because it is procured under tied aid. TELECO, the public company, needs to improve the number of employees per exchange line, like EdH.

10. **Urban Development and Housing.** Port-au-Prince urgently needs an urban development plan. Its absence greatly duplicates the major urban investment, a drainage program (G 29.5 million in FY87), as well as the planning of water supply investments. More attention should also be paid to urban transport, minor works and traffic management to relieve congestion that impedes workers' access to industrial assembly plants and through traffic to the southeastern part of the country. Sites and services projects are also included in the program, some in Port-au-Prince and others in provincial towns. The total program amounts to G 79.6 million.

11. **Water Supply.** The sector has three public executing agencies (CAMEP, SNEP and POCHEP). Their FY87 programs (G 49.8 million in total) are regionally balanced as between the capital, provincial towns and villages. They are well justified but CAMEP, the Port-au-Prince utility, needs to reduce excess staff and to accelerate its metering program so as to be able to collect charges on actual rather than estimated water consumption.

12 **Education.** With the large increase of its current budget in FY87, the Ministry of National Education could now begin to tackle the problems of low teachers' salaries and insufficient school supplies which caused

inefficiency in basic public education and public training; due to past negligence and irresponsibility, success will not come easily. However, the bulk of primary education is in the private sector and this will remain so. The FY87 investment program adds up to G 81.1 million compared to G 65.0 million in FY86. This program is on the whole well related to urgent needs and not too costly.

13. **Health.** The health sector has also benefited in FY87 from a very large increase in its current budget so that it should now be able to deliver medical supplies and services more adequately than in the past and make more effective use of its staff and physical facilities. The FY87 health investment program is slightly smaller, as it should be, than the FY86 program which included expensive special projects of the past regime; it amounts to G 110.0 million (G 116.5 million in FY86) with three large ongoing projects to extend rural health services, control malaria and provide maternal and child care. The investment program includes, as one would expect, a large share (84 percent) of support activities, representing wages and medical supplies financed by foreign donors. Sizeable fraud in wage payments will have to be eliminated from the ministry and its agencies since it can only demoralize those willing to work for the pay they receive and discourage continued external donor support.

Table 1: FY87 PUBLIC INVESTMENT PROGRAM BY SECTOR AND BY SOURCE OF FINANCING
(G million)

Sector	No. of Projects	---Domestic Financing---			--------External Financing------				Overall	Share of Program Cost (%)
		Treasury	Public Ents.	Total	PL-480	Other Food Aid	Project Aid	Total	Total	
01. Agriculture	40	16.9	0.0	16.9	37.3	4.3	183.5	225.1	241.9	21.2
02. Mining	4	1.5	0.0	1.5	0.0	0.0	6.6	6.6	8.1	0.7
03. Industry	5	0.0	21.7	21.7	0.0	0.0	25.2	25.2	46.9	4.1
04. Energy	7	0.0	68.6	68.6	0.0	0.5	76.2	76.6	145.2	12.7
05. Water Supply	10	6.4	0.0	6.4	0.8	0.0	47.9	48.7	55.1	4.8
07. Transportation	20	14.9	12.0	26.8	22.5	30.0	60.1	112.6	139.4	12.2
08. Communications	7	1.1	77.2	78.3	0.0	0.0	49.0	49.0	127.3	11.2
09. Urban Development	13	19.2	0.0	19.2	0.0	0.0	55.5	55.5	74.6	6.5
10. Education	21	7.7	0.0	7.7	1.6	0.9	70.8	73.4	81.1	7.1
11. Population, Health and Nutritution	14	2.3	0.0	2.3	26.0	0.0	81.7	107.7	110.0	9.6
12. Social Affairs	3	0.8	0.0	0.8	0.0	0.3	1.8	2.0	2.8	0.2
13. Community Development	15	1.9	0.0	1.9	14.8	1.8	31.3	47.9	49.8	4.4
14. Youth and Sports	1	1.0	0.0	1.0	0.0	0.0	0.0	0.0	1.0	0.1
15. Statistics and Information	3	1.6	0.0	1.6	1.6	0.0	0.7	2.3	3.9	0.3
16. Other Administrations	17	8.2	0.0	8.2	2.0	0.0	17.8	19.8	28.0	2.5
17. Commerce	2	0.0	0.0	0.0	0.0	0.0	0.2	0.2	0.2	0.0
18. Regional Development	4	16.6	0.0	16.6	0.0	3.1	4.9	8.0	24.6	2.2
TOTAL	186	100.0	179.5	279.5	106.5	40.9	713.2	860.6	1140.1	100.0
Share of Total Program Cost (%)		8.8	15.7	24.5	9.3	3.6	62.6	75.5	100.0	

Table 2: FY87 PUBLIC INVESTMENT PROGRAM BY SECTOR AND TYPE OF INVESTMENT
(G million)

Sector	Pre-Investment Number	Pre-Investment Amount	--Investment-- Number	--Investment-- Amount	---Support--- Number	---Support--- Amount	-----Total----- Number	-----Total----- Amount
01. Agriculture	12	18.1	26	218.2	2	5.7	40	241.9
02. Mining	3	3.6	0	0.0	1	4.5	4	8.1
03. Industry	0	0.0	3	46.7	2	0.2	5	46.9
04. Energy	2	20.9	4	118.3	1	6.0	7	145.2
05. Water Supply	0	0.0	10	55.1	0	0.0	10	55.1
07. Transportation	4	2.2	16	137.2	0	0.0	20	139.4
08. Communications	0	0.0	7	127.3	0	0.0	7	127.3
09. Urban Development	1	1.0	12	73.6	0	0.0	13	74.6
10. Education	0	0.0	7	57.4	14	23.7	21	81.1
11. Population, Health and Nutritution	2	1.9	5	15.6	7	92.4	14	110.0
12. Social Affairs	0	0.0	3	2.8	0	0.0	3	2.8
13. Community Development	0	0.0	12	13.9	3	35.9	15	49.8
14. Youth and Sports	0	0.0	1	1.0	0	0.0	1	1.0
15. Statistics and Information	3	3.9	0	0.0	0	0.0	3	3.9
16. Other Administrations	9	8.2	2	7.3	6	12.5	17	28.0
17. Commerce	0	0.0	0	0.0	2	0.2	2	0.2
18. Regional Development	1	0.6	3	24.0	0	0.0	4	24.6
TOTAL	37	60.5	111	898.5	38	181.1	186	1140.1
Share of Total Program Cost (%)	19.9	5.3	59.7	78.8	20.4	15.9	100.0	100.0

Table 3: FY87 PUBLIC INVESTMENT PROGRAM BY EXECUTING AGENCY AND SOURCE OF FINANCING
(G million)

Project Code	Project Title	Agency Acronym	No. of Projects	---Domestic Financing--- Treasury	Public Ents.	Total	-------External Financing------- PL-480	Other Food Aid	Project Aid	Total	Overall Total
National Airport Authority		AAN	2	0.0	8.1	8.1	0.0	0.0	19.7	19.7	27.8
National Port Authority		APN	5	0.0	3.7	3.7	0.0	0.0	10.3	10.3	14.0
Port-au-Prince Metropolitan Water Authority		CAMEP	1	3.5	0.0	3.5	0.0	0.0	27.4	27.4	30.9
Planning Commissariat		CPNAP	14	12.1	0.0	12.1	3.0	0.6	18.6	22.2	34.3
Center For Planning Technique And Applied Economics		CTPEA	1	2.2	0.0	2.2	0.0	0.0	0.0	0.0	2.2
Haiti Electricity		EdH	6	0.0	68.6	68.6	0.0	0.0	75.3	75.3	143.8
Public Housing Enterprise		EPPLS	7	6.6	0.0	6.6	0.0	0.0	28.6	28.6	35.2
Agronomy And Veterinary Faculty		FAMV	1	1.3	0.0	1.3	0.0	0.2	3.9	4.1	5.4
Haitian Statistical Institute		IHSI	3	1.6	0.0	1.6	1.6	0.0	0.7	2.3	3.9
Institute For Preservation Of The National Heritage		ISPAN	2	1.6	0.0	1.6	0.5	0.1	3.0	3.6	5.1
Ministry of Agriculture		MARNDR	46	16.3	0.0	16.3	45.2	5.5	210.4	261.1	277.4
Ministry of Social Affairs		MAS	3	0.8	0.0	0.8	0.0	0.3	1.8	2.0	2.8
Ministry of Commerce And Industry		MCI	8	0.5	21.7	22.2	0.0	0.0	25.4	25.4	47.6
Ministry of National Education		MEN	20	7.2	0.0	7.2	1.1	0.9	67.8	69.9	77.0
Ministry of Economy And Finance		MEF	2	0.0	0.0	0.0	0.0	0.0	1.5	1.5	1.5
Ministry of The Interior And National Defense		MIDN	1	7.5	0.0	7.5	0.0	2.5	0.0	2.5	10.0
Ministry of Justice		MJ	1	3.0	0.0	3.0	0.0	0.0	0.0	0.0	3.0
Ministry of Health and Population		MSPP	17	1.9	0.0	1.9	26.0	0.0	92.8	118.8	120.7
No Executing Agency		NONE	6	0.0	0.0	0.0	5.2	0.5	0.8	6.4	6.4
National Civil Aviation Office		OFNAC	1	0.0	0.0	0.0	0.0	0.0	1.8	1.8	1.8
Popular Education Office		OPEP	1	1.2	0.0	1.2	0.0	0.0	0.5	0.5	1.7
National Water Service		SNEP	7	1.8	0.0	1.8	0.8	0.0	11.3	12.0	13.8
Haiti Telecommunications Company		TELECO	5	0.0	77.2	77.2	0.0	0.0	49.0	49.0	126.2
National Television Of Haiti		TNH	1	0.7	0.0	0.7	0.0	0.0	0.0	0.0	0.7
Ministry of Public Works, Transport and Communications		TPTC	24	28.9	0.2	29.1	23.2	30.5	62.6	116.2	145.3
State University of Haiti		UEH	1	1.5	0.0	1.5	0.0	0.0	0.0	0.0	1.5
TOTAL			186	100.0	179.5	279.5	106.5	40.9	713.2	860.6	1140.1

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GOVERNMENT OF NICARAGUA

STRATEGY FOR PRIVATIZATION

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GOVERNMENT OF NICARAGUA
PRIVATIZATION STRATEGY

GOVERNMENT OF NICARAGUA
PRIVATIZATION STRATEGY

I. INTRODUCTION

The Government of Nicaragua (GON) has requested assistance from three donor institutions, AID, IDB and UNDP, in preparing a strategy and action plan for implementing a national privatization program.

Coincidentally, representatives and consultants from these institutions arrived in Managua within days of each other, and met together on November 27, 1990. In the interest of facilitating the preparation of a GON strategy for privatization the three institutions decided to pool their resources to develop a unified approach to privatization for CORNAP, the GON agency charged with responsibility for privatization. This strategy is the product of the joint effort.

II. BACKGROUND

A. History

Most APP ("Area de Propiedad Publica") enterprises were acquired through expropriation of Somoza related holdings following that regime's overthrow, confiscation by the Sandinista administration of properties of owners who absented themselves from the country for more than six months, or acquired by foreclosure due to non-payment of debt to the public sector financial system. A few were purchased outright or actually established by the state.

Prior to 1988, most APP's were dependencies of various Ministries. In 1988, nearly all were grouped by general activity area under 24 holding entities, called "corporations". Under the corporations, the APP's remain differentiated as "companies". A few retained autonomous status.

In May 1990, immediately following the change in government, the corporations and a handful of autonomous companies were placed under the umbrella of a new non-incorporated holding entity, Corporaciones Nacionales del Sector Publico (CORNAP), reporting directly to the Presidency of the Republic.

There are currently about 300 companies under the control of CORNAP. In addition, some of the companies have an undetermined number of subsidiaries and affiliates, and own shares in each other and in overseas enterprises. A few companies and properties have already been privatized and others have been returned to previous owners. Many companies are simply informal organizations without any legally constituted statutes.

B. Legal Framework

Presidential Decree No. 7-90 (See Annex 1) established a three person Junta General or General Board of CORNAP, nominated by the President of Nicaragua, and composed of a president, vice-president and secretary. The General Board in turn is empowered to appoint the boards of directors of the corporations and autonomous companies, including a representative of the workers, and a non-voting Executive President. The decree also provides for a Consultative Council, composed of the presidents of the boards of the corporations, to advise the General Board. It has not yet been established.

CORNAP's mandate is basically threefold: to recommend to the President the areas of economic activity and policy which should be handled and developed by the State; to privatize the other activities; and meanwhile, to approve policy guidelines for the Corporations.

Nicaragua's constitution explicitly vests in the President the direction of the economy. CORNAP's legal advisors have consequently concluded that the President is legally empowered to privatize state owned enterprises (SOE's) without congressional approval.

Presidential Decree No. 11-90 creates the Comision Nacional de Revision, presided over by the Attorney General, to review and pronounce on the legality of claims for the return of confiscated properties. It also establishes terms for the return of such properties. Decree No. 57-90 extended until December 31, 1990, the deadline for registering claims.

The law decreeing expropriation of Somoza related properties remains unaffected and such properties can be privatized. The return to previous owners of other expropriated and confiscated properties on which claims are validated will be negotiated on a case by case basis by CORNAP. At this writing, a complete list of claims has not been obtainable.

C. Description of CORNAP and holdings

To implement its mandate, the General Board of CORNAP has established and staffed an organization of about 73 positions. Reporting to the President of the Board are six directors who provide policy direction and guidance to most of the corporations and autonomous companies as presidents of some of their boards of directors, and directors of others. Also reporting to CORNAP's president are four directors and managers of staff departments: Legal; Administration (Accounting, Personnel, Budgets, Finance, General Services); Information and Analysis; and Investments and Privatization. The head of the Legal Department sits on the board of CORNAP as secretary. He, the President, Vice President (non-employee) and other staff directors also head or sit on corporation boards.

The corporations, in turn, are similarly staffed. As an example, COIP, the holding entity for industrial companies, has 70 employees. Six division heads, under an Executive President, provide policy direction to 76 companies, and four directors manage staff departments.

Total manpower of CORNAP and its holdings is about 78,000 or over 9% of total national employment. In 1989, these holdings contributed about 31% of GDP. They represented 40% of national industrial production, well over half the output from fishing, mining and passenger transport, and a significant participation in many agricultural and service sectors. They have a monopoly on many traditional exports, including sugar and gold.

CORNAP's holdings run the gamut of hotels, restaurants, shops, car dealers, car rental and tourist agencies; many manufacturing sectors, including a cement plant and a large carton producer; transport, including the national airline and railroad; agricultural sectors, including several large sugar mills; forestry, and mining.

In the manufacturing sector, plants and equipment are generally antiquated or use obsolete processes, especially in textiles. A basic profile of the 76 companies of this sector shows the following: about 25 are being claimed by previous owners, 5 were founded by the state, 45 have minority interests, 15 are estimated to be unprofitable and 10 marginally profitable.

There is virtually no consolidation of financial and other data and statistics at the CORNAP or corporation levels. At the company level, data is often unreliable and very distorted by the high inflation and devaluations. CORNAP is in the process of improving its management information system.

D. Concertacion

On October 26, 1990, a Principles of Agreement was signed by the Administration, labor unions and private sector employers. Among other items, all parties agreed that workers would be given an interest, level unspecified, in privatized companies, and that a private financial system would be established. Labor frequently voices the position that workers deserve to be given, virtually for nothing, a significant equity share of companies to be privatized because they have rights acquired through sweat equity. The acquisition of equity by labor will undoubtedly be negotiated on a case by case basis.

E. Financial Context

The banking system consists of The Central Bank, and four public sector banks, two of which are virtually defunct. These banks operate basically as credit departments of The Central Bank. The system is in chaos. IDB is providing emergency technical assistance to the Central Bank; however, the whole system needs to be restructured, including regulatory functions. Almost no local capital and credit are available to finance a privatization program. Legislation governing the establishment of private sector financial institutions is expected to be approved in the National Assembly in the near future.

III. PRIVATIZATION STRATEGY

A. Objectives

The purpose of establishing a privatization strategy is to have an orderly and methodological framework in the process of privatization that will lead to the divestiture of SOE's in the best interests of the people of Nicaragua and the economy of the country.

Privatization is a process, not an objective. The objectives can be and are varied -- income from sales, worker participation, increased management efficiency, for example, are some of the objectives stated by Nicaraguan authorities and political leaders surveyed by the Consultants. All of these objectives can be met at some point in the privatization process. Not all objectives can be met at once, nor with every sale, but at some point in the process each and every objective can be built into the process.

In keeping with CORNAP's mandate to advise Government on sector strategies, the process as designed has built-in strategic advisory services for developing strategies sector-by-sector. The program can be envisioned as building sector strategies on the back of privatization. With this mandate in mind, it is even more important that the privatization process be as methodical and comprehensive as possible.

Following the procedures explained in the next section, based on interviews with major decision makers, representatives of government, labor and private sector organizations, the consultants arrived at the following prioritization of objectives for privatization in Nicaragua.

Short-term priorities:

1. Demonstrate progress and early privatization success
2. Obtain revenue from early sales

Long-term priorities:

1. Obtain revenue from sale of businesses
2. Attract private sector investment (domestic and foreign)
3. Improve efficiency of enterprises and performance of sectors
4. Spread ownership
5. Control job losses/identify opportunities for employment creation

B. Small Scale Divestiture - In-House Process

Easily saleable companies will immediately be prepared for privatization, in view of the political urgency to show results. Criteria for selecting such companies are, among others, small scale and no legal claims. The privatization process will be handled by CORNAP in-house with the help of outside local accounting/auditing firms, asset valuation experts, and lawyers to the extent CORNAP's legal department needs additional help.

C. Sectoral Restructuring and Privatization

For the remaining companies, the privatization program will be undertaken by activity sectors, prioritizing the sectors and then the companies within sectors in line with consensus objectives expressed in interviews with government, opposition, labor and business leaders. The sector approach takes advantage of the one-time opportunity to optimize sector efficiency through restructuring (fragmentation and consolidation), thus potentially enhancing sales values as well.

Implementation of the privatization process for a number of sectors will be contracted out to international consulting firms by sectors. The donor agencies should agree on common selection guidelines to expedite the awarding of these contracts. Other activity sectors will be privatized in-house.

The use of international consulting firms, despite high cost, is justified by the number of companies involved, the complexity of the program and need to do the job rapidly and well, and the lack of in-country expertise to handle it. Further, their involvement in the whole process will help ensure the required transparency and objectivity. International consulting firms, by their very nature, will be able to market worldwide, and attract a larger number of potential buyers. Consequently, the greater potential demand should result in higher prices for the companies and assets sold. These higher prices should more than compensate for the increased cost. Even if local expertise were available to manage each project, international consultants would be recommended to undertake valuations.

CORNAP will closely monitor the work done by the consulting firms who will incorporate the government's objectives and suggestions concerning sale schemes. Sale negotiations will be carried out by negotiating teams specially appointed by the government supported by the consultants.

C. "Political Sectors": Special Treatment to Agriculture

The agriculture sector has been singled out for special attention in the privatization process. In reviewing the sector, many highly politicized issues appeared such as the unclear or undefined ownership of assets, government programs to resettle former resistance members on unused land, and competing land tenure claims as well as many strategic economic issues such as the large number of workers who will be affected by any sales, the need for continuing large investments to keep the sector going, and the fact that divestitures are actually being negotiated on an ad hoc basis by corporations with or without the government's blessing. There are also administrative issues involved such as national commissions and a strong planning department within the Ministry of Agriculture which need to be involved in any divestiture decisions.

The highly politicized nature of the sector and its strategic national economic importance make it an unsuitable candidate for the straight business valuation and step-by-step methodology proposed for all other divestitures, which require the virtual freezing of any divestiture activities until the sales take place. It is recommended that responsibility for major agriculture divestitures be taken out of CORNAP, and spread among appropriate GON agencies. CORNAP will act only as a technical process advisor.

The need of the agriculture sector for strategic planning, investments and divestiture can be handled in other ways however. Some suggestions: The technical work for national strategic planning can be carried out by national commissions and the Ministry of Agriculture who should be able to rely on inputs provided from bilateral and multilateral donors. Bilateral and multilateral donors could be requested to provide technical assistance, investment funds and assist in meeting the costs of restructuring many facets of the sector. For example, the IDB is expected to prepare a sector loan probably in the agriculture sector, for consideration immediately after debt arrears are cleared. USAID and other bilateral donors are currently involved in agriculture support and activities and could possibly be approached to continue and expand such support.

IV. REQUISITES FOR SUCCESSFUL PRIVATIZATION

Critical requisites for a successful privatization program in Nicaragua are:

- Maintenance of integrity and transparency of the process and avoidance of even the perception of conflict of interest throughout the process.

- Development of a legal framework for the regulation of the financial system and establishment of private sector financial institutions. Provisions of credit lines to these institutions, earmarked for the privatization process.

- Establishment of an assistance program for worker purchase of companies and/or worker equity participation. Technical assistance for workers' outright purchase of companies is needed to guide workers' groups, including cooperatives, syndicates, etc. in preparing a business plan, purchase offers and negotiating with CORNAP. Worker equity participation can take several forms: a leveraged employee stock ownership plan (ESOP); creation of cooperatives; selling shares at a preferential price with financing; and/or donating a share for one or more shares purchased. The shares can either be held in trust by a worker's association or distributed directly to workers as the shares are paid for. An ESOP usually involves a worker's association which borrows the funds to purchase shares. The loan is guaranteed by the company's assets. Dividends on these shares plus contributions out of company profits are used to amortize the loan. The association holds the shares in trust for the workers until they are paid for, when they can be distributed.

- The funding of termination allowances for redundant personnel. Because of the bargaining strength of the labor unions, termination of workers without cause is virtually impossible unless an acceptable termination package is negotiated. Recent examples of negotiated package deals range from three months to ten months salary, depending on circumstances.

- Establishment of an assistance fund to finance the subsidy equivalent of debt restructuring by the banks for companies to be privatized.

V. PRIVATIZATION PROCESS FLOW

This section describes the methodology recommended to organize the process of privatization of most of the sectors and enterprises of CORNAP. The output of the methodology is a detailed plan of action, and a step by step approach to organize the process and the multiplicity of activities that privatization entails.

The procedures obtained from the methodology are logically derived from the prioritization of objectives and the criteria to measure success in achieving these objectives. It should be stressed that this approach does not involve rigidity in implementation, because at different points in the implementation of the process. There are decision points and choices that have to be taken by CORNAP, and CORNAP remains in full control of the process. However, a good understanding of the methodology suggests that while there is enough room for flexibility, adapting to local conditions, and all the amount of creativeness that the process of privatization normally involves, there are also clear rules that must be followed in setting the priorities and complying with the sequencing of actions.

In fact, adhering to pre-established rules and to the resulting sequencing of actions is precisely the basic mechanism recommended to ensure that CORNAP is not overtaken by political pressures, nor falls into disorganized responses to the many demands it will be subject to, but instead maintains full control over the process, is able to explain the logic and reasons for its actions in terms of policy objectives, and maintains transparency throughout the management of the process. The systematic methodology proposed in this chapter is designed to provide CORNAP with a powerful instrument to achieve the policy objectives of the government and maintain an active management of the process.

Figure 1 presents an overall view of the privatization process, and Annex 2 contains in a series of 33 charts all the different aspects in more detail than is included in the text. Annex 2 and the text of this chapter can be considered a complete and comprehensive guide or manual for the different activities involved in the process of privatization recommended for CORNAP. The main steps of a well ordered privatization process can be divided in two stages, planning and implementation, as follows:

A. Planning Procedure

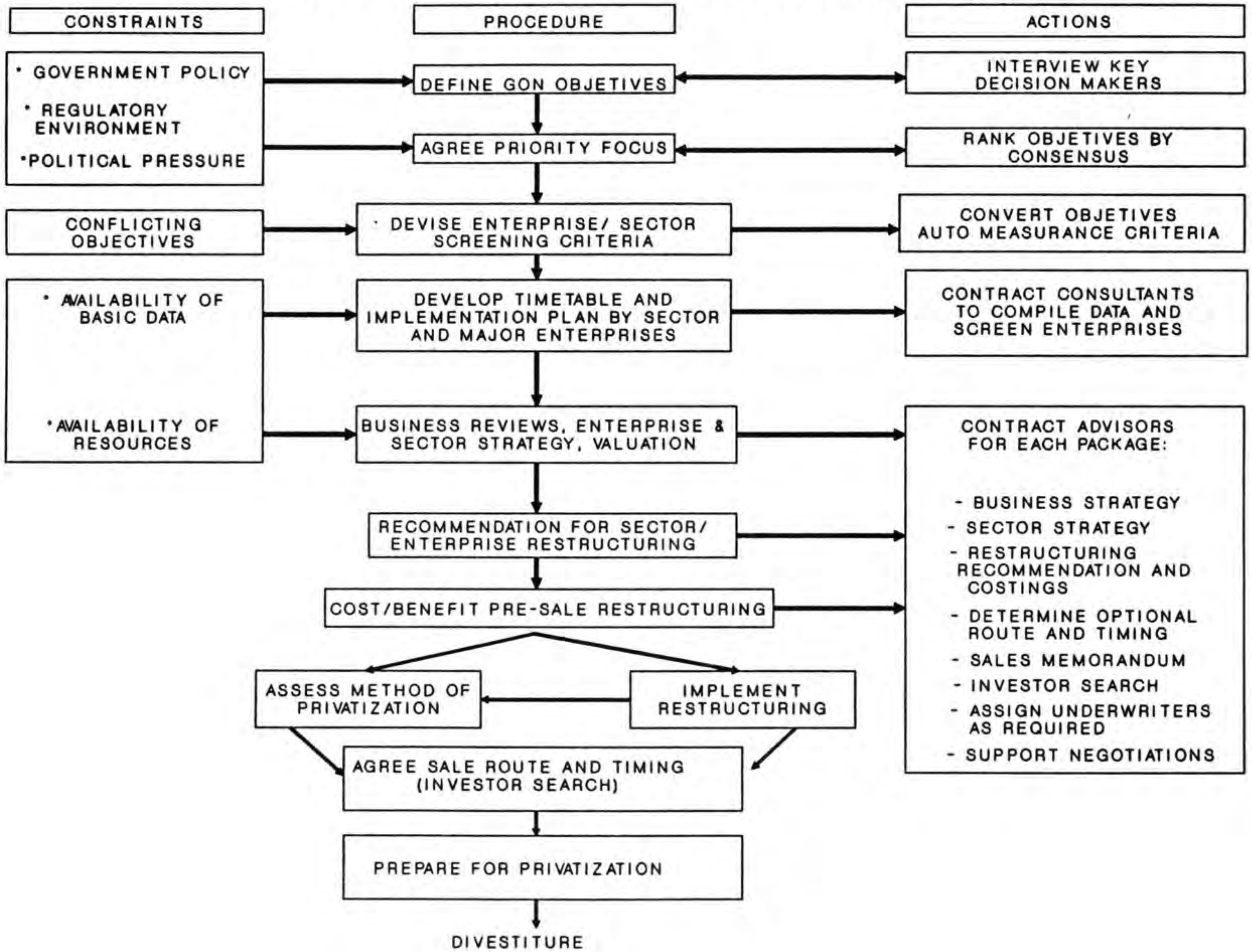
1. Define government objectives
2. Agree priority focus
3. Devise enterprise/sector screening criteria
4. Develop timetable and implementation plan by sector and major enterprises

B. Implementation Procedure

1. Business reviews, enterprise and sector strategy, valuation
2. Recommendations for sector/enterprise restructuring
3. Cost benefit pre-sale restructuring
4. Assess method of privatization
5. Implement restructuring
6. Agree sale route and timing (investor search)
7. Prepare for privatization
8. Divestiture

Steps A1, A2 and A3 were actually accomplished during the

PRIVATIZATION PROCESS FLOW: NICARAGUA



present consultancy.

A. Planning procedure

A1. Identification and Definition of Government Objectives

One characteristic of privatization processes around the world is the multiplicity of objectives that might be achieved and that governments find it difficult to reconcile. Nicaragua is no exception. Therefore, the first step in the design of a well ordered process is the identification of objectives and their prioritization in time. Objectives can be defined at three different levels: macroeconomic objectives, sector-specific objectives and enterprise-specific objectives, described as follows:

Macroeconomic Objectives. Maximize income from sale of business, reduce size of public deficit, reduce size of public sector, payment of foreign debt, promote wider share ownership, demonstrate privatization success. The last objective raises the question: what are the criteria for success?

Sector-specific objectives. Strengthen market competitiveness, reduce dependence on government support (eg. implicit or explicit subsidies), broaden private sector participation, attract foreign investment, control level of job losses, identify opportunities for employment creation.

Enterprise-specific objectives. Improve performance, reduce dependence on government support, relieve public sector financial and operational constraints, access to private sector inputs.

As regards the objectives of the privatization process in Nicaragua the consultants proceeded as follows: (1) A questionnaire was developed jointly with the authorities of CORNAP, containing a list of all possible objectives for the process, including all those mentioned above. This questionnaire, which contained a list of 19 objectives, requested the interviewees to rank the principal objectives from 1 to 5 both in the short and in the long-term. (2) Interviews were developed with 18 key decision-makers representative of the government, private sector and workers' organizations, in order to complete the questionnaire and discuss the reasons for the choice of objectives and for the stated priorities. (See questionnaire and list of persons interviewed in Annex 2).

A2. Agree Priority Focus

The results of the interview program were statistically weighted, grouped into seven generic objectives and ranked. The generic objectives that received the highest weight in the short and in the long-term are the following:

Short-term priorities:

1. Demonstrate progress and early privatization success
2. Obtain revenue from early sales

Long-term priorities:

1. Obtain revenue from sale of businesses
2. Attract private sector investment (domestic and foreign)
3. Improve efficiency of enterprises and performance of sectors
4. Spread ownership
5. Control job losses/identify opportunities for employment creation

A3. Devise Enterprise/Sector Screening Criteria

Screening criteria were established to meet each of the objectives. As an example, the criteria for meeting the short- term objectives stated above (demonstrating progress and early success and obtain revenue from early sales), were determined to be:

- Small scale enterprises (sales smaller that US$ 100.000 per annum)
- Clean legal status
- Clean balance sheet
- Basic data available
- Easy restructuring
- Existing offer to acquire the enterprise.

This list of "quick-sale" criteria generates the first implementation module or group of enterprises.

A second point in time comes when entire sectors are screened out and prioritized in a time sequence. As explained, this sectoral approach is central to the strategy of privatization proposed. The "screening criteria" table in Annex 2 contains a preliminary list of criteria for implementing each of the long-term objectives, however, this criteria should be seen as indicative and subject to revision by the consultancy firm contracted to prioritize and propose the implementation plan for the second module of the program.

A4. Develop timetable and implementation plan by sector and major enterprises

Once the objectives are clearly defined and prioritized, and criteria have been developed to screen out the enterprises and sectors, we come to the fourth and final step of the planning stage of the process: to develop a time table and an implementation plan by sector and major enterprises. This timetable and implementation plan must be guided by the principal objectives of the Government: demonstrate progress and early success, and develop a flexible approach capable of incorporating all objectives through time.

These requirements and the limitations concerning the availability of information to screen out all enterprises and sectors in the short-term, led the consultants to define a two module approach to the implementation of objectives. The first implementation module consists of identifying a group of suitable early privatization candidates for which information is available or easily generated and initiate the process with this set of enterprises. The second implementation module involves undertaking a systematic planning of the process for the majority of enterprises and sectors.

(1) First implementation module. Identification of suitable early privatization candidates and initiation of the process.

A methodology was developed for selecting a small number of first and second tier candidates for early privatization. This two tier approach ensures early privatization success and offers a systematic method for divesting all small scale enterprises not included in the sectoral strategies. This methodology involves the following basic steps for each tier:

First tier.

Develop screening criteria. This task was already achieved and includes the criteria cited above.

Screen the enterprises. This involves the following tasks: compiling a database with the necessary information, screening for basic criteria, and establishing a priority list and a substitute list of enterprises. This task was also achieved but partially. The use of the criteria above and the available information generated a list of 39 enterprises. However, this list could change as better information is obtained which might add or remove enterprises from the original list.

Initiate implementation. For priority list this involves: confirming availability of the enterprises for privatization and legal status, obtaining the latest available financial information, contract accountants to update financial statements as appropriate and confirm suitability for early privatization.

The action plan for implementation of this tier involves contracting four process managers full time in CORNAP, each of whom will be in charge of implementing the privatization of 10 enterprises in a period of four months. This means, for example, that if the first tier privatization process starts in February 1991, the privatization of forty small enterprises should have been achieved by the end of May 1991. If the new data invalidates the candidacy of enterprises from the first group, these can be replaced with enterprises from the second group, in such a way that there are always 10 enterprises in process by a process manager at any one time.

Second tier.

The methodology for the selection of second tier candidates involves the following:

Develop screening criteria and screen the resulting enterprises. The screening criteria are the same as for first tier, with one exception: second tier enterprises have sales levels between US$ 100.000 and US$ 500.000 per annum. Enterprises to be reviewed under sector strategies have to be excluded even if they meet the criteria for second tier.

Develop implementation plan and timetable. Implementation involves grouping the listed enterprises by activity and selecting 3 or 4 groups for simultaneous processing under the responsibility of process managers in the same way as for first tier.

Once process managers have been appointed and reliable lists of enterprises have been generated for each tier, the next steps in implementation are data gathering, valuation and preparation for divestiture.

Compiling database. Both screening of small enterprises and their preparation for divestiture require the generation of reliable basic data. For this first module of small enterprises it is recommended that each process manager in charge of a group of enterprises have one PC-AT where all the information on each enterprise is adequately processed and presented. Additionally, it is envisaged that an extra process manager be appointed responsible for coordinating basic data gathering for all enterprises (small and large).

(2) Second implementation module: large scale enterprises and sectors

The key characteristic of the procedure recommended for this second module is a sectoral approach to restructuring and privatization. The initial conditions that the planning and implementation of this module should consider are: lack of basic data on enterprises, large number of enterprises to be privatized, the enterprises are spread across most economic sectors, there are limited resources available to assist privatization, and there are many objectives that should be addressed by the process.

These initial conditions suggest the need for two basic requirements: objective criteria should be applied to classify and prioritize sectors and enterprises, and central coordination of the process is needed to ensure a systematic approach, demonstrate active management of the process and build consensus.

Thus, the guiding objectives for this module are to develop a systematic approach to the prioritization of sectors and the enterprises within them, and to identify opportunities for restructuring sectors by using privatization as an instrument of this restructuring.

The basic steps to develop the timetable and implementation plan are:

1. Develop screening criteria
2. Screen enterprises according to the agreed criteria
3. Group the enterprises into sectors or subsectors to target key issues.
4. Rank the groups of enterprises according to agreed objectives
5. Identify the requirements to prepare each group for privatization, particularly whether the planning and implementation of the group/sector will be managed in house or will be contracted out.

The present consultancy identified a preliminary grouping of enterprises into 30 sectors and suggested a series of criteria to implement the long-term objectives. However, the groupings should be revised with more detailed knowledge of the nature of each business, the screening criteria for the long-term objectives should also be worked out in more detail, and the screening requires the compilation of a comprehensive database. For these reasons the consultants recommend that a consultancy firm be contracted during the first semester of 1991 to develop the timetable and implementation plan of this second module, including the five steps cited, the writing of terms of reference for the work to be done on each of the sectors/groups, and the costing of this work.

The terms of reference for the work to be developed by this consultancy firm are included in Annex 4.

Develop action plan for each enterprise/group. The final step of the implementation plan includes deciding for each sector whether the process will be managed in-house or will be contracted out. The consultancy firm should include a recommendation in this respect as well as the capacities CORNAP should have to manage in-house a number of sectors. The in-house management of sectors would involve the assignment to process managers of groups of enterprises in a similar way as in the first (small enterprise) module. On the other hand, the contracting out of sectors implies that particular firms take the responsibility for the sectoral work including the realization of the transactions, for which a "success fee" could be established. CORNAP should be able to monitor the development of the work by the consultants and the consultants should present the preliminary sectoral strategy, the alternative sales routes and other strategic decisions to CORNAP for discussion and approval.

Initiation of implementation for each sector. This implies the following activities: initiation of business reviews, valuation and preparation of enterprises for privatization. All these activities constitute the first step of the implementation stage. But before proceeding to this next step, further clarifications should be made concerning the data requirements for screening.

Compilation of a comprehensive database for screening. The screening process for this second module requires different types of data which at present are not readily available: data on legal status of enterprises (shareholders list, legal documentation), financial information (up-to-date and reliable statements), operational information (tangible fixed assets, market positioning, restructuring needs, etc). This suggests the urgent need to compile a comprehensive database with all the information required for the screening process. Ideally this information should be available and well organized before the arrival of the consultancy firm. As explained in more detail in section VI. F. the recommended information strategy for the screening stage is the appointment of one process manager in charge of coordinating basic data gathering for all enterprises (both small and large, that is, first and second module) prior to the arrival of the consultants. The compilation of the database for the second module can be contracted out under the coordination of this process manager. Assuming the second module includes approximately 200 enterprises, the database can be built using 5 PC-ATs, each one dedicated to 40 enterprises.

B. Implementation Procedure

B1. Business/sector reviews

The first step of implementation for individual enterprises and/or sectors involves carrying out a comprehensive enterprise/sector review. This is a comprehensive evaluation of all the relevant aspects that influence the operation, profitability and prospect of the business. It includes:

Regulatory Environment: Government policy, product specifications, employment levels, investment incentives, quotas, taxation, tariffs, pricing policy.

Markets/competitors: Size, growth, segments, profitability levels, competitive advantages, market shares.

Financial Performance: Revenue, profits, cash flow management, net worth, balance sheet structure.

Management: Organization structure, planning process, information systems, employment levels, reporting lines, budgeting, autonomy.

Operations and costs: Production stages, productivity, supplier sourcing, physical installations, distribution, cost structure, profit centers.

Customers: Profile, location, diversity, purchase criteria.

B. Recommendations for sector/enterprise restructuring.

The enterprise reviews for all enterprises in a particular sector result in the derivation of key success criteria for the enterprises, an identification of the industry profitability drivers, an identification of the competitive advantages of the enterprises in the sector, and the critical aspects to develop competitiveness, and an identification of the competitive advantages of the sector in global markets. All these elements constitute the basis to define a sector strategy and a business unit strategy for restructuring and privatization. The restructuring requirements of enterprises are determined on a case by case basis.

B3. Cost-benefit of pre-sale restructuring and implementation

A decision has to be made on whether to implement restructuring before or after privatization, this decision depends on the following factors: the availability of government resources, the need for foreign or private participation to implement restructuring successfully, the impact of restructuring on the achievable sale price, and the ability of CORNAP to guarantee that the new owners will implement the enterprise or sector strategy.

Other considerations bearing on the decision whether to implement restructuring before or after privatization are:

(1) Some financial restructuring may be unavoidable. For instance, long-term debt would have to be written-off to make the enterprise attractive to investors. This could be done in several ways: by transferring to CORNAP or to the corresponding corporation the liabilities, by having the banks rescheduling the debt and setting up a fund in support of privatization that finances the subsidy

equivalent or the financial cost to the bank of the restructuring, in such a way that monetary discipline from the point of view of the financial sector is not affected.

(2) The new owners may prefer to reap the benefits of their own restructuring investments instead of paying an extra price for government investments.

B4. Valuation.

This is a crucial issue in the privatization process. In general terms three valuation methods can be distinguished: (1) Discounted Cash Flow (DCF), (2) market value of assets and (3) replacement cost of assets. It is convenient to obtain a range of DCF values generated from a sensitivity analysis to different assumptions and from three basic cases:

(1) The base case of the stand alone business as it is.

(2) The value of the business to specific groups of interested investors: trade buyers may be able to realize cost savings from integrating their acquisition with their existing businesses, hence the value of an acquisition to a trade buyer may be higher than the base case.

(3) The value of the business after restructuring: this would be higher than the base case; however, the investment required to restructure may not be reflected fully in the achievable sale price. In this sense, valuation is closely linked to the cost-benefit analysis of pre-sale restructuring described above.

Valuation efforts should establish a range of values to provide an indication of the achievable sale price, a basis for negotiating the final sale price in case of trade sales, or the minimum price in case of public offers or licitation.

B5. Assess methods of privatization

The forms and methods of privatization can have many variations. The optimal privatization method has to be determined on a case-by-case basis. The factors that influence the choice of method are:

Predetermined factors: type of business, government objectives and priorities, government resources, timing of the study and preparation stage for privatization.

Influencing factors at enterprise level: whether the business is a going concern, levels of operational/financial restructuring required, need for foreign expertise and technology, size of the asset base, quality of existing management.

Influencing factors at the macro level: availability of commercial financing, existence of developed capital markets, desire to launch capital markets.

Three basic forms of privatization can be distinguished: public flotation, in which there is a wide range of investors; private placement, in which the offering is restricted to institutional investors; and trade sale, in which there is a limited, known number of investors, the sale price is negotiated and the shares are sold in a package deal. More details on each of these basic forms of privatization are included in Annex 2. As is clear from the criteria for each one of them, public flotations and private placements are not viable short-term options in the case of Nicaragua. This means that most cases of privatization will take the form of trade sales.

Trade sales.

Trade sales are transactions that involve one other party (which itself may be a consortium of interested parties) or a small number of interested parties. Typically trade buyers already have interests in some business competing with or related to the privatization candidate, or have experience in managing similar businesses. Trade sales may be implemented under several structures: outright trade sale, joint ventures or management buy-outs (MBOs) which may, in turn, include worker participation schemes. The corresponding chart in Annex 2 contains the criteria to choose between these different routes and structures for sale.

B6. Agree sale route and timing (investor search)

The basic steps that have to be followed to agree a sale route and structure are the following:

1. Review the objectives for each case
2. Review each case for sale route criteria (Flotation, private placing, trade sale structure)
3. On the basis of (1) and (2), identify the options for sale route and structure
4. Carry out a preliminary investor search to determine the level of interest
5. Agree sale route
6. Agree sale date

In assessing the timing for each sale, it should be taken into account that flotations and private placements require a longer time frame (4-6 months) because they need more rigorous preparatory requirements (eg. sale audits), and longer, more intensive promotional campaigns. Trade sales, on the other hand, require a shorter time frame (2-4 months) because less rigorous preparatory work is required and a more focused promotional campaign which normally involves invitations to tender. However, the negotiating process for trade sales might be lengthy.

B7. Preparation for privatization and divestiture

This is the last but very important step before the actual divestiture transaction takes place. The preparation stage can in turn be divided into three steps: (1) Documentation, (2) Promotional campaign, and (3) negotiating package.

Documentation. The documentation required to successfully complete a transaction includes:

- Articles of incorporation and supporting legal documentation.
- Financial Statements (audited for major sales and all flotations and private placements).
- Corporate charter, capital structure, employment terms and organization structure.
- Sales memorandum and company prospectus including a description of the business, financial information, terms of the offer, and criteria for qualification.

Promotional campaign. This involves advertising the offer for sale to targeted investors, appointing a public relations agency to write press releases, speeches, articles and design the campaign.

Negotiating package. All trade sales involve negotiations with the prospective investors. The negotiating process should be carefully prepared. This involves substantiating the valuation, having a range of values clearly derived from the different valuation assumptions, and agreeing the main trade-offs: sale price vs. employment levels, sale price vs. restructuring, sale price vs. strategy implementation. When enterprises have been readied for sale and the invitation to tender has resulted in bids, the General Manager will mobilize an ad hoc negotiating team to undertake the actual negotiations. The consultant firms will provide advice and support during this process. A suggested composition of the negotiating team is:

- Delegate from CORNAP's Junta General
- Delegate from the Corporation's Board

- Delegate from the enterprise's Board
- Delegate from the Ministry of Finance (for oversight)

The negotiating team should have a very clear understanding of the government's objectives, should be able to substantiate valuation, and should have the skills to argue and decide as regards the main trade-offs.

VI. ROLE AND ORGANIZATION OF CORNAP

A. CORNAP's Present Organizational Structure

The organization chart on Figure 2 shows CORNAP's present organizational and institutional structure.

CORNAP's mandate to 1) recommend strategies to the Government, 2) undertake privatization, 3) appoint the management of the corporations under its umbrella, and 4) provide them with policy direction and guidance, has produced internal confusion and competing demands on the time and energies of management and staff. Members of the Junta General and key members of CORNAP's staff simultaneously serve on the Boards of Directors of several corporations, and all the large conflicts within CORNAP's companies are brought to the attention of the Junta to resolve. The mandate to both privatize and operate the companies has a built-in conflict of interest in which management and staff become absorbed in the day-to-day problems and operations of the corporations and companies and are not free in terms of time or responsibilities to take a global view and undertake a disinterested process of strategic planning and divestiture.

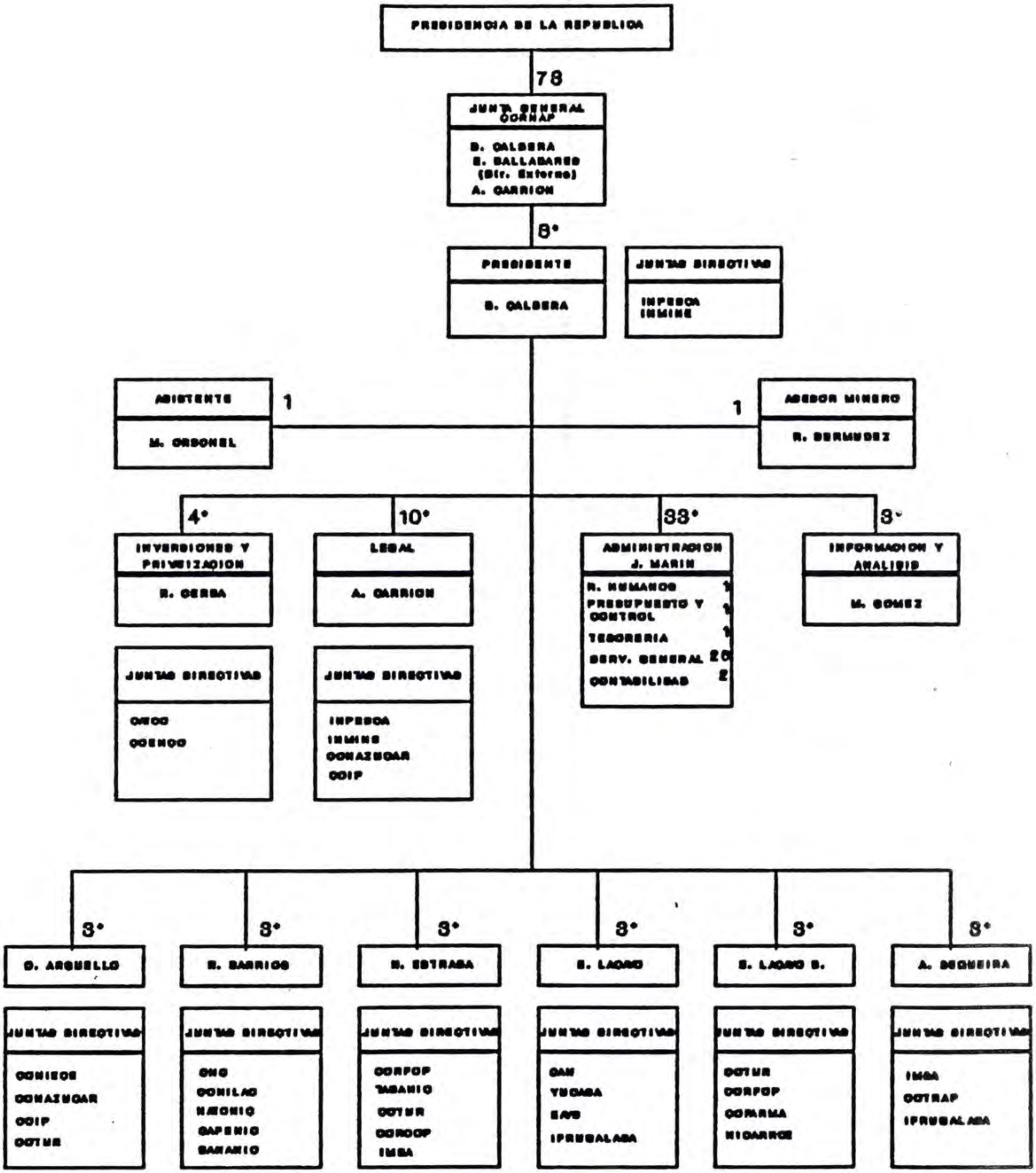
B. Separation of Privatization and Managerial Functions

The proposed solution to resolve this situation is to take all responsibility for day-to-day operations away from CORNAP and return these responsibilities to each of the corporations and their respective Boards of Directors. The Executive Director of CORNAP must be free to devote essentially all his time and energies to privatization. CORNAP would retain responsibility for appointing representatives to the Boards of Director and for appointing the Executive Presidents, but would ensure that no members of the Junta General nor staff of CORNAP would directly serve on the Boards. CORNAP representatives on the Boards would continue to report to CORNAP management and the Executive Presidents continue to serve at the pleasure of CORNAP. The consultant team believes this could be handled simply through internal regulation ("reglamento interno") of CORNAP.

C. Recommended Organization

The recent change in CORNAP management, specifically, the

PRESENT CORNAP ORGANIZATION



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appointment of the President of the Junta to serve as CEO, and the assignment of one of the Junta members to serve at CORNAP in part-time position, is considered to have had a very favorable and positive impact in the management of the organization.

In previewing the workload for the privatization process which will be carried out to a great extent by CORNAP's in-house staff, and after a review of CORNAP's current institutional structure and human resources, the consultants came to the conclusion that a second executive decision-maker is needed to back-stop the President of the Junta and to make operational decisions in his absence, by delegation or by fiat. This General Director position should carry the weight and authority that the other members of the Junta have in order to be an effective decision-maker. The consultants recommend the appointment of a highly qualified senior executive with all assurances made to the international agencies that the person appointed has significant technical expertise and personal prestige to assist in leading the privatization.

The General Director would be directly responsible for implementing the defined privatization strategy, monitoring political objectives, and coordinating all process activities, excluding agriculture. He would manage the in-house process and coordinate with the international consulting firms.

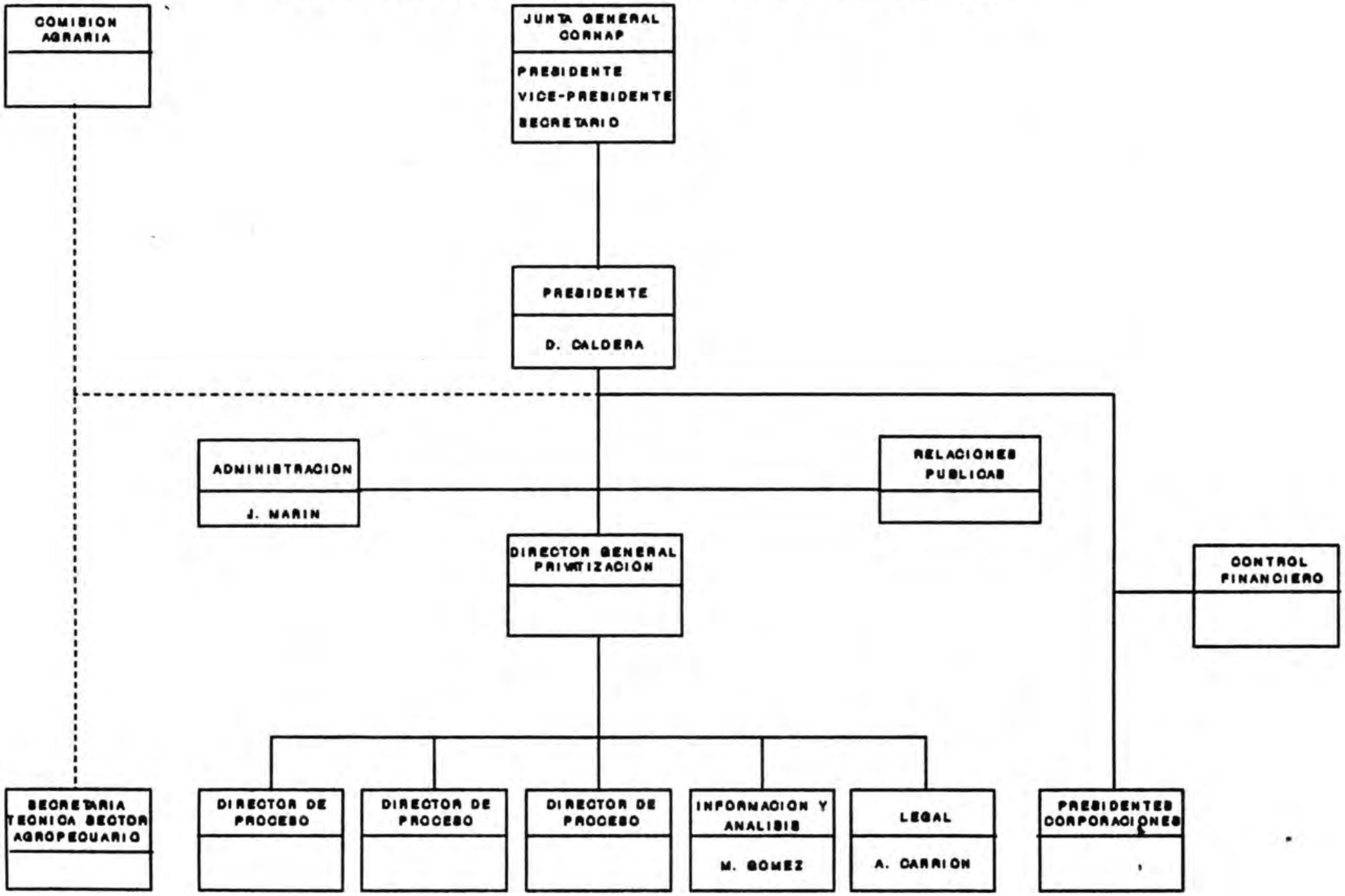
Reporting to the General Director would be several Process Managers. Each would be assigned groups of 5 to 10 enterprises on an activity sector basis and manage the total process for their divestiture. They will contract out locally the gathering and compilation of basic financial data, market studies, asset valuation and obtain legal assistance from CORNAP's legal department, which in turn may have to contract for outside legal assistance. In large scale divestitures, Process Managers would work with the consultant firms.

Appointment of Process Managers will require an increase in personnel. The current Investment and Privatization division would be eliminated and incorporated into the General Director's portfolio.

Most of the Process Managers will coordinate with international consultants. They would ensure the cooperation of the managements of corporations and of firms to be divested, and help the consultants with political and institutional issues and relationships. Also, they will work on a close basis with consultants, and ensure continual interchange of knowledge and activities so as to build in CORNAP a repository of expertise in privatization.

A recommended organization chart is shown on Figure 3. If political considerations make it impossible to separate the agricultural privatization process from CORNAP, this activity

PROPUESTA DE ORGANIZACION DE CORNAP



should be kept as an exclusively technical process advisory service, with responsibility for strategy and sales route to reside elsewhere in the government.

It is also recommended that an internationally experienced privatization consultant be made available to CORNAP immediately to advise on the early implementation of the in-house process until the first international consulting firm is in place, which may not be until March or April.

The role of consultants is to build consensus at every decision-making point with relevant decision-makers. This necessarily implies the involvement of the Junta Directiva of Corporaciones at each stage. All decisions will be recorded with supporting documentation. Consultants will be working for CORNAP; thus, their responsibility to corporations is secondary.

E. Public Relations Support

Establishment of an effective public relations and awareness program should be started as soon as possible with the initial goal of educating the public on the well-known benefits of privatization and to alleviate any perception that privatization will cause massive unemployment. The public should be kept informed of progress during the process. Press releases announcing the intention to privatize specific firms should be sent to the media as soon as tranches of firms have been readied for privatization. Also, to help maintain transparency during the process, actual sales should be announced. A full-time public relations advisor should be appointed, reporting to CORNAP's president. In addition to managing the public awareness campaign through media he would be speech-writer and spokesman. Terms of reference for the contracting of a public relations adviser are included in Annex 4.

F. Information Strategy

Information systems at all enterprises, with few exceptions, are extremely poor. Some enterprises have microcomputers which are mostly used to carry out isolated tasks like payroll preparation or to register inventories. Most accounting and financial tasks are carried out manually with large delays and scarce analysis. There are no integrated managerial information systems.[1]

Relatively isolated and partial information is flowing to

[1]. Portocarrero, Emilio, Aspectos preliminares para el diseño de un sistema de control financiero en las empresas de CORNAP, U.N.D.P., Project, NIC/90/006, Managua, Nicaragua, 22 November, 1990.

CORNAP. In fact, the difficulties the consultants encountered to analyze sectoral priorities and group enterprises according to the screening criteria for privatization, emerged mostly from the poor quality and unreliability of information.

Consistent with the view of assigning to CORNAP as its overriding priority making progress in the process of privatization, a strategy was developed to generate the information the privatization process requires as an input. The consultants are aware that information systems within enterprises are poor and that this poses a serious problem for the management of the enterprises and for the control and monitoring functions of the corporations. However, the investment required to implement managerial information systems in most enterprises and consolidated results by corporations, although important for the country as a whole, is considered much beyond the requirements of the privatization process. Additionally, privatization will imply either the disappearance or major restructuring of most corporations in the medium term, and it does not seem justified to make major investments in information systems under the present corporate structures.

However, good quality and reliable information on all the candidates for privatization is required at two critical conjunctures during the privatization process: at the initial screening stage and during the preparation stage.

A major centralized effort must be made to gather the basic data required for these two stages and throughout the process. It is envisaged that an Information Processing Manager (IPM) be appointed at CORNAP in charge of coordinating the basic data gathering for <u>all</u> the enterprises prior to the arrival of the general and sectoral consultants. The IPM (preferred profile: high level accountant with extensive experience with computerized accounting softwares) at CORNAP will have a systems analyst and a programmer as technical support. They will collect and organize the information in the way and with the resources explained below. (See also Annex 3).

<u>Compilation of a comprehensive database</u>.

As explained, the screening and planning process involves separating first and second module enterprises, and then prioritizing enterprises within each module. Screening and planning activities require compilation of the following basic information:

<u>Basic financial information</u>: Profit and loss accounts, balance sheets, cash flows, production volumes, and ideally in large enterprises, breakdowns of profits and sales by product group.

<u>Legal documents and status</u>: articles of constitution, company books, shareholders list, availability of shares, registration,

pending legal cases, existence of previous owners' claim.

Operational information: tangible fixed assets, market positioning, restructuring needs, overmanning levels, etc.

The preparation stage also requires this basic information but with complete reliability and certainty, because it will be used in the sales memorandum and the prospectus that will be distributed to prospective buyers.

Information strategy for first module (Small enterprises).

Available information permitted the consultants to obtain a preliminary list of companies that on a first examination meet the criteria for first module processing. However, the data should be validated and examined in more detail. The information gathering process proposed for small enterprises is that each of the Process Managers (PM), supported by the team of accountant-valuation or expert-lawyer for each enterprise, will assume the responsibility of validating and collecting the information on the group of enterprises assigned to him, not only for final screening, but also for preparation for privatization and prospectus writing. In the task of centralizing and organizing the information he will receive the support of the Information Processing Manager. Each PM should count with one PC to organize and centralize the database of the companies he/she is responsible for privatizing.

Information strategy for second module. (Large enterprises/sectors).

The Information Processing Manager will be in charge of two parallel and related processes as regards large enterprises:

1. Data compilation for the sectoral/enterprise screening and planning job to be developed by the consultancy firm expected to arrive in April. A comprehensive database should be developed before the arrival of this firm. In gathering the information the IPM will use the resources of the corporations. The information will be organized in a centralized database at CORNAP. Assuming that the second module includes approximately 200 enterprises, the database for these 200 enterprises can be built and stored using 5 PC-ATs, each one dedicated to 40 enterprises. (See details and costs in Annex 6).

2. Data compilation and improvement for business review, valuation and preparation for sale. For this task CORNAP will target 30 large enterprises to develop a computerized Management Information System (MIS) on each of them. This task will be accomplished by two on site accountants on each enterprise for a maximum of three months financed by the

international organizations. These accountants will have a dedicated PC-AT also financed by international organizations. If, at the discretion of CORNAP, this job can be better accomplished within the same total budget, by consultancy firms that develop the MIS for several enterprises at a time, then this second course of action could be taken.

The information strategy described has an estimated total cost of US $ 540,750 including the hardware, and personnel for the first year. (Annex 6)

The use of the database for financial control purposes.

CORNAP's authorities have insisted on the need for an information system that allows flexible monitoring of the performance of corporations and enterprises. The consultants consider that a full holding company information system is an inappropriate investment at the present time for the reasons stated above. However, the database described above, built primarily to satisfy the information requirements of privatization, can be used for performance monitoring, particularly as regards the 30 enterprises targeted for the establishment of a MIS. It is recommended; however, that the responsibility for the use of this information for performance evaluation purposes be assigned to separate personnel within CORNAP, and not to the Information Processing Manager and his/her team, who should be 100% devoted to the improvement and use of the database in support of privatization activities.

G. Training

The process of privatization entails a large amount of in-house work within CORNAP, it is also convenient that the local experts share a common framework on how their different techniques fit into the overall process of privatization and that they develop a sense of team effort. For these reasons the following training activities are envisaged in the project:

1. A one day workshop on the Nicaraguan Privatization Process Flow to take place in January 1991. This workshop will cover in detail the material included in Chapter IV of this report and the Flow Charts of the Appendix. The target group will be CORNAP's staff and Corporations' staff who will be directly or indirectly involved in the privatization process. It is recommended that other similar workshops be later carried out with other target groups not as training but as public relations exercises to communicate the government's privatization strategy to different sectors.

2. Training on valuation techniques. This will best be achieved

by a one month visit to CORNAP by a valuation expert who will support the valuation process of the small businesses, will develop a few examples of different techniques using Nicaraguan examples, will prepare a dossier with relevant materials on valuation techniques, and will prepare at least one workshop to give systematic training and discuss the valuation issues that the progress of the process had posed so far. This visit should take place during February 1991.

3. Seminar on Privatization Techniques. This is a one week seminar in which different topics relevant for privatization will be covered by specialists with wide experience on their respective subjects. The main topics to be covered in this seminar will be: Privatization methods, sale schemes, worker participation schemes, international case (enterprise/sector) studies of privatization, techniques for preparing business and sector reviews, preparing sale brochures and prospectuses.

   The estimated cost of this component is US$ 61,000.

VII. SUPPORTING INSTITUTIONS AND ACTIONS FOR THE PROCESS

A. Private Financial Institution

As soon as the national financial system has been overhauled, a regulatory framework and Superintendency of Banks are in place, and a law permitting private financial institutions has been passed, donor agencies should consider the establishment and financing of a private investment corporation. Its initial purpose would be to help finance buyers of SOE's and credit lines would be provided for this purpose. Later the institution would also finance investments with an export orientation.

B. Foreign Investment Promotion Agency

Donor institutions should consider the establishment of a foreign investment promotion institution, patterned after CINDE in Costa Rica. Initially, it could be limited to investment promotion geared to attract buyers for SOE's and to provide technical assistance in industrial restructuring and reconversion. Later, it could expand into new investment and also export promotion. This agency could be funded through annual donations by donor institutions or by larger donations into an endowment or trust designed to provide continuing operating income for the agency.

The agency would establish one person promotional offices in three or four cities in the USA, and one or two in each of Europe and the Far East. As in the case of CINDE, for industrial restructuring it could use volunteer experts from organizations such as the International Executive Service Corps and similar organizations in Canada and Europe.

C. Separation Allowances

Out of about 78,000 workers in CORNAP's enterprises, a roughly estimated 30% or about 20,000 are redundant. To facilitate the privatization process by providing for satisfactory separation allowances for redundancies, the consultants recommend establishment of a fund to pay these allowances. The program could initially be based on voluntary separation, followed by negotiated packages to reach desired levels. Six months wages might be an acceptable average, requiring about $12 million in total.

D. Debt Restructuring and/or Write-Off

In many divestiture cases, a need for financial restructuring, including long-term debt write-off, can be anticipated in order to make an enterprise saleable.

The donor institutions should consider some manner of funding debt restructuring and/or write-off. One possibility would be for the donors to fund the purchase of public sector foreign debt and donate the face value to the GON, conditioned on it being applied to write-off long-term debt of CORNAP's enterprises. Another possibility is to fund the economic cost of restructuring the debt.

E. Debt for Assets Swaps

Foreign debt for public sector asset swaps at a discount off face value might be acceptable to the GON, according to the Finance Minister, if it were accompanied with a credit line from the bank selling the debt.

F. Trust Fund

If and when no buyers for one or more significant enterprises can be found who are willing to pay a reasonable price, because of extensive restructuring needs or other problems, the creation of a private sector trust, patterned after FINTRA in Costa Rica, could be considered. The trust would take over the full management of the enterprise in trust for the GON, restructure it operationally and financially, and then sell it on behalf of the GON.

VIII. IMPLEMENTATION OF THE PRIVATIZATION PROGRAM[2]

To initiate the privatization process, substantial financial resources and consultancy services are needed. The entire privatization process has been designed in outline as described above. The first phase has been designed and costed out in detail,

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[2] The implementation plan in chart form is included as Annex 2.

and the first steps have been taken. The second phase has been outlined with indicative costs; detailed terms of reference and costs for the second phase will be prepared during the first phase. Indicative costs for the second phase are high, these costs are expected to be lowered as more data on the companies and their financial situation become available.

CORNAP staff is capable of the umbrella management of the entire privatization process. The organizational structure of CORNAP is to be left purposefully flat and small (a total of 8-10 key professionals) to promote task-oriented management and a joint collaborative approach between CORNAP professionals and the consultant firms' staff. CORNAP staff will be supported by ad hoc training programs explained elsewhere in this document.

PHASE I: Planning and Privatization of First Small Companies

The Privatization Program can begin immediately by CORNAP staff without outside assistance. The first steps in identifying and quantifying objectives have already been taken. CORNAP staff can begin to collect data and information on the small companies identified as first-tier candidates for privatization. CORNAP will proceed to begin public international bidding procedures in accord with IDB requirements, which is expected to provide initial funding for a high level consultant firm of international reputation and substantive experience in privatization program planning. The terms of reference for 4 months work of the consultant firm in detailed planning and program preparation are attached as Annex 4 to this document. The consultant firm together with CORNAP staff will continue data collection and detail the entire privatization process, including terms of reference for the second module of program implementation.

The task force (AID, BID, UNDP) which developed the overall strategy had hoped to accomplish sector prioritization. However, unavailability of data, and unreliability of that which was available, made this imprudent. Therefore, an international consulting firm should be contracted to undertake the financial analyses and data compilation necessary to prioritize sectors and needed by sector consultants to implement privatization, define final sector selection and write the terms of reference for contracting out the privatization process for each sector. In undertaking this task, the consulting firm would be required to sub-contract to local accounting firms to the extent possible and practical.

During implementation of the first module (January-July 1991) CORNAP will collect data and sell the first small companies, work with the consultant firm in the design of the second module and undertake begin the following process support activities:

Initiate the Public Relations Component
Initiate the In-House Staff Training Component
Install the Management Information System
Initiate contracting consultant firms for the second module

PHASE II: Implementation of the Entire Program

During the first phase the priority sectors and terms of reference for consultant firms to undertake strategy for each of the sectors will have been prepared. Phase II of the program will be implementation of each of the estimated 30 sector and sub-sector strategies. (A list of the sectors is attached as Annex 5)

After completion of sector prioritization and terms of reference, international consulting firms with privatization experience should be contracted for the development of sector-specific strategies and the subsequent privatization of all companies in the sector, in order of sector priority. This will include the whole process from financial review and cleanup, through valuation, determining pre and post privatization restructuring potential, prospectus and tender document preparation, marketing and assisting in negotiations with potential buyers. Each consulting firm will in effect be its own project manager.

Several sector strategies can be done simultaneously. About two-thirds of the estimated strategies will need to be done by outside consultant firms; the smaller sector and sub-sector strategies can be done in-house by CORNAP staff with the assistance of outside auditors, lawyers and specialists/experts hired in Nicaragua or neighboring countries in Central America.

The rapidity with which Phase II is executed will be increased by working on several sectors at the same time; however, none of the companies should step out of their place in line for sector analysis which would undermine the logic of the process.

Promotion Campaign

The promotional campaign for the sale of the small scale enterprises can be handled in-house by project managers under the guidance of the Public Relations Advisor. It involves the preparation of press releases, holding of press conferences and writing and advertising invitations to tender. The cost of the campaign is basically the cost of the advertising. This can probably be limited to two advertisements for each enterprise to be sold in each of the three local newspapers and in the principal newspapers of communities in the USA and elsewhere with sizable Nicaraguan populations.

For the larger enterprises, the promotional campaign should be contracted with an international public relations agency. In these cases, in addition to advertising in the aforementioned newspapers used for small enterprises, articles and press releases announcing their forthcoming sale would be sent to principal international financial publications such as the Wall Street Journal, Journal of Commerce and London Financial Times, followed up with announcements of invitations to tender.

"Watch-Dog" Commission

One of the consultants of the team recommends the appointment of a watch-dog commission which on an exception basis is triggered into action if and when serious claims of impropriety or conflict of interest arise.

IX. BUDGET AND FINANCIAL REQUIREMENTS

A. Cost

The full cost of Nicaragua's privatization program has been roughly estimated in order to give GON authorities a general idea of the order of magnitude for implementing a full privatization program. The full cost of the Privatization Program is approximately US$18.9 million, divided as follows:

Phase I - Planning & Initial Implementation	$ 1.6 million
Phase II - Full Implementation	$11.4 million
Support Activities	$ 5.9 million
Total:	$18.9 million

The costs for Phase I and Support Activities are relatively accurate. The cost for Phase II are subject to refinement and are most likely to be reduced as further data and information on the companies become available. The cost estimates are detailed in Annex 6. Costs for parallel activities such as technical assistance and loan resources and separation allowances for workers are not directly CORNAP costs, but rather correspond to agencies outside CORNAP. A rough estimate of $62 million for these activities would be additional to direct costs.

B. Packaging

The privatization Program has been divided into packages to make it easier for the financing agencies involved (initially IDB, UNDP and USAID) to fund one or more packages. Not all packages need assured funding at the beginning of the program. Funding for some of the packages can be sought on a rolling basis at later dates, as costs are more accurately defined.

The Privatization Program has been divided into the following costs packages:

Cost Packages for Phase I

Interim Consultant (One person for up to 6 months to continue planning process until consultant firm arrives)

Consultant Firm for Planning and Initial Implementation (one package)

Independent Accountants and Auditors (This package can be subdivided into several contracts).

Cost Package for Phase II

30 Sector and Sub-Sector Strategies (This can be subdivided in up to 30 packages)

- Approximately 20 strategies/divestiture packages will go to international consultant firms. The sectors will include those of major economic impact and those which have major accounting requirements and/or require special marketing techiques or technical expertise for valuation. The contracts could be bunched for international bidding purposes.

- Approximately 10 strategies/divestiture packages can be prepared directly by CORNAP with the assistance of local and Central American auditors, accountants and sectorial specialists.

Individual Cost Packages for the First Two Years Implementation Period

Management Information System

Training Program

Public Relations Program

Privatization Advisor

Promotional Campaign

Printing Expenses

Equipment (vehicles, copying and facsimile machines, telephones)

The IDB, in principle, and subject to approval of its management and Board of Directors would be willing to consider financing of approximately 3.0 million The financial participation of USAID and UNDP are not known as yet and it is recommended that coordination and agreement for full financing immediately take place. Additional financing will be required from other outside sources and should be sought by GON.

C. Timing

Figure 4 presents a process-flow schedule for 1991.

The Government of Nicaragua is understandably anxious to demonstrate effective privatization as soon as possible. The strategy takes the need for immediate and demonstrable success into account by including a list of first candidates for immediate privatization. These are small companies with a maximum of $100,000 sales and a sales asset ratio of 0.25. This list of 22 companies is presented as candidates for first tier privatization and included in Annex 5.

The list of first companies to be privatized has been limited to smaller companies for two very specific reasons: the companies can be handled by CORNAP without outside additional assistance (except perhaps for some auditing work that can be contracted out in-country); and, importantly, CORNAP staff needs to develop operational experience and work through procedures, before proceeding to the larger enterprises.

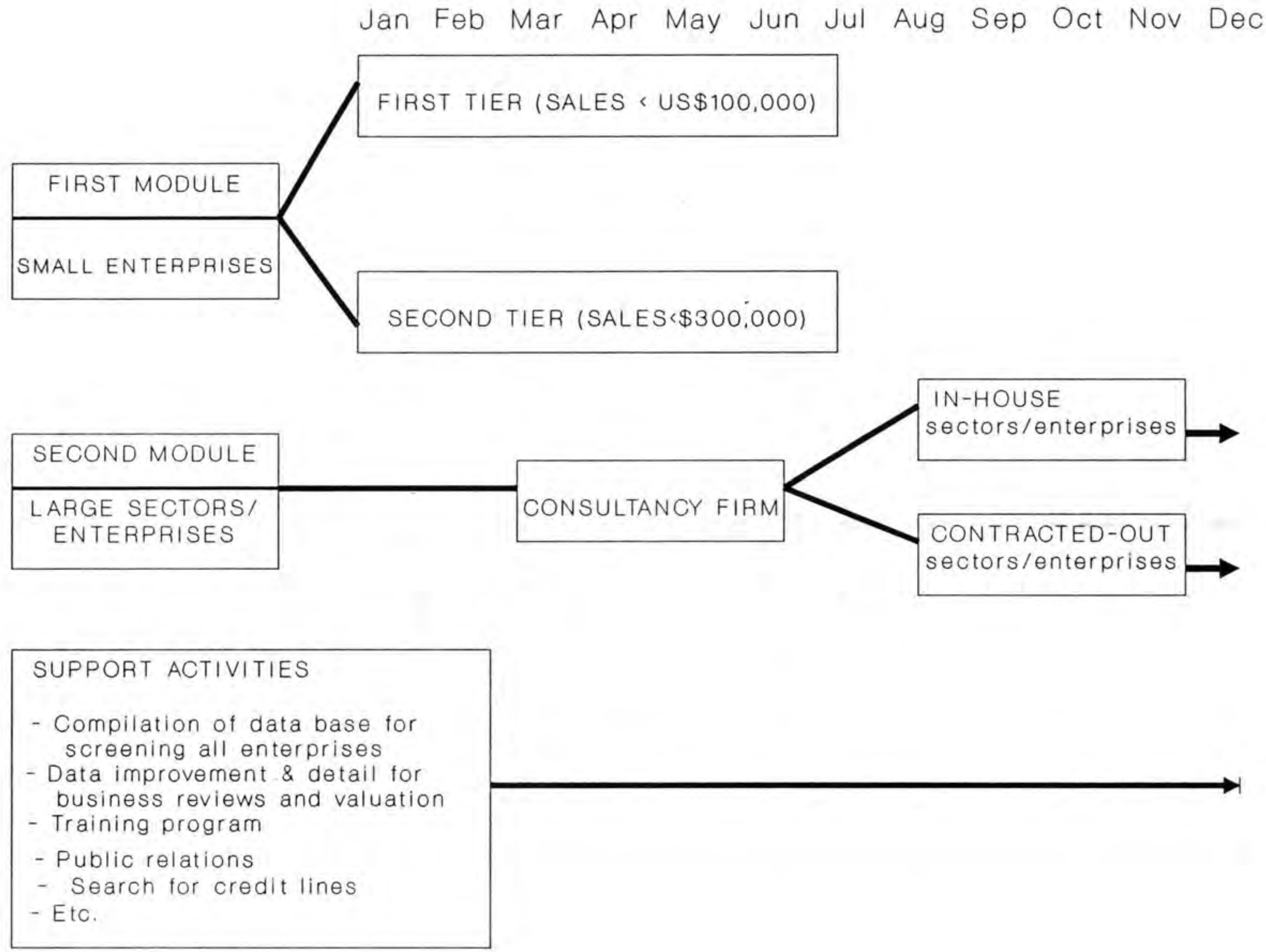
The time estimated for CORNAP to undertake all of its first phase activities, which include initial small company privatization, completing the planning process, negotiating international funding for the whole program, and collecting and preparing the necessary data to understand the companies' current financial status and assets, is six months. Moreover, a commercial banking system is critical to privatization, and it is estimated that a commercial banking system will not be in place before June 1991.

X. ISSUES AND VIABILITY

A. Credibility and Integrity of the Process

The strategy, as designed, will ensure credibility and confidence in CORNAP and position the organization as a neutral and technical entity in service all of the people of Nicaragua. However, the process can be easily undermined by political pressure.

FIGURE 4
NICARAGUA: PROCESS FLOW SCHEDULE SYNTHESIS, 1991



The proposed plan for the privatization process will ensure credibility and integrity because it is designed to be completely data-driven which means that at every step of the way CORNAP and the Government can show exactly how and why a sale is being structured the way it is. Once the objectives are set (and the objectives can include political objectives) the process of careful step-by-step procedures for examining the enterprises and developing a sector strategy cannot be violated.

In the short-term, and especially at the beginning of the process, political pressure is to be expected. For this reason a public relations component has been included to manage relations with the press and special interest groups, and CORNAP top management will receive training in public presentations, speech making, etc. In the long-term; however, the benefits of strict adherence to a methodical process will far outweigh political expediency and will strengthen CORNAP's reputation, its credibility in recommending strategies to Government and its negotiating position with buyers.

B. Banking Services

A necessary adjunct to the privatization process is the establishment of commercial banking services in the country. Banking services are expected to be established by June 1991 which would be in sufficient time for the majority of the firms to be privatized under the proposed strategy. Between now and the time a viable commercial banking system is restored in the country a number of services for the privatization process will be required such as checking account services, letters of credit, etc.

The Central Bank has been functioning as a commercial banking service. CORNAP will have to confirm that the commercial banking services required for the privatization process will be provided by the Central Bank or how ad-interim banking services will be handled.

C. Assistance to Workers

Privatization has generated interest among workers in obtaining companies. To date workers groups addressing their interests to CORNAP have made poor and unbusinesslike presentations, usually without knowledge on possible options for purchase and skill in negotiating with CORNAP.

It is recommended assistance be provided to workers groups (including cooperatives and syndicates) on how to prepare a business plan, options for purchase and assistance in negotiating with CORNAP. This technical assistance could take the form of an office established in Managua which would be open to any and all workers' groups on a first come-first serve basis. The costs of establishing and manning the office could well be borne by bilateral donors such as the Scandinavian countries and Germany, which have experience in worker-ownership programs. NORAD (Norway) and GTZ (Germany) have both been informally approached by the IDB and are interested; other bilateral assistance donors should be approached as well. In funding an office for assistance in worker ownership in principle it would be better not to involve the three agencies that are funding CORNAP as the seller of companies to avoid conflict of interest.

Loan funds for worker buy-outs will also eventually be required. A loan fund of US$10 million could assist workers in the financing of their purchase of companies. It is recommended the Government of Nicaragua independently seek financial assistance apart from the funding of the CORNAP privatization program, for a workers buy-out fund.

D. <u>OTHER DIVESTITURE CANDIDATES</u>

The privatization strategy and process described in this paper was designed principally with CORNAP in mind. However, they are equally adaptable to non-CORNAP enterprises and institutions. The consultants recommend that privatization, full or partial, be considered for the following, among others:

- Telecommunications
- Energy
- Health care and related support services
- Road construction

ANNEXES:

1. Presidential Decree No. 7-90 (extract)
2. Privatization Process Flow
3. Information Strategy
4. Terms of Reference
5. CORNAP's Enterprises
6. Budgets

ANNEX 1. PRESIDENTIAL DECREE NO. 7-90

Decreto Ley No. 7-90

Ley de Creación de la Junta General de Corporaciones Nacionales del Sector Público

El Presidente de la Republica de Nicaragua, en uso de sus facultades,

DECRETA:

Arto. 1 Adscrita a la Presidencia de la República, se crea la Junta General de Corporaciones Nacionales del Sector Público (CORNAP), la que en el texto de este Decreto se designa simplemente como la Junta General.

Arto. 2 La Junta General estará integrada por tres miembros nombrados por el Presidente de la República, quienes ejercerán los cargos de Presidente, Vicepresidente y Secretario.

Arto. 3 La Junta General tendrá las siguientes funciones y facultades:

a.— Proponer al Presidente de la República las áreas y políticas de actividad económica en que deba existir y desarrollarse la función empresarial del Estado.

b.—De conformidad con tales políticas, autorizar los actos jurídicos, no judiciales o legislativos, de privatización de las Corporaciones, sus empresas y activos.
No se consideran actos de privatización los actos de disposición realizados en el giro normal de la activi-

dad que constituye el objeto de la corporación o empresa.

c.— Dictar las políticas que deban regir las relaciones entre corporaciones estatales en lo concerniente a sus ámbitos de acción, y aprobar lineamientos de políticas general aplicables a las distintas corporaciones.

d.—Designar a los representantes del Estado en el organismo de dirección superior de las corporaciones del sector público y nombrar a su principal Ejecutivo, con el cargo de Presidente Ejecutivo.

e.—Informar al Presidente de la República sobre la situación de las corporaciones del sector público, y ser el órgano de comunicación entre ellas y la Presidencia de la República.

f.— A través de uno de sus miembros, representar a las corporaciones del sector público en los organismos del Estado donde esta representación estuviese estipulada.

g.—Las demás que le asigna el presente Decreto, en especial, las referidas en los artículos 8, 9 y 10, inclusive, más no limitado a, las facultades que las diferentes leyes de empresas asignaban a los ministros en cuanto a creación, modificación, fusión y disolución de empresas.

Arto. 4 La Junta General sesionará al menos dos veces cada mes. La Junta General podrá asistirse en sus sesiones con las personas que considere conveniente.

Arto. 5 Las resoluciones de la Junta General serán válidas cuando sean tomadas al menos por dos de sus miembros, en reuniones válidamente convocadas, según el Reglamento Interno que la misma Junta emita.

Arto. 6 El Secretario de la Junta General deberá levantar acta de cada sesión y remitirla al Presidente de la República, debidamente firmada por los miembros asistentes, a más tardar, 72 horas después de finalizada la sesión.

Arto. 7 La Junta General contará con un Consejo Consultivo conformado por los Presidentes de Consejos o Juntas Directivas de Corporaciones. La Junta en pleno sesionará con dicho Consejo Consultivo al menos una vez cada mes. Las resoluciones de la Junta General deberán hacerse del conocimiento del Consejo.

Arto. 8 Se transfiere a esta Junta General la relación de adscripción y se le confieren todas las facultades que las siguientes leyes otorgan al Ministro, Ministerio e Instituto a que éstas se refieren, así como las que, correspondiendo al Presidente de la República según tales leyes, éste delegare:

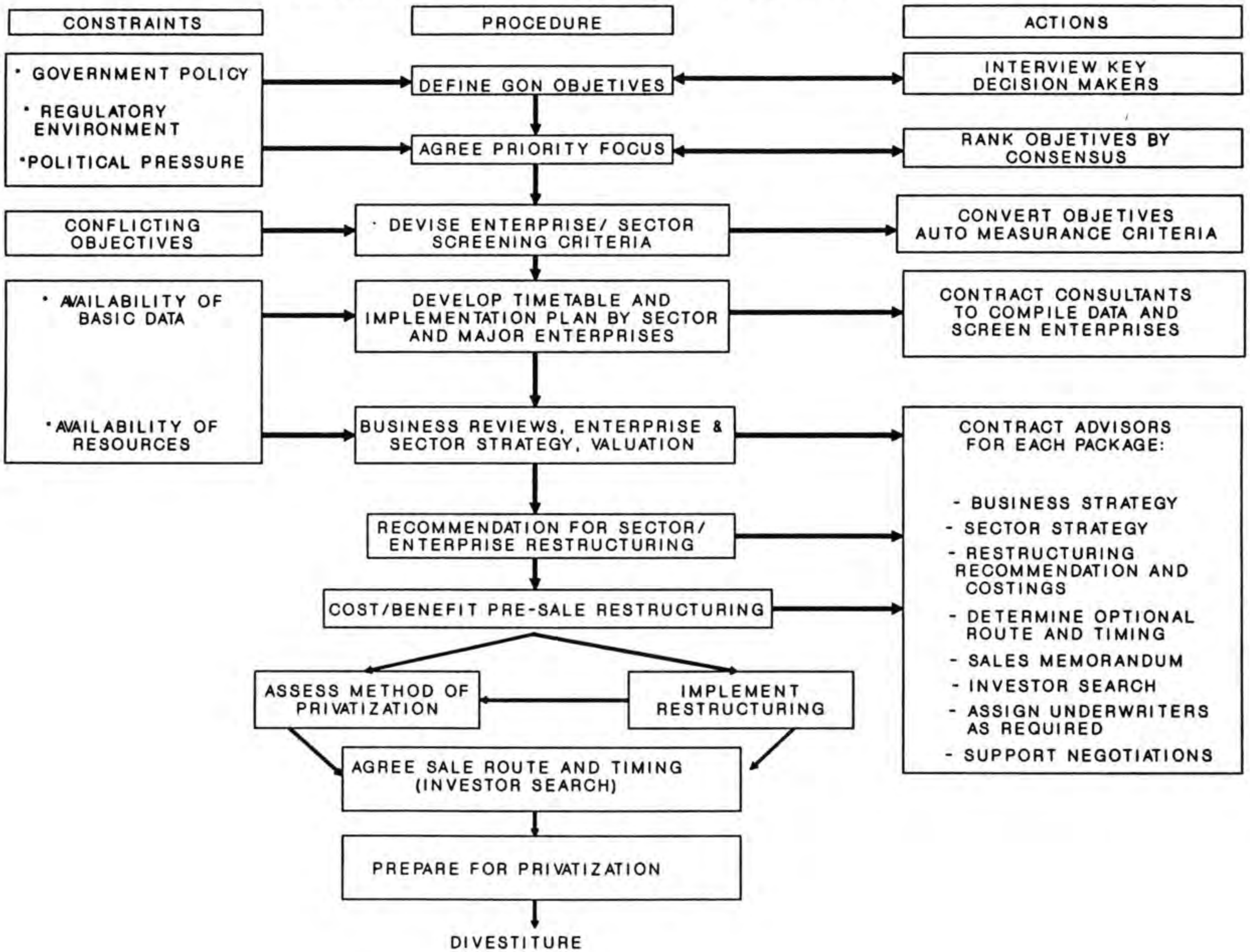
ANNEX 2. PRIVATIZATION PROCESS FLOW

NICARAGUA

PRIVATIZATION PROCESS

FLOW CHARTS

PRIVATIZATION PROCESS FLOW: NICARAGUA



NICARAGUA: PRIVATIZATION
IDENTIFYING GOVERNMENT OBJECTIVES

MACRO OBJECTIVE	SECTOR-SPECIFIC OBJECTIVES	ENTERPRISE-SPECIFIC OBJECTIVES
• INCOME FROM SALE OF BUSINESSES	• STRENGTHEN MARKET COMPETITIVENESS	• IMPROVE PERFORMANCE
•REDUCE SIZE OF PUBLIC SECTOR	• REDUCE DEPENDENCE ON GOVERNMENT SUPPORT	• REDUCE DEPENDENCE ON GOVERNMENT SUPPORT
• PAYMENT OF FOREIGN DEBT	• BROADEN PRIVATE SECTOR PARTICIPATION	• RELIEVE PUBLIC SECTOR FINANCIAL AND OPERATIONAL CONSTRAINTS
• PROMOTE WIDER SHARE-OWNERSHIP	• ATTRACT FOREIGN INVESTMENT	• ACCESS TO PRIVATE SECTOR INPUTS
DEMONSTRABLE PRIVATISATION SUCCESS	• CONTROL LEVEL OF JOB LOSSES	
	• IDENTIFY OPPORTUNITIES FOR EMPLOYMENT CREATION	

↓

ACTION STEPS:

- DEVELOP QUESTIONNAIRE
- SET UP INTERVIEW PROGRAM TARGETING KEY DECISION-MAKERS
- AGREE BASIS FOR COLLATING AND PRIORITIZING OBJECTIVES
- DEFINE MEASURABLE CRITERIA FOR IMPLEMENTING AGREED OBJECTIVES

NICARAGUA: PRIVATIZATION
IDENTIFYING GOVERNMENT OBJECTIVES

INTERVIEW PROGRAM

. VIOLETA CHAMORRO	**PRESIDENT OF THE REPUBLIC OF NICARAGUA**
· DAYTON CALDERA	PRESIDENT CORNAP
· ROGER CERDA	DIRECTOR PRIVATISATION CORNAP
· SILVIO DE FRANCO	MINISTER OF ECONOMY AND DEVELOPMENT
· ERNESTO BALLADARES	VICE-PRESIDENT, CORNAP
· FRANCISCO ROSALES	MINISTER OF LABOUR
· RAUL LACAYO	PRESIDENT OF THE CENTRAL BANK
· ALFREDO CESAR	FIRST SECRETARY, DELEGATE ASSEMBLY
· MYRIAM ARGUELLO	PRESIDENT ASSEMBLY
· SERGIO RAMIREZ	OPPOSITION PARTY LEADER
· LUCIO JIMENEZ	OPPOSITION UNION LEADER
· JAIME ICABALCETA	MINISTER CONSTRUCTION & TRANSPORT
· DUILIO BALTODANO	ATTORNEY GENERAL
· VICTOR TIRADO	MINISTRY OF DEFENCE
· DANIEL NUNEZ	OPPOSITION AGRIC. COOPS LEADER (UNAG)
· DANIEL FAJARDO	INDUSTRIAL STATE HOLDING, EXECUTIVE-PRESIDENT
· ALEJANDRO CARRION	SECRETARY, CORNAP

15

OBJETIVOS DE LA PRIVATIZACION

A. **Indicar los cinco objetivos más importantes clasificándolos de 1 a 5 para el corto y para el largo plazo.**

OBJETIVOS	PRIORIDAD CORTO	PRIORIDAD LARGO
-Obtener ingresos por medio de venta	----	----
-Reducir déficit fiscal	----	----
-Eliminar subsidios	----	----
-Reducir tamaño del sector público	----	----
-Reducir los gastos públicos	----	----
-Mejorar eficiencia por sector y/o por empresa	----	----
-Aumentar el ingreso de divisas	----	----
-Pagar la deuda externa	----	----
-Atraer inversión privada	----	----
-Atraer inversión extranjera	----	----
-Desarrollar el mercado de capitales	----	----
-Incrementar la participación del sector privado	----	----
-Creación de empleo/controlar pérdidas puestos de trabajo	----	----
-Aumentar la competencia en los mercados	----	----
-Deshacer monopolios	----	----
-Demostrar éxito (criterios para medirlo)	----	----
-Democratización de bienes de capital	----	----
-Distribución de acciones a trabajadores	----	----
-Distribución de acciones a pequeños propietarios	----	----
-Priorizar las clases de accionistas	----	----

B. **Sectores prioritarios para la privatización.** Clasificar de 1 a 5
Cuáles son los sectores prioritarios de reestructuración que se puede lograr mediante la privatización?

-Agroindustria	---
-Agricultura	---
-Forestal	---
-Pesca	---
-Ganadería	---
-Minas	---
-Construcción	---
-Transporte	---
-Comercio interior	---
-Comercio exterior	---
-Metalmecánico	---
-Textil	---
-Químico	---
-Turismo	---

NICARAGUA: PRIVATIZATION

PRIORITISATION OF OBJECTIVES

* PRIVATIZATION OBJECTIVES FALL INTO TWO CATEGORIES:

<u>SHORT TERM</u>

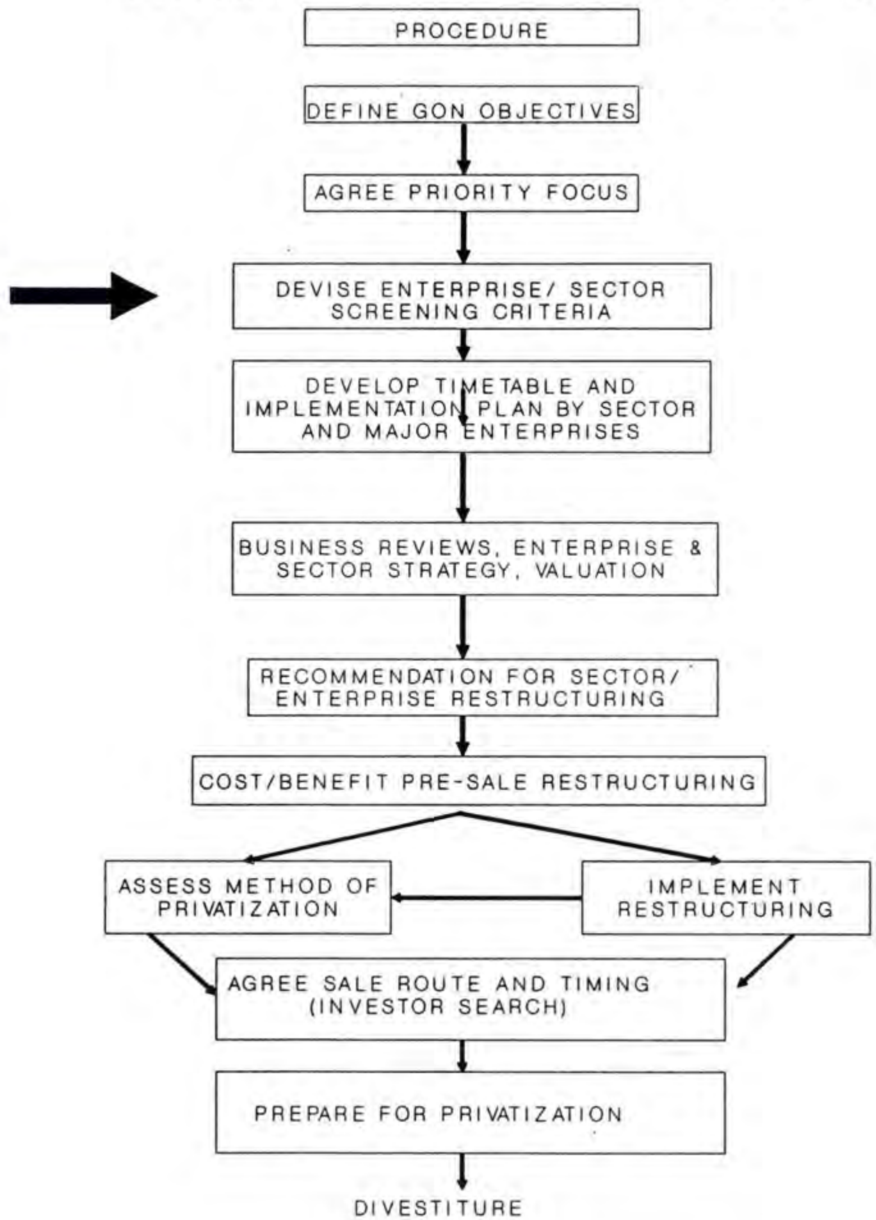
* DEMONSTRATE EARLY PRIVATIZATION SUCCESS
* OBTAIN REVENUE FROM EARLY SALES

<u>LONG TERM</u>

* OBTAIN REVENUE FROM SALE OF BUSINESSES
* ATTRACT PRIVATE SECTOR/ INVESTMENT (DOMESTIC AND FOREIGN)
* IMPROVE EFFICIENCY OF ENTERPRISES AND PERFORMANCE OF SECTORS
* SPREAD OWNERSHIP
* CONTROL JOB LOSSES/ IDENTIFY OPPORTUNITIES FOR EMPLOYMENT CREATION

* DEVISE CRITERIA FOR SCREENING ENTERPRISES TO ACHIEVE OBJECTIVES

PRIVATIZATION PROCESS FLOW: NICARAGUA



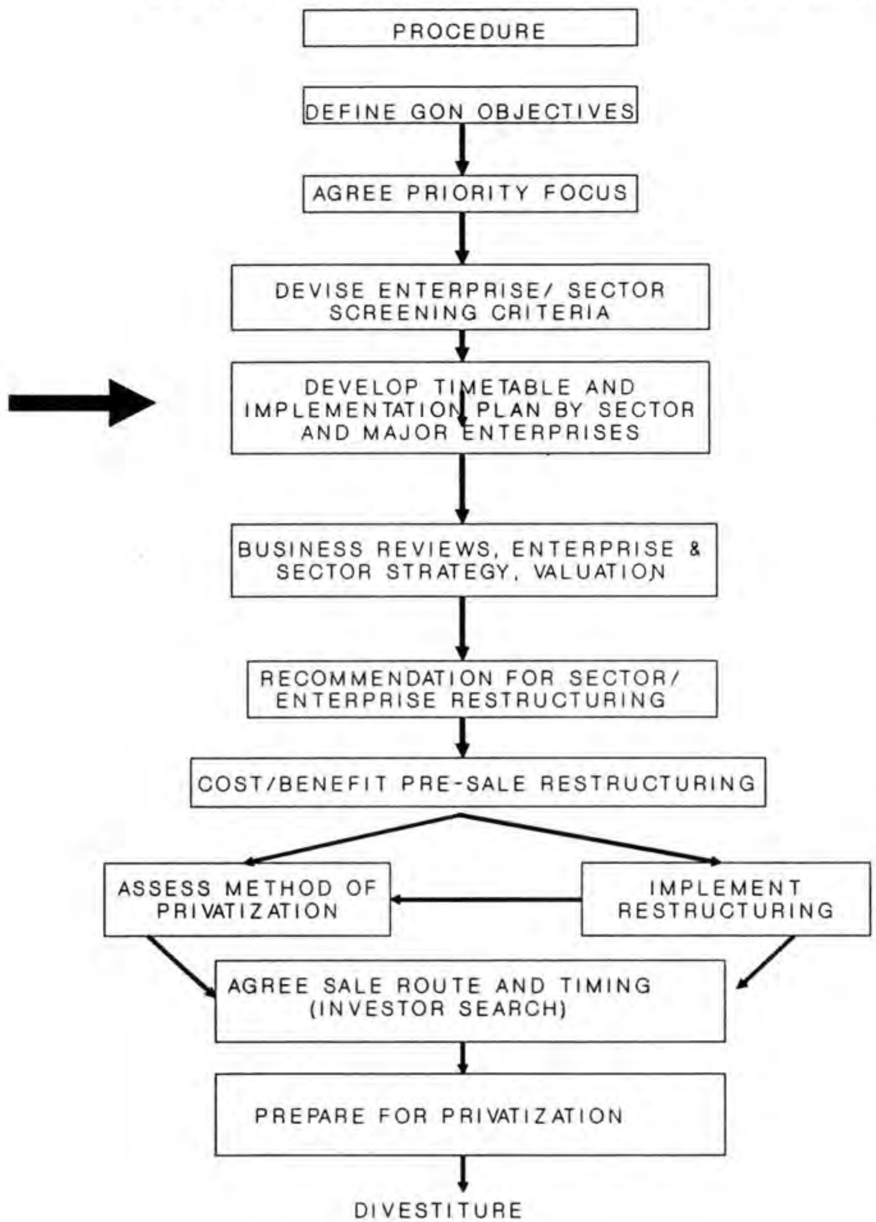
NICARAGUA: PRIVATIZATION

DEVISE ENTERPRISE SCREENING CRITERIA

AGREED PRIORITY OBJECTIVES	CRITERIA FOR SCREENING ENTERPRISES	
QUICKSALE	• SMALL SCALE (T/O)<$300 K • LEGAL STATUS • CLEAN BALANCE SHEET	• BASIC DATA AVAILABLE • EASE OF RESTRUCTURING • EXISTING OFFER TO ACQUIRE
REVENUE FROM DIVESTITURE	• PROFITABILITY • POSITIVE CASH FLOW • LARGE ASSET BASE	• STRONG MARKET GROWTH/ PROSPECTS • RESTRUCTURING FEASIBLE PRE-PRIVATIZATION
ATTRACT PRIVATE INVESTMENT	• EXPORT SALES/ POTENTIAL • TURNAROUND CANDIDATES • UNDERVALUED ASSETS	• ACTIVITIES NOT SUBJECT TO STATE CONTROLS • STRONG MARKET GROWTH/ PROSPECTS
IMPROVE EFFICIENCY	• CONSOLIDATE/ MONOPOLY MARKETS • EXISTING INFORMAL MARKETS • OPPORTUNITY TO REDUCE GVT. INTERVENTION	
SPREAD OWNERSHIP	• CASH POSITIVE ENTERPRISES FOR MBOs • LARGE ASSET BASE FOR MBOs • MINOR RESTRUCTURING NEEDS	
CONTROL JOB LOSSES	• LOW LEVELS OF EXCESS LABOUR • NEGOTIABLE SALE PRICE • SPIN-OFF POTENTIAL	• SHORT TERM RECOVERY PROSPECTS • OPPORTUNITY FOR NEW BUSINESS DEVELOPMENT

PRIORITIES:
- DEMONSTRATE PROGRESS AND EARLY SUCCESS
- DEVELOP FLEXIBLE PROGRAM TO INCORPORATE MAXIMUM NUMBER OF OBJECTIVES
- DEVELOP SYSTEMATIC METHODOLOGY

PRIVATIZATION PROCESS FLOW: NICARAGUA



NICARAGUA: PRIVATIZATION

DEVELOP TIMETABLE AND IMPLEMENTATION PLAN

PRINCIPAL OBJECTIVES OF PRIVATIZATION PROGRAM:

- DEMONSTRABLE PROGRESS AND EARLY SUCCESS
- DEVELOP A FLEXIBLE APPROACH CAPABLE OF INCORPORATE ALL OBJECTIVES

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IMPLEMENT A TWO-MODULE APPROACH:

- IDENTIFY A GROUP OF SUITABLE EARLY PRIVATIZATION CANDIDATES, AND INITIATE PROCESS
- UNDERTAKEN SYSTEMATIC PLANNING OF PROCESS FOR MAJORITY OF ENTERPRISES AND SECTORS

NICARAGUA: PRIVATIZATION

IMPLEMENTATION OF OBJECTIVES

OBJECTIVE:

* NEED TO DEMONSTRATE EARLY PRIVATIZATION SUCCESS

ISSUES:

* SELECT FIRST TIER PRIVATIZATION CANDIDATES FROM 300 ENTERPRISES
* OWNERSHIP OF MANY ENTERPRISES IN DISPUTE
* OFFERS TO ACQUIRE SEVERAL ENTERPRISES ALREADY SUBMITTED

ACTIONS

* DEVISE METHODOLOGY FOR SELECTING SMALL NUMBER OF FIRST TIER CANDIDATES FOR EARLY PRIVATIZATION

DEVELOP SCREENING CRITERIA

* SIZE (TURNOVER)
* AVAILABILITY (NOT IN DISPUTE)
* RELIABILITY OF BASIC DATA
* NEED FOR RESTRUCTURING
* EXISTING OFFER TO ACQUIRE

SCREEN ENTERPRISES

* COMPILE DATABASE WITH AVAILABLE INFORMATION
* SCREEN FOR BASIC CRITERIA
* ESTABLISH PRIORITY LIST AND SUBSTITUTE LIST OF ENTERPRISES

INITIATE IMPLEMENTATION

* FOR PRIORITY LIST:
  - CONFIRM AVAILABILITY AND LEGAL STATUS
  - OBTAIN LATEST AVAILABLE FINANCIAL INFORMATION
  - CONTRACT ACCOUNTANTS TO UPDATE FINANCIALS AS APPROPRIATE
  - CONFIRM SUITABILITY FOR EARLY PRIVATIZATION

OUTPUT:

* LIST OF 10-15 CANDIDATES FOR EARLY PRIVATIZATION
* BACK-UP LIST OF CANDIDATES FOR SUBSEQUENT PRIVATIZATION
* ACTION PLAN FOR IMPLEMENTATION

NICARAGUA: PRIVATIZATION

IMPLEMENTATION OF OBJECTIVES

METHODOLOGY FOR SELECTION OF FIRST TIER CANDIDATES

	NUMBER OF ENTERPRISES
SELECT CRITERIA FOR SCREENING	300
SCREEN FOR ENTERPRISES WITH SALES <$100,000/Yr	42
ELIMINATE ENTERPRISES WITH KNOWN OWNERSHIP CLAIM	39
FIRST CUT CHECK ON DATA RELIABILITY ASSET TURN (>0.25)	22

NEXT STEPS

- CONFIRM LEGAL STATUS OF 22 ENTERPRISES SELECTED
- DIVIDE INTO TWO GROUPS BY ASSET TURN
- INITIATE DATA GATHERING FOR FIRST GROUP OF ENTERPRISES
- IF NEW DATA INVALIDATE CANDIDACY OF ENTERPRISES FROM FIRST GROUP, REPLACE WITH ENTERPRISES FROM 2nd GROUP, 10 ENTERPRISES IN PROCESS AT ANY ONE TIME

NICARAGUA: PRIVATIZATION

IMPLEMENTATION OF OBJECTIVES

METHODOLOGY FOR SELECTION OF SECOND TIER CANDIDATES

SELECT CRITERIA FOR SCREENING:

- WIDEN CRITERIA FROM FIRST TIER
  - eg. SALES $100,000 - $500,000/Yr.
- EXCLUDE ENTERPRISES IN FIRST TIER
- EXCLUDE ENTERPRISES TO BE REVIEWED UNDER SECTOR STRATEGIES

DEVELOP IMPLEMENTATION PLAN AND TIMETABLE:

- GROUP ENTERPRISES BY ACTIVITY
- SELECT 3-4 GROUPS FOR SIMULTANEOUS PROCESSING
- OUTLINE TIMETABLE FOR IMPLEMENTATION

NEXT STEPS

- INITIATE PROCESS OF DATA GATHERING, VALUATION, AND PREPARATION FOR DIVESTITURE

NICARAGUA: PRIVATIZATION

IMPLEMENTATION OF OBJECTIVES

GUIDELINES FOR FIRST AND SECOND TIER CANDIDATES

FIRST TIER CANDIDATES

- METHODOLOGY DESIGNED TO ACHIEVE EARLY IMPLEMENTATION
- CANDIDATES NOT SUITABLE FOR RAPID PROCESSING SHOULD BE TEMPORARILY DELAYED

SECOND TIER CANDIDATES

- METHODOLOGY DESIGNED TO ENSURE SUCCESSFUL PRIVATIZATION OF ALL ELIGIBLE ENTERPRISES
- ANY OBSTACLES SHOULD BE OVERCOME AS ENCOUNTERED

- TWO TIER APPROACH ENSURE EARLY PRIVATIZATION SUCCESS, AND SYSTEMATIC METHOD FOR DIVESTING ALL SMALL SCALE ENTERPRISES NOT INCLUDED IN SECTORIAL STRATEGIES

NICARAGUA: PRIVATIZATION

DEVELOP TIMETABLE AND IMPLEMENTATION PLAN

LARGE SCALE ENTERPRISES/ SECTORS

OBJECTIVES

* DEVELOP SYSTEMATIC APPROACH TO PRIORITIZATION OF SECTORS AND ENTERPRISES TO BE PRIVATIZED
* IDENTIFY OPPORTUNITIES FOR RESTRUCTURING SECTORS THROUGH IMPLEMENTATION OF PRIVATIZATION

ISSUES

* LACK OF BASIC DATA ON ENTERPRISES
* LARGE NUMBER OF ENTERPRISES TO BE PRIVATIZED
* ENTERPRISES ARE SPREAD ACROSS MOST ECONOMIC SECTORS
* LIMITED RESOURCES AVAILABLE TO ASSIST PRIVATIZATION
* MANY CONFLICTING OBJECTIVES SHOULD BE ADDRESSED BY THE PROCESS

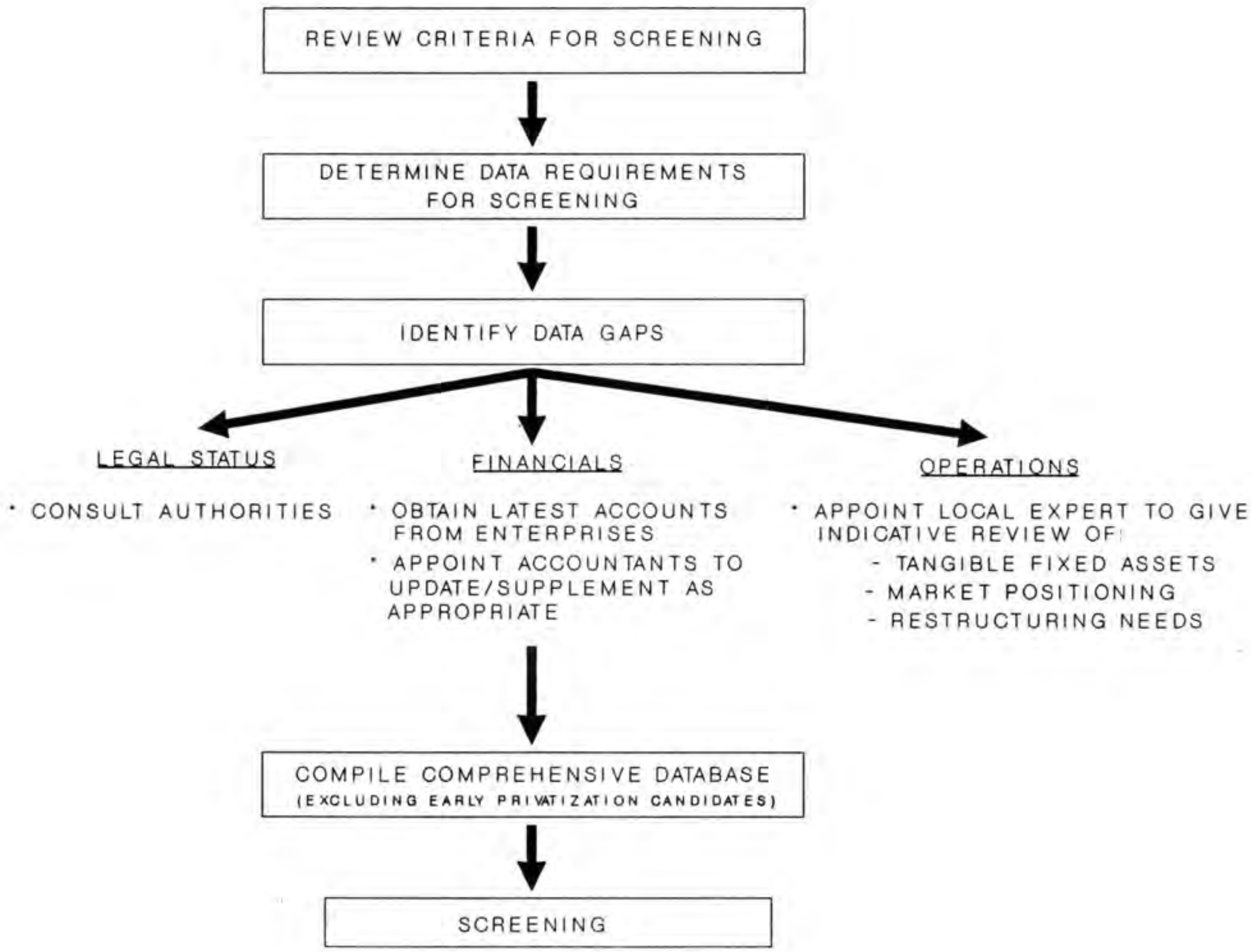
↓

* OBJECTIVE CRITERIA SHOULD BE APPLIED TO CLASSIFICATION OF PRIORITY SECTORS/ ENTERPRISES
* CENTRAL COORDINATION OF PROCESS NEEDED TO:
  - ENSURE SYSTEMATIC APPROACH
  - DEMONSTRATE ACTIVE MANAGEMENT OF PROCESS
  - BUILD CONSENSUS THROUGHOUT PROCESS

NICARAGUA: PRIVATIZATION

DEVELOP TIMETABLE AND IMPLEMENTATION PLAN

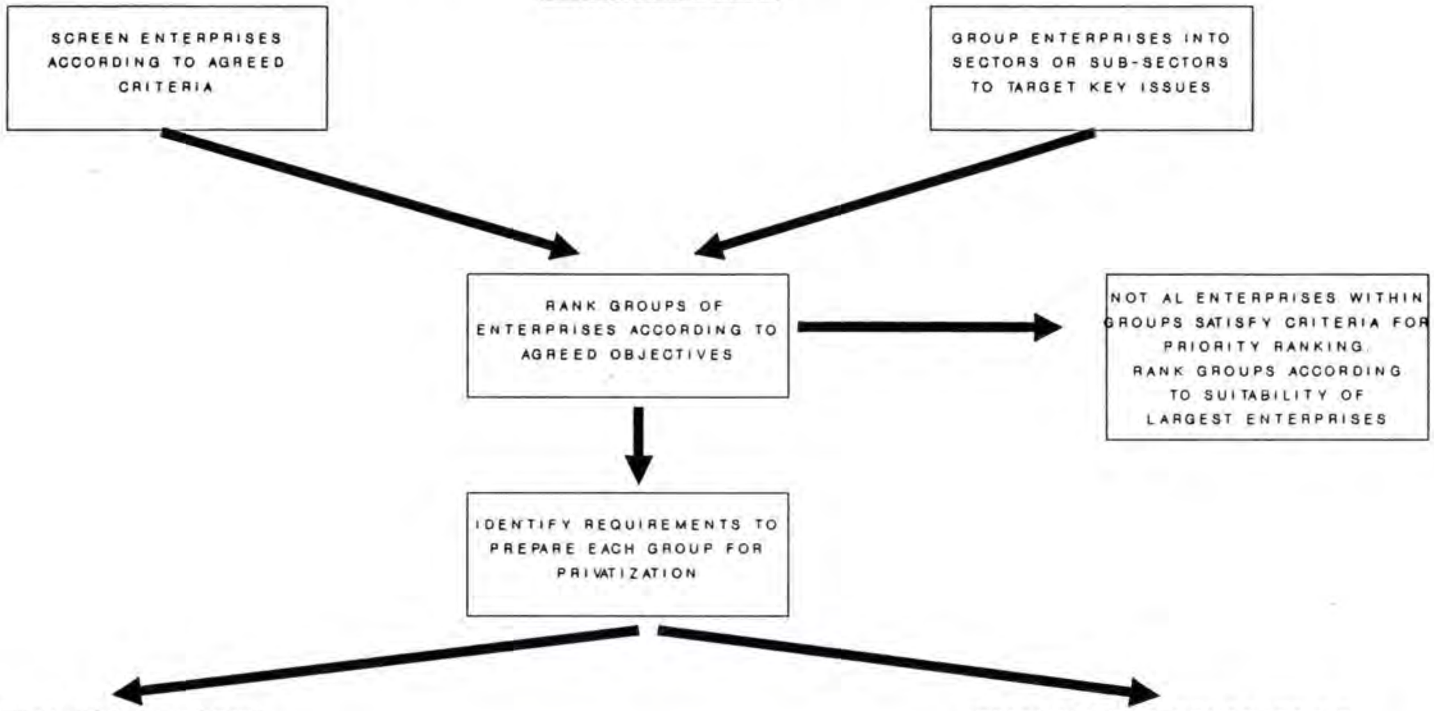
PROCESS FLOW



NICARAGUA: PRIVATIZATION

DEVELOP TIMETABLE AND IMPLEMENTATION PLAN

PROCESS FLOW



CRITERIA FOR IN-HOUSE MANAGEMENT OF PROCESS

* MINIMAL OPERATIONAL RESTRUCTURING
- COMPETITIVE MARKET SECTOR
* NO NEED FOR SECTOR RESTRUCTURING
* MINIMAL OVERSTAFFING
* GOING CONCERN
* SMALL SCALE
* SINGLE BUSINESS UNIT
* LIKELY SINGLE SALE ROUTE
* DOMESTIC ACQUIRER

CRITERIA FOR CONTRACTING OUT MANAGEMENT OF PROCESS

* NEED FOR OPERATIONAL RESTRUCTURING
* CONCENTRATED OR MONOPOLY MARKET
* NEED FOR SECTOR RESTRUCTURING
* LARGE SCALE OVERSTAFFING (NEED TO IDENTIFY EMPLOYMENT CREATION OPPORTUNITIES)
* LIQUIDATION CANDIDATES
* LARGE SCALE ENTERPRISES
* MULTIPLE BUSINESS UNITS
* OPPORTUNITY TO STRUCTURE MULTIPLE SALE ROUTES
* INTERNATIONAL ACQUIRER AND/OR NEED FOR FOREIGN INVESTMENT

NICARAGUA: PRIVATIZATION

DEVELOP TIMETABLE AND IMPLEMENTATION PLAN

DEVELOP ACTION PLAN FOR EACH ENTERPRISE/GROUP

IN-HOUSE PROCESS MANAGEMENT

- GROUP ENTERPRISES BY ACTIVITY

RANK GROUPS ACCORDING TO OBJECTIVES

- AGREE PHASE TIMETABLE FOR PREPARING EACH GROUP FOR PRIVATIZATION (NUMBER OF GROUPS TO BE PREPARED SIMULTANEOUSLY DEPENDS ON AVAILABILITY OF RESOURCES)
- ASSIGN PROCESS MANAGER TO EACH GROUP OF ENTERPRISES

CONTRACTED-OUT PROCESS MANAGEMENT

- FOR ALL ENTERPRISES GROUPS:
  - SELECT EXTERNAL ADVISORS ACCORDING TO REQUIREMENTS OF EACH GROUP:
    - SECTOR SPECIALIZATION
    - NEED TO SUPPLEMENT FINANCIAL/ MANAGEMENT INFORMATION
    - NEED ATTRACT EXTERNAL INVESTMENT
  - AGREE PHASED TIMETABLE FOR PREPARING EACH GROUP FOR PRIVATIZATION

    NB: NUMBER OF SECTORIAL RESTRUCTURING AND MAJOR PRIVATIZATIONS WHICH CAN BE UNDERTAKEN SIMULTANEOUSLY IS CONSTRAINED BY POLITICAL SENSITIVITY, AVAILABILITY OF MINISTERIAL, DECISION-MAKING RESOURCES

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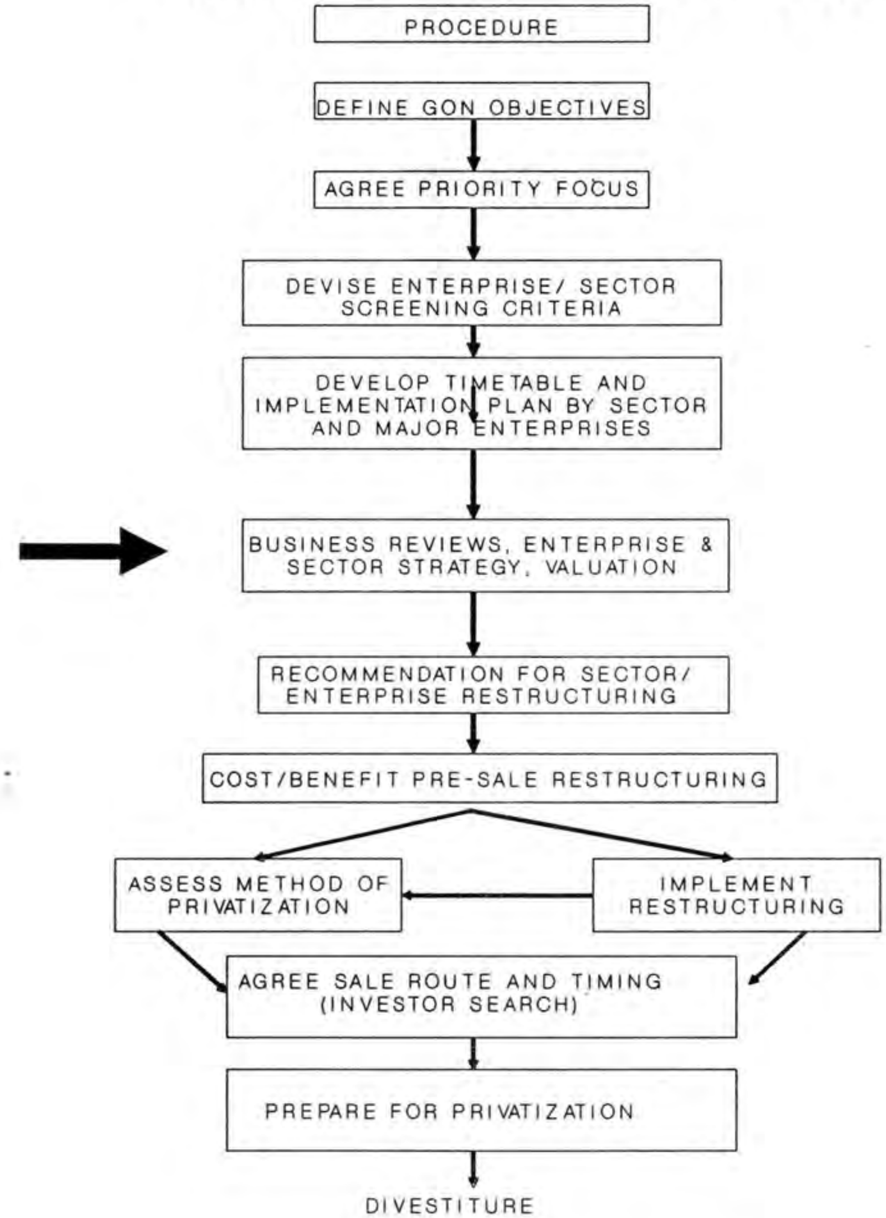
- INITIATE BUSINESS REVIEWS, VALUATION, AND PREPARATION OF ENTERPRISES FOR PRIVATIZATION

PRIVATIZATION PROCESS FLOW: NICARAGUA



NICARAGUA: PRIVATIZATION

ENTERPRISE REVIEW, ENTERPRISE AND SECTOR STRATEGY, VALUATION

ENTERPRISE REVIEW

REGULATORY ENVIRONMENT
- GOVERNMENT POLICY
- PRODUCT SPECIFICATIONS
- EMPLOYMENT LEVELS
- INVESTMENT INCENTIVES
- QUOTAS
- TAXATION
- TARIFFS
- PRICING POLICY

MARKETS/ COMPETITORS
- SIZE
- GROWTH
- SEGMENTS
- PROFITABILITY LEVELS
- COMPETITIVE ADVANTAGES
- MARKET SHARES

FINANCIAL PERFORMANCE
- REVENUE
- PROFITS
- CASH FLOW MANAGEMENT
- NET WORTH
- BALANCE SHEET STRUCTURE

MANAGEMENT

ORGANIZATION STRUCTURE
- PLANNING PROCESSES
- INFORMATION SYSTEMS
- EMPLOYMENT LEVELS
- REPORTING LINES
- BUDGETING
- AUTONOMY

OPERATIONS/ COSTS

PRODUCTION STAGES
- PRODUCTIVITY
- SUPPLIER SOURCING
- DISTRIBUTION
- PHYSICAL INSTALLATIONS
- COST STRUCTURE
- PROFIT CENTERS

CUSTOMERS
- PROFILE
- LOCATION
- DIVERSITY
- PURCHASE CRITERIA

- KEY SUCCESS CRITERIA FOR ENTERPRISES
- INDUSTRY PROFITABILITY DRIVERS
- COMPETITIVE ADVANTAGE OF ENTERPRISES IN SECTOR
- COMPETITIVE ADVANTAGE OF SECTOR IN GLOBAL MARKETS

- DEFINE SECTOR STRATEGY AND BUSINESS UNIT STRATEGY

NICARAGUA: PRIVATIZATION

VALUATION

VALUATION METHODS:

- DISCOUNTED CASH FLOW
- MARKET VALUE OF ASSETS
- REPLACEMENT COST OF ASSETS

RANGE OF DCF VALUES:

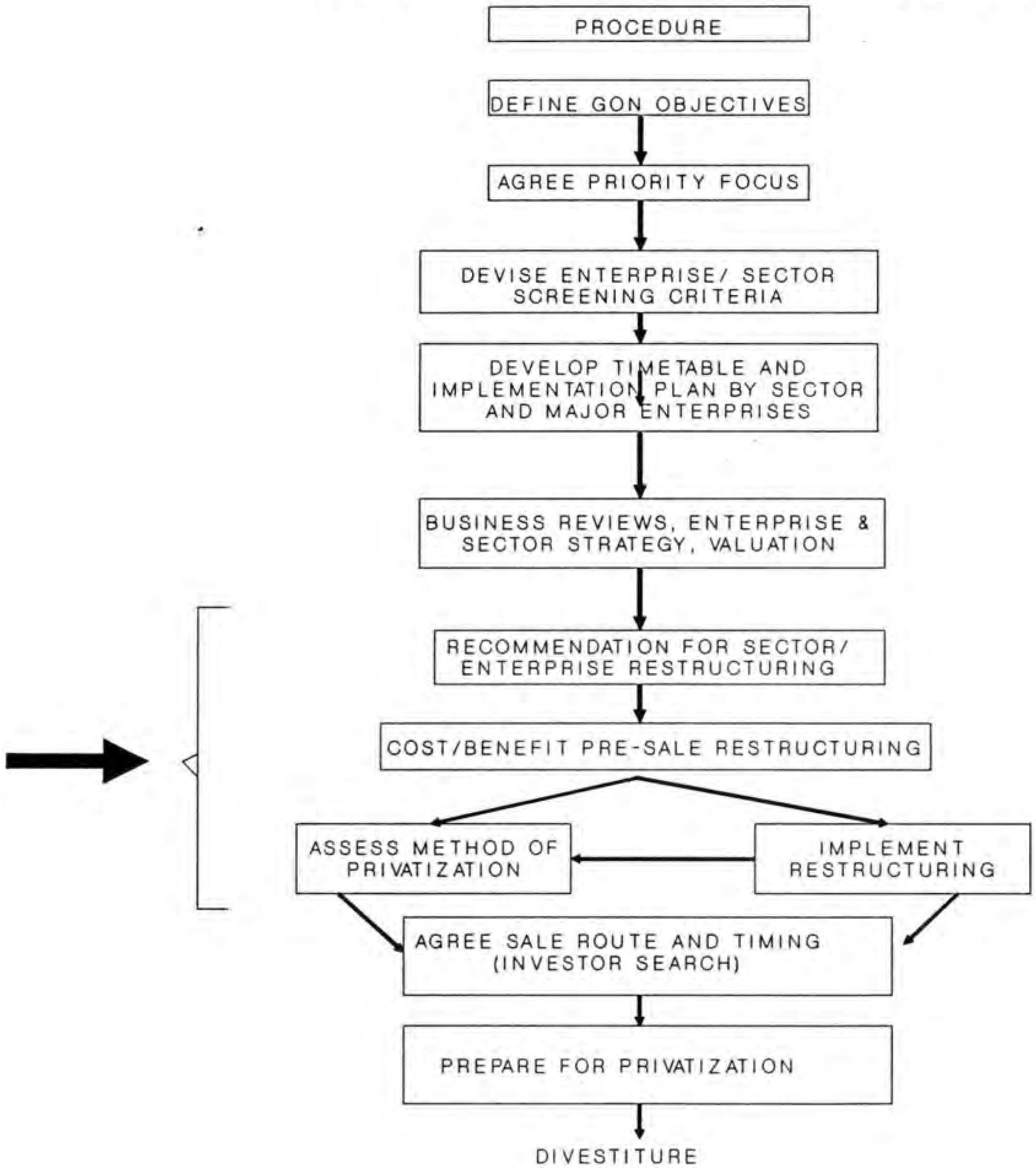
* STAND ALONE BUSINESS-AS IS (BASE CASE)

* VALUE OF BUSINESS TO SPECIFIC GROUPS OF INTERESTED INVESTORS. (TRADE BUYERS MAY BE ABLE TO REALIZE COST SAVINGS FROM INTEGRATING THEIR ACQUISITION WITH THEIR EXISTING BUSINESSES; THE VALUE OF AN ACQUISITION TO A TRADE BUYER MAY BE HIGHER THAN THE BASE CASE)

* VALUE OF BUSINESSES AFTER RESTRUCTURING (HIGHER THAN BASE CASE, BUT INVESTMENT REQUIRED MAY NOT BE REFLECTED IN THE ACHIEVABLE SALE PRICE)

* ESTABLISHING A RANGE OF VALUES PROVIDES:
  - AN INDICATION OF THE ACHIEVABLE SALE PRICE
  - A BASIS FOR NEGOTIATING A FINAL SALE PRICE

PRIVATIZATION PROCESS FLOW: NICARAGUA



NICARAGUA: PRIVATIZATION

• RESTRUCTURING REQUIREMENTS AND TIMING

• RESTRUCTURING REQUIREMENTS ARE DETERMINED ON A CASES-BY-CASES BASIS

• DECISION TO IMPLEMENT RESTRUCTURING PRE-OR-POST-PRIVATIZATION DEPENDS ON:

- AVAILABILITY OF GOVERNMENT RESOURCES
- NEED FOR FOREIGN/PRIVATE PARTICIPATION TO IMPLEMENT SUCCESSFULLY
- THE IMPACT OF RESTRUCTURING ON THE ACHIEVABLE SALE PRICE (NPV OF RESTRUCTURING >1)
- ABILITY TO GUARANTEE NEW OWNERS WILL IMPLEMENT ENTERPRISE/SECTOR STRATEGY

• OTHER CONSIDERATIONS:

- SOME FINANCIAL RESTRUCTURING MAY BE UNAVOIDABLE (eg. WRITE OFF LONG TERM DEBT)
- NEW OWNERS MAY PREFER TO REAP BENEFITS OF OWN RESTRUCTURING INVESTMENTS RATHER THAN PAY FOR GOVERNMENTS INVESTMENTS
- TIMING OF RESTRUCTURING CAN FORM BASIS OF NEGOTIATING SALE PRICE
- RESTRUCTURING NEEDS MAY INFLUENCE DECISION ON OPTIMAL SALE ROUTE

NICARAGUA: PRIVATIZATION

METHODS OF PRIVATIZATION

* OPTIMAL PRIVATIZATION METHOD DETERMINED ON A CASES-BY-CASE BASIS:

* PREDETERMINED FACTORS INCLUDE:
  - TYPE OF BUSINESS
  - GOVERNMENT RESOURCES
  - TIMING OF STUDY AND PREPARATION FOR PRIVATIZATION

* INFLUENCING FACTORS INCLUDE:

AT ENTERPRISE LEVEL

* WHETHER THE BUSINESS IS A GOING CONCERN
* LEVELS OF OPERATIONAL/FINANCIAL RESTRUCTURING REQUIRED
* NEED FOR FOREIGN EXPERTISE/TECHNOLOGY
* SIZE OF ASSET BASE
* QUALITY OF EXISTING MANAGEMENT

AT MACRO LEVEL

* AVAILABILITY OF COMMERCIAL FINANCING
* EXISTENCE OF DEVELOPED CAPITAL MARKETS
* DESIRE TO LAUNCH CAPITAL MARKETS

NICARAGUA: PRIVATIZATION

METHODS OF PRIVATIZATION

THREE BASIC FORMS OF PRIVATIZATION:

PUBLIC FLOTATION	PRIVATE PLACEMENT	TRADE SALE
WIDE RANGE OF INVESTORS	OFFERING RESTRICTED TO INSTITUTIONAL INVESTORS	LIMITED, KNOWN NUMBERS OF INVESTORS

Public flotation / Private placement:

- SALE PRICE FIXED IN ADVANCE
- NO GUARANTEE THAT OFFER WILL BE TAKEN UP
- COMPLEX REQUIREMENTS FOR SUCCESS

Trade sale:

- SALE PRICE NEGOTIATED
- SHARES SOLD IN PACKAGE DEAL
- FLEXIBLE REQUIREMENTS FOR SUCCESS
- VARIATIONS ON TRADE SALES INCLUDE JOINT VENTURES, MBOs WORKERS PARTICIPATION, CO-OPS

- EACH ENTERPRISE MAY BE PRIVATIZED THROUGH ONE OR A COMBINATION OF THESE FORMS- BUT USUALLY NOT AT ALL THE SAME TIME

NICARAGUA: PRIVATIZATION

METHODS OF PRIVATIZATION

CRITERIA FOR PUBLIC FLOTATION AND PRIVATE PLACEMENTS

PUBLIC FLOTATION

* HISTORIC RECORD OF STRONG PERFORMANCE (NORMALLY 5 Years)
* STRONG MARKET GROWTH
* SOUND BASIS FOR FUTURE EPS GROWTH
* LARGE SCALE OFFERING
* EXISTENCE OF CAPITAL MARKETS

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* NOT A VIABLE SHORT TERM OPTION IN NICARAGUA

PRIVATE PLACEMENT

* MOST CRITERIA FOR PUBLIC FLOTATION
* IF HIGH LEVELS OF RETURNS AVAILABLE, INSTITUTIONAL INVESTORS MAY TAKE UP SOME OF OFFERING
* CRITERIA MAY BE RELAXED IF ASSETS MANAGED BY MANAGEMENT CONTRACT TO REPUTABLE GROUP (eg. international HOTEL CHAIN

↓

* FOREIGN INSTITUTIONAL INVESTORS MAY BE PERSUADE TO INVEST, BUT CONDITIONS TO BE MET MAY BE UNATTRACTIVELY STRINGENT (eg. GVT MAY HAVE TO GUARANTEE EPS)

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* PUBLIC FLOTATIONS AND PRIVATE PLACEMENTS CARRY THE RISK THAT NOT ALL OF THE OFFERING WILL BE TAKEN UP AT THE PRICE FIXED IN ADVANCE
* IF GOVERNMENT NEEDS TO GUARANTEE PROCEEDS OF THE ISSUE , UNDERWRITERS MAY BE APPOINTED

NICARAGUA: PRIVATIZATION

METHODS OF PRIVATIZATION

<u>THE ROLE OF UNDERWRITERS</u>

UNDERWRITERS FULFILL THREE FUNCTIONS IN THE PROCESS OF PRIVATIZATION:

1.- ELIMINATE RISK TO GOVERNMENT THAT SHARES WILL NOT BE TAKEN UP BY INVESTORS AT THE PREDETERMINED PRICE.

- GVT NEEDS TO GUARANTEE ITL WILL RECEIVE PROCEEDS OF ISSUES
- GVT CANNOT NEGOTIATE WITH ALL BUYERS OF AN ISSUE
- GVT DECIDES TO DIVEST ALL OR MAJORITY OF SHAREHOLDING AT ONCE

2.- ADD CREDIBILITY TO THE PROMOTIONAL PROGRAM- INSPIRE INVESTOR CONFIDENCE.

3.- ASSIST IN PROMOTIONAL PROGRAM

- DISTRIBUTE PROSPECTUSES AMONG INSTITUTIONAL INVESTORS
- PROMOTE THE SHARE ISSUE THROUGH NETWORK OF CONTACTS

NICARAGUA: PRIVATIZATION

METHODS OF PRIVATIZATION

HOW UNDERWRITERS WORK

- UNDERWRITERS GUARANTEE THAT THE ENTIRE SHARE ISSUE WILL BE TAKEN UP AT THE PREDETERMINED PRICE

- UNDERWRITERS UNDERTAKE TO BUY ANY UNSOLD SHARES AT THE FULL PRICE, AND ASSUME ANY LOSS FROM RESALE

CONDITIONS AND CHARGES

- THE COST OF APPOINTING UNDERWRITERS IS AN AGREED PERCENTAGE OF THE FULL ISSUE AS A FLAT FEE

- THE ACTUAL PERCENTAGE RATE DEPENDS ON THE PERCEPTION OF RISK THAT THE ISSUE WILL BE UNDERSUBSCRIBE

- GOVERNMENT CAN NEGOTIATE A REDUCTION IN THE RATE BY PROVIDING MECHANISM FOR CONTROLLING THE LEVEL OF RISK:

  * COMPENSATING UNDERWRITERS FOR THE GAP BETWEEN THE SALE PRICE AND THE MARKET PRICE OF UNSOLD SHARES (CASH, DEBT, OTHER INSTRUMENTS)

  * AGREEING TO BUY BACK SOME OR ALL UNSOLD SHARES

NICARAGUA: PRIVATIZATION
METHODS OF PRIVATIZATION

CRITERIA FOR TRADE SALES

TRADE SALES ARE TRANSACTIONS WHICH INVOLVE ONE OTHER PARTY (WHICH ITSELF MAY BE A CONSORTIUM OF INTERESTED PARTIES) OR A SMALL NUMBER OF INTERESTED PARTIES

- TYPICALLY TRADE BUYERS ALREADY HAVE INTERESTS IN BUSINESS COMPETING WITH ON IN RELATED BUSINESSES TO THE PRIVATIZATION CANDIDATE, OR HAVE EXPERIENCE OF MANAGING SIMILAR BUSINESSES
- TRADE SALES MAY BE IMPLEMENTED UNDER SEVERAL STRUCTURES KEY SUCCESS CRITERIA FOR EACH ROUTE:

OUTRIGHT TRADE SALE

- HISTORIC RECORD OF STRONG PERFORMANCE
- STRONG MARKET POSITION
- STRONG MANAGEMENT TEAM OR OPPORTUNITY TO REPLACE MANAGEMENT
- IDENTIFIABLE COST-SAVINGS/PROFIT IMPROVEMENT OPPORTUNITIES FOR ACQUIRER

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- SHORTCOMINGS IN ANY OF ABOVE WILL ADVERSELY IMPACT SALE PRICE
- SIGNIFICANT OPPORTUNITIES FOR NEGOTIATING DEAL STRUCTURE
- MAY BE COMBINED WITH MBO

JOINT VENTURE

- ALL PARTIES MUST BE ABLE TO CONTRIBUTE SUBSTANTIVELY TO THE NEW BUSINESS
  - MARKET SHARE/CUSTOMER BASE
  - REQUISITE TECHNOLOGY
  - MANAGEMENT SKILLS
  - ACCESS TO FINANCE
  - ACCESS TO FOREIGN EXPERTISE
  - ACCESS TO FOREIGN/DOMESTIC MARKETS

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- SUM OF THE WHOLE MUST BE GREATER THAN THE PARTS, AND REQUIRED INPUTS UNAVAILABLE FROM DIRECT ACQUISITION
- MAY COMBINE WITH MBO

MANAGEMENT BUY-OUT

- ALL TRADE SALE CRITERIA
- PRICE: ABILITY OF MANAGEMENT TO PAY
- PROVEN MANAGEMENT SKILLS
- SUBSTANTIAL ASSET BASE AGAINST WHICH TO GUARANTEE FINANCING
- AVAILABILITY OF COMMERCIAL FINANCING OR WILLINGNESS OF GOVERNMENT TO ACCEPT DEFERRED PAYMENT

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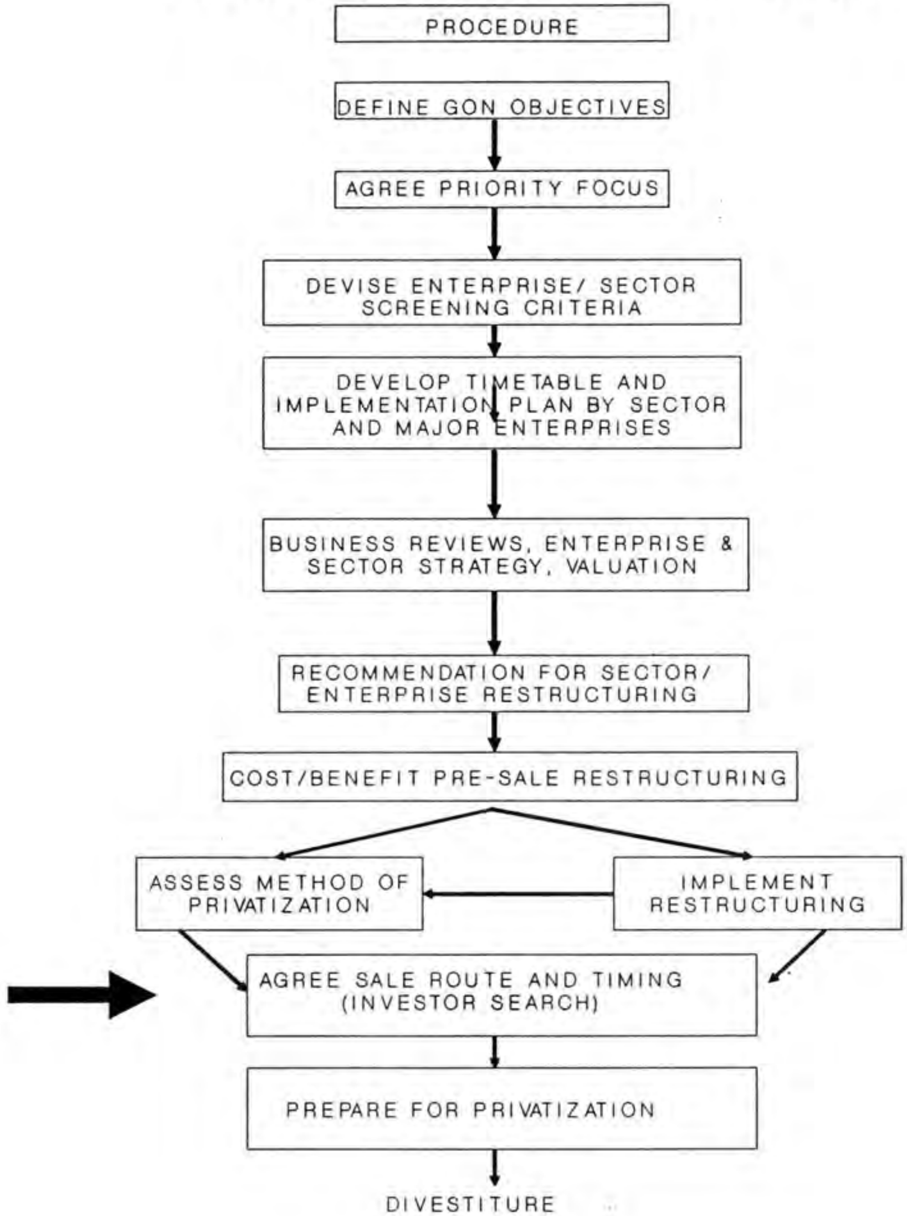
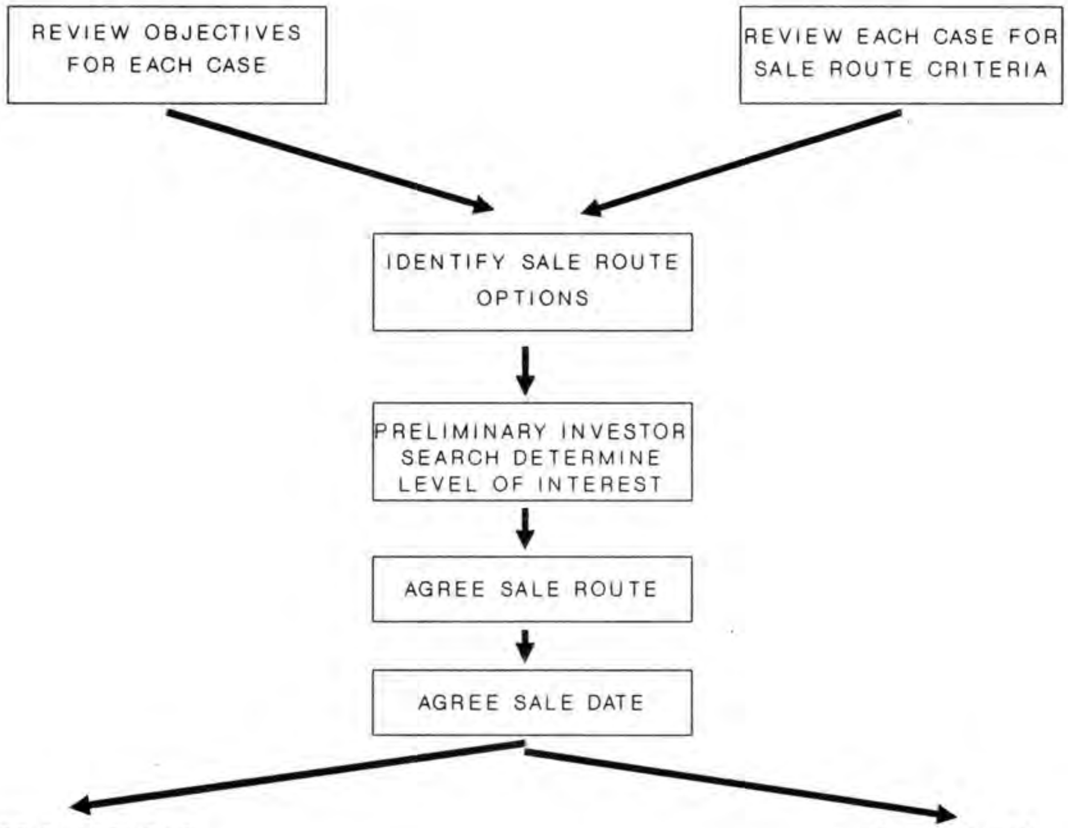
- MOST MBOs ARE HIGHLY LEVERAGED MBOs MAY INCLUDE WORKERS
- SIGNIFICANT OPPORTUNITIES FOR NEGOTIATING DEAL STRUCTURE
- MAY BE COMBINED WITH TRADE SALE AND J.V.

PRIVATIZATION PROCESS FLOW: NICARAGUA



NICARAGUA: PRIVATIZATION

SALE ROUTE AND TIMING



<u>FLOTATION/PRIVATE PLACEMENT</u>

- LONGER TIME FRAME (4-6 MONTHS)
- MORE RIGOROUS PREPARATORY REQUIREMENTS
- LONGER, MORE INTENSIVE PROMOTIONAL CAMPAIGN

<u>TRADE SALES</u>

- SHORTER TIME FRAME (2-4 MONTHS)
- LESS RIGOROUS PREPARATORY REQUIREMENTS
- FOCUSED PROMOTIONAL CAMPAIGN (INVITATION TO TENDER)
- NEGOTIATING PROCESS CAN BE LENGTHY

NICARAGUA: PRIVATIZATION DIVESTITURE

PREPARATION FOR PRIVATIZATION

DOCUMENTATION

. ARTICLES OF INCORPORATION SUPPORTING LEGAL DOC.

. FINANCIAL STATEMENT (AUDITED FOR MAJOR SALES AND ALL FLOTATIONS/PRIVATE PLACEMENTS

. CORPORATE CHARTER
- CAPITAL STRUCTURE
- EMPLOYMENT TERMS
- ORGANIZATION STRUCTURE

. SALES MEMORANDUM/PROSPECTUS
  . DESCRIPTION OF BUSINESS
  . FINANCIAL INFORMATION
  . TERMS OF OFFER
  . CRITERIA FOR QUALIFICATION

PROMOTIONAL CAMPAIGN

. ADVERTISE OFFER FOR SALE TO TARGETED INVESTORS

- APPOINT PRIV. AGENCY TO WRITE PRESS RELEASES, WRITE SPEECHES WRITE ARTICLES, DESIGN CAMPAIGN

NEGOTIATING PACKAGE

. PREPARE FOR NEGOTIATIONS (TRADE SALES ONLY

- SUBSTANTIATE VALUATION
- AGREE TRADE-OFFS:
  EMPLOYMENT LEVELS
  RESTRUCTURING
  STRATEGIC IMPLEMENTATION

VS.

SALE PRICE

DIVESTITURE

NICARAGUA: PRIVATISATION

THE ROLE OF EXTERNAL ADVISORS

CONSULTANTS

- Business Reviews - Financial Analysis
- Business/sector strategies
- Assessment/costing of restructuring needs
- Valuation
- Target investor groups
- Identify optimal privatisation route
- Assit in negotiations

ACCOUNTANTS/AUDITORS

- Financial Analysis
- Ensure quality of data
- Perform audits
- Prepare financial statements

BANKERS

- Structure complex deals
- Direct contact with institutional investors and trade buyers
- Provide advice on market perceptions
- Contribute to valuation (discount rate)
- Advise on pricing of large (non-negotiated) deals

. For large deals, all three external advisors are needed.

ANNEX 3. INFORMATION STRATEGY

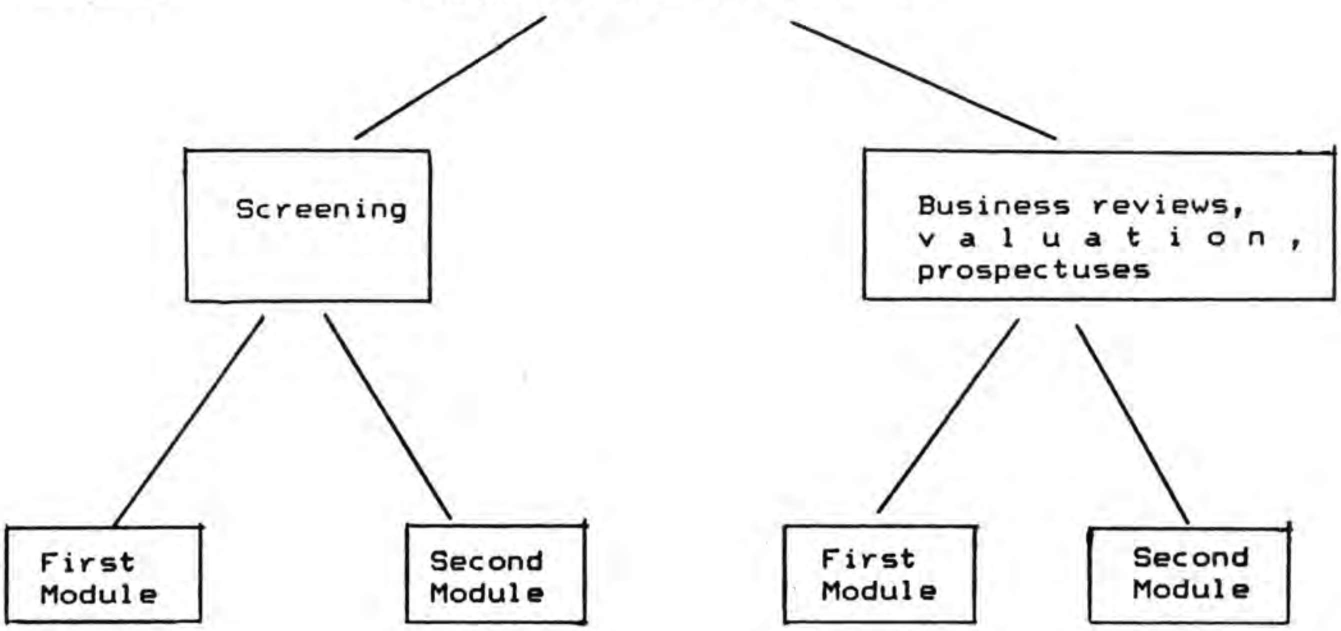
ANNEX 3
INFORMATION STRATEGY

SITUATION: Poor information systems at all enterprises

COMPLICATION: Reliable data is required for initial screening, and later for business reviews, valuation, etc.

QUESTION: What resources are needed to develop a basic information system at enterprise level?

ANSWER: Resources are needed for:



COMPILATION OF BASIC DATA FOR BASE SCREENING

First Module
<u>Small Enterprises</u>

Implement small scale privatization

4 Process Managers

4 PCs-AT

Second Module
<u>Large Enterprises/Sectors</u>

- Design overall strategy
- Implement large scale privatizations, some 200 enterprises.

5 work modules of about 40 enterprises each.

6 PCs, 1 of them to consolidate

HUMAN RESOURCES

1. <u>Process Manager</u>

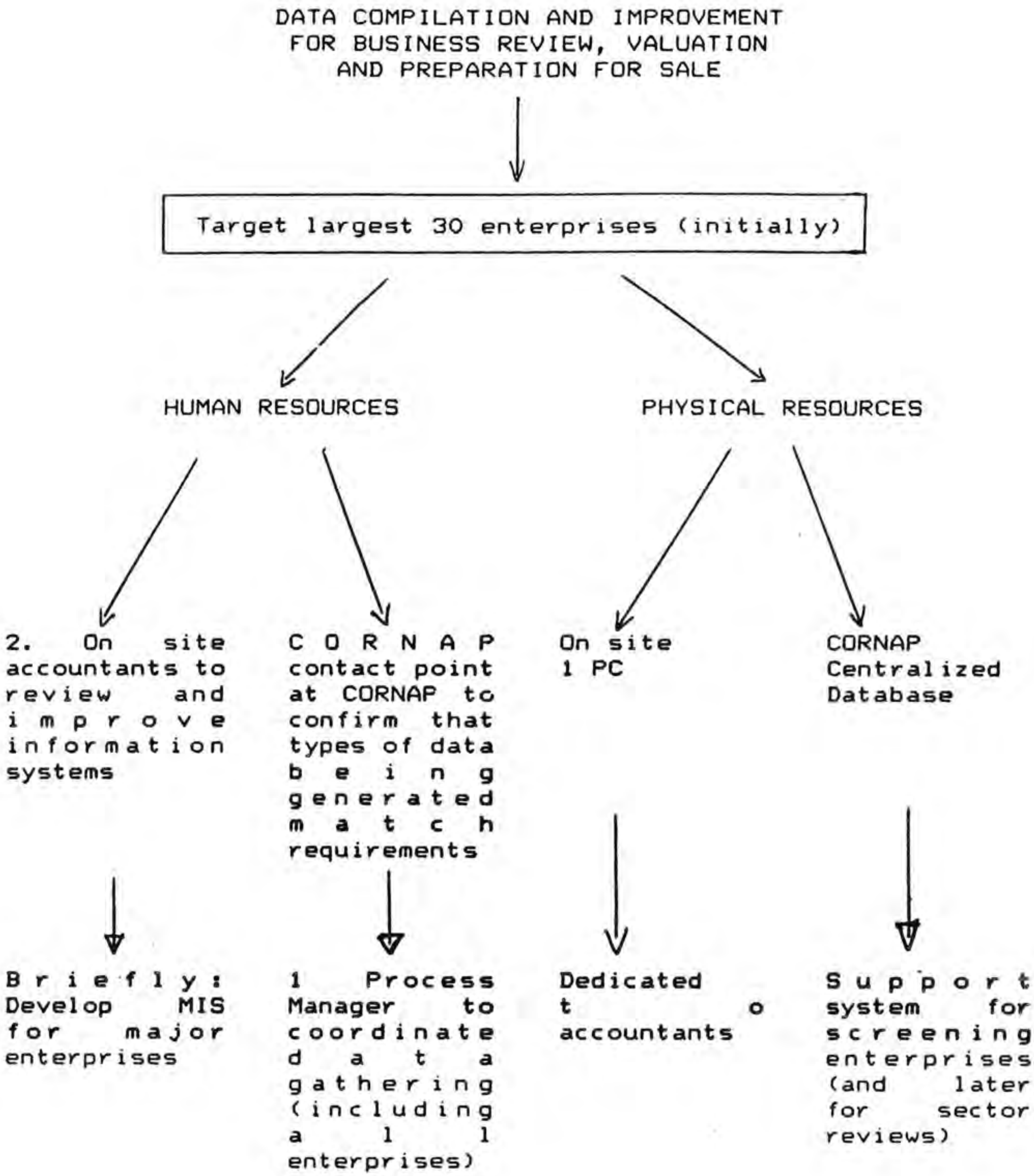
Coordinating basic data gathering for <u>all</u> enterprises prior to arrival of general and sectoral consultants.

1 Systems Analyst
1 Programmer

PHYSICAL RESOURCES

10 PCs AT at CORNAP plus supporting equipment.

COMPILATION OF BASIC DATA BASE FOR SCREENING


DATA COMPILATION AND IMPROVEMENT FOR BUSINESS REVIEW, VALUATION AND PREPARATION FOR SALE
Target largest 30 enterprises (initially)
HUMAN RESOURCES
PHYSICAL RESOURCES
2. On site accountants to review and improve information systems
CORNAP contact point at CORNAP to confirm that types of data being generated match requirements
On site 1 PC
CORNAP Centralized Database
Briefly: Develop MIS for major enterprises
1 Process Manager to coordinate data gathering (including all enterprises)
Dedicated to accountants
Support system for screening enterprises (and later for sector reviews)

ANNEX 4: TERMS OF REFERENCE

C O R N A P
NICARAGUA: PRIVATIZATION PROGRAM

TERMS OF REFERENCE FOR THE CONSULTANT FIRM
(Phase I of the Privatization Program)

1. <u>Background</u>

Most SOEs were acquired through expropriation of Somoza related holdings following that regime's overthrow, confiscation by the Sandinista administration of properties of Contra supporters and of owners who absented themselves from the country for more than six months. Others were acquired by foreclosure due to non-payment of debt to the public sector financial system. Only a few were actually founded by the state.

Prior to 1988, all SOEs were dependencies of Ministries. In 1988, nearly all were grouped by general activity area under about 25 non-incorporated holding entities, called "corporations" to differentiate them from the SOEs, called "companies". A few retained autonomous status.

In May 1990, immediately following the change in government, the corporations and a handful of autonomous companies were placed under the umbrella of a new non-incorporated holding entity, Corporaciones Nacionales del Sector Publico (CORNAP), reporting directly to the Presidency.

CORNAP has requested international donor assistance in designing a privatization strategy and action plan. The strategy recognizes the importance of educating all constituencies initially in the benefits of privatization, and then keeping them informed of progress, and of each actual sale negotiated, in the interest of maintaining the process completely transparent.

2. CORNAP has already initiated its privatization program. In December 1990, with the assistance of the IDB, UNDP and USAID, CORNAP devised a strategy and methodology for the implementation of the privatization of the enterprises under its auspices.

The first step in the privatization strategy was the clear definition and prioritization of Government objectives. These objectives have now been clearly defined and incorporated into CORNAP policy. Two overriding priorities have emerged:

1/ To demonstrate progress in early success in the implementation of privatization.

2/ To approach privatization in a well structured manner which will enable the implementation of the stated objectives.

A two-module approach has been designed to respond to these priorities.

1/ Criteria have been applied to the selection of first tier privatization candidates. These are predominantly small businesses. The process of preparation for privatization and negotiating the transactions is being handled internally by CORNAP.

2/ For the larger privatization candidates a step-by-step approach will be designed which will comprise a detailed timetable and implementation plan for groups of enterprises. It is intended that privatization be used as a mechanism for the implementation of sector and sub-sector strategies.

II Objectives

1. To design a detailed timetable and implementation plan for the privatization of major enterprises.

2. To group privatization candidates according to activity and assess their suitability for inclusion into sector or sub-sector strategies.

3. To prepare Terms of Reference for consultants to undertake sector strategies, preparation for privatization, and implementation of divestiture for identified groups of enterprises.

4. To prepare timetables and indicative costings for each project as defined.

5. Propose for the implementation of restructuring and privatization of up to 5 enterprise groups.

III. Detailed Description of Tasks

1. Database CORNAP has limited information about the performance of enterprises under its auspices. The process of gathering basic financial data has been initiated. The consultants will be responsible for ensuring that all data required to effectively screen enterprises is compiled. The consultants will design and build a database specifically for the purpose of screening enterprises, bearing in mind that this process has been initiated by CORNAP. The consultants should work alongside CORNAP personnel and build on their efforts rather than duplicating or replacing them.

2. Screening CORNAP has developed measurable criteria for selecting enterprises and grouping them according to their suitability for fulfilling stated objectives. The consultants will review the criteria and suggest and agree modifications with CORNAP as appropriate. The consultants will then screen the enterprises according to the agreed criteria, and group them for preparation for privatization.

3. Implementation Plan The consultants will assess the suitability of each group of enterprises to satisfy stated government objectives. This will form the basis for an outline implementation plan which will include a preliminary assessment of restructuring requirements at both sector and enterprise levels, and sale route options for each group.

4. Timetable for Implementation The successful implementation of privatization program depends on a realistic phased timetable for preparing groups of enterprises for privatization. This will ensure:

a. That CORNAP will maintain control over an orderly process; and
b. That CORNAP will be able to report on its progress against measurable criteria.

In developing the timetable for implementation the consultants will take into account:

a. The agreed priority ranking of objectives for the privatization program;
b. The likely time frame for implementation of restructuring and privatization for each group of enterprises; and
c. The availability of financial and managerial resources to implement privatization of more than one group of enterprises simultaneously.

5. Preparation of Terms of Reference and Indicative Costings For each major enterprise, group of enterprises, sub-sector or sector (the groupings to have been previously defined by the consultants) the consultants will prepare detailed Terms of Reference for consultants to undertake the implementation of privatization. It is expected that these Terms of Reference will include detailed information about the findings obtained during the course of this consultancy in order to ensure that there is no duplication of effort by subsequent consultancies. It is anticipated that the scope of subsequent consultancies will vary considerably between enterprise groups. The Terms of Reference should give clear indications of the scope of work required in preparing each group of enterprises for privatization.

The terms of reference should specify as appropriate:

a. The need for sector-level restructuring and strategy;
b. The need for enterprise-level restructuring and strategy;
c. Outline of requirements for preparation for privatization of enterprises within the group;
d. Indication of need to appoint auditors and/or bankers to support implementation of privatization; and
e. In all cases the consultants will be expected to ensure the successful conclusion of privatization.

Based on this information, the consultants will provide the financing agency (for example, IDB, AID or UNDP) with indicative costings for each consultancy package.

6. Implementation of Privatization for Up To 5 Enterprise Groups In order to ensure the continuous progress of the privatization program, the consultants appointed to design the detailed program will be able to undertake the implementation of up to 5 sector or enterprise modules. However, as the scope of work required will not be determined until the completion of the tasks outlined in 1-5 above, any subsequent work will form part of a separate contract.

OUTPUTS

1. A database of basic information on all CORNAP enterprises which will form part of the main privatization program (ie. excluding the early privatization candidates).

2. A briefing pack on each group of enterprises, as defined by the consultancy, with sufficient information to make a preliminary judgement about restructuring requirements and possible sale routes.

3. A detailed timetable for implementation of privatization.

4. Detailed Terms of Reference and costings for each group of enterprises.

TERMS OF REFERENCE
PUBLIC RELATIONS ADVISOR

Objective

To assist the Government of Nicaragua (GON) in successfully implementing its decision to divest itself of about 290 state-owned enterprises (SOEs) by conceptualizing and managing a public relations and public awareness process designed to educate the public at-large in the benefits of privatization to Nicaragua and its people, and to keep them fully informed during the process.

Background

Most SOEs were acquired through expropriation of Somoza related holdings following that regime's overthrow, confiscation by the Sandinista administration of properties of Contra supporters and of owners who absented themselves from the country for more than six months. Others were acquired by foreclosure due to non-payment of debt to the public sector financial system. Only a few were actually founded by the state.

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CORNAP has requested international donor assistance in designing a privatization strategy and action plan. The strategy recognizes the importance of educating all constituencies initially in the benefits of privatization, and then keeping them informed of progress, and of each actual sale negotiated, in the interest of maintaining the process completely transparent.

Responsibilities

The Public Relations Advisor will report directly to the President of CORNAP. His responsibilities will include but not be limited to the following tasks:

- Review the objectives and desired results of the various constituencies - GON, the opposition party, labor and business - relative to privatization.

- Determine the public's perception of the pros and cons of privatization.

- Review institutional relationships and political realities that impact on the process.

- Establish working relationships with key media personnel and special interest groups.

- Design and implement a public relations strategy and public awareness campaign. Specifically undertake the following:

- Arrange for the writing of articles and preparation of press releases to promote divestiture and keep the public informed of progress and results.

- Arrange TV interviews of CORNAP executives and others involved in the process.

- Promote divestiture through direct contact with special interest groups.

- Train and advise CORNAP's top management in making effective public presentations and speeches. Assist in the preparation of speeches.

- Coordinate the promotional campaign for the sale of each enterprise and assist in preparing invitations to tender.

- Contract a public relations firm to handle the promotion of large scale divestitures.

Terms and Conditions

The assignment contract will be for an initial period of two years, cancellable by either party at any time upon at least thirty days written notice. Automobile and driver will be provided. Local leave will accrue at the rate of two hours per week.

ANNEX 5. CORNAP's Enterprises

CORNAP

LISTA DE EMPRESAS QUE TIENEN VENTAS MENORES DE US$ 100,000.00

CORPORAC.	EMPRESA	VTAS. US$ miles	ACTIVOS US$ miles	RELAC. VTAS/ACT.
CATCO	ENIRA	48.00	913.80	0.053
	COMETALES	56.50	96.05	0.588
	EMPI	26.90	268.80	0.100
COENCO	INS	24.00	39.15	0.613
COIP	EMPRESA NACIONAL DE SAL	51.48	356.99	0.144
	HIELERA POLAR	97.31	180.42	0.539
	COMPLEJO TEXTIL	17.15	0.00	0.000
	AGROTEX	62.70	708.40	0.089
	LAS 3 F	55.80	78.70	0.709
	PRODEMASA	2.30	6.00	0.383
	LABORATORIOS UNIDOS C.A.	73.94	812.32	0.091
	CONCRETO PRETENSADO DE NI	4.67	11.26	0.415
	PROCON	86.12	65.81	1.309
	CRISCASA	29.12	176.32	0.165
	ENVASES DE CENTROAMERICA	93.81	348.64	0.269
	ALUNISA	17.75	33.44	0.531
	ESPUMA Y AISLANTES DE NIC	77.00	166.50	0.462
	SONIDO INDUSTRIAL	1.97	5.00	0.394
	ENIPLAS	69.60	3,071.00	0.023
CORCOP	APATLAN	45.50	43.80	1.039
	EDICOSA	15.10	6.40	2.359
	ENASER	27.80	194.60	0.143
	CIMSA	75.30	2,926.30	0.026
	ENA	39.00	13.30	2.932
	SUPER TIENDA MASAYA	56.40	46.30	1.218
COFARMA	EMPRESA DE INSUMOS NO MED	96.70	1,317.90	0.073
	EMPRESA DE SERV. AUTOMOTR	7.30	2.00	3.650
	CDC	22.60	1.80	12.556
COTRAP	MATRA	45.60	5,238.30	0.009
	EMCAFLET	1.40	1,170.00	0.001
	FERROCARRIL	9.30	637.60	0.015
COTUR	HOTEL JINOTEPE	99.33	19.69	5.045
	RESTAURANTE EL VOLCAN	87.80	42.40	2.071
	MOTEL 10 1/2	73.02	118.00	0.619
	HOTEL ALHAMBRA	57.93	41.34	1.401
	HOTELINSA	46.17	7,705.95	0.006
	CENTRO DIVERSIONES JINOTE	89.70	67.83	1.322
NICARROZ	EMP. NAC. DE TALLERES	31.70	139.00	0.228
INSA	ECAMI	71.8	278.5	0.258

PRELIMINARY GROUPING OF ENTERPRISES BY SECTOR/SUBSECTOR
(Regrouping may be required as more information becomes available)

TEXTILES
Texlasa
Fabratex
Fabrica Nac Textiles
Testilera Nicaragua
Tricotextil
Fabrica de Ropa
Fabrica de Tejido
Hilados Nicaraguenses
Complejo Textil
Agrotex
Fabrica Nac del Vestuario
Las 3 F
Fabrica de Ropa el Triunfo
Complejo HNN
Macén
Prosan

CALZADO
Centroamericana del Calzado
Pronto

CUERO
Teneria Condega

WOODWORKING/FURNITURE
Industrias Madereras
Mudesa
Fanesa

VIDRIOS
Criscasa

NON-FERROUS METALS
Alunisa
Nicalun
Envases Metalicos
Envases Centroamerica
Alumnio
Edison Industrial

FERROUS
Intercasa
Imep
Inca
Metasa
Emensa
Implagsa

CHICKEN FARMING
Nutribal
Erara
Eparha
Emp. de Prod. Avicola de Carne

GOLD MINING
Emp. Fco. Meza Rojas
La Libertad
Bonanza
Siuna
Enimep
Ecomin
Sumin
Proyecto La India
Laboratorio Central
Geonic

VENTA AUTOMOTRIZ Y REPUESTOS
Dismotor
Edina
Vimsa
Autenisa

TALLERES MAQUINADO
Enira
Comanicsa
Empi
Trecons Central
Trecons Battahola
Taller Central (Leon) (Proyecto)
Julio Barrios (Rebuild Agric. Machinery
Fabrica Moldes y Matrices

CAFE
13 Coffee Plantations

FRUIT AND VEGETABLE PROCESSING
Valle de Sebaco
1 Frugalasa

ALGODON
Ajonjoli

FUMIGACION AEREA
Cochisa
Etsa

CONSTRUCCION
Ene
Conicsa
Sovipe

Cartonera Nicaraguense

Companic (Printing)
Empresa de Insumos No Medicos

CHEMICALS
Nicar Quimica
Fab. Nac. Fosforos y Grillos
Cia Productos Atmosfericos
Electroquimica Pesada (Stand Alone)

PHARMACEUT/COSMETICS
Laboratorios Unidos
Laboratorios Solka
Empres Nic. de Sueros

PLASTICOS
Eniplas
Plastinic
Hules de Nicaragua
Espina y Aislantes de Nic.
Sonio Industrial

Dia Nacional Prod. de Cemento

CONCRETE
Materiales y Construccion
Concreto Pretensado
Proinco
Procon
Panelnic
Nicalit

DAIRY
La Perfecta - Reclamo
La Completa - Asset Sale

MARKETING BOARDS
Encafe - Deregulate - cooperatise
Enal - " "
Eniprex - " "
Deltonic- " "

IMPORT MAQUINARIA PESADA
Agromac - Claim
Enimaq - Divest
Enicons Traksa - Stand alone

FERTILIZANTES
Enia
Proagro

EQUIPO RADIO
Ecami

FERRETERIAS
Sumagro - Divest
Gallo y Villa - Divest
Matra - Divest
Cortasa (Hardware)
Comacripsa (Hardware)

INGENIOS
Javier Guerra
Benjamin Zeledon
Julio Buitrago
Camilio Ortega
German Pomares
Victoria de Julio
San Antonio
Emsa
Enazucar

ABATTOIRS
Carnic
Condega
San Martin
Amerrisque
Igosa
Encar

GANADERIA NO GO

Corcop: - In-House w/excepsion

FISHERIES
Combinado Peq Camilo Ortega
Alimentos Int.
Pequeros del Caribe
Maritina Corn Island
Dist. Prod. Mar y Lago

TABACO
Emp. Oscar Turcios
Emp. Laureano Mairena
Emp. Nicaragua Cigars

TRANSPORTE
Enatt
Enabin
Enabus
Aeronica
Emcaflet
Ferrocarril

NGINEERING/CONSULTANTS

.MS
Enadis
Ingenieria y Proyectos
Hotel INSA
Ecomin
Matconsult (Liquidation)
Proisa (Liquidation)

BANANA

Banana Intl
Empresa Bananera de Occident

LOGGING/FOREST MANAGEMENT

Corexsa
Plynic
Madecasa
Yodeco
Agrofocsa
Comsonicsa
Acripsa
Projonisa
Madsa
Pierson
Jackman

HOTELS

Las Mercedes
Montelimar
Camino Real
Xiloa Turistica

COTUR (excl hotels)

ARROZ

Pagronica
Rigoberto Lopez Perez
Juan Loredo
Emp. Nac. Talleres

ALIMENTOS

Empresa Nacional de Sal
Industrias Delmor
Industrias Chipirul
Hielera Polar
ENA

DRINKS

Cia. Cervezera Nic.
Embotelladora Nacional

ALCOHOL

Induquinisa
Licores Bell

Aeropuerto
Nanica
Van Pac
Transagro

MISCELLANEOUS

Enimport

Empresa Nacional Porcina

Cometales - Foundry

Fabrica Nac. Baterias

Import y Represent. Industrial

Bodegas Industriales S.A.

Comnomet - Non-metal quarrying

Atlantic Maritime

Apatlan - Aduaneros

Alpac

Aldenic/Avassa/Pamar

Tecnomedic - Health
Empresa de Servicio Automotriz
Cojarma
CDC

Yucasa

ANNEX 6: BUDGETS

NICARAGUA

TOTAL ESTIMATED COST OF THE PRIVATIZATION PROGRAM 1/ 2/

I. PHASE I: PLANNING AND INITIAL IMPLEMENTATION

	US DOLLARS
Interim consultant (one person for up to 6 months)	100,000
International consultant firm for planning and initial implementation (TOR attached) for 4 months	1,170,000
Independent accountants and auditors for first stage (small scale) privatization (estimated based on 70 firms)	300,000
Total phase I	$1,570,000

II. PHASE II: FULL PROGRAM IMPLEMENTATION

10 Sector strategies and divestitures prepared	
In-house (estimate of 90 companies)	
Local costs of accountants, lawyers and experts	
Auditing of 20 small firms at $2,300 each	46,000
Auditing of 60 medium firms at $5,000 each	300,000
Auditing of 10 large firms at $8,000 each	80,000
Sub-total	426,000
Lawyers/legal services	
14 packages of 5 firms at $20,000	280,000
10 small firms at $5,000	50,000
10 large firms at $15000	150,000
Sub-total	480,000
20 local sector/subsector experts ("peritos")	200,000
20 sector strategies and divestitured prepared by international consulting firms	
5 secotrs at $800,000	4,000,000
10 sectors at $500,000	5,000,000
5 sectors at $250,000	1,250,000
Sub-total	10,250,000
Total phase II	$11,356,000

Continues ...

NICARAGUA

TOTAL ESTIMATED COST OF THE PRIVATIZATION PROGRAM (Continuation)

III. SUPPORT ACTIVITIES

Management information system	429,000
Training program	61,000
Privatization adviser	288,300
Public relations adviser	288,300
Promotional campaign	3,720,000
Printing expenses including security printing in U.S.	1,000,000
Equipment (vehicles, photocopying and facsimile machines)	163,000
Total support activities	$5,949,600
GRAND TOTAL	$18,875,600

PARALLEL ACTIVITIES OUTSIDE OF CORNAP (Estimates only)

Technical assistance office for workers groups (2 persons for 2 years)	577,000
Loan Fund for workers buy-outs	10,000,000
Separation allowances 20,000 redundant employees X $100/month X 6 months	12,000,000
Management assistance to existing corporations for 1 - 3 years to improve operations and/or costs of restructuring organization	5,000,000
Fund to finance debt restructuring and/or debt write-off	10,000,000
Line of credit through commercial banks	25,000,000
Total	$62,577,000

1/ See attached budgets for detailed cost estimates.
2/ Does not include CORNAP staff costs and administrative expenses.

FIRST PHASE CONSULTANCY COSTS

2 Team leaders:

1 to consolidate data gathering and coordinate screening

1 to design process and ensure application of measurable criteria

5 analysts:

-- Each to be responsible for compiling database for some 50 enterprises

-- Responsible for writing terms of reference

-- Responsible for compiling sector data packs

Elapsed time: 18 weeks

Team leaders:	
2 X 18 weeks at @$15,000 per week	$ 540,000
Analysts:	
5 X 18 weeks at @ $7,000 per week	$630,000
TOTAL COST:	$1,170,000

EXAMPLE OF CONSULTING FIRM COSTS
TOURISM SECTOR
CONSULTANT BUDGET[1]

1.	Market over view	4
2.	Regulatory and institution (?) design sector strategy	2
3.	Review each hotel: financial survey 2 persons X 2 months X 4 hotels	16
4.	Business strategies 1 person X 2 months X 4 hotels	8
5.	Hotel specialist 1 person X 2 months X 4 hotels	8
6.	Senior supervisor 1 person X 3 months	3
7.	Contingency = Advisor 1 person X 4 hotels	4
8.	Bankers 1 person X 4 hotels X 1 month	4
Total Person Months		49

= 196 person weeks
estimated average at $4,000 per week = $784,000

[1] Budget includes overhead, travel, per diem and other consultant firm expenses

INFORMATION STRATEGY BUDGET

		NO.	SALARY	P/H	TOTAL
A.	PERSONNEL				$429,000
	Experts at CORNAP				114,000
	- Information Process Manager	1	3,500	1	42,000
	- Systems Analyst	1	3,000	12	36,000
	- Programmer	1	3,000	12	36,000
	On site Accountants on targeted enterprises				315,000
	- Chief Accountant	30	2,500	3	225,000
	- Assistant	30	1,000	3	90,000
B.	EQUIPMENT	NO.	UNIT PRICE		111,750
	At CORNAP				41,250
	PC-AT	10	2,000		20,000
	Small Printers	10	350		3,500
	Fast Line Printer	1	1,000		1,000
	Laser Jets	2	2,500		5,000
	Graph Plotters	2	2,000		4,000
	Unit Power Supply	10	375		3,750
	Software				4,000
	At Targeted Enterprises				70,500
	PC-AT	30	2,000		60,000
	Small Printers	30	350		10,500
TOTAL:	A & B				$540,750

TRAINING PROGRAM BUDGET

ACTIVITIES	DURATION	NO. OF PARTICIPANTS	COSTS UNIT	COSTS TOTAL
Workshop on Nicaraguan pfivatization process flow	1 day	10		$7,000
Training on valuation techniquesbased on on-site valuation expert	1 month	1	$10,000	$10,000
Privatization techniques seminar	1 week			$44,000
Consultants/instructors		4	$4,000	$16,000
Average cost per participant		40	$700	$28,000
TOTAL TRAINING PROGRAM				$61,000

PUBLIC RELATIONS DEPARTMENT

Budget

Compensation	$100,000 per year for two years	$ 200,000
Travel	Two round trip fares USA/Managua @ $1000	2,000
Shipping of Personal Effects		20,000
Per Diem	Hotel stay up to two months after arrival and one month before departure 90 days X $200	18,000
Housing Allowance	21 Months X $1500	31,500
Driver	24 months X $200 - Automobile provided by CORNAP	4,800
Entertainment Allowance	24 months X $500	12,000
TOTAL ESTIMATED COSTS		$288,300

PROMOTIONAL CAMPAIGN BUDGET

Estimated Budget

Small Scale Firms	
2 ads each in 3 local papers for 100 firms @ $200	$ 120,000
2 ads each in 5 international papers for 100 firms @ $1,000	1,000,000
Total Small Firms	$1,120,000
Larger Sectoral Firms	
2 ads each in 3 local papers for 50 firms @ $500	165,000
2 ads each in 10 international papers for 50 firms @ $200	$2,000,000
Total Larger Firms	$2,165,000
Public Relations Agency 20%	433,000
Total	$3,718,000

Equipment (other than computers)

7 vehicles for CORNAP management and consultants	$120,000
1 photocopying machines	1,500
1 FAX machine	3,500
2 car phones at $1000 each	2,000
7 telephone sets	1,000
local cost of telephone lines	7,000
office furniture (7 sets)	28,000
Total	$163,000

BUDGET FOR THE
TECHNICAL ASSISTANCE OFFICE
FOR WORKERS GROUPS

2 International Advisors (donation) (travel, insurance & transport)	$400,000
3 Local Advisors	64,000
Rental of office space for two years	40,000
2 Secretaries for 2 years	17,000
1 Receptionist for 2 years	6,000
Miscellaneous office expenses for 2 years	50,000
Total	$577,000