THE WORLD BANK GROUP ARCHIVES

PUBLIC DISCLOSURE AUTHORIZED

Folder Title:	Managing Committee Official Files: Records of the Operations Policy Subcommittee - Correspondence 01
Folder ID:	1775782
Series:	Managing Committee official files
Dates:	11/01/1982 - 12/31/1982
Subfonds:	Records of President A. W. Clausen
Fonds:	Records of the Office of the President
ISAD Reference Code:	WB IBRD/IDA EXC-09-3963S
Digitized:	03/23/2023

To cite materials from this archival folder, please follow the following format:
[Descriptive name of item], [Folder Title], Folder ID [Folder ID], ISAD(G) Reference Code [Reference Code], [Each Level Label as applicable], World Bank Group Archives, Washington, D.C., United States.

The records in this folder were created or received by The World Bank in the course of its business.

The records that were created by the staff of The World Bank are subject to the Bank's copyright.

Please refer to http://www.worldbank.org/terms-of-use-earchives for full copyright terms of use and disclaimers.

THE WORLD BANK
Washington, D.C.
© International Bank for Reconstruction and Development / International Development Association or
The World Bank
1818 H Street NW
Washington DC 20433
Telephone: 202-473-1000
Internet: www.worldbank.org

PUBLIC DISCLOSURE AUTHORIZED

MC - Operations Policy Subcommittee

1982

①

DECLASSIFIED

WBG Archives

The World Bank Group Archives

1775782

A1995-271 Other #: 39 209398B

Managing Committee Official Files: Records of the Operations Policy Subcommittee - Correspondence 01

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

OPS/MC82-46

TO: Members of the Managing Committee

DATE: December 30, 1982

FROM: Ernest Stern, SVP, Operations

SUBJECT: Compliance with Loan Covenants

WPH 1/7

Attached, for your information, is our response to the OED Report on Compliance with Loan Covenants. We plan to distribute the document to the Executive Directors in the first week of January.

I do not recommend a Managing Committee discussion but would be glad to schedule one if anyone wishes. There are no significant policy issues. The paper has been prepared with the assistance of the Legal Department, and discussed in the OPSC.

Attachment

cc: Mr. Hunphrey
Mr. Southworth

ES:dpw

MANAGEMENT RESPONSE TO OED'S OPERATIONAL POLICY REVIEW:
COMPLIANCE WITH LOAN COVENANTS

Executive Summary

Recommended Management Decision

It is recommended that the Management Committee approve the attached response for submission to the Executive Directors. The response does not call for any changes in Bank policies or procedures but suggests that we make a greater effort to consolidate related covenants into a plan of action.

The proposed response is based on reviews of the OED report and of the Proposed Management response by the Regions and the Legal Department. It was discussed by the OPSC on December 15, 1982, and there is full agreement on it.

Summary of OED Report and Management Response

The adequacy of loan covenants is an important and continuing concern of the Bank's Management because they form an essential part of our dialogue with borrowing member countries. Compliance with loan covenants has been reviewed by the Bank Management and the Board on several occasions in the past. The major conclusion of these reviews has been that Bank policies and procedures in respect of covenants are generally adequate. Moreover, a number of steps have been taken in recent years to focus more explicitly on compliance with loan covenants.

The OED Report points out that noncompliance is a neutral indicator: it may indicate that unforeseen events have occurred which call for reformulation of loan agreements, or reflect difficulties which borrowers may have in complying with covenants that address broad and ambitious development goals. Noncompliance may also reflect poorly designed covenants, unrealistic objectives or inadequate communications between the Bank and its client, leading to misunderstandings on objectives and the means of achieving them. We generally agree with the OED findings.

The OED Report makes two types of recommendations: first, greater flexibility in loan documents through more selective use of covenants. To achieve this it suggests that a) covenants dealing with a number of "minor" actions could be consolidated into a plan of action or implementation schedule which may take the form of a schedule to the agreement, a supplemental letter or a combination of both. The Management agrees that such consolidation has merit. It has been used in the past and its wider application will be undertaken. And b) project objectives or general undertakings which are really targets or intentions rather than firm obligations might appropriately be registered in less formal and more flexible instruments such as letters of intent or memoranda of understanding, rather than in covenants. The Management believes that the range of alternative instruments to register agreements and understandings is adequate. OMS 3.18 provides for a system of legal documentation which can serve the particular purposes of the loan and accommodate both legally-binding covenants and nonbinding understandings.

Second, the OED Report suggests improved procedures for reaching agreements, including a) appraisal missions to leave an Aide Memoire with the borrower; b) making the legal documents and appraisal report available to borrowers four weeks before negotiations; c) recording agreements reached on the interpretation of specific covenants in Agreed Minutes of Negotiations, signed by both parties; d) careful monitoring of compliance with all covenants by supervision missions; and, e) advising borrowers promptly of possible violations, asking for corrective actions, and renegotiating covenants which cannot be complied with. The Management is in agreement with the intent of these recommendations. Recommendations c), d) and e) are current practice. However, somewhat greater flexibility is required in regard to recommendations a) and b); detailed specification of covenants at appraisal is sometimes premature and a four-week requirement for making documents available would be unnecessarily rigid, as the OED Report recognizes.

The OED Report is a helpful reminder that project objectives and requirements must be reasonable and realistic, that the dialogue with our clients must be conducted so as to assure full mutual understanding, that we must be flexible in situations which are inherently complex and changing. While we rely primarily on the professional and diplomatic judgments of Bank staff in these matters, we also have extensive review procedures to minimize poor judgments and mistakes.

12/28/82

MANAGEMENT RESPONSE TO OED'S OPERATIONAL POLICY REVIEW: COMPLIANCE WITH LOAN COVENANTS

A. INTRODUCTION

1. Loan covenants are an essential aspect of the dialogue on economic development between the Bank and its clients.[1] The Bank Management, therefore, welcomes OED's "Operational Policy Review--Compliance with Loan Covenants" (Report No. 4090, September 1, 1982), as part of its continuing review of this important subject.

2. The Articles of Agreement of the Bank provide that the Bank shall make arrangements to ensure that the proceeds of any loan are used only for the purposes for which the loan was granted, with due attention to considerations of economy and efficiency. The Articles of Agreement of IDA contain a similar provision. Thus, the Bank is required to agree with the borrower on a description of the purposes for which the loan is to be granted, and on appropriate disbursement, procurement, accounting and reporting covenants. The provision also implicitly requires the Bank to ensure that the purposes for which the loan proceeds are disbursed will be realized; this is accomplished through covenants covering the financial, administrative and technical aspects of project execution and the achievement of any other purposes for which the loan is granted.

3. The nature of the relationship between the Bank and the borrower, as embodied in loan covenants, has a number of dimensions. One type of covenant directly related to project objectives deals with the physical implementation of projects. This includes such diverse requirements as adequate staffing and the provision of full financing for the project; appropriate procurement procedures, while in the Bank's direct interest, are also important for efficient project implementation. A more complex type of covenant, arising from the Bank's special role as a development agency, deals with sector and project developmental policies and the

---

1/ The OED Report and this response are limited to "development covenants" dealing primarily with project objectives and execution; they do not deal with other covenants, such as loan service covenants.

strengthening of institutions. The range of these concerns is very wide and includes such matters as long-term staff development; policies concerning prices, tariffs and charges; operations and maintenance; and accounts and auditing systems. Often covenants serve several purposes concurrently such as, for instance, tariff covenants that are designed to ensure the financial viability of the borrower as well as to relate tariffs properly to the economic costs of the service for which they are charged. The rationale for the wider range of covenants is well summarized in para. 2.31 of the OED Eighth Annual Review of Project Performance Audit Results (R82-270) as follows:

> Institutional or other development objectives at the project level are increasingly linked to wider sector objectives as both the Bank and borrowers have become aware that the effectiveness of projects and of institutions which they help to establish or to strengthen, often depend on a sector environment supportive of these objectives. Thus, price structures and levels for agricultural products are crucial to the success of farm projects as are marketing arrangements, taxes, manpower training or infrastructure investments. Tariff policies can have a major impact on the viability of institutions operating in transport or public utilities while appropriate interest rate policies may be essential for the development of DFCs. Sector issues are therefore addressed through project lending where such initiatives are considered essential to the attainment of basic project objectives.

4. Given this wide range in types of covenants, the fact that some covenants are more important than others to achieving project objectives, that some noncompliance may arise in spite of the borrower's best efforts because changed circumstances have made the agreed objectives no longer feasible, and that some noncompliance may involve only a minor deviation while another may threaten the basic objective of the project, there can be no predetermined, automatic reaction by the Bank to noncompliance. Instead, the Bank's response requires symphathetic understanding of the problems involved, sensitivity in communications between the Bank and the borrower and a joint effort to try to resolve these problems so that the agreed objectives can be met, or if this is no longer possible, modified appropriately. In contrast to "arms-length" commercial agreements where the interests of the parties may be directly opposed, the Bank and its borrowers have a mutual interest in the realization of project objectives and thus in arriving at effective and constructive solutions, rather than the imposition of penalties. This is not to imply that the Bank does not take failure to comply with covenants seriously, but rather that the approach to compliance requires flexibility, difficult judgments and good communications between the Bank and borrowers.

B. RECORD OF COMPLIANCE AND ACTIONS TAKEN

5. Since the OED Report relies on prior studies in determining the scale of the compliance problem,2/ it may be useful to summarize the major findings of these studies:3/

a) Bankwide in 1979, 39% of all projects (then totalling about 1,500) suffered from violations of one or more major covenants. The majority of noncompliances took place among financial covenants, primarily audit covenants.

b) The Bank was satisfied that in 68% of the projects involving noncompliance, the borrower and country were taking adequate measures to solve the problem. In an additional 17% of the projects, the covenants were overtaken by events and had to be modified or deleted. Thus, in only 15% of the projects involving noncompliance were Bank remedies considered necessary. While the study did not analyze noncompliance in terms of number of covenants, it seems that about 6% of the total number of major covenants involved violations.

6. A more recent study of loan covenants reviews the compliance record in regard to 14 different types of covenants for about 180 projects, selected at random. In general, about 40 percent of the projects present no significant problem in compliance and an additional 50 percent have moderate problems which are being adequately resolved; 6 percent have moderate problems not being resolved; and only about 4 percent of the projects have major compliance problems but most of these are being resolved. Among the types of covenants, the range of compliance is quite wide. Compliance with procurement guidelines presents a major problem in only 3 percent of the projects. On the other hand, provision of adequate funds for the project is a major problem in 18 percent of the projects and

---

2/ The Report includes nine case studies. They are not intended to be representative, but to illustrate issues that had been identified beforehand (para. 1.15).

3/ Major recent studies include "Experience with Revenue Covenants" in the report on Project Implementation and Supervision (R78-68, March 24, 1978); and "Experience with Loan Covenants" in the Fifth Annual Report on Project Implementation and Supervision (R80-141, May 29, 1980). The OED Report, in para. 1.11, lists a number of other studies related to covenants.

a moderate problem in an additional 27 percent of the projects, but in two-thirds of these projects, the problem is being resolved. Noncompliance with financial covenants involving prices, tariffs or charges is one of the most pervasive problems, involving moderate or major problems in about 50 percent of projects, but about three-fourths of these problems are being adequately resolved. These findings are generally consistent with those of the earlier studies and help to put the issue of noncompliance into perspective.

7. The OED Report summarizes the findings of the earlier studies as follows (para. 1.12): Bank policies and procedures in respect of covenants are on the whole adequate. They are generally necessary and workable, although greater flexibility in the use of legal instruments, better communications with borrowers on project objectives, and more realistic implementation schedules would be desirable.

8. As a result of the lessons learned from prior studies, we have taken a number of actions in recent years to focus more explicitly on loan compliance.

a) As part of the process of project appraisal, a meeting is held with all interested staff shortly after return of the appraisal mission at which major project issues are discussed and tentative decisions are made. The decisions are submitted in a Decision Memorandum to the Senior Vice President for Operations, through the Regional Vice President, for approval. In 1981, the transmittal sheet for the Decision Memorandum was modified to require a listing of major covenants not in compliance on problem projects in the same sector. This calls significant noncompliance to the attention of managers at different levels, so that it can be taken into account in the decision to proceed with a new project. As a result, new lending has on occasion not proceeded until the noncompliance issue has been adequately resolved.

b) Because noncompliance with audit covenants presents an important problem, as highlighted in earlier studies, a special task force was established in 1980 to review the matter. Following its recommendations, a number of actions were taken:

i) Each Region has established a detailed monitoring system on compliance, which provides managers with up-to-date information on receipt of audited financial statements.

ii) Country surveys of accounting and auditing capabilities are being undertaken; by the end of FY82, twenty surveys had been completed and an additional twenty will be done in FY83.

iii) On the basis of these surveys, programs for improving these capabilities are being developed. These include, for example, the identification of training needs, the design of training programs, the clarification of responsibility for auditing within Government agencies, and the promotion of appropriate accounting and auditing standards.

iv) A person was designated in each Region responsible for assuring adequate progress on the above. In addition, further guidelines on financial reporting and auditing have been issued for both borrowers and staff and training is being strengthened.

c) We have been reviewing the extension of closing dates for projects more carefully in recent years, and as part of these reviews have focused explicitly on noncompliance with covenants. We are not prepared to extend closing dates where noncompliance undermines the basic objectives of the project.

d) Some Regions have established a computerized information system on loan covenants which indicates the status of compliance and the action taken in case of noncompliance. This information is useful both for periodic reviews of the portfolio, as well as for regular project supervision, e.g., supervision missions get a printout before departure so that the issue can be adequately discussed during field supervision.

C. MAJOR FINDINGS

9. As the OED Report points out, "noncompliance of itself is a neutral indicator" (para. 3.02). It may indicate that unforeseen events have occurred which call for reformulation of loan agreements, or reflect difficulties which borrowers may have in complying with covenants that address broad and ambitious development goals. On the other hand, noncompliance may also reflect poorly designed covenants, unrealistic objectives or inadequate communications between the Bank and its client, leading to misunderstandings on objectives and the means of achieving them.

10 Project Preparation and Appraisal. The OED Report discusses specific causes of noncompliance in chronological order of the project

cycle. During project preparation and appraisal, it finds that unrealistic project objectives and project complexity can lead to noncompliance (paras. 2.04-2.15). The Management agrees. The finding that project objectives and implementation schedules are not always fully achievable is supported by prior studies. The 1980 Bank study on compliance with covenants[4/] pointed out that a covenant with a fully "realistic" target, reflecting what the borrower would be expected to do anyway, is meaningless. Covenants are included to achieve particular results which add to the economic development of the country; this is the essential rationale for Bank involvement. But unrealistic targets are counterproductive. A reasonable covenant has to take into account the nature of the activity; the borrowers' expected rate of achievement of the objectives agreed upon; the planned supervision effort; and the expected evolution of exogenous factors. Covenants should be realistic both in substance and in their time horizon and if they cannot be met, in spite of reasonable efforts, because of changed circumstances they should be modified. We have found, for example, that implementation of many projects takes 1-2 years longer than was anticipated at appraisal, even when the appraisal estimates are more realistic than the borrowers' own expectations. To achieve more realistic implementation and disbursement schedules, we have required, since 1981, that Appraisal Reports indicate how these schedules are related to prior experience in the sector and country which has now been systematically collated. We have also obtained over the years a better understanding that many institutional objectives take longer to achieve than the completion of investments and that they must therefore either be more modest or spread over a number of projects.

11. The problem of project complexity was discussed at length in the Seventh Annual Report on Project Implementation and Supervision (R82-111, April 19, 1982, paras. 35-61). The Report pointed out that in recent years, many Bank-financed projects have included a large number of components, dealing with several sectors, subsectors and geographical areas, involving a number of institutions and tackling multiple development constraints--this in contrast with "old style" projects generally addressing only one subsector, one institution and one development constraint. There are several reasons for such increased project complexity. First, the realization that what prevents development in a particular setting is a group of interrelated constraints, making an attack on just one of them ineffective. Second, development objectives themselves are getting broader. An agriculture project, for example, may not only be concerned with increasing production, but also with the distribution of benefits and perhaps with the provision of basic needs. Third, activities such as education and health, traditionally regarded as more in the nature of consumption than production, are now recognized to be important factors

---

4/ Fifth Annual Report on Project Implementation and Supervision (R80-141, May 29, 1980).

influencing the level of production and are increasingly being included as components in development projects. And fourth, many countries, especially in Asia and Latin America, have already completed most of the "easy" initial stages of the development process, for example, building basic infrastructure and using the best resources readily available. The second generation of projects entails dealing with less obvious alternatives and more difficult solutions, technologically and institutionally. The 1982 Report found that in several instances, especially with regards to agriculture, education and urban projects, objectives may have been too ambitious and projects too complex.

12. The Report outlined factors which determine a feasible level of project complexity and suggests ways in which complexity can be reduced, taking into account political, economic, institutional and technical constraints. For example, if a project appears unduly complex, it may be possible to divide it into separate components or subprojects that can be implemented and operated independently by entities in the public or private sectors, so as to minimize the coordination requirements. Other alternatives include to phase the program over time, to start initially with a pilot project, or to use minimum packages limited to the most important components, leaving out subsidiary ones. The application of these guidelines in specific project situations requires difficult judgments by both the Bank and the borrower, which are, in turn, reflected in loan covenants. Since these judgments cannot be avoided and since some mistakes are bound to arise, it is important to adjust constructively to necessary changes as soon as they are identified, by modifying covenants accordingly.

13. Loan Documents and Negotiations. As far as loan documents are concerned, the OED Report identifies the problems under four broad categories:

a) Deficiencies in the design of covenants (paras. 2.17-2.18). The OED Report points out that the design of covenants is sometimes defective so that the intended objective is not met. A recent staff review of 13 projects approved in FY81, selected at random from the agriculture and transport sectors, found that the formulation of the 96 covenants involved was generally satisfactory, but some of the covenants presented such possible issues as excessive generality, excessive detail, lack of clarity, unrealistic timing, etc. However, the degree of detail in the formulation of a covenant depends in part on the extent of prior discussions and understandings with the borrower. For example, where the Bank and the borrower share common policy objectives, detailed covenants may be less important than where objectives are not fully shared.

The degree of generality may have been intended to provide greater flexibility in situations which are perceived to be complex and changing. Design of covenants receives careful attention; the need for improvements must continue to be addressed on a case by case basis.

b) Conflict with local law and administrative practice (paras. 2.19-2.21). The OED Report finds that noncompliance with covenants can also result from conflict with the country's law or administrative practices. The Management believes that the policy set out in OMS 3.18 on Loan/Credit Contractual Documents provides appropriate guidance on this problem. While recognizing that the Bank's agreements are international agreements governed by international public law and as such are binding in spite of domestic law, it states that "the Bank avoids wherever possible covenants which would be inconsistent with, or which could not be performed under, the domestic law of the member concerned. If such covenants are required, they should be accompanied by clear agreement on the appropriate steps to be taken to amend domestic law" (para. 6). In practice, the Bank endeavors to ensure compatibility of its agreements with domestic law and to avoid situations where changes in domestic law would be required. We also require, as a standard condition of loan effectiveness, an appropriate legal opinion from the borrower confirming the enforceability of the covenants under domestic law. Similarly, the Bank takes special care to work within the established administrative framework of the country. Where a project contains any special feature going beyond established practices, the issue is addressed and undertakings are reached on the specific measures that will be required for implementation. However, the Bank is not in a position to foresee all potential administrative difficulties; borrowers are generally in a better position to do so. Also, administrative difficulties are sometimes the excuse rather than the reason for failure to take appropriate steps.

c) Unreasonable project requirements (paras. 2.22-2.25). The OED Report finds that some project requirements are unreasonable in that they seem to go beyond what borrowers consider to be the appropriate concern of the Bank in regard to the project. Unreasonable requirements should of course be avoided. OMS 3.18

specifically provides that "it is the policy of the Bank to negotiate only covenants that are realistic and reasonable" and spells out some of the implications of such a requirement. For example, care must be taken to avoid covenants that impose excessive burdens on the borrower or reach beyond what the borrower may be expected to be able to accomplish. The OMS explains that unreasonable or unrealistic covenants will not, in most cases, be fully met, and may become an irritant in the relations between the Bank and the borrower. To determine what is reasonable in the particular circumstances of a given project may be a difficult matter of judgment, and therefore open to mistake. The OED Report presents no evidence on the size of the problem, but a recent staff review found that all 96 special covenants in the 13 projects studied were relevant to the project objectives. The review did not examine the appropriateness of the project designs, but in some cases the timing of actions required seemed unduly optimistic. The issues concerning unreasonable requirements are closely related to those of unrealistic covenants, discussed in para. 10, as well as to the design of covenants, discussed in para. 13a.

d) <u>Excessive use of covenants (paras. 2.26-2.28)</u>. The OED Report points out that problems in compliance sometimes arise if a project imposes a large number of covenants on the borrower, and that neither the borrower nor the Bank may have the capacity to monitor a large number of covenants. The Management agrees that an excessive use of covenants should be avoided. But as the OED Report recognizes, "an extensive list of covenants does not necessarily mean that the project has 'too many covenants'" (para. 2.27). Again, what is excessive or insufficient depends on the particular circumstances of a given project and even then is inevitably subjective. It depends on appropriate judgments with respect to such factors as the number of agencies involved, the number of project components, the range of policy objectives, and the prior performance of the borrower. No doubt some judgments on these matters have been mistaken and resulted in excessive covenants. The most obvious way to reduce the number of covenants significantly would be to limit ourselves to simple projects but this would have other disadvantages (this issue is discussed in paras. 11-12). Excessive covenants may also result when certain measures, such as appointment of some key staff, have not been taken by the time the loan was approved and therefore have to be reflected in covenants. This is generally not desirable and should be minimized, but cannot always be avoided. As to difficulties in monitoring covenants, these arise less from their numbers than from the substantive issues involved in specific covenants. The possibility for more selective use of covenants is discussed further in para. 17.

14. Inadequate negotiating process (paras. 2.29-2.31). As to the negotiating process, the OED Report finds that legal documents are not always made available to the borrower in time to permit full consideration and that, on occasion, when documents are made available in advance, changes have been made in the meantime. The question of making documents available in time is discussed in para. 18b. Where the documents are distributed in advance of negotiations, it is made clear that they are drafts and therefore subject to change. We agree that the borrower must be promptly advised of all significant changes.

15. Project Implementation. During project implementation, the OED Report finds the following problems:

a) Inadequate communication (paras. 2.32-2.36). According to the Report, the borrower's understanding of the objectives and meaning of a covenant is not always the same as that of the Bank's. There are no doubt instances of differences in understanding, emphasis and interpretation between the borrower and the Bank, between different agencies within the country or even between Bank staff. Given the complexity of development issues, their economic, social and political implications and the cultural diversity among the persons involved, some differences in interpretation are inevitable. However, we do not believe that this is a frequent occurrence because the nature of most noncompliances (as identified in the 1980 study5/), e.g., those involving audit covenants, budget support, etc., is such that they are probably not based on misunderstandings. The major causes of noncompliance with revenue covenants were identified in the 1978 Report on "Project Implementation and Supervision" (R78-68) as lack of government commitment

---

5/ Fifth Annual Report on Project Implementation and Supervision (R80-141, May 29, 1980).

to the financial objectives and factors internal to the project or the agency. Misunderstandings no doubt occur occasionally as a result of inadequate communication, but were not identified as a significant factor.

b) Inadequate government commitment to project objectives (paras. 2.37-2.43). The OED Report finds that governments are not always fully committed to the objectives of a covenant. It is also our observation that inadequate commitment or political support for certain objectives is a significant factor in noncompliance. Both the 1978 and 1980 studies on loan covenants found that there may occasionally be differences in philosophy and approach, especially in the financial field, on such matters as the financial policies of public utilities. Moreover, the commitments of senior officials may not fully reflect the views of the bureaucracy that has to implement them, and, under the pressure of changing circumstances, priorities also change. Differences also arise where changes in governments or in government officials lead to changes in policies, so that the commitment of the prior government is no longer shared by the new one. In these situations, compliance is bound to present difficulties. While such difficulties can and should be minimized by bringing to the attention of the new officials the agreements and their rationale, they cannot always be avoided. For as the 1978 study pointed out, revenue covenants are a reasonable and necessary tool for helping governments and borrowers establish and maintain financial discipline and achieve long run institutional development objectives. Revenue covenants have helped in the adoption of measures to stop the financial deterioration of many entities, and to mobilize resources and obtain tariff increases that otherwise would not have been possible. In most cases, even if the objectives of the covenant were not fully achieved, the situation without these covenants would have been less satisfactory. In line with the recommendations of the 1978 study, we are continuing our efforts to make revenue covenants realistic and flexible, and to promote a better understanding and commitment of the borrowers to the objectives underlying these covenants.

c) Limited implementation or supervision capacity (paras. 2.44-2.47). The Report points out that limited implementation capacity, such as a shortage of local staff or local funds, creates difficulties in compliance. We agree with the importance of these factors. They are closely related to the need for realistic project objectives (see para. 10) and reasonable project requirements (see para. 13c). We try to deal with these problems in a number of ways, such as financing local or foreign technical assistance, establishing the requirements for local funds in advance and determining that they can reasonably be met by government budgets or internally generated funds. As for supervision, we believe that we have provided adequate staff resources to give supervision the high priority which it deserves. There are, of course, occasional questions of priority, temporary absences of key staff or mistakes in judgment which affect supervision, but staff resources have generally been adequate.

d) Change in circumstances (paras. 2.43-2.51). We agree with the OED Report that changes in circumstances beyond the control of either the Bank or the borrower can affect compliance with covenants. These changes include, for example, a slower growth of the domestic or world economy, lower commodity prices, serious financial difficulties and droughts. In these situations, the Bank is generally sympathetic and flexible in the interpretation of covenants and, if necessary, they are modified.

e) Use of remedies (paras. 2.52-2.54). The OED Report points out that compliance with covenants is also affected by the Bank's use of remedies and that the Bank is less concerned with the implementation of less important covenants. "While such an approach may be justified in some cases, it raises the question as to whether there was need for a covenant in the first place" (para. 2.54). Some covenants are clearly more important than others in achieving project objectives and the Bank's response to noncompliance should reflect both the importance of the covenant and the degree of noncompliance. For example, the failure to provide any local funds is more serious than a shortfall of ten percent; or inadequate meat prices may be more serious to the objectives of a livestock project than a month's delay in the audited accounts. Moreover, while a particular covenant may be less important by itself, a number of such covenants in combination may be very significant. We agree that every covenant should be relevant and that the number should not be excessive, but it does not follow that less important covenants should be omitted entirely. The use of remedies in case of noncompliance should reflect this hierarchy of importance. Extreme action such as suspension of disbursements, should in general be restricted to cases where a basic objective of the project is threatened, and the Bank has not been able to achieve a satisfactory solution through a constructive dialogue with the borrower (see para. 4).

D. RECOMMENDATIONS

16. The OED Report makes two types of recommendations: greater flexibility in loan documents and improved procedures for reaching agreements with borrowers.

17. Greater flexibility in loan documents. The OED Report recommends greater flexibility in loan documents through more selective use of covenants (para. 3.03). Specifically, it suggests the following two procedures for achieving this objective (paras. 3.04-3.12):

a) Covenants dealing with a string of "minor" actions could be consolidated into a plan of action or implementation schedule which may take the form of a schedule to the Agreement, a supplemental letter or a combination of both (para. 3.08). Comment. The Management agrees that such consolidation has merit in reducing the body of the loan agreement and putting related covenants together in one place, without compromising the effectiveness or the binding character of undertakings necessary for achieving project objectives. Such consolidation has in fact been used on occasion in the past, and it is our intention to use it more frequently and consistently in the future.

b) Project objectives or general undertakings which are really targets or intentions rather than firm obligations might appropriately be registered in less formal and more flexible instruments such as letters of intent or memoranda of understanding, rather than in covenants (paras. 3.09-3.12). Comment. The Management believes that the range of alternative instruments to register agreements and understandings currently available is adequate. OMS 3.18 provides for a system of legal documentation which can serve the particular purposes of the loan and accommodate both legally-binding covenants and non-binding understandings. There are three major types of legal instruments--covenants, supplemental letters directly related to a covenant and supplemental letters of intent---of which the first two are legally binding in that they are subject to such remedies as suspension of disbursement, which might be followed by cancellation of loan amounts or prematuring of loans. These instruments can be further supplemented by agreed Minutes of Negotiations which, although not legally enforceable, are useful in clarifying the record of negotiations, especially concerning controversial matters (see also para. 18c). Covenants are the appropriate instrument to record "any undertaking of a substantive nature which should be binding upon the party involved" (OMS 3.18, para. 32). Covenants can either cover the general substantive undertaking only, or can also include specific steps necessary to achieve it. In the former case, the instrumentality of supplemental letters directly related to covenants is available to provide greater particularity with respect to a covenant, if more details are required (OMS 3.18, paras. 31(a) and 32). A third type of instrument is the supplemental letter of intent which is designed to cover "statements of intention and the like which are significant to the project (and may sometimes pave the way for future covenants on the occasion of future loans to the same borrower for projects continuing, or expanding the one under consideration), but which are clearly not meant to constitute a covenant" (OMS 3.18, paras. 31(c) and 35). Such letters, which serve as a basis of a continuing dialogue between the Bank and the borrower, have been used in the past. Because they are not legally binding, they constitute less formal undertakings, as suggested by OED. On the other hand, we believe that by the standards suggested in the OED Report (para. 3.07), with which we agree, the scope for enlarging the use of legally non-binding instruments is limited. As OED has clearly recognized (in the passage quoted in para. 3 above), development objectives at the project level need to be linked increasingly to sector objectives.

18. Improved Procedures for Reaching Agreements. The OED Report suggests the following five changes in Bank procedures "to strengthen the process of preparing, negotiating and supervising legal covenants, and to

ensure that their implications are fully understood by the borrower" (para. 3.15):

a) Appraisal missions should generally leave with the borrower an agreed Aide Memoire which would include recommendations regarding specific covenants that might be required (para. 3.15a). Comment. The Management agrees with the intent of the recommendation that borrowers should be advised as soon as possible of specific covenants that will probably be required. Appraisal missions generally discuss likely topics to be covered by covenants with the borrower and some leave an Aide Memoire. However, field appraisal is only the first step of the appraisal process, and a considerable part of the analysis can usually take place only after the appraisal mission returns to Washington. In many cases, therefore, a detailed determination of probable covenants is not possible during field appraisal. It would, therefore, be more helpful to advise borrowers of probable undertakings after the Decision Meeting, at which the staff from all interested departments review the recommendations of the appraisal team and reach tentative decisions on major issues. By this time the project and major conditions have been defined more clearly and the appraisal mission's recommendations have received some internal review. It is now common practice to advise borrowers in writing of the details of the project and of major conditions at this time, and we believe that this is more helpful to them than the preliminary and unreviewed findings at the time of field appraisal. Since the conclusions of the Decision Meeting are generally available well in advance of negotiations, borrowers have adequate time for their thorough consideration. Moreover, we do not believe that an Aide Memoire, even where it can be meaningfully prepared during field appraisal, should be "agreed" between the mission and the borrower, as the OED proposal suggests. While it is useful to reach prompt understandings, the requirement for agreement at this early stage would not be helpful to the borrower or the Bank, could not bind them and could delay missions unduly.

b) As a rule, the legal documents and the draft Appraisal Report should be made available to the borrower four weeks before the start of negotiations. Alternatively, any other mechanism which might be more time-efficient and yet inform the borrower fully and in good time, could also be considered (para. 3.15b). Comment. The Management agrees that the borrower should be fully and promptly informed about the Bank's appraisal of the project and the related covenants. The Operational Manual (OMS 2.00, para. 44) permits the Regions to distribute the draft legal agreements and the Appraisal Report to the borrower prior to negotiations, and this is done in some cases (see also para. 14). In other cases, the key covenants and their rationale are submitted to borrowers at the time of the invitation to negotiate, which can be anything between several days to two months before negotiations. Because a 4-week requirement would be unnecessarily rigid and would lead to significant delays, a more flexible approach is preferable, as the OED Report recognizes. Current practice is to provide borrowers with the draft legal documents and Appraisal Report shortly before negotiations. Where borrowers request these documents for a longer period in advance, we are prepared to do so within reasonable limits appropriate to the case, e.g., taking into account the number and complexity of the issues, prior experience, and other relevant factors.

c) Agreements reached on the interpretation of specific covenants should be recorded in Agreed Minutes of Negotiations, signed by both parties (para. 3.15c). Comment. The Management agrees. This is current practice. OMS 3.18 recognizes that "the legislative history of an international agreement may be a supplementary means of interpretation of the agreement. Therefore, it is at times useful to have a concise and brief agreed record of negotiations, especially concerning controversial matters" (para. 38).

d) Supervision missions should carefully monitor the borrower's compliance with all covenants (para. 3.15d). Comment. The Management agrees. The Operational Manual (OMS 3.50, Attachment B) requires a specific annex to all Supervision Reports summarizing the status of compliance with the most important conditions on which the loan was based. It requires identification of conditions met, those upon which action is pending and those not complied with, and for the latter a discussion of the causes of noncompliance and the remedies being pursued. This is general practice for supervision missions, except certain specialized missions which issue only a limited Supervision Report.

e) Borrowers should be promptly informed in writing if they are deemed to be in violation of covenants and be asked what corrective action will be taken. Covenants which cannot be complied with should be promptly renegotiated (para. 3.15e). Comment. The Management agrees. An Aide Memoire is usually prepared by supervision missions and left with the borrower summarizing the mission's findings, including those relating to the question of compliance with loan conditions. Furthermore, a letter is sent as a matter of course to the borrower after each Supervision Mission, indicating the main issues and problems identified by the mission and outlining the recommendations on actions to be taken. These issues are followed up in our regular dialogue with the borrower. If, in fact, a covenant is no longer appropriate, it is usually amended or waived. The OED case studies illustrate this process in that they involve "situations where Bank staff recommended deletion or revision of covenants, or otherwise considered the application of formal remedies" (OED Report, para. 1.16).

E. CONCLUSION

19. The adequacy of loan covenants is an important and continuing concern of the Bank's Management because they form an essential part of our dialogue with our borrowing member countries. Compliance with loan covenants has been reviewed by the Bank Management and the Board on several occasions over a number of years. The major conclusion of these studies has been that Bank policies and procedures in respect of covenants are generally adequate. The OED Report is a helpful reminder that project objectives and requirements must be reasonable and realistic, that the dialogue with our clients must be conducted so as to assure full mutual understanding, that we must be flexible in situations which are inherently complex and changing. While we rely primarily on the professional and diplomatic judgments of Bank staff in these matters, we also have extensive review procedures to minimize poor judgments and mistakes.

20. We are in broad agreement with the recommendations of the OED Report as they relate to procedures for strengthening the process of preparing, negotiating and supervising legal covenants. We believe that the Bank's current system of legal documentation (as set out in OMS 3.18) is adequate in providing for a range of alternative instruments to register

agreements and undertakings considered essential to the attainment of project objectives. We will continue our endeavor to ensure selective application of the available instruments.

12/28/82

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

M. Humphrey

OFFICE MEMORANDUM

File with OPSC paper

TO: Members of the OPSC

DATE: December 13, 1982

FROM: Sidney E. Chernick, Assistant Director, CPD

AS km

wlt 12/21

SUBJECT: December 15 OPSC Meeting - Compliance with Loan Covenants

Attached is a brief addition to the draft management response to the OED review on this subject scheduled for discussion at the December 15 OPSC meeting. The paper was distributed to you on November 24.

Attachment

cc: Ms. Pratt
Messrs. Rajagopalan
Rovani
Waide
Adler

AS:ww

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Mr. A. Shakow

DATE: December 13, 1982

FROM: Hans A. Adler H.A.A.

SUBJECT: Supplement to Management Response on OED Review of Loan Covenants

Attached is an addendum prepared at Mr. Stern's request on Recent Actions on Compliance with Loan Covenants. The material will be added after para. 7 of the Management Response to the OED Review.

HA:da

Attach.

12-30

WB

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

SURE

OFFICE MEMORANDUM

TO: Mr. Ernest Stern, Senior Vice President, Operations DATE: December 8, 1982 12/8

FROM: Mr. Warren C. Baum, Vice President, Operations Policy

SUBJECT: Recent Actions on Compliance with Loan Covenants

In line with your request of November 15, 1982, there are listed below four specific actions which have been taken in recent years to focus more explicitly on loan compliance as a result of the lessons learned from prior studies. If you agree, this material will be incorporated in the Management Response to the OED Review.

1. As part of the process of project appraisal, a meeting is held with all interested staff shortly after return of the appraisal mission at which major project issues are discussed and tentative decisions are made. The decisions are submitted in a Decision Memorandum to the Senior Vice President for Operations, through the Regional Vice President, for approval. In 1981, the transmittal sheet for the Decision Memorandum was modified to require a listing of major covenants not in compliance on problem projects in the same sector. This calls significant noncompliance to the attention of managers at different levels, so that it can be taken into account in the decision to proceed with a new project. As a result, new lending has on occasion not proceeded until the noncompliance issue has been adequately resolved.

2. Because noncompliance with audit covenants presents an important problem, a special task force was established in 1980 to review the matter. Following its recommendations, a number of actions were taken:
i) Each Region has established a detailed monitoring system on compliance, which provides managers with up-to-date information on receipt of audited financial statements.
ii) Country surveys of accounting and auditing capabilities are being undertaken; by the end of FY82, twenty surveys had been completed and an additional twenty will be done in FY83.
iii) On the basis of these surveys, programs for improving these capabilities are being developed. These include, for example, the identification of training needs, the design of training programs, the clarification of responsibility for auditing within Government agencies, and the promotion of appropriate accounting and auditing standards.
iv) A person was designated in each Region responsible for assuring adequate progress on the above. In addition, further guidelines on financial reporting and auditing have been issued for both borrowers and staff and training is being strengthened.

3. We have been reviewing the extension of closing dates for projects more carefully in recent years and as part of these reviews have focused explicitly on noncompliance with covenants. We are not

prepared to extend closing dates where noncompliance undermines the basic objectives of the project.

4. Some Regions (S. Asia, EMENA) have established a computerized information system on loan covenants which indicates the status of compliance and the action taken in case of noncompliance. This information is useful both for periodic reviews of the portfolio, as well as for regular project supervision, e.g., supervision missions get a printout before departure so that the issue can be adequately discussed during field supervision.

HAAdler/sc

Mr. Humphrey

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

UMA 12/21

TO: Members of the OPSC

DATE: December 10, 1982

FROM: Sidney E. Chernick, Assistant Director, CPD AS for

SUBJECT: Agenda for December 15 OPSC Meeting

Attached is a two-part agenda for the December 15 OPSC discussion of (a) the Joint UNDP/Bank Energy Sector Assessment Program Paper, and (b) Management's Response to OED's Operational Policy Review: Compliance with Loan Covenants.

Attachment

cc: Ms. Pratt
Messrs. Rajagopalan
Rovani
Waide
Rao
Adler
Bharier

Operations Policy Subcommittee

December 15, 1982

Agenda

A. Joint UNDP/World Bank Energy Sector Assessment Program Paper

1. Background. Two years ago, the Bank and UNDP began a program of country energy assessments. This paper describes the assessment process and the results achieved thus far. It emphasizes the importance of follow-up work, both in-country and within the Bank. OPSC views are particularly sought on the proposal for an Energy Program Paper to help coordinate country energy sector activities in the Bank.

2. Evaluation of the Program. The paper notes that the response from governments to the assessment program "has been strong" with requests exceeding the 60 countries originally envisaged; "there is also growing evidence that governments [and other donors] are making extensive use of the advice provided by the assessments" (page 1).

Does Regional experience support this evaluation? Have the completed assessments proven useful in the Bank's work?

3. In-Country Follow-Up. The paper (page 13 ff) proposes various steps to ensure that assessment recommendations are implemented. Tasks for the Bank and/or UNDP to carry out in-country (at the request of the government) are suggested on page 15. These include, among others, helping identifying "sponsors" to take up individual activities; assisting the government in review of proposals from donors; and monitoring progress on such assistance. According to the UNDP/IBRD Progress Report on this subject recently sent the Board (SecM82-950, Nov. 22, 1982), an Energy Sector Management Program has already begun, on an informal basis, to provide aid of this type; donors are encouraged to provide approximately $36 million to finance this program for the 1983-86 period.

Can the Bank contribute effectively through these follow-up functions? Do other donors seek Bank/UNDP involvement in this fashion? What are the staff implications in EGY (presumably in the Energy Assessments Division which the paper suggests should have responsibility for follow-up of this category) or elsewhere? What are the costs to the Bank of this program and is it judged cost effective?

4. Follow-Up in the Bank. Energy Program Papers are proposed to assure effective follow-up action in the Bank. These papers would be "brief (1-10 pages), free-standing statements of the Bank's program of policy analysis and lending, designed to articulate lending priorities and conditions"; they would be part of the CESW and CPP processes. The content of such papers is suggested on page 16.

Is it agreed that such papers, prepared initially on a selective and trial basis, would be desirable? If so, how should the initial group of countries be chosen? Is there agreement that the Country Program Division Chief should have management responsibility? How much staff support would be needed, from EGY and elsewhere? Where should these resource requirements be budgeted?

B. Management Response to OED's Operational Policy Review: Compliance with Loan Covenants

1. Background. In September, 1982 OED issued its report which "reveals general problems in compliance among...development covenants dealing primarily with project objectives and project execution" (ii). Legal issues are not the focus of this review. Based on case material from about 100 PPARs and nine case studies, the review concludes that "changing project conditions...are often at the root of covenant violations" and that problems "also derive from inadequacies in the ways understandings are formulated and negotiated" (iv). While Bank policies and procedures "were deemed on the whole to be adequate", OED makes two types of recommendations: greater flexibility in loan documents and improved procedures for reaching agreements with borrowers. OED's Review and Management's response will be discussed by the Executive Directors at a future Board meeting.

2. Scope and Nature of the Problem. Management's response clarifies the scope of the problem, noting that a relatively small percentage of covenants (about 6%) have major compliance problems (para. 5b). The response generally concurs with OED's major findings (paras. 8-14).

Does the OPSC wish to raise any issues concerning the scope and nature of the problem as described in the first twenty pages of the response? Should we anticipate that EDs, representing borrower attitudes, may be more critical of the way in which covenants are used?

3. OED's Recommendations. Does the OPSC concur with the following draft Management positions?

a) OED proposes greater flexibility in loan documents by:

1) consolidation of covenants dealing with minor actions into a schedule attached to the loan agreement and/or a supplemental letter (para. 16a); and

2) use of instruments which are not legally binding for general undertakings which are really targets or intentions (para. 16b).

Management agrees with both, although it believes "the scope for enlarging the use of legally non-binding instruments is limited".

b) OED proposes improved procedures for reaching agreement. Two of the five OED recommendations seem of particular interest:

1) appraisal missions should generally leave with the borrower an agreed aide memoire which would include recommendations regarding specific covenants that might be required. The Management response suggests it will usually be more practical and more helpful to the borrower to advise borrowers after the Decision Meeting; where an aide memoire is prepared, it should not be "agreed" at field appraisal (para. 17a).

2) as a rule, the legal document and the draft Appraisal Report should be made available to the borrower four weeks before the start of negotiations; alternatively, other approaches which achieve the same result should be considered. The Management response believes that the four week requirement is too "rigid and would lead to significant delays"; instead, more flexible arrangements should be implemented on a case-by-case basis. Is this response adequate or should a minimum time period be indicated?

4. Does the OPSC have any major suggestions as to presentation, style or tone of the response?

5. Are there other questions surrounding the use of covenants in Bank lending that deserve attention which are not raised by the OED report?

AS:ww

December 10, 1982

M. Humphrey
WA

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Members of the OPSC

DATE: December 3, 1982

FROM: Sidney E. Chernick, Assistant Director, CPD

SUBJECT: Sector Support Strategy Paper: Transportation

Attached is an agenda for the December 8 OPSC discussion of the Transportation Sector Support Strategy paper.

Attachment

cc: Ms. Pratt
Mr. Willoughby
Mr. Waide

OPERATIONS POLICY SUBCOMMITTEE

December 8, 1982

Agenda

Sector Support Strategy Paper: Transportation

1. Policy Environment: While SSSPs are not intended to be sector policy papers, in setting the stage for discussion of the Transportation Department priorities over the next several years, this paper emphasizes important changes occurring in the transport sector which offer new opportunities for Bank action. Long-standing Bank efforts to promote basic principles of how the transport market should work have produced limited results (paras. v, vi, 1.07-1.10), but the SSSP describes greater government willingness (especially due to resource scarcities) to undertake necessary, albeit politically difficult, reforms (vii, viii, 1.11-1.18). Do OPSC members agree with this assessment? Is it found across a wide spectrum of countries?

2. Sector Work Priorities: Based on this assessment of the environment for policy dialogue and the needs for the 1980s (xii-xvii, 2.01-2.27), four policy areas are emphasized for sector work (in addition to increased attention to investment planning): institutional and legal structures affecting competition within and between modes; pricing and taxing rules, practices and structures; other measures to improve energy efficiency; and measures to raise the responsiveness to market demands of public agencies (4.24). Are these consistent with regional views of the highest priorities?

3. Lending Program Issues: a) Transport lending is expected to remain at about 17-18% of overall Bank lending in FY1982-85, although much more concentrated than in past (half the total is in four Asian countries, Brazil and Colombia) and with substantially reduced levels in Western Africa as compared to 1977-81. The paper suggests lending levels in West Africa, EMENA and LAC may now be insufficient "to sustain the dialogue on improvement in policies and practices". (4.10) Do the regions agree? What are the opportunities, given the increased interest in improving policies, of moving in these countries beyond use of individual projects for the policy dialogue to links with the entire sector lending program - or the total program?

b) The paper also suggests that an increased range of lending instruments be used to enhance the policy impact of Bank transport activity. More highway sector loans are encouraged (4.30), as is increased willingness to finance recurrent costs (4.35); the paper also advocates more support for the sector from SALs and the related general country dialogue (4.62). How much potential is there for expansion of SALs to incorporate transport issues more directly? Are there other devices, including certain types of fast disbursing and conditional non-project lending, which would be appropriate to the transport sector (e.g. import of road repair equipment, spare parts, trucks, other commodities)?

4. Poverty Impact: While recognizing the complexity of determining the "true distributional impact of transport projects" (4.03), the paper emphasizes the importance of pursuing poverty-reduction objectives within the transport sector, especially in improvement of rural infrastructure. It notes that lower level

infrastructure - tracks, trails and non-conventional vehicles - may have even greater impact on large numbers of poor people than lending for rural roads (4.36-37). The dominant need of the 1980s for road maintenance will undoubtedly cut into funding - and staffing - available for projects of this kind. Can more be done to strengthen the Bank's work in this area?

5. <u>Staff Training</u>: Despite an expected slight reduction in staff positions, the wide range of enhanced work called for in the paper is considered feasible, including the increase in sector policy work which lies at the heart of the effort (5.02-06). Are these assumptions realistic? Especially high priority is given to more systematic staff training, including 3-4 month external programs for "one staff member per annum per division within a few years" (5.34). Would this have regional support?

6. <u>Intersectoral Coordination</u>: The paper's first paragraph emphasizes the critical place of transport in the development process (i); throughout the text there are references to the links to other sectors, particularly agriculture and industry. The paper stresses the need for increased inter-divisional cooperation in the "selection and formulation of projects, their components and emphases" (5.14). Other than the suggestions for better use of Transport Sector Memoranda, are more substantial management actions required to ensure the necessary degree of cross-sectoral collaboration?

7. <u>Donor Coordination</u>: While the paper does not describe the place of Bank lending in the context of total donor financing for transport, it does note that donors have occasionally contributed to undermining efficiency in the sector by inappropriate projects (2.09). One way to increase the flow of resources in more constructive ways is to expand co-financing from public and private sources. To accomplish this will be a staff intensive exercise. The paper proposes experimenting with annual meetings of financing agencies interested in transport development in Africa and other low-income countries (4.19-20). Does the OPSC support this initiative?

December 3, 1982

M. Humphrey

File

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

Litt

TO: Members of the Operations Policy Subcommittee

DATE: November 24, 1982

FROM: Sidney E. Chernick, Assistant Director, CPD

SEC.

SUBJECT: Management Response to OED's Operational Policy Review: Compliance with Loan Covenants

The Operations Policy Subcommittee will consider the attached paper on Wednesday, December 15. For your convenience, a copy of the OED Review is also enclosed.

This session might last until 11:00 a.m. as two items are now scheduled, including a paper on UNDP/IBRD energy assessments distributed on November 18.

Attachments

cc: Ms. Pratt
Messrs. Rajagopalan
Adler

AShakow/ww

DRAFT
HAAdler/Jabri
Oct. 29, 1982

MANAGEMENT RESPONSE TO OED'S OPERATIONAL POLICY REVIEW: COMPLIANCE WITH LOAN COVENANTS

A. INTRODUCTION

1. Loan covenants are an essential aspect of the dialogue on economic development between the Bank and its clients.1/ The Bank Management, therefore, welcomes OED's "Operational Policy Review--Compliance with Loan Covenants" (Report No. 4090, September 1, 1982), as part its continuing review of this important subject.

2. The Articles of Agreement of the Bank provide that the Bank shall make arrangements to ensure that the proceeds of any loan are used only for the purposes for which the loan was granted, with due attention to considerations of economy and efficiency. The Articles of Agreement of IDA contain a similar provision. Thus, the Bank is required to agree with the borrower on a description of the purposes for which the loan is to be granted, and on appropriate disbursement, procurement, accounting and reporting covenants. The provision also implicitly requires the Bank to ensure that the purposes for which the loan proceeds are disbursed will be realized; this is accomplished through covenants covering the financial,

---

1/ The OED Report and this response are limited to "development covenants" dealing primarily with project objectives and execution; they do not deal with other covenants, such as loan service covenants.

administrative and technical aspects of project execution and the achievement of any other purposes for which the loan is granted.

3. The nature of the relationship between the Bank and the borrower, as embodied in loan covenants, has a number of dimensions. One type of covenant directly related to project objectives deals with the physical implementation of projects. This includes such diverse requirements as adequate staffing and the provision of full financing for the project; appropriate procurement procedures, while in the Bank's direct interest, are also important for efficient project implementation. A more complex type of covenant, arising from the Bank's special role as a development agency, deals with sector and project developmental policies and the strengthening of institutions. The range of these concerns is very wide and includes such matters as long-term staff development; policies concerning prices, tariffs and charges; operations and maintenance; and accounts and auditing systems. Often covenants serve several purposes concurrently such as, for instance, tariff covenants that are designed to ensure the financial viability of the borrower as well as to relate tariffs properly to the economic costs of the service for which they are charged. The rationale for the wider range of covenants is well summarized in para. 2.31 of the OED Eighth Annual Review of project Performance Audit Results (R82-270) as follows:

> Institutional or other development objectives at the project level are increasingly linked to wider sector objectives as both the Bank and borrowers

have become aware that the effectiveness of projects and of institutions which they help to establish or to strengthen, often depend on a sector environment supportive of these objectives. Thus, price structures and levels for agricultural products are crucial to the success of farm projects as are marketing arrangements, taxes, manpower training or infrastructure investments. Tariff policies can have a major impact on the viability of institutions operating in transport or public utilities while appropriate interest rate policies may be essential for the development of DFCs. Sector issues are therefore addressed through project lending where such initiatives are considered essential to the attainment of basic project objectives.

4. Given this wide range in types of covenants, the fact that some covenants are more important than others to achieving project objectives, that some noncompliance may arise in spite of the borrower's best efforts because changed circumstances have made the agreed objectives no longer feasible, and that some noncompliance may involve only a minor deviation while another may threaten the basic objective of the project, there can be no predetermined, automatic reaction by the Bank to noncompliance. Instead, the Bank's response requires symphathetic understanding of the

problems involved, sensitivity in communications between the Bank and the borrower and a joint effort to try to resolve these problems so that the agreed objectives can be met, or if this is no longer possible, modified appropriately. In contrast to "arms-length" commercial agreements where the interests of the parties may be directly opposed, the Bank and its borrowers have a mutual interest in the realization of project objectives and thus in arriving at effective and constructive solutions, rather than the imposition of penalties. This is not to imply that the Bank does not take failure to comply with covenants seriously, but rather that the approach to compliance requires flexibility, difficult judgments and good communications between the Bank and borrowers.

B. RECORD OF COMPLIANCE

5. Since the OED Report relies on prior studies in determining the scale of the compliance problem,[2/] it may be useful to summarize the major findings of these studies:[3/]

a) Bankwide in 1979, 39% of all projects (then totaling about 1,500) suffered from violations of one or more major covenants. The majority of

---

2/ The Report includes nine case studies. They are not intended to be representative, but to illustrate issues that had been identified beforehand (para. 1.15).

3/ Major recent studies include "Experience with Revenue Covenants" in the report on Project Implementation and Supervision (R78-68, March 24, 1978); and "Experience with Loan Covenants" in the Fifth Annual Report on Project Implementation and Supervision (R80-141, May 29, 1980). The OED Report, in para. 1.11, lists a number of other studies related to covenants.

noncompliances took place among financial covenants, primarily audit covenants.

b) The Bank was satisfied that in 68% of the projects involving noncompliance, the borrower and country were taking adequate measures to solve the problem. In an additional 17% of the projects, the covenants were overtaken by events and had to be modified or deleted. Thus, in only 15% of the projects involving noncompliance were Bank remedies considered necessary. While the study did not analyze noncompliance in terms of number of covenants, it seems that about 6% of the total number of major covenants involved violations.

6. A more recent study of loan covenants, on which we plan to report to the Board in detail early in 1983, reviews the compliance record in regard to 14 different types of covenants for about 180 projects, selected at random. In general, about 40 percent of the projects present no significant problem in compliance and an additional 50 percent have moderate problems which are being adequately resolved; 6 percent have moderate problems not being resolved; and only about 4 percent of the projects have major compliance problems but most of these are being resolved. Among the types of covenants, the range of compliance is quite wide. Compliance with procurement guidelines presents a major problem in only 3 percent of the projects. On the other hand, provision of adequate

funds for the project is a major problem in 18 percent of the projects and a moderate problem in an additional 27 percent of the projects, but in two-thirds of these projects, the problem is being resolved. Noncompliance with financial covenants involving prices, tariffs or charges is one of the most pervasive problems, involving moderate or major problems in about 50 percent of projects, but about three-fourths of these problems are being adequately resolved. These findings are generally consistent with those of the earlier studies and help to put the issue of noncompliance into perspective.

7. The OED Report summarizes the findings of the earlier studies as follows (para. 1.12): Bank policies and procedures in respect of covenants are on the whole adequate. They are generally necessary and workable, although greater flexibility in the use of legal instruments, better communications with borrowers on project objectives, and more realistic implementation schedules would be desirable.

C. MAJOR FINDINGS

8. As the OED Report points out, "noncompliance of itself is a neutral indicator" (para. 3.02). It may indicate that unforeseen events have occurred which call for reformulation of loan agreements, or reflect difficulties which borrowers may have in complying with covenants that address broad and ambitious development goals. On the other hand, noncompliance may also reflect poorly designed covenants, unrealistic objectives or inadequate communications between the Bank and its client, leading to misunderstandings on objectives and the means of achieving them.

9. Project Preparation and Appraisal. The OED Report discusses specific causes of noncompliance in chronological order of the project cycle. During project preparation and appraisal, it finds that unrealistic project objectives and project complexity can lead to noncompliance (paras. 2.04-2.15). The Management agrees. The finding that project objectives and implementation schedules are not always fully achievable is supported by prior studies. The 1980 Bank study on compliance with covenants[4/] pointed out that a covenant with a fully "realistic" target, reflecting what the borrower would be expected to do anyway, is meaningless. Covenants are included to achieve particular results which add to the economic development of the country; this is the essential rationale for Bank involvement. But unrealistic targets are counterproductive. A reasonable covenant has to take into account the nature of the activity; the borrowers' expected rate of achievement of the objectives agreed upon; the planned supervision effort; and the expected evolution of exogenous factors. Covenants should be realistic both in substance and in their time horizon and if they cannot be met, in spite of reasonable efforts, because of changed circumstances they should be modified. We have found, for example, that implementation of many projects takes 1-2 years longer than was anticipated at appraisal, even when the appraisal estimates are more realistic than the borrowers' own expectations. To achieve more realistic implementation and disbursement

---

4/ Fifth Annual Report on Project Implementation and Supervision (R80-141, May 29, 1980).

schedules, we have required, since 1981, that Appraisal Reports indicate how these schedules are related to prior experience in the sector and country which has now been systematically collated. We have also obtained over the years a better understanding that many institutional objectives take longer to achieve than the completion of investments and that they must therefore either be more modest or spread over a number of projects.

10. The problem of project complexity was discussed at length in the Seventh Annual Report on Project Implementation and Supervision (R82-111, April 19, 1982, paras. 35-61). The Report pointed out that in recent years, many Bank-financed projects have included a large number of components, dealing with several sectors, subsectors and geographical areas, involving a number of institutions and tackling multiple development constraints--this in contrast with "old style" projects generally addressing only one subsector, one institution and one development constraint. There are several reasons for such increased project complexity. First, the realization that what prevents development in a particular setting is a group of interrelated constraints, making an attack on just one of them ineffective. Second, development objectives themselves are getting broader. An agriculture project, for example, may not only be concerned with increasing production, but also with the distribution of benefits and perhaps with the provision of basic needs. Third, activities such as education and health, traditionally regarded as more in the nature of consumption than production, are now recognized to be important factors influencing the level of production and are increasingly being included as

components in development projects. And fourth, many countries, especially in Asia and Latin America, have already completed most of the "easy" initial stages of the development process, for example, building basic infrastructure and using the best resources readily available. The second generation of projects entails dealing with less obvious alternatives and more difficult solutions, technologically and institutionally. The 1982 Report found that in several instances, especially with regards to agriculture, education and urban projects, objectives may have been too ambitious and projects too complex.

11. The Report outlined factors which determine a feasible level of project complexity and suggests ways in which complexity can be reduced, taking into account political, economic, institutional and technical constraints. For example, if a project appears unduly complex, it may be possible to divide it into separate components or subprojects that can be implemented and operated independently by entities in the public or private sectors, so as to minimize the coordination requirements. Other alternatives include to phase the program over time, to start initially with a pilot project, or to use minimum packages limited to the most important components, leaving out subsidiary ones. The application of these guidelines in specific project situations requires difficult judgments by both the Bank and the borrower, which are, in turn, reflected in loan covenants. Since these judgments cannot be avoided and since some mistakes are bound to arise, it is important to adjust constructively to necessary changes as soon as they are identified, by modifying covenants accordingly.

12. Loan Documents and Negotiations. As far as loan documents are concerned, the OED Report identifies the problems under four broad categories:

a) Deficiencies in the design of covenants (paras. 2.17-2.18). The OED Report points out that the design of covenants is sometimes defective so that the intended objective is not met. A recent staff review of 13 projects approved in FY81, selected at random from the agriculture and transport sectors, found that the formulation of the 96 covenants involved was generally satisfactory, but some of the covenants presented such possible issues as excessive generality, excessive detail, lack of clarity, unrealistic timing, etc. However, the degree of detail in the formulation of a covenant depends in part on the extent of prior discussions and understandings with the borrower. For example, where the Bank and the borrower share common policy objectives, detailed covenants may be less important than where objectives are not fully shared. The degree of generality may also hide lack of full agreement on the specific means for achieving agreed objectives or may have been intended to provide greater flexibility in situations which are perceived to be complex and changing. Design of covenants receives careful attention; the need for improvements must continue to be addressed on a case by case basis.

b) Conflict with local law and administrative practice (paras. 2.19-2.21). The OED Report finds that noncompliance with covenants can also result from conflict with the country's law or administrative practices. The Management believes that the policy set out in OMS 3.18 on Loan/Credit Contractual Documents provides appropriate guidance on this problem. While recognizing that the Bank's agreements are international agreements governed by international public law and as such are binding in spite of domestic law, it states that "the Bank avoids wherever possible covenants which would be inconsistent with, or which could not be performed under, the domestic law of the member concerned. If such covenants are required, they should be accompanied by clear agreement on the appropriate steps to be taken to amend domestic law" (para. 6). In practice, the Bank endeavors to ensure compatibility of its agreements with domestic law and to avoid situations where changes in domestic law would be required. We also require, as a standard condition of loan effectiveness, an appropriate legal opinion from the borrower confirming the enforceability of the covenants under domestic law. Similarly, the Bank takes special care to work within the established administrative framework of the country. Where a project contains any special feature going beyond established practices, the issue is addressed and undertakings are reached on the specific measures that will be required for implementation. However, the Bank is not in a position to foresee all potential administrative difficulties; borrowers are generally in a better position to do so. Also, administrative difficulties are sometimes the excuse rather than the reason for failure to take appropriate steps.

c) Unreasonable project requirements (paras. 2.22-2.25). The OED Report finds that some project requirements are unreasonable in that they seem to go beyond what borrowers consider to be the appropriate concern of the Bank in regard to the project. Unreasonable requirements should of course be avoided. OMS 3.18 specifically provides that "it is the policy of the Bank to negotiate only covenants that are realistic and reasonable" and spells out some of the implications of such a requirement. For example, care must be taken to avoid covenants that impose excessive burdens on the borrower or reach beyond what the borrower may be expected to be able to accomplish. The OMS explains that unreasonable or unrealistic covenants will not, in most cases, be fully met, and may become an irritant in the relations between the Bank and the borrower. To determine what is reasonable in the particular circumstances of a given project may be a difficult matter of judgment, and therefore open to mistake. The OED Report presents no evidence on the size of the problem, but a recent staff review found that all 96 special covenants in the 13 projects studied were relevant to the project objectives. The review did not examine the appropriateness of the project designs, but in some cases the timing of actions required seemed unduly optimistic. The issues concerning unreasonable requirements are closely related to those of unrealistic covenants, discussed in para. 9, as well as to the design of covenants, discussed in para. 12a.

d) Excessive use of covenants (paras. 2.26-2.28). The OED Report points out that problems in compliance sometimes arise if a project imposes a large number of covenants on the borrower, and that neither the borrower nor the Bank may have the capacity to monitor a large number of covenants. The Management agrees that an excessive use of covenants should be avoided. But as the OED Report recognizes, "an extensive list of covenants does not necessarily mean that the project has 'too many covenants'" (para. 2.27). Again, what is excessive or insufficient depends on the particular circumstances of a given project and even then is inevitably subjective. It depends on appropriate judgments with respect to such factors as the number of agencies involved, the number of project components, the range of policy objectives, and the prior performance of the borrower. The most obvious way to reduce the number of covenants significantly would be to limit ourselves to simple projects but this would have other disadvantages (this issue is discussed in paras. 10-11). As to difficulties in monitoring covenants, these arise less from their numbers than from the substantive issues involved in specific covenants. The possibility for more selective use of covenants is discussed further in para. 16.

13. Inadequate negotiating process (paras. 2.29-2.31). As to the negotiating process, the OED Report finds that legal documents are not always made available to the borrower in time to permit full consideration and that, on occasion, when documents are made available in advance, changes have been made in the meantime. The question of making documents available in time is discussed in para. 17b. Where the documents are distributed in advance of negotiations, it is made clear that they are drafts and therefore subject to change. We agree that the borrower must be promptly advised of all significant changes.

14. Project Implementation. During project implementation, the OED Report finds the following problems:

a) Inadequate communication (paras. 2.32-2.36). According to the Report, the borrower's understanding of the objectives and meaning of a covenant is not always the same as that of the Bank's. There are no doubt instances of differences in understanding, emphasis and interpretation between the borrower and the Bank, between different agencies within the country or even between Bank staff. Given the complexity of development issues, their economic, social and political implications and the cultural diversity among the persons involved, some differences in interpretation are inevitable. However, we do not believe that this is a frequent occurrence because the nature of most noncompliances (as identified in the 1980 study5/), e.g., those involving audit covenants, budget support, etc., is such that they are probably not based on misunderstandings. The major causes of noncompliance with revenue covenants were identified in the 1978 Report on "Project Implementation and Supervision" (R78-68) as lack of government commitment to the financial objectives and factors internal to the project or the agency. Misunderstandings no doubt occur occasionally as a result of inadequate communication, but were not identified as a significant factor.

b) Inadequate government commitment to project objectives (paras. 2.37-2.43). The OED Report finds that governments are not always fully committed to the objectives of a covenant. It is also our observation that inadequate commitment or

5/ Fifth Annual Report on Project Implementation and Supervision (R80-141, May 29, 1980).

political support for certain objectives is a significant factor in noncompliance. Both the 1978 and 1980 studies on loan covenants found that there may occasionally be differences in philosophy and approach, especially in the financial field, on such matters as the financial policies of public utilities. Differences also arise where changes in governments or in government officials lead to changes in policies, so that the commitment of the prior government is no longer shared by the new one. In these situations, compliance is bound to present difficulties. While such difficulties can and should be minimized by bringing to the attention of the new officials the agreements and their rationale, they cannot always be avoided. For as the 1978 study pointed out, revenue covenants are a reasonable and necessary tool for helping governments and borrowers establish and maintain financial discipline and achieve long run institutional development objectives. Revenue covenants have helped in the adoption of measures to stop the financial deterioration of many entities, and to mobilize resources and obtain tariff increases that otherwise would not have been possible. In most cases, even if the objectives of the covenant were not fully achieved, the situation without these covenants would have been less satisfactory. In line with the recommendations of the 1978 study, we are continuing our efforts to make revenue covenants realistic and flexible, and to promote a better understanding and commitment of the borrowers to the objectives underlying these covenants.

c) Limited implementation or supervision capacity (paras. 2.44-2.47). The Report points out that limited implementation capacity, such as a shortage of local staff or local funds, creates difficulties in compliance. We agree with the importance of these factors. They are closely related to the need for realistic project objectives (see para. 9) and reasonable project requirements (see para. 12c). We try to deal with these problems in a number of ways, such as financing local or foreign technical assistance, establishing the requirements for local funds in advance and determining that they can reasonably be met by government budgets or internally generated funds. As for supervision, we believe that we have provided adequate staff resources to give supervision the high priority which it deserves. There are, of course, occasional questions of priority, temporary absences of key staff or mistakes in judgment which affect supervision, but staff resources have generally been adequate.

d) Change in circumstances (paras. 2.43-2.51). We agree with the OED Report that changes in circumstances beyond the control of either the Bank or the borrower can affect compliance with covenants. These changes include, for example, a slower growth of the domestic or world economy, lower commodity prices, serious financial difficulties and droughts. In these situations, the Bank is generally sympathetic and flexible in the interpretation of covenants and, if necessary, they are modified.

e) Use of remedies (paras. 2.52-2.54). The OED Report points out that compliance with covenants is also affected by the Bank's use of remedies and that the Bank is less concerned with the implementation of less important covenants. "While such an approach may be justified in some cases, it raises the question as to whether there was need for a covenant in the first place" (para. 2.54). Some covenants are clearly more important than others in achieving project objectives and the Bank's response to noncompliance should reflect both the importance of the covenant and the degree of noncompliance. For example, the failure to provide any local funds is more serious than a shortfall of ten percent; or inadequate meat prices may be more serious to the objectives of a livestock project than a month's delay in the audited accounts. Moreover, while a particular covenant may be less important by itself, a number of such covenants in combination may be very significant. We agree that every covenant should be relevant and that the number should not be excessive, but it does not follow that less important covenants should be omitted entirely. The use of remedies in case of noncompliance should reflect this.

D. RECOMMENDATIONS

15. The OED Report makes two types of recommendations: greater flexibility in loan documents and improved procedures for reaching agreements with borrowers.

16. Greater flexibility in loan documents. The OED Report recommends greater flexibility in loan documents through more selective use of

covenants (para. 3.03). Specifically, it suggests the following two procedures for achieving this objective (paras. 3.04-3.12):

a) Covenants dealing with a string of "minor" actions could be consolidated into a plan of action or implementation schedule which may take the form of a schedule to the Agreement, a supplemental letter or a combination of both (para. 3.08). Comment. The Management agrees that such consolidation has merit in reducing the body of the loan agreement and putting related covenants together in one place, without compromising the effectiveness or the binding character of undertakings necessary for achieving project objectives. Such consolidation has in fact been used on occasion in the past, and its wider application will be explored by the Bank as may be appropriate in particular cases.

b) Project objectives or general undertakings which are really targets or intentions rather than firm obligations might appropriately be registered in less formal and more flexible instruments such as letters of intent or memoranda of understanding, rather than in covenants (paras. 3.09-3.12). Comment. The Management believes that the range of alternative instruments to register agreements and understandings currently available is adequate. OMS 3.18 provides for a system of legal documentation which can serve the particular purposes of the loan and accommodate both legally-binding covenants and non-binding understandings. There are three major types of legal instruments--covenants, supplemental letters directly related to a covenant and supplemental letters of intent--of which the first two are legally binding in that they are subject to such remedies as suspension of disbursement, which might be followed by cancellation of loan amounts or prematuring of loans. These instruments can be further supplemented by agreed Minutes of Negotiations which, although not legally enforceable, are useful in clarifying the record of negotiations, especially concerning controversial matters (see also para. 17c). Covenants are the appropriate instrument to record "any undertaking of a substantive nature which should be binding upon the party involved" (OMS 3.18, para. 32). Covenants can either cover the general substantive undertaking only, or can also include specific steps necessary to achieve it. In the former case, the instrumentality of supplemental letters directly related to covenants is available to provide greater particularity with respect to a covenant, if more details are required (OMS 3.18, paras. 31(a) and 32). A third type of instrument is the supplemental letter of intent which is designed to cover "statements of intention and the like which are significant to the project (and may sometimes pave the way for future covenants on the occasion of future loans to the same borrower for projects continuing, or expanding the one under consideration), but which are clearly not meant to constitute a covenant" (OMS 3.18, paras. 31(c) and 35). Such letters, which serve as a basis of a continuing dialogue between the Bank and the borrower, have been used in the past. Because they are not legally binding, they constitute less formal undertakings, as suggested by OED. On the other hand, we believe that by the standards suggested in the OED Report (para. 3.07), with which we agree, the scope for enlarging the use of legally non-binding instruments is limited. As OED has clearly recognized (in the passage quoted in para. 3 above), development objectives at the project level need to be linked increasingly to sector objectives.

17. Improved Procedures for Reaching Agreements. The OED Report suggests the following five changes in Bank procedures "to strengthen the process of preparing, negotiating and supervising legal covenants, and to ensure that their implications are fully understood by the borrower" (para. 3.15):

a) Appraisal missions should generally leave with the borrower an agreed Aide Memoire which would include recommendations regarding specific covenants that might be required (para. 3.15a). Comment. The Management agrees with the intent of the recommendation that borrowers should be advised as soon as possible of specific covenants that will probably be required. Appraisal missions generally discuss likely topics to be covered by covenants with the borrower and some leave an Aide Memoire. However, field appraisal is only the first step of the appraisal process, and a considerable part of the analysis can usually take place only after the appraisal mission returns to Washington. In many cases, therefore, a detailed determination of probable covenants is not possible during field appraisal. It would, therefore, be more helpful to advise borrowers of probable undertakings after the Decision Meeting, at which the staff from all interested departments review the recommendations of the appraisal team and reach tentative decisions on major issues. By this time the project and major conditions have been defined more clearly and the appraisal mission's recommendations have received some internal review. It is now common practice to advise borrowers in writing of the details of the project and of major conditions at this time, and we believe that this is more helpful to them than the preliminary and unreviewed findings at the time of field appraisal. Since the conclusions of the Decision Meeting are generally available well in advance of negotiations, borrowers have adequate time for their thorough consideration. Moreover, we do not believe that an Aide Memoire, even where it can be meaningfully prepared during field appraisal, should be "agreed" between the mission and the borrower, as the OED proposal suggests. While it is useful to reach prompt understandings, the requirement for agreement at this early stage would not be helpful to the borrower or the Bank, could not bind them and could delay missions unduly.

b) As a rule, the legal documents and the draft Appraisal Report should be made available to the borrower four weeks before the start of negotiations. Alternatively, any other mechanism which might be more time-efficient and yet inform the borrower fully and in good time, could also be considered (para. 3.15b). Comment. The Management agrees that the borrower should be fully and promptly informed about the Bank's appraisal of the project and the related covenants. The Operational Manual (OMS 2.00, para. 44) permits the Regions to distribute the draft legal agreements and the Appraisal Report to the borrower prior to negotiations, and this is done in some cases (see also para. 13). In other cases, the key covenants and their rationale are submitted to borrowers at the time of the invitation to negotiate, which can be anything between several days to two months before negotiations. Because a 4-week requirement would be unnecessarily rigid and would lead to significant delays, a more flexible approach is preferable, as the OED Report recognizes. Current practice is to provide borrowers with the draft legal documents and Appraisal Report shortly before negotiations. Where borrowers request these documents for a longer period in advance, we are prepared to do so within reasonable limits appropriate to the case, e.g., taking into account the number and complexity of the issues, prior experience, and other relevant factors.

c) Agreements reached on the interpretation of specific covenants should be recorded in Agreed Minutes of Negotiations, signed by both parties (para. 3.15c). Comment. The Management agrees. This is current practice. OMS 3.18 recognizes that "the legislative history of an international agreement may be a supplementary means of interpretation of the agreement. Therefore, it is at times useful to have a concise and brief agreed record of negotiations, especially concerning controversial matters" (para. 38).

d) Supervision missions should carefully monitor the borrower's compliance with all covenants (para. 3.15d). Comment. The Management agrees. The Operational Manual (OMS 3.50, Attachment B) requires a specific annex to all Supervision Reports summarizing the status of compliance with the most important conditions on which the loan was based. It requires identification of conditions met, those upon which action is pending and those not complied with, and for the latter a discussion of the causes of noncompliance and the remedies being pursued. This is general practice for supervision missions, except certain specialized missions which issue only a limited Supervision Report.

e) Borrowers should be promptly informed in writing if they are deemed to be in violation of covenants and be asked what corrective action will be taken. Covenants which cannot be complied with should be promptly renegotiated (para. 3.15e). Comment. The Management agrees. An Aide Memoire is usually prepared by supervision missions and left with the borrower summarizing the mission's findings, including those relating to the question of compliance with loan conditions. Furthermore, a letter is sent as a matter of course to the borrower after each Supervision Mission, indicating the main issues and problems identified by the mission and outlining the recommendations on actions to be taken. These issues are followed up in our regular dialogue with the borrower. If, in fact, a covenant is no longer appropriate, it is usually amended or waived. The OED case studies illustrate this process in that they involve "situations where Bank staff recommended deletion or revision of covenants, or otherwise considered the application of formal remedies" (OED Report, para. 1.16).

E. CONCLUSION

18. The adequacy of loan covenants is an important and continuing concern of the Bank's Management because they form an essential part of our dialogue with our borrowing member countries. Compliance with loan covenants has been reviewed by the Bank Management and the Board on several occasions over a number of years. The major conclusion of these studies has been that Bank policies and procedures in respect of covenants are generally adequate. The OED Report is a helpful reminder that project objectives and requirements must be reasonable and realistic, that the dialogue with our clients must be conducted so as to assure full mutual understanding, that we must be flexible in situations which are inherently complex and changing. While we rely primarily on the professional and diplomatic judgments of Bank staff in these matters, we also have extensive review procedures to minimize poor judgments and mistakes.

19. We are in broad agreement with the recommendations of the OED Report as they relate to procedures for strengthening the process of preparing, negotiating and supervising legal covenants. We believe that

the Bank's current system of legal documentation (as set out in OMS 3.18) is adequate in providing for a range of alternative instruments to register agreements and undertakings considered essential to the attainment of project objectives. We will continue our endeavor to ensure selective application of the available instruments.

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

CONFIDENTIAL 12/2

wbt

TO: Operations Policy Sub-Committee

DATE: December 16, 1982

DECLASSIFIED

FEB 14 2017

WBG ARCHIVES

FROM: E. Bevan Waide, Director, CPD

SUBJECT: NEPAL CPP: OPSC Review

1. Attached is an agenda and comments on major policy issues identified by CPD and PAB for consideration by the Sub-Committee. The suggested agenda items are:

(i) scope and feasibility of the proposed country assistance strategy;

(ii) proposed size of lending program;

(iii) strengthening the Bank's non-financial assistance; and

(iv) project cost sharing.

2. The Review Meeting will be held on Wednesday, December 22, 1982 at 2:30 p.m. in Room E-1208.

ML/SEC/moa

Attachments

cc: Regional Office: Messrs. Holsen
Wiehen
Thalwitz
Shibusawa
Fazel
West
Pilvin

cc: Messrs. Wuttke
Robless
Chernick

CONFIDENTIAL

DECLASSIFIED
FEB 14 2017
WBG ARCHIVES

NEPAL CPP

Topics for Discussion

Nepal's development constraints are severe. The country's geography, generally poor resource endowment, low level of human resource development, and poorly developed institutions all make progress very difficult indeed. Moreover, past policies have proved ineffective. Per capita incomes have been virtually stagnant. Agricultural production per capita has declined over the roughly 20 years for which data are available. The CPP proposes a country strategy that appropriately addresses these problems; it emphasizes agriculture, human resouce development, population, and development administration. Policy initiatives and the country dialogue in the recent past are evaluated in the CPP. However, subsequent to CPP preparation, Mr. Hopper visited Nepal to discuss, among other things, the need for a comprehensive approach to development administration reforms and IDA's role in the population sector. The Region may wish to present its most recent findings to the OPSC.

1. Is the scope of the proposed country assistance strategy feasible?

The country assistance strategy seeks to support Government policies for accelerating production growth, strengthening institutional capacity and promoting human resource development in virtually all sectors of the economy. PAB feels that even though recent policy initiatives by the Government suggest that its receptivity to Bank advice has improved, such a wide-ranging effort on the part of the Bank appears too ambitious. In PAB's view, the scope and priorities of the Bank's assistance strategy need to be more focussed taking the country's limited absorptive capacity into account. PAB proposes that the Region establish priorites among the major development problems that are to be addressed specifically by the Bank over the next two years based on the issues listed in para. 39 and the programs outlined in para. 53. The size of the program of reserve projects should also be addressed in this context. Such an agenda should be included in the CPP Postscript.

In CPD's view, the success of the implementation of the proposed program, ambitious as it is, hinges on the early introduction of the major administrative reforms, described in paras. 15, 39, and 43 of the CPP. The technical assistance project proposed for FY84 should help in the implementation of the reforms. CPD proposes that the Region define an action plan and monitorable criteria for implementing these reforms. Approval of the lending program for FY85-87 should then be subject to satisfactory progress in the field in implementing the reforms. The key aspects of this plan should be included in the CPP Postscript. Since the Bank is only one among many external agencies which can provide the needed technical assistance, it is also important that the Region help Government, UNDP, and other agencies establish a properly coordinated program of institutional support. The addition of a professional economist to the Bank's office in Kathmandu would be important to support this initiative.

2. Is the proposed size of the IDA lending program appropriate?

The FY83-87 IDA lending of $460 million as recommended by the Region compares to an IDA allocation for Nepal of $425 million at the recent Bankwide lending program review. We recommend confirmation of the lower lending level which is consistent with the reductions applied to the proposed programs for other LDCs in view of the constraints on IDA resources. Such a reduction should not hinder the implementation of the Bank's assistance strategy as the first priority at this stage must be a well-focussed effort to increase Nepal's absorptive capacity for the considerable external assistance that is already available.

3. Can the Bank's non-financial assistance for Nepal be strengthened?

The Region attaches high priority to technical assistance, policy dialogue, institution-building, and administrative support. Management has approved assignment of staff for two years in Nepal under the Bank's new program of non-reimbursable technical assistance. The Government is planning to request another staff allocation for FY84 and FY85. We endorse this request. Given the country's substantial needs and the priorities set in the country assistance strategy, it is not clear, however, why more emphasis is not being proposed for CESW, especially with respect to sector work in agriculture and education. In particular, the ESW allocation for agricultural sector work entailing only 5 MW in FY83, 10 MW in FY84 and 15 MW in FY85 appears insufficient in relation to the need to fully define, and help implement, an effective sector development strategy.

4. Project cost sharing

We support the Region's request to increase the maximum project cost sharing authorization for Nepal from 85% to 90% of total project costs, or full foreign exchange costs, whichever is higher (para. 52). This is in line with the extent of cost sharing approved for countries with similar levels of per capita income.

5. Other Matters

The next CPP review should be in two years, as suggested by the Region.

Annex I compares the lending program proposed for Nepal in this CPP with programs approved earlier and with the IDA allocation for Nepal at the recent Bankwide lending program.

Annex II presents a comparison of various country performance indicators.

Annex 1

Nepal

	FY78	FY79	FY80	FY81	FY82	FY83	FY84	FY85	FY86	FY87	Total FY78-82	Total FY82-86	Total FY83-87
Operations Program (No.)													
Approved, February 1977	3	4	3	3	3	..	..	..	..	..	16	..	..
Std. Table IVa, Oct. 1981	4	2	2	5	3	7	3	3	3	..	16	19	..
Proposed, November 1982	4	3	2	5	3	6	6	6	5	6	17	26	29
Lending Program (No.)													
Approved, February 1977	2	3	4	3	4	..	..	..	..	..	16	..	..
Std. Table IVa, Oct. 1981	4	2	2	5	3	5	5	3	3	..	16	19	..
Proposed, November 1982	4	3	2	5	3	3	5	4	4	4	17	19	20
Lending Program (Cur. $m)													
Approved, February 1977	40.0	40.0	47.0	48.0	56.0	..	..	..	..	..	231.0	..	..
Std. Table IVa, Oct. 1981	67.2	39.8	33.0	62.2	30.8	149.2	120.0	105.0	85.0	..	233.0	490.0	..
Proposed, November 1982	67.2	39.8	33.0	62.2	30.0	120.0	83.0	92.0	75.0	90.0	232.2	400.0	460.0
Lending Program (Const. FY82 $m)													
Approved, February 1977	50.6	48.3	53.8	51.4	56.0	..	..	..	..	..	260.1	..	..
Std. Table IVa, Oct. 1981	85.1	48.0	37.8	66.6	30.8	140.0	106.0	87.5	66.8	..	268.3	431.1	..
Proposed, November 1982	85.1	48.0	37.8	66.6	30.0	112.6	73.3	76.7	59.0	66.7	267.5	351.6	388.3
Commitment Deflator (FY82=100)	79.0	82.9	87.3	93.4	100.0	106.6	113.2	120.0	127.2	134.9			

NOTE: November 1982, Review Group Decision: (IDA FY83-87 $425 million, FY83-84 $181 million, FY85-87 $244 million at 1SDR = $1.06321).

PABCP
12/15/82

Annex II

COMPARATIVE COUNTRY ANALYSIS

Nepal's stagnant economy, few natural resources, and growing population pose serious development problems. Agriculture, the predominant sector, has improved little. Investment, savings, and government revenue are all low. Infant mortality, life expectancy, literacy, and the other social indicators clearly identify the country's needs in human resource development.

	NEPAL	UPPER VOLTA	HAITI	MALAWI
Economic Structure				
Population 1980 (millions) a/	15.0 b/ c/	6.1	5.0	6.2 c/ k/
GNP per capita 1980 a/	156.0 b/ c/	210.0	270.0	162.0 c/ k/
% Agriculture in GDP 1980 a/	54.3 b/	40.0	32.7 i/	34.7 k/
% Labor Force in Agriculture 1980 a/	93.0	82.0	74.0	86.0
% Industry in GDP 1980 a/	13.0	18.0	23.0 i/	17.9 k/
Debt Service Ratio 1980 d/	1.9 b/	6.8	4.1	18.4
Economic Performance	1975-80 b/	1970-80 a/	1970-80	1975-80 k/
Real GDP Growth Rate	2.4	3.5	4.0 a/	5.6
Real Export Growth Rate	5.7	2.0	0.5 j/	8.7
	1980 b/	1976-81 l/	1976-81 i/	1980 k/
Gross Domestic Investment/GDP	13.5	19.2	14.9	25.9
Exports and NFS/GDP	11.3	13.7	17.6	30.9
Resource Balance/GDP	-7.0	-25.9	-9.8	-11.8
Gross Domestic Savings/GDP	6.5	-6.7	5.1	14.1
Government Revenue/GDP	8.1	13.7	14.8	17.4 c/
Recent Social Indicators e/	1978-80	1978-81	1978-81	1978-81
Population Growth Rate	2.6 b/	1.8 h/	1.7	2.9
% Change in Crude Birth Rate (1960-80)	-3.4	-1.2	-8.5	5.8
% Change in Crude Death Rate (1960-80)	-25.3	-9.7	-29.2	-17.6
Infant Mortality Rate (per 1000)	150.2	211.2	114.6	171.9
Life Expectancy (years)	44.2	38.9	53.2	44.2
Adjusted Enrollment Ratio: - Primary	88.0 m/	20.5	62.0	59.0
- Secondary	19.0	3.3	15.0	4.0
Adult Literacy Rate	19.0 f/	5.0 g/	23.0	25.0

Lending Program	NEPAL FY78-82	NEPAL FY83-87 n/	UPPER VOLTA FY78-82	UPPER VOLTA FY83-87 n/	HAITI FY78-82	HAITI FY83-87	MALAWI FY78-82	MALAWI FY83-87 n/
Nominal IDA $USM	232.2	425.0	147.4	204.5	87.3	154.4	156.8	300.4
Nominal IBRD $USM	-	-	-	-	-	-	49.0	165.0
p.c.p.a. Lending ($US)	3.1	5.6	4.8	6.7	3.5	6.2	6.6	15.0
p.c.p.a. Grant Equivalent ($US)	2.8	5.0	4.3	6.0	3.1	5.5	4.9	9.7
p.c.p.a. in Constant 1982 ($US)	3.6	4.8	5.3	5.5	4.0	5.2	7.4	12.4

a/ World Development Report, 1982.
b/ Nepal CPP, November 1982.
c/ 1981
d/ World Debt Tables, December 1981.
e/ Social Indicators Data Sheets, May 1982.
f/ 1977
g/ 1974
h/ Due to emigration growth rate shown is less than natural rate of increase.
i/ Economic Memorandum on Haiti, May 1982.
j/ 1976-81 Data.
k/ Malawi CPP (Draft), October 1982.
l/ Upper Volta CEM, draft June 1982.
m/ Figure is for 6 to 8 year-old children only.
n/ Review Group Decision, December 1982.

Country Assistance Division
Country Policy Department
December 16, 1982

FORM NO. 75
(9-78)

THE WORLD BANK

ROUTING SLIP	DATE: Nov. 29, 1982

NAME	ROOM NO.
~~Mr. Humphrey~~ File	E-1231
WMH	

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

REMARKS:

The attached Country Program Paper on NEPAL is scheduled to be discussed at the OPSC meeting on Wednesday, December 22, 1982 at 2:30 p.m. in Room E-1208. The meeting will be chaired by Mr. Stern.

FROM:	ROOM NO.:	EXTENSION:
C. L. Robless	D-1348	75533

REVIEW DRAFT
FOR OPERATIONS POLICY SUB-COMMITTEE
CONFIDENTIAL

DECLASSIFIED
FEB 14 2017
WBG ARCHIVES

Country Program Paper

NEPAL

November 18, 1982

Distribution

Operations Policy Sub-Committee
Senior Vice President, Operations
Regional Vice Presidents
Vice President, Operations Policy Staff
Vice President, Energy and Industry Staff
Vice President, Economics and Research Staff
Assistant General Counsel, Operations
Director, Programming and Budgeting Department

Other Attendance
Executive Vice President, IFC
Director, Country Policy Department
Chief, Country Assistance Division, CPD
Chief, Country Program Review Division, PAB

For Information

Directors, Operations Policy Staff
Directors, Energy and Industry Staff
Director, IFC Investment Department concerned
Director, Economic Analysis and Projections Department
IMF, Area Department concerned

A Country Program Paper has a restricted distribution and may be used by recipients only in the performance of their official duties. Neither the reproduction of copies of this document nor distribution outside The World Bank is permitted. When the paper is no longer needed it should be sent to the appropriate Country Programs Division for disposal.

CONFIDENTIAL
REVIEW DRAFT

November 18, 1982

DECLASSIFIED
FEB 14 2017
WBG ARCHIVES

COUNTRY PROGRAM PAPER

NEPAL

		FY78-82	FY83-87 /b	FY84-88
1981 Population: 15.0 million /a				
1981 Per capita GNP: $156 /a	IBRD (TW)	-	-	-
	IDA	232.2	460.0	460.0
	Total	232.2	460.0	460.0
Current population growth rate: 2.6% p.a.				
	No. of Loans/Credits	17	19	21
	No. of Loans/Credits per million pop.	1.13	1.27	1.40
Current Exchange Rate: Rupees 13.2 = US$1.0				

Average Lending Per Capita Per Annum: Current $ (Const. FY82 Commitment $)			
IDA	3.1(3.6)	6.1(5.2)	6.1(4.8)

/a World Bank Atlas, 1982 (forthcoming)
/b The FY82-86 lending program proposed in this CPP compares with the program for the same period approved at the last Bankwide lending program review in January 1982 as follows:

	FY82-86 Lending Program		Percentage Change
	Approved	Proposed	Proposed/Approved
No. of loans and credits	20	18	-10.0%
Current $ million	400.0	400.0	0
Constant FY82 Commitment $	349.7	351.3	+0.5%
Per capita per annum (Constant FY82 Commitment $)	4.7	4.7	0

I. BACKGROUND

A. Introduction

1. The last CPP for Nepal was reviewed by Senior Management on February 9, 1977. At that time a substantially increased lending program was approved, emphasizing assistance to directly productive sectors and complementary infrastructure, and subject to continued improvements in domestic resource mobilization. The most recent economic report (Nepal: Policies and Prospects for Accelerated Growth) was distributed on October 21, 1981, and subsequently discussed at the fourth meeting of the Nepal Aid Group on December 1-2, 1981, where the Bank also presented a paper on the impact of population growth on Nepal's development prospects. Noteworthy developments since the last CPP have been the adoption of a new five-year plan (1981-85), constitutional changes, as well as positive policy initiatives over the last two fiscal years, which could have a significant impact on the management of the economy. Economic growth has been slow, barely keeping pace with the rise in population. However, prospects for faster growth in the medium term appear to have improved somewhat with the recent Government policy initiatives emphasizing increased production, administrative reforms, and resource mobilization along the lines suggested in our last economic report. The effectiveness of these initiatives will depend, however, upon sustained emphasis on implementing the measures announced so far, as Nepal needs to overcome past inertia in implementing suitable policies. To sustain development in the long run, Nepal needs more concerted efforts at developing its institutional capability and human resource base, which are very poor, and at raising long-term agricultural productivity. Our proposed strategy is to assist Nepal in all these tasks, while maintaining our financial assistance at the level approved during the last Bankwide lending program review. The proposed IDA program would emphasize development of agriculture, complementary power and transport, and human resources. We expect to reassess our proposals in this CPP in about two years.

B. Recent Political Events

2. During 1978 and 1979, intermittent civil disturbances occurred, partly reflecting agitation by banned political parties for reforms, and partly reflecting economic hardships. In a referendum held in May 1979, the partyless Panchayat system was sustained by a 55:45 margin, which was smaller than anticipated. In December 1980, the King proclaimed the Third Amendment to the Constitution, which provided for direct elections to the Rastrya Panchayat (national assembly) on the basis of adult franchise, replacing the previous three-tier (village, district, national) collegiate system of elections. The amendment also gave the Rastrya Panchayat a voice in the selection and removal of the Council of Ministers where previously these functions had been the prerogative of the King; however, the King has retained emergency powers to suspend the Constitution -- a feature which drew criticism from non-Panchayat forces.

3. The first general election under the amended constitution was held on May 9, 1981. The non-Panchayat forces, notably a major faction of the Nepali Congress, boycotted the elections. Of the incumbent Ministers who contested seats, all but one were elected to the Rastrya Panchayat, although not all were appointed to the new Cabinet. The Prime Minister and Finance Minister retained their portfolios. Local and district Panchayat elections were held

in May 1982; many politicians who had boycotted the general election decided to participate in the local elections.

4. The traditionally slow machinery for deciding and implementing economic policies in Nepal had been further weakened by the above political developments, which absorbed the attention of the political leaders and made an already weak civil service even more reluctant to take decisions. The political situation appears to be stabilizing now, enabling Government to devote attention to economic problems. The Prime Minister announced a "crash economic program" on February 20, 1982 providing a comprehensive statement of the development needs of Nepal and the Government's approach to dealing with them. A four-day Pancha Convention (of village, district and national Panchayat members) in mid-March sharply debated Government policies and reaffirmed support for the present administration whose survival in the longer run, however, will depend to an important extent on its ability to deal with the country's pressing economic problems.

C. Recent Economic Events

5. Despite a fairly rapid growth in public revenues, foreign aid and development spending, overall economic performance during the Fifth Plan (1976-80) fell short of expectations, and was further weakened by political uncertainty. GDP growth averaged 2.4% per year, similar to the rate achieved during the Fourth Plan period and far below the 4-5% per year anticipated by the Fifth Plan.1/ The shortfall in overall growth was the result largely of stagnant agricultural production, which constitutes nearly 60% of GDP.2/ To a large extent, the weak performance of agriculture in the recent past has been the result of poor monsoons in 1976, 1977 and 1980, but also reflects a poor long-term trend in agricultural productivity resulting from failure to exploit fully the existing irrigation infrastructure, lack of intensive application of improved agricultural technology, and weak support services. Following a good monsoon during the 1981 growing season, agricultural output recovered from the effects of the 1980 drought, and foodgrain production in the last two seasons, 1980/81 and 1981/82, has improved modestly over the

---

1/ Economic information on Nepal is generally available only for the Nepali fiscal year, which runs from mid-July to mid-July. Except as otherwise noted, calendar year data in this CPP refer to the fiscal year ending in that calendar year. Thus 1976-80 refers to 1975/76-1979/80.

2/ In our analysis we have had to rely on official statistics of agricultural output even though the methods and coverage of these statistics are far from adequate. The large subsistence sector, difficult communications and long open border with India present serious estimation problems, and most production statistics are obtained through interviews with selected farmers. Nevertheless, the official data, which indicate stagnation in output of major products such as paddy, maize, oilseeds and livestock, are corroborated by domestic sales as well as export data.

recent past. Owing to shortages of raw materials and power, agro-based industries and consumer goods manufacturing did not fare much better during the Fifth Plan period. The only significant growth was in the services sector, notably government, tourism and trade, and in construction, partly resulting from the rise in public investment. Because of the decline in agricultural supplies and inflationary developments in trading partner countries, the annual rate of increase in consumer prices in the last two years has been 10-12%, nearly twice the historical rates in Nepal. The rate of price increases would have been higher still were it not for the lagged response of Nepal's prices to inflation abroad, delays in the adjustment of administered prices, and the Government's cautious financial policies.

6. The poor performance of directly productive sectors partly accounts for the steady deterioration of the trade balance. The current account deficit grew more than fivefold between 1976 ($17 million) and 1980 ($92 million). A sharp deterioration in the overall balance was staved off by aid receipts, which rose from $35 million (2.4% of GDP) in 1976 to $114 million (5.7% of GDP) in 1980. A recovery in 1981 agricultural exports helped to contain the current account deficit at about $96 million, and a further increase in aid inflows ($125 million) resulted in a positive overall balance. Gross international reserves, which were equivalent to more than one year of imports of goods and services during the early seventies, currently cover about six months of imports. Nepal unified its dual exchange rate with the US dollar in September 1981 at Rs 13.2=$1. Previously, a basic rate of Rs 12=$1 had applied for invisibles and capital transactions as well as for imports of petroleum products, fertilizer and cement; and a second rate of Rs 14=$1 had applied to all other merchandise trade. The September 1981 measure thus devalued the basic rate by ten percent but resulted in a six percent appreciation for most overseas merchandise trade. The exchange rate with the Indian rupee remained fixed at Nepalese Rs 145=Indian Rs 100. The maintenance of fixed rates vis-a-vis the US dollar and the Indian rupee continues to give rise to broken cross rates.

II. REVIEW OF COUNTRY OBJECTIVES AND PERFORMANCE

7. Following centuries of self-imposed isolation, efforts to modernize the economy of Nepal began in the mid-1950's against extremely heavy odds. The country had virtually no physical infrastructure, an ancient administrative system, and very limited educational and health services. The resource base is relatively narrow and its development hindered by the difficult topography and landlocked position. Against this background, Nepal's primary development objective for twenty years, between 1955 and 1975, was to build basic infrastructure and lay the groundwork for future economic growth. The country has progressed remarkably in pursuit of that objective. It now has a basic road network linking most economic centers. Kathmandu and a few other towns have basic utilities and public transport. Schools have been built for almost half of the primary school age children and there are a number of high schools and a national university. A rudimentary hospital system, including rural health posts, has been built. Some progress has also been made in establishing the institutional framework for agricultural and industrial

development. The Government established extension and research services for agriculture and set up financial institutions, trading corporations, a national construction company, industrial estates and a number of industrial enterprises. Yet in all these areas the country has a long way to go to achieve a level of development comparable to other developing economies: thus, for example, the public and private institutions in Nepal must continue to expand and upgrade essential physical facilities, acquire the necessary expertise in handling economic and financial affairs, build up adequate technical and managerial cadres, and establish merit-based systems of personnel management.

8. The Fifth Plan (1976-80) marked a shift in development objectives, with increased emphasis being placed on acceleration of economic growth, employment creation, and raising the living standards of the population. To that end, Nepal succeeded in gradually shifting emphasis towards directly productive investments, especially in agriculture. However, these efforts have not yet paid off, either in terms of accelerated economic growth or in any significant alleviation of widespread poverty. Per capita income during the period remained stagnant at about $140 in 1980 prices. A low adult literacy rate (19%), low average life expectancy (44 years) and high infant mortality (150 per thousand) indicate the extent of deprivation and the magnitude of the task still facing development efforts. The total fertility rate of 6.3 has remained constant and the death rate, although declining, is still very high at 20 per 1,000 population. The decline in the latter coupled with an increase in the number of women in the reproductive age group has been responsible for the continuing increase in the population growth rates. The average population growth in the decade 1971-81 was 2.6% per year compared to 2.2% per year in the previous decade. The pressure of population on resources manifests itself in the extension of cultivation beyond economically feasible and ecologically safe limits in the hills; in the denudation of forests to meet housing and fuel needs, with resulting soil erosion; and in migration from hill areas. While the natural obstacles to development in Nepal are staggering, the potential does exist for increasing production, regulating population growth and conserving fragile parts of the environment.

9. The principal objectives of the Sixth Plan (1981-85) are a continuation of those of the Fifth Plan. The stated strategy of the Plan (a) accords high priority to developing agriculture, small-scale industries and Nepal's abundant water resources; (b) stresses soil conservation and population control; and (c) emphasizes full utilization of existing infrastructure and alleviation of absorptive capacity constraints, including human resource development. The development strategy also calls for increased involvement of the private sector in agriculture, manufacturing, trade, tourism, construction and transport operations. The "crash economic program", announced earlier this year on the initiative of the Prime Minister himself, essentially reiterated this strategy and added an element of export promotion as well as reduction of imports of luxury goods and their deflection to India.

III. EVALUATION OF NEPAL´S STRATEGY AND PLAN

10. As described above, the Government´s overall objectives and strategy for the medium term, contained in the Sixth Plan, are appropriate to Nepal´s circumstances. However, in order to enhance the attainment of the objectives, important adjustments are desirable particularly in the composition of the public investment program, and in programs to strengthen development administration and domestic resource mobilization efforts.

The Public Investment Program

11. Essentially, the current public investment program needs to be modified to better complement past outlays in economic infrastructure, agriculture and industry, so as to gain more rapid returns, and to strengthen programs for human resource development. Past investments in major irrigation works, agricultural research, input supplies and credit institutions would make rapid gains in output during the medium term more feasible if those investments were now complemented with secondary and field-level irrigation, improved water management, correct and timely supply of inputs, adequate storage and marketing facilities. Such complementary investments, moreover, would not necessarily involve high capital costs. For example, in the Terai, the existence of appropriate improved seed varieties tested in neighboring countries offers a unique opportunity to obtain yield improvements without major investments in research. There is also substantial information available on improved farming practices for the Hills (e.g., line planting, proper spacing, weed control, manuring). Where power supplies and underground aquifers permit, tubewell irrigation involving limited works can increase cropping intensity in the Terai, and is the type of development which, to some extent, can be pursued directly by the private sector. In the industrial sector, higher returns could be obtained from existing enterprises (rather than from new investments), many of which are now running at below 60 percent capacity for lack of complementary outlays for raw material supplies, unbalanced technology and inimical institutional and policy frameworks. Savings obtained by such restructuring of the investment program could usefully be allocated to operations and maintenance programs for infrastructure already or soon to be in place -- an area of spending which has been overlooked in the current investment program.

12. Despite the substantial progress made in the past decade (para 7), the human resource base of Nepal is still among the least developed in the world, as evidenced by the low rate of literacy, the prevalence of disease and nutritional deficiencies, and a demographic situation easily among the worst in the world. If the Government´s own activities in these sectors were expanded modestly and full advantage were taken of ongoing foreign assistance to these sectors, expenditures in the social sectors could increase significantly and thus help ensure longer term gains in productivity, population and erosion control, and living standards. The education sector in Nepal is beset with qualitative deficiencies in teacher qualifications and motivation, in school curricula and in teaching materials; and there is inefficiency in the primary--and to some extent secondary--education

system, causing an estimated wastage of recurrent budget expenditures in excess of 50% for the primary subsector. Clearly this indicates a need to emphasize measures for qualitative improvements and higher efficiency, which can be achieved with relatively small financial outlays.

13. Adjustments in the investment program along the lines suggested above are essential to attaining the objectives espoused in the Sixth Plan. The Government's own review of the previous Plan achievements indicated that, for lack of complementary investments which left installed capacity significantly underutilized, overall employment creation and growth were much below expectation. At the same time, the low level of basic educational attainment and a nearly 20% shortfall in technical manpower availability severely retarded overall productivity and project implementation, thus underscoring the need to pay attention to manpower training in ongoing and future development plans of the country.

Development Administration

14. Considering the state of the country 30 years ago, Nepal has made remarkable progress in building up its machinery of government, in training people to staff it and in equipping it to manage the complex process of economic and social development. The size of government, including clerical staff and peons, has expanded rapidly in recent years, from 50,000 in 1973 to an estimated 70,000 at present. A further 30,000-35,000 work for public enterprises, as compared with 23,000 in 1976. When account is taken also of school and university teachers, the police and the army, there would appear to be approximately 200,000 people on the government payroll, equivalent to roughly half of all wage and salary employment outside agriculture. However, the administrative environment in which the public service operates has not been conducive to efficient and energetic work, and the process of decision-making is slow. Public servants are poorly paid (pay scales for top government executives are less than half the Indian scale, itself one of the lowest in the world) and rotated frequently; authority is concentrated at the center; senior appointments and promotions are usually decided by the Cabinet; facilities for in-service training are rudimentary and people who do receive specialized training are often posted to unrelated jobs. The Ministry of Finance, which has a central role in economic decision-making, and several important line ministries, are not sufficiently staffed to conduct thorough economic analysis of development programs and projects; information flows and procedures for programming and monitoring are poorly adapted to the needs of development. In addition to these inherent weaknesses, development administration was adversely affected by the political uncertainties of the past few years, and it will take some time to reverse this situation.

15. The Sixth Plan has drawn attention to these administrative constraints to development and indicated some of the actions that might be taken to overcome them. Government has started implementing some important reforms (para 21), but further measures will be required in order to accelerate the pace of development. The situation calls, on the one hand, for a slowing down in the growth of government employment and the proliferation of public

sector agencies and, on the other hand, for an overhaul of the present incentive system, including substantial salary increases for senior officials, for a more professional approach to the management of public enterprises, and for strengthening the programming and implementation capabilities of key development ministries.

Domestic Resource Mobilization

16. While the Sixth Plan states that additional domestic resources will have to be mobilized for the medium term, it does not contain specific measures to do so. Over the past decade, the Government has made continuous efforts and has succeeded in increasing tax revenue. Even so, the tax effort is still small by comparable international standards. Also, while agriculture accounts for 60% of GDP, it is lightly taxed and landowners contributed only 5% of government revenues during the Fifth Plan -- far below their share (20-30%) in earlier times. Furthermore, a weak tax administration translates into a substantial revenue loss; inefficient public enterprises and user charges set below cost constitute a major drain on public revenues; and food and fertilizer subsidies, the bulk of which not economically justified, add to budgetary expenditures: these subsidies amounted to about 5% of government revenues in 1980 and, if unchecked, could rise to about 8% of projected revenues in 1985.

17. We have suggested to Government a number of alternative measures to rectify the above deficiencies in Nepal's system of domestic resource mobilization. These measures include improvements in tax administration aimed at timely assessment and collection of taxes; increased coverage of the income tax and the urban property tax; raising motor vehicle taxes and extending the tax to buses and trucks; shifting certain import and excise taxes to an ad valorem basis; selective increases in import duty and sales tax rates; appropriate increases in user charges; reduction of food and fertilizer subsidies. We have estimated and indicated to Government that by 1985 such measures could generate additional revenues (about Rs 1.6 billion in 1980 prices) equivalent to 6% of projected GDP in that year. Also, a government-commissioned study on the reform of public enterprises was completed last year by Nepal's Centre for Economic Development and Administration (CEDA). CEDA's report has made specific and detailed recommendations on appropriate pricing policies and wage incentives, efficient management, reduction in excess capacity as well as divestiture of certain enterprises to the private sector.

Government Response

18. In the course of preparing the last CEM about a year ago, and subsequently, we conveyed to Government our assessment of development performance and plans in Nepal as described above, and the initial policy response since then has been encouraging both to us and other donors. Thus, for example, special efforts have been devoted to increasing the supply and storage of fertilizer, agricultural lime and seeds; to accelerating the completion of seed processing and post-harvest grain preservation projects;

to increasing local production from existing sugar and textile factories; and to selecting new projects aimed at intensifying command area development and at increasing local production of cement and other construction materials. Aided by good weather, these special efforts obtained notable increases in productivity in the cultivation of the 1981/82 crops of paddy, wheat, oil seeds and potatoes. These are quite positive results but will have to be sustained over a number of years for agricultural growth to accelerate and catch up with population growth. Industrial production during 1981-82 has also improved somewhat over the recent past, with significant increases in the volume of production of fertilizers, polyethelene pipes, plywood, shoes and leather goods, iron goods, sugar and textiles. Again this encouraging performance has to be kept up because, even with higher output in the past year, capacity utilization in the manufacturing sector is still low at 60-70%. We believe that there are reasonably good prospects for manufacturing output to grow further following improvements in the supply of agricultural raw materials; in the output of power, helped by the Kulekhani hydroelectric project (60 MW) completed this year; and in the overall industrial incentives provided to the private sector in last year's New Industrial Enterprises Act.

19. Following our presentation of the seriousness of the demographic situation in Nepal (para 8) at the December 1981 Aid Group Meeting, Government requested our assistance in designing a more concerted and intensive action program for controlling population growth. Accordingly, a Bank mission in cooperation with USAID and UNFPA -- the established donors in the PHN sector in the country -- visited Nepal in April this year. The mission findings stressed that progress in three problem areas -- coordination of program activities, effectiveness of services, and demand for contraception -- will be especially important in improving the capacity to reduce population growth in Nepal. The full report, which was discussed with Government in October 1982, is expected to help Government to formulate a more cohesive and intensive population strategy.

20. In May this year, Nepal obtained substantive agreement under the long-standing Trade and Transit Treaty with India. The new agreement provides insurance coverage for Nepalese goods in transit; concessions on railway and port facilities, procedures and charges; an additional transshipment point on the Indian side; land for construction of warehouses for Nepalese goods on the Indian side; and regular consultations on measures to track smuggling across the border. Upon implementation, this agreement would be an important step towards alleviating a major bottleneck and cost item in Nepal's international trade and development.

21. Government has also begun to respond to the much needed reforms in development administration. We have seen some first steps with the establishment of an Administrative Staff College, for which external assistance has been secured; appointment of a Permanent Pay Commission to review civil service salaries and schemes of service; creation of a Central Monitoring

Unit within the Foreign Aid Division of the Ministry of Finance; and establishment of district treasury offices to expedite release and audit of budgetary funds. The record 49% increase in development expenditures during fiscal 1981/82 -- with sharp increases noted in agriculture, irrigation and social services -- may indicate that efforts to speed up project implementation and aid disbursements are starting to pay off.

22. Again in the current year, we have seen a positive response to our suggestions on domestic resource mobilization. A revenue training center has been established and external assistance secured for a building, equipment, and instructors; incentives have been offered to tax payers to encourage speedy assessment and collection of income taxes; a Tariff Board headed by a senior Treasury official was formed and recommended increases in rates of customs, excise and other taxes for the 1982/83 budget; and Government has decided to phase out rice subsidies in Kathmandu and to reduce fertilizer subsidies in the Kathmandu Valley and the Terai. Initial response has also been favorable to recommendations in our urban sector memorandum to overhaul the urban property tax system as a means of improved domestic resource mobilization in cities, and to making greater use of existing resources in the Provident Fund for low income infrastructure and housing schemes. Eight publicly owned Rice Exporting Companies have been liquidated and the trade opened up to private mills; three other public enterprises have been divested to the private sector; at least two other public corporations are being considered for joint ownership with, and management by, private firms; the 1981/82 budget provided funds to eight enterprises which had experienced difficulties due to under-capitalization; and the Treasury has made preparations for close monitoring of all public enterprises. The interest rate structure of commercial banks has been revised to mobilize private savings; and the New Industrial Enterprises Act and Foreign Investment Act have provided incentives to attract private investment in manufacturing and related services.

23. Our assessment of the country's response todate would be that, within a short period, Government has made significant efforts to deal with some of the major development constraints: these efforts are particularly notable considering the policy and administrative inertia of the past. Equally, these efforts will have to be sustained, refined and implemented effectively, for more visible and widespread improvements to occur over the next few years. Also, other, sector-specific issues will need to be addressed, including operations and maintenance programs and cost recovery in the agriculture, energy and transport sectors. The main conclusion is that the various measures of the recent past now have to be moulded into a solid long-run development strategy, with emphasis on developing the country's institutional capability and human resource base, and on raising agricultural productivity. The latter includes the need to conserve land and forest resources, and to develop complementary power and transport infrastructure.

Macro Economic Prospects

24. Compared to actual outturn during the preceding Plan, the Sixth Plan's macro economic framework, in constant 1980 prices, decelerates total export growth (from 5.7% to 3.5% per year), doubles total import growth (from 5.2% to 12.4% per year), and accelerates the growth of aid inflows (from 18% to 23% per year) to provide for increased growth in consumption (from 2% to 4% per year) and investment (from 5.3% to 16% per year) out of a GDP whose average growth rate is assumed to double immediately (from 2.4% to 4.3% per year). The overall implication is a fivefold increase in the current account deficit from $92 million in 1980 (4.6% of GDP) to about $500 million in 1985 (13% of GDP). Given the lead time required for investments to start yielding, and the administrative as well as financial constraints described above (paras 14, 16), we think that these projections of the Government are unrealizable.

25. In Attachments 3a-c, we have attempted to present a more feasible macro-economic scenario for the medium to long term based on improvements outlined in the preceding sections (paras 11, 12, 15, 17). The key assumptions underlying the medium-term projections include:

(a) a gradual acceleration of the annual rate of growth of GDP from 2.4% at present to 3.5% by 1985. Agricultural GDP is assumed to grow at 2.6% per year through 1985. Preliminary estimates for 1981 seem to suggest that such growth in agriculture may be feasible given suitable weather and intensive efforts along the lines proposed in paragraph 11;

(b) an investment: GDP ratio rising from 13.5% in 1980 to 16.5% in 1985, implying an average ICOR of 4.9 during the period;

(c) an annual real growth in exports (goods and nonfactor services) of 4-5%. Given the concern to satisfy domestic food requirements, exports of rice are projected as a residual from gross paddy production after meeting domestic consumption; and

(d) the following import elasticities with respect to GDP: food and other consumer goods (0.5); petroleum (2.5); manufactures and miscellaneous (2.0); intermediate goods (1.5); capital imports are assumed at a fixed proportion (25-26%) of investment.

Practically all past aid to Nepal has been on concessional terms, and the same has been assumed for the medium term. Debt service is therefore not expected to increase significantly relative to export receipts. From our projections (Attachments 3a-c), Table 1 below gives the likely structure of import financing and debt service in current prices.

Table 1: PROJECTIONS OF IMPORT FINANCING AND EXTERNAL DEBT, 1983-90

	1983		1985		1990	
	$m	%	$m	%	$m	%
Imports of goods and services	562	100.0	773	100.0	1,317	100.0
Financed by:						
Exports of goods and services	417	74.2	545	70.5	920	69.9
Current transfers (net)	10	1.8	12	1.5	20	1.5
Official capital (net)	136	24.2	224	29.0	392	29.8
Change in reserves /a	-1	-0.2	-8	-1.0	-15	-1.2
Debt service ratio /b		3.1		4.0		5.4
Reserves as months of imports	5		4		3	

/a (-) indicates increase.
/b Interest and repayment on MLT loans as proportion of exports of goods and services.

26. Our projections above indicate that the share of exports in import financing is expected to decline over the medium term before starting to pick up towards the end of the decade. Our assessment of exports is based on a number of feasible outcomes. First, concerted efforts to obtain a 2-3% growth in agriculture would continue to generate some exportable surpluses of rice, oilseeds and animal products while also reducing requirements for food imports. Exports of raw jute and jute products could recover with sustained growth in agriculture and some expansion of jute processing capacity. Second, effective implementation of planned growth in nontraditional exports, aided by our cottage and leather industry projects, could assist merchandise export earnings. Third, earnings from tourism, which rose rapidly during the 1970s and still have considerable untapped potential, could be sustained by effective promotion and improvements in transportation. In particular, immediate measures to halt the deterioration in the operations of the Royal Nepal Airline Corporation, and improve it in the medium term, would help to counter disenchantment of many tourists and tour operators. Fourth, further action to relieve transit and shipment bottlenecks -- especially those of an institutional nature within government control -- would facilitate the flow of goods and reduce the foreign exchange costs incurred by inefficient transport. Fifth, implementation of a comprehensive export strategy, aided by our ongoing study on export policies and prospects (Attachment 4, Economic and Sector Work Program) would improve export incentives and performance over the medium to long term.

27. The government officials concerned have concurred with our assessment of the Sixth Plan macro economic framework as well as with our alternative scenario presented in the preceding paragraphs. Also, preliminary data for 1981 and 1982, the first two years of the Plan, indicate that the actual rate of investment has been lower than the planned rate, as our projections had

envisaged. For the same years, preliminary balance of payments data indicate that the actual current account deficits in both years have been close to our projections. Thus it would seem that our medium-term scenario sketched out in paragraphs 25-26 could be realized approximately if Government continues to adhere to the underlying policy framework. We intend to monitor these developments closely and reiterate to Government that, should the pace of institutional and policy reforms slacken, Nepal's development performance could revert to stagnant per capita incomes and an accelerating resource gap. In such an event, aid disbursements and further commitments to enhancing the country's longer-term productive capacity would decline as, quite conceivably, Government and donors would become preoccupied with short-term crisis management.

IV. EXTERNAL ASSISTANCE

28. During the past five years, annual gross disbursements of external aid to Nepal grew rapidly in current prices, from a fairly low base of $35 million in 1976 to $130 million in 1981, and an estimated $156 million in 1982. About 58% of aid disbursed during these years was in grants and the rest in concessional loans at average interest rates of about 1% and maturity of about 40 years. Annual commitments took a substantial jump between 1975 and 1976; since then they have grown at about 7% in current terms, averaging about $165 million per year. As a result funds in the pipeline by the end of 1980 amounted to about $560 million, of which 38% was committed to agriculture; 8% to industry; 14% to power; 18% to transport and communications; 3% to education; 16% to health and water supply; and 3% to Panchayat development (minor rural works).

29. During these years, multilateral lending has become increasingly important to Nepal; 45% of aid disbursements during 1976-80 came from such sources, compared to 20% during 1971-75. Among multilaterals, IDA and ADB have been the principal donors providing, respectively, 46% and 26% of multilateral aid disbursed during 1976-80. The bulk of external assistance to Nepal has been in the form of project aid (57%) and technical assistance (38%); food aid (3%) has played a minor role since Nepal has been a net food exporter so far; and commodity aid (2%) has been confined to fertilizer and some construction materials (FRG, Japan).

30. In accordance with Nepal's changing sectoral priorities beginning in 1976, the proportions of aid disbursements have shifted towards the agriculture and power sectors, and away from the transport sector. Furthermore, about two-fifths of the pipeline of undisbursed commitments identified above is for agriculture, irrigation and forestry programs. At present, there are 15 large irrigation programs under implementation, including the IDA-assisted Birganj-Narayani, Bhairawa-Lumbini, and Sunsari-Morang projects and the ADB-assisted Chitwan and Kankai projects. Donor support has been especially strong for rural development projects in the Hills (ADB, Canada, IDA, Switzerland, U.K., USAID), and seven programs are now underway covering 25 of the 35 hill districts. Donors are also supporting reafforestation efforts (Australia with nurseries, Tree Seed Unit and advisors; USAID with watershed

management in about five districts; IDA with community forestry). Recent disbursements in the power sector have been mainly for the Kulekhani Hydroelectric Project (IDA, UNDP, Japan, Kuwait Fund, EEC and OPEC Fund). The Indian Government is assisting with the Devighat Power Project. Assistance in the transport sector is for the East/West Highway (India, U.K., U.S.A., U.S.S.R.), and for some feeder roads, tracks and trails being financed under rural development and irrigation projects. Major investments in the industrial sector are the cement factories, financed by the ADB and FRG, and the textile mill financed by China. The largest investments in the social sectors are the USAID and UNFPA programs in family planning and maternal and child health, and the three IDA-assisted water supply and sewerage projects.

31. For the future, our macroeconomic projections (para 25 and Attachments 3a-c) indicate that gross aid disbursements, in current prices, would need to be about $180 million in 1983, $200 million in 1984, and rise to about $280 million by 1988. Such a rate of disbursements would finance about 55-60% of projected public investment in the medium term, and would help to attain a feasible average economic growth of about 4% per year. Our information on the expected pipeline of aid (Attachments 1b and 3c) indicates that this would be adequate to generate the required rate of disbursements over the medium term.

V. IDA STRATEGY

A. BACKGROUND

32. During FY78-82, our strategy in Nepal emphasized primarily the development of agriculture. Secondary emphasis was on developing economic infrastructure (power, transport and communications), which is essential to supporting agriculture, some industries and tourism -- an important source of foreign exchange. In implementing this strategy, which was consistent with that of the Government, we also attempted to mobilize external resources from, and to coordinate our efforts with, other donors -- a task much facilitated by the formation of the Nepal Aid Group in 1976 under Bank leadership. The Aid Group, providing about 70% of aid disbursements to Nepal, now comprises eight DAC countries and four multilateral agencies. To date, four meetings of the Aid Group have been held outside Kathmandu, and the fifth one is scheduled for December 1983. Our efforts at mobilizing external resources for Nepal succeeded in raising per capita aid commitments almost fourfold, in current prices, from about $3 in 1975 to an average of $11 during the Fifth Plan period (1976-80). Per capita aid disbursements also increased over the period, in current prices, from about $3 in 1975 to $8 in 1980.

33. In the recent past, annual disbursements from IDA Credits have increased steadily, from less than $6 million in FY77 to $28.5 million in FY82. The overall disbursement rate improved as well, from less than 10% in FY77 to over 16% in FY82 (Table 2).

Table 2: NEPAL - DISBURSEMENTS
(IDA only)

		FY77	FY78	FY79	FY80	FY81	FY82
		($ Million, current)					
1.	Undisbursed balance on July 1 /a	59.75	81.91	137.37	158.92	169.45	174.65
2.	Commitments during FY	34.00	28.00	67.20	39.80	33.00	62.20
3.	Total disbursed during FY /b	5.84	11.39	18.25	22.56	27.80	28.50
		(Percent)					
4.	Disbursement rate (3/1)	9.8	13.9	13.3	14.2	16.4	16.3
5.	Comparators' disbursement rates /c						
	(a) All other countries in S.Asia	25.9	21.8	19.7	20.2	18.9	18.9
	(b) Bank-wide IDA average	26.6	24.9	22.1	19.4	19.8	20.9
	(c) Selected comparators:						
	Bangladesh	9.7	16.6	18.6	20.2	19.2	15.4
	Niger	9.8	26.7/d	31.1/d	22.3	20.5	15.4
	Yemen, A.R.	26.2	27.5	22.6	14.9	22.4	11.8

/a Includes approved but unsigned and signed but not effective credits.
/b Excludes exchange adjustments on IDA credits.
/c Wherever applicable, program lending has been extracted from calculations for appropriate comparison with Nepal, where there has been no program lending during the period shown.
/d Disbursement rates were high because no commitment was made in FY77 and a small ($9.5 mn) commitment was made in FY78.

34. Major donors, including IDA, have found that implementation of development projects in Nepal has had to progress against very heavy odds, particularly in cases involving critical civil works and procurement components. The local construction industry is very poorly developed, and local sources of construction materials and equipment are very limited or simply non-existent. At the same time, international contractors have been extremely reluctant to undertake small civil works in Nepal, where difficulties of physical access and logistics, and severe monsoons, which limit the construction period, further compound the problem of project implementation. With the exception of few projects such as the Kulekhani hydroelectric project, which was large enough to attract external contractors and engineering supervisors, we have had to break, repackage and retender even modest civil works to suit the local contracting industry -- a process which has proved to be heavily time-consuming and has slowed disbursement performance. Against this background, donor requirements, such as international competitive bidding (ICB), have involved lengthy delays over which Nepal has little

control. There have also been cases of donor-inspired faulty design, inappropriate location, and incorrect sequencing of projects, again leading to delays outside Nepalese control as rectifications were sought.

35. Most donors have also found that working with the weak and inexperienced public service has often involved lengthy delays in preparation and execution of documents and decisions relating to tender, procurement, consultant services and project personnel. For example, in cases requiring ICB, delays occur because the implementing agency which evaluates bids must refer its recommendation not only to the Secretary of the relevant Ministry for a decision, but frequently to the Cabinet and beyond. Substantial time is lost at each step.

36. We have tried to deal with the above constraints by providing necessary technical assistance and training to established government implementing agencies and by assisting with the formation of new project-specific development boards to oversee project execution and management. Some such boards have functioned quite well and served as useful media for imparting training and skills to local manpower, but ultimately we must aim at strengthening, to the extent possible, the established public and private sector institutions and personnel rather than proliferating the number of boards and agencies. Following past representation by ourselves, a Government-commissioned study to streamline procurement procedures was recently submitted to the Prime Minister; the study recommended that implementing agencies or the Secretary of the concerned Ministry, be empowered to make decisions on ICB awards. We have further suggested that Government appoint a task force to propose how construction and other project work should be designed so that tender documents reflect the realities of the relatively unsophisticated construction industry in Nepal.

37. Recognizing the difficult development situation in Nepal, we opened a Resident Mission (RMN) in Kathmandu in 1971. The mission today consists of the Resident Representative, together with a locally employed Operations Officer and supporting staff. The work of the RMN has made a substantial contribution to building a high degree of understanding between the Bank and the Government of Nepal. The RMN's overview of work in all sectors and familiarity with local institutional arrangements provide an important input to development of Bank policies and lending strategy for Nepal. Also, in Nepal's situation of limited managerial and administrative capabilities, the RMN provides much needed support to the various Bank Group missions, to tracking the status of ongoing Bank operations, and to following up on project issues. Furthermore, the RMN has succeeded in operating as a *de facto* local aid coordinator, arranging informal meetings among donor representatives in Kathmandu, and keeping the Bank informed about donor programs in the country. All these activities of the RMN continue to be essential to the efficiency of our operations.

B. PROPOSED STRATEGY

38. Essentially, our proposed strategy is:

(a) to encourage and assist Government to press on with its recent policy initiatives (paras 18-22) aimed, in the short-to-medium term, at accelerating the growth of production, strengthening development administration and increasing domestic resource mobilization;

(b) to assist Government in designing and implementing a long-run strategy aimed at developing the country's institutional capability and human resource base, and at raising agricultural productivity; and

(c) provided policy response and action continue to improve, to maintain our most recently approved level of assistance to Nepal, emphasizing the development of agriculture and small industries, complementary power and transport infrastructure, and human resources development.

The different elements of this strategy would be pursued variously by senior management dialogue with Nepal's leaders, suitable economic and sector work, technical assistance and advice, and lending activities. We would monitor the country response to our dialogue and operations, and, accordingly review the proposed strategy and program in about two years' time. If the present trends on the institutional front and in economic policy improvements are not adhered to we would reduce our program and refocus it on those areas where there is institutional capacity. Alternatively, if there is an acceleration in the current positive trends, the review of our program would concentrate on where we might increase our assistance to further the development of this very poor country. In any event, we expect this process to be self-regulating as we propose to proceed with follow-up projects only after we are satisfied with progress made in ongoing projects and in accompanying institutional change.

39. As noted before, our last CEM, distributed in October 1981, covered medium-term policy requirements and prospects for accelerating economic growth in Nepal and provided specific recommendations on adjusting the public investment program to make it more quick-yielding, more cost-effective and responsive to the need for human resources development (para 11, 12); on improving development administration and project implementation (para 15); and on increasing domestic resource mobilization (para 17). Those recommendations would form the basis for monitoring the quantitative as well as qualitative results of the ongoing Government initiatives in all these areas. We would review annual agricultural production and export trends; progress in the implementation of the New Industrial Policy, which is designed to promote private investment in manufacturing; the recommendations of the Civil Service Pay Commission; performance of the district treasury offices, which have been set up to speed up disbursements of project funds; public revenue and expenditure indicators; and performance of public enterprises. Our economic and sector work program for FY83-84 has been designed to support this review process.

40. Further, we intend to continue to convey to the Government institutional and policy improvements which we wish to see in conjunction with any follow-up projects to be undertaken. Before launching follow-up projects in such areas as agricultural extension and rural development or taking on a fertilizer program, we will wish to see good progress not only on the ongoing projects, but also the development of sound national and district institutions. One issue of particular concern is that, in the past, operations and maintenance (O&M) requirements for roads, irrigation, urban infrastructure, etc. have been overlooked, and recurrent expenditures on essential staff, equipment and materials unduly restricted. While continuing to use our leverage to get electricity and water rates changed, we would also need to develop a better understanding and commitment within the government of why such O&M activities and charges are necessary; and we intend to pursue this through our economic and sector dialogue as well as via individual projects. Further projects for highways and irrigation should be linked to reaching agreement on how O&M will be arranged and funded; specific projects with O&M components could be designed to help launch such programs.

41. We would also consider ways of involving outside expertise more directly to expedite implementation of IDA-assisted projects. For the power, water supply and irrigation sectors, engineering assistance has been routinely included under the projects, and funded by IDA credit or other donors. In the case of Kulekhani Hydroelectric project, for example, we found that the involvement of external engineering consultants to supervise the entire project--rather than just certain components of the project--was highly effective in project execution. Subject to Government concurrence, we suggest continuing this practice in future projects, especially those involving complex engineering and heavy civil works components. At the same time, we will seek to strengthen Nepal's own economic and project management capability.

Institutional Development

42. In keeping with government policy in the past, we had confined our institution-building activities to specific project related bodies. As noted above (para 36), some such efforts were quite successful. Also, through our long involvement in the telecommunications sector, for example, we have been able to develop the Nepal Telecommunications Corporation from a very rudimentary government department into one of the more efficient public corporations in the country. Several ongoing IDA projects, and those of other donors, contain institution-building components in agricultural extension, forestation, power supply and highway maintenance. The total impact of such approach, however, and indeed the overall effectiveness of foreign aid in Nepal, seems to be constrained by the administrative environment described in paragraph 14, implying the need for an active and sustained pursuit of institutional reforms and development at the national level. In this respect, we have been encouraged by recent government initiatives (para 21), and therefore propose to coordinate closely with Government and donors on a general strategy for further and sustained improvements.

43. Lately, Government policy has tended to be more receptive to external technical assistance in economic and institutional management at the national level. It has observed the effectiveness of the long-term involvement of a CIDA-sponsored team in building up policy and programming capability in the Ministry of Water Resources, and in the Water and Energy Commission. Hence we intend to explore with Government and donors similar means of developing better capabilities for program analysis, aid coordnation, policy formulation and project implementation in the Ministry of Finance and important line ministries. Within this framework, the recent approval to provide to Nepal the services of Bank staff for two years under the Bank's new program of non-reimbursable technical assistance is an important beginning. The functions of the staff assigned to Nepal would be to help in establishing and operating the newly formed Central (project) Monitoring Unit in the Foreign Aid Division of the Ministry of Finance. We expect to recruit and place a person in the field by the beginning of April 1983; the appointment would run through FY84 and the first three quarters of FY85. The Government has also requested assistance for upgrading economic research and policy analysis work in the Minitry of Finance. We are discussing the terms of reference for this work and propose another allotment of a one staff position for two years under the same program of technical assistance, to begin in FY84. We further propose to continue to provide appropriate institution-building components in our projects in Nepal, and to budget for more staff resources in supervision of ongoing projects. In addition, our future lending program is proposing a second technical assistance credit to support project identification, preparation and implementation, similar to the first such credit ($3 million in FY77, of which $2.7 million has been disbursed), which assisted in the preparation of investments amounting to over $30 million and supported implementation of projects amounting to over $40 million.

44. The proposed strategy outlined so far would aim to improve prospects for development in the short- to medium-term and, further, make a concerted effort at institutional development. Another important element of our total strategy would be to intensify efforts at improving Nepal's longer-term development prospects. Such prospects are severely conditioned by Nepal's poor human resource base (para 12), and by its demographic situation and the related problems of deforestation, soil erosion and dwindling fuelwood supplies, on which Nepal currently depends for over 90% of its energy consumption (para 8). The lack of a well-defined national strategy to raise stagnant agricultural productivity is another fundamental long-term constraint.

Long-term Strategy

45. Our education sector memorandum (1981), and a recent Bank research project on farmer education and farm efficiency in Nepal (reported in WDR 1982), suggest that strengthening a variety of education activities, including primary, technical and vocational education, would contribute significantly to raising agricultural production and alleviating several dimensions of rural poverty in the long term. We are therefore proposing to continue our assistance to the education sector with a strong focus on

linkages to productive sectors, and on quality improvement and institution-building. We have recently complied to Government's request for assistance in designing a cohesive and intensive population strategy (para 19). We are following up on Government action in this field and have offered further assistance, including project assistance. Deforestation and soil erosion have reached alarming levels in many parts of the Hills and the consequences are being felt also in the Terai and in northern India, where flooding occurs because river beds have risen as a result of large amounts of silt being carried down. We intend to impress upon Government the need for a more concerted nationwide action program to deal with this problem, which our economic report in 1979 aptly characterized as "having the makings for a circle of unparalleled ecological destruction".

46. It was only six years ago, beginning with the Fifth Plan in 1976, that Nepal's development strategy shifted emphasis from building essential primary infrastructure to developing the commodity-producing sectors, particularly agriculture, which is the mainstay of the economy. Since then, donor support to agricultural development has been quite strong, with about $375 million committed, and about $160 million disbursed, to project and technical assistance in agriculture. As the projects initiated in the mid-1970s begin to come on stream, and new ones are planned, there is a clear need to identify a long-term strategy aimed at addressing the problem of very slow annual growth rate in foodgrain production (almost entirely accounted for by increase in area), which has severe consequences for Nepal's ability to feed its population and to sustain agricultural products as the main export base. Previous government plans have alluded to a long-term objective of agro-climatic specialization (potatoes, horticulture, tea and livestock in the Hills; foodgrains and tropical/subtropical cash crops in the Terai) accompanied by development of internal trade, but this is obviously constrained by difficult transport and communications between the Hills and the Terai, and by the limited purchasing power of the Hill population. Meanwhile, Government and donors, including IDA, have by now accumulated considerable experience in the sector through projects in irrigation, rural development, extension and research, input supply, and forestry. Our agricultural sector memorandum and irrigation subsector review, both produced in 1982, have provided a good overview and identified broad elements of an appropriate strategy (see para 54). During FY83-84, we are proposing to consolidate further our sector experience to date--and those of Government and other donors--to elaborate on a long-term agricultural strategy, which should form an important topic of our country dialogue and a useful input to Nepal's preparation of the Seventh Plan (1986-90).

47. Nepal's economic relations with India are also very pertinent to the country's long-term development. Government and donors have known all along that the absence of sound water sharing agreements with India impede all major surface water development in the trans-Terai rivers of Nepal; that unresolved transit and transshipment bottlenecks seriously constrain Nepal's foreign trade and flows of critical intermediate and capital goods; and that lack of close coordination of policies between India and Nepal severely circumscribes Nepal's options in pursuit of important policies (agricultural

input and producer prices, interest rates, taxation), particularly in the Terai, which has the greater potential for surplus production. As such matters touch on delicate national sentiments in both countries, and on intricate politics of that region, our role seems limited. Nevertheless, our longer-term involvement in economic development in Nepal would indicate that the Bank's Senior Management will need to continue to urge more haste, flexibility and preparedness on the country's leaders to come to terms with India, at least on outstanding matters of riparian rights, flood control, and protocols on trade and investment. Being the less experienced and less equipped of the two countries, Nepal will probably need technical assistance and advice in negotiating and implementing various measures. In this connection, we continue to provide assistance in arranging Karnali River meetings between India and Nepal. We should also be prepared to assist in, for example, a rapid implementation of the latest Indo-Nepali agreement on trade and transshipment referred to in paragraph 20.

48. The proposed economic and sector work program, shown in Attachment 4, is intended: (a) to support our review of ongoing country measures for intensifying production, improving development administration, and increasing resource mobilization, which we have proposed to Government earlier (see para 39); (b) to assist Government in devising suitable strategies and action plans in areas affecting long-term development prospects of Nepal, namely, human resources development, agricultural productivity, energy assessment, transport and transit development; and (c) to strengthen our future lending activities.

49. Government has generally been very receptive to the undertaking of Bank economic and sector work in the country, and we have consulted closely with the Fund, other donors and relevant local institutions (CEDA, APROSC, IDS) in the course of our past activities. We intend to continue this modus operandi which, among other benefits, has enabled us to evolve more concerted strategy and policy proposals to Government. The most recent economic report received wide support at the Nepal Aid Group meeting in December last year and prompted an encouraging response from Government, which announced new policies to streamline development administration and to strengthen resource mobilization. Our sector studies have led to lending in a sector (forestry), have helped to assess past results and future strategy (agriculture), and induced Government to incorporate agreed strategies in project design.

50. We would discuss our findings and recommendations from the FY83-84 work program with Government, and our FY84 CEM with other donors at the December 1983 Aid Group meeting. After the ensuing country response, which most likely will be reflected in the July 1984 budget of Nepal, and after allowing for our internal preparation time, we expect to be in a position to reassess our country assistance strategy approximately in December 1984.

input and producer prices, interest rates, taxation), particularly in the Terai, which has the greater potential for surplus production. As such matters touch on delicate national sentiments in both countries, and on intricate politics of that region, our role seems limited. Nevertheless, our longer-term involvement in economic development in Nepal would indicate that the Bank's Senior Management will need to continue to urge more haste, flexibility and preparedness on the country's leaders to come to terms with India, at least on outstanding matters of riparian rights, flood control, and protocols on trade and investment. Being the less experienced and less equipped of the two countries, Nepal will probably need technical assistance and advice in negotiating and implementing various measures. In this connection, we continue to provide assistance in arranging Karnali River meetings between India and Nepal. We should also be prepared to assist in, for example, a rapid implementation of the latest Indo-Nepali agreement on trade and transshipment referred to in paragraph 20.

48. The proposed economic and sector work program, shown in Attachment 4, is intended: (a) to support our review of ongoing country measures for intensifying production, improving development administration, and increasing resource mobilization, which we have proposed to Government earlier (see para 39); (b) to assist Government in devising suitable strategies and action plans in areas affecting long-term development prospects of Nepal, namely, human resources development, agricultural productivity, energy assessment, transport and transit development; and (c) to strengthen our future lending activities.

49. Government has generally been very receptive to the undertaking of Bank economic and sector work in the country, and we have consulted closely with the Fund, other donors and relevant local institutions (CEDA, APROSC, IDS) in the course of our past activities. We intend to continue this modus operandi which, among other benefits, has enabled us to evolve more concerted strategy and policy proposals to Government. The most recent economic report received wide support at the Nepal Aid Group meeting in December last year and prompted an encouraging response from Government, which announced new policies to streamline development administration and to strengthen resource mobilization. Our sector studies have led to lending in a sector (forestry), have helped to assess past results and future strategy (agriculture), and induced Government to incorporate agreed strategies in project design.

50. We would discuss our findings and recommendations from the FY83-84 work program with Government, and our FY84 CEM with other donors at the December 1983 Aid Group meeting. After the ensuing country response, which most likely will be reflected in the July 1984 budget of Nepal, and after allowing for our internal preparation time, we expect to be in a position to reassess our country assistance strategy approximately in December 1984.

VI. IDA PROGRAM

51. For FY84-88, we are proposing IDA commitments of $460 million, which would be equivalent to about 28% of total aid commitments to Nepal which could reasonably be expected during the period. Implementation of this proposed program would be subject to continued improvements in policies and measures outlined in the section on our proposed strategy. IDA presently accounts for about 44% of Nepal's total external debt outstanding and disbursed. Nepal's debt burden is quite low; its debt outstanding and disbursed was about 9% of GNP in 1980. For the future, we estimate that by FY88, this ratio may reach about 20%. Nepal's total debt service ratio is 1.9% at present and 0.1% on account of IDA credits. By 1988, the debt service ratio is projected to be about 4.5% and 0.8% on account of IDA credits.

52. We estimate that even with increasing efforts at raising Government revenues in Nepal, annual recurrent expenditures would more or less exhaust revenues over the next five years to provide for adequate O&M of infrastructure and for salary and other expenditure increases needed to improve public sector performance. In such a situation, external financing of a large share of costs of new projects should continue in order to enable essential investments to take place. We therefore recommend that IDA should finance up to 90% of total project costs, or full foreign exchange costs, whichever is higher, instead of the present 85% limit.

53. The proposed lending program for FY84-88 is shown below by sectors and compared to the preceding five-year program (Table 3).

Table 3: NEPAL - SECTORAL DISTRIBUTION OF IDA LENDING PROGRAM

	Past FY78-82		Current FY83		Future FY84-88		No. of Projects in FY		
	Amount ($ mn)	Share (%)	Amount ($ mn)	Share (%)	Amount ($ mn)	Share (%)	78-82	83	84-88
Agriculture	123.2	53.1	22.0	18.3	245.0	53.3	9	2	10
Industry	6.5	2.8			20.0	4.3	1		2
Energy & Power	24.0	10.3	98.0	81.7	50.0	10.9	2	1	1
Transport & Communications	31.5	13.6			52.0	11.3	2		2
Water Supply	27.0	11.6			35.0	7.6	1		2
Education	20.0	8.6			50.0	10.9	2		4
Technical Assistance	-	-			8.0	1.7			
TOTAL Proposed	232.2	100.0	120.0	100.0	460.0	100.0	17	3	21
TOTAL Approved /a					400.0 (FY82-86)				

a/ At the last Bankwide lending program review in January 1982.

The total amount of the proposed future program (FY82-86) is equivalent to that approved at the last Bankwide lending program review. Compared to the past (FY78-82), the current and future programs show a large increase for the following main reasons. First, we are proposing to make major efforts in agricultural development, continuing our assistance to irrigation and forestry, and undertaking complementary investments within agriculture (credit, input supply, research and extension, area development), which were earlier identified as essential to fuller utilization of existing investments (para 11), and which our recent sector reviews have identified as very basic to any strategy for raising long-term agricultural productivity. Second, we are proposing to increase our role in institution-building and human resources development, and to provide for more institution-building components in all projects. Third, to support agriculture and industry (see paras 59-60), we have provided for investments in power and transport; these investments are lumpy, and happen to be due in the FY83-88 period within the context of Nepal's long-term sector plans. Even then, the proposed IDA contributions to the power and transport projects would meet only partial costs of the projects (less than a third of Marsyangdi power project, and less than a half of the final link in the East-West highway), the rest expected to be met with contributions by prospective cofinanciers.

54. Agriculture, which includes forestry, continues to receive the largest share in the program. The irrigation sector in Nepal remains vital to increased agricultural production and it is one of the major sectors receiving IDA assistance. A recent review of the sector has indicated that nearly two-thirds of the potential irrigable area, mostly in the Terai, remains to be developed by a short- and medium-term strategy of concentrating effort at completion of basic infrastructure (roads, irrigation, power) at the more favorable locations in the Western Terai. In the somewhat better developed Central and Eastern Terai the best strategy would appear to be strong promotion of year-round multiple cropping combined with cash crop development. This would be driven by year-round intensive irrigation including private and community wells, conjunctive use of groundwater in existing rudimentary irrigation project areas and surface water modernization coupled with intensive management of existing assets, and agricultural extension. The proposed lending program includes (a) irrigation works which upgrade farmer-built systems and those which expand irrigated areas under existing systems; and (b) expanded agriculture extension coverage, increased credit and fertilizer use, and cash crop development programs to increase returns to cultivators. Through several ongoing as well as recently approved projects in agriculture (Bhairawa-Lumbini Stages I and II, Narayani Zone Irrigation Stage II, Mahakali Irrigation, Agricultural Extension and Research, Cash Crops), we are attempting to strengthen agricultural support services and institutions. These efforts will continue with further development of the T&V system of agricultural extension; strengthening of the research and training programs of the Bhairawa Agricultural Farm and other regional

research stations; promotion of the Agricultural Input Corporation's scheme of producing high quality cereal seeds through a contract system with private growers; and rationalization of the research institutions for important cash crops such as sugarcane, tobacco, oilseeds and ginger.

55. We continue to believe that the appropriate strategy for development of the Hills is an integrated one. The goals of these efforts are to enhance food production as much as possible and to halt environmental deterioration. Recent experience has shown that including a large number of social sector components in integrated rural development projects tends to slow down the whole process. The Hill Food Production Projects attempt to confine the integrated approach mainly to the essentials for increasing food production, including those programs which are run mainly through one ministry, in this case the Ministry of Agriculture. As experience with these projects evolves, we intend to add other such hill food production projects as well as hill irrigation projects to the program. We propose to structure these programs to capitalize on the significant, but essentially short-term potentials of increasing food production through introduction of improved but low-cost farming practices.

56. Another major thrust of the proposed program for the development of the hills is in the cottage and small industries sector. The first cottage and small industries project (Credit No. 1191) was approved recently. The project would upgrade private and public sector technical, marketing and credit services, and redirect Government incentives to better reach the cottage and small industries sector. As a first phase program, the project would focus on the Kathmandu Valley and the Gandaki Zone to test, develop and improve the various institutions and services. A follow-up project is tentatively scheduled in the lending program, but, its processing will depend on the progress and results of the first project. We have included a project to provide credit, technical assistance and an improved planning framework for the leather industry, which is an important source of foreign exchange earnings.

57. The first Community Forestry Development and Training Project (Credit No. 1008-NEP) is initiating a twenty-year national forestry program for the hills and establishing training facilities for forestry and soil and water conservation personnel. As the project design of community forestry programs through the system of Panchayat Forests and Panchayat Protected Forests is refined and improved, and as additional staff are trained, the forestry and soil and water conservation programs for the hills can be intensified. A follow-up project is being planned to assist with financing this expansion. We are also working with the Government to identify similar community forestry programs for the Terai, which will also include some commercial fuelwood development.

58. The IFC makes an important Bank Group contribution to developing private industry in Nepal, and to increasing Nepal's foreign exchange earnings. The first IFC operation ($2.7 million loan and $0.4 million equity in 1975), now fully disbursed, expanded room capacity at the Soaltee Hotel from

110 to 290, and also improved public facilities at the hotel. The second operation ($6.23 million loan in 1982), with Nepal Orind Magnesite (Private) Limited, is assisting a major development of Nepal's mineral resources and the country's first industrial joint venture with a foreign private sector partner. The firm in Nepal will produce 50,000 MT of dead burnt magnesite annually for export, primarily to India, earning some $16 million a year in foreign exchange, and providing about 700 new jobs. Another mining venture with foreign partners, the Lead-Zinc Concentrate Project in the Ganesh Himal range, is currently being appraised for a $2 million IFC loan, which is expected to be committed in the current fiscal year. A prospective proposal for a light engineering project has been received by the Corporation. Recent industrial legislation in Nepal (the Industrial Enterprises Act and the Foreign Investment and Technology Act, 1981/82), aiming to promote local and foreign private investment through a program of fiscal and administrative incentives, suggests that the IFC's role in Nepal could be increased further.

59. Domestic demand for electric power, the relatively very low installed capacity, and limited options for other sources of commercial energy fully justify further investments in hydroelectric power generation in Nepal. Inadequate power supply remains a serious constraint to industrial production, and the nearly $70 million of foreign aid disbursed to industry since 1976 would not produce the benefits envisaged if power supply is not increased. Similarly, investments in potentially productive groundwater irrigation projects would be constrained. To relieve these constraints, Nepal has devoted a significant share of public investment to the power sector (18% in the ongoing Sixth Plan), involving substantial work and expenditures on external contracting and procurement in which Bank advice and assistance would benefit the country. For all these reasons, our program includes a commitment to the Marsyangdi hydroelectric project in FY83 and another power generation project in the outer years, either in FY86 or FY88. In addition, Nepal's immense potential for hydroelectric power is well known and, as prospects for eventual export of power to India have improved somewhat recently, we would provide a technical assistance credit to facilitate project preparation activities for development of the Karnali River Basin. Our Kulekhani hydroelectric project assisted in establishing a highly effective institution--the Kulekhani Board--and the proposed Marsyangdi project will promote reorganization and strengthening of the Nepal Electricity Corporation.

60. We have also provided for a project to complete the East-West Highway. The uncompleted 190 km of this 1,040 km long highway is preventing exploitation of fertile land in Far Western Nepal ideally suited for staple crops (paddy, maize, wheat) and horticulture. In the area, we ourselves have the Mahakali Irrigation Project ($16 million) under implementation, and the Babai Irrigation Project ($40 million) under preparation, besides numerous small ongoing projects of Government and other donors. About 850 km of the Highway have been, or are being, built by other donors (India, UK, USA, USSR), and we are now proposing to undertake the remaining link. This project would also aim at improving the Government's highway maintenance program; this is a high priority requirement in Nepal, where maintenance of

roads is very poor and extensive works are often necessary to repair roads damaged by landslides.

61. The proposed telecommunications project is to continue the program of increasing the countrywide penetration and quality of telecommunications services. IDA assistance to this sector has evolved over a long period. Three credits extending over a period of thirteen years have expanded and upgraded infrastructure, provided valuable technical advice and critical procurement assistance, and substantially enhanced the institutional capability of the Nepal Telecommunications Corporation. IDA presence through the proposed fourth credit is also expected to facilitate coordination of cofinancing arrangements to meet the total cost of the project.

62. The water supply project proposed for FY86 would be the fourth in a series of projects designed to introduce and improve water supply and sewerage in 22 urban centers. At completion of the third project, scheduled for end-1985, 83% of the population of the 12 towns under the first three projects will have access to wholesome water. The fourth project would aim for a similar situation in the remaining 10 towns, and for completing the institutional and financial improvement efforts started under the first 3 projects. Another urban renewal and solid waste disposal project is proposed for FY88. In our dialogue on population issues with Government (para 19), we have indicated that we would be prepared to assist with planning, training, linking demand creation to services, and evaluation of population programs. One or two small operations in such activities could provide important impetus to faster and effective utilization of the substantial funds granted by other donors (USAID, UNFPA, WHO, UNICEF) to the PHN sector in Nepal.

63. Our proposals for human resources development also include an agricultural manpower program to rationalize the training given to extension staff; assistance for upgrading primary and secondary education, in which there has been little donor involvement in the past; and a project to cover low level vocational and basic skills training. As noted above, the Community Forestry Project involves training for forestry, and soil and water conservation personnel. Our ongoing Highway II project has a component financing equipment for training, and UNDP is financing two experts to train 200 mechanics. To continue with this, our proposed East-West Highway project would have a component for training mechanics, operators, civil engineering supervisors and young managers in the transport sector. To promote efficiency and expansion in the water supply and sewerage sector, a UNDP financed project, for which the Bank is executing agency, will study manpower and training needs and also help prepare a pipeline of projects by engineering studies.

64. Our lending program includes reserve projects in agricultural extension, input supply and rural development to conform with the proposal to increase emphasis on agricultural development. Similarly, our proposed thrust at enhancing institutional capability in Nepal has been backed with reserve projects to provide technical assistance (Karnali Preparation, Petroleum Exploration Promotion II, Technical Assistance III). For further

assistance in human resource development, we have provided a reserve project in engineering education, pending an engineering and technical manpower study in FY84, and a reserve project in population pending the outcome of our current discussions with Government on the need for IDA assistance in the PHN sector. Finally, a reserve project to facilitate transit of Nepalese goods has been included in anticipation of further progress on the implementation of the Indo-Nepali Trade and Transit Treaty referred to in paragraph 20.

65. The Bank would continue to assist Nepal in mobilizing external resources through the Nepal Aid Group (para 32), and co-financing. Many projects in Nepal are of a relatively small size which tend to limit the scope for co-financing. Nevertheless, the Bank has been successful in attracting co-financing in the past. In the case of the Kulekhani Hydroelectric project the Bank not only acted as a catalyst to mobilize external resources to fill the unfinanced gap, but also introduced two new important lenders--the OECF of Japan and the Kuwait Fund--to Nepal. Currently, we are actively pursuing co-financing possibilities for the proposed Marsyangdi Hydroelectric project (70 MW) with a number of potential donors including ADB, Kuwait Fund, Saudi Fund and the Federal Republic of Germany. The Bank has also been successful in getting other donors, particularly UNDP and smaller bilateral donors, to fund the technical assistance component of IDA-financed projects. These co-financing efforts will be vigorously pursued in the future also.

VII. CONCLUSIONS

66. The political situation, which had adversely affected overall economic performance in Nepal during 1976-80, appears to be stabilizing and enabling Government to devote more attention to pressing economic problems. The Government's development objectives and basic strategy (paras 7-9) are appropriate to Nepal's circumstances and, following firm commitment conveyed at the Bank Annual Meetings and the Aid Group Meeting in 1981, Government has initiated a series of measures aimed at accelerating economic growth, strengthening development administration, and increasing domestic resource mobilization (paras 18-22).

67. We propose to assist Government to refine and implement effectively its ongoing initiatives. We would also urge and assist concerted Government action to develop Nepal's institutional capability and human resources, and to raise long-term agricultural productivity (paras 42-47). Anticipating Nepal's response in these areas to continue improving, approval is requested for:

(a) the attached lending program (Attachment 1a), which emphasizes agriculture, supporting infrastructure and human resources development, and which would be reviewed in about two years;

(b) allotment of a staff position for two years to Nepal from the Bank's new program of non-reimbursable technical assistance, in addition to the two-year position already approved (para 43); and

(c) IDA financing of up to 90% of total project costs or the full foreign exchange costs, whichever is higher (para 52).

Population : 15.0 million (mid-1981)
GNP Per Capita: $156 (1981)
Area : 140,800 sq.km.
Literacy Rate : 19% (1980)

Attachment 1a

NEPAL: ACTUAL AND PROPOSED PROGRAM OF LENDING OPERATIONS THROUGH FY88
($ million)

Operations: All IDA	Through FY77	FY78	FY79	FY80	FY81	FY82	Current FY83	FY84	FY85	FY86	FY87	FY88	Total FY73-77	Total FY78-82	Total FY83-87	Total FY84-88	Reserve Projects
Irrigation I: Birganj-Narayani 1	6.0																
Irrigation II: Bhairawa Lumbini 1	9.0																
Irrigation III: Sunsari Morang		30.0															
Irrigation IV: Narayani 2			14.0														
Irrigation V: Mahakali				16.0													
Irrigation VI: Babai Engineering					3.5												
Irrigation VII: Bhairawa Lumbini 2							16.0										
Irrigation VIII: Babai								40.0									
Irrigation IX: Medium Irrigation										25.0*							
Irrigation X: Sunsari Morang 2											35.0						
Agricultural Extension I					17.5												
Agricultural Extension II																	20.0 (85)
Agricultural Research & Development										20.0							
Grain Storage I					6.2												
Settlement	6.0																
Hill Food Production I					8.0												
Hill Food Production II											25.0*						
Rural Development I	8.0																
Rural Development II			11.0														
Rural Development III																	15.0 (87)
Cash Crops							6.0										
Livestock I												20.0					
Agricultural Inputs																	20.0 (85)
Agricultural Credit												20.0					
Terai Area Development									30.0								
Forestry I: Community forestry				17.0													
Forestry II: Terai								10.0*									
Forestry III: Hills											20.0						
Tourism	4.2																
Industry I: NIDC	4.0																
Industry II: Cottage Industry I						6.5											
Industry III: Cottage Industry II											10.0*						
Industry IV: Leather Industry								10.0									
Power I & Supp.: Kulekhani	26.0		14.8														
Power II: Marsyangdi							98.0										
Karnali Preparation																	10.0 (83)
Power III												50.0*					
Petroleum Exploration Promotion I						9.2											
Petroleum Exploration Promotion II																	25.0 (86)
Telecommunications I	1.7																
Telecommunications II	5.5																
Telecommunications III		14.5															
Telecommunications IV									20.0*								
Highway I	2.5																
Highway II		17.0															
Highway III									32.0*								
Transit Transport																	20.0 (88)
Water Supply I & Supp.	11.8																
Water Supply II	8.0																
Water Supply III					27.0												
Water Supply IV										20.0*							
Sewerage, Waste Disposal												15.0					
Education I: Technical Ed.1		5.7															
Education II: Technical Ed.2						14.3											
Education III: Primary Ed.								15.0									
Agricultural Training									10.0								
Vocational Training										10.0							
Secondary Education												15.0					
Engineering Education																	20.0 (87)
Population I																	5.0 (84)
Tech. Asst. I	3.0																
Tech. Asst. II								8.0*									
Tech. Asst. III																	10.0 (87)
Lending Program	95.7	67.2	39.8	33.0	62.2	30.0	120.0	83.0	92.0	75.0	90.0	120.0	87.3	232.2	460.0	460.0	
Number (all IDA)	14	4	3	2	5	3	3	5	4	4	4	5	11	17	20	22	
Lending Program in Constant FY82 Commitment $		85.1	48.0	37.8	66.6	30.0	112.3	73.3	76.7	59.0	66.7	83.9		267.5	388.0	359.6	
Commitment Deflator (FY82=100)		79.0	82.9	87.3	93.4	100.0	106.6	113.2	120.0	127.2	134.9	143.0					
Standby Projects: Total							18.0	52.0	45.0	35.0	50.0						
Number							2	2	2	2	1						

*Standby Projects

South Asia Regional Office
November 15, 1982

Attachment 1b

NEPAL: SUMMARY OF BANK GROUP AND OTHER OFFICIAL LENDING

SECTORAL DISTRIBUTION OF BANK GROUP COMMITMENTS (%)	Through FY77	FY78	FY79	FY80	FY81	FY82	Current FY83	FY84	FY85	FY86	FY87	FY88	Total FY73-77	Total FY78-82	Total FY83-87	Total FY84-88
Agriculture	30.3	44.6	62.8	100.0	56.6	-	18.3	60.2	32.6	60.0	88.9	33.3	33.2	53.1	49.3	53.3
Industry & Tourism	8.6	-	-	-	-	21.6	-	12.0	-	-	11.1	-	4.6	2.8	4.3	4.3
Energy	-	-	-	-	-	30.7	-	-	-	-	-	-	-	4.0	-	-
Power	27.2	-	37.2	-	-	-	81.7	-	-	-	-	41.7	29.8	6.4	21.3	10.9
Transportation	2.6	25.3	-	-	-	-	-	-	34.8	-	-	-	-	7.3	7.0	7.0
Telecommunications	7.5	21.6	-	-	-	-	-	-	21.7	-	-	-	6.3	6.2	4.3	4.3
Water Supply	20.7	-	-	-	43.4	-	-	-	-	26.7	-	12.5	22.7	11.6	4.3	7.6
Education	-	8.5	-	-	-	47.7	-	18.1	10.9	13.3	-	12.5	-	8.6	7.6	10.9
Technical Assistance	3.1	-	-	-	-	-	-	9.6	-	-	-	-	3.4	-	1.7	1.7
Total	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	100.0	100.0
BANK GROUP DISBURSEMENTS ($ mm)																
IDA o/s including undisbursed a/	95.7	162.9	202.7	235.7	297.9	327.9	447.7	530.4	622.0	696.1	785.0	903.5				
excluding undisbursed a/	12.7	24.1	42.4	65.0	92.8	121.3	153.9	193.1	242.7	305.3	375.8	451.5				
IDA Gross disbursements	12.7	11.4	18.3	22.6	27.8	28.5	32.8	39.5	50.0	63.5	71.6	77.2				
less: amortization	-	-	-	-	-	-	0.2	0.3	0.4	0.9	1.1	1.5				
equals: net disbursements	12.7	11.4	18.3	22.6	27.8	28.5	32.6	39.2	49.6	62.6	70.5	75.7				
less: interest & charges	0.2	0.1	0.2	0.3	0.5	0.9	1.8	2.3	3.1	3.8	4.5	5.4				
equals: net transfer	12.5	11.3	18.1	22.3	27.3	27.6	30.8	36.9	46.5	58.8	66.0	70.3				
COMMITMENTS FROM OFFICIAL SOURCES ($ mm)																
	Actual							Projected								
Grants	68.4	76.5	99.5	90.7	188.8	145.0	200.0	150.0	150.0	182.0	200.0	220.0				
Bilateral	50.9	68.5	85.9	65.3	151.3											
Multilateral	17.5	8.0	13.6	25.4	37.5											
Concessional Loans	84.5	81.8	101.9	67.4	145.6	125.0	200.0	125.0	150.0	175.0	200.0	225.0				
Bilateral	11.7	9.1	12.6	3.5	8.3											
Multilateral	72.8	72.7	89.3	63.9	137.3											
IDA	28.0	67.2	39.8	33.0	62.2	30.0	120.0	83.0	92.0	75.0	90.0	120.0				
ADB	23.5	5.5	15.7	30.9												
Other	21.3	-	33.8	-												
TOTAL COMMITMENTS	152.9	158.3	201.4	158.1	334.4	270.0	400.0	275.0	300.0	357.0	400.0	445.0				

a/ At end of fiscal year

South Asia Regional Office
November 15, 1982

TABLE 3A
NEPAL - SOCIAL INDICATORS DATA SHEET

AREA (THOUSAND SQ. KM.) TOTAL 140.8 AGRICULTURAL 40.2	NEPAL 1960 /b	1970 /b	MOST RECENT ESTIMATE /b	REFERENCE GROUPS (WEIGHTED AVERAGES - MOST RECENT ESTIMATE) /a LOW INCOME ASIA & PACIFIC	MIDDLE INCOME ASIA & PACIFIC
GNP PER CAPITA (US$)	50.0	70.0	156.0	261.4	890.1
ENERGY CONSUMPTION PER CAPITA (KILOGRAMS OF COAL EQUIVALENT)	4.3	14.9	13.0	448.7	701.7
POPULATION AND VITAL STATISTICS					
POPULATION, MID-YEAR (THOUSANDS)	9447.0	11355.0	15020.5 /c	.	.
URBAN POPULATION (PERCENT OF TOTAL)	3.1	3.9	5.0	17.3	32.4
POPULATION PROJECTIONS					
POPULATION IN YEAR 2000 (MILLIONS)			22.3	.	.
STATIONARY POPULATION (MILLIONS)			53.9	.	.
YEAR STATIONARY POPULATION IS REACHED			2135	.	.
POPULATION DENSITY					
PER SQ. KM.	67.1	80.6	101.3	158.1	255.9
PER SQ. KM. AGRICULTURAL LAND	267.4	312.4	354.8	355.9	1748.0
POPULATION AGE STRUCTURE (PERCENT)					
0-14 YRS.	39.1	42.0	42.5	36.8	39.9
15-64 YRS.	57.4	55.0	54.5	59.7	56.8
65 YRS. AND ABOVE	3.5	3.0	3.0	3.5	3.3
POPULATION GROWTH RATE (PERCENT)					
TOTAL	1.3	1.8	2.5/c	2.0	2.3
URBAN	4.4	4.2	4.9	3.3	3.9
CRUDE BIRTH RATE (PER THOUSAND)	43.6	45.5	42.1	29.3	31.8
CRUDE DEATH RATE (PER THOUSAND)	26.5	23.7	19.8	11.0	9.8
GROSS REPRODUCTION RATE	2.7	3.0	3.0	2.0	2.0
FAMILY PLANNING					
ACCEPTORS, ANNUAL (THOUSANDS)	..	37.4	146.0	.	.
USERS (PERCENT OF MARRIED WOMEN)	..	0.7/d	4.3/d	19.3	36.3
FOOD AND NUTRITION					
INDEX OF FOOD PRODUCTION PER CAPITA (1969-71=100)	106.0	101.0	89.0	108.1	115.6
PER CAPITA SUPPLY OF					
CALORIES (PERCENT OF REQUIREMENTS)	94.2	94.5	88.7/e	97.3	106.4
PROTEINS (GRAMS PER DAY)	50.8	50.5	46.5/e	56.9	54.4
OF WHICH ANIMAL AND PULSE	9.5	9.2	8.4/e	20.0	13.9
CHILD (AGES 1-4) MORTALITY RATE	32.6	27.8	23.0	10.9	6.7
HEALTH					
LIFE EXPECTANCY AT BIRTH (YEARS)	37.6	40.5	44.2	57.8	59.8
INFANT MORTALITY RATE (PER THOUSAND)	194.5	172.5	150.2	89.1	63.7
ACCESS TO SAFE WATER (PERCENT OF POPULATION)					
TOTAL	..	2.0	8.0/f	32.9	32.0
URBAN	47.7	53.0	81.0/f	70.7	51.9
RURAL	..	..	5.0/f	22.2	20.5
ACCESS TO EXCRETA DISPOSAL (PERCENT OF POPULATION)					
TOTAL	..	1.0	1.0/g	18.1	37.7
URBAN	..	14.0	14.0/g	72.7	65.7
RURAL	..	..	..	4.7	24.0
POPULATION PER PHYSICIAN	73804.7	51380.1/h	35896.6/h	3297.8	8540.4
POPULATION PER NURSING PERSON	..	70528.0/h	13513.6/h	4929.3	4829.4
POPULATION PER HOSPITAL BED					
TOTAL	8294.1	6938.4	6398.5/e	1100.4	1047.5
URBAN	286.8	329.1	360.0/e	301.3	651.6
RURAL	..	..	..	5815.7	2597.6
ADMISSIONS PER HOSPITAL BED	..	..	..	..	27.0
HOUSING					
AVERAGE SIZE OF HOUSEHOLD					
TOTAL	..	5.5	..	..	..
URBAN	5.4	..	..	..	..
RURAL	..	..	..	..	..
AVERAGE NUMBER OF PERSONS PER ROOM					
TOTAL	..	..	..	..	..
URBAN	2.0	..	..	..	..
RURAL	..	..	..	..	..
ACCESS TO ELECTRICITY (PERCENT OF DWELLINGS)					
TOTAL	..	..	..	..	..
URBAN	30.2	..	..	..	..
RURAL	..	..	..	..	..

TABLE 3A
NEPAL - SOCIAL INDICATORS DATA SHEET

	NEPAL			REFERENCE GROUPS (WEIGHTED AVERAGES - MOST RECENT ESTIMATE) /a	
	1960 /b	1970 /b	MOST RECENT ESTIMATE /b	LOW INCOME ASIA & PACIFIC	MIDDLE INCOME ASIA & PACIFIC
EDUCATION					
ADJUSTED ENROLLMENT RATIOS					
PRIMARY: TOTAL	10.0	26.0	88.0	97.4	96.2
MALE	19.0	43.0	124.0	101.0	99.8
FEMALE	1.0	8.0	49.0	87.8	92.1
SECONDARY: TOTAL	6.0	10.0	19.0	53.0	37.6
MALE	11.0	16.0	30.0	63.8	41.1
FEMALE	2.0	3.0	8.0	41.3	34.1
VOCATIONAL ENROL. (% OF SECONDARY)	0.2	2.4	6.8/e	1.7	20.8
PUPIL-TEACHER RATIO					
PRIMARY	33.3	21.7	32.9/e	37.7	35.5
SECONDARY	32.0	..	24.8/e	20.2	25.0
ADULT LITERACY RATE (PERCENT)	8.8	14.3	19.0/f	52.1	73.1
CONSUMPTION					
PASSENGER CARS PER THOUSAND POPULATION	0.1	0.4/i	..	1.5	9.8
RADIO RECEIVERS PER THOUSAND POPULATION	3.0/j	4.8	17.5	35.4	116.5
TV RECEIVERS PER THOUSAND POPULATION	..	..	..	3.2	37.6
NEWSPAPER ("DAILY GENERAL INTEREST") CIRCULATION PER THOUSAND POPULATION	0.7	2.4	7.3/f	16.4	53.7
CINEMA ANNUAL ATTENDANCE PER CAPITA	..	..	..	3.6	2.8
LABOR FORCE					
TOTAL LABOR FORCE (THOUSANDS)	4875.1	5536.6	6967.9	.	.
FEMALE (PERCENT)	40.5	39.2	39.1	29.5	33.6
AGRICULTURE (PERCENT)	95.0	94.0	93.0	70.0	52.2
INDUSTRY (PERCENT)	2.0	2.0	2.0	15.0	17.9
PARTICIPATION RATE (PERCENT)					
TOTAL	51.6	48.8	47.6	40.0	38.5
MALE	[illegible]	58.8	[illegible]	[illegible]	[illegible]
FEMALE	41.8	38.6	37.5	23.8	26.6
ECONOMIC DEPENDENCY RATIO	0.8	0.9	1.0	1.0	1.1
INCOME DISTRIBUTION					
PERCENT OF PRIVATE INCOME RECEIVED BY					
HIGHEST 5 PERCENT OF HOUSEHOLDS	..	..	35.3/e	..	..
HIGHEST 20 PERCENT OF HOUSEHOLDS	..	..	59.2/e	..	..
LOWEST 20 PERCENT OF HOUSEHOLDS	..	..	4.6/e	..	..
LOWEST 40 PERCENT OF HOUSEHOLDS	..	..	8.0/e	..	..
POVERTY TARGET GROUPS					
ESTIMATED ABSOLUTE POVERTY INCOME LEVEL (US$ PER CAPITA)					
URBAN	..	..	95.0	133.8	194.7
RURAL	..	..	45.0	111.1	155.1
ESTIMATED RELATIVE POVERTY INCOME LEVEL (US$ PER CAPITA)					
URBAN	..	..	..	..	178.2
RURAL	..	..	41.0	..	164.9
ESTIMATED POPULATION BELOW ABSOLUTE POVERTY INCOME LEVEL (PERCENT)					
URBAN	..	..	55.0/e	43.8	24.4
RURAL	..	..	61.0/e	51.7	41.1

.. Not available
. Not applicable.

NOTES

/a The group averages for each indicator are population-weighted arithmetic means. Coverage of countries among the indicators depends on availability of data and is not uniform.

/b Unless otherwise noted, data for 1960 refer to any year between 1959 and 1961; for 1970, between 1969 and 1971; and for Most Recent Estimate, between 1978 and 1981.

/c 1981, annual growth rate is for 1971-81. /d Government programs only. /e 1977.
/f 1976. /g 1975. /h Personnel in government services only. /i 1968. /j 1963.

Revised
September, 1982

DEFINITIONS OF SOCIAL INDICATORS

Notes: Although the data are drawn from sources generally judged the most authoritative and reliable, it should also be noted that they may not be internationally comparable because of the lack of standardized definitions and concepts used by different countries in collecting the data. The data are, nonetheless, useful to describe orders of magnitude, indicate trends, and characterize certain major differences between countries.

The reference groups are (1) the same country group of the subject country and (2) a country group with somewhat higher average income than the country group of the subject country (except for "High Income Oil Exporters" group where "Middle Income North Africa and Middle East" is chosen because of stronger socio-cultural affinities). In the reference group data the averages are population weighted arithmetic means for each indicator and shown only when majority of the countries in a group has data for that indicator. Since the coverage of countries among the indicators depends on the availability of data and is not uniform, caution must be exercised in relating averages of one indicator to another. These averages are only useful in comparing the value of one indicator at a time among the country and reference groups.

AREA (thousand sq.km.)

Total - Total surface area comprising land area and inland waters; 1979 data.

Agricultural - Estimate of agricultural area used temporarily or permanently for crops, pastures, market and kitchen gardens or to lie fallow; 1979 data.

GNP PER CAPITA (US$) - GNP per capita estimates at current market prices, calculated by same conversion method as World Bank Atlas (1978-80 basis); 1960, 1970, and 1980 data.

ENERGY CONSUMPTION PER CAPITA - Annual consumption of commercial energy (coal and lignite, petroleum, natural gas and hydro-, nuclear and geothermal electricity) in kilograms of coal equivalent per capita; 1960, 1970, and 1979 data.

POPULATION AND VITAL STATISTICS

Total Population, Mid-Year (thousands) - As of July 1; 1960, 1970, and 1980 data.

Urban Population (percent of total) - Ratio of urban to total population; different definitions of urban areas may affect comparability of data among countries; 1960, 1970, and 1980 data.

Population Projections

Population in year 2000 - Current population projections are based on 1980 total population by age and sex and their mortality and fertility rates. Projection parameters for mortality rates comprise of three levels assuming life expectancy at birth increasing with country's per capita income level, and female life expectancy stabilizing at 77.5 years. The parameters for fertility rate also have three levels assuming decline in fertility according to income level and past family planning performance. Each country is then assigned one of these nine combinations of mortality and fertility trends for projection purposes.

Stationary population - In a stationary population there is no growth since the birth rate is equal to the death rate, and also the age structure remains constant. This is achieved only after fertility rates decline to the replacement level of unit net reproduction rate, when each generation of women replaces itself exactly. The stationary population size was estimated on the basis of the projected characteristics of the population in the year 2000, and the rate of decline of fertility rate to replacement level.

Year stationary population is reached - The year when stationary population size will be reached.

Population Density

Per sq. km. - Mid-year population per square kilometer (100 hectares) of total area; 1960, 1970 and 1979 data.

Per sq. km. agricultural land - Computed as above for agricultural land only; 1960, 1970 and 1979 data.

Population Age Structure (percent) - Children (0-14 years), working-age (15-64 years), and retired (65 years and over) as percentages of mid-year population; 1960, 1970, and 1980 data.

Population Growth Rate (percent) - total - Annual growth rates of total mid-year population for 1950-60, 1960-70, and 1970-80.

Population Growth Rate (percent) - urban - Annual growth rates of urban populations for 1950-60, 1960-70, and 1970-80.

Crude Birth Rate (per thousand) - Annual live births per thousand of mid-year population; 1960, 1970, and 1980 data.

Crude Death Rate (per thousand) - Annual deaths per thousand of mid-year population; 1960, 1970, and 1980 data.

Gross Reproduction Rate - Average number of daughters a woman will bear in her normal reproductive period if she experiences present age-specific fertility rates; usually five-year averages ending in 1960, 1970, and 1980.

Family Planning - Acceptors, Annual (thousands) - Annual number of acceptors of birth-control devices under auspices of national family planning program.

Family Planning - Users (percent of married women) - Percentage of married women of child-bearing age (15-44 years) who use birth-control devices to all married women in same age group.

FOOD AND NUTRITION

Index of Food Production per Capita (1969-71=100) - Index of per capita annual production of all food commodities. Production excludes seed and feed and is on calendar year basis. Commodities cover primary goods (e.g. sugarcane instead of sugar) which are edible and contain nutrients (e.g. coffee and tea are excluded). Aggregate production of each country is based on national average producer price weights; 1961-65, 1970, and 1980 data.

Per capita supply of calories (percent of requirements) - Computed from energy equivalent of net food supplies available in country per capita per day. Available supplies comprise domestic production, imports less exports, and changes in stock. Net supplies exclude animal feed, seeds, quantities used in food processing, and losses in distribution. Requirements were estimated by FAO based on physiological needs for normal activity and health considering environmental temperature, body weights, age and sex distribution of population, and allowing 10 percent for waste at household level; 1961-65, 1970 and 1977 data.

Per capita supply of protein (grams per day) - Protein content of per capita net supply of food per day. Net supply of food is defined as above. Requirements for all countries established by USDA provide for minimum allowances of 60 grams of total protein per day and 20 grams of animal and pulse protein, of which 10 grams should be animal protein. These standards are lower than those of 75 grams of total protein and 23 grams of animal protein as an average for the world, proposed by FAO in the Third World Food Survey; 1961-65, 1970 and 1977 data.

Per capita protein supply from animal and pulse - Protein supply of food derived from animals and pulses in grams per day; 1961-65, 1970 and 1977 data.

Child (ages 1-4) Death Rate (per thousand) - Annual deaths per thousand in age group 1-4 years, to children in this age group; for most developing countries data derived from life tables; 1960, 1970 and 1980 data.

HEALTH

Life Expectancy at Birth (years) - Average number of years of life remaining at birth; 1960, 1970 and 1980 data.

Infant Mortality Rate (per thousand) - Annual deaths of infants under one year of age per thousand live births; 1960, 1970 and 1980 data.

Access to Safe Water (percent of population) - total, urban, and rural - Number of people (total, urban, and rural) with reasonable access to safe water supply (includes treated surface waters or untreated but uncontaminated water such as that from protected boreholes, springs, and sanitary wells) as percentages of their respective populations. In an urban area a public fountain or standpost located not more than 200 meters from a house may be considered as being within reasonable access of that house. In rural areas reasonable access would imply that the housewife or members of the household do not have to spend a disproportionate part of the day in fetching the family's water needs.

Access to Excreta Disposal (percent of population) - total, urban, and rural - Number of people (total, urban, and rural) served by excreta disposal as percentages of their respective populations. Excreta disposal may include the collection and disposal, with or without treatment, of human excreta and waste-water by water-borne systems or the use of pit privies and similar installations.

Population per Physician - Population divided by number of practising physicians qualified from a medical school at university level.

Population per Nursing Person - Population divided by number of practising male and female graduate nurses, assistant nurses, practical nurses and nursing auxiliaries.

Population per Hospital Bed - total, urban, and rural - Population (total, urban, and rural) divided by their respective number of hospital beds available in public and private general and specialized hospital and rehabilitation centers. Hospitals are establishments permanently staffed by at least one physician. Establishments providing principally custodial care are not included. Rural hospitals, however, include health and medical centers not permanently staffed by a physician (but by a medical assistant, nurse, midwife, etc.) which offer in-patient accommodation and provide a limited range of medical facilities. For statistical purposes urban hospitals include WHOs principal/general hospitals, and rural hospitals, local or rural hospitals and medical and maternity centers. Specialized hospitals are included only under total.

Admissions per Hospital Bed - Total number of admissions to or discharges from hospitals divided by the number of beds.

HOUSING

Average Size of Household (persons per household) - total, urban, and rural - A household consists of a group of individuals who share living quarters and their main meals. A boarder or lodger may or may not be included in the household for statistical purposes.

Average number of persons per room - total, urban, and rural - average number of persons per room in all urban, and rural occupied conventional dwellings, respectively. Dwellings exclude non-permanent structures and unoccupied parts.

Access to Electricity (percent of dwellings) - total, urban, and rural - Conventional dwellings with electricity in living quarters as percentage of total, urban, and rural dwellings respectively.

EDUCATION

Adjusted Enrollment Ratios

Primary school - total, male and female - Gross total, male and female enrollment of all ages at the primary level as percentages of respective primary school-age populations; normally includes children aged 6-11 years but adjusted for different lengths of primary education; for countries with universal education enrollment may exceed 100 percent since some pupils are below or above the official school age.

Secondary school - total, male and female - Computed as above; secondary education requires at least four years of approved primary instruction; provides general, vocational, or teacher training instructions for pupils usually of 12 to 17 years of age; correspondence courses are generally excluded.

Vocational enrollment (percent of secondary) - Vocational institutions include technical, industrial, or other programs which operate independently or as departments of secondary institutions.

Pupil-teacher ratio - primary, and secondary - Total students enrolled in primary and secondary levels divided by numbers of teachers in the corresponding levels.

Adult literacy rate (percent) - Literate adults (able to read and write) as a percentage of total adult population aged 15 years and over.

CONSUMPTION

Passenger Cars (per thousand population) - Passenger cars comprise motor cars seating less than eight persons; excludes ambulances, hearses and military vehicles.

Radio Receivers (per thousand population) - All types of receivers for radio broadcasts to general public per thousand of population; excludes unlicensed receivers in countries and in years when registration of radio sets was in effect; data for recent years may not be comparable since most countries abolished licensing.

TV Receivers (per thousand population) - TV receivers for broadcast to general public per thousand population; excludes unlicensed TV receivers in countries and in years when registration of TV sets was in effect.

Newspaper Circulation (per thousand population) - Shows the average circulation of "daily general interest newspaper", defined as a periodical publication devoted primarily to recording general news. It is considered to be "daily" if it appears at least four times a week.

Cinema Annual Attendance per Capita per Year - Based on the number of tickets sold during the year, including admissions to drive-in cinemas and mobile units.

LABOR FORCE

Total Labor Force (thousands) - Economically active persons, including armed forces and unemployed but excluding housewives, students, etc., covering population of all ages. Definitions in various countries are not comparable; 1960, 1970 and 1980 data.

Female (percent) - Female labor force as percentage of total labor force.

Agriculture (percent) - Labor force in farming, forestry, hunting and fishing as percentage of total labor force; 1960, 1970 and 1980 data.

Industry (percent) - Labor force in mining, construction, manufacturing and electricity, water and gas as percentage of total labor force; 1960, 1970 and 1980 data.

Participation Rate (percent) - total, male, and female - Participation or activity rates are computed as total, male, and female labor force as percentages of total, male and female population of all ages respectively; 1960, 1970, and 1980 data. These are based on ILO's participation rates reflecting age-sex structure of the population, and long time trend. A few estimates are from national sources.

Economic Dependency Ratio - Ratio of population under 15 and 65 and over to the total labor force.

INCOME DISTRIBUTION

Percentage of Private Income (both in cash and kind) - Received by richest 5 percent, richest 20 percent, poorest 20 percent, and poorest 40 percent of households.

POVERTY TARGET GROUPS

The following estimates are very approximate measures of poverty levels, and should be interpreted with considerable caution.

Estimated Absolute Poverty Income Level (US$ per capita) - urban and rural - Absolute poverty income level is that income level below which a minimal nutritionally adequate diet plus essential non-food requirements is not affordable.

Estimated Relative Poverty Income Level (US$ per capita) - urban and rural - Rural relative poverty income level is one-third of average per capita personal income of the country. Urban level is derived from the rural level with adjustment for higher cost of living in urban areas.

Estimated Population Below Absolute Poverty Income Level (percent) - urban and rural - Percent of population (urban and rural) who are "absolute poor".

Economic and Social Data Division
Economic Analysis and Projections Department
May 1982

Attachment 3a

NEPAL - ECONOMIC INDICATORS

Population : 15.0 million (mid-1981)
GNP Per Capita: US$156 (1981)

Indicator	Amount (Million $ at current prices) 1980	Annual Growth Rates (%) at Constant 1980 Prices: Actual 1976	1977	1978	1979	1980	Projected 1981	1982	1983	1984	1985
NATIONAL ACCOUNTS											
Gross domestic product a/	1988.9	4.4	2.9	2.2	3.1	-1.4	6.3	2.7	2.9	3.2	3.5
Agriculture	1080.8	0.6	-4.1	0.0	3.0	-4.8	6.2	2.6	2.6	2.6	2.6
Non-agriculture	908.1	13.2	17.5	4.0	4.9	4.0	6.5	2.8	3.2	3.9	4.5
Consumption	1860.8	4.2	0.8	4.1	1.1	0.2	6.6	2.5	2.6	3.1	3.8
Gross investment	268.0	9.8	12.5	3.1	5.4	-5.6	8.0	8.0	8.0	8.0	8.0
Exports of GNFS	224.6	13.4	9.3	-8.3	17.0	2.3	3.9	3.6	5.4	5.3	5.8
Imports of GNFS	364.5	12.7	2.5	5.6	2.1	6.3	7.2	6.5	7.0	7.6	9.8
Gross national savings	176.2	26.0	14.1	-20.4	15.3	-16.3	6.5	7.6	10.3	5.4	2.0
PRICES											
GDP deflator (1980=100)		78.0	75.3	84.1	87.4	100.0	112.0	121.0	131.0	141.0	151.0
Exchange rate (Rupees per $)		12.0	12.5	12.4	12.0	12.0	12.0	13.2	13.2	13.2	13.2

	Share of GDP at Market Prices (%) (at current prices) b/ 1965	1970	1975	1980	1985	1990	Average Annual Increase (%) (at constant 1980 prices) 1975-80	1980-85	1985-90
Gross domestic product	100.0	100.0	100.0	100.0	100.0	100.0	2.4	3.5	4.5
Agriculture	..	..	69.7	54.3	52.4	49.2	-0.9	2.9	3.2
Non-agricultue	..	..	30.3	45.7	47.6	50.8	8.5	4.2	5.9
Consumption	99.0	96.1	95.2	93.5	92.6	90.0	2.1	3.4	3.9
Gross investment	7.0	5.8	9.3	13.5	16.5	20.5	5.3	8.0	9.2
Exports GNFS	7.8	5.5	8.9	11.3	12.7	14.8	5.7	4.8	7.6
Imports GNFS	13.8	7.4	13.4	18.3	21.8	25.3	5.2	7.4	7.7
Gross national savings	..	..	10.0	8.9	10.2	12.8	2.0	6.5	10.2

PUBLIC FINANCE	% of GDP at Current Market Prices 1965	1970	1975	1980	1981	1982
Current revenues	3.4	4.7	6.0	8.1	8.4	8.8
Regular expenditures c/	2.1	2.2	3.2	5.0	4.7	5.2
Surplus (+) or deficit (-)	1.3	2.5	2.8	3.1	3.7	3.6
Development expenditures c/	4.1	4.7	5.8	9.9	9.4	13.3
Foreign financing	2.6	2.3	2.3	5.7	5.4	6.2

OTHER INDICATORS	1975-80	1980-85	1985-90
GNP growth rate (%)	2.4	3.4	4.4
GNP per capita growth rate (%)	0.0	0.6	1.7
ICOR	6.0	4.9	4.5
Marginal savings rate (x 100)	8.6	17.1	25.0
Import elasticity	2.2	2.1	1.7

a/ At market prices.
b/ Projected years at constant prices.
c/ These are terms used in Nepali fiscal data. They do not correspond exactly to current and capital expenditures, respectively. Various estimates show that 40-60% of development expenditures may be of recurrent (regular) nature.

Note: Economic data on Nepal are generally available only for the Nepali fiscal year, which runs from mid-July to mid-July. All calendar year data in these attachments, 3a-c, refer to the fiscal year ending in the calendar year; e.g., 1976 refers to 1975/76.

Attachment 3b

NEPAL - EXTERNAL TRADE

Population : 15.0 million (mid-1981)
GNP Per Capita: US$156 (1981)

Indicator	Amount (Million $ at current prices) 1980	Annual Growth Rates (%) at Constant 1980 Prices: Actual 1976	1977	1978	1979	1980	Projected 1981	1982	1983	1984	1985
EXTERNAL TRADE											
Merchandise exports	97.2	14.8	3.7	-18.9	22.6	-16.1	2.3	1.3	6.1	5.7	7.1
Primary	68.1	12.1	2.7	-23.2	16.2	-25.5	3.0	-0.3	6.6	6.1	8.0
Manufactures	29.1	40.2	11.5	10.9	53.1	17.5	5.0	5.0	5.0	5.0	5.0
Merchandise imports a/	297.4	17.0	-0.8	7.8	1.8	4.9	6.7	5.4	5.9	6.2	8.9
Food	36.3	50.3	-11.3	18.2	-17.3	-8.8	1.1	1.4	1.6	1.6	1.6
Petroleum	30.2	-1.4	1.7	7.5	13.3	1.4	5.9	6.7	7.3	8.1	8.6
Machinery & equipment	62.5	42.4	-13.5	14.8	7.8	10.5	15.8	7.9	8.2	7.8	12.2
Others	168.4	5.3	7.2	2.8	3.9	7.1	2.3	5.0	5.4	6.0	8.5
PRICES		1980=100									
Export price index		91.7	87.0	96.0	95.9	100.0	109.7	123.1	140.2	157.8	177.8
Import price index		65.4	66.7	76.1	86.5	100.0	107.2	115.9	125.7	135.7	146.1
Terms of trade index		140.2	130.4	126.1	110.9	100.0	102.3	106.2	111.5	116.3	121.7

	Composition of Merchandise Trade (%) (at current prices) b/ 1965	1970	1975	1980	1985	1990	Average Annual Increase (%) (at constant 1980 prices) 1975-80	1980-85	1985-90
Exports	100.0	100.0	100.0	100.0	100.0	100.0	-0.4	4.5	10.5
Primary	87.3	86.0	90.0	69.4	69.9	68.3	-5.2	4.5	10.0
Manufacturers	12.7	14.0	10.0	30.6	30.1	31.7	24.6	5.0	11.7
Imports	100.0	100.0	100.0	100.0	100.0	100.0	5.2	6.4	7.4
Food	21.7	20.7	14.8	12.3	9.6	7.8	1.8	1.5	2.9
Petroleum	8.8	10.3	10.1	10.3	11.9	13.0	5.3	9.1	9.3
Machinery & equipment	6.5	9.2	14.9	21.2	25.3	27.4	8.8	9.7	9.2
Other	63.0	59.8	60.2	56.2	53.2	51.8	5.0	5.4	6.9

DIRECTION OF TRADE

	Share of Trade with Industrial Countries (%) 1970	1975	1979	Share of Trade with Developing Countries (%) 1970 India	1970 Other	1975 India	1975 Other	1979 India	1979 Other	Share of Trade with Capital Surplus Oil Exporters (%) 1970	1975	1979
Exports	19.8	8.8	32.8	62.3	17.9	83.3	6.9	50.2	17.0	0.0	1.0	0.0
Primary	..	7.4	19.8	53.6	..	75.0	3.2	48.1	10.3	0.0	1.0	0.0
Manufactures	..	1.4	13.0	8.7	..	8.3	3.7	2.1	6.7	0.0	0.0	0.0
Imports	20.4	15.4	28.5	74.7	4.9	81.3	3.3	54.3	9.9	c/	c/	7.3

a/ c.i.f.
b/ Projected years at constant prices.
c/ Prior to 1976 Nepal obtained petroleum and products indirectly, from India, and hence oil imports were recorded under imports from India.

Attachment 3c

NEPAL - BALANCE OF PAYMENTS, EXTERNAL CAPITAL AND DEBT
(millions $ at current prices)

Population : 15.0 million (mid-1981)
GNP Per Capita: US$156 (1981)

Indicator	Actual					Est. Actual	Projected				
	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1990
BALANCE OF PAYMENTS											
Exports of goods and services	182.1	191.2	194.7	253.8	270.2	347.3	362.3	417.1	475.2	544.6	920.0
Of which: Merchandise f.o.b.	100.6	95.1	86.2	108.6	97.2	134.4	121.4	146.7	174.5	210.5	400.0
Imports of goods and services	208.3	200.6	249.3	298.8	368.9	451.2	484.0	561.9	652.8	772.3	1317.0
Of which: Merchandise f.o.b.	150.4	154.7	186.1	225.0	279.6	365.9	383.5	440.4	504.9	591.0	980.0
Net current transfers	9.7	9.7	7.9	5.7	6.9	7.5	8.8	9.7	10.7	11.6	20.0
Current account balance	-16.5	0.3	-46.7	-39.3	-91.8	-96.4	-112.9	-135.1	-166.9	-216.1	-377.0
Capital grants	21.6	20.1	23.2	42.6	63.5	71.7	63.0	65.0	90.0	106.0	190.0
Private direct investment	-	-	-	-	-	-	-	-	-	-	-
MLT loans (net)	12.1	17.2	23.6	35.7	48.1	52.8	66.0	71.0	85.0	118.0	202.0
Official	12.1	17.2	23.6	35.7	48.1	52.8	66.0	71.0	85.0	118.0	202.0
Private	-	-	-	-	-	-	-	-	-	-	-
Other capital a/	12.7	-12.7	0.8	9.6	-17.4	-12.0	-	-	-	-	-
Change in reserves b/	-29.9	-24.9	-0.9	-48.6	-2.4	-16.1	-16.1	-0.9	-8.1	-7.9	-15.0
International reserves	120.3	145.3	140.6	179.8	187.0	203.1	226.5	227.4	235.5	243.4	300.0
Of which: Gold	5.5	5.6	6.2	6.3	6.4	-	-	-	-	-	-
Reserves as months of imports	6.9	8.7	6.8	7.2	6.1	5.4	5.6	4.9	4.3	3.8	3.0
EXTERNAL CAPITAL AND DEBT											
Gross disbursements	35.2	38.8	48.3	79.9	114.4	125.4	132.0	140.0	180.0	231.0	405.0
Official grants	21.6	20.1	23.2	42.6	63.2	71.7	63.0	65.0	90.0	106.0	190.0
Concessional loans	13.6	18.7	25.1	37.3	49.8	53.7	69.0	75.0	90.0	125.0	215.0
DAC	1.7	1.9	2.3	3.8	6.1						
OPEC	-	4.1	4.5	2.9	5.8						
IDA	2.7	5.8	11.4	18.3	22.5						
Other	9.2	6.9	6.9	12.3	15.4						
Non-concessional loans	-	-	-	-	1.4	-	-	-	-	-	-
Official export credits	-	-	-	-	1.4	-	-	-	-	-	-
IBRD	-	-	-	-	-	-	-	-	-	-	-
Other multilateral	-	-	-	-	-	-	-	-	-	-	-
Private	-	-	-	-	-	-	-	-	-	-	-
External debt c/											
Debt outstanding & disbursed	43.8	55.6	84.8	115.4	161.1	214.1	280.1	351.1	436.1	554.1	1287.8
Official	43.8	55.6	84.8	115.4	161.1	214.1	280.1	351.1	436.1	554.1	1287.8
Private	-	-	-	-	-	-	-	-	-	-	-
Undisbursed debt	138.5	209.9	260.8	330.2	350.0	420.0	476.0	601.0	636.1	661.0	989.8
Debt service											
Total service payments	2.8	2.1	2.8	4.0	5.1	6.4	8.8	11.7	15.0	20.1	50.0
Interest	1.6	0.8	1.1	2.1	3.3	4.4	5.8	7.7	10.0	13.1	36.1
Payments as % of exports	1.5	1.1	1.4	1.6	1.9	2.0	2.4	2.8	3.2	3.7	5.4
Average interest rate on new loans(%)	1.0	0.8	0.8	0.9	0.8	1.1	1.0	1.0	1.0	1.0	
Official	1.0	0.8	0.8	0.9	0.8	1.1	1.0	1.0	1.0	1.0	
Private	-	-	-	-	-	-	-	-	-	-	
Average maturity of new loans(%)	41.0	42.9	43.2	41.7	44.6	43.2	45.7	45.1	44.7	44.9	
Official	41.0	42.9	43.2	41.7	44.6	43.2	45.7	45.1	44.7	44.9	
Private	-	-	-	-	-	-	-	-	-	-	

	As % of Debt Outstanding at End of Most Recent Year (1981)
Maturity structure of debt outstanding	
Maturities due within 5 years	8.3
Maturities due within 10 years	23.6
Interest structures of debt outstanding	
Interest due within first year	0.8

a/ Includes unidentifiable items; errors and omissions; and unaccounted trade transactions.
b/ (-) indicates increase.
c/ As at end of fiscal year.

NEPAL

COUNTRY ECONOMIC AND SECTOR WORK PROGRAM FY83-87

1. As described in the text, our FY82 CEM prompted an encouraging response from Government, which announced new policies to increase production at a faster rate, streamline development administration and strengthen resource mobilization (text para 18-22). We have also had favorable responses to our recent sector work in manufacturing policies and incentives, urban development, education and population. Given Nepal's limited capability for detailed policy design and implementation, the effectiveness of our economic and sector work can be increased if we continue our involvement with further, downstream, work of monitoring and refining pronounced policies and measures. Equally, we need to identify additional issues requiring broad policy decisions.

2. In the light of the above background, the proposed economic and sector work program is intended to: (a) support our review of ongoing country measures for intensifying production, improving development administration, and increasing resource mobilization; (b) assist Government in devising suitable strategies and action plans in areas affecting long-term development prospects of Nepal, namely, agricultural productivity, industrial strategy, energy, transport, and human resources development; and (c) strengthen our future lending activities.

3. In the past, we divided responsibility, and consulted closely, with the Fund, which addressed the exchange rate reforms and interest rate adjustments, while we addressed issues in domestic resource mobilization, particularly public finances. We also consulted with all donor representatives in Kathmandu regarding their respective experiences in implementation of projects assisted by them, and with Nepal's Center for Economic Development and Administration (CEDA) regarding issues in taxation, and in public enterprise performance. In addition, some studies in the context of our recent projects have involved local institutions--the Agricultural Projects Services Centre (APROSC) in a study on grain pricing; the Water and Energy Commission in a study on electricity pricing; Integrated Development Systems (IDS) in a study on project budgeting and accounting procedures. We intend to continue this mode of work which, among other benefits, has enabled us to evolve more concerted strategy and proposals to Government. Our proposed work program is outlined below.

4. The country economic memoranda have been timed to provide background material for discussions at the future Aid Group meetings. The FY84 CEM will first analyze the progress and impact of policy reforms and measures (in development administration, resource mobilization, investment planning) initiated upon recommendations in our FY82 CEM, including progress on adoption of a concerted and intensive action program for controlling population growth. Second, it will incorporate the industrial policies and exports study (para 9), and identify prospects for accelerating agricultural production and for a gradual revival of agricultural exports. Third, the CEM will outline a

proposed strategy for Nepal's Seventh Plan (1985/86-1989/90) and suggest external assistance requirements to support ongoing and planned development activities.

5. In development administration, we intend to (i) review progress of the Permanent Pay Commission, which is formulating recommendations on civil service salaries and schemes of service; (ii) follow up on the CEDA proposals for reform of public enterprises; (iii) review the functioning of district treasury offices set up to streamline disbursement of budgetary funds. These reviews will be undertaken prior to, or in conjunction with, the economic mission scheduled for April 1983. On the occasion of these reviews, we would also discuss with Government and other donors practical steps to begin developing better capabilities for program analysis, aid coordination, policy formulation and project implementation in the Ministry of Finance and important line ministries.

6. In domestic resource mobilization, we intend to monitor implementation of measures announced in the last two budgets (text para 22), and to encourage officials in the Ministry of Finance, the Income Tax and Customs departments, and the Ministry of Agriculture to put forth additional proposals for raising revenue from various sources. In this respect, the Fund Staff Report for the 1982 Article IV Consultation (November 1982) has proposed that measures to broaden the tax base and to limit the recent growth of government bank borrowing should receive priority attention. We intend to consult closely with the Fund to review Government response in this area. This activity is also scheduled in the context of the forthcoming economic mission.

7. Our lending operations in Nepal have highlighted a number of important issues which need to be addressed carefully in Nepal's circumstances. Such issues include weak organization and maintenance (O&M) programs; input/product pricing and cost recovery problems; slow project tender and procurement procedures. Addressing these issues will be an important part of our future work program. We would begin with review and analyses of ongoing or recently completed studies on fertilizer and foodgrain pricing (studies included, respectively, under the Agricultural Extension and Grain Storage projects), and water and electricity tariffs (studies included in preparation of water supply and power projects).

8. The agricultural sector memorandum and the irrigation subsector review completed in 1982 have provided good sectoral overview and identified broad elements of a long term agricultural development strategy. We are proposing to complement these reports with studies of further key questions such as the economics of groundwater development, the replicability of successful Indian agricultural projects located in areas adjacent to Nepal, the appropriate blend of projects to promote institutional development and enclave projects to insure feasibility in the absence of adequate institutions, etc. This way, over the next one to two years, we expect to consolidate our sector experience--and

those of the government and other donors--to elaborate on a suitable strategy for raising long-stagnant agricultural productivity in Nepal.

9. The industrial policies and exports work will follow upon our previous (FY81-82) assistance to Government in reforming the manufacturing sector policies, and on our preliminary review (FY82) of Nepal's export policies and prospects. Our previous assistance resulted in the recent Industrial Enterprises Act, which is designed to promote private sector participation in manufacturing and trade; and the preliminary review of export prospects has identified non-agricultural exports, including tourism, as a potential source of increased foreign exchange earnings. The follow-up work now suggested would assist Government in designing and adopting rules and regulations for effective implementation of the Industrial Enterprises Act, and would elaborate on a strategy and measures for promoting non-agricultural exports. This will be followed with work aimed at improving the efficiency of important public sector manufacturing enterprises, and at identifying promising subsectors for future Bank assistance. We would then combine all our findings into a short industrial strategy paper in FY84-85.

10. The power development study is an inhouse review of ongoing Nepalese/CIDA studies which include a ranking of various proposed hydro-sites, proposals for institutional reorganization and a tariff study. The energy assessment report will aim to provide an integrated overview of the country's energy situation and a strategy for bridging the widening gap between energy supply and demand. The report will include analysis of energy pricing and taxation (petroleum, electricity, fuelwood etc.) taking account of conservation, inter-fuel substitution, balance of payments and resource mobilization considerations. A review of all energy institutions and donor activities is also planned with a view toward greater coordination and efficiency.

11. The transport study is planned because the transport sector in Nepal is weak and complicated by a multiplicity of modes and institutions involving road, rail, air, ropeways, foot trails and, possibly in future, waterways. Donors have for some time now been aware of the heavy costs imposed by the slow and difficult transport system. A UNCTAD/ESCAP transport advisory team in Nepal has compiled short reports on the infrastructure, technology and institutions of road, rail and ropeways. The advisory team is also examining the technical alternatives for improving transhipment of Nepali goods along the Calcutta route and of developing another route through Chittagong. This ongoing work needs to be complemented with studies of other modes, such as air transport, and the economic feasibility of improving transhipment via Calcutta and Chittagong to understand the needs for future investment and operations. Our proposed transport mode study would involve drawing on and building upon the ongoing UNCTAD/ESCAP work. An important feature of this study would be an opportunity to coordinate our transport sector lending to Nepal with such lending to India and Bangladesh in relevant areas.

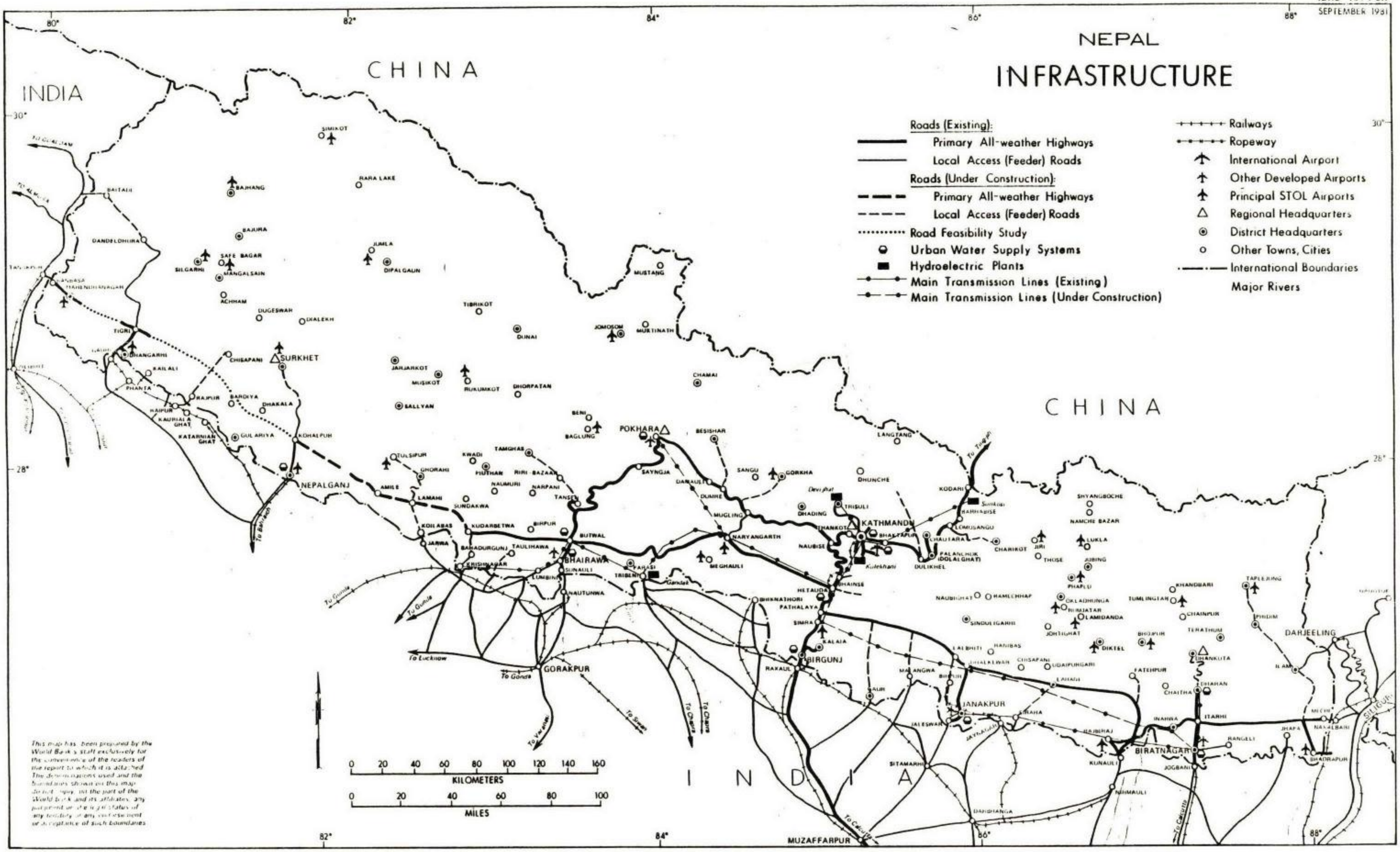
12. The education sector memorandum completed in 1981 had focussed on major issues in primary education. An engineering and technical manpower study is planned for FY84. This study will be done by consultants preparing a campus development plan for the Institute of Engineering under the provision of our ongoing second technical education project. The subsector study on education finance, already prepared by the International Institute of Education Planning, needs some refinement to provide an estimate of the financial requirements of the education system in the long term, and the extent to which these can be met by community contributions. A full education sector review is planned for FY85 to assess progress during the Sixth Plan, and to analyze policies and programs for the Seventh Plan.

13. The population sector report, now being finalized, was requested by Government to help it in designing a more cohesive and intensive national strategy to reduce population growth. The report provides an implementation program, estimates the costs involved and the sources of funding, and suggests a framework for the coordination of donor activities.

NEPAL - ECONOMIC AND SECTOR WORK PROGRAM

Subject	Type of Work	Remarks	Responsible Department	Total Staff Weeks Required FY83	FY84	FY85	FY86	FY87
1. Economic performance and prospects	Economic missions and CEM following 18-24 month Aid Group cycles.	Main audience is Bank, Government and Aid Group members	ASA	35	15	35	15	35
2. Agricultural development	Sector/subsector studies identifying long-term strategy for raising productivity.	Main audience will be Bank and Government.	ASP	5	10	15		
3. Industrial policies and export promotion	Sector mission and informal reports to assist implementation of Industrial Enterprises Act; improvement of public enterprise performance; Analysis of export performance, prospects and policies for medium to long term.	Study is planned for inclusion in FY84 CEM. Main audience would be Bank, Government and Aid Group.	ASA	25	15			
4 Industrial development	Industrial strategy paper consolidating previous sector work.	Main audience will be Bank and Government.	ASP			10		
5. Power development	In-house review of ongoing Nepalese/CIDA studies on national policies and programs for power development, pricing and institutional reorganization.	Main audience is Bank.	ASP	3	3			
6. Energy assessment	Mission and report providing overview of country's energy situation; future demand-supply; pricing and taxation; conservation; institutions; and donor coordination.	Main audience will be Bank, Government and relevant donors.	EGY	70				
7. Transport	Study, probably involving consultant, to examine infrastructure, technology, institutions and investment needs of various transport modes.	Main audience would be Bank, and Government.	ASA/ASP	5	10	10		
8. Tech. manpower	Subsector study on eingineering and technical manpower demand and supply.	Main audience would be Bank, and Government.	ASP		3			
9. Education finance	Special study on financial requirements of ed. system and modalities of community support.	Main audience would be Bank, Government and other donors.	ASP	3				
10. Educational policies and programs	Sector review to assess progress and analyze policies and programs for Seventh Plan.	Main audience would be Bank, Government and other donors	ASP			12		
11. Population programs	Mission and sector report to assist Government in developing cohesive national population strategy and action program.	Main audience will be Bank and Government. Findings will also be communicated to Aid Group members.	PHN	10				

IBRD 15778R
SEPTEMBER 1981



WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

OPS/MC82-43

TO: Members of the Managing Committee

DATE: December 2, 1982

FROM: Ernest Stern, SVP, Operations ES.

SUBJECT: Review of Progress Since the Sub-Sahara Africa Report

This is to inform you that we have started work on a review of progress since the Sub-Saharan Africa Report. The review will discuss the evolution of the debate, the reactions of donors, policy actions in Africa and the reorientation of our operations against the main themes in the Sub-Sahara Africa Report. We plan to complete the review by the end of FY1983. We plan to circulate the review to the Board after the appropriate internal discussion.

The review will be carried out by the two Regions, supported by OPS/OPD. Mr. Please, of my office, is chairing the steering group.

cc: Mr. Humphrey
Mr. Southworth

ES:dpw

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OPS/MC82-39

OFFICE MEMORANDUM

TO: Members of the Management Committee

DATE: November 22, 1982

FROM: Ernest Stern, SVP, Operations ES.

SUBJECT: URUGUAY - Graduation Memorandum

Attached is the draft Graduation Memorandum on Uruguay. Having reviewed and discussed extensively with the Bank two earlier versions of this paper, the Uruguayan Government is in agreement with the approach to graduation outlined therein. Subject to the approval of the Management Committee, it will be ready to submit to the Board in December. As you know, our original intention was to submit this paper jointly with the Yugoslav paper. The latter is being delayed in view of the acute economic problems in Yugoslavia. It seems unlikely that we can submit the Yugoslav paper before March/April, at the earliest. I recommend we proceed with the Uruguay paper on schedule.

Attachment

cc: Mr. Humphrey
Mr. Southworth

URUGUAY - GRADUATION PROGRAM

Summary

1. Uruguay's recorded per capita income in 1980 exceeded the graduation threshold set by the Board. The attached paper reviews recent economic developments and prospects in Uruguay, in order to provide a planning basis for the graduation process. Since Uruguay's income levels over the next year may fall below the threshold the paper recommends that:

(i) we plan on terminating Bank financial assistance in FY1988 but that the situation would be reviewed during FY1985 based on an updated assessment by Management; and

(ii) lending during FY1984-88 be reduced slightly in current dollar terms to around $300 million, or by about 30% in real terms compared to actual lending during the most recent five-year lending period.

2. The proposed strategy is based, inter alia, on the following considerations:

(i) Uruguay has carried out an ambitious program of structural adjustment and economic liberalization since 1974. Until recently, this program had achieved notable success in accelerating investment and growth, stimulating export diversification, stabilizing the balance of payments, and restoring fiscal equilibrium following two decades of economic stagnation and chronic balance of payments crises. The impact of the world recession and spill-over effects from the economic difficulties of neighboring countries have induced a domestic economic downturn, which has greatly complicated the structural adjustment process. The Government is actively striving to adjust its economic policies in order to reactivate production and carry forward an ecomomic liberalization program, but it will take a number of years to complete this effort;

(ii) Uruguay's access to capital markets is currently more severely restricted than it was in the recent past. Commercial banks have become reluctant to make medium and long-term loans to Uruguay in the wake of the recent conflict in the South Atlantic and in the light of growing concerns about the economic prospects and debt-servicing capacity of countries in Latin America generally. As a result, there has been a very rapid and undesirable build-up of Uruguay's short-term indebtedness during 1982; and

(iii) Uruguay's institution-building needs in critical areas such as public sector investment planning and enterprise management are significantly greater than might be inferred from the country's <u>per capita</u> income and level of social development. Without the proposed Bank involvement, progress toward solving the country's major institutional bottlenecks would probably be significantly delayed.

November , 1982

MEMORANDUM TO THE EXECUTIVE DIRECTORS

Subject: URUGUAY - Graduation from the Bank.

Introduction

1. The Board's decision of January 26, 1982 (M82-4 (Rev.)) set a *per capita* income figure of US$2,650 income in 1980 dollars as a benchmark against which a country would be considered eligible for graduation from the Bank. This memorandum outlines the approach to graduation to be followed in the case of Uruguay. The proposals it contains have been agreed upon with the Uruguayan authorities, whose views it reflects.

2. In 1980, Uruguay's *per capita* income was about 6% above the benchmark established at that time by the Executive Directors. In 1981, estimated *per capita* income was unchanged at US$2,820 compared to the updated threshold level of US$2,830. Recent economic developments suggest that the country's *per capita* income may actually decline in terms of US dollars in the near future. This reflects exchange rate realignments and the fact that, after a period of strong economic recovery during 1974-80, Uruguay is now experiencing a severe recession. The deterioration in the economy is a result of adverse changes in external demand conditions--particularly in Brazil and Argentina, Uruguay's major trading partners--and severe domestic cost-price distortions associated with price stabilization policies introduced late in 1978. In this connection, it should be noted that the rise in Uruguay's *per capita* income in dollar terms up to 1980 (by 94% in three years) was caused to an important degree by its lagging exchange rate policy, a major element in the Government's anti-inflation program. Between the end of 1977 and the end of 1981, the peso was devalued by only 114% despite an increase in domestic consumer prices of 394%. The distortions in relative prices, the low level of external demand for Uruguay's exports, and the consequent unfavorable short-term outlook for domestic growth have now led the authorities to accelerate the rate of peso depreciation against the US dollar. Taking into account the current lower rate of domestic inflation, it seems likely that the peso will experience a real devaluation of nearly 15% in 1982. During 1983, inflation is expected to accelerate slightly, but is likely to remain substantially below the rate of devaluation, reflecting depressed aggregate demand and strong competition from imports in domestic markets. In these circumstances, it is quite possible that Uruguay's updated dollar-denominated *per capita* income will fall still further below future years benchmarks.

3. In view of the uncertainties caused by this situation, agreement has been reached with the Government on a flexible strategy for phasing down and ultimately ending Bank lending to the country. Initially, a five-year

program is proposed, a period considered long enough to permit the introduction of the policy changes still needed to improve Uruguay's prospects for self-sustaining development. Should Uruguay's per capita income remain below the benchmark or should the country's access to capital markets be seriously impaired, and assuming that satisfactory economic policies are pursued, we would provide a further assessment of graduation prospects to the Board. A review of these issues and appropriate recommendations will be submitted in FY 1985.

A. RECENT ECONOMIC DEVELOPMENTS

Economic Background

4. After having become one of the most prosperous countries in Latin America in the first half of the twentieth century, Uruguay's economy deteriorated steadily in the 1950s and 1960s. A highly literate and predominantly urban population increasingly demanded well-paid employment, together with improvements in public services and social benefits. These demands were met through fiscal, exchange rate, pricing, and external trade policies which led to a sustained transfer of income from the resource-rich livestock sector chiefly into consumption by the urban population. Industrialization, strongly stimulated by shortages of consumer goods during World War II, was fostered during the post-war era by a protectionist import substitution policy and an overvalued exchange rate. As a result, the economic environment discouraged the growth of export-oriented production, whether agricultural or industrial, eventually producing a sharp deterioration in the country's external accounts. By 1958, the nominal value of Uruguay's exports was similar to that of the 1940s, while the value of imports had risen by 159%; in particular, the share of imported inputs in manufacturing output had grown substantially. Thus, far from achieving economic autonomy, Uruguay's import-substitution strategy made the economy as a whole, and especially the industrial sector, increasingly dependent on imports.

5. During the 1920s, when the resources available from the livestock sector seemed inexhaustible, the Government had enacted comprehensive welfare legislation to provide a range of social benefits that included retirement and survivors' pensions, job security, unemployment compensation, and free health and education services. Uruguay was thus able to achieve a high level of social progress; its pattern of income distribution compared favorably with that of many developed countries. Redistributive mechanisms were not, however, immune to the effects of economic stagnation and instability. The uncoordinated growth of the social security system placed increasing stress on the country's resources. As the economy continued to deteriorate, unemployment and underemployment rose sharply and Government policies for maintaining urban incomes and consumption reinforced inflationary pressures. During the early 1970s, political and social unrest led to urban terrorism and labor strife. Savings, investment and initiatives to expand output and exports were adversely affected. The three-fold increase in the price of oil in 1973, substantial increases in manufactured import prices, and the temporary closure of the European Common Market to meat imports exacerbated

the situation. There followed a severe crisis in the balance of payments, a precipitous deterioration of fiscal performance, and an acceleration of domestic inflation.

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

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

8. The initial impact of the new policies was contrary to expectations. The rate of consumer price inflation nearly doubled between 1978 and 1979, rising from 46% to 83%, as large amounts of foreign capital, attracted by high peso interest yields and a comparatively low rate of devaluation, flowed into the economy. Inflation was also fueled by other factors, including the one-time liquidity effect of removing all bank reserve requirements; a surge of tourist and real estate investment demand from

neighboring Argentina; a sharp increase in international beef prices together with the removal of longstanding domestic livestock price controls; shortfalls in domestic crop production; and unused margins of tariff protection which insulated domestic producers from foreign competition. Although inflation subsequently fell rapidly (to 43% in 1980, 29% in 1981, and 14% on an annual basis during the first 7 months of 1982), it remained substantially above the rate of devaluation until late 1981, generating a severe cost-price squeeze that eroded both the international competitiveness of domestic production and public confidence in the peso. In addition, exogenous factors such as the world recession, rising international interest rates, and the appreciation of the U.S. dollar vis-à-vis the currencies of Uruguay's other major trading partners made it harder for domestic producers to adjust to sharper competition from imports.

9. As a result, Uruguay now faces a serious recession. GDP growth declined steadily from a 4.5% annual rate in 1980 to -1.3% in 1981 and an estimated -6.0% during the first half of 1982. Unemployment rose from 5.7% of the active labor force in the first half of 1981 to 11.0% in the first half of 1982. Nominal export growth slowed from 34% in 1980 to 15% in 1981, and then fell by 21% in the first quarter of 1982. Real peso interest rates rose from -1% in 1979 to 26% in 1980 to over 40% during the most recent 12-month period. The non-financial public sector fiscal balance shifted from a surplus of .5% of GDP in 1980 to a deficit of 2.4% in 1981, and an anticipated deficit in the order of 8% of GDP in 1982. Net Central Bank international reserves, after rising by US$122 million in 1980 and US$24 million in 1981, fell by an estimated US$500 million during the first nine months of 1982; the decline would have been even greater had it not been for substantial net short-term borrowing, estimated at around US$400 million during this period.

10. In May 1982 the Government announced a new package of corrective measures designed both to consolidate the gains achieved in reducing inflation and to reactivate the economy. The measures included (i) an acceleration in the pre-announced rate of peso depreciation from 1.1% monthly in the first quarter of 1982 to 2.2% monthly during the last four months of the year; (ii) a temporary across-the-board export subsidy of 10% and an equivalent surcharge on imports; (iii) cancellation of officially-mandated salary increases for the remainder of 1982; (iv) new revenue measures, including increases in value-added and corporate income taxes, the introduction of a new salary withholding tax earmarked for housing construction, and stricter enforcement of existing legislation covering tax evasion; and (v) plans to create a new Development Department in the state-owned Banco Republica to increase the flow of medium and long-term credit to industry and agriculture. The Government also announced that it would begin to negotiate a multi-year stabilization agreement with the IMF. In October 1982, significant measures to curb social security expenditures and raise employer-employee contributions were announced. Together, these measures are expected to halve the projected 1983 fiscal deficit from around 12% to 6% of GDP.

Medium Term Outlook and Policy Issues

11. Despite these recent steps to curb the fiscal deficit and reactivate production, further measures will be needed to restore a sustainable macro-policy framework. The range of policy options poses difficult choices for Uruguay's political leadership, which is strongly committed to maintenance of stable prices, an open economy, and the current pre-announced system of devaluation. Several priority issues will require prompt attention, however. First, it remains to be seen whether current efforts to engineer a gradual acceleration of the rate of devaluation will provide sufficiently speedy relief to domestic producers, many of whom are nearly bankrupt. Moreover, since the accelerated devaluation schedule is known in advance, additional short term pressure is placed on interest rates (already at prohibitively high levels). This may thwart an early recovery of investment, even if demand conditions improve. Second, additional fiscal measures will probably be needed so that the deficits foreseen for 1983-84 can be held to a level consistent with manageable losses in foreign exchange reserves. Finally, the program of reducing import protection needs to be continued if the desired reallocation of resources to more efficient lines of production is to be achieved (the next general reduction in tariffs is scheduled for January 1, 1983). However, domestic support for this program is being undermined by the overvalued exchange rate (which tends to penalize the most efficient domestic sectors) at a time when neighboring countries, faced with their own adjustment difficulties, are pursuing programs of rapid devaluation and the closure of domestic markets.

12. Uruguay's prospects over the next several years may also be constrained by less favorable access to external capital than in the recent past. During the 1977-81 period, net foreign capital inflows - mainly direct investments and long term bank deposits - reached an unprecedented level of 6% of GDP; at the same time, however, the maturity structure of public and publicly guaranteed debt was stretched dramatically. As a result, annual service payments on this debt fell from US$245 million in 1977 to US$173 million in 1981.

13. This situation is changing rapidly, however. The need for new borrowing to finance the public sector deficit has coincided with a shortage of medium and long-term credit. Foreign commercial banks, which are Uruguay's main sources of such credit, are currently reluctant to increase their exposure in the country in the wake of the recent conflict in the South Atlantic, the growing debt-service difficulties of major borrowers in the region generally, and concern about the future of the Government's economic program. As a result, the Government has stepped up net short-term borrowing this year by approximately US$400 million, an amount considerably larger than the entire stock of short-term indebtedness outstanding at the start of the year. Thus, taking into account the need to roll over mounting short-term indebtedness, Uruguay's total public debt service burden is expected to rise from around 19% of exports of goods and non-factor services in 1981 to 29% in 1982, and to around 60% in 1983. If Uruguay can refinance a major share of its short-term indebtedness at longer maturities, the burden should decline rapidly in succeeding years: nevertheless, under current Bank projections, debt service costs will not fall below 40% of export earnings for some time

to come. These projections assume a recovery in real export growth to around 8% annually, real import growth of around 2% annually, a restoration of fiscal equilibrium by 1984, and no further reserve losses after 1983.

14. Given these external financing constraints, it is unlikely that the average GNP growth rate will exceed 2-3% during the 1983-88 period. By 1986, however, Uruguay should have a more favorable balance of payments and external debt configuration, more secure long-term sources of finance, and the possibility of again achieving the economic growth rates of the recent past.

Development Constraints and Bank Role

15. In addition to solving its current economic problems, Uruguay has a number of major long-term development priorities. In the first place, the success of efforts to improve the efficiency of resource allocation will require maintaining the momentum of the tariff liberalization process, accelerating progress toward the reduction of non-tariff barriers, and speeding the restructuring and modernization of production facilities in the light of international comparative advantage. The Bank's lending program has provided critical support for the Government's decision to lower import barriers and reduce price controls, by financing needed infrastructure and by providing medium to long-term producer credits designed to accelerate the adjustment process. In the current difficult economic situation, Bank lending will need to be structured so as to encourage the Government to press forward with reforms of the kind suggested in the paragraphs which follow and to resist strong domestic pressures to reverse the process of opening up the economy.

16. Second, Uruguay's human resource base, though well developed in terms of literacy levels, needs to be further adapted to the needs of an open economy. Upper and middle managers, in both the public and private sectors, generally have a background of broad academic training which is not always well-suited to the pragmatic, problem-solving needs of a modern society. An on-going Bank-supported vocational training and technological development project is addressing one aspect of this problem. Future Bank involvement in the process of human resource development, through technical assistance for projects in individual sectors and for a proposed business administration institute, will depend on reaching agreement with the Government about the nature of the deficiencies in the educational system and appropriate solutions to them.

17. Third, Uruguay has not yet achieved the degree of institutional development required to assure self-sustaining growth. Some significant progress has been made, however, with the help of the Bank. Power, telecommunications, and ports projects supported by Bank loans are gradually transforming three of Uruguay's oldest and most poorly managed agencies into modern institutions. Longstanding assistance to the livestock sector has given birth to a high-quality extension service. Two recent industrial credit projects have led to the establishment of an independent appraisal unit that is rapidly becoming a model of public sector project evaluation and technical assistance to industry. Bank lending for highways has promoted the

development of a previously nonexistent transport planning capability. Nevertheless, institutional capacity remains fragmented and ineffective in areas such as public sector planning and management, agricultural research and crop support services, and export marketing. In fact, the lending program proposed in paragraphs 22-29 below is based mainly on the Bank's own economic, sector and operational work over recent years, as the Government has not yet prepared a comprehensive, multi-year public investment program. This state of affairs has prompted the authorities to ask the Bank to consider providing technical assistance to strengthen project identification and appraisal, leading gradually to the formulation of a soundly based public investment program.

18. The projects which make up the proposed lending program are closely linked to Uruguay's main unmet institutional development needs. Without Bank involvement, the effort to meet these needs is likely to be significantly delayed, if not neglected altogether; with such involvement, Uruguay's capacity to sustain satisfactory growth should be significantly enhanced. Processing of the proposed program will depend on the restoration of consistent macroeconomic policies; in particular it will be necessary to harmonize current fiscal, wage, trade and exchange rate regimes. The lending proposed for each sector will hinge on success in reaching agreement on the adoption of the individual sectoral policies outlined in paragraphs 22-29 below. The Bank will monitor sectoral developments and review them regularly with the authorities.

Criteria for Disengagement and Development Prospects after Graduation

19. Uruguay's future comparative advantage will probably lie in two major areas: (i) primary production and processing of agricultural commodities, including livestock (beef, mutton, wool, and milk, together with livestock by-products such as leather, clothing, shoes, etc.) and selected crops (rice, wheat, barley, etc.); and (ii) exports of services (tourism, banking, transportation, etc.). Promoting these activities will require: (a) greater economic integration, both domestically and with neighboring countries in the region; (b) a strengthening of the private sector, particularly in agriculture, industry and services; (c) further reduction of the distorting effects of inappropriate exchange rate, tariff, tax, subsidy, and regulatory policies; and (d) a strengthening of those public functions, such as investment in infrastructure and manpower training, which support private sector development.

20. The Government and the Bank recognize Uruguay's need for further institutional strengthening, and the risk that this process may be delayed by premature graduation from Bank lending. During the graduation phase, Bank lending will concentrate on promoting institutional development in the sectors of greatest comparative advantage. This does not mean that, once graduated, Uruguay will have achieved a level of institutional development comparable to that attained by earlier Bank graduates from the OECD area. Uruguay's post-graduation development borrowing needs may be accommodated in part by its continuing access to IDB lending, which, under present plans, will not be subject to any graduation process.

21. As it phases out its lending program, the Bank will limit its involvement to those areas where: (i) there is good potential for achieving significant institutional or policy improvement through Bank financial and/or technical assistance; and (ii) the targeted sector is instrumental in overcoming constraints on self-sustaining development. The specific objectives to be sought in each sector are described below.

Sectoral Activity and Strategy

22. Agriculture is and will continue to be the mainstay of the Uruguayan economy. The contribution of this sector to GDP and employment is relatively modest, but it is of crucial importance as a foreign exchange earner and a supplier of raw materials to domestic industry. Although the sector generates only around 11% of GDP and directly employs a roughly similar share of the labor force, agricultural raw materials go into products accounting for more than 85% of export earnings.

23. Changing policies have heightened uncertainty among producers; as a result, some past improvements in production technology have been abandoned and the short-term potential for major output growth has been reduced. The Bank has hitherto concentrated on the livestock sector, particularly on strengthening producer incentives and ranch management. It has been instrumental in setting up a solid extension/appraisal institution and, more recently, in supporting Government efforts to formulate a series of reforms in the livestock sector. These reforms, announced in August 1978, represented an important first step toward reducing official intervention in pricing and marketing, and enhancing the role of market forces. They were limited in scope, however, and have thus far been implemented slowly; as a result, they have not yet had the desired impact on long-term agricultural development.

24. Future Bank agricultural lending will depend on the Government's agreement to broaden the reforms (e.g., by increasing the role of the private sector in meat export operations). In the livestock subsector, emphasis will shift downstream to the processing stage, where the meatpacking industry continues to suffer from the effects of past government intervention. Investments are needed to meet sanitary requirements in major consumer markets to which Uruguay has no access at present, and to promote Uruguay's reintegration into major world beef-marketing channels through greater foreign investment in domestic meatpacking. The IFC in particular might play a constructive role in this area. In the crops subsector, intensified livestock/crop rotation techniques will be promoted through credits, a reduction in domestic crop protection, strengthened export promotion mechanisms, improved crop-oriented research services, and a more comprehensive crop extension network. The proposed projects should both help to stabilize producer incomes, enhance productivity and reduce soil erosion. Experience derived from an on-going agricultural development loan, including a pilot lending program and a study, should further clarify the prospects for intensifying small farmer production.

25. Despite the high literacy rate in Uruguay, the educational system suffers from a number of problems, notably its limited responsiveness to the rapidly evolving manpower needs of a more open, internationally competitive economy. Initially, this problem is being addressed through a vocational training and technological development project. The Bank is also exploring prospects for the creation of an institute of business administration to make managers more familiar with modern management techniques and their use.

26. Uruguay depends heavily on imported oil, which supplies nearly two-thirds of total energy requirements and accounts for about one-third of total imports. The Government is anxious to substitute hydropower and natural gas for oil as quickly as possible. This will require the expansion of transmission and distribution networks in line with the hydroelectric projects now coming on stream and with growing Argentine surplusses of exportable gas. The success of such a program will depend on the strengthening of UTE (the country's electric power company). Under the Fifth Power Project, currently in execution, UTE undertook to carry out a range of managerial and institutional reforms. The results achieved so far are broadly satisfactory; new lending would be designed to finance needed physical plant, and to follow up on institution-building objectives.

27. Increased attention to the petroleum sector will be necessary in view of Uruguay's heavy dependence on oil imports. The Bank and the Government are currently discussing the design of a refinery modernization feasibility study being financed by ANCAP, the state-owned petroleum company. This study will need to consider the projected supply and demand for all forms of energy, the potential for inter-fuel substitutability, the role of the petroleum refinery sector, and the energy pricing system. Eventual Bank financing of a refinery project will depend on the opportunities for dialogue between the Government and the Bank on broad questions of petroleum usage and ANCAP planning and management.

28. The Bank has made two loans for industrial development, both designed to help transform industry from a predominantly inward-looking and protected sector to an export-oriented one. The second industrial loan was linked with the tariff reduction program enacted in December 1978, and provided for a review and analysis of progress in reducing tariffs and in promoting a healthy restructuring of industry. The project included assistance in establishing mechanisms for project evaluation in the Ministry of Industry and for project preparation and promotion within the banking system. Industrial credit should continue to be provided through a follow-up IDF operation, which should support (i) import liberalization efforts beyond those set out in the December 1978 framework decree and (ii) the transformation of the domestic banking system into an efficient mechanism for providing medium and long-term industrial credit. This latter goal will require actions easing legal and institutional constraints on multi-service banking and improving the usefulness of bank reporting systems to savers, borrowers and shareholders. Any new IDF loan will also need to take into account how effectively sectoral and macroeconomic policy tools, such as exchange rate management and financial market liberalization, are being used and how they are affecting the industrial adjustment process.

29. It is proposed to present another ports project to help finance investment needs identified in the Montevideo Port Master Plan (to be prepared under an ongoing project). The Plan would focus on improvements in bulk cargo facilities, a transit cargo terminal, and the deepening of port access. The project will also be designed to consolidate the organizational changes in the Port Authority initiated in the ongoing project. Another area of the transport sector requiring upgrading is the rail system, where there is an urgent need to rationalize services, streamline operations, strengthen the system's investment planning capability, and reduce the burden of the rail deficit on the public sector budget. A railway project is included in the lending program.

B. LENDING PROGRAM MAGNITUDES AND TRENDS

Bank Lending

30. In current US dollars, the proposed Bank lending program would total around US$300 million, i.e. slightly below the amount lent during the most recent five fiscal years (FY79-83). Annual lending would peak in FY85 and fall significantly thereafter. This lending profile would yield a positive net transfer from the Bank of about US$115 million during FY84-88. By FY88, the annual net transfer would be close to zero. In real terms, the level of proposed commitments would decline by 25% or more relative to the most recent actual five-year total. The average loan size is also expected to decline significantly. This implies increased reliance for project funding on cofinancing and Government contributions. The Bank will link the proposed loans for railways, ports, and power (and, wherever possible, for agriculture) with co-financing arrangements.

IFC Activities

31. Provided that current cost-price distortions and excessively high real interest rates can be reduced, the climate for private investment seems likely to improve, opening the way to active IFC involvement in Uruguay beyond the IBRD graduation period. IFC has developed sound working relationships with the Unidad Assesora in the Ministry of Industry and other key Government agencies, as well as with private sector banking and industrial groups. Further promotional work is required, however, to identify projects of a size and scope suitable for IFC financing. Priority is being given to (i) medium-to-large-scale investment projects in export-oriented sectors where the country has demonstrated a strong competitive potential, particularly the production and processing of agricultural commodities, (beef, wool, packaged meat, milk, leather clothing, shoes, rice, citrus fruits, and wood and wood pulp); (ii) viable smaller-scale import-competing projects which are often hampered by the lack of access to long-term credit; and (iii) technical assistance designed to deepen the capital market through the development of new private sector financial instruments, including leasing, bonds, debentures, new share issues, and commercial paper.

Implications for Country Economic and Sector Work (CESW)

32. In order to provide a detailed basis for the policy recommendations referred to above, the proposed CESW program for FY83-85 is relatively extensive. First, the Region has already undertaken a substantial amount of economic and sector work on the structural adjustment process in Uruguay. The most recent CEM (3652-UR), circulated to the Board in March 1982, listed a series of measures urgently needed to bring the Government's liberalization program back on course. The CEM, together with the sector policy analysis synthesized in this memorandum, forms the basis of our on-going discussions with the Government on a more desirable macro-economic policy framework.

33. Second, a special study of the existing production and marketing framework for grain and oilseed crops, comparable to an FY82 study of livestock policy issues, is in an advanced draft stage. Together, these studies will enable the Bank to offer comprehensive policy recommendations and to pursue a fully integrated lending strategy for the agricultural sector. Third, a report on industrial export prospects completed in FY81 is being followed by a microeconomic survey at the firm level of the corporate adjustment strategies developed in response to import liberalization. This survey is being financed under the Bank-supported IDF II loan and will be analyzed in an FY84 sector memorandum.

34. With respect to the public sector, the Government has instituted a number of accounting and procurement reforms in recent years. Nevertheless, deficiencies persist in the way in which projects are identified, selected, and managed. Also, the investment programming and budgeting procedures need to be coordinated more closely. For these reasons, a study of public finance and administration is planned for FY84.

35. Finally, considerable work has already been done on economic integration questions. An FY79 transport sector memorandum and an FY82 Survey on Intermodal Transport in the Southern Cone highlighted Uruguay's potential for providing regional transport services through fuller development of freight-forwarding and intermodal facilities. An FY82 economic memorandum examined prospects for integrating the livestock and banking sectors with overseas markets in addition to conducting a general review of the experience with trade liberalization. An FY85 economic memorandum will update the Bank's evaluation of Uruguay's efforts in this direction.

Technical Assistance (TA)

36. The TA ideas contained in this paper are still at a relatively early stage of formulation. The CESW and new projects proposed for Uruguay during the graduation period would add to currently high levels of Bank TA in areas such as public enterprise management and sectoral policy planning.

Supervision of on-going projects, as well as Uruguay's participation in EDI activities, would assure continuing Bank TA well into the post-graduation period. IFC investment would provide an additional source of TA after graduation.

37. This matter would be reviewed with the Government prior to Board presentation of the FY85 review paper mentioned in paragraph 3. In that review, reaching agreement on a TA program for strengthening the public sector investment and financial programming systems would be assigned highest priority. Consideration would also be given to the development of a new program of reimbursable TA, which might be phased in during the outer years of the graduation period as lending is being phased down. This TA program could be designed inter alia to provide follow-up to the institution-building activities associated with our previous lending efforts.

A. W. Clausen

President