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M· QURESHI'S
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January – March 3, 1989

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The World Bank
OPERATIONS COMMITTEE

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Minutes of the Operations Committee to consider Competition Policies for Industrializing Countries and Industrial Restructuring: Policy and Practice held on March 3, 1989 at 10.30 a.m. in Room E-1243

A. Present

Committee		Others	
Messrs.	M.A. Qureshi (Chairman)	Messrs/Ms.	N. Barry (IENIN)
	E. Jaycox (AFRVP)		T. Baudon (SVPOP)
	A. Karaosmanoglu (ASIVP)		S. Burmester (SEC)
	V. Rajagopalan (VPPRE)		F. Chaudhri (EAS)
	P. Hasan (EMNVP)		T. Churchill (IENDR)
	J. Wood (VPFPR)		V. Dubey (EAS)
	H. Scott (VPLEG)		C. Frischtak (IENIN)
			J. Hamid (IFC)
			D. Lee (COD)
			C. Obidegwu (SPRPA)
			K. Siraj (COD)

The meeting was called to consider two PRE papers, one on competition policies and the other on industrial restructuring. The papers are scheduled for discussion at a President's Council meeting on March 15, and a Board seminar on April 14.

B. Discussion

The Chairman in his opening remarks welcomed and strongly endorsed the papers, especially the one on Competition Policies. He asked the Committee to focus the discussion on how to integrate the key recommendations into Bank's policies and operations. Regarding the competition policy paper, he stressed the importance of promoting greater competition in developing countries and emphasized that the Bank needs to pursue a more balanced approach to industrial development in its adjustment operations. Programs need to be structured to better coordinate import liberalization, export promotion activities and domestic regulatory reform. In particular, he felt that greater emphasis was needed on removing regulatory and other barriers to domestic competition.

One committee member commended the paper's balanced approach in contrast to what he called the "slogan approach to liberalization". He pointed out that premature liberalization in franco-phone Africa had been severely detrimental to the industrial sector. He felt that a balanced approach, with possible use of regional competition, is a means of applying the paper's recommendations to the small markets in

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Africa. He also felt that the paper's emphasis on internal competition was very well taken.

A committee member asked whether industrializing countries would be able to withstand the surge of imports if they were to use import competition as a tool of competition policy. PRE staff responded by stating that phased import liberalization was only one of the elements of competition policy and that it would need to be balanced by the promotion of domestic competition and by stimulating domestic producers to compete in export markets. Most industrializing countries had now achieved the maturity to integrate these dimensions and to compete in domestic and international markets. Other developing countries, particularly the least industrialized ones, would need to build up their industrial endowments, markets and institutions before they can use competition to the fullest advantage as a tool of industrial policy.

One committee member thought the Bank was already moving in the general direction advocated by the competition policy paper. The Committee member pointed out there were, however, problems of sequencing policies in the transition process, issues of shutting-down of many enterprises and the long-term nature of the deregulation mechanism to enhance competition. PRE staff responded by noting that there was no "right" sequence of competition policy reform; it depended on country characteristics, stage of industrial development and the government's perception of the political economy of policy implementation. Some countries have successfully moved towards a more neutral competition policy regime by initially promoting domestic competition through regulatory reform and then moving to promote exports, before embarking on reform of the trade regime. Others have initiated the policy reform by pushing domestic firms to compete in export markets, then liberalizing imports and finally undertaking regulatory reform. Although the order may vary, what is key is to focus attention on the three components and phase in a coordinated way all three dimensions of competition taking due account of the individual country situation. The Chairman indicated that while steps in this direction had been taken, a more concerted effort was needed to integrate the various elements of competition policy.

Another committee member noted that one should not judge what the Bank was doing in industrial policy reform by just analyzing the proportion of loan conditionalities in specific areas as the competition paper seemed to. He felt that several countries, in Asia at least, have done a lot on the export side outside the Bank's conditionality ambit. He also wondered what should be the relative weight given to individual conditions in such an analyses. Other criteria, including the Bank's policy dialogue and the government's own program of policy reform (not always reflected in conditionality) and its ultimate impact might be more useful. In its response, PRE staff noted that the paper used what was thought to be the most objective indicator of Bank intentions in its adjustment loans, namely the conditions related to the operation (which incorporate legal conditions and measures taken by Government prior to the loan).

The Chairman reiterated the importance of using competition as a key tool of industrial policy, and stated that he would like to see more work to expand on some of the issues raised by the paper and sought further elaboration of what was called "functional interventions" in the paper. PRE staff noted in response that work is being conducted in a number of key areas including: technology policies, institutions and mechanisms; export finance, import-export facilities, trading companies and private catalytic agents; education, training and human resource development.

The Chairman suggested that the discussion on the industrial restructuring paper be focussed on three issues raised in the agenda: (a) the paper's proposal that the definition of eligible expenditures be broadened in Bank restructuring operations to reflect the variety of financing requirements; (b) the proposal that the Bank use only sound, solvent financial intermediaries, with increasing reliance on commercial banks; and (c) the proposal that the Bank conduct and commission global subsector studies.

On the issue of eligible expenditures for Bank reimbursement under restructuring operations, PRE staff emphasized that most of the areas proposed for financing required changes in Bank practice, not in Bank policy. R&D, marketing and distribution expenditures could be covered under the definition of fixed assets or working capital. The difficulty existed in financing the purchase of assets, under mergers or acquisitions. The Chairman requested clarification from the Legal Department as to whether such asset purchases could be financed. The Legal Department representative indicated that there was no serious problem with R&D expenditures but in the case of asset transfers a strong case would have to be made that such asset transfers would lead to clear increases in productivity and output. The Chairman indicated that such improvements would be the objective of most mergers and acquisitions, but that he understood the Legal Department to be saying that the Bank should move cautiously in this area. Another member asked whether widening the eligibility criteria might lead to an even higher reliance on loan financing by industrial firms. PRE staff indicated that this was a leveraging issue, which needed to be treated separately from eligibility criteria.

The Chairman wondered whether a large and sudden shift towards using commercial banks as intermediaries in the Bank's credit operations would not be problematic particularly because the investment banks have not yet been born and financing companies are in trouble in many countries. PRE staff emphasized that the report recommended that we limit our involvement to sound, solvent financial intermediaries -- whether they be commercial, development or investment banks. In many countries, commercial banks had the advantage of having more ongoing contract with their clients, the ability to provide a range of financing services, and less political interference in decision-making.

On global restructuring studies, a question of possible contradiction in the two papers was raised; the Chairman and a committee member also questioned whether such studies warranted priority given budgetary constraints and the temptation to use such studies to pick winners. PRE staff stressed that there was no

contradiction between the two recommendations because the proposed studies are intended to be of use to policymakers, bankers, and industrialists as they move from inward to outward-oriented strategies. These studies would assess market and technology trends and key factors for competition in major product-markets. Such subsector studies at present are conducted on a country-by-country basis in the context of specific operations, despite the fact that the bulk of these subsector reports assess global rather than country situations. The purpose of having the Bank conduct and commission global subsector studies would be to provide an adequate information base for designing Bank-supported and other industrial restructuring operations. Several committee members indicated that such global subsector studies would be useful. PRE staff informed the committee that it was also studying the 'least developed country scenarios'.

One committee member felt that the recommendations of both papers had major potential implications for the size and composition of our lending program. He indicated that many Bank operations under preparation did not have the basic characteristics which the papers indicated as critical for successful adjustment and restructuring. He indicated that managers in Operations would need to review lending programs in light of the two reports.

Conclusion

The papers, strongly endorsed, will be discussed by the President's Council on March 15.

March 10, 1989 FMC
Barry/Frischtak/Chaudhri:gs

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: February 28, 1989

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

EXTENSION: 78051

SUBJECT: Competition Policies and Industrial Restructuring - Agenda

1. The Operations Committee will meet on March 3, 1989, at 10:30 a.m. in Room E-1243 to discuss two papers: Competition Policies for Industrializing Countries and Industrial Restructuring: Policy and Practice.

Background

2. These papers, prepared by PRE's Industry Development Division are based on analyses of country policies and performance--and of Bank industrial adjustment and restructuring operations in the eighties. The papers reflect direct inputs by colleagues in Operations, and were discussed at Bank-wide seminars in January 1989.

3. These papers deal with the mix of policies and institutional programs needed if industrial firms in developing countries are to restructure toward international competitiveness. Both papers draw on the lessons learned from strategies pursued by countries, with Bank support, in the eighties: (a) macro reforms alone are not enough to get positive, efficient supply responses; (b) rigid structures reinforced by government policies contrast with the flexible organizations required for firms to be competitive in rapidly changing world markets; and (c) governments need to be active, dismantling barriers to competition, eliminating special deals for public enterprises, and promoting services and linkages that help firms increase their competitive capabilities.

4. The analysis and recommendations are particularly relevant for those low and middle-income countries which have a sizeable manufacturing sector. These countries account for over 80% of Bank Group lending in industry, trade and finance. While most recommendations also apply to other developing countries, additional actions would be required to build basic endowments if industry is to play a role in efficient, dynamic growth in these economies.

Competition Policies for Industrializing Countries

5. The main proposition of the Competition paper is that developing countries should use competition as a "powerful tool of industrial policy". It distinguishes three forms of competition: (a) domestic competition, encouraged by elimination of barriers to exit and entry; (b) import competition, stimulated by trade policy reform; and (c) competition in export markets, which may require a "temporary pro-export bias in competition policy". It is a major recommendation of the paper that

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"trade, export development and regulatory reforms need to be coordinated and undertaken either jointly or with relatively small lags...to be most effective".

6. The paper is skeptical about the targeting of individual firms and subsectors as a tool of industrial policy, supporting instead broad based human, technological and institutional resource development as a means for shifting comparative advantage.

Against sectoral work

7. The review of Bank operations in the paper finds that "strong emphasis has been given to import competition policies, less attention to export development policies, and scanty treatment of industrial regulatory and promotion policies". It therefore recommends that industry-related lending operations should pay more attention to the balance and coordination of trade, export development, and industrial policies. In particular in countries where previous Bank-supported operations have focused on import liberalization, the paper recommends that the emphasis should shift to reducing domestic barriers to mobility and growth, and promoting export competition. Does the Operations Committee agree that the Bank should give increased attention to removing domestic regulatory and incentive barriers to competition? If so, how can these priorities be effectively reflected in Bank country sector work and lending?

Industrial Restructuring: Policy and Practice

8. The industrial restructuring paper argues on the basis of experience that "industrial restructuring operations can be effective only as complements to policies that promote efficient competitive supply responses by industrial enterprises". The Bank's projects in the early 1980s focussed narrowly and with limited success on physical rehabilitation and financial solvency of a few public sector enterprises. The loans in the second half of the 1980s have given more importance to policy institutional and management reform.

9. The restructuring of private enterprises has been supported by the Bank almost always indirectly through credit operations. The paper supports a subsector focus in such operations. Subsector diagnoses help pinpoint the key success factors and identify major constraints in technology, organization and marketing. Institutional development and services to provide information and build capabilities are also often best geared to specific subsectors. However, subsector credit allocations, as has been done in some Bank projects, are an inappropriate way of providing a subsector focus, since they can create distortions and rigidities and other problems. The paper proposes that the Bank commission global subsector studies, to provide policymakers, bankers, enterprise managers and Bank staff with information on technology and market trends, key international players and what it takes to be competitive in major industrial product groups. If such studies are to be undertaken, what would be the best arrangements for management, funding, and commissioning of these studies?

10. In restructuring public enterprises, the paper finds that physical rehabilitation and financial restructuring have not succeeded unless they were accompanied by policies requiring competitive performance and by enterprise level changes in management and organization. Privatization can be an important means to achieve competitiveness but poses formidable difficulties of implementation. The paper posits that key features for successful public enterprise restructuring include ensuring clear government and enterprise management commitment, eliminating monopoly status of public enterprises, replacing mixed mandates with simple efficiency objectives, and forging effective links with leading international firms. Does the Operations Committee agree that these are important dimensions in Bank support for restructuring public industrial enterprises? If so, are there implications for project preparation, loan conditionality, and the pipeline?

11. A well functioning financial sector is a prerequisite for industrial restructuring. This may often require systemic reforms which are appropriately supported by sector adjustment loans.

12. Financial assistance for industrial restructuring programs differs substantially from financing under traditional development finance operations. Therefore the Bank has to be more selective in the use of financial intermediaries for these operations than in the past. Given the record of government-owned DFIs, the paper argues that commercial banks could become the primary channel for the Bank's financial intermediation loans, especially for industrial restructuring programs.

13. Industrial restructuring operations require funds for a number of purposes which are presently not eligible for direct Bank financing. R and D expenditures and incremental marketing and distribution expenses as well as the acquisition of existing firms may be considered as eligible for Bank financing in order to provide greater support for effective restructuring.

14. Does the Operations Committee agree that while industrial restructuring operations normally are not good vehicles for financial sector reforms, industrial restructuring projects which use financial intermediaries need to be highly selective in using only sound, solid institutions? Is it agreed that a change in Bank policy on eligibility for financing is needed to support industrial restructuring operations and better respond to corporate restructuring requirements?

Operations Committee
Messrs. Qureshi, Husain, Jaycox, Karaosmanoglu, Thalwitz, Rajagopalan, Fischer, Shihata, Wood, Vergin

cc: Messrs. Lee, Shakow, Holsen, Rao, Burmester/Thahane, Liebenthal, Steer, Baudon, Hopper, Bock, Goldberg, Frank, Parmar, Pfeffermann, Baneth, Kavalsky, Tanaka, Robless, Colaco, Churchill, Frischtak, Ms. N. Barry, Ms. Haug

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THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: February 17, 1989

TO: Mr. Moeen A. Qureshi, OPNSV

FROM: V. Rajagopalan, VPPRE

EXTENSION: 33419

SUBJECT: Papers for Operations Committee Review

1. Attached are copies of two papers -- "Policies for Competition for Industrializing Countries" and "Industrial Restructuring -- Policy and Practice" -- that have been prepared by the Industry and Energy Department of PPR.

2. The papers are based on a number of country studies carried out in the course of the Bank's operational work in countries that already have an established industrial sector. They add a dimension -- namely, industrial regulation and restructuring policies -- to the Bank's traditional trade policy approach to the dialogue on country competitiveness. Although the papers broaden the ambit of the Bank's policy dialogue, as is always the case, the application of the enlarged approach will have to be tailored to the circumstances of individual countries. The papers reflect the Bank's experience in countries with established industrial sectors. This, obviously, excludes a number of Sub-Saharan countries and smaller economies in Asia and Latin America, to whom the lessons of the experience of the more industrial of the developing countries may nevertheless be relevant.

3. The papers have benefited from comments by Operations staff and managers in informal discussions and formal review meetings.

4. I understand that the papers are scheduled for Operations Committee discussion on March 3, 1989. We look forward to receiving the Committee's comments prior to sending the paper further to the President's Council and for a Board seminar on April 14, 1989.

cc: Ms. N. Barry
Messrs. Grilli, Churchill, Frischtak

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COMPETITION POLICIES

FOR INDUSTRIALIZING COUNTRIES

February 18, 1989

Industry Development Division
Industry and Energy Department
Policy, Planning and Research

COMPETITION POLICIES FOR INDUSTRIALIZING COUNTRIES

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ANNEX 1: On the Nature of Competition

ANNEX 2: The Complementarity of Domestic Competition, Import Competition, and Export Rivalry

ANNEX 3: Dumping and Anti-Dumping Policies

ANNEX 4: A Note on Competition Policy for Natural Monopolies

This paper was written by Claudio Frischtak (principal author), Ulrich Zachau and Bita Hadjimichael, with editorial assistance from Stephanie Gerard and word processing support of Wilson Peiris and Zai Fanai.

EXECUTIVE SUMMARY

(i) This paper examines the nature and impact of barriers to competition in industrializing countries. These include 26 low and middle income economies which have a sizable manufacturing sector (at least $2 billion in manufacturing value-added in 1985). This set of countries also represents more than 80% of Bank lending in industry, trade and finance. The paper argues that policy-generated barriers instituted by regulatory, promotional and trade regimes have been a major constraint to efficient industrial development and suggests that the primary objective of competition policy should be to remove those barriers through coordinated policy reforms. In a neutral competition policy regime, the major policy-generated impediments to competition and resource mobility would be phased out.

(ii) Most Bank policy-oriented operations in this area have focused on liberalization of the trade regime through the reduction of import barriers. To a lesser extent, adjustment operations have also promoted the development of exports. They have given considerably less emphasis to reforming domestic industrial regulations and promotion policies, even though these constitute important barriers to domestic competition. Changes in domestic regulatory and promotion systems need to accompany phased reforms in the trade regime if reforms are to be effective and sustained. Broader, more balanced Bank analysis, advice and conditionality on trade and industrial reform programs is required.

(iii) The objectives of this paper are first, to provide an understanding of major barriers to competition in industrializing countries; second, to outline the main elements of effective domestic competition policies for these economies; and, third, to recommend shifts in the scope and policy content of Bank operations that deal with industrial adjustment and growth.

A. Barriers to Competition

(iv) A growing body of firm-level case studies indicates that competition is the prime motivation for managers to cut waste, improve technical parameters of production and allocate resources efficiently. Subsector evidence shows, in addition, that competition is a compelling force for industrial restructuring as firms shed outdated operations, introduce new product lines and search for new markets. Assuring a competitive environment is thus the most effective means to stimulate modernization and structural change in industrializing economies.

(v) Competition should not be regarded, however, as a sufficient condition for industrial development. It is an effective force for modernization of the industrial sector in the presence of an entrepreneurial class actively engaged in industrial activity, able to mobilize and deploy resources in response to market opportunities or threats. Firms must have access to skilled human resources, basic physical infrastructure, supplier networks, and industrial maintenance and service facilities. This paper deals mainly with

those developing countries in which these requirements are broadly satisfied.1/ In such countries, the introduction of a more competitive environment would elicit supply responses in the short to medium term.

(vi) A competitive environment is one in which efficiency in resource allocation and use is stimulated by competition among domestic producers (domestic competition), between domestic producers and foreign exporters to the domestic market (import competition), and between domestic exporters and their foreign rivals in international markets (export rivalry). The emphasis on these three forms of competition has, in historical terms, varied between countries and over time. Nonetheless, the experience of successful industrializing countries suggests that efficient supply responses depend on subjecting firms to the dynamism and pressures of competition in both domestic and international markets.

(vii) At early stages of industrial development, policy-makers relied on regulatory controls, promotional instruments, and trade restrictions to spur industrial development. These tools were used to create capacity in specific sectors and promote the growth of infant firms, and were perceived by policy-makers to be justified since there only existed an incipient entrepreneurial class, relatively thin markets and resource scarcity. Capacity licensing was the means to regulate entry and attempt to balance supply and demand. Investment incentives and trade barriers raised the profitability and attracted resources to the industrial sector. Procurement policies made use of public sector demand to support local producers. Cost-plus pricing policies accommodated inefficient firms. Restrictive labor legislation, complex bankruptcy procedures, and financial bail-outs discouraged exit (section I.A).

(viii) In some countries, as the industrial sector matured, governments progressively removed these protective barriers and increased domestic firms' exposure to competitive forces. But, in most countries, barriers to entry and exit solidified. Capacity licensing and other regulations concerning the establishment and expansion of firms--in countries as diverse as India and Mexico--effectively deterred capacity growth and entry of new firms. Investment incentives and procurement policies, for example in Argentina, also prevented entry, with rules skewed in favor of dominant producers. Price controls, as observed in Ghana and Brazil, for example, preempted price competition and helped less efficient firms survive. Other barriers to exit, such as complex bankruptcy rules, have saddled the economies of Portugal, Hungary, Pakistan and Turkey. By slowing down the mobility of capital and other resources across industrial subsectors, barriers to entry and exit have been a major impediment to structural change in these economies.

1/ A number of findings and recommendations contained in this paper have broader validity. For example, reform of entry and exit regulations to enable producers to react in a timely manner to changing market and technology conditions do not depend on the size of the industrial sector.

(ix) Barriers to import competition in the form of both tariff and non-tariff restrictions, act as an additional brake to structural change. As documented for Indonesia and a host of other countries, protection was often most extensive in sectors that had benefitted from it originally but continued to be sheltered. The infant industry rationale turned upside down: relief from import competition continued to be provided for the more mature and declining subsectors, while new activities were penalized. Although in recent years many countries (Mexico, Thailand, Turkey, Argentina, Morocco, Nigeria, Indonesia and others) have lowered effective protection on manufactured goods as part of their efforts at structural reform, trade restrictions still are pervasive in most developing (and developed) countries (Section I.B).

(x) Often, in sheltered environments, as in the case of India, domestic market profitability was three to five times that of international markets. This difference in profitability constituted the major disincentive for domestic firms to compete in export markets. Other barriers for domestic firms to penetrate export markets have been the difficulty of obtaining imports at international prices; the unavailability of pre- and post-shipment export finance and credit insurance; and the absence of support from government and private sector agencies in the acquisition of technological, management and marketing know-how (section I.C). These barriers continue to affect a large number of industrializing economies in spite of their export development efforts .

B. Competition as a Tool of Industrial Policy

(xi) The main proposition of this paper is that developing countries should use competition as a powerful tool of industrial policy. It is an instrument that might have been unavailable in the early stages of industrial development, but is more effective than government controls and incentive systems in the presence of functioning markets and a dynamic entrepreneurial class. More fundamentally, competition is required if countries are to move efficiently beyond the initial stages of industrialization. As Japan and other successful East Asian countries have shown, stimulating domestic producers to compete at home and in international markets is the key for helping firms to mature technologically and managerially.

(xii) The promotion of competition in domestic markets calls for the removal of policy-generated barriers to entry and exit (specific measures are discussed in section II.B). In India, for example, regulatory reform has relaxed major barriers to domestic competition, such as capacity licensing, and the response has been significant. Since the late 1970s, the rate of growth of manufacturing output has nearly doubled, which many analysts associate with the more liberal domestic economic environment. Since the mid-1980s output growth has further accelerated (to over 9% p.a. despite the recent drought). In the last 2-3 years, as the pace of reforms has quickened, manufacturing output growth has further accelerated.

(xiii) Ongoing reform not only led to significant entry and output expansion, but a squeeze in company profits as firms were forced to cut prices, streamline operations and improve their marketing efforts. There has been increased pressure on firms to exit, which has yet to be allowed on a

timely basis. The compression of profits from domestic sales has also reduced the historically strong anti-export bias in India. Combined with more effective export promotion policies, the relaxation in barriers to entry and expansion has resulted in rapid growth of manufacture exports in the more recent period.

(xiv) The experience of India and other countries draws attention to two crucial aspects of competition policy. First, there is the need to coordinate entry and exit policies, as new entries increase the degree of actual competition and put pressure on less efficient firms to exit (for a discussion of policies affecting exit see section II.B.2; for issues of coordination of regulatory policy changes see section II.B.4). Second, domestic competition policies must be accompanied by policies that enable domestic firms to compete in international markets. Simply squeezing profits in domestic markets will not ensure that producers turn around and become significant exporters.

(xv) The experience of successful East Asian economies is instructive in this regard. A long-term, stable and credible commitment to achieving very high rates of export growth was critical for domestic firms to enter into this activity and sustain their position in export markets. A number of key institutional mechanisms have facilitated competitive export supply responses. They provide "free trade status" for all activities that generate export value-added and ensure automatic access to credit for all exporters. The effectiveness of the instruments used to stimulate exports not only was based on their innovative designs but also depended as much on the principles that guided their use: automaticity, expediency, simplification and unification of procedures, decentralization of tasks, and equal treatment for all activities that generate export value-added. From the perspective of competition policy, the importance of these export policies is that rivalry in international markets leads domestic firms to achieve technological and organizational maturity much earlier than if they remain in a protected environment. This is a key development lesson from the East Asian countries.

(xvi) This paper argues for an increase in domestic and export competition through regulatory reform and export supportive policies. It also stresses the importance of import competition to accelerate structural change, improve resource allocation and curb the exercise of monopoly power. This is particularly true when production technology calls for scales of production typical of natural monopolies, or when one dominant local producer is entrenched and protected by high entry barriers (section II.C and annex 3). Imports should be free from all restrictions other than a moderate tariff, non-tariff barriers should be removed, and import procedures should be transparent and not subject to discretionary changes.

(xvii) Trade reform should, however, be coordinated with regulatory policy reform (Section II.A). Rapid import liberalization when economic agents are constrained in their flexibility to allocate resources might lead to a limited or negative supply response, large social costs, and reversal of reforms. Regulatory changes should be introduced with import liberalization to give producers the flexibility and incentives to enter into promising activities, expand profitable operations, shift product lines or exit from shrinking or stagnant markets. In the case of Mexico, entry barriers have

made significant restructuring unlikely, despite decisive trade liberalization; in Turkey, the constraints on timely exit slowed down the trade adjustment process.

(xviii) It is not essential, however, that regulatory reform precede export development efforts and trade liberalization. In Indonesia, successful export policies have been the basis and the stimulus for phased trade liberalization and reform of domestic regulations. The reforms have been bunched within a relatively short period and led to substantial domestic and foreign investment response. The point to stress is that trade, export development and regulatory reforms need to be coordinated and undertaken either jointly or with relatively small lags (one to two years) to be most effective.

C. Departures from a Neutral Competition Policy Regime

(xix) When natural and strategic barriers to competition prevail in an economy, removing policy-generated barriers might not be enough to stimulate efficient supply responses. Country policymakers might need to provide a structure of incentives and an institutional setting that goes beyond a neutral competition policy regime.

(xx) The design of policies that stimulate competition in domestic markets should focus on the more concentrated and stable industrial segments, where dominant public or private sector incumbents need to be challenged to improve their performance (section III.A and annex 4). These policies should help entrants overcome large natural barriers (such as limited access to fixed facilities, and lack of technical and marketing information). In some instances they should discourage mergers if there is a significant probability that the merged company would have the market power--in the specific product-market--to deter entry, engage in unfair trade practices and push and keep prices above competitive levels. Governments should in any case establish a legal and regulatory framework that delimits acceptable market conduct and effectively curbs anticompetitive behavior.

(xxi) Several arguments favor a temporary pro-export bias in competition policy (section III.B). First, natural barriers to competition are higher in export markets than in domestic markets. Not only are transportation costs greater, but marketing know-how is more complex and expensive for exporters to acquire. Second, in most industrializing countries that have experienced an anti-export regime for long periods, managers' attitudes tend to be inward-oriented. Third, export markets involve a higher risk than do domestic markets.

(xxii) To the extent that most barriers for domestic firms to compete in export markets are temporary, there is little justification for export incentives on a permanent basis. Instead, governments may aid producers to become permanent, non-marginal exporters by providing compensatory tax and financial export incentives for a definite and limited period of time. At the end of perhaps three to five years, a neutral structure of incentives--that does not discriminate between domestic and international sales--would be sufficient to sustain the efforts of exporting firms.

(xxiii) Policymakers, recognizing that markets may fail to attract sufficient resources to subsectors commanding the largest profits or the greatest externalities, have on occasion elected to depart from a policy of non-discriminatory incentives and open competition and resorted to some form of targeting (section III.C) Industrial targeting has been focused on individual firms or whole subsectors. Certain firms were targeted on the presumption that size and financial staying power are necessary to achieve international competitiveness. Yet, European experience shows that economies of size achieved through targeting might be more than offset by lax management practices allowed by sheltered markets. Successful cases of firm targeting (as in South Korea) have been systematically associated with substantial rivalry in domestic markets and a strong commitment by targeted firms to compete internationally.

(xxiv) Successful sectoral targeting is equally difficult. If departure from a neutral competition policy is justified, and sectoral targeting becomes a policy objective, it should neither preclude domestic competition nor block the threat of import competition. Moreover, targeting should be temporary and linked to an explicit and credible commitment to reverse it. In sum, protection and promotion should be of moderate intensity and limited to a relatively short period, should not discriminate against entrants, and should be evaluated against the performance gains of domestic firms in international markets.

(xxv) Instead of targeting incumbents or specific sectors, governments might want to focus on the build-up of human, technological and institutional resources as a means of shifting comparative advantage. Policy and institutional interventions would be targeted functionally to alleviate market imperfections that broadly constrain the emergence of competitive areas. The development of financial markets and instruments, support for the acquisition of technological capabilities, and a strong commitment to education and training would constitute some of the dimensions of such an affirmative policy regime.

D. Implications for Bank Group Action

(xxvi) Composition and Orientation of Bank Industrial Lending. FY82-88 samples of 91 adjustment operations and 75 IFI (industrial lending through financial intermediaries) operations give strong indications that most operations have an incomplete competition policy mix (for a detailed discussion and presentation of evidence see section IV). Strong emphasis has been given to import competition policies, less attention to export development policies, and scanty treatment of industrial regulatory and promotion policies.

(xxvii) A detailed breakdown of coverage of industrial policy areas in loan conditionality indicates that only 2% of adjustment operations have included specific conditions on entry and exit policies, 3% on other regulatory policies, and 8% on investment promotion and incentives. Only pricing policies have attracted more attention, being specific conditions in 16% of the loans. In all regions but Africa, specific industrial policy conditions are a minor part of adjustment loans. This is most clearly so in LAC and EMENA, where a small proportion of adjustment loans contain regulatory and

promotional reform conditions, despite the importance of regulatory and other barriers to domestic competition in the two regions. The Bank's industrial operations have not been better in stimulating competition: IFI operations have generally favored incumbents. The FY82-88 sample shows that on average about 70% of subloans were made to established producers.

(xxviii) Industrial lending as a vehicle for the promotion of competition (section IV). Industry-related lending packages should pay more attention to the balance of trade, export development, and industrial policies. In countries where previous operations have focused on import liberalization, the emphasis should shift to reform of the regulatory regime and promotion of export competition. Far greater emphasis should be placed on removing domestic barriers to mobility and growth, which have remained serious obstacles to domestic firms making competitive supply responses. Recent economic and sector work on regulatory policies and incentive regimes in India, Philippines, Pakistan, Mexico, Indonesia and other countries are beginning to lay the basis for Bank policy dialogue and operations in this area.

(xxix) Industry operations through financial intermediaries should facilitate credit access for new entrants by supporting regulatory reform and improved financial market mechanisms. Participating institutions should scrutinize incumbents' proposals closely to avoid bolstering monopolies and bailing out insolvent firms. Financial programs and venture capital facilities that complement pro-entry regulatory reforms and facilitate access to finance by newer and smaller firms should be encouraged or promoted.

(xxx) Public enterprise restructuring and privatization operations need to deal with issues of competition as well as the exercise of monopoly power. Regulatory and other policy-generated barriers to entry in markets dominated by public sector entities should be removed. Removal of monopoly status is equally important for privatized entities, as there is no solid evidence that a private monopoly performs better than a public one. Privatization operations must ensure that they not maintain or exacerbate barriers to entry and competition.

(xxxi) Finally, to the extent that competitive supply responses depend on the establishment of a procompetitive regulatory framework, a modernized institutional setting supportive of export activities, and functional interventions in areas commanding high externalities, the Bank's industrial policy work should contain a serious analysis of the scope of supportive government action in the industrial sector. The Bank needs to devote more of its resources to assist in the design of policies, regulatory frameworks and institutional arrangements that encourage competition, stimulate human resource development, and promote the acquisition of technological, managerial and marketing capabilities necessary to penetrate world markets.

I. BARRIERS TO COMPETITION

1.01 A growing body of firm-level case studies indicates that competition is the prime motivation for managers to cut waste, improve technical parameters of production, and allocate resources efficiently. Subsector evidence shows in addition that competition is a compelling force for firms to restructure outdated operations, introduce new product lines, and search for new markets. Increasingly, competition is viewed as the principal engine of structural change in both developed and industrializing economies.1/

1.02 Competition should not be regarded, however, as a sufficient condition for industrial development. It is an effective force for modernization of the industrial sector in the presence of an entrepreneurial actively engaged in industrial activity, able to mobilize and deploy resources in response to market opportunities or threats. Firms must have access to skilled human resources, basic physical infrastructure, supplier networks, industrial maintenance and service facilities.

1.03 This paper deals mainly with those developing countries in which these requirements are broadly satisfied.2/ These include 26 low, and middle income economies which have a sizable manufacturing sector (at least $2 billion in manufacturing value-added in 1985).3/ This set of countries also represents more than 80% of Bank lending in industry, trade and finance.4/

1.04 Most such economies have attempted, at one time or another, to spur industrial development by regulating, promoting, protecting or creating capacity in specific activities. In many cases, policies designed initially to provide temporary incubation for infant industries

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1/ A conceptual discussion of the nature of competition and its complementary dimensions is provided in Annexes 1 and 2 respectively.

2/ A number of findings and recommendations contained in this paper have broader validity. For example, reform of entry and exit regulations to enable producers to react in a timely manner to changing market and technology conditions do not depend on the size of the industrial sector.

3/ According to the 1988 World Development Report, there are at least 26 countries (excluding high-income oil exporters) that fulfill this criterion: India, China, Pakistan, Indonesia, Philippines, Morocco, Nigeria, Egypt, Thailand, Peru, Turkey, Ecuador, Colombia, Chile, Brazil, Malaysia, Mexico, Hungary, Poland, Yugoslavia, Greece, Argentina, Republic of Korea, Venezuela, Hong Kong and Singapore.

4/ In FY88, these countries accounted for 85% of Bank lending geared to reforming industrial and trade policies, 85% of lending dealing with financial systems, and 91% of lending for industrial subsectors.

hardened into policies protecting mature industries from both domestic and international competitive pressures. As a result, competitive market configurations did not develop.

1.05 At early stages of many countries' industrial development, competition was not perceived as critical to the attainment of major development goals. Moreover, regulatory controls, promotional instruments, and trade restrictions had a significant impact in stimulating entry of new firms into industrial activities. They raised the profitability of the incipient industrial sector and attracted resources to it.

1.06 In some countries, as the industrial sector matured. governments increased domestic firms' exposure to competitive forces. In most, however, protective barriers solidified, stifling new economic participants and the emergence of new areas of comparative advantage. Dynamic efficiency losses from insufficiently competitive markets grew, overshadowing short term gains achieved through the build-up of an industrial base. This section highlights factors which have been most critical in creating these barriers and impeding their removal.

A. Barriers to Domestic Competition

1.07 Most markets in industrializing countries can be described as imperfectly competitive. Firms face significant barriers to entry and exit. Among natural barriers, the most important are economies of scale and financial market imperfections.5/ They are reflected in the high levels of market concentration found in industrializing countries (Table 1).

1.08 The impact of concentration on efficiency depends on the extent to which incumbents are subject to competition. High levels of concentration generally increase the probability of collusive and other forms of noncompetitive behavior. However, the main issue with imperfect competition in developing economies is not concentration; it is the shelter provided by high policy-generated barriers to competition. The protected and stable nature of those markets results in substantial economic losses over time. Rents (monopoly profits) can be extracted

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5/ Other natural entry barriers would be associated with: a post-entry absolute advantage (related, for example, to the proprietary or closely-held nature of technology used by incumbents); or a pre-entry asymmetry (for example, incumbents may have lower production costs due to acquired experience or attract greater consumer loyalty). A special type of asymmetry is related to capital market imperfections. Generally entrants are perceived by investors as posing a greater risk, and therefore they face higher capital costs than established firms. While in developed countries certain market segments (such as for venture capital finance) properly discount for this higher risk, in many industrializing countries financial markets are shallower and newcomers have relatively less access to credit.

because incumbents are protected from the challenge of entrants. The examples that follow illustrate the regulatory and incentive barriers most commonly found in industrializing countries.

Table 1: MARKET CONCENTRATION IN SELECTED COUNTRIES

Country	Year	Average of Four-Firm Concentration Ratios a/	Number of Industries b/
Argentina	1984	43	172
Brazil	1980	51	119
Chile	1979	50	41
India	1984	46 c/	n.a.
Indonesia	1985	56	119
Mexico	1972	73	73
Pakistan	1985	68 d/	n.a.
Turkey	1976	67	125
US	1972	40	323

Sources: The figures for Argentina, Chile, Mexico and Turkey are from World Bank (1988b). The figures for Brazil are from L. Willmore (1988). The four firm concentration ratio for India is estimated using figures from World Bank (1986b). The four firm concentration ratio for Pakistan is estimated using figures from World Bank (1988a). The figures for Indonesia are World Bank staff estimates.

a/ Percentage of total sales or output accounted by four largest firms.
b/ To compare concentration ratios between countries requires using statistics with the same level of disaggregation (i.e., with the same number of industries). Despite similar four-firm concentration ratios, the degree of industrial concentration in Argentina, for example, appears to be much larger than in the U.S. as the Argentine data refer to 172 industries and the U.S. data to 323 industries.
c/ Weighted by value of output for 1983/84.
d/ Average for the spinning, weaving, polyester yarn, polyester fiber, fertilizers, automotive products, bicycles, and tractors.

1.09 Incentive Systems. In Argentina, a system of investment incentives of fiscal nature, comprising tax and other exemptions, has been a major barrier to competition and structural change. Through the incentive system, established firms obtained unit cost advantages of up to 41%, which helped them consolidate their market position. Entrants, competing for scarce fiscal resources, have been at a disadvantage relative to well-informed incumbents that had already demonstrated the

ability to fulfill domestic demand requirements.6/ The system's bias in favor of capital-intensive techniques and low value-added activities, in which Argentina has no obvious comparative advantage, and its emphasis on mature and declining sectors, deterred investment in new industrial segments, slowing down industrial restructuring.7/

1.10 Credit incentives for industry, which at an early stage promoted entry, have often turned into instruments that reinforced the position of large incumbents. In many industrializing countries, these firms absorb a significant proportion of development bank lending, which generally is the sole or major source of term finance to industry. In Mexico, 70% of all development banks' preferred credit to industry in 1987 were allocated to 10 firms. In Brazil, in that same year, 25 firms commanded 50% of credit approvals of the National Economic and Social Development Bank system. Such high levels of concentration of scarce investment resources have made entry more difficult and deterred competition.

1.11 Regulatory controls have functioned as anti-competitive devices. Possibly the most pervasive regulatory instrument in industrializing countries has been capacity licensing and other market reservation policies. They have precluded potential competition by regulating entry, encouraged entry-deterrence by incumbents, and reduced actual competition by constraining supply.

1.12 Capacity licensing in India used to function as a significant, often binding barrier to entry and growth outside the small scale sector. Incumbents filed applications for additional capacity to preempt entry or expansion of competitors; firms accumulated licenses to ensure a pipeline of potential projects. With licensed capacity fixed according to projections of domestic demand, unused licenses resulted in demand exceeding supply, with incumbent producers able to sell high cost, low quality goods in markets protected from domestic and import competition. Licenses were approved at the expense of those that would have translated licenses into actual capacity expansion.

1.13 In Pakistan, licensing has been used in an attempt to avoid excess capacity and reduce market concentration. It has instead

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6/ About 80% of promoted investments were for large dominant firms: nearly all promoted investments in cement, paper paste, fertilizer, plastics and resins, were undertaken by one of the top eight firms in the industry. See World Bank (1988b), Chapter II.

7/ Simulation results showed the subsidy per unit of value-added rising from 39% to 82% as capital intensity increased from 10% to 85%; and the unit subsidy went up from 63% to 75% as the value-added share of the production value fell from 75% to 48%. See World Bank, ibid.

protected incumbents while deterring firm growth. As a result, producers have been unable to reach minimum efficient scales.8/

1.14 Regulatory constraints often go beyond capacity licensing. In Mexico, extensive bureaucratic requirements significantly raise the cost of doing business. Lengthy procedures are needed not only to open or expand industrial firm capacity, but to gain access to imported inputs, price output, or close an enterprise. These procedures cause particular problems for firms, since large firms have specialized departments to deal with these requirements. While these transaction costs are difficult to measure, dealing with these regulations could account for 5% of a firm's operating costs, and opening a business can take up to 420 mandays.

1.15 Public sector procurement systems have been another important barrier to entry. In Argentina, bidding and evaluation procedures were, in the past, not sufficiently transparent to ensure that the most competitive bidder was awarded the contract. Collusion, agreements on market sharing, price rigging and other non-competitive strategies were stimulated by the system. Most firms regarded profitability on public contracts as superior to what otherwise prevails in the domestic market. Also, since the early 1960s, excessive preference was given to national suppliers, including those holding monopoly positions, providing an additional shield from external competition.

1.16 Exit barriers. Particularly damaging barriers to competition are those that restrict exit. They often block the introduction of new or better technologies, which necessitate eliminating product lines and scrapping older plants. Constraints on labor mobility, asset transfer, financial restructuring and bankruptcy make firms more risk-averse in undertaking new activities, thereby blocking a more decisive approach to resource reallocation. Managers choose to expand operations by incremental steps, even if such an approach is less economical. Entrepreneurs become unwilling to shift resources to areas characterized by rapid demand changes and short product cycles.

1.17 In Hungary, during the postwar period, bankruptcy was considered incompatible with indivisible social property and guaranteed full employment. Failing state enterprises were merged, rather than

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8/ In the cotton spinning industry, for example, optimal scales are in the range of 25,000 spindles per mill; the average size in Pakistan is 15,000, because it has been easier to obtain licenses for units of 12,500 spindles than for larger ones. In the cement industry average domestic plant size is 450,000 tpy, whereas efficient scales are on the order of 900,000 tpy. At the same time, with the small size of Pakistan's domestic market, the policy of fragmenting output has not prevented the degree of market concentration from remaining fairly high in several industrial subsectors. See World Bank (1988a).

dissolved or restructured. This pattern continued even after a legal framework was introduced for dissolving state enterprises over a decade ago. A key reason was that bankruptcy threatened organizations representing local social and political vested interests. Moreover, financial instruments and markets to conduct orderly bankruptcy or financial restructuring did not exist. As a result, soft mergers rather than bankruptcy or real corporate restructuring continued to be the practice, increasing concentration. Beginning in the late 1970s, however, reforms began to lower regulatory barriers to exit. Starting in 1980, large state enterprises began to be broken up administratively. In 1984 two industrial enterprises were liquidated. However, de facto barriers to bankruptcy have continued; only recently have loopholes been filled and a social safety net introduced to facilitate effective restructuring.

1.18 In Portugal, the Government rarely has allowed exit of firms with more than 100 employees. Instead, overdue loans are refinanced on a concessional basis by public sector banks. Their financial position has been weakened by a high share of nonperforming corporate loans. Bankruptcy is avoided due to its legal complexity and cost. Portuguese banks have faced a soft budget constraint, due to the Government's willingness to step in and bail out firms. Similar circumstances preclude exit in many other industrializing countries.

1.19 In Pakistan, efforts to restructure or close firms have been hampered by banking regulations and practices limiting write-offs and loan loss provisions. In the cotton textiles industry, for instance, out of a total of 223 textile mills, 89 were out of production by the end 1986. While many of these mills have been closed for years and would require complete replacement of plant and equipment to resume production, they had not been liquidated, and liabilities continued to grow. By not exiting, these plants have prevented entry, as the perceived existence of excess capacity led to regulatory restrictions on new entry and expansion.

1.20 To put these country examples in perspective, it should be stressed that the historical focus of development policy has been to promote sustained industrial growth. In this sense, regulatory controls and promotional systems should not be measured by the yardstick of ensuring mobility and competition. Yet, by decreasing the risk and bolstering profits in the industrial sector, such policies initially promoted entry and competition. Over time, entry-inducing rents were appropriated by those who had become wellplaced incumbents. This was partly a function of growing disparities in information available between incumbents and entrants. New entrants generally lacked knowledge of promotional and regulatory instruments, as well as access to officials who managed these discretionary regulations and incentives. In turn, government operatives who have much information on established producers, often assume a protective attitude toward incumbents--and have nurtured them with implicit guarantees of minimum profitability. The very shelter provided by the policy regime has led to slowdown in productivity growth, prolonging the need for protection and further

tilting of the regime in incumbents' favor.9/ Thus, the increasingly anticompetitive bias of domestic policy regimes and mounting losses from inefficiency have come to dominate whatever early gains for development were made in building up the industrial base.

B. Barriers to Import Competition

1.21 Protection against import penetration is the other major policy-generated barrier to competition.10/ Although in recent years numerous countries (Mexico, Thailand, Turkey, Argentina, Morocco, Nigeria, Indonesia and others) have lowered effective protection on manufactured goods as part of their efforts at structural reform, trade restrictions still are pervasive in most developing and developed countries (Table 2).11/

9/ The pro-incumbent bias was reflected in certain criteria adopted by many regulatory and promotional agencies for screening industrial projects. Often, entry-inducing fiscal and financial incentives were denied on the presumption that demand growth could be balanced by incumbents, and excess capacity brought by new entry would destabilize markets and waste resources. This clearly disregards the economic benefits of potential competition, which is absent unless entry is a credible possibility to newcomers.

10/ Those restrictions take the form of tariff barriers, quantitative import constraints, and a myriad of rules and regulations which constrain the flow of imports. While GATT limits the use of QRs and tariffs, more sophisticated import restrictions like regulations concerning physical import procedures and administrative delays often hinder and prevent imports as effectively. Furthermore, production subsidies that artificially lower the price of import competing products also function as barriers to import competition.

11/ As noted in the 1988 World Development Report (p. 16), "manufacturing has seen a resurgence of protectionism, especially in the guise of NTBs such as Voluntary Export Restraints and import quotas. Between 1981 and 1986 the proportion of imports from North America and the European Community affected by NTBs rose by more than 20%. Trade between industrial and developing countries is increasingly affected by NTBs. Roughly 20% of developing countries exports were covered by NTBs.

Table 2: IMPORT PROTECTION AMONG SELECTED COUNTRIES

Country	Year	Unweighted Average Tariff Rate a/	Nontariff Barriers b/	
			% of Imports	% of Production
Argentina	1988	27.7	n.a.	18.0
Brazil	1988	37.4	n.a	41.0
Colombia	1988	56.9	n.a.	84.6
India	1988	118.0 c/		75.0 d/
Indonesia	1988	23.0 c/	25.0 e/	34.8 e/
Madagascar	1988	46.0	0.0 f/	0.0
Mexico	1988	4.3 g/	n.a.	23.2
Morocco	1986	35.1	14.0	n.a.
Nigeria	1988	32.0		
Pakistan	1988	102.0	31.0	n.a.
Philippines	1988	28.0		
Turkey	1988	39.0	18.0	n.a.
Venezuela	1987	34.1	n.a.	48.0
Yugoslavia	1987	12.0	29.9 h/	36.0 i/
EEC j/	1987	4.2 k/	29.8	n.a.
Japan	1987	3.5 k/	36.9	n.a.
United States	1987	3.9 k/	16.8	n.a.

Source: World Bank staff estimates; Laird and Yeats (1987 and 1988).

a/ Tariffs include surcharges. However, in view of the widespread practice of granting exemptions from duties, effective tariffs are generally lower than the official rates reported here. b/ Nontariff barriers include quantitative restrictions (including prohibitions, quotas and restrictive licensing), minimum pricing, antidumping and countervailing duties, tariff quotas, and state or importing agency monopoly of imports. c/ Average for all products. d/ Percent of domestic value added. e/ Figures are as of December 1987; Expected to drop to 15% for import coverage and 30% for production coverage in 1988. f/ All import restrictions have been removed as of 1/88. g/ The production weighted average is 11%. h/ A further 57% is covered by a quota which is semiautomatic depending upon foreign exchange availability. i/ Expected to fall to 31% in 1988. j/ Figures are based on the external trade of EEC. k/ These rates are trade weighted most-favored-nation (MFN) average tariffs for all products. Although the average rates appear low, they are high in some sectors. Tariffs on clothing and footwear, for example, are respectively 19.9% and 22.5% in EEC, 15.0% and 14.2% in Japan and 20.3% and 11.7% in United States.

1.22 Import restrictions not only constitute a barrier to competition, but also have acted as a brake to structural change in developing economies. Protection often has been most extensive in sectors which have benefitted from it for the longest periods. The infant industry argument was in this sense turned upside down: relief from import competition was provided for the more mature and declining subsectors, while new or innovative activities were penalized, discouraging producers from entering areas of emerging comparative advantage.

1.23 The tire and downstream aluminum industries in Indonesia illustrate this point. In tires, the first producer entered 50 years ago and the second 30 years later. Their survival is assured by an import ban on tires, so that domestic prices remains 20 to 50 percent above international levels. In aluminum-using industries, the level of protection is directly correlated with the age of activity. Certainly, neither the level of protection in the tire industry nor the structure in aluminum metal fabrication could be justified on infant industry grounds.12/

1.24 Although import restrictions generate severe resource allocation distortions in the economies of industrializing countries, trade reform should not be approached as a magical catalyst for industrial adjustment. The intensity of import competition and the reaction of producers to a more open trade regime depend first on the credibility of trade policy reform. For producers to adjust their technological and market behavior, they need to perceive that the government is bound by an irrevocable commitment (e.g., GATT) or has developed a reputation for implementing announced policies systematically.

1.25 The effectiveness of trade reform also can be limited through "tariff privatization." Most buyers do not buy directly from foreign producers, but from local distributors, which often are linked to dominant domestic firms. In many cases, the wholesale importer is the dominant local producer. Thus, even if imports act to relieve supply constraints, the intensity and impact of import competition may

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12/ Until recently the structure of protection in Argentina has had similar features. Tariff protection was particularly high for traditional sectors such as textiles and apparel but below average in electric machinery and scientific instruments. Similarly, the sectors most heavily protected by non-tariff barriers were, until recently, food products and textiles (where respectively 60% and 49% of production was sheltered from imports). World Bank (1988b), Chapter I.

be diminished by the specific organizational arrangements that serve to link foreign sellers and domestic buyers.13/

1.26 In Argentina, Somisa, the dominant steel producer, also has been the dominant importer for many years. It has been able to shield itself from import competition, and reap substantial rents by controlling the volume of imported steel.14/ Similar problems of "tariff privatization" have been observed in other countries, such as in Hungary and in Chile, where collusion between domestic producers and foreign trading companies tended to form a powerful barrier against competing imports.15/

1.27 Import penetration is not necessarily or immediately translated into an effective competitive force for an additional reason. The organization of foreign trading, domestic wholesale and retail trade sector can form an effective, "invisible" barrier to import competition. Non-tradable services--marketing, product repair and maintenance, product adaptation, other engineering services--are critical in enabling imports to penetrate domestic markets. Difficulties in entering Japanese markets, for example, often have been associated with various regulations and organizational barriers against foreign entry or foreign business partnerships in the commercial sector.

1.28 Finally, import liberalization may open up new possibilities for international suppliers to behave strategically, reducing developing country benefits. Dumping and overpricing are two forms of behavior that have attracted attention. Both are generally associated with negative welfare effects that at least partially offset the gains from a

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13/ There is an interesting symmetry here. Many of the import-substitution efforts in developing countries were undertaken by traditional importers, with their ready links to sources of production technology, designs, and components. Over time, many of these importers became dominant producers (often in association with their foreign suppliers). With liberalization of imports and their increased penetration, these same producers, with an already established distribution and servicing network, become dominant importers. As a result, import penetration often does not pose a significant threat to the market position of major domestic producers.

14/ This resembles closely the prevailing arrangement in Indonesia, where the Government has granted exclusive import rights for all raw materials and semi-finished inputs to P.T. Krakatau Steel, which dominates the steel industry with 65% of crude steel capacity and an even larger proportion in flat products (See World Bank, 1985b).

15/ On Hungary, See World Bank (1986a), Chapter III; for Chile, see J. de Melo and S. Urata (1986).

more open trade environment. (A detailed discussion of dumping is provided in Annex 3).

C. Barriers to Export Rivalry

1.29 Developing an internationally competitive product typically requires that firms improve quality and design, making capital outlays in export-oriented production lines. Furthermore, firms must incur irretrievable (or sunk) costs to identify suitable markets and set up distribution channels. Many of these activities are resource-intensive and subject to increasing returns to scale. Small and medium-sized "cash-strapped" producers are constrained in competing successfully with larger, better financed and more cost-efficient foreign competitors.

1.30 Lack of institutional support also can be a strong barrier for firms competing in export markets. An export supply response is unlikely in the absence of institutional arrangements which fill market gaps, and place domestic exporters on at least an equal footing with their foreign competitors. These arrangements involve timely access to imports at international prices, access to pre and post-shipment export finance and credit insurance, and support by government and private sector agencies in acquiring technological, management and marketing know-how. Support should be available direct exporters and indirect manufacturing exporters, and trading firms.16/

1.31 Firms not only need resources and a supportive institutional environment to become committed exporters; they also must be willing to put their efforts into an activity which is riskier and has longer lead times. Ultimately it requires firms to have a real commitment to exports.17/

1.32 To make a non-marginal commitment to export markets, domestic firms need to face incentives which make exports at least as profitable as domestic sales. Two dimensions of the policy regime are particularly critical in determining the relative profitability of export markets. One is the exchange rate policy. An overvalued and unstable exchange rate has been shown to be a major policy-generated barrier to export rivalry. Being overvalued, it lowers profits from export sales. Being unstable, it deters firms from devoting resources, and making the kind of medium to long-term commitments that are needed

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16/ For a detailed discussion of some of these policies see Y. Rhee (1985).

17/ If a segment of a firm's business (in this case export sales) is to influence the decisions and attitudes of management, it must have a certain minimum size. To receive significant attention and resources, the international market must be important to a large number of people in the organization.

for them to become significant exporters.18/ As important as the real exchange rate is the level of competition in domestic markets. All barriers to competition in domestic markets function as barriers to export rivalry by increasing the relative profitability of domestic sales. The removal of these barriers and the introduction of a mix of competition policies is the theme of the next section.

18/ There is strong evidence from individual case studies linking real exchange rates and export supply response. One such example comes from Morocco's exports of leather garments, which fell dramatically between 1982 to 1986 (its share in the world market dropped from 2.8% to 0.2% during the period) as its real exchange rate appreciated significantly relative to its competitors (India, Pakistan, South Korea). See World Bank (1987b).

II. COMPETITION POLICIES

2.01 A competitive environment is one in which efficiency in resource allocation and use is stimulated by competition among domestic producers (domestic competition), between domestic producers and foreign exporters to the domestic market (import competition), and between domestic exporters and their foreign rivals in international markets (export rivalry). The emphasis on these three forms of competition has, in historical terms, varied between countries and over time. Nonetheless, the experience of successful industrializing countries suggest that efficient supply responses depend on subjecting firms to the dynamism and pressures of competition in both domestic and international markets. The previous section has suggested that domestic industrial regulations and promotional policies often undermine the incentives and ability of domestic producers to provide flexible and efficient supply responses. Domestic regulatory reform need thus to accompany phased changes in the trade regime if the reforms are to be effective and sustained.

2.02 The main proposition of this section of the paper is that developing countries should use competition as a powerful tool of industrial policy. It is an instrument that might have been unavailable in the early stages of industrial development, but is more effective than government controls and incentive systems in the presence of functioning markets and a dynamic entrepreneurial class. More fundamentally, competition is required if countries are to move efficiently beyond the initial stages of industrialization. As Japan and other successful East Asian countries have shown, stimulating domestic producers to compete at home and in international markets is the key for helping firms to mature technologically and managerially. The basic aim of competition policy would be thus to ensure that domestic firms are forced to operate in competitive environments.

A. An Integrated Approach to Competition Policy

2.03 Improvements in managerial, technical and allocative efficiency result from entry or its continuous threat in the domestic market, substantial penetration of export markets, and progressively greater pressure from imports. It is important that industrializing countries pursue an integrated competition policy, promoting domestic competition and stimulating producers to move into international markets.

2.04 Should the steps to increase competition be sequenced in any specific order to maximize the probability of a positive supply response? Compelling reasons suggest that simultaneous phasing might be most advantageous. Stimulating domestic competition, by removing regulatory and promotional barriers to entry, growth and exit is critical to the success of trade reform. Rapid import liberalization when economic agents are constrained in how flexibly they can allocate their resources might lead to a limited or negative supply response,

large social costs, and reversal of reform. Regulatory changes should be introduced with import liberalization, to give producers the flexibility and incentives to enter promising markets, expand profitable operations, shift product lines, and exit from shrinking markets.

2.05 Turkey illustrates the importance of coordinating trade and regulatory policy reform. Large devaluations combined with trade reform in the early 1980s, led to a sharp drop in profitability of import-competing sectors, creating non-performing assets. Once in distress, bankers (especially smaller ones) pursued risky survival strategies, and competed fiercely for deposits, offering high interest rates and bailing out insolvent borrowers, rather than allowing them to go bankrupt.19/ As a result, resource reallocation benefits from adjustment policies were reduced, as was the investment response. Timely exit was the missing link in the adjustment process. More stringent regulations that forced banks to clean up their portfolios and liquidate insolvent firms were then called for.

2.06 A distorted structure of relative prices may thus increase the likelihood that the banking system is exposed to non-performing assets as competitive pressures increase, making critical the restructuring of bank portfolios. In its absence, banks are tempted to bail out insolvent incumbents to salvage bank balance sheets. Interest rates are pushed up as borrowers in distress are willing to pay high rates, regardless of their ability to repay. Promising investments are squeezed out. Also, as interest rates rise due to distress borrowing, investors find financial instruments more attractive than investments in real assets.

2.07 In Mexico, entry barriers have precluded significant adjustment, despite decisive trade liberalization.20/ The restructuring process in the Mexican economy has been slow in subsectors covered by special programs. Entry restrictions and other policy distortions have

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19/ I. Atiyas (1989).

20/ Quantitative restrictions were reduced from a production coverage of 92.2% in July 1985 to 23.2% in April 1988. During 1986, the maximum tariff was reduced from 100% to 50%. The liberalization process was accelerated in 1987, leading to a reduction in the tariff range of 0-20% which surpassed the target of 0-30% for the end of 1988. In addition, the 5% tariff surcharge was eliminated. As a result, the production weighted average tariff fell from 24.5% at the end of 1986 to 11% in April 1988.

resulted in large efficiency losses and reduced the ability of producers to compete with imports.21/

2.08 While regulatory reform is essential for a positive supply response, trade reform normally should not be delayed in the expectation that domestic deregulation would create sufficient competition pressures. Behind high trade barriers, financial and economic incentives are not aligned, and investments are not necessarily directed to economical activities. In particular, easing entry behind substantial import impediments might lead to excessive entry, an insufficient degree of intraindustry specialization, and uneconomic fragmentation of production. Reform of the import regime is also critical to markets where high natural or strategic entry barriers have allowed a few firms to attain unchallenged or dominant positions, such as in intermediate and heavy industries.

2.09 As domestic markets become more competitive and less profitable, producers are encouraged to enter or substantially expand their commitments to international markets. The role of a supportive export rivalry policy is to ensure a free trade regime, at least for exporters, as overall import liberalization is introduced, and to provide the marketing, finance, and infrastructural services needed to enable producers to compete in export markets. Import and domestic competition help narrow the profitability differential between domestic and export sales; they enable proexport arrangements to tip the balance in favor of the international market.

2.10 The recent dramatic increase in domestic competition in India is instructive. Ongoing regulatory reform has led to substantial entry and a squeeze in company profits. The top 100 firms reported a drop of about 24.3% in profits, despite a 9% rise in sales in 1986-87. The profits of all but one of the 10 largest private sector companies in the country fell. Moreover, as a result of intensified domestic competition, companies have been forced to cut prices, reduce costs,

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21/ The auto industry, for example, has faced a complicated set of regulations including model limitation, domestic content requirements (DCR), export requirements and foreign investment restrictions. Assembled automobile producers must comply with DCRs of 60% for domestic production and 0-30% for exports. Autopart producers on the other hand have a DCR of 60%. Foreign ownership of Mexican autopart firms is 40%, while there is no limit for the assembled automobile producer. The relatively more flexible regulation of the assembled automobile industry compared to the autoparts industry may be the reason why the former has been able to shift more timely to exports.

streamline operations, and increase their marketing efforts.22/ There has been increased pressure on firms to exit, which has yet to be allowed as a timely basis. The compression of profits from domestic sales has reduced the historically strong anti-export bias in India. Combined with more effective export promotion policies, the relaxation in barriers to entry and expansion has resulted in rapid manufactured export growth in 1987/88. The improved competitive standing of Indian producers has also decreased opposition to a phased reform of trade barriers.

2.11 It is not essential, however, that regulatory reform precede export development efforts and trade liberalization. In Indonesia, successful export policies have been the basis and the stimulus for phased trade liberalization and reform of domestic regulations. The reforms have been bunched within a relatively short period and have led to substantial domestic and foreign investment response. The point to stress is that trade, export development and regulatory reforms need to be coordinated and undertaken either jointly or with relatively small lags (one to two years) to be most effective.

B. Domestic Competition Policy

2.12 The first key step to promote domestic competition is to remove policy-generated barriers to entry, growth, and exit through regulatory reform. Governments should assess the extent to which regulatory and promotional policy instruments constitute barriers to competition. Policies and institutional arrangements that deter entry, facilitate collusion, and preclude adjustment need to be removed.

2.13 Three areas of regulatory policy are discussed below: entry policies, as reflected in systems of capacity licencing, investment incentives and public sector procurement; exit policies, including labor retrenchment, asset transfer, and financial restructuring and bankruptcy procedures; and pricing policies. Reform in these areas would be instrumental in eliciting from industry a strong and sustainable supply response.

1. Policies Affecting Entry

2.14 Capacity licensing. Through capacity licensing, governments in many industrializing countries have attempted to control the total amount of domestic capacity, as well as the allocation of that capacity among sectors, firms and locations. Industrial licensing has been used

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22/ See detailed firm-specific accounts of the changes brought about by a more competitive environment in India Today (1988). Trimming labor costs, selling unviable units, while modernizing and optimizing remaining ones, has been the strategy employed by firms as sectors as diverse as cement, tractors, motors and two-wheelers, steel, telecommunications equipment, computers, etc.

in efforts to promote growth of priority subsectors, decentralize plant location to less developed regions, and conserve resources by balancing domestic supply and demand.

2.15 Systems of capacity licensing often have functioned as binding barriers to entry and growth. In addition, with the multiplicity of objectives guiding licensing authorities, only rarely was the attainment of international competitiveness a main consideration in their decisions. Industrial policy reform would call for all industries to be delicensed, except a few "special-case" activities, which would be included in an interim "negative" list until appropriate controls, procedures and instruments are developed to monitor them. (These might be products with environmental risks or those directly related to national security.)

2.16 Investment Incentives and Sectoral Programs. Investment incentive systems and related sectoral programs have generated heavy fiscal burdens, while undermining competition and structural change in most industrializing countries. Often these systems have introduced highly distortionary factor biases, favored low value-added activities, promoted highly concentrated industries and helped foster oligopolistic practices. Regional investment incentives generally have not had a significant influence on resource allocation. However, investments motivated by regional incentives often have resulted in large economic efficiency losses.

2.17 Generally, fiscal and credit incentives need to be reduced significantly, to help regain fiscal balance in public sector accounts, and to reduce the economic efficiency losses associated with dislocation of industrial activities. To encourage competition, governments should drastically reduce the extended periods for which fiscal incentives are awarded, which confer significant and undue cost advantages on incumbents. Making screening automatic and more transparent also would lessen the proincumbent bias of incentive systems, since major producers normally enjoy preferential access under discretionary systems. To reduce the transfer of rents to selected industries, governments should phase out sectoral programs and remove entry-restricting provisions that usually accompany them.

2.18 More generally, a number of anticompetitive decision-making rules employed by regulatory and investment promoting agencies should be reassessed. Static physical supply-demand equilibrium has been used widely as a justification for sealing subsectors from potential competition.23/ Such criteria reflect an extremely pessimistic view of export

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23/ In India, for example, only 43% of applications were approved between 1981 and 1985. The reason most commonly given Indian licensing authorities for rejecting applications was that adequate capacity existed in the economy. Yet, data are limited and estimating actual capacity and future demand is a complex exercise.
(continued...)

potential. Also, its crude notion of equilibrium disregards the economic benefits of excess supply, which can be a positive force for efficiency, when uncompetitive conditions prevail.

2.19 Another broadly applied rationale for determining entry is the need to establish plants with minimum efficient scale to avoid fragmentation. Yet, the predominance of plants of suboptimal size normally occurs not because entry barriers are low, but due to a combination of high domestic rents and high exit barriers. If producers need to compete in international markets, grossly suboptimal scales of production would not be a rational choice. Moreover, uneconomic operations do not survive unless exit is precluded or easy credit provided.

2.20 Public Sector Procurement systems can constitute major barriers to competition due to: opaqueness in the rules that govern the procurement process; unequal information among producers competing for government bids; preferential treatment of certain domestic suppliers; collusion among preferred suppliers; and overpricing of substandard products.

2.21 More transparent, equitable procurement systems would increase competitive performance in "government markets." Bids should be publicized well in advance of their public openings, and with specifications that are clear, precise, and complete. New entrants should be encouraged under public procurement, to increase competition and to move away from single-sourcing. This is particularly critical when dominant or monopoly suppliers have cornered government procurement markets. In this perspective, registration of newcomers should be facilitated and entry of foreign suppliers allowed at least in monopolized or cartelized sectors.

2.22 To stimulate supplier development, including the acquisition of technological capabilities, governments can introduce a procurement budget structured on a multi-annual basis. The volume and composition of public purchases should be diffused widely among actual and potential suppliers, to encourage development of capabilities by multiple suppliers. Performance goals need to be announced well in advance so that firms have enough time to generate the needed capacity, by acquiring technology.

23/(...continued)
Officials were generally limited to information on licensed capacity. Since licensed capacity would normally be an overestimate of installed capacity, the system consistently generated markets characterized by excess demand and limited competition.

2. Policies Affecting Exit

2.23 In many industrializing countries, barriers to exit were established to protect workers from unemployment and to conserve scarce capital resources. Restrictions on closures and mergers resulted in continued operation of unprofitable firms, while deterring entry and expansion by others. Also, without the ability to exit, entrepreneurs become more cautious in their investment plans, foregoing opportunities that, in a more competitive regime, would have led to capacity creation and expansion.

2.24 Financial Restructuring and Bankruptcy Procedures. In many developing countries, firms with outstanding loans cannot close without the agreement of their creditors. This practice has constituted a major impediment to exit, as many lending institutions have been reluctant to agree to closures which may require them to write off bad debts. Banks often have opted to extend additional credit, hoping that the lossmaking unit would be rehabilitated and eventually repay its loans. An unwillingnees to recognize and write off bad debts has led to imprudent lending decisions and exposure levels. Such practices arise, in part, from management systems which allow non-performing or bad debts to remain on the asset side of a bank's balance sheet until the loan is written off. Shifting the questionable loan to a non-performing debt category would detract from the apparent profitability of banks. Central Banks' guidelines should be revised to require banks to shift loans that have been non-performing for a period to a risky asset category, instructing them to set aside reserves to cover for possible losses.

2.25 Governments also must avoid taking over loss-making units. Until this policy is firmly enforced, there will be a significant "moral hazard" problem: the management of lending institutions and industrial units will continue to see the government as the lender of last resort. Investors and banks often believe that if an important project fails, the government will step in, with the investor absolved of his obligations and the banks guaranteed some repayments.

2.26 This problem is reinforced by the nature of bankruptcy procedures, generally complex and time-consuming. Bankruptcy procedures should be simplified, with flexible rules for the disposition of assets and payment of creditors and a strong policy against interventions to save non-viable enterprises. Sound implementation of bankruptcy laws also requires strong capacity in the judicial system. Finally, the success of reforms in the area of liquidation is closely linked to the development of securities markets and a competitive banking system, offering flexible instruments for liquidation, acquisition and financial restructuring.

2.27 Labor Retrenchment. Firms generally need greater flexibility to adjust the volume and structure of their work force. Government permission should not be required to release employees. To soften the social costs of plant closures and labor retrenchment, governments

also might consider increased funding for retraining linked with specific employment opportunities and skill requirements.

2.28 Transfer of Assets. In many developing economies, procedures for transferring assets through mergers and takeovers often are too lengthy to allow for an efficient restructuring process. The transfer of industrial assets should be executed expeditiously to increase the efficiency of resource allocation. Licenses, when required, should be transferred automatically with the acquisition. Restrictions on labor retrenchment, if they exist, should be lifted for a specified period. This measure would facilitate the capital reallocation and efficiency improvements.

3. Pricing Policies

2.29 Price and distribution controls, used in many developing countries as a means of allocating goods on a priority basis and minimizing the impact of short-term supply shortfalls, have had negative effects on competition, growth and modernization. Controlled prices tend to induce explicit and tacit collusion among firms, both when price controls are in effect and after they are eliminated. Moreover, controlled prices often do not ensure adequate profits, reducing entry incentives and resources for modernization and technological change.

2.30 Ghana has used price controls since 1962 to limit scarcity rents to sellers of products, to fight inflation and to keep down the price of key commodities affecting the cost of living. By 1970, for example, nearly 6,000 prices for 700 groups of products were controlled by the Ghanaian government. Price controls, however, proved inefficient in an environment of scarcity and rapid inflation. Prices were set by adding a fixed margin to costs, thereby reducing the incentive on part of the producers to compete in prices and reduce costs.24/ As part of a reform program introduced in April 1983, the government decided to gradually lift price controls. The inflationary impact of price liberalization was limited because market prices already reflected scarcities. Inflation fell from 122% in 1983 to 40% in 1984. As a result of price liberalization, the hoarding of consumer goods was eliminated, scarcity rents were shifted from distributors to producers and new investments were encouraged.25/

24/ Industrial price controls have also been shown to deter competition in Brazil, where they were introduced in the mid 1960s to help achieve price stability. By institutionalizing the frequency and method of price setting, these controls have substantially reduced price competition while facilitating oligopolistic practices. See Frischtak (1980).

25/ See G. Meier and W. Steel, Chapter 7.5 (1989).

2.31 Governments should decontrol prices fully for competitive sectors. In uncompetitive markets, progressive removal of barriers to mobility and competition, including substantial reduction in trade barriers, should accompany the decontrol of industrial prices. In such cases, prices should be fixed at import price levels during the transition period, until import competition becomes fully binding and regulatory barriers to entry are removed. Eventually prices should be liberalized completely, except in cases of monopolies producing non-tradeables.26/

2.32 To the extent that price controls are continued in certain limited areas for non-economic reasons, the following general guidelines are instrumental in minimizing their adverse impact on industrial performance. First, governments should establish pricing formulae that are transparent to producers, frequently monitored and reviewed, and result in prices that remain within moderate limits (say, 20%) of the level and movement of border prices. Administered prices should be reviewed regularly and systematically. Small and frequent price changes are preferable to large and infrequent ones. The approach should minimize discretion, linking price changes in each industry with changes in input costs or border prices.

4. Coordination of Regulatory Policy Changes

2.33 Effective phasing and coordination of industrial regulatory reforms are critical. Entry and exit policies need to be reformed jointly. Policy-induced exit barriers are in effect entry barriers; exit barriers make investment activity riskier and less attractive, by depressing the overall profitability of the industry. Even when exit barriers do not preclude entry, there is another pressing reason to coordinate the two reforms. New entries increase the degree of actual competition and thus the probability that firms may need to exit. The inability of producers to respond flexibly to changing market conditions by shedding old products, restructuring, and consolidating operations will increase the financial distress of firms. The very success of the policy reforms, in terms of new entries, would lead to this pressure on exit and restructuring.

2.34 Other links between entry and exit policies call for close coordination of reforms. Freer entry without easier exit could further increase capacity fragmentation, a major cause of production inefficiencies. The managerial or x-efficiency gains from subjecting market-dominating firms to more contested markets would be reduced by policy-determined exit barriers. If survival is assured, competitive pressures will be muted. In sum, growth and competition are predicated upon exit policies that facilitate rather than block adjustment.

26/ See Annex 4 for a discussion of competition policies for natural monopolies.

2.35 In this sense, financial sector policies need to encourage banks to deal more aggressively with non-performing assets, restructuring viable concerns and writing off bad loans, while instilling more prudent lending behavior. A first step is to strengthen the supervision and control functions of Central Banks. Information and monitoring systems are required to facilitate timely action on questionable assets and to make banks' portfolios more transparent. Guidelines should be revised to reward banks for the strength of their lending portfolios. Banks should be required to shift loans that have been non-performing for period of time (say, six months) to a risky asset category and set aside reserves to cover possible losses.

2.36 Finally, coordination is needed between mobility, growth and modernization policies and price controls. Entry and expansion would be discouraged if price controls constrained incumbents to low or negative profitability. Producers would fall into obsolescence. To the extent that exit is precluded, industrial "sickness" will grow. In this sense, lowering entry and expansion barriers should be accompanied by the progressive decontrol of prices. Conversely, if prices are freed from controls in a market where entry and expansion are precluded or discouraged by regulatory fiat, the exercise of market power by incumbents could lead to the gouging of consumers. Producers would not face the threat of actual or potential competition, and they could extract from buyers the rents generated by protection. Therefore, price decontrol should be accompanied by regulatory policy changes, to lower the barriers to entry and expansion.

C. Import Competition Policy

2.37 Moderate to strong competition from imports is an important means of improving resource allocation and use. It also is an effective way of curbing the exercise of market power, particularly when production technology calls for scales typical of natural monopolies, or when one dominant local producer is entrenched and protected by high entry barriers. Imports should be free from all restrictions other than a moderate tariff (e.g., in the range of 10 to 20 percent). Nontariff barriers should be removed, and import procedures should be transparent, not subject to discretionary changes.

2.38 In countries where opposition to import liberalization is strong, trade reform might be initiated by providing a free trade regime at least for exporters, by introducing import duty exemptions or drawbacks for direct and indirect exports. From the point of view of import liberalization, this should be regarded as a first and moderate step, aiming at building support for reforms. Its advantage is that it gets the process moving at low political cost.27/

27/ Trade liberalization efforts in Argentina were initiated in 1986/87 as a moderate exercise in providing exporters with access to inputs at international prices. It picked up momentum as a pro-reform

2.39 A second and still preliminary step is to rationalize the tariff regime to make it feasible to move away from quantitative restrictions into a tariff-based system. This would be achieved by eliminating the use of exemptions and special tariff surcharges, which tend to undermine the validity of the tariff system, while reducing its transparency, introducing discretionary elements, and increasing the dispersion of effective protection. In addition, the government should attempt to progressively narrow the tariff band.

2.40 In what order should import liberalization take place? In the absence of knowledge about effective rates of protection, a specific sequence cannot be recommended. A number of countries (including Japan and South Korea) that have been able to sustain reforms in the trade regime have initiated import liberalization with intermediate goods subsectors, which often have increasing returns to scale and monopolistic organization. This first stage of liberalization raised users' effective rates of protection, which often had been negative, and created a large interest group backing trade reform.28/

2.41 The design of trade reform should not overlook welfare implications of aggressive or monopolistic conduct by foreign suppliers. Nor should it be mute on the exercise of monopoly power by domestic importers (through tariff "privatization").29/ However, the policy options open to governments illustrate the difficulties of effectively addressing monopolistic conduct in trade.

2.42 In the case of tariff "privatization," the government could reintroduce the tariff whose abolition resulted in the privatization of government revenues; this shifts the rents back from the firms to the government but does not pass them on to consumers. Alternatively, the government can buy directly from foreign suppliers; however, in most

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constituency gained strength, and none of the adverse effects associated with the disastrous liberalization of the late 1970s occurred.

28/ However, if this process raises already high levels of effective protection among final users, steps must be taken simultaneously to lower the levels of protection to this group. See World Bank (1988b), Chapter IV.

29/ As noted in the previous section, if domestic producers can effectively control the distribution of imports, they may be able to avoid adjustment and continue enjoying the benefits of protection. In particular, domestic consumers do not usually buy directly from foreign producers but from wholesale firms. If the dominant domestic producers control these wholesalers, they can shield themselves from import competition by controlling the volume of imports and not passing on the tariff reduction to consumers.

developing countries, such an approach is likely to create more problems than it resolves. It would be preferrable for the government to encourage entry by domestic producers and wholesale firms, although new distributors will find it hard to compete against dominant vertically integrated firms that are both producers and wholesalers. A last option is to split up the dominant firms and separate their wholesale activities from domestic production.

D. Export Rivalry Policy

2.43 Supportive policies and institutions are needed to put exporters on an equal footing with their international competitors. The experience of successful East Asian economies (particularly Singapore, Hong Kong and the Republic of Korea) is instructive. A long-term, stable, and credible commitment to achieving very high rates of export growth was critical to their performance. The expansion of exports took place in the context of a macroeconomic environment that allowed these economies to pursue, until recently, an aggressively competitive exchange rate policy.30/

2.44 A number of key institutional mechanisms have helped facilitate competitive export supply responses.31/ First, they provided "free trade status" for all activities that generated export value--added, initially through duty exemption/drawback systems (in Korea and Singapore). This mechanism was then broadened to include smaller, indirect exporters (subcontractors and suppliers of parts, components and raw materials) and incorporate its main features in other institutional arrangements (such as free trade zones). In its core form, this mechanism has gained wide acceptance among other industrializing countries.

2.45 Second, exporters in successful East Asian countries found support in financial markets, where the general orientation was to ensure automatic access to credit for all exporters. Financing arrangements were modernized and a number of financial innovations introduced. These included undisrupted and speedy rediscount by central banks, preshipment export finance, automatic loan disbursement, and liquidation mechanisms tied to import and export bill negotiations, domestic letter

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30/ In Korea, credibility was promoted through the government's adherence to long-term trade objectives and policies; by setting export target systems; by negotiating and pursuing diligently specific targets; and by establishing an appropriate forum ("trade promotion" meetings) to discuss these and other export-related matters with management of exporting firms. See World Bank (1987a).

31/ For a detailed analysis of the institutional aspects of export promotion, see Y. R. Rhee (1985). What follows summarizes some of the main points of this study.

of credit systems, export credit insurance mechanisms, and postshipment finance arrangements.32/ Possibly the most important innovation, not only in export finance but in the overall incentive framework was the domestic letter of credit, a vehicle extensively used in Korea. It allows indirect exporters (either input suppliers to manufactures or output suppliers to trading companies) to gain access to export credit and incentives. The major impact of the domestic L/C system has been the substantial improvements in backward linkages, development of trading companies, and the fast growth of small-scale export firms.33/ In particular, the domestic letter of credit became the prime instrument for deterring discrimination against small and medium-scale enterprises, most of them engaged only indirectly in export activities.34/

2.46 One additional lesson is highlighted by the East Asian experience. The effectiveness of the instruments used to stimulate export rivalry was not only based on their innovative designs, but depended as much on the principles that guided their use.35 As already stressed, automaticity and expediency have been key means of minimizing administrative uncertainty and response time by exporters. Also important has been equal treatment of all activities that generate export value-added. Another important feature has been the prevention of abuse, with officials compelled to adhere strictly to the rules. A final key aspect has been administrative efficiency, through simplification and unification of procedures, decentralization of tasks through delegation of authority to either public or private agencies (commercial banks, export associations).

32/ Y.W. Rhee (1985), p. 202.

33/ Cf. Y. Rhee (1985), pp. 119-120. The depth of backward linkages is suggested by the fact that "...67 percent of the total value of domestic L/Cs [letters of credit] issued in Korea during 1976-78 was for the purchase of domestically produced intermediate inputs, 31 percent was for the purchase of domestically produced finished goods, and 2 percent was for the payment of subcontract fees" (p.119).

34/ A 1979 survey in Korea found that the total value of direct and indirect exports by "small-medium scale" (defined as those firms with more than 5 and less than 300 employees) amounted to 41.8 percent of total manufacturing exports in that year. See Y. Rhee (1985), pp. 119-120.

35/ Cf. Y. Rhee (1985), pp. 16-19.

III. DEPARTURES FROM A NEUTRAL COMPETITION POLICY REGIME

3.01 The policy direction advanced in this paper is toward a neutral competition policy regime, with the view that industrializing economies would gain by subjecting domestic firms to greater rivalry in domestic and international markets. This paper has emphasized the importance of removing policy-generated barriers to competition. Yet, when natural and strategic barriers prevail, country policy makers might need to provide a structure of incentives and an institutional setting that goes beyond a neutral competition policy regime. This section discusses the rationale for policies that stimulate competition in domestic and export markets and the role of industrial targeting within a non-neutral policy regime.

A. Pro-Competitive Policies in Domestic Markets

3.02 The notion that policies should be designed and implemented to promote competition applies with particular force to more concentrated and stable industrial segments. The threat of entry lowers the probability that established firms will exert market power or coordinate their moves. Dominant public [36] or private sector incumbents have to be challenged if they are to improve their performance.[37]

3.03 Should industrializing countries develop an activist policy toward highly concentrated sectors? Competition in specific industries is closely related to the number of firms and the distribution of market shares. A highly skewed firm size distribution is an indication that imperfect forms of competition prevail. If imperfect competition in domestic markets is the result of large natural barriers due to high sunk costs or inherent informational asymmetries between entrants and incumbents, governments can develop affirmative policies to help entrants overcome some of these barriers. Depending on the nature of those irretrievable costs and information asymmetries, proactive policies could range from increasing the supply of infrastructural services, enabling firms to share fixed facilities (such as transportation terminals), establishing a regulatory framework to facilitate the development of leasing arrangements for durable goods (including plant and equipment), and assisting entrants with technical and marketing information as well as finance for employee training.

36/ S. Domberger and J. Piggot (1986), in their recent survey concluded that "...opening a market to competition is crucial in promoting improved (public firms') economic performance," p.150. The authors further noted that "...liberalization without ownership transfer will generate substantial improvements in productive efficiency." (p.152).

37/ This might not be feasible if protection takes the form of fully binding natural entry barriers, as in the case of natural monopolies. See Annex 4 ("A Note on Competition Policy for Natural Monopolies").

3.04 Competition should not be promoted by encouraging fragmentation or deterring amalgamation to maximize the number of producers in a given market. In some industries, moderate or even high degrees of concentration may be needed for firms to operate at the production frontier and exploit available economies of scale and scope. What is critical in those cases is to ensure that entry remains a credible threat to the profit and market position of incumbents. Managers should not be allowed to enjoy an "easy life." In this context, mergers should not be blocked, as they can be essential to rationalizing an industry structure, by enabling firms to compete effectively in international markets. Mergers should be discouraged only when there is a significant probability that the merged company would have the market power--in the specific product-market--to deter entry, engage in unfair trade practices and push and keep prices above competitive levels. Some guidelines could be established, for example, prohibiting firms to merge if their combined market shares exceed a certain level.

3.05 Lowering barriers to entry and exit, and deterring extreme forms of concentration would be structural dimensions of a competition policy. Controlling "predatory", collusive, entry-deterrent and other forms of anticompetitive conduct would be its behavioral counterpart. Predatory conduct, in particular with the intent to gain and maintain monopolistic market positions, should be forestalled by appropriate legislation and enforcement.38/ The role of government would be to set a legal and regulatory framework that establishes the limits of acceptable market conduct so as to effectively curb anticompetitive behavior.

B. Pro-Competitive Policies in Export Markets

3.06 Several arguments favor a temporary pro-export bias of competition policy. First, natural barriers to competition are higher in export than domestic markets; not only are transportation costs

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38/ "Predatory" behavior should be the object of restraint and penalty whenever two conditions are present. First, the actions of the "aggressor" firm are selective, that is, they entail targeting one or few competitors. Uniform actions such as across-the-board price cuts or broad-scale advertising campaigns are not harmful to competition. Second, differential market shares between the "aggressor firm" and its targets are sufficiently high that selective actions are necessarily anti-competitive. A large mismatch in market shares between producers normally does not permit effective competition. The reason is that dominant firms, in addition to having access to resources which are unavailable to smaller competitors, work under different sets of incentives; equal gains in market shares translate into proportionately larger profits for the former. The outcome of a market game where the dominant producer uses selective actions against smaller competitors tends to be biased against the latter, and should be restrained by regulatory or judicial means. See W. Shephard (1986).

larger, but marketing know-how is more complex and expensive to acquire for exporters than domestic firms. Generally, export-oriented set-up costs--in improving product design and quality, and in modernizing production lines--are substantial. These irretrievable costs represent a resource hump that producers in industrializing countries have rarely overcome without active government support.

3.07 Second, to the extent that most industrializing countries have experienced an anti-export regime for long periods, managers' attitudes and habits tend to be inward oriented, guided by a parochial view of the world. Without prior and sustained exposure to the "ground rules" of export markets, they cannot be expected to behave in a manner conducive to immediate gains in foreign market shares. Even if a change in the policy regime makes exports more profitable than domestic sales, producers do not generally "turn around" and immediately engage in non-marginal export activities. A temporary pro-export bias may be necessary to ease and speed up a change in management's conduct.

3.08 Finally, it can be argued that export markets involve a higher risk than do domestic markets. Consequently, to compensate for a larger variance in exporters' income, marginal profitability needs to be higher for export than for domestic markets. However, the export risk appears to be higher than the risk of domestic sales only in the short run: once a firm has established itself internationally, the risk from export activities is substantially lowered. The need for risk compensation is therefore a temporary one.

3.09 More generally, an activitist, pro-export policy need not provide permanent incentives that guarantee a superior profitability of export sales even in the long run, because most barriers to export rivalry tend to be of a temporary nature. After resources have been sunk in export-oriented activities and producers have gained sufficient knowledge of the international market, producers would have a natural propensity to commit themselves to export markets in more than a marginal or countercyclical way. Unless they face more profitable opportunities in the domestic market, or severe unexpected constraints (such as new protectionist barriers in importing countries or a sharp restriction in the supply of infrastructural services), they would have an incentive at least to sustain their export market position.

3.10 To the extent that most barriers for domestic firms to compete in export markets are temporary, there is little justification for export incentives on a permanent basis. Instead, governments may aid producers to become permanent, non-marginal exporters by providing compensatory tax and financial export incentives for a definite and limited period of time. At the end of perhaps three to five years, a neutral structure of incentives--that does not discriminate between domestic and international sales--would be sufficient to sustain the efforts of exporting firms. During this transition, the government would attempt to build certain key institutions and administrative export-supporting arrangements, while phasing out those policies that artificially enhance the profitability of domestic markets. At the end of this period, a neutral structure of incentives that does not discrim-

inate between domestic and international sales would be sufficient to sustain the efforts of exporting firms.

C. Industrial Targeting

3.11 Recent advances in the theories of industrial organization and international trade suggest legitimate, systematic departures from a neutral competition policy.39/ Targeting investment in high-profit sectors--restraining import competition and promoting sectoral development--can have economic benefits, if a more open trade environment were to bring a contraction of these sectors.40/

3.12 It is worth stressing that the object of policies that attempt to foster the growth of domestic high-profit sectors is to increase national income by fostering high-profit domestic activities (i.e., by shifting profits home). In this sense it is different from the purpose of infant industry protection which is to assist the growth of firms that in the short run may have low (or negative) profits but generate positive externalities. There is, however, a strong similarity in the two arguments for targeting. Both are based on the failure of markets to attract sufficient resources to industries that could bring the largest gains to the domestic economy. A neutral competition policy in this case might bring about the contraction or deter the formation of high-rent or positive-externality sectors.

3.13 Firm and Sectoral Targeting. Industrial targeting has been focused on individual firms or whole sectors. Certain firms were targeted on the presumption that size and financial staying power are necessary to achieve international competitiveness. It should be pointed out, however, that there may be steep trade-offs in pursuing such a policy. Although there are substantial economies of scale (and scope) in industrial activities, it does not follow that a policy of sheltering and promoting individual "national champions" should be pursued. Economies of size achieved through targeting might be more than offset by lax management practices allowed by sheltered markets.41/ By deterring entry, favoring concentration, and restricting import

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39/ See, for example, P. Krugman (1983, 1985, 1986), A. Venables and A. Smith (1986), and D. Rodrik (1987).

40/ To prod domestic firms to expand output, lower their costs (as, by assumption, targeted sectors would be operating under increasing returns to scale), increase shares in domestic and international markets, and shift rents from foreign producers, governments might legitimately resort to certain time-bound policies, such as capacity licensing, export and investment subsidies, tariffs, and even quotas.

41/ The European experience in this respect is instructive. Attempts to target winner firms in key industrial segments failed, in large measure, through absence of competition. See P. Geroski and A. Jacquemin (1985).

competition, some rents might indeed be transferred to the targeted firm. Still, in the absence of strong competitive pressures, firms would have no incentives to attain superior performance. It should be stressed that successful cases of firm targeting (as observed in South Korea) have been systematically associated with substantial rivalry in domestic markets and a strong commitment by targeted firms to compete internationally.

3.14 Targeting high-rent or large-externality sectors also might create problems. First, which high-rent sectors should be targeted? The fact that some command high profits now is no assurance that they will do so in the future. Equally difficult is finding out what industrial activities provide significant externalities. Often, large externalities are not associated with a particular industrial segment but with a cluster of productive or informational activities that provide the basis for industrial competitiveness. These are extremely difficult for governments to target.

3.15 If a departure from a neutral competition policy is found to be justified, and sectoral targeting becomes a policy objective, it should neither preclude domestic competition nor block the threat of import competition. Moreover, targeting should be temporary and linked to an explicit and credible commitment to reverse it.42/ In sum, protection and promotion should be moderate in intensity and limited to a relatively short period (3-5 years), should not discriminate against entrants, and should be evaluated against performance gains of domestic firms in international markets.

3.16 For most countries, instead of targeting incumbents or specific sectors, governments might want to focus on accumulating endowments by building-up human, technological and institutional resources as a means of shifting comparative advantage. Policy and institutional interventions would be targeted functionally to alleviate market imperfections that broadly constrain the emergence of competitive areas. The development of financial markets and instruments, support for the acquisition of technological capabilities, and a strong commitment to education and training would constitute some of the dimensions of such an affirmative policy regime.

42/ K. Matsuyama and M. Itoh (1986) argue, on the basis of the Japanese postwar experience, that it is only to the extent that protective measures are perceived to be temporary that producers have the incentives to develop new products and penetrate export markets. Although some sectors were heavily protected, protection was not accommodative of inefficiency, and there has been no major backslide in the liberalization program. Enterprises in the protected sector had the firm expectations that they could not depend on protection in the long run.

IV. IMPLICATIONS FOR BANK GROUP ACTION

4.01 This paper provides evidence that policy-generated barriers to domestic and international competition have been a major constraint to industrial development. It suggests that the primary objective of competition policy should be to remove those barriers through a coordinated reform of regulatory, promotional, and trade regimes.

4.02 Bank Policy Analysis and Advice. For the past ten years, the Bank has emphasized the external trade regime and its distortions, on the presumption that their removal would generate a strong supply response from producers. In many cases, the desired supply responses have either not emerged or have been less than adequate. Weak or inadequate responses suggest that other factors are constraining domestic producers.

4.03 This paper suggests that the Bank's approach to industrial development should be broadened, both in analytical terms and in policy dialogue with member countries. Industrial sector work should start from the more general perspective of competition policy, with explicit recognition that a combination of domestic competition, import competition, and export rivalry ensures a competitive environment. Industrial policy dialogue should be expanded, and its thematic focus shifted to the introduction of a new competition policy. Import competition is one dimension, but equal emphasis should be placed on removing domestic barriers to competition and promoting export rivalry measures.

4.04 Undertaking reform may be quite a demanding task for government officials, who may be asked to modify systematically or do away with policies, instruments, and agencies that are demonstrably outdated but which, in their view, still perform a useful function. In this context, it is critical that the Bank demonstrates its awareness of the historical importance of policies to be phased out or reformed, and the specific costs associated with this process. Yet, it is equally critical to insist on reform of these policies once they become detrimental to the development of the economy. This approach introduces a more acceptable "evolutionary" context to the reform process.

4.05 Composition and orientation of industrial lending. The Bank can have a direct impact on industrial and trade policies in three categories of operations: structural and sectoral adjustment lending; lending through financial intermediaries; and lending for industrial restructuring. IENIN's FY82-88 samples of 91 adjustment operations and 75 IFI (industrial lending through financial intermediaries) operations give strong indications that most operations have an inadequate competition policy mix. Strong emphasis has been given to import competition policies, less attention to export development policies, and scanty treatment of industrial regulatory and other policies (Chart 1). This

is particularly true in adjustment operations, but also applies to IFI lending.43/

4.06 A detailed breakdown of coverage of industrial policy areas in loan conditionality indicates an unbalanced policy focus of adjustment lending (Chart 2). The emphasis on regulatory changes is marginal. Only 2% of adjustment operations have included specific conditions on entry and exit policies, 3% on other regulatory policies, and 8% on investment promotion and incentives. Only pricing policies have attracted more attention, being specific conditions in 16% of the loans.

4.07 The observed emphasis of adjustment loans' conditionality on trade policies was not uniform across regions (Chart 3). African operations have been the most balanced, with trade, export development and industrial policies being specific conditions in 47%, 30% and 40% of the adjustment loans respectively. In EMENA, 60% of operations have specific conditions relating to export development policies. In Asia, 69% of operations had import policy conditions, and 38% dealt directly with export regimes. In LAC adjustment operations, import liberalization has dominated, with specific conditionality in about 70% of adjustment loans; conditions to unravel entry and exit barriers and other industrial policy reforms were included in only 10% of LAC adjustment operations. What is striking is the marginal role of industrial policies as specific conditions in adjustment loans made to all regions but Africa (Chart 4). This is most clearly seen in LAC and EMENA, where only a small proportion of adjustment loans contain relevant regulatory reform conditions (no adjustment loans in either LAC or EMENA have addressed issues of entry and exit, for example), despite the importance of regulatory and other barriers to domestic competition in these regions.

4.08 The Bank's industrial operations have been much better in stimulating competition: IFI operations have generally favored incumbents. The majority of Bank's non-SMI lending is for expansion, modernization or improvements in capacity utilization of existing plants--rather than for new products or entrants. The FY82-88 sample of 75 IFI loans show that on average about 70% of subloans were made to incumbents.

43/ The record of implementation of adjustment loan conditionality was, however, mixed. "Significant" reforms of import policy were undertaken in 19 out of 40 countries that received adjustment loans; in 11, changes were "negligible" and in 10, "less significant." See World Bank (1988c).

CHART 1

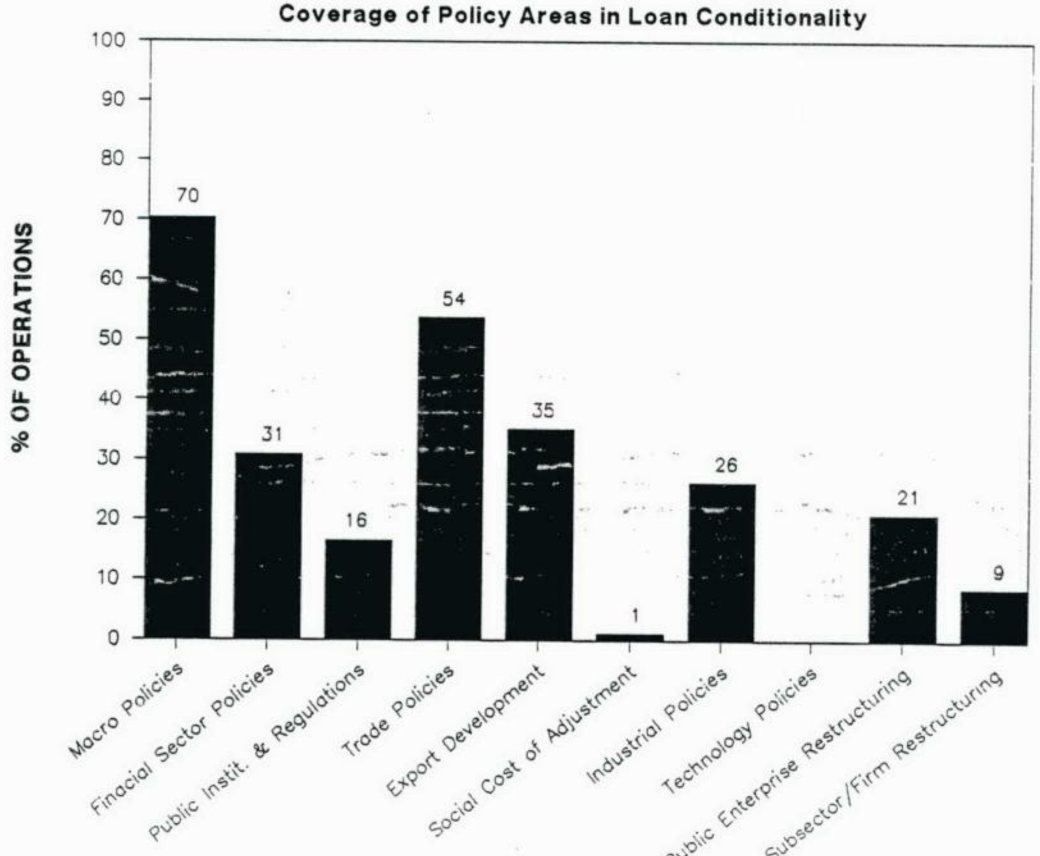


CHART 2

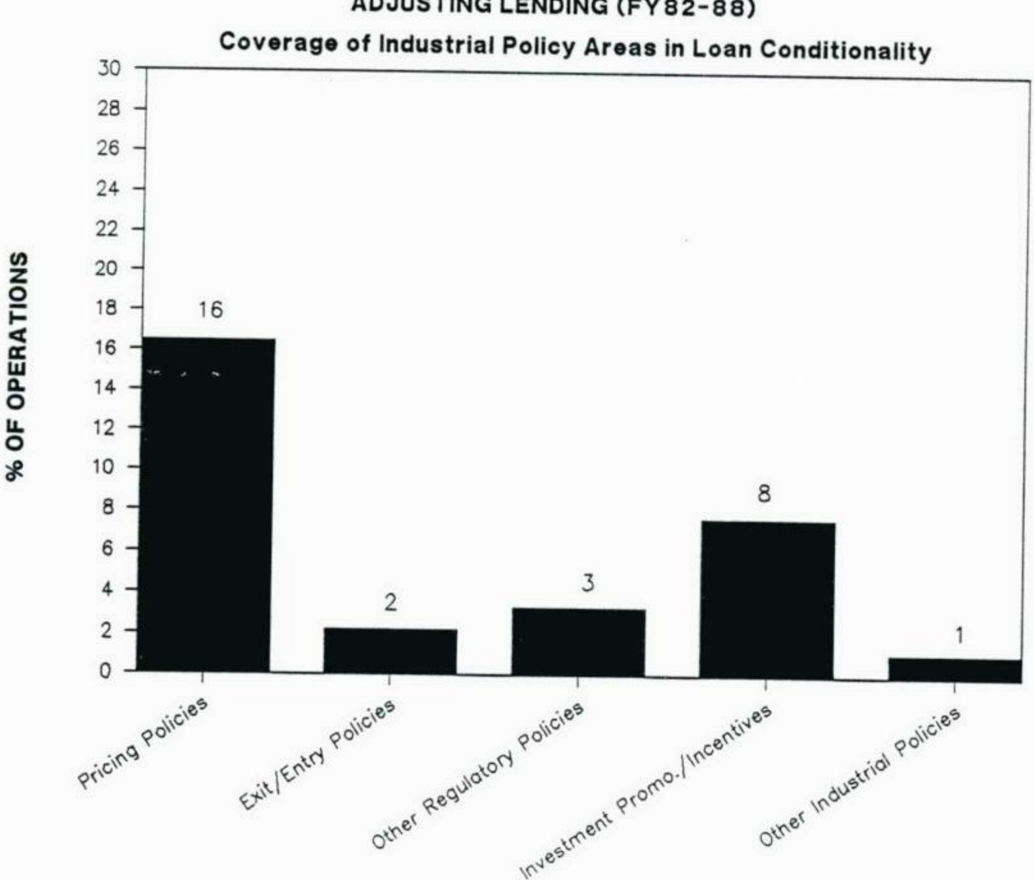


CHART 3

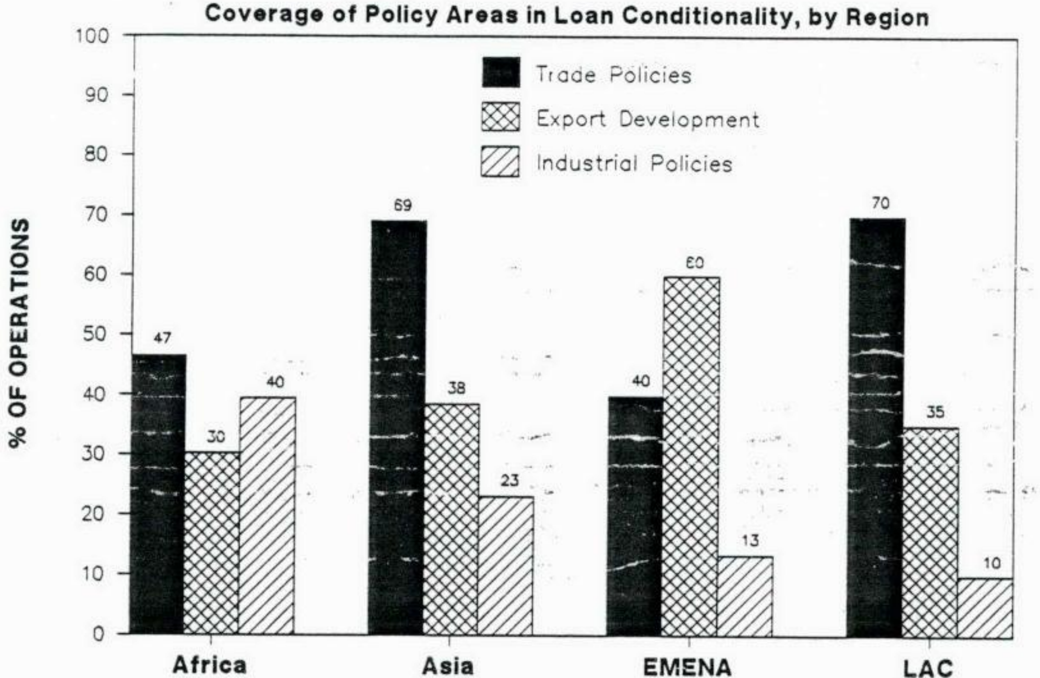
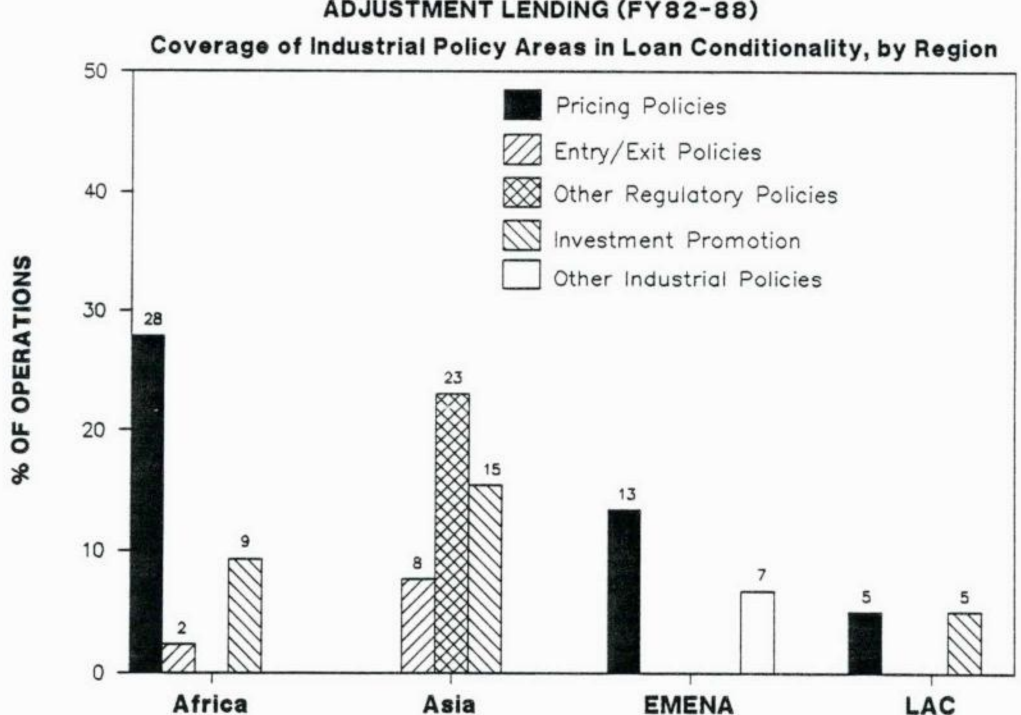


CHART 4



4.09 Industrial lending as a vehicle for the promotion of competition. Competition policy should be an explicit concern in sectoral adjustment and industrial investment operations. The object would be to remove, in a phased and coordinated way, key regulatory, promotional and protective barriers to competition, while helping to develop a regulatory framework, an institutional setting, and financial mechanisms that enable firms to compete more effectively in domestic and international markets.

4.10 Industry-related lending packages should pay more attention to the balance of trade, export development, and industrial policies. In countries where previous operations have focused on import liberalization, the emphasis now should shift to reform of the regulatory and the promotion of export competition. Far greater emphasis should be placed on removing domestic barriers to mobility and growth, which have remained serious obstacles to domestic firms making competitive supply responses. Recent economic and sector work on regulatory policies and incentive regimes in India, Philippines, Pakistan, Mexico, Indonesia and other countries are beginning to lay the basis for Bank policy dialogue and operations in this area.

4.11 Industry operations through financial intermediaries should facilitate credit access to new entrants by supporting regulatory reform and improved financial market mechanisms. When competitive pressures are increased, problems of inefficient industrial firms can be transmitted to the financial system. Restructuring of banks' portfolios often needs to accompany regulatory reform. Otherwise, credit will be absorbed in bailing out uncompetitive incumbents, thus squeezing out more promising investments. In credit operations, only financially sound and operationally strong intermediaries should be utilized in Bank operations. Participating credit institutions should scrutinize incumbents' proposals closely, to avoid bolstering monopolies and bailing out insolvent firms. Financial programs and venture capital facilities that complement pro-entry regulatory reforms and facilitate access to finance by newer and smaller firms should be encouraged or promoted. These measures also apply to IFC's operations, which have focused mainly on dominant industrial concerns.[44]

4.12 Public enterprise restructuring and privatization operations. In most cases, these operations need to deal with issues of competition and the exercise of monopoly power. It is essential that

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44/ IFC's investment portfolio is heavily concentrated in relatively few firms. At the end of FY88, just 19 firms accounted for 25% of IFC's investment on its own account (i.e., excluding other participants) and 50% of IFC's portfolio was concentrated in 56 firms. These figures were calculated on the basis of disbursed and undisbursed balances. The average investment in the 19 top firms is $44 million, nearly six times as large as the portfolio-wide average of approximately $7.5 million for 446 firms. See IFC Annual Report, 1988.

public enterprise restructuring loans not be limited to improvements in the autonomy and operational capabilities of enterprises. The monopoly standing of these firms must be also tackled directly. Regulatory and other policy-generated barriers to entry in markets dominated by public sector entities should be removed. Only then will the stimulus to improve resource allocation and managerial efficiency be adequate to achieve significant performance improvement or exit. Such removal of monopoly status is equally important when public enterprises are privatized, as there is no solid evidence that a private monopoly performs better than a public one. These operations must be analyzed from an industrial organization perspective, to ensure that privatization does not maintain or exacerbate barriers to entry and competition.

4.13 Finally, to the extent that competitive supply responses depend on the establishment of a procompetitive framework, a modernized institutioinal setting supportive of export activities, and functional interventions in areas commanding high externalities, the Bank's policy work should contain a serious analysis of the scope of supportive government action in the industrial sector. The Bank needs to devote more of its resources to assist in the design of policies, regulatory frameworks, and institutional arrangements that encourage competition, stimulate human resource development, and promote the acquisition of technological, managerial and marketing capabilities necessary to penetrate world markets.

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ANNEX 1

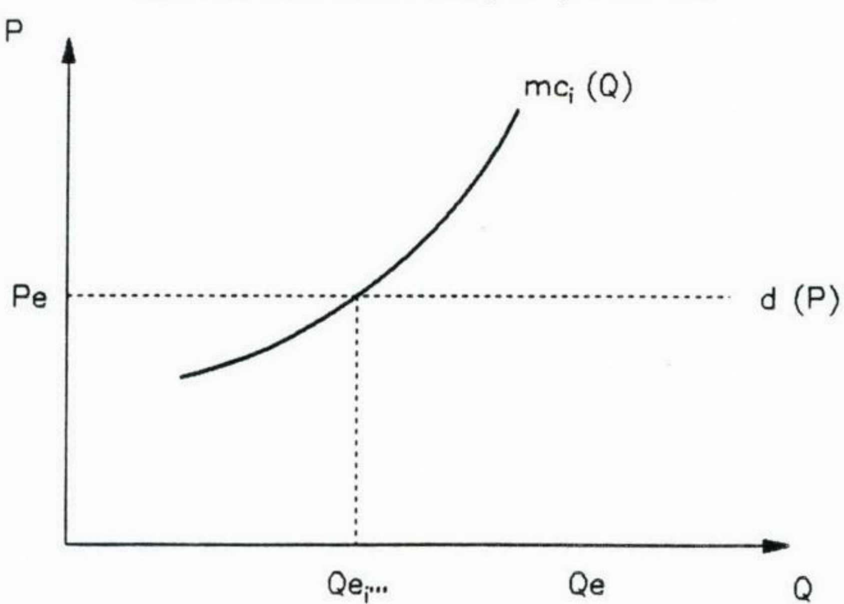
ON THE NATURE OF COMPETITION

1. Most industrial markets in developing countries are characterized by imperfect competition. This annex briefly reviews the main features of the different forms of competition.

2. Perfect Competition. Few markets can be described as perfectly competitive. The competitive market paradigm nonetheless provides a benchmark against which other structures can be evaluated. The model presumes that a large number of firms produce a homogeneous good under decreasing returns, and that entry and exit are both fast and costless. There is no strategic interaction among producers because no single producer has a perceptible impact on the market. As a result--and this is the basic assumption of this model--firms take prices as given.

3. Individually, producers face infinitely elastic horizontal demand curves, and prices are just sufficient to cover marginal costs. Figure 1 portrays a representative firm (the ith producer). The pair (Qe_i, Pe) is determined by the intersection of the individual firm's supply (given by its marginal cost curve--mc_i) and its perceived market demand. All productive factors are rewarded according to their marginal contribution to output. Economic profits (or rents) are zero. Productive factors also are fully and efficiently utilized; as a result, under perfect competition industry's output Qe (obtained by horizontal summation of each firm's production) is at its maximum, and welfare or deadweight losses are nil.

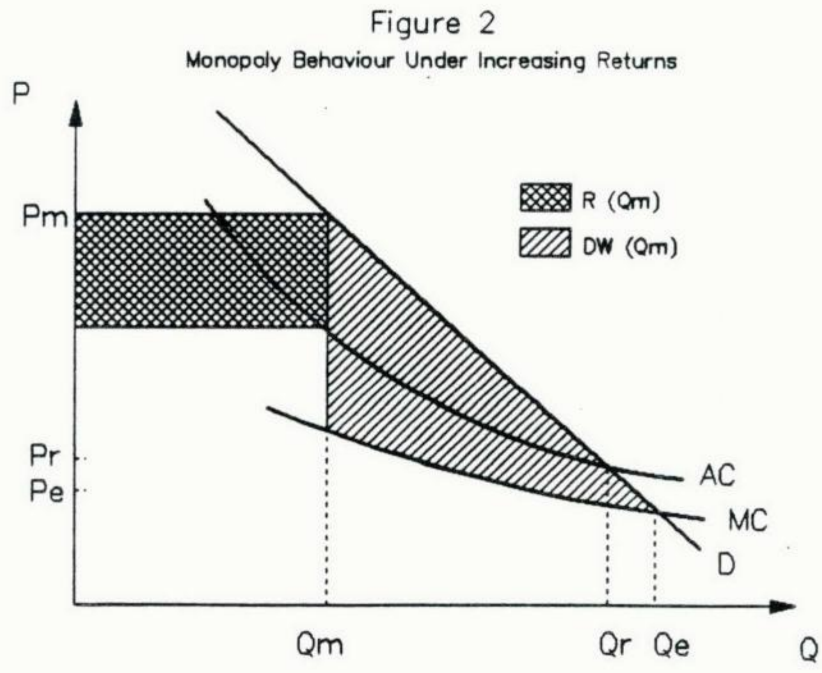
Figure 1
Representative Firm in a Perfectly Competitive Market



4. Pure and Contestable Monopolies. The polar case of a perfectly competitive market is a monopolistic market with a single seller. Most often, monopolies arise either by fiat, when a government decides to grant monopoly rights to a given producer, or as a result of a technological imperative. In the latter case, the monopoly is "natural," in the sense that economies of scale are so large (relative to the size of the market) that cost minimization calls for the presence of a single producer. Figure 2 portrays the price-output behavior of a "natural" monopolist, facing a linear demand curve D, and producing under increasing returns to scale in the relevant output range (the average cost curve AC is falling throughout, and the marginal cost curve MC lies always below it).

5. This description approximates the conditions under which the production of many non-tradable services (such as telecommunications, electricity, water, etc.) takes place. Were their provision left unregulated, the profit-maximizing solution (Qm, Pm) would be the firm's choice. It allows the monopolist to capture R(Qm) in rents and brings inefficiency losses of DW(Qm).[1/] In this model, it is implicitly assumed that the producer confronts no potential competition which would place a constraint on prices. This is a fair assumption for many natural monopolies, where the volume of sunk (or irretrievable) costs is such that it poses a binding barrier to entry, thus precluding potential competition.

Figure 2
Monopoly Behaviour Under Increasing Returns



1/ As in the case of perfect competition, it is being assumed here that the monopolist faces a unified market. Were it segmented, the monopolist could do even better by price discriminating consumers and charging them according to their willingness to pay, thus absorbing all their surplus. This (Ramsey) pricing strategy maximizes the monopolist's rents.

6. The opposite presumption lies behind contestable market models. In these, entry and exit barriers are assumed to be absent, and entrants are able to quickly replicate the cost structures of incumbents. Another key assumption of the model is that against the threat of entry, producers respond by moving prices downward.2/ The monopolist's profit-maximizing solution would then be the pair (Pr, Qr). Rents are driven to zero, as price falls and is eventually equated to average cost.3/ This model has a striking implication: a monopolist would be driven to the competitive outcome (one which constrains monopoly profits to zero) so long as it is operating in a perfectly (or structurally) contestable market. In this case, potential competition would fully substitute actual competition.

7. Oligopolistic Rivalry. Most industrial markets are characterized by moderate barriers to competition. As such, they neither fit the perfectly contestable or competitive model, where barriers are absent, nor are they consistent with the characterization of a "natural" monopoly, where these barriers are binding. Entry in oligopolistic markets is possible, but not easy. As a result, there are relatively few dominant firms, facing moderate threats from the outside.4/

2/ See W. Baumol, "Contestable Markets: An Uprising in the Theory of Industrial Structure," American Economic Review, March 1982, 72, 1-15, and the excellent critique of W. Shephard, "Contestability vs. Competition," American Economic Review, September 1984, 74, 572-587.

3/ Nonetheless, deadweight losses would still be positive in the case of a contestable monopoly producing under increasing returns to scale. The reason is that the efficient solution (Pe, Qe) is only attainable it the producer is willing to take losses--an unlikely market outcome--or if the government offsets them through subsidies.

4/ The concept of monopolistic competition may be regarded as a particular case of oligopolistic rivalry, with firms competing in prices and variety (of products, location, etc.). It is in some ways a blend of opposites: on the one hand, firms are assumed to be able to differentiate their products so each would face a downward sloping demand curve; on the other, free entry is postulated and new entries would continuously drive profits to zero. Product variety is a reflection of the large number of producers which populate monopolistically competitive markets.

8. In contrast to perfectly competitive markets, where the actions of individual agents have no perceptible influence on the behavior of others, in oligopolies firms "play" strategic games with one another.[5] The fundamental few agents, prices and other market outcomes are to be regarded as a product of their strategic interaction.[6]

9. An oligopolistic market is not an anonymous mechanism. Each firm uses a number of devices in its efforts to compete: the level and structure of prices, alterations in product design and quality, advertising and other promotional campaigns. Tacit cooperation, as found in cartels, is not generally assumed to be a sustainable form of conduct (and explicit cooperation even much less so). However, in mature oligopolies, firms do develop more predictable and stable relationships, eventually settling down to accommodating patterns of behavior.

10. In the basic (non-cooperative) oligopoly model, each individual firm enters the market by specifying a vector of product characteristics with which it competes. Most propositions in oligopoly theory flow from either assuming that output is the decision variable and that firms maximize profits taking the level of output chosen by rivals as given (in the case of a so-called "Cournot" oligopoly), or that price is the decision variable, and it is the prices of competitors that are taken as given (in case of a "Bertrand" oligopoly).[7]

5/ Initially, the theory of oligopoly allowed only a very limited extent of strategic interaction, with moves (and threats) by one player always assumed to be credible and not generating countermoves. In limit pricing models, for example, an oligopoly would set a price sufficiently low to discourage entry; other firms would react by simply not attempting to enter. If entry deterrence was a credible or empty threat, and therefore, if the prospect of entry would or not discipline incumbents, was not discussed in limit-pricing and other early entry models. For a brief and very good survey of entry and entry deterrence, see A. Dixit, "Recent Developments in Oligopoly Theory," American Economic Review, May 1982, 72, 12-17.

6/ The way firms compete also affects the configuration and boundaries of markets. Market structure becomes in this sense endogenous to firm behavior, reversing the traditional assumption. Thus, as products are modified and differentiated, and niches carved out, the market is redefined and so is its degree of concentration.

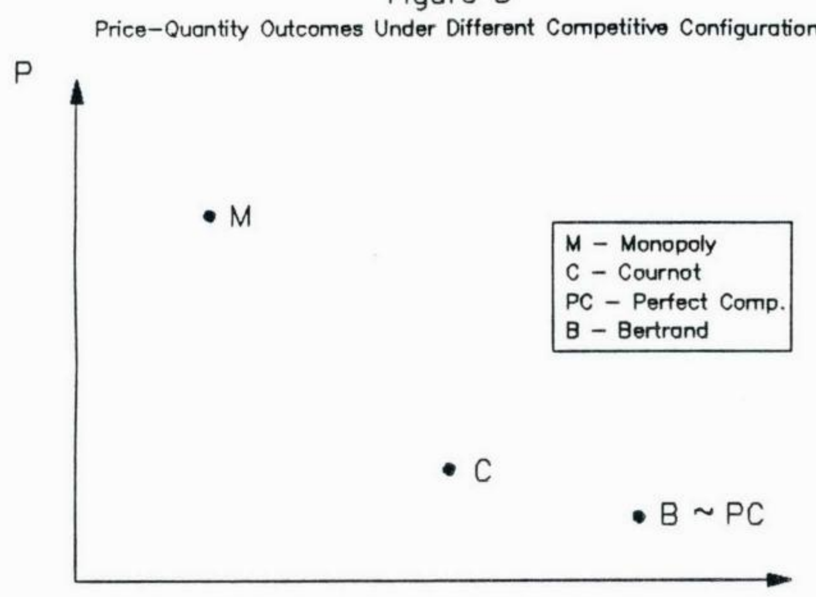
7/ There are other types of non-cooperative fixed conjectures which might be closer to reality, but are seldom used. Firms might, for example, maximize market shares taking other firms' market shares as given, subject to a minimum profit restriction. The conduct of many of the larger Japanese firms might be reflective of this strategy.

11. These assumptions are not exactly "realistic" and present a static (or at best a short-term) view of how oligopolistic firms behave. It is not commonly the case that firms maintain their output or prices under changing competitive conditions. Nonetheless, this model is useful to the extent that it does suggest what kind of market outcomes to expect, at least in qualitative terms, from different oligopolistic configurations.

12. In equilibrium, prices, quantities as well as levels of pure profits vary (considerably, depending if oligopolists compete in quantities or prices (Figure 3). As long as the number of firms is assumed fixed (due, for example, to binding entry barriers) and producers do not compete in prices (not an unreasonable assumption for differentiated products), the market is not driven to the competitive outcome, but to an intermediate solution allowing moderate rents (C, the Cournot solution). Were oligopolies competing in prices, however, the market would be driven to the competitive or efficient outcome B=PC, in which case rents would be zero. A similar result would be reached if the number of entrants were to be very ("infinitely") large. Finally, were firms cooperating with each other, they would be producing and charging at M, the monopoly rent-maximizing solution.

13. Competition and Efficiency. This description of market outcomes under different competitive configurations underlines the importance of entry barriers and market concentration for prices, quantities and profits. It also suggests that, at least in a static sense, the impact of concentration on performance is most adverse when entry barriers are fully binding. The relationship between concentration and barriers to entry is equally important in assessing how dynamic efficiency gains respond to different patterns of competition. From a longer term development perspective, this is the critical question for competition policy.

Figure 3
Price-Quantity Outcomes Under Different Competitive Configurations



14. At any time, perfectly competitive markets generate optimal price-output combinations. Over time, however, economic performance might actually suffer under perfect competition. The reason is that firms operating in perfectly competitive markets often lack the resources to fund research and development, an increasing-returns activity that is responsible for most technical change. They also lack the scales to internalize many of the learning economies that drive productivity growth. In this sense, the perfectly competitive market is not a progressive one as far as technical change is concerned. To the contrary, technical progress tends to be exogenous and driven by outside agents (such as research institutions and suppliers).

15. The example of the wheat farmer, the textbook paradigm of an atomistic producer, is illustrative: agricultural research stations normally produce the innovations (such as new seed varieties and farming techniques) that extension services and input suppliers disseminate among producers.[8/] In such sectors as housing, services and some segments of traditional manufacture characterized by significant atomistic competition, producers tend to be passive adopters.

16. Thus, there is a trade-off between static and dynamic efficiency. Market concentration and positive rents are needed both to finance ongoing research and as an incentive for further research and innovation.[9/] This, however, is predicated on competition barriers being low and easily surmountable. If markets are simultaneously concentrated and sheltered by high barriers to competition, rents serve only to strengthen the position of established producers. In this case, concentration increases the probability of anticompetitive behavior resulting in substantial dynamic welfare losses.

8/ This is not peculiar to agriculture. See K. Pavitt "Technology Transfer Among the Industrially Advanced Countries: An Overview," in N. Rosenberg and C. Frischtak (eds.), International Technology Transfer: Concepts, Measures and Comparisons, Praeger, 1985.

9/ Schumpeter was the first to point out that market concentration and positive rents may be positively correlated with innovativeness. (Schumpeter, 1934, Theory of Economic Development, London: Oxford University Press).

ANNEX 2

THE COMPLEMENTARITY OF DOMESTIC COMPETITION, IMPORT COMPETITION, AND EXPORT RIVALRY

A. The Three Dimensions of Competition

1. This annex discusses ways in which domestic and import competition, and export rivalry, complement each other. Establishing this complementarity is a fundamental step in making the case that only an integrated competition policy--combining domestic regulatory reform with import liberalization and export promotion--can ensure a positive, efficient supply response.

2. Each dimension of competition is likely to improve both resource allocation and firm-level efficiency, but domestic competition seems to be a particularly strong force in improving managerial efficiency. Import competition provides the strongest pressures to improve resource allocation efficiency, and export rivalry is instrumental in moving out the domestic efficiency frontier. The basic forces of competition also act in synergy, mutually reinforcing each other. In particular, an increase in either domestic or import competition has a positive impact on export rivalry in the medium to long run, even though the short-run impact of import competition on exports might be negative. Finally, each dimension of competition encounters barriers (discussed in detail in Section I), and barriers to one dimension of competition can prevent firms from behaving competitively along another dimension.

3. Section B of this annex discusses the impact of competition on economic efficiency. The synergies among the three dimensions of competition are analyzed in Section C. Section D focuses on the short-run impact of domestic and import competition on export rivalry.

B. Impact of Different Competition Forces

4. Competitive domestic markets provide strong incentives for firms to improve x- (or managerial) efficiency. The main effect of domestic competition is to force managers to cut waste and use resources more efficiently.1/ Domestic competitive pressures prod local firms into gathering information from their immediate competitors and emulate the best practitioners. It is through this process of learning from each other's operational characteristics and managerial practices that domestic firms are able to improve efficiency.

5. Import competition can have a particularly marked impact on the structural efficiency of industry, by giving domestic firms greater access to inputs unavailable or more costly in domestic markets and by

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1/ Managers seem to respond when exposed to direct competitors working under similar conditions, using similar resources, and producing for the same market.

putting them in touch with more advanced processes and designs. Firms are thus able to improve their factor mix. However, possibly the greatest impact of import competition is on intra and interindustry resource allocation. Many developing country industries are characterized by excessive diversification and segmentation and inefficient scales of production. Import competition creates strong incentives to restructure or shed inefficient operations and to expand output along more specialized lines.2/

6. Bank sector analyses in Argentina, Chile and, more recently, in Mexico, have shown that trade reform has led firms to make significant adjustments in their production strategy,3/ initially through improvements in product quality, packaging and design (as in Mexico). Competition from imports eventually led to the introduction of new products, new product mix, and narrower product lines in which producers found they were more competitive. The reallocation of resources has taken place through mergers, consolidations, and plant closings as well.

7. Export rivalry policies can cause major dynamic efficiency gains. Export facilities can induce progressive managerial behavior by exposing firms to new technological trends, designs and production characteristic of the international production frontier. A commitment to export markets represents an incentive for firms to adapt their production and marketing organizations continuously in response to rapidly changing market requirements.4/

8. Korea's experience suggests the importance of exports to industrial technology development. Indeed, the authors of a detailed study of the behavior of Korean exporting firms conclude that there is "a tremendous efficacy of export activity as a means of acquiring industrial competence: [through it] Korean firms have enjoyed costless access to a tremendous range of information, diffused to them in various

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2/ This, of course, presumes that competition from imports is effective and that there are no significant barriers to exit (or that they are removed simultaneously with the entry of imports). Moreover, the increase in efficiency resulting from the restructuring of firms--induced by import competition--may not help a country if, eventually, income losses from the shrinking of domestic industry offset the gains from greater specialization.

3/ See Corbo and de Melo (1985) and World Bank (1988c).

4/ The proposition that export rivalry stimulates technical change is supported by a recent study of Brazilian manufacturing firms. The study establishes that the probability of firms engaging in technological activities (defined as import of technology, R&D, and process rationalization through engineering efforts) generally increases, inter alia, with exports and decreases with the extent of import protection. See H. Braga and L. Willmore (1988) They base their conclusions on estimates of a logit model using data generated by a 1980 sample of 4,342 manufacturing establishments.

ways from the buyers of their exports. The minor innovations that have resulted have been significant in increasing production efficiency, changing product designs, upgrading quality and improving management practices. Exporting thus appears to offer a direct means of improving productivity..."5/

C. Synergies Among the Forces of Competition

9. Among the forces of competition, important synergies exist. An increase in domestic competition tends to stimulate export rivalry. In Japan, for example, intergroup rivalry has been an important incentive for firms to move to export markets. Particularly since the early 1960s, as the heavy and chemical industries matured, export activities became critical to avoid fragmentation of output and the erosion of profits in an increasingly contested market.6/ The recent experience of India seems to be another significant example of intensifying domestic competition stimulating a more aggressive posture in the international market, with "...dozens of companies making an unprecedent push for export markets, partly because this is needed for survival, partly because exports have become profitable."7/

10. Another relevant synergy is between import competition and export rivalry, which the medium and longer term is generally positive and appears to be particularly strong for partial forms of import liberalization. Korea is a classic case of promoting exports by subjecting one segment of its economy to import competition--by completely liberalizing imports of inputs for direct and indirect exporters.8/ This form of import liberalization--creating a free trade regime for such inputs--is a key dimension of export rivalry policies as advocated in this paper.

11. Evidence also exists that broader forms of import competition correlate with an expansion of exports. A study of trade liberalization policies in 19 countries in the post-war period found that export growth was nearly twice as large in the "liberalizing" group of

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5/ See L. Westphal, Y. Rhee and G. Pursell (1981, p.77) and Y. Rhee, B. Ross-Larson and S. Pursell (1984, Chapter 4). Both studies are based on a 1976 survey of 112 Korean exporting firms.

6/ A glimpse of how competitive Japan's domestic industrial market has been is suggested by its relatively low concentration ratios and considerable product overlap. This was already observed in 1963, when Japanese GNP was only 15% of the U.S. GNP. Industrial concentration was nonetheless lower in Japan. The unweighted average concentration ratio was then 37.5% for Japanese industries and 38.3% for the U.S.; the weighted averages were 35.4% and 40.9% respectively. See Caves and Uekusa (1976, p. 19).

7/ See India Today, op. cit., pp. 58.

8/ See Y. Rhee (1984, 1985).

countries, i.e., those that persistently pursued policies of trade liberalization, rather than those that were unable to sustain a more open trade environment.9/

12. Although significant, these findings do not definitively establish causality between domestic competition and export supply response.10/ To make a cogent case for the proposition that competition stimulates export rivalry requires, in addition, an outline of the economic mechanism explaining this synergy. The main argument is sketched as follows.

13. The basic mechanism explaining the positive impact of domestic and import competition on export rivalry is the movement of firms across markets. Profit-maximizing firms will exit markets characterized by relatively intense competition and low profitability, and orient their output toward more attractive alternatives. If import liberalization or domestic deregulation lowers the profitability of domestic markets, this provides an incentive for firms to increase their exports.

14. Because moving from less profitable domestic to more profitable export markets takes time and resources, the influence of increased domestic and import competition on exports will be different in the short and in the long run. In the short run, firms can increase marginal exports without reducing their costs or increasing their

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9/ See M. Michaely (1988). According to the study, "among the 'non-liberalizers' only one country--Yugoslavia--shows a rate of growth of exports which is above the average (or medium) of the group of 'liberalizers'; all [others] are far below it. In all the 'liberalizing' countries, export growth exceeded--usually by much--the growth of GDP; for the group as a whole, the former was [nearly] twice the latter. For the 'non-liberalizers,' on the other hand,...the two growth rates were [on average] rather similar." (pp. 2-3)

10/ This was pointed out, for example, by D. Hachette (1988) in the case of Chile. He notes that "exports increased in real terms between 1973 and 1979 at an average rate of 8% per year. They increased regularly, in constant prices, and as a share of GDP. [Further, non-traditional exports were stimulated relative to copper, and they grew from 2.7% of total exports in 1971-73 to 34.7% in 1980-81]. The real exchange rate remained during this period at a higher average level than during previous decades despite declining steadily since 1976. Relatively low wages, large increases in port efficiency, and administrative expediency supported export activities. External conditions also were favorable to non-traditional Chilean export, while investment became more concentrated on exportables, while relative prices became more favorable to exports. How much of that success story can be assigned to liberalization policies and how much to exogenous circumstances is difficult to know" (pp.3-4).

international competitiveness. In the medium to long run firms will be able to reallocate resources and change their investment decisions (once they observe lasting changes in the relative competitiveness and profitability of markets). This will then reduce their costs and increase their technical efficiency.

15. The immediate impact of increased import competition on exports and the trade balance may even be negative. While foreign firms become more active in domestic markets and falling prices cause demand to expand, the competitive position of domestic firms may deteriorate. Additional demand is met mostly by more competitive foreign firms. As a result, imports rise, and net exports fall (i.e., the trade balance worsens).11/ In contrast, increasing domestic competition will in the short run increase net exports. A rivalry-driven output expansion or an oligopolistic price war forces domestic prices down and increases profitability of exports. Imports contract, since they become relatively more expensive. The net result is an increase in net exports.12/

16. In the long run, entering a foreign market or sustaining a substantial increase in exports generally is not possible without investments: for example, a larger plant, developing a better product, setting up or extending a distribution and service network. Since only changes in competitive conditions regarded as permanent will affect firms' investment decisions, an increase in domestic competition through entry (a "permanent" competitive move) would be a particularly effective stimulus ensuring that resources move to export markets. Increased import competition through reform of the trade regime has a positive impact on non-residual exports only if regarded by producers as a credible and sustainable policy measure. The difficulties of lending credibility to trade reform initiatives is an additional reason to lean on domestic competition as a complementary instrument for inducing efficient supply response.

D. The Short-Run Impact of Domestic and Import Competition on Export Rivalry

17. This section deals in more detail with the short-run impact of domestic or import competition on export rivalry. It is assumed that

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11/ To the extent that input markets are liberalized, the cost curves of domestic firms would be shifted down. This cost effect may offset, at least in part, the primary demand-driven net export contraction.

12/ The short-run impact of increased import and domestic competition are analyzed in more detail in Section D of this annex. While that section adopts a partial equilibrium framework, it is important to emphasize that the short-run expansionary impact on domestic demand (which makes net exports go up and down in the cases of increased domestic and import competition, respectively) as well as the contraction of sectors which are under pressure as the result of import liberalization are economy-wide phenomena.

in the short-run firms can shift from the domestic market to the export market and vice versa at any time without incurring additional costs. The effects on firms' cost curves and on their longer term investment decisions are ignored.13/ Of course, entering a foreign market or increasing exports substantially in the long run is typically not possible without some capital and R+D investments: a larger plant may have to be built, a better product may have to be developed, a distribution and service network may have to be set up or extended. Such long-run non-marginal increases of exports generally will have a positive effect on firms' technical efficiency. Short-run marginal increases of exports, however, do not require cost reductions or improvements of firms' international competitiveness and are not associated with changes of firms' technical efficiency.

18. The results of this section can be summarized in form of three propositions. First, an increase in domestic competition brought about by an increase in the aggressiveness of domestic firms has a positive short-run impact on exports, while an increase in import competition brought about by an increase in the aggressiveness of foreign firms has a negative short-run impact on exports. Second, the short-run effect of increased import competition on exports, through the reduction of a specific tariff, is negative and that of a general import liberalization is ambiguous. Third, an increase in domestic competition through entry of domestic firms has a positive impact on exports.

19. Consider first an increase of domestic or import competition caused by an increase in the aggresiveness of domestic and foreign firms, respectively. That is, the number of domestic and foreign firms active in domestic markets goes unchanged, and the increase in competition is reflected simply in falling prices and increasing outputs (as happens when domestic or foreign oligopolistic firms engage in a price war).14/ If the increasing competition is initiated by domestic firms, the effect on exports will be positive: domestic production goes up to serve the increasing domestic demand, and residual exports that cannot be sold profitably at home go up as well. Furthermore, if products are differentiated and as imports become relatively more expensive, their volume will, if anything, go down, which again improves net exports. Analogous to this, if the increasing competition is initiated by foreign firms, imports go up and the export rate tends to

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13/ In particular, the model to be presented below will be a partial equilibrium model, and if increasing import competition is associated with lower input costs for domestic firms, this effect is ignored. A partial equilibrium approach is justified to the extent that it highlights the short-run demand impact of increased domestic and import competition on exports and that no appropriate general equilibrium framework with imperfect competition exists that could be used to analyze these effects.

14/ In a general oligopoly model, an increase in competition by domestic or foreign firms respectively can, for example, be modelled as a change in firms' conjectural variation terms.

go down. Again, if products are differentiated, there is the additional effect that imports become relatively cheaper, which will reduce net exports.15/ Thus, an increase in domestic or import competition through an increase in the aggressiveness of domestic or foreign firms tends to have a positive and negative short-run impact on exports, respectively.

20. Next, consider the effect of increasing import competition through a reduction of a specific tariff in a certain market. In the standard case of a small open economy in which a tariff protects the domestic industry from world market competition, this effect will be negative. The decreasing relative profitability of the domestic market for the individual domestic firms does not matter here. In aggregate, increasing import competition leaves industry output (as determined by firms' marginal costs and world market prices) unchanged, while it raises domestic demand by lowering domestic prices.16/ Consequently, net industry exports are likely to fall. This has been demonstrated in cases of perfect competition and monopoly under the assumption that the tariff being abolished is prohibitive.17/ A straightforward, but tedious analysis shows that these results continue to hold for the oligopoly case and for general, not necessarily prohibitive tariffs.

21. Further assume that not only a specific tariff is reduced, but also that input markets are liberalized, and increasing import competition gives exporters access to all tradable inputs at lower international prices. Thus exporters will be on an equal footing with international competitors. This cost effect will ceteris paribus increase exports and may at least partly offset the primary negative effect on net exports. The total short-run effect of a general reduction of tariffs on the trade balance is ambiguous.

22. Finally, consider an increase of domestic competition through entry. In this case, the market share of domestic firms as well as domestic industry output increases. The aggregate effect is that both net exports and the export share of domestic firms go up. The results concerning this third and last proposition derive from comparative static analysis of a simple oligopoly model, as follows.

15/ Imports will become relatively more expensive only if products are differentiated. If imports and domestically produced products are homogenous, domestic and import products have a common price that falls as a result of the increasing competition.

16/ If firms' marginal costs are so high that outputs are determined by equalizing marginal costs and domestic marginal revenues (instead of world market price), in which case firms produce only for the domestic market and exports are zero, a tariff reduction will reduce firms' outputs (by lowering their marginal revenues). This will lead to an additional increase of imports as the difference between domestic demand and domestic production widens.

17/ Sadao Nagaoka, "A note on the impact of import liberalization on exports," World Bank (INDSP, now IENIN), mimeo, October 3, 1986.

23. Model. The domestic market is a Cournot oligopoly (that is firms compete in quantities) consisting of n firms with the cost function:

$$C(q_i) = cq_i^2.$$

Domestic demand is:

$$P = a - b\sum_{i=1}^{n} q_i$$ 18/

The world market is perfectly competitive. The world market price is p*. Domestic firms are protected by a prohibitive tariff. Since firms can sell either in the domestic or in the world market, their effective demand function is

$$P = \max\left(a - b\sum_{i=1}^{n} q_i, P^*\right)$$

and their marginal revenues are

$$MR = \max\left(a - 2bq_i - b\sum_{j\neq i} q_j, P^*\right)$$

Note that since firms are protected by a prohibitive tariff, imports are not modeled here, and net exports coincide with exports. This simplifying assumption is made to isolate and study the effect of domestic entry on exports in a framework that is as simple as possible.

24. Equilibrium. There exists a unique equilibrium characterized by the first-order condition that marginal revenues be equal to marginal costs. This equilibrium is symmetric, that is, all firms produce (and export) the same quantities. Since the domestic price is higher than the world market price, firms will first sell their products on the domestic market. There are then two cases: either firms produce only for the domestic market or they export. In the first case (case a), firms' marginal revenues in equilibrium are above the world market price but are equal to marginal costs so that any increase in output reduces profits. In the second case (case b), firms expand production up to the point where marginal costs equal the world market price. Equilibrium outputs, exports, and prices for the two cases can be calculated as follows.

25. Case a. In equilibrium, marginal revenues are equal to marginal costs:

$$a - 2bq_i - b\sum_{j\neq i} q_j = 2cq_i \quad (i=1,\ldots,n).$$

18/ This demand function is chosen for simplicity only. The model can be generalized to non-linear demand functions.

This implies:

$$q_i = \frac{a}{(n+1)b + 2c}$$

$$\sum_{i=1}^{n} q_i = Q = \frac{na}{(n+1)b+2c} \quad .$$

This is the equilibrium if and only if the marginal revenue from domestic sales exceeds the world market price so that domestic production is fully sold in the domestic market and exports are zero, i.e. if

$$a - 2bq_i - b\sum_{j\neq i} q_j \geq P^*, \text{ i.e. } P^* \leq \frac{2ca}{(n+1)b + 2c} \quad .$$

26. Case b. In equilibrium, marginal revenues are equal to marginal costs:

$$P^* = 2cq_i \quad .$$

This implies:

$$q_i = \frac{P^*}{2c} \quad (i=1,\ldots,n)$$

$$\sum_{i=1}^{n} q_i = Q = \frac{np^*}{2c} \quad .$$

This is the equilibrium if and only if the marginal revenue from domestic sales falls short of the world market price so that part of the domestic production is exported, i.e. if

$$a - 2bq_i - b\sum_{j\neq i} q_j < p^*, \text{ i.e. } p^* > \frac{2ca}{(n+1)b+2c} \quad .$$

The volume of exports can be calculated as the difference between production and the level of domestic demand at the world market price:

$$X = Q - \text{domestic demand } (P^*) = \frac{np^*}{2c} - \frac{n}{n+1}\,\frac{a-p^*}{b} \quad .$$

27. Exports are positive exactly in case b, that is if and only if

$$\text{(A)} \quad P^* > \frac{2ca}{(n+1)b + 2c} = f(n).$$

The cut-off value f(n) falls in n, that is, entry by new firms may make all firms in the industry became exporters. Furthermore, whenever exports were positive before entry, entry increases these exports. This

follows directly from the fact that the first derivative of X with respect to n is positive, wherever condition (A) is satisfied:

$$\frac{dX}{dn} = \frac{P^*}{2c} - \frac{1}{(n+1)^2}\frac{a-p^*}{b} > 0 \text{ for } P^* > f(n).$$

Finally, the industry's export share is a positive function of the number of firms in the industry as well:

$$\frac{X}{Q} = \frac{(a-p)^* \; 2c}{(n+1) \; bp^*} \Rightarrow \frac{d(X/Q)}{dn} > 0.$$

Consequently, the export share rises as a result of entry into the industry. As mentioned already, imports are not modeled here, so that net exports coincide with exports.

28. Although this is a simple model, its clear-cut and unambiguous results concerning the effect of entry on exports also hold for a more general class of demand and cost functions. In summary, the three propositions that were derived in Section D of this annex lead to the following conclusions. The short-run effect of increasing import competition on exports is negative. Imports will go up, exports will go down and the overall effect on both the trade balance and firms' export shares will be negative.19/ But the short-run impact of increasing domestic competition on exports is unambiguously positive: both net exports and export share will go up.

19/ This general claim is only subject to the above-mentioned qualification that, in the context of a general import liberalization, the additional indirect positive effect on exports of cheaper access to inputs at international prices can make the overall effect ambiguous.

ANNEX 3

Dumping and Anti-Dumping Policies

1. Dumping can be defined in two possible ways: as pricing export sales below domestic sales and as pricing export sales below average cost. Either circumstance constitutes dumping according to U.S. trade law, and other countries apply similar definitions. Note that in the second case the foreign firm that engages in dumping cross subsidizes losses with profits from the domestic market.

2. Generally, dumping is perceived as a particularly aggressive sales strategy, aimed at acquiring greater market shares and market power in the long run by deliberately sacrificing short-term profits.1/ From the point of view of the firm, such behavior would be justified if there is some stickiness in market shares. Otherwise, when the foreign firm finally raises its prices to reap the benefits of a larger market share, consumers will just switch back to domestic products and the foreign firm is stuck with the losses that it incurred in the period of dumping.

3. "Dumping," however, may reflect neither aggressive nor strategic behavior. It can arise simply as a result of international competition between foreign and domestic firms. It may occur "naturally" in oligopolistic industries when firms have fixed costs.2/ Furthermore, dumping may be aggressive without being strategic.3/ Still, the notion that dumping reflects "unjustly" aggressive or strategic behavior is frequently used to justify anti-dumping policies. In fact, GATT allows the use of anti-dumping duties if dumping "materially injures" the importing country.

4. The economic rationale for anti-dumping measures remains, however, unclear. Dumping improves the terms-of-trade of the importing country, which consequently experiences a real income again. Under competitive conditions, pure economic profits are zero, and the importing country is clearly better

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1/ Market shares might be sticky because consumers would interpret high shares as a sign of quality. In addition, producers might be able to stimulate brand loyalty through product differentiation. Finally, there might be certain demand externalities, so that it pays not to switch products in spite of higher prices.

2/ W.J. Ethier (1988) shows that dumping could be an outcome of simple one-period Cournot competition if firms do not maximize their profits strategically over time.

3/ Dixit (1988) discusses the case of an international oligopoly in which dumping is caused by a deliberate increase in "aggressiveness" of the foreign firms, as measured by their competitive response to output changes by domestic firms.

off.4/ Consumers gain from lower prices and no profits are transferred to foreign firms. Only under imperfect competition can dumping be harmful and anti-dumping measures be justified. In this case, dumping has the additional effect of shifting profits from home to foreign firms. Anti-dumping measures can help to capture back some of these profits, which might more than offset the losses in domestic consumer surplus from higher prices.

5. In general, an optimal trade policy regime in the presence of oligopolistic distortions in international markets can be designed with the help of two policy instruments, a production subsidy (or tax) and a tariff.5/ These instruments compensate for distortions by shifting profits from foreign to home firms. How does the use of these instruments vary when foreign firms become more aggressive and start practicing dumping? The answer is that a more competitive behavior by foreign firms lowers both the optimal production subsidy and the optimal tariff. The reason is intuitive: the production subsidy only has to compensate for a relatively smaller oligopolistic distortion, and there is less pure profit to be appropriated by imposing a tariff.6/ If a foreign firm is pricing its exports below average cost, then clearly no normative case for an antidumping duty can be made as there are no profits to be captured (although there still might be a case for an output--expanding production subsidy). Even if there are positive profits, however, the part appropriated domestically would have to be larger than the losses in consumer surplus generated by the antidumping tariff for a duty to be justified.7/

6. So far dumping was assumed to be the outcome of a deliberately more aggressive and competitive behavior by foreign firms. It was argued that antidumping duties against such procompetitive dumping would be welfare reducing. However, antidumping tariffs make more sense against strategic dumping aimed at increasing long-run market shares through short-run pricing

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4/ If owners of factors of production that are used intensively in import-competing industries are hurt, it is preferable to compensate them directly without resorting to trade restrictions.

5/ If a tariff is the only available instrument (often a general production subsidy is an unrealistic alternative), it takes over in part the role of the subsidy in increasing domestic production to counter oligopolistic distortions. This results in a higher "optimal tariff" than when a production subsidy is granted as well.

6/ Cf. A. Dixit (1988), which treats the case of an international oligopoly with quantity competition.

7/ Interestingly, countervailing duties increase social welfare in the same circumstances in which antidumping duties reduce it. The reason is that countervailing duties compensate for export subsidies by foreign governments that do not reflect competitive advantages. The losses in consumer welfare recurring from those duties would be fully offset by the gains in Government revenues and in the profits of domestic producers.

below cost.8/ They are an appropriate measure to counter attempts by foreign firms to shift long-run profits that are not based on significant cost advantages or sustained competitive behavior. Thus, antidumping duties are only justified to prevent strategic dumping that does not reflect a true competitive advantage by foreign firms. In other circumstances they lower consumer surplus by more than they increase the profits of domestic firms.

7. If antidumping duties are imposed, their exact specification can make a difference. Simply to charge a prohibitively high tariff is generally not optimal. Rather, it is advisable to make the duty proportional to the dumping margin (the difference between its ex-factory and fob price). This provides an incentive for domestic firms to behave competitively, thereby making it harder for foreign firms to increase their market shares. The penalty for dumping is increased and the duty becomes a more powerful deterrent.

8. Unfortunately, antidumping measures can be easily abused. Antidumping laws can be sufficiently vague as to allow domestic firms to file a complaint whenever they are seriously threatened by imports. For example, many Mexican antidumping cases have been initiated by national firms enjoying monopoly positions and dominant subsidiaries of private foreign firms, "...raising the possibility that the Mexican antidumping system is being captured by large firms for price-fixing reasons."9/ It is therefore crucial to impose antidumping duties only if domestic industry is materially hurt (for which there must be clear proof like significant layoffs or substantially lowered price-cost and profit margins that prevent necessary investments), and its losses clearly dominate the gains in consumer surplus resulting from dumping. All too often, antidumping duties are just the result of pressure from industrial lobbies and interest groups.

9. Finally, a general problem with antidumping duties as with many protectionist policies is to keep them temporary. Antidumping duties once imposed to protect domestic firms from dumping motivated by strategic profit-shifting considerations can easily turn into long-run protection of inefficient domestic producers.10/ In addition, antidumping duties can provoke similar measures by foreign governments and end up being just one step towards generally higher trade barriers.

8/ This, of course, only makes sense if market shares are sticky. See Section III on "barriers to import competition".

9/ See World Bank (1988c), p.124.

10/ It has been suggested that antidumping duties be subject to a "sunset" clause which consists of automatically repealing a protective measure after say, three to five years. Furthermore, it should be impossible to extend the protection beyond this term by simply filing a new case in the same matter. See World Bank, op.cit., p.129.

ANNEX 4

A Note on Competition Policy for Natural Monopolies

1. If a market is monopolized by a single producer producing non-tradeables and entry barriers are binding, the government might consider the break-up of the concern into independent units. This step, however, might not be economically advisable if scale economies are substantial relative to the size of the market. In those circumstances, the Government might want to establish price-constraining or output-setting regulations to minimize deadweight welfare losses. It might do that in a number of ways. It is willing to subsidize the monopolist, the first-best solution (Pe, Qe) can be achieved (Figure 2 of Annex 1).[1] If budgetary or other restrictions preclude the Government from subsidizing the monopolist, the second-best outcome would be the regulatory solution (Pr, Qr). It lies between the monopoly and the efficient outcomes, and is obtained by constraining the monopolist to zero economic profits (see Figure 2).

2. A more common alternative scheme is the one normally used for the regulation of public utilities; static efficiency is sacrificed to allow the producer to reap some pre-established level of profits that would provide the incentives and the resources for investment, productivity growth and dynamic efficiency gains. This however depends very much on the technical abilities of the regulatory body to establish the right structure of incentives, one which would drive the producer to cost-minimizing production techniques and practices within a growth-oriented strategy.[2]

3. These difficulties arise to a lesser extent in the case of a "natural" monopolist producing a tradeable good. Then, the regulatory solution would need to take into account the price differential between domestically produced goods and their equivalent available in the international market. Competitive imports would set an upper bound beyond which the monopolist could not cross without risking losing market share. These limits

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1/ Note in Figure 2 of Annex 1 that it is always efficient to expand production towards Qe, since in the interval (0, Qe), the consumers' willingness to pay (as given by the demand curve) is always greater than marginal cost, and whatever losses occur between due to the difference between average cost and price, they merely represent a pure transfer between the Government and consumers.

2/ The fact that most public utilities in developing countries are state enterprises is explained in large part by the difficulties of balancing the interest of consumers (and thus moving towards efficient prices and an adequate supply of services) and producers (and thus allowing for significant rent-absorption). This was aggravated by the perception that private owners of these utilities had undue influence over government decisions.

are however elastic and in many cases allow for substantial rent-absorption. They depend on the availability of efficient distribution channels and service networks, and an irreversible commitment by the Government to a reasonably open market. Moreover, if the domestic monopolist is more efficient than foreign competitors, import competition would not be sufficient to constrain the monopolist to zero profits. In such cases, the Government might have to combine import competition with some degree of regulatory control.

4. Although "natural" monopolies are not faced with domestic rivalry for export markets, they have nonetheless to face competition by other international firms. To the extent that the requirements of international markets are sufficiently tight that they force management to adopt a progressive conduct, the government should push the domestic monopolist out. The pitfall of such a strategy is clear: through price discrimination (or discrimination along any other product characteristic), the monopolist can effectively shift the cost of penetrating and remaining in export markets to the domestic consumers (on the presumption that domestic and export markets are segmented). Nonetheless, the positive externalities from export activities in terms of improved quality, reliability and technical performance do tend over time to spill over to domestic consumers.

5. In sum, the competition policy for "natural" monopolies producing tradeable which is simultaneously welfare improving for domestic consumers and would force the monopolistic to allocate rents to productivity improving measures, would need to integrate policies promoting import competition and export rivalry with elements of regulatory control to curb the exercise of monopoly power in the domestic market. Consumers should be protected against unfair trade practices and other behavior that is detrimental to the public interest by some quasi-judicial agency established for this purpose. And the monopolist should be progressively forced to face international competition abroad and at home.

DRAFT

INDUSTRIAL RESTRUCTURING -

POLICY AND PRACTICE

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INDUSTRIAL RESTRUCTURING - POLICY AND PRACTICE

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EXECUTIVE SUMMARY AND INTRODUCTION

(i) Industrial restructuring involves actions by enterprises to become internationally competitive. Firms are prompted by policy, regulatory and institutional changes to take these actions. Restructuring is said to have occurred when a firm, a subsector or an industry has shifted to a product mix and cost structure that is competitive now--and positioned dynamically to remain competitive.

(ii) Experience shows that restructuring at the firm level will not take place automatically in response to macroeconomic policy changes or rapid shifts in global conditions. Governments need to establish policies that facilitate flexible movement of resources, promote institutions capable of filling information gaps, and ensure that appropriate financing is available. Policies and institutional programs can help scale down uncompetitive industrial activities, reshape those capable of being internationally competitive, and enlarge the share of promising new activities.

(iii) This paper examines the reasons for restructuring and outlines the policies and institutions needed to make it effective. The evolution of Bank lending for industrial restructuring is described, with lessons learned from past operations highlighted. The purpose of the paper is to provide guidance on the design and implementation of Bank-supported industrial restructuring programs. The paper identifies core industry and trade policies; outlines key elements in successful approaches to subsector and enterprise restructuring; and describes the financial policies, instruments, and institutions required to promote industrial restructuring.

Policies as Preconditions for Effective Restructuring

(iv) The Bank has supported industrial restructuring programs since 1980, beginning with narrow physical rehabilitation of a few public enterprises, evolving into operations with increased attention to policy and institutional change at subsector and industry-wide levels. Experience demonstrates that industrial restructuring operations can be effective only as complements to policies that promote efficient, competitive supply responses by industrial enterprises. In addition to sound macroeconomic policies, the following measures need to take place prior to an industrial restructuring operation--at least in those subsectors covered by the operation:

- Removal, or significant reduction, of barriers to entry, exit and expansion of industrial enterprises.

- Elimination of policy-induced public or private sector industrial monopolies. When domestic competition is inadequate to force efficiency in production, import competition is required, particularly in key intermediates, e.g., steel, fertilizers, petrochemicals, cement.

- Elimination or major reduction in subsidies, unilateral transfers, and "special deals" for certain enterprises.

- Institution of market-oriented pricing policies.

(v) These policy measures can be incorporated as preconditions of an industrial restructuring operation, supported under parallel adjustment operations, or undertaken independently as part of the government's overall policy reform program. Experience indicates that physical rehabilitation and financial restructuring of industrial enterprises will not result in significant performance improvements unless competitive pressures force firms to improve their organizational and operational efficiency.

Industrial Subsector Restructuring

(vi) The World Bank has supported restructuring of private enterprises at subsector level, as well as the restructuring of state-owned industrial enterprises. World Bank support for private enterprise restructuring almost always is indirect. Credit is provided through the financial system and technical and marketing services through financial, commercial or government agents. In many cases, a subsector focus in such operations is useful. Subsector diagnoses help pinpoint key success factors for global competitiveness in major product groups and identify major gaps between domestic and international practice in technology, organization and marketing. Since competitive requirements are specific to different product market segments, services to provide market information and build capabilities often are best geared to specific subsectors.

(vii) World Bank-supported industrial subsector restructuring operations need to incorporate institutional programs that help firms develop competence in critical functional areas. Such programs can include:

- Measures to help individual firms devise export marketing strategies and productivity improvement programs;

- Human resource development programs aimed at creating a flexible, technical labor force and management;

- Funding for research and development, with a focus on applying technologies available internationally to domestic uses; and

- Mechanisms to help firms form strategic alliances with companies operating globally.

(viii) Given rapid changes in technology and markets and the increasing focus on exports, financial intermediaries need to develop product specific technical and marketing expertise in project evaluation. In some Bank-supported operations, subsector credit allocations

have been justified on the grounds of providing this focus. However, such credit allocations can create distortions, rigidities and problems in attempting to predict future investment areas. Subsector credit allocations should be avoided. It is preferable to involve financial intermediaries in subsector diagnoses and to make them responsible for technical assistance components which provide direct exposure to technology and marketing issues in the major product groups.

Restructuring State-Owned Industrial Enterprises

(ix) Major debt, fiscal and financial sector problems being faced by many developing countries mean that they cannot afford to maintain insolvent, uncompetitive public industrial enterprises. Programs to close and downsize nonviable public enterprises--and deep restructuring of those that can be competitive--deserve priority attention. In restructuring large and powerful public enterprises (PEs), overall competition policies need to be combined with explicit measures to remove or reduce the special benefits that public enterprises usually receive: subsidies, sales arrangements with other PEs, and monopolies on sourcing, production, and sales. Due to their monopoly status, soft financing, and mixed mandates, many PEs have used their monopoly power to absorb related enterprises or have expanded into unrelated businesses. Tough decisions, based on solid subsector and enterprise analysis, are needed to unwind these PE-specific distortions.

(x) Physical rehabilitation and financial restructuring of public enterprises have not succeeded, unless they were accompanied by policies requiring competitive performance, and by enterprise-level changes in management, organization, technology, and marketing strategies and capabilities. Also, limited results have been achieved (or can be expected) through management information, performance evaluation, or performance contract systems. Improved transparency and management information systems are useful only as complementary systems once real power and financial relationships (subsidies, transfers, special credits) change.

(xi) Key Success Factors. The following approaches are basic to sound restructuring programs involving government-owned enterprises.

- Industrial firms should exist to provide goods and services at competitive prices and quality. The objective should be reduction and ultimate removal of producer and consumer subsidies. Public industrial enterprises should pay their own way--or have clearly demonstrated prospects for doing so after restructuring.

- Incremental investments in public enterprises should be supported only if international competitiveness in price and quality will be achieved or approached as a result of the restructuring operation. This is particularly critical in basic intermediates--steel, petrochemicals, fertilizers--since inefficient public enterprises undermine prospects for competitiveness of downstream users. When a company is a

domestic monopoly, competition from imports often is the primary mechanism for promoting efficiency.

- Means to increase participation of local and foreign private sector partners should be explored actively. Joint ventures or strong collaborative arrangements with successful foreign firms operating globally should be promoted, as these can provide funding, create external pressure for competitive performance, and introduce best international practices.

- For enterprises remaining in the public sector, power relationships need to change, with government becoming an arms-length shareholder in the firms it oversees. Holding companies--often seen as a mechanism for distancing the bureaucracy from the enterprises--are important only if they have budget responsibilities for public enterprises and are free to liquidate, privatize, or form joint ventures. Otherwise, holding companies are just another layer of controls.

- Public enterprise restructuring programs should address issues of labor redundancy; compensatory payments as incentives for voluntary redeployment; and retraining of management and labor.

- Given the extreme complexities, strong social and political dimensions, and tenuous nature of public enterprise restructuring programs, strong government commitment is critically important. This commitment needs to be evidenced by concrete actions that have been implemented and by a convincing program of measurable actions agreed to by all participants.

(xii) Privatization can be an important means to achieve competitiveness and to reduce political interference. However, the selling of public enterprises poses formidable issues. The number of potential buyers often is limited, and capital markets in developing countries often are inadequate for absorbing divestitures. Also, if not properly implemented, privatization may merely replace public with private monopolies.

(xiii) Other means to increase private participation in ownership and management of public industrial enterprises include employee buy-outs, leasing of assets, direct sales of all or part of the enterprise, off-loading of marginal activities, and formation of joint ventures with local or foreign private partners. Potential benefits of such measures to increase private participation include more efficient use and reduced drains on scarce public sector resources; less crowding out of the private sector in domestic capital markets; and more transparency in the industrial sector, increasing confidence of investors. Perhaps the most effective and pragmatic means to increase private participation is the downsizing of existing public enterprises, limiting future expansion to give room to private initiatives.

Financial Sector and Industrial Restructuring

(xiv) A well-functioning financial sector is a prerequisite for industrial restructuring. In countries in deep financial distress, sound new investments can take place only after restructuring of the industrial portfolios of insolvent intermediaries, and only after dealing explicitly with nonperforming assets. Without restructuring of the financial system, banks will bail out unhealthy investments, thus pushing financial costs up and healthy new investments out. To improve the financial health and efficiency of the banking system, governments must introduce regulatory incentives and initiate financial restructuring of affected intermediaries, so that only financially sound intermediaries survive. These systemic reforms are best tackled with support of financial sector adjustment operations.

(xv) In industrial restructuring projects which involve credit lines, through financial intermediaries, care is needed to ensure that: only sound and solvent institutions are used; basic principles of corporate finance are employed; and appropriate instruments and eligible expenditures are incorporated.

(xvi) Financial assistance for industrial restructuring programs differs substantially from financing under traditional development finance operations. Under previous credit lines, the World Bank offered long-term loans for investments in equipment and as permanent working capital, relying primarily on government-owned development finance institutions (DFIs) to make loans to companies directly and through refinancing arrangements. In restructuring operations (and in new credit lines) the World Bank will need to be more selective in the use of financial intermediaries.

(xvii) Despite ostensibly superior capacity for project appraisal, development banks have lent--and lost--large sums for unviable projects, have experienced related deterioration in portfolio quality, and have serious solvency problems. Many commercial banks are capable of handling corporate finance and equity investments. Successful commercial banks have strong market knowledge, financial engineering expertise, and long standing relationships with industrial clients. The commercial banks--and the small but growing group of investment banks--could become the primary channel for the Bank's financial intermediation loans, especially in industrial restructuring programs.

(xviii) Eligible expenditures could be expanded include investments in research and development, and incremental marketing and distribution expenses. Bank funds do not now finance acquisition of domestic companies because acquisitions involve transfer of the ownership of existing assets rather than creation of new assets; a change in policy could be considered here to provide another means for effective restructuring.

(xix) Investments in equipment and working capital may require parallel financial restructuring of a company. Restructuring of a company's liabilities can comprise: maturity extension, debt consolidation, and debt/equity conversion. The Bank's policies currently do not allow direct financing of these instruments.

World Bank Lending Experience

(xx) The World Bank has had a significant and growing role in industrial restructuring. From FY80 to FY88 the Bank provided about US$3.8 billion for over 50 industrial rehabilitation or restructuring projects. More than 70% of this lending was in the FY86 to FY88 period. These projects mark successive shifts from the industrial lending strategy of the 1960s and 1970s. During the earlier period, the Bank supported "greenfield" industrial projects geared to create new capacity, mainly in capital-intensive government-owned enterprises. In the early 1980s, the Bank shifted its focus to physical rehabilitation projects, which dealt primarily with modernizing public sector enterprises. These rehabilitation operations reflected the hope that plant modernization and cost-plus pricing would be enough. Insufficient attention was paid to organization, marketing, or management weaknesses. The focus was on financial solvency of a few public enterprises. Market pricing, import and export competition, entry and exit barriers and government intervention were not concerns of most operations. The weak results of these narrow approaches and the economic costs of business-as-usual became apparent to Bank staff and many policymakers by the mid 1980s.

(xxi) Industrial restructuring loans in the second half of the 1980s have given more importance to policy, institutional, and management reform. The increased lending for subsector and sector-wide restructuring in the FY85 to FY88 period facilitated this enlarged scope.

(xxii) The FY89 to FY91 pipeline includes US$5.4 billion for 41 industrial subsector and restructuring loans. In addition, the bulk of the Bank's projected US$6.5 billion in FY89 to FY91 lending through financial intermediaries is likely to fund existing industrial enterprises, which need to restructure their operations to respond to changing policies and competitive conditions.

(xxiii) This report reflects analysis of over 50 Bank-supported industrial restructuring operations in 29 countries, initiated in the FY80 to FY88 period. Narrow physical rehabilitation approaches, typifying FY80 to FY85 operations, have not proven to be effective. While it is still early to judge the effectiveness of broader subsector and industry-wide approaches, assessment of project documents and interviews of task managers highlight important lessons for the next generation of industrial restructuring operations. In Volume II, Annex 1 provides a matrix of the basic features, objectives, components and lessons on the 50 restructuring operations. Annex 2 provides fifteen case studies of industrial restructuring operations, with lessons learned.

(xxiv) First, the most critical factor for success is the involvement in all phases of competent, committed local participants. Second, restructuring operations should be geared to promote competitive responses to rapid global changes and policy shifts. Third, global subsector studies--which assess key success factors in cost, quality, technology and marketing--are important in judging whether enterprise restructuring will make firms internationally competitive.

(xxv) Fourth, Bank restructuring projects cannot succeed if they deal primarily with physical aspects--without giving adequate attention to regulatory policy issues, ownership, and organization. Fifth, in Bank lending operations supporting parastatals with monopoly status, at a minimum, competitive pressures should be created by removing entry barriers, liberalizing imports, and/or breaking up monopolies. Sixth, minimum regulatory, pricing, and public enterprise reforms should be agreed upon as part of restructuring operations or supported by parallel adjustment operations. Seventh, industrial restructuring requires a five to ten year commitment to change. Eighth, a coherent, sequenced restructuring program, over that period, phased as several back-to-back projects, is desirable. Ninth, being an ongoing process, restructuring operations need more than usual Bank supervision, and are therefore resource-intensive.

(xxvi) Tenth, solvent, competent financial intermediaries should be used, with appropriate financial instruments introduced to meet distinct needs of industrial restructuring. Eleventh, finance for marketing, research and development, retraining, and production systems are important in restructuring and should be included in a wider definition of eligible expenditures. Twelfth, since restructuring almost always has adverse short-term employment consequences, worker retraining and, in selected cases, severance payments warrant support.

CHAPTER I

POLICIES FOR INDUSTRIAL RESTRUCTURING

A. Key Policy Dimensions

1.01 A business environment that rewards efficient performance is necessary if enterprises, subsectors, and industry overall are to restructure toward global competitiveness. Successful restructuring depends on a framework with the following critical elements:

(a) macroeconomic policies geared to providing a stable business environment, with exchange rates adjusted to maintain equilibrium between domestic and international prices, and with prudent public revenue and expenditure practices;

(b) effective competition policies combining: phased-in import liberalization; changes in regulations and incentives to reduce domestic barriers to entry, exit, and expansion; and export rivalry measures;

(c) liberalization of factor and final output prices; and

(d) institutional services and infrastructure to aid firm-level restructuring, e.g., effective market information/consulting extension services, human resource development, telecommunications, transport, power.

Table 1.1 provides a detailed breakdown of instruments in these main areas.

1.02 Some recent World Bank industrial sector reports have increased the analysis of the mix and phasing of macroeconomic, trade, and regulatory policy reforms. The Bank's 1988 Industrial Sector Study on Argentina, based on analyses of industrial structure and performance, recommended the phasing of domestic regulatory and price reforms, liberalization of import tariffs, and phasing out of special incentives. In India, sector work analyzed needed changes in entry, exit and expansion regulations, with the first set of reforms supported under the Industrial Export Project-Engineering Products, a restructuring operation.[1]

1/ See India--Industrial Export Project, Engineering Products, Staff Appraisal Report, 1985, and India--Industrial Regulatory Policy Study, World Bank Report No. 6479-IN, December 9, 1986; Argentina--Industrial Sector Study, World Bank Report No. 6990-AR, April 11, 1988.

Table 1.1: MAJOR COMPONENTS OF THE POLICY AND INSTITUTIONAL ENVIRONMENT

1. Macroeconomic Policies

   - Exchange rate regime--means to increase competitive pressures and use external markets as the signal for resource allocation and use
   - Fiscal and credit policies--means to the problem of public expenditures squeezing out private restructuring and development financing

2. Competition Policies

   A. Import Liberalization--quantitative import restrictions, import tariffs, import taxes, administrative import controls, and other import restrictions

   B. Free Trade Regime for Exports--duty drawbacks and duty exemption schemes for imported inputs for export production; pre- and post-shipment credit and insurance for exports and related imports, production; and export-import administration, including customs

   C. Internal Regulations and Incentives

   - Licensing, subsidy and incentive barriers to entry, exit and expansion of industrial capacity. These regulations--including weaknesses in bankruptcy law, limits on enterprise size, licensing of new capacity--reduces the flexibility of the domestic productive base, and constrains the ability of existing and new enterprises to respond to new competitive challenges
   - Taxation, subsidies, incentives, discretionary access to foreign exchange and other measures reflecting mixed objectives, and reducing the focus on efficient, competitive performance
   - Constraints on foreign collaboration--including limitations on direct foreign investment, royalty payments, repatriation of profits, intellectual property rights--limits domestic firms' access to best practice production technology and marketing/distribution networks
   - Protection of state-owned enterprises--including public monopolies, special pricing and procurement arrangements, direct subsidies, and access to special budgetary or bank credit--insulates state-owned enterprises from domestic or external competitive pressures, thus limiting the incentives to restructure
   - Price controls--represent a strong distortion in many developing economies, reducing the role of market pricing signals in guiding resource allocation and use

3. Domestic Factor Prices

   - Pricing: prices for inputs, utilities, transportation, and basic consumer goods; subsidies
   - Labor: minimum wage; ease of lay-off (by regulation or in practice); mobility; retraining; severance pay; hiring practices; unionization
   - Taxation: level and coverage of corporate taxation; concessions and exemptions; dividends; depreciation rules; carry over; profits of foreign investors
   - Enterprise autonomy: freedom of entry or exit; operational autonomy

4. Infrastructure, Institutional, and Proactive Services

   - Information services: economic statistics; trade data; export market information
   - Physical infrastructure: power, transport, communication, water,ports
   - Development of human resources: education, vocational training; management development
   - Marketing: distribution/promotion; warehousing; trading
   - Technological development: standard institute; quality control and testing laboratories; technology; information system; R&D centers and support
   - Consulting Services: engineering; market/marketing; maintenance; legal; accounting (auditing and taxation)
   - Accounting: auditing standards.

1.03 Bank-supported restructuring projects increasingly recognize the importance of interrelated policy reforms. An integrated approach toward policy and institutional reform characterizes the Hungarian government's systematic, phased program--supported by the Bank with a series of industrial restructuring operations.[2] Senegal's sectorwide restructuring effort includes comprehensive policy reforms supported by a series of prior structural adjustment loans (SALs).[3]

Macroeconomic Policy

1.04 Industrial restructuring operations are not feasible in the midst of serious macroeconomic instability. The main macroeconomic issues affecting restructuring operations are the relative, trade-weighted exchange rate, and fiscal and credit policies. Developing countries often maintain overvalued, unrealistic exchange rates that make import substitution activities artificially profitable. Inflation, fueled mainly by public sector deficit spending, also represents a serious destabilizing element in many developing countries. Restructuring projects cannot be expected to shift macro policies; conditionality under adjustment loans will continue to be the appropriate means to support macroeconomic reforms.

Competition Policies

1.05 Industrial restructuring operations should support directly or be used to complement import liberalization, domestic regulatory and incentive reforms, and export rivalry measures--all geared to use competition as a tool for inducing competitive decisions by industrial firms. This mix of competition policies is treated fully in the companion paper, Competitive Policies for Industrializing Countries. This chapter focuses on those policies and practices which most often hinder competitive industrial restructuring.

1.06 An example of appropriate Bank support for policy change and industrial restructuring programs is Mexico. Mexico's adherence to GATT in 1986, and its decision to remove most industrial QRs, reduce protection, and harmonize tariff classifications, were measures supported by two quick-disbursing Bank trade policy loans. Major barriers to entry, exit, and expansion of domestic and foreign firms were subsequently reviewed, with reform to be supported under a proposed FY89 industrial sector loan. Simultaneously, industrial restructuring operations, with preparation initiated in 1986, will help public and private enterprises meet rapid changes in policy signals and global conditions. Mexico's

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2/ See Hungary--Industrial Restructuring Project, World Bank Report No. 6069-HU, May 7, 1986.

3/ Senegal--Industrial Restructuring, Bank Document No. 6947-SE, November 25, 1987.

case reflects serious commitment to trade reform and enterprise restructuring. It also reflects recognition of the critical importance of internal regulatory and incentive reforms, to give domestic enterprises the needed flexibility to respond to competitive challenges.

1.07 Regulatory Framework. Industrial regulations cover an array of laws, rules, and regulations governing the commercial operation of firms. Of greatest relevance to restructuring are those that deter competition, generally defined as barriers to entry, exit, and expansion. Barriers to entry and expansion include licensing of new capacity, limits on the size of firms, and restrictions on ownership. Barriers to exit encompass laws on bankruptcy, liquidation, and downsizing of firms.

1.08 Typically, entry barriers protect dominant local enterprises. Policies designed to foster infant industries often ossify into protection for monopolies or oligopolistic firms. Such progressive rigidities can be byproducts of import substitution strategies, with governments and firms often colluding to make domestic production capacity equal domestic demand. Entry barriers inhibit real competition. As a result, the gap in competitiveness between firms operating in the world market and enterprises operating in protected subsectors increases.

1.09 Capacity and Import Licensing Procedures. Complex licensing processes--which are long and costly--discriminate against small enterprises that cannot afford the costs or the time. Often several ministries are involved, each deploying different, highly opaque criteria. This complexity in procedures has led to the growth of a large informal sector in many developing countries, where firms operate outside the purview of regulations and taxes, and forego access to formal sector financing, incentives, and services.

1.10 Reservation of Strategic and Priority Sectors. Many developing countries reserve basic industries and services (steel, fertilizers, petrochemicals, oil and gas, and telecommunications) exclusively for state-owned enterprises. Arguments for parastatal monopolies refer to their strategic nature and large-scale financing requirements. Many of these concerns are anachronistic, and the financial and economic costs of monopoly practices are high. Ownership regulations often preclude domestic firms' access to technology, organization, and marketing channels that foreign firms can provide. Privatization of monopolies can sort out mixed objectives, emphasizing those directly related to efficiency, provided that monopoly status is removed, since private monopolies have not demonstrated better performance than public monopolies.[4]

4/ From M.A. Ayub and S.O. Hegstad, Public Industrial Enterprises - Determinants of Performance, World Bank, 1986.

1.11 Limits on firm size can result in major distortions. In India, reservation of certain products for exclusive production by small firms, and other targeted incentives, resulted in enterprise fragmentation, capital-intensive small industries, and low efficiency in industrial segments with clear returns to scale. In Poland, the limits on private enterprise size, combined with import protection and regulations that carve up product-markets among public firms, leave most markets in the hands of uncontested cartels.

1.12 Exit barriers include anticlosure regulations, inadequate bankruptcy and foreclosure legislation, government subsidies for failing enterprises, and low-cost loans to prop up bad investments. A loss-making government-owned enterprise that a government refuses to close often requires debt forgiveness, preferential credits, and other special arrangements. Government budgets and the financial system deploy scarce resources to bolster inefficient firms rather than for competitive investments. Also, foreign exchange constraints can lead governments to make imported inputs available only to existing firms. In a phoenix effect, failing firms make efforts to survive by engaging in predatory pricing and other short-term strategies to attract business, thus reducing overall industry margins and new investments in the subsector. Particularly in now prevalent situations of financial stringency, barriers to the exit of inefficient firms become barriers to entry of new companies.

1.13 Exit barriers tend to be major hurdles for industrial restructuring. If policies make it difficult for firms to get out of unsuccessful ventures, enterprise owners and managers will be risk-averse in undertaking new activities. Exit barriers often block decisive restructuring and investment approaches; managers choose to expand operations in increments, even if uneconomical, to avoid the risk of more significant investment decisions.

1.14 The fundamental link between entry and exit barriers and successful restructuring programs should be clear. Laws that facilitate mergers, acquisitions, reorganization, and bankruptcy are vital tools for competitive industrial restructuring. Firms that have failed financially and economically must be allowed to fail legally, or the country's industry structure will remain stagnant and unproductive.

1.15 Direct Foreign Investment/Technology Transfer. Foreign collaboration can be an important ingredient of successful enterprise restructuring, particularly when competitive technologies are closely held, when export marketing links are crucial, or when the infusion of outside organizational methods and accountability is needed to alter the operations of an enterprise. Yet government policies often preclude or discourage direct foreign investment (DFI) through such laws and regulations as:

- preservation of "strategic" or "priority" subsectors for SOEs or domestic investors;

- non-transparent licensing procedures, subject to case by case negotiations;

- limits on capital and profit repatriation; and

- nationalization or expropriation of private holdings.

1.16 Brazil's decision to limit the development of the computer industry to national companies, and India's decision not to allow IBM to enter its market as a 100% foreign-owned company, are clear examples of policy barriers to direct foreign investment. Mexico reversed its policy on DFI for the computer industry in 1985--allowing the entry of IBM as 100% foreign owned--and subsequently attracted many other major international manufacturers. As part of the agreement, IBM committed itself to exporting a large percentage of its microcomputer production from Mexico. In addition, the computer industry has spawned national companies that import components and assemble and sell IBM clones in the domestic market in competition with the major foreign producers. Still, until very recently, Mexico's DFI policy remained subject to case by case approval and lacked the transparency for easily attracting DFI. Also, Mexico and other developing countries have found that macro-economic stability is more important than specific DFI regulations in regaining business confidence and attracting additional foreign investment.[5]

Domestic Factor and Output Prices

1.17 Pricing. The link between pricing policies and restructuring operations is direct. Too often, firms--particularly state-owned enterprises--operate under controlled pricing policies which either guarantee a return regardless of efficiency, or preclude commercial viability. Governments bail out enterprises with budgetary transfers or subsidies. Increasingly, Bank-supported restructuring programs dealing with public enterprises emphasize pricing reforms, with the objective of allowing prices to move toward world market levels.[6] One issue concerns the transition period for price adjustments, given social and political constraints and inflationary impact. Should market prices be introduced immediately and across the board or in selected subsectors?

5/ See Carl Dahlman, Mexico: Direct Foreign Investment Prospects and Strategies 1988, World Bank Report No. 7146-ME; Jung-Taik Hyun and Katherine Whitmore, Japanese DFI: Patterns and Implications for Developing Countries, 1988; and Ashoka Mody, Changing Firm Boundaries: Analysis of Technology-Sharing Alliances.

6/ Examples of restructuring projects that included measures to remove or reduce subsidies and price controls are the cement project in India; fertilizer and energy saving projects in China; the Bangchak Oil Refinery Restructuring Project in Thailand; steel and fertilizer restructuring projects in Mexico. However, Mexico has recently reintroduced price controls, under an overall stabilization program.

Can this be done without new pricing distortions? These issues have been particularly difficult for centrally planned economies such as China, Hungary and Poland, which are attempting more market-based approaches. New pricing policies in basic subsectors such as steel, fertilizer, and energy production have been difficult for large, heavily regulated economies such as India, Pakistan, and Argentina as well. Yet, introduction of market pricing is critical if industrial enterprises are to behave as commercial concerns.

1.18 Labor Policies. Labor policies may form a substantial barrier to restructuring, with unions representing a powerful political force in industry-labor-government relations. Layoffs may be restricted or prohibited under law. In other cases, regionally or ethnically concentrated layoffs may provoke political resistance. The Bank has been reluctant to confront labor issues. Yet worker retraining, retrenchment schemes, and employee buyouts are important to the success of restructuring programs. The Senegal Industrial Sector Restructuring project was one of the first to calculate the loss of jobs with and without restructuring, showing eventual job losses greater without restructuring. The Senegal project also incorporates components for vocational training and redeployment of the labor force.

1.19 Taxation. Taxation policies may be a major disincentive to restructuring investments. Policies encompass exemptions, corporate taxation, loss carryovers, depreciation and amortization allowances, deferrals and allowable deductions, treatment of dividends, and repatriation of profits by foreign investors. Poland is an example where frequent and erratic changes in tax policies since 1981 have frustrated the country's economic reform and have eroded enterprises' confidence in reform altogether.

B. Positive vs. Defensive Restructuring

1.20 A key judgement needs to be made about the size of the gap between local and globally competitive performance--in cost, design, quality control, delivery, and marketing. A critical point is when restructuring becomes a necessity vs. the point at which no measure of restructuring will restore international competitiveness. In the second case, the options are to free up resources by drawing capacity down, eventually to zero, or to extend the life of an unviable entity through government and consumer transfers. Investment in subsectors that have reached the second stage is rarely a fruitful use of scarce resources. In many industrializing countries, some subsectors have reached the first threshold, with restructuring necessary and still viable, provided the competitive gap can be eliminated or reduced dramatically over a short period.

1.21 A key requirement in closing the gap is to use competition as a tool to promote industrial efficiency. Domestic, import, and export rivalry are three elements at the core of a competition policy for industrial restructuring. (The companion paper on Competition Policies for Industrializing Countries deals in detail with these

dimensions.) Two aspects are critical in policy and regulatory change: consistency and appropriate sequencing of reforms; and continuity of reforms over the medium term providing predictability in the incentive framework. Both are important in reducing business uncertainty, increasing confidence, and increasing the chances that the necessary supply response will occur. Hungary's industrial restructuring program has worked over a five-year timespan to implement a coherent of program economic policy, industrial regulatory, and financial reforms. Necessary adjustments and corrections have been made and, at times, second-best solutions adopted; nevertheless, the reforms have operated in a coherent, announced framework.

C. Infrastructure and Services

1.22 While the World Bank has funded extensive infrastructure investments, the problems of inadequate and high cost infrastructure undermining industrial competitiveness have not been dealt with adequately. The costs and efficiency of ports, roads, water, electricity, and telecommunications need to be linked more closely with industrial competitiveness. Some developing countries are exploring financing from the private sector for infrastructure investments.7/ Private investment reduces the fiscal burden on government and facili-tates private sector construction and efficient delivery of services.

1.23 Also crucial are other components of the service sector--information, marketing, technology transfer, and investment banking. Plans for competitive industrial restructuring should include organizational and technology process transfers. Developing countries need to reorient DFI policies, research and development, and education and vocational training institutions to take advantage of the new competitive challenges. Governments should devote substantial resources to: developing a flexible, technical labor poor; helping fill information and knowhow gaps on global technology and market developments; and upgrading infrastructure. Privatization, closure and downsizing public industrial enterprises make resources available for these vital new services.

7/ One method of private sector funding is through BOT (build, own/operate, and transfer) schemes. These have grown rapidly in developing countries, such as Malaysia and Turkey. BOT involves partnerships between public agencies providing infrastructure services and private investors who agree to take over such services. See Charles Vulstyke, Techniques of Privatization, World Bank Publication, 1988.

CHAPTER II

RESTRUCTURING INDUSTRIAL SUBSECTORS

2.01 This chapter provides a framework for designing and implementing industrial subsector operations. It highlights criteria for selecting subsectors, the scope of diagnostic studies and projects, arrangements for government and private sector participation, and the role of the Bank.

A. What is Subsector Restructuring?

2.02 Under subsector restructuring, incentives and institutions are altered to force and facilitate structural change and competitive performance by enterprises in selected product groups.

2.03 Some recent subsector restructuring operations treat policy. subsector strategy, and enterprise dimensions systematically. The following examples of Bank-supported operations demonstrate how different the scope and content of subsector restructuring operations can be:

- The Hungary Industrial Restructuring Program involves phased trade, industrial, financial and labor policy reforms--cutting across subsectors. Industrial restructuring projects support these reforms and tackle restructuring in priority subsectors.

- The India Industrial Export Project-Engineering Products supported major reforms in domestic regulatory and incentive policies, and has provided innovative technical assistance and credit mechanisms for productivity improvement, export marketing, and restructuring of private industrial firms.

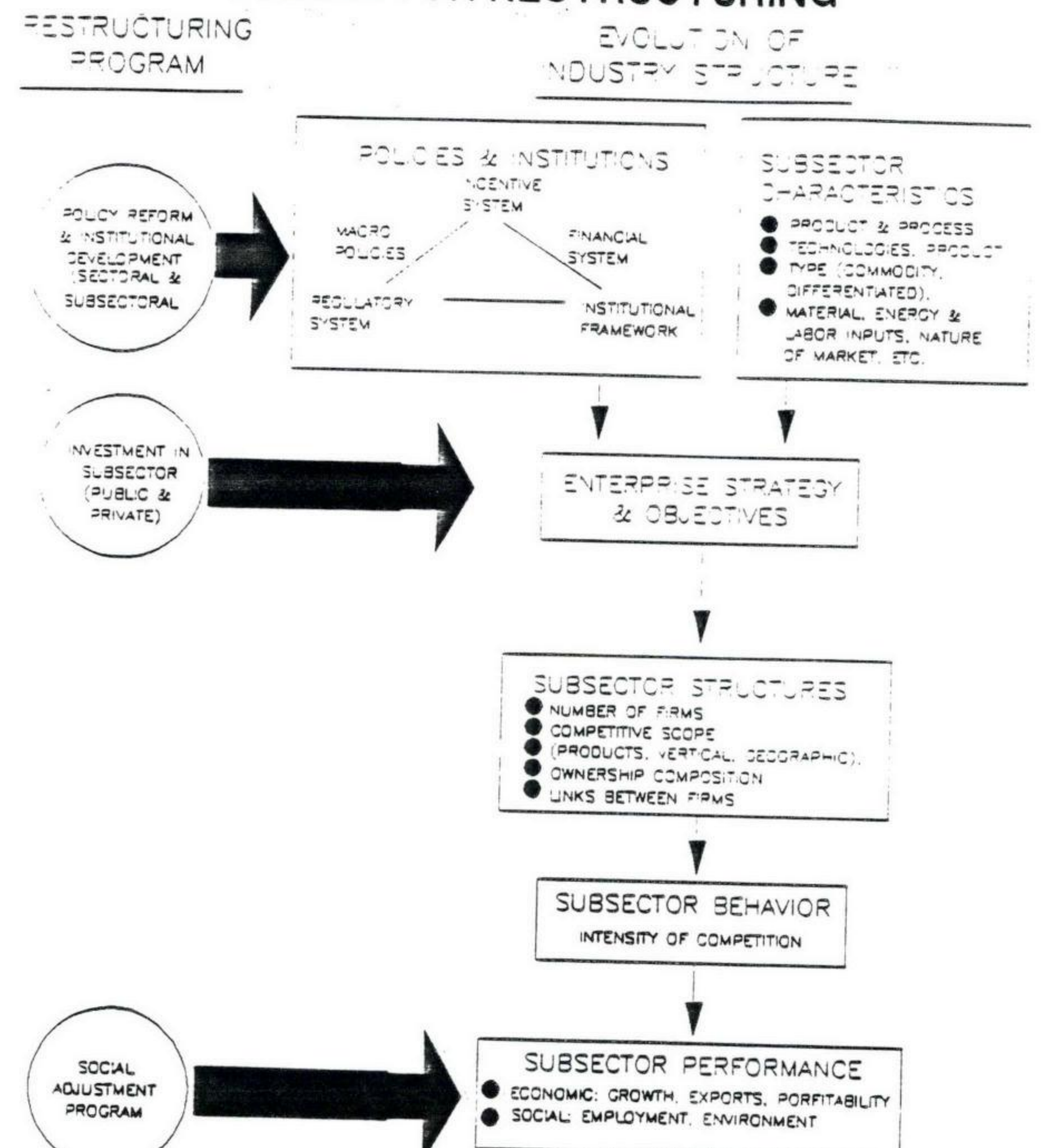
- In Mexico, three operations affect: (i) fertilizer, with one parastatal monopoly comprising the sector; (ii) steel--major public and private holdings are restructuring; and (iii) multiple subsector restructuring, which focuses on reforming policies and improving capabilities of private enterprises in textiles, auto parts, and agroindustry.

- The Senegal restructuring program, designed to complement macro reform, involved detailed analysis of restructuring needs in agroindustrial and textiles companies. The project incorporates a credit line and components for labor training and alternative employment generation.

These and other subsector restructuring operations are described in Annexes 1 and 2.

2.04 As charted in Figure 2.1 and detailed in Annex 3, subsector restructuring involves a dynamic interaction of factors, including policies and institutions, subsector structure and characteristics, enterprise strategies and performance, and human and financial resources.

Figure 2.1
SUBSECTOR RESTRUCTURING



B. <u>When to Restructure Subsectors</u>

2.05 A subsector approach might be described as targeting--trying to pick winners. Such product targeting, pursued with varying results in East Asia, run major risks when a developing country government has weak skills in assessing winners and in implementing programs required to create comparative advantage. At the same time, countries without clear information and know-how on what is happening in global product-markets are lost. Countries and companies must know what is required to be competitive in specific product-markets. A number of situations can motivate a concerted effort to restructure selected subsectors:

(a) <u>Dominant subsectors</u>. One or a few subsectors may dominate industrial output or exports, meaning that a focused subsector restructuring effort may have significant overall economic impact.

(b) <u>Losing subsectors</u>. One or a few subsectors may have a dramatically adverse effect on the public sector budget (due to heavy enterprise losses, subsidies or recapitalization outlays).

(c) <u>Downstream impact</u>. Many producers of basic industrial inputs--usually government-owned and protected enterprises--make high-cost, low-quality products, undermining prospects for downstream industries. Often, monopoly status and other special deals mute overall market signals.

(d) <u>Demonstration effect</u>. In countries characterized by severe policy-induced inefficiencies, a history of inward-orientation, and weak political will to reform, a major subsector-specific restructuring program can have a substantial demonstration effect. Deep reforms in competition policies in a major subsector can be combined with financial, technical, and marketing support for firm-level restructuring. If, as has been the case in some subsectors in India, the result can be improved competitiveness of output and exports, governments may be less reluctant to take similar steps in other subsectors or industry-wide.

(e) <u>Backing winners</u>. East Asian programs directed at creating new areas of comparative advantage have been accompanied by substantial, explicit maneuvers to downsize older industries that had lost their attractiveness, e.g., the shipbuilding industry in Japan. This approach--downsizing the old to make room for the new, and filling functional gaps through focused technology adaptation and human resource development--providing the incentives for international competitiveness and positive restructuring programs.

C. Which Subsectors to Restructure?

2.06 Most subsectors selected for restructuring under Bank loans have been those dominated by public enterprises generating large economic and financial losses, or product groups in which Bank staff has built expertise. Although no rigorous, scientific criteria exist, more useful criteria in selecting priority subsectors for restructuring projects include the following:

(a) Major subsectors. Improvements in subsectors with a major share of industrial output, exports, and employment could have significant overall economic impact. These subsectors often represent a major share of the "drain" on the economy--and will enable economies of scale in building subsector knowhow and functional services.

(b) Promising subsectors. Product groups characterized by relatively small gaps between performance of firms in country versus global competitiveness levels are strong candidates for restructuring. Effective protection, domestic resource cost, and total factor productivity tools are useful in determining potentially promising subsectors. Relatively static snapshots should be combined with knowledge of technology change and organizational and business dynamics to pick potential candidates for restructuring.

(c) Strong key players. Successful industrial restructuring processes depend most critically on policymakers, bankers, and enterprises committed to a significant response to global competitive requirements. The Bank can reinforce such key players, but Bank programs cannot substitute for local commitment and capabilities. The assessment and reinforcement of this critical dimension--people--should be a fundamental element of subsector selection and project preparation.

2.07 In subsectors in which public enterprises dominate, the selection criteria should be similar, in selecting important subsectors and supporting operations only when competent, committed people are in charge. Yet it may be necessary to select chronically uncompetitive subsectors for attention, due to the need to cut heavy public sector losses. Here, the Bank needs to be wary of throwing good money after bad.

2.08 In selecting subsectors for restructuring, it is important to assess their present and potential contribution to GDP, non-traditional exports, and employment. The present and potential efficiency of subsectors also should be analyzed, using domestic resource cost and total factor productivity tools.

Table 2.1: SOME CRITERIA FOR SELECTING SUBSECTORS

	Textile	Auto Parts	Chemicals	Agro-Industry	Pulp Paper
Impact on Economy	XXX	XX	XXX	XX	XX
Export Potential	XX	XX	XX	XXX	X
Sector Composition	XXX	XXX	XX	XX	XX
Import Substitution	XXX	XXX	XXX	XX	XXX
Competitive Advantage (Uniqueness)	XX	XX	XXX	XXX	X
Policy Constraints	X	X	XX	XX	XX
Issues Flow Across Sectors	X	X	XX	XX	XX
Overall Rating	XXX	XXX	XXX	XX	XX

Agenda: HIGH XXX MEDIUM XX LOW X

2.09 Another key dimension is the domestic structure of the industry--size, degree of concentration, and patterns of ownership--in relation to best practice. Structural analysis is needed to determine policy and institutional measures for competitive performance.

2.10 Policy analysis needs to be complemented with realistic diagnoses of commercial viability--of cost, quality, organization, technology, and marketing characteristics needed for subsector firms to become competitive. How big is the gap between present behavior and best practice, if domestic firms are to be competitive in price and in non-price aspects?

D. Subsector Diagnosis

2.11 Policies, institutions and enterprises need to change if developing country firms are going to compete. This global market place increasingly comprises highly differentiated product-market niches. Analyses of subsectors at the global and local levels--and wide diffusion of these diagnoses--make it possible for managers, bankers, and policymakers to see:

- what it takes to compete in different niche markets;
- where the gaps are between best international practice and domestic firms' size, organization and technologies;
- what the most binding policy and regulatory constraints are on firms moving toward competitive performance;

- what kind of institutional services are needed to increase local capabilities, provide needed technical and marketing information, and facilitate collaborations; and

- what the magnitude of financing requirements for firm-level restructuring and related institutional support is.

2.12 In most recent subsector restructuring operations, detailed global and local subsector studies were used as the basis for project design and development. Increasingly, in-house Bank expertise is being complemented by major consulting firms, which bring current business expertise to these subsector diagnoses. (Annex 3 provides a partial list of recent subsector studies, by country and subsector). These subsector studies provide the strategic, structural, technical and marketing information needed for project design. Perhaps more important, these studies can be used in consensus-building among policymakers, bankers, enterprise managers, and Bank mission members.

E. Scope of Subsector Restructuring Operations

2.13 With subsector analysis in hand--and provided to enterprises and their bankers--a broader scope for industrial restructuring operations may be useful. Often, the actual operation needs to concentrate on:

- policy change cutting across subsectors: competition policy, price decontrol, direct foreign investment, and technology policy;

- functional components: human resource capabilities, export marketing, and productivity improvements--which can focus on key subsectors, with coverage broadened in subsequent phased operations; and

- finance for competitive ventures, with appropriate instruments and broad eligibility criteria, without allocations to specific subsectors.

2.14 Policy Change Cutting Across Subsectors. Subsector and enterprise analyses can be useful in uncovering policies that impede efficient industrial development. Special deals provided to some industrial subsectors--tax breaks, direct subsidies, regional incentives, pricing controls, import protection, domestic content regulations and special access to public procurement contracts--can severely distort resource allocation decisions and subsector development. Benefits normally accrue to established incumbents, effectively blocking new and potentially more competitive entrants. Bank-supported industrial adjustment and restructuring operations should unravel special deals and aim for a subsector-neutral incentive framework. As with industrial licensing, capacity and ownership laws, bankruptcy constraints, and other competition barriers, the ideal is to eliminate special deals across the board, despite some governments'

reluctance to do so all at one time. Deep policy changes in a major subsector can have substantial demonstration effects, making subsequent industry-wide change easier. In fact, it is important that industrial firms understand that industry-wide policy change is expected to follow; this undercuts the possibility of increased competitive pressures in one subsector forcing the shift of resources to other, protected subsectors.

2.15 Functional Components of Subsector Restructuring. Subsector-specific subsidies for firms should be avoided. At the same time, services are needed to help firms fill gaps between their operations and best international practices. Components geared to help firms fill functional gaps can include:

- institutional measures, including information dissemination, to help individual firms devise export marketing strategies and productivity improvement programs;
- human resource development programs, reflecting the need to develop flexible, technical labor pools and management capable of continual adaptation of their enterprises to changing global conditions;
- publicly and privately sponsored research and development, with a focus on adapting technology available internationally to indigenous conditions and requirements;
- retraining, outplacement and entrepreneurial development programs to facilitate reductions in the labor force in restructured firms; and
- specific infrastructural components, such as improvements in transportation, port facilities and communications, targeted at breaking overall or subsector bottlenecks.

2.16 The East Asian NICs have established successful targeted programs geared to fill competitiveness gaps, but many developing countries lack effective public sector institutions capable of providing such programs. The task of reforming such institutions as exist can undermine a program's direct assistance to private firms. It would be more effective and efficient to provide leaner private or otherwise autonomous, commercially oriented arrangements to support marketing, productivity, and training/apprenticeship for individual firms--industry associations and efficient banks are often the best agents for identifying and arranging appropriate technical assistance and training.

2.17 Avoiding Subsector Credit Allocations. Subsector approaches usually should stop short of subsector/product group credit allocations, to avoid picking winners and because it is recognized that global conditions can rapidly alter the most promising industrial investment opportunities. If subsector allocations are deemed necessary, however, the selected product groups should be broad enough to allow substantial flexibility and avoid forcing banks into artificial portfolio concentra-

tion. One argument for subsector credit allocations is that concentrated attention on one product group enables bankers to develop subsector expertise in project evaluation. This institutional development may be achieved better by supplying bankers with global subsector studies, involving them in country subsector diagnoses, and making participating credit institutions responsible for administering output marketing and productivity funds. Another argument used to justify subsector credit allocations is that the participating banks' overall financial and operating conditions would not justify a general credit line. This is not an acceptable argument; all industrial restructuring operations should involve detailed appraisal of potential credit institutions and should use competent financially and institutionally solid banks.

F. Role of the Bank in Subsector Restructuring

2.18 The Bank has accumulated substantial expertise and a global perspective, particularly in heavy industries dominated by public enterprises: steel, petrochemicals, fertilizers, mining. Currently, the Bank has a chance to play a major role in subsector restructuring by conducting, or commissioning, global subsector diagnoses.

2.19 A major portion of any subsector study is assessment of the global market and best firm and industrial practices internationally. For example, 60% to 70% of the studies of textiles in Senegal, in contrast to those in Mexico and Turkey, were to determine international trade patterns and quality and price standards required to be competitive in major product-market segments. These studies also evaluated technology choices, systems, and scale economies in production and distribution; identified key participants; and examined the most beneficial types of collaboration. This same type of diagnosis will be repeated soon in Colombia.

2.20 If the Bank can provide such global dimensions, country-specific subsector diagnoses could start from global points of comparison and focus on local situations. Although subsector diagnoses are important in the preparatory process, the duration and costs of these exercises must be reduced. For example, subsector diagnoses by major consulting firms usually take from six months to a year to complete, plus the time for disseminating the results and discussing them with representatives from government, industry and the financial sector. The cost of these studies can be as much as US$500,000 to US$750,000 each.

2.21 Subsector diagnoses performed by the Bank can consume hundreds of staff-weeks. The risks in such long lead times are that the windows of opportunity for major policy and institutional change may close, since political commitment to reform usually reflects a political cycle. Also, the studies often become a means for stalling--particularly when undertaken as part of an operation rather than preceding it. Many basic changes needed in policies, industrial

regulations, and structure are already obvious to government officials, enterprise managers, and Bank staff with experience in the subsector.

2.22 However, the Bank's reorganization has undermined its capacity to undertake global subsector studies. Prior to reorganization, the central Industry Department housed 120 professionals specialized in these subsectors. The Technical Departments currently house about 40 of the former Industry Department staff. Most remaining subsector expertise lies with technical specialists; the majority of the financial analysts and economists who had developed subsector expertise are located elsewhere in the Bank Group.

2.23 Expertise in business and policy would need to complement the technical knowhow of TD staff to enable comprehensive global subsector analysis. Rapid technological change, led by industrialized country firms, makes it difficult for Bank staff to keep up with best international practice.

2.24 Finally, the Bank has extremely limited expertise in light industry subsectors, which dominate output and exports of private industrial firms in developing countries: textiles and garments, agroindustries, light engineering products, wood, plastics, leather and rubber products, and consumer electronics--an will continue to do so.

2.25 If the Bank is to conduct global subsector studies, it will need to complement in-house capabilities by outside expertise efficiently supplied by major international consulting firms. Bank or external funding would need to be mobilized to fund global subsector work.

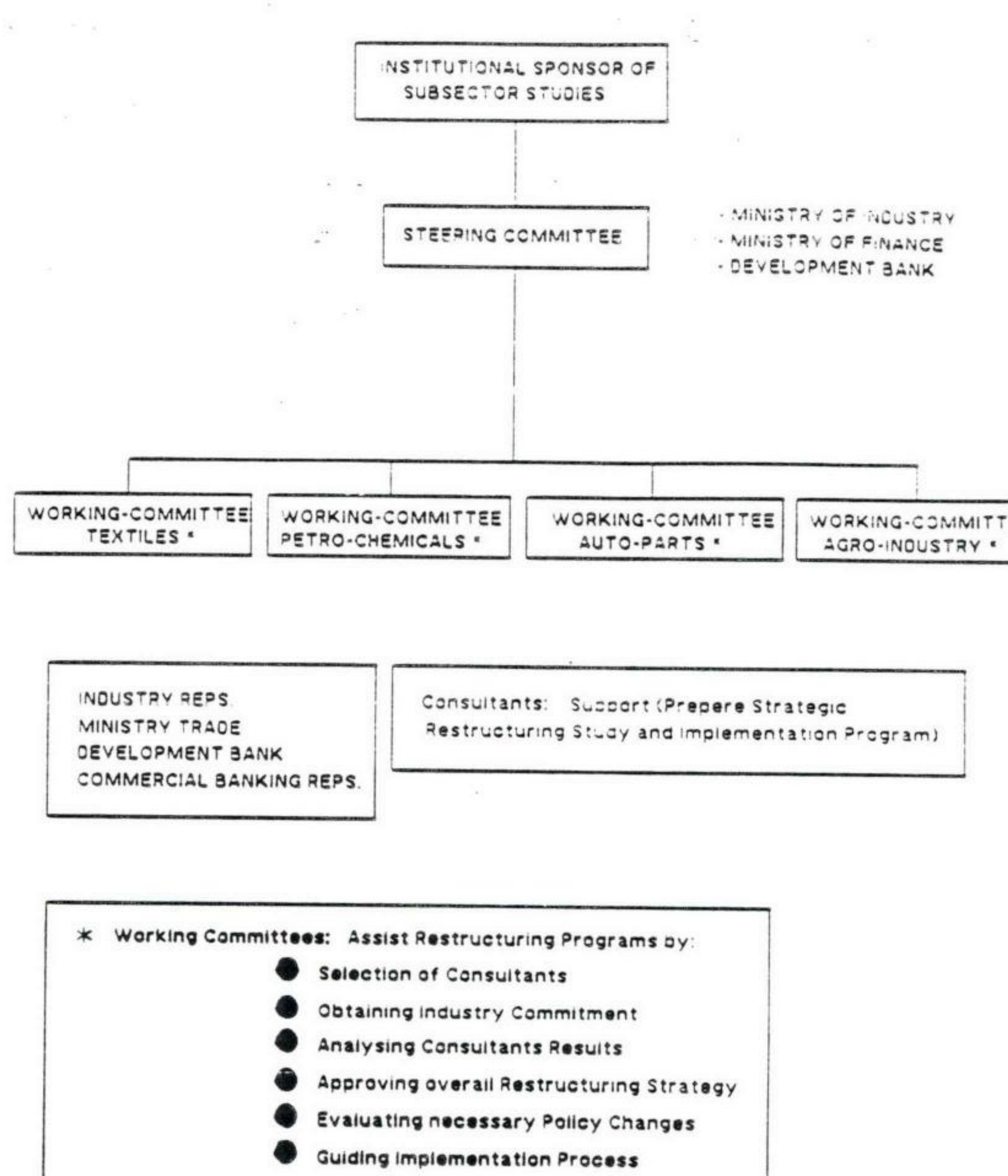
G. Institutions for Implementation

2.26 Government policymakers, financial institutions, and business leaders need to develop a constructive dialogue on restructuring. During the diagnostic phase of a restructuring program, consultants' progress reports can serve as the basis for discussions. After the consultants submit recommendations, discussion among the active participants should cover necessary changes in policies and institutions: organization, steps, and timing for implementation of the program, and resource requirements for firm-level restructuring, institutional support, and technical assistance components. During implementation of the restructuring program, a temporary institutional structure that can provide technical assistance to restructuring enterprises may be necessary.[8] Figure 2.2 provides an example of how such arrangements can be structured.

8/ Spain established an institution to support its restructuring programs during the early 1980s: reporting to the Ministry of Industry, it was composed of qualified technical experts from the private sector.

Figure 2.2

INSTITUTIONAL ORGANIZATION OF RESTRUCTURING PROGRAM



2.27 Restructuring is intensive in its use of human capital. The Bank can play an important catalytic and technical role, by providing substantially more mission time for preparation and supervision. Time and resources now allocated to supervision missions are inadequate. Well-designed technical assistance components can be key in supporting implementation.

CHAPTER III

ENTERPRISE RESTRUCTURING

A. A Focus on Enterprises

3.01 Enterprise restructuring refers to a set of actions carried out by a firm's owners and managers in response to major shifts in the underlying economics of a subsector or in the policy, regulatory, and institutional environment in which a firm operates. Table 3.1 highlights some typical enterprise restructuring actions.

Table 3.1: TYPICAL ENTERPRISE RESTRUCTURING ACTIVITIES

- Acquisitions and divestitures, leveraged buy-outs, recapitalization, and scaling down of operations are ways to restructure firms--their physical assets, finances, and operations.
- Changes in firm-level technology and organization can increase efficiency and competitiveness.
- Firms often need to change the products and markets in which they compete, and their internal strategies and organizations to enable competitive performance in niche markets.
- Companies can reorganize management and improve labor productivity through retraining, and eliminate redundant labor through employee retrenchment.
- Significant changes in power and financial relationships between public enterprises and governments alter the pressures and abilities of state-owned enterprises to invest and perform efficiently.

3.02 This chapter deals mainly with the restructuring of state-owned industrial enterprises, since support by the World Bank and IDA for private enterprise restructuring is almost always indirect, through financial intermediaries. (In these operations, it is the local bankers who must appraise and assist enterprise-level restructuring proposals.)

3.03 While the Bank does not normally provide direct finance for private enterprise restructuring, strong arguments exist for attention to enterprise-level issues during Bank preparation and supervision of all industrial restructuring operations.

3.04 First, Bank-supported industry-wide and subsector restructuring operations need to reflect how enterprises are likely to respond to policy and institutional change. Demonstrating links between policy distortions and poor performance at the enterprise level often can be an effective tool in Bank-government policy reform dialogue, moving the discussion beyond philosophical or theoretical differences. Such assessments of likely enterprise responses should become a major part of preparing policy reform programs. Often governments and the Bank are disappointed at the slow supply response in the wake of adjustment and restructuring programs. In fact, the glut of imports, remaining rigidities in financial and regulatory systems, and firms' wait-and-see response could have been predicted if the preparation of the policy package involved more systematic interviews of private entrepreneurs.

3.05 Second, an enterprise focus in subsector restructuring programs and in industrial sector studies is needed to understand where firms are versus where they need to be to meet competitive pressures. Firm-level interviews, combined with statistical analysis, can help segment industrial subsectors by size, efficiency levels, and management practices.

3.06 A frequent assumption underlying many adjustment programs is that once policy changes occur, firms will respond automatically with efficient, competitive supply responses. This assumption neglects the fact that firms and their bankers--accustomed to catering to protected domestic markets--frequently are only vaguely aware of global changes in technology, organization, and markets. The World Bank can help build knowhow by conducting or commissioning subsector diagnoses; these can help bankers determine which industrial restructuring proposals have strong prospects for international competitiveness. Also, having the banks administer technical assistance funds--designed to give firms access to top expertise in developing their export and productivity strategies--can have significant spinoffs in building bankers' knowledge on technology, marketing and organizational trends and requirements in different product groups.

B. Restructuring State-Owned Industrial Enterprises

3.07 In many developing countries, operations of public industrial enterprises involve heavy borrowing and subsidies, impenetrable barriers to internal and external competition, and large waste of financial, material, and human resources. Public debt and deficits have made such perverse practices unsustainable. Most policymakers recognize the need for deep restructuring of public enterprises. In restructuring large and powerful PEs, overall competition policies normally will not be enough to offset the special deals that public enterprises usually receive: subsidies, sales arrangements with other PEs, and monopolies on sourcing, production, and sales. PEs often have mixed mandates: to employ more workers than needed, to report to several ministries, to operate under politically appointed managers, to produce for specified industry or consumer needs, and to provide these products at financially unsustainable prices. Due to their monopoly status, soft financing, and

mixed mandates, many PEs have expanded into unrelated businesses or have used their monopoly power to absorb related industries.

3.08 To unwind all these PE-specific distortions requires tough decisions, based on solid subsector and enterprise analysis. Such programs warrant support, since major public enterprises generating heavy financial losses can hemorrhage the public budget, aggravating debt and deficit problems. Also, large public enterprises producing intermediate goods often undermine competitive prospects for user industries. Governments may be unwilling to open the sector to imports or local private competition if such competition would result in closure of government-owned firms. Governments often are more willing to allow competition if concomitant measures are taken to enable the core businesses of public enterprise to become competitive as well--and to survive. Given the potential pitfalls, the Bank should be rigorous in its approach to such operations.

C. What Works and What Doesn't

3.09 Before discussing key elements for successful public enterprise restructuring, it is important to note what has not worked well:

- Limited results have been achieved or can be expected through management information, performance evaluation, or performance contract systems. Improved transparency and management information systems are usefully only as complementary systems once real power and financial arrangements (subsidies, transfers, special credits) change.

- Physical rehabilitation and financial restructuring of public enterprises have failed unless policies requiring competitive performance are introduced at the same time, and unless financial measures are combined with effective enterprise-level changes in management, organization, technology, and marketing strategies and capabilities.

3.10 Key Success Factors. The following approaches are basic to sound restructuring programs involving government-owned enterprises.

3.11 Public ownership and monopolies of industrial enterprises should not be viewed as strategic. Adopting this basic attitude enables objective determinations of which enterprises should be closed, scaled down, or privatized. Whether public or private, industrial firms should exist to provide goods and services at competitive prices and quality. Other objectives almost always are pursued poorly and at high cost. For example, steel plants should be expected to make steel of world quality and price. Steel plants should not be seen as employment generators, sources of backward area development, or captive suppliers of downstream industries. The cost of overemployment is extremely high: poor morale, low productivity, poor product quality, and the high cost of basic intermediate goods to domestic user industries.

3.12 The objective should be reduction and ultimate removal of producer and consumer subsidies. They muddle decision-making and make performance evaluation difficult. Industrial companies, regardless of ownership, should pay their own way--or have clearly demonstrated prospects for doing so after restructuring. If importing is advantageous, governments should allow imports. If governments will not allow competition, or when additional investments will not result in world class output, industrial restructuring programs do not warrant support.

3.13 Under public enterprise restructuring operations, it is critically important that investment not be used to create new capacity in a chronically uncompetitive subsector. The rationale for public enterprise restructuring often is to downsize and liquidate uncompetitive firms in uncompetitive subsectors--for "damage control." Such operations can be important in stopping a major drain on the fiscal budget and in reducing government resistance to liberalizing imports of basic industrial intermediates. Policymakers and their bankers need to be diligent in avoiding public enterprises restructuring operations that downsize particular segments but result in net additional investment in a basically uncompetitive subsector.

3.14 It is useful to begin the design of public enterprise restructuring programs with an ABC analysis of where the money, bodies, and downstream costs are buried. In most developing countries, more than 80% of assets, employment, and output in public industrial enterprises is accounted for by steel, fertilizers, petrochemicals, mining, and telecommunications. PE restructuring operations could support offloading all but the basics. The practice of basing major adjustment or restructuring operations on liquidating or privatizing small, unimportant industrial PEs does not appear to be justified. Such measures need to be taken to clean up the public sector's portfolio, enabling more concentrated attention to major PE issues. In the main intermediate PE subsectors, incremental investments should be supported only if international competitiveness in organization, technology, price and output will be achieved or approached. Utilities usually are much more important than industry in terms of debt, fiscal drain, assets, employment, and social impact. Thus public enterprise restructuring in water, electricity, railways, and other transport--not treated in this paper--is important. Restructuring these sectors takes place through major changes in management, operations, regulations, and privatization of certain functions. Liquidation is not an option, since these sectors provide basic, non-tradable services. In contrast, PEs in industry and other tradables may opt out of the industrial base--which greatly increases restructuring options.

3.15 For industrial enterprises remaining in the public sector, power relationships need to change, with government becoming an arms-length shareholder and firms behaving as commercial concerns. Governments need to tighten their levers on public enterprises in the areas of debt, major new investments, and operational results. Intervention in procurement, employment levels, and operating decisions should be reduced. It is crucial that the operating management and boards of

directors of public enterprises consist of professional managers with relevant knowledge and experience.

3.16 Holding companies are important only if they break the pattern of public intervention and public subsidies. Holding companies must have budget responsibilities for PEs and be free to liquidate, privatize, or form joint ventures for all or part of public enterprises in the holding. They need to be free to make or delegate all ownership, management, organization, and company strategy decisions. Without this level of autonomy, holding companies are just another layer in the controls and multiple objectives imposed on publicly-owned enterprises. They impose another layer of overheads as well.

3.17 Turnarounds of major public enterprises have never been achieved under Bank-supported operations that fund diagnostic studies and require that open-ended action programs are developed at a later date. Public enterprise restructuring operations warrant support only if strong, concrete actions have been taken prior to loan negotiations, and if a concrete, convincing program of measurable action has been agreed to by enterprise managers and all key government officials.

3.18 Public or private sector industrial monopolies in tradables cannot be expected to develop competitive behavior. Breaking the monopoly status of local enterprises is crucial. If domestic markets are large enough for strong competition among multiple public and private enterprises, removing domestic entry barriers can provide a start in breaking up monopolies. However, for most developing countries, adequate competition in basic, intermediate industries can come only from imports.

3.19 General trade and industrial policy measures may not provide enough stimulus. To create real competitive policies and capabilities, joint ventures or strong collaborative arrangements with successful foreign firms operating globally can be key. Such collaboration can provide domestic firms with funding; at lest as important, collaborations can create external pressure for competitive performance, and provide needed technology and marketing knowhow.

3.20 Public enterprise restructuring programs need to deal explicitly with eliminating overemployment and reducing inflated wage bills. Golden, silver, and platinum handshakes are critical in getting voluntary redeployment of labor and have been highly successful in several restructuring exercises. Retraining of management and labor, once it is clear what an industry is restructuring toward, also can be critical for success.

3.21 Experience suggests that industrial restructuring operations focusing on one or a few specific public enterprises normally are poor vehicles for policy and institutional change, at the subsector or overall industrial level. Reshaping a few dominant enterprises can have major overall economic as well as demonstration effects, but usually it is important that PE restructuring operations be pursued under a subsector framework. This perspective helps to maximize overall

economic welfare and competitiveness objectives, rather than support measures that serve the survival interests of the enterprise.

3.22 The most critical element for successful public enterprise restructuring is commitment to and capacity for major change--by the main participants in the central government, relevant ministries, and affected enterprises. Given the extreme complexities, strong social and political dimensions, and tenuous nature of public enterprise restructuring programs, the Bank should limit its involvement to situations where it can provide technical and financial support to actual initiatives taken by a government--with strong leadership at the policy and enterprise management levels.

D. Privatization Redefined

3.23 Privatization, an important means to achieve competitiveness and to reduce political interference, should form part of comprehensive industrial restructuring packages. A major dilemma for a government trying to privatize a poorly performing public enterprise is whether restructuring should precede divestiture. Privatization without restructuring usually results in a low bid price for the enterprise. However, restructuring to gain a better purchase price is difficult. Most parameters that caused poor performance in the first place remain. It is difficult to motivate management and staff to improve performance if their jobs will be at risk from privatization. Restructuring measures pursued before privatization may differ markedly from the direction intended by the subsequent buyers.[9/]

3.24 Despite its merits, selling public enterprises poses formidable obstacles. The number of potential buyers often is limited. Governments may offer purchasers special privileges that result in private sector monopolies with distortions even larger than under government ownership. Further, political opposition may delay the sale. Finally, capital markets in developing countries often are inadequate for absorbing divestitures.

3.25 Means to increase private participation in ownership and management of public industrial enterprises include employee buy-outs, leasing of assets, direct sales of all or part of the enterprise, off-loading of marginal activities, and formation of joint ventures with local or foreign private partners.[10/] Potential benefits of such privatization measures include more efficient use and reduced drains on scarce public sector resources; less crowding out of the private sector

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9/ Bangladesh elected to reprivatize 15 textile mills that had been nationalized in the mid-1970s. Reprivatization has been difficult because of disagreement over the eventual purchase price and the cost of retrenchments.

10/ See Charles Vuylsteke (1987) for a report on the techniques of privatization of state-owned enterprises.

in domestic capital markets and greater depth and breadth of local capital markets through share flotations of privatized enterprises; and more transparency, disclosure, and accountability in the industrial sector, increasing confidence of investors.

E. Physical, Organizational and Financial Restructuring

3.26 Physical Restructuring. Physical restructuring encompasses upgrading or replacement of obsolete plant and equipment, introduction of new technological processes, and investments to improve overall capacity utilization and energy efficiency. Plant closure can be considered part of physical restructuring because it deletes fixed assets from an enterprise and subsector. A broader definition of physical restructuring could include relocation of production facilities to take advantage of lower wages, better skills, advantageous market access, supporting infrastructure, or manufacturing synergies. Restructuring through relocation has been significant for firms in industrial economies, particularly in East Asia.

3.27 Most of the Bank's early restructuring operations, by focusing on physical rehabilitation of public enterprises, failed to force the needed changes in: the power relationships between the government bureaucracy and the enterprises; the fundamental management and organization of the enterprises: and production, marketing and financial strategies. These programs tended to apply physical, technical solutions to problems of public enterprises. Of the 40 projects reviewed by IENIN for this exercise, at least 15 (38%) aimed primarily at plant rehabilitation. Bank projects focused on plant rehabilitation have included the Egypt Pulp and Paper Rehabilitation and HADISOLB Steel Rehabilitation Project; Bangladesh Textile and Jute Rehabilitation projects; China Machine Tool Rehabilitation Project; Pakistan Fertilizer Rehabilitation Project; and Guyana Bauxite Rehabilitation.[11]

3.28 Most stand-alone rehabilitation projects have not been successful. Ex-post financial and economic rates of return on Bank-assisted rehabilitation projects tend to be similar to those prevailing in a country's subsector as a whole. In most cases, problems in these operations did not arise from poorly conceived physical restructuring programs but from the isolated nature of these physical investments--without complementary changes in organization, management, and methods, without a strong marketing and product mix strategy, and without policy changes to induce competitiveness.

3.29 Recent Bank-supported enterprise restructuring operations give greater attention to these other dimensions. Most frequently, pricing policies have been modified to reflect world market prices and to eliminate subsidies. Increasingly, privatization, closures, mergers,

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11/ A number of IFC restructuring projects have focused on plant rehabilitation as well, including investments in sugar and tea in Uganda.

joint ventures, and technology licensing have been means to galvanize enterprises into meeting competitive pressures.[12/] India's Cement Industry Rehabilitation focused primarily on improvements in energy utilization but also dealt with pricing structures. Jamaica's Sugar Rehabilitation Project supported industry consolidation through closure of some plants and rehabilitation and modernization of others. In addition to substantial funding for plant rehabilitation, the Mexico Steel Sector program supports the government's decision to close a major steel facility and to divest itself of non-essential and non-related subsidiaries of the state-owned steel company.[13/]

3.30 Managerial/organizational restructuring incorporates firm-level measures to revise organization, improve capacities, and adjust human resources for production, marketing, and financial gains. These changes often are more important for competitive performance than are improvements in capital stock.[14/] Successful penetration of export markets requires not only productive efficiency but also attention to quality, service, innovation, product differentiation, and market segmentation. Analysis of Bank-supported restructuring projects indicates that unsatisfactory results most often relate to inadequate restructuring of these soft dimensions. Important elements in organizational restructuring are listed in Table 3.2.

3.31 A growing number of Bank-supported restructuring operations have included managerial and organizational dimensions of restructuring. The Bangchak Oil Refinery Restructuring Project in Thailand illustrates the benefits of public enterprise autonomy. It was removed from the control of the Ministry of Defense in 1984 and established as an autonomous commercial company. A second example is the Textile (SOGITEX) Rehabilitation Project in Tunisia. It demonstrated the benefits of an integrated approach to enterprise restructuring--SOGITEX's Subsidiary SITEX--through rehabilitation of physical plant and equipment, technology adaptation, and export marketing measures. (See Annex 2, the Case Studies.)

12/ A total of 21 projects (42% of restructuring operations reviewed) dealt with privatization (12 projects), closure (11 projects) and spinning off production facilities (5 projects). These projects are mostly in Africa.

13/ Mexico's steel restructuring program provided a strategic marketing study focusing on the future steel market in Mexico, the required product mix that various plant units should produce, and SIDERMEX's marketing and distribution structure. A reorientation to market needs would represent an important change in SIDERMEX's operations. (See Case Study.)

14/ Taiwan's Automation Center, which provides consulting services to thousands of firms, reports that in 40% of its cases, substantial improvements in productivity have been made with no incremental investments in plant and machinery.

Table 3.2: ORGANIZATION AND MANAGEMENT ASPECTS OF ENTERPRISE RESTRUCTURING

Product-market reorientation, e.g., changes in product, market or customer mix; shifts from domestic market focus to export standards, sales, and distribution channels.

Reorganization, including decentralization, creation of profit and cost centers, development of strategic business units, establishment of international marketing and sales offices, and break-up of parastatal monopolies into competing enterprises.

Staff reductions and redeployment of redundant personnel, with training and enterprise development schemes.

Management planning, information, and control systems to provide more timely information for effective decision-making and improved enterprise accountability.

Enterprise autonomy (related to SOEs) through changes in the composition and powers of boards of directors, appointment of professionally qualified managers, and contractual arrangements with governments to increase managers' accountability while minimizing government political interference in enterprise operations.

Management development and worker training programs to build professional and technical skills and to introduce new organizational methods.

Incentive compensation schemes for management and hourly workers.

Management contracts for business operations lacking specific managerial or technical skills.

Joint ventures, marketing arrangements, or co-investment with overseas companies to tap foreign firms' expertise.

3.32 Financial Restructuring. During the last decade, many large parastatal and private enterprises in developing countries acquired significant external debt in hard currencies, at variable interest rates, and with increasingly short maturities. Subsequent debt restructurings have allowed many of these enterprises to postpone repayment, while others have converted external debt into domestic debt under government-sponsored conversion schemes. Many such enterprises remain overly indebted, undercapitalized.

3.33 In the case of SOEs, there are sometimes additional objectives for financial restructuring: (a) elimination of subsidies and government transfers of resources to the entity; (b) promotion of financial autonomy, including the ability to borrow from the commercial banking sector, to float shares and bonds, and to enter into joint ventures with domestic and foreign investors; and (c) creation of a heterogenous capital mix suited to the financing needs of the enterprise. Because capital markets are poor in many developing countries and many SOEs earn little or no profit, financial restructuring of public enterprises normally requires heavy debt restructuring or relief. Such financial restructuring involves write-downs of nonproductive assets, which rid SOEs of their bloated capital structures. These steps are particularly critical for privatization.

3.34 Other financial restructuring measures and instruments can have a significant effect on the operating and financial performance of SOEs. For example, sale of assets can downsize companies to more manageable core businesses. Debt-equity swaps and other joint venture equity arrangements can help infuse SOEs with technical and marketing knowhow, external commercial accountability, and additional financing. New instruments such as convertible debentures, convertible preferred shares, share and bond flotations can help diversify SOEs' funding sources and provide greater accountability for the results.[15/] (See Chapter VI.)

F. Social Dimensions of Restructuring

3.35 Virtually all industrial restructuring programs displace workers. However, layoffs related to industrial restructuring normally do not affect the poorest of the poor. The affected groups often are unionized and politically active, or are members of the protected managerial elite. These groups can represent powerful vested interests, resisting proposed reductions in the work force, and seeking significant compensation. They often have the political power to block restructuring measures. Governments need to recognize and address this potential source of resistance to restructuring programs.

3.36 Few Bank-supported industrial restructuring projects have dealt directly with labor dimensions of industrial restructuring consequences. One exception is the FY88 Senegal Industrial Restructuring Project. Preparation of this project involved an assessment of likely job losses with and without restructuring, and incorporated

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15/ The Bank does not finance asset transfer or straight financial restructuring with project finance. The IFC has engaged in financial restructuring of industrial enterprises, primarily with enterprises in IFC's portfolio. In Tunisia, financial restructuring was part of a package designed to help private investors purchase part of a state-owned textile company. In Brazil, IFC has sponsored several debt/equity conversions and extensions of debt maturity for enterprises in the cement, slaughterhouse, textile, chemical, and agro-industry subsectors.

innovative solutions for labor retrenchment and retraining.[16] The ongoing industrial restructuring projects in Hungary, begun in FY86, address the issue of layoffs, and the Mali Public Sector Enterprise Project calls for establishing a government fund for worker retrenchment.

3.37 Restructuring may result in layoffs affecting a particular geographic constituency or ethnic group: the regional concentration of layoffs in sectors such as mining creates major social and political problems. The skills required in new jobs may differ substantially from those of the displaced workers. In countries that lack a safety net to meet basic retrenchment needs, the government may have to take a direct role in retraining, relocation, and employment generating programs--if the restructuring programs are to be implemented.

3.38 Defusing the Political Problem. In surmounting political opposition to a restructuring project, it may be possible to identify vested interests and respond specifically to each. Consulting with opponents, such as unions, at an early stage of project preparation gives them a sense of participation. The most effective way to overcome opposition to layoffs is cost-effective assistance programs, showing that government is responding to worker needs.

3.39 Social assistance programs may vary, depending on the extent of the restructuring, the objectives of the government, and the size of the budget. Measures include severance payments for workers and assistance in finding new jobs, relocating, retraining, or developing small-scale enterprises. The savings generated by the programs often can justify the costs of such assistance. However, not all programs are effective. Job retraining is not useful, for example, if there are no related jobs available; in fact, it could result in unrealistic expectations for the trainees.

3.40 Severance Payments. Severance payments can be used to compensate workers for the loss of jobs. Relevant issues are the

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16/ Calculation of the number of jobs likely to be lost in the absence of restructuring, and estimation of the long-term gain in employment with restructuring, can be crucial. The government can show the opposition that the net loss in jobs is likely to be lower than initially apparent. For the Senegal Industrial Restructuring Project, of the 5,000 estimated layoffs resulting from the project, approximately 3,000 would have taken place as a result of declining competitiveness. This information proved instrumental in overcoming opposition to the restructuring program.

appropriate level of payment [17] and how to structure payment to retain qualified workers when voluntary departure schemes are also in effect. To prevent the loss of the best qualified workers, higher salaries and a merit-based incentive scheme may be offered. The World Bank approved this measure in a project involving the Bolivian Central Bank, where the work force was reduced from 1,000 to 400. Reducing the labor force resulted in savings adequate to give attractive severance packages, and to pay increased salaries for those remaining with the Bank. Some qualified staff did leave, but the increased salary levels attracted new talent.

3.41 An issue of concern in layoffs is the potential loss of trained human capital, both managers and workers. Because investment and time have gone into developing specific skills, their loss is a waste of investment. Several steps to help workers re-enter the work force are outlined below.

3.42 Assistance in Finding New Jobs. The scope of this assistance can include support facilities for job searching, career counselling and advice, and even for relocation.

3.43 Retraining Programs. Based on expertise, performance, ability, training, education, and ambition, retraining programs might focus on areas of immediate need or in which demand is expected in the future. Refresher or skills maintenance courses might assist those expected to fill vacancies in the short term.[18]

3.44 Development of Entrepreneurship. For workers who want to go into business for themselves, programs could provide screening for entrepreneurship potential, help with project development, and training in key business, finance, and marketing skills. Professional assistance in project preparation and presentation could improve the likelihood of obtaining funding for new microenterprises. Special arrangements can be made to use severance pay as equity investments in new businesses.

17/ In the Bank's experience, this issue has proved especially difficult in the case of public sector restructuring, which involves layoffs of civil servants who expect lifetime employment. Frequently the provisions of their termination are limited, without contractual arrangements for compensation. In lieu of any other methods, estimating how long the worker will be out of the civil service serves as a benchmark. This procedure yields an approximate calculation of the savings to be achieved by laying the worker off. A severance payment exceeding this amount would not be beneficial to the economy.

18/ An important consideration in all retraining programs is what happens at the end. The Bank's experience in certain African countries has been that retrained workers frequently expect the government to find them jobs, which often are not available after the training.

3.45 Employee Buy-Outs. Programs to facilitate employee buy-outs could give workers assistance in basic finance, management and marketing techniques. Programs could provide help for the transition to new ownership and for management of the enterprise during the early stages.

3.46 Related issues that surface frequently in Bank-supported restructuring operations concern who should underwrite different aspects of a government's assistance program and what is the appropriate role for the World Bank. Bank funds can be used to cover the costs of retraining, entrepreneurial development, and other assistance programs, but the issue of funding severance payments remains controversial. In some cases, allocation of counterpart or Bank funds to cover severance pay can be important to the success of restructuring programs.

CHAPTER IV

THE FINANCIAL SECTOR AND INDUSTRIAL RESTRUCTURING

4.01 The industrial restructuring process can succeed only if adequate financial resources, supplied by an efficient financial intermediation system, are available at reasonable cost. The World Bank can play an important role in improving the capabilities of the financial system. When the financial system is in deep distress, and when most banks in the system are unsound, financial sector adjustment operations are the appropriate vehicles, since further lending through financial intermediaries would only worsen the problem.

4.02 Industrial restructuring and other loans through financial intermediaries may help with incremental institutional improvements, provided that such operations involve sound and solvent banks. Industrial restructuring operations could be particularly useful in: building knowhow among good bankers on what it takes for industrial firms to be internationally competitive; and in introducing new financial instruments and eligible expenditures consistent with sound corporate restructuring. However, several policies and practices used under credit line operations will need modification. In particular, the Bank needs to assist clients in:

- working directly with competent, financially sound banks, with increased use of commercial and investment banks;
- introducing basic principles of corporate finance into financial intermediation projects; and
- expanding the range of financial instruments and eligible expenditures available to industrial firms engaged in restructuring.

4.03 Section A of this chapter deals with reforming financial sector policies, improving banking regulation and supervision, and restructuring financial intermediaries and their portfolios. In an increasing number of developing countries, these financial sector reforms are preconditions of successful industrial restructuring--or any prudent lending through financial intermediaries. The Bank can be helpful through financial sector adjustment loans which support strong, measurable actions in each of these areas. Section B of this chapter deals with the type of financial intermediaries, instruments, and expenditures needed for successful restructuring of industrial firms. These--and not broad systemic reforms--are the dimensions best tackled under industrial restructuring operations which finance firms through financial intermediaries.

A. Restructuring the Financial System and Intermediaries

Adjusting Financial Sector Policies

4.04 In many developing countries, excessive market regulation and government intervention in the financial system are prime obstacles to efficient, sounder financial markets and intermediation systems. At the same time, tight interest rates and extensive directed credit schemes seriously distort resource allocation and limit competition among intermediaries.

4.05 As a consequence, market deregulation is a key element in financial sector reform. Reduction of forced reserve requirements and mandated investments, accompanied by contraction of public sector borrowing (or publicly-financed directed credit schemes), would help lower interest rates and halt the crowding-out of private sector borrowers. Interest rate deregulation is particularly important in ensuring an adequate risk-return profile for commercial bank lending and in fostering competition among intermediaries.

Restructuring the Intermediaries

4.06 The impact of economic and financial crises is reflected in the low operating returns and high gearing ratios evident in the income statements of many intermediaries. These published data in fact underestimate the problems: they do not reflect banks' insufficient loan loss provisions, and they include accrued but unpaid interest on doubtful loans. Many banks' financial problems are due mainly to difficulties with loan recovery, a situation that persists despite various refinancing attempts (e.g., in Uruguay) and debt dilution schemes (e.g., in Argentina). In addition, overvalued fixed assets, revalued on the basis of general price indices, misrepresent the real financial situation.

4.07 Despite the troubled financial condition of many banks, the shake-out process, whereby the system adjusts to the demand for intermediation, takes place slowly, largely because orderly exit of intermediaries and clients from the financial sector is difficult. In a market economy, the threat of bankruptcy is the ultimate incentive to improve product value and production efficiency. In many developing countries, government regulation and reluctance to let large banks and enterprises fail have impeded the liquidation or serious restructuring of inefficient market participants.

4.08 A special problem is the poor discipline and performance of many public banks. In these institutions, the political pressure to make heavy investments in capital-intensive but non-viable SOEs has impeded sound analysis of creditworthiness and decision-making. Adequate supervision, financial and operational restructuring, and redefinition of public banks' roles and their relation to commercial banks are issues of prime importance in financial sector reform.

Strengthening Banking Supervision

4.09 Traditionally, supervision and control have focused on compliance with central bank rules governing reserve requirements and interest rates. Portfolio analysis and operating efficiency have received less attention. Inadequate systems for assessing the quality of portfolios is the more serious problem. Current systems typically confuse loan arrears (which may or may not result in losses) and risky loans (which may or may not be in arrears). Information on the performance of individual banks is severely limited--balance sheets and income statements appear infrequently, if at all, and do not address portfolio quality. The practice of allowing loans in arrears to accrue interest until the borrower is liquidated distorts banks' income statements. Unclear liquidation procedures, especially regarding loan and asset recovery, are problematic. Loan loss provisions often become obligatory only when the borrower goes bankrupt.

4.10 Banking supervisors are reluctant to intervene in a bank situation before portfolio difficulties cause financial collapse. As a first step in strengthening supervision and control, bank supervisory agencies should introduce portfolio classification systems that focus on the probability of default rather than on analysis of arrears in evaluating portfolio quality and exposure to risks.

B. Industrial Restructuring through Financial Intermediaries

Introducing Corporate Finance Principles

4.11 Financial assistance for industrial restructuring programs differs substantially from financing for traditional development bank operations. Under previous credit lines, the World Bank offered long-term loans for investments in equipment and as permanent working capital, relying primarily on government-owned DFIs to make loans to companies directly and through refinancing arrangements. These arrangements are not sufficient for financing industrial restructuring. It is recommended that the World Bank be more selective in the use of financial intermediaries, and broaden the definition of eligible expenditures. Such operations should incorporate a range of financial instruments, on market-oriented terms and conditions.

Defining Eligible Expenditures Broadly

4.12 Bank policies and practices in determining eligible expenditures for Bank finance do not adequately reflect the range of activities needed for effective firm level restructuring. These practices also do not recognize adequately that funds are fungible, meaning that excessive attention to defining eligible categories can be self-defeating. As the Bank increases reliance on commercial banks, which are positioned to offer the range of fixed and working capital financing, it would be useful if the Bank could broaden and simplify its approach to determining eligible expenditures.

4.13 Working Capital. Recently, supplying working capital has gained increasing importance in a number of Bank-supported projects, as working capital accompanying investments in fixed assets and as free-standing working capital unrelated to investment in equipment. However, Bank financing for working capital has been restricted to increasing raw material and spare part inventories. Eligible expenditures preclude financing for other working capital expenses such as labor, receivables, and short-term sales financing, to prevent borrowers from substituting working capital subloans for a company's equity. The Bank enforces this restriction by requiring that executing agencies submit a list of goods to be financed, as part of subproject documentation. The restriction is difficult to enforce, however, and does not reflect firms' working capital realities.

4.14 It would be useful if Bank eligibility criteria for working capital loans could be modified with all production inputs certified as eligible expenditures. The amount of working capital loan could be based on a company's production cycle, taking into account inventories, finished products, and receivables. To prevent the substitution of equity through excessive working capital loans, the Bank could require that the amount of the working capital loan not exceed a certain proportion of sales and/or equity.

4.15 It also would be useful if eligible expenditures could include investments in research and development, particularly related to the commercialization of new products. Other key expenditures include incremental marketing and distribution expenses, including investments in the distribution system, start-up and initial financing of a sales force in new export markets, and financing promotion campaigns in foreign markets.

4.16 Acquisition of domestic companies is important for reducing overcapacity and consolidating fragmented firms with potential economies of scale. Bank funds do not now finance acquisition of domestic companies because acquisitions involve transfer of the ownership of existing assets rather than creation of new assets. At the minimum, the Bank could ensure that domestic funds are available to encourage strategic mergers and acquisitions.

4.17 Acquisition of, or participation in, foreign companies could be used by domestic enterprises as a means to establish their products in international markets. Of particular interest are joint ventures between domestic producers and foreign distributors of trading companies to combine low-cost domestic production with access to foreign markets. These foreign-local joint ventures and technology licensing agreements can be important in increasing production efficiency and market organization.

4.18 Worker severance, retraining and relocation could be made eligible for financing. A shift in market focus or improved production process are likely to affect the size and the composition of the work force. Retraining and relocation will be important to protect jobs, use

new machinery, or take advantage of new technologies. Restructuring projects could make financing of these expenses at the level of individual companies eligible for reimbursement under Bank loans.

Assisting Financial Restructuring

4.19 Investments in equipment and working capital may require parallel financial restructuring of a company. In situations of massive instability and devaluation, financial restructuring can be an essential part of the work-out plan. Restructuring of a company's liabilities can comprise the following three main elements:

- Maturity Extension. In many cases, the financial structure of a company would improve if the maturity of its liabilities could be extended and the negative cash-flow impact of high nominal interest (front-loading of early maturities) avoided;

- Debt Consolidation. Debt consolidation is of particular importance if the number of creditors is larger and the size of loans is varied. Consolidation of the debt with a smaller number of creditors may be essential to achieve the necessary agreements concerning debt write-off, debt-equity conversions, maturity extensions, and additional funds for future growth; and

- Debt/Equity Conversion. Partial conversion of debt into some form of equity is likely to be a key element of many financial restructuring plans. Although the average debt/equity ratio of the industrial sector in many developing countries has improved over the last few years, compared to levels of the early 1980s, many companies are still overleveraged. Their high debt level and the associated financial costs are causing substantial liquidity problems that prevent generation of resources for new investments.

4.20 The Bank's guidelines currently do not allow direct financing of these instruments because, as with the acquisition of used domestic assets, they involve transfer and not creation of domestic financial assets and liabilities. The Bank could promote these instruments, however, by introducing maturity swaps and by more flexible application of its financing percentage. Normally the Bank finances only a percentage of eligible expenditures, which, in many cases, correspond to the foreign exchange portion. Traditionally, the Bank has applied this percentage to each subproject. Under an industrial restructuring project, the Bank could apply the percentage to the project as a whole, financing more than the average percentage in some subprojects and less in others. In lending for industrial restructuring, the Bank needs to be more flexible about subloan maturities. Restructuring operations also should include direct equity and quasi-equity investments.

4.21 Some countries have initiated their own enterprise-level financial restructuring programs. Chile has sponsored an aggressive, successful debt/equity swap program covering both public and private enterprises. Mexico has signed restructuring agreements with several major parastatal enterprises, providing debt forgiveness in conjunction with major strategic, technical, and organizational restructuring programs. These include steel, fertilizer, and agroprocessing and distribution. It is critically important that the Bank support such financial restructuring only when deep overall restructuring programs have been agreed to, with strong action taken before financial restructuring is allowed. Otherwise, financial restructuring will result in cosmetic change only and further financial drain, with the basic causes for financial distress untreated.

F. Providing a Comprehensive Package of Financial Instruments

4.22 Flexible Subloan Maturities. As noted, Bank funds can finance permanent working capital, corresponding to the long-term nature of Bank funds. Short-term and seasonal working capital are not eligible expenditures; loan agreements typically impose a minimum maturity (e.g., three years) on working capital subloans financed with Bank funds. Yet sharp lines between long- and short-term working capital requirements are artificial. Many companies roll working capital loans over to finance permanent requirements--but with the advantage of matching credit to their actual working capital requirements. In many cases, financing requirements are seasonal and could be serviced through short-term loans.

4.23 Long-term credit lines could allow variable usage. The maturity requirement for restructuring loans could be modified. While insisting on a maximum maturity for subloans, the Bank explicitly could allow penalty-free prepayments and credit lines for working capital, on which the borrower could draw as required. Innovative repayment systems that alleviate the negative cash flow impact of high nominal interest rates also are important.[19/]

4.24 Equity Investments. Equity investments are vital for highly-leverage companies in developing countries and for risky restructuring investments. The recent rise in international debt equity swaps

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19/ The Sistema de Pagos Variables al Valor Presente (PVP) scheme in Mexico, first introduced in a Bank-supported operation in 1985. By capitalizing interest payments at current market rates (rather than indexing the subloan principal to the inflation rate), the cash drain on borrowers is greatly reduced during the early part of the maturities. This facility is likely to induce borrowers to undertake investment projects in the normally unfavorable climate of high nominal interest rates.

will likely make an increased supply of foreign equity available.[20/] Restructuring projects could help mobilize additional equity by providing long-term resources for intermediaries' direct foreign investment.

4.25 Quasi-Equity Investment. Quasi-equity investments offer investors and recipients flexibility with respect to liquidity, profit sharing, and distribution of risk:

- Conditional loans, recently introduced in Bank operations, can be a useful instrument for risk-sharing among final borrowers, participating intermediaries, and executing agency. Moreover, convertible loans are highly flexible in their design. Conditional payments by the borrower can refer to interest payments, principal, or both. The yield of a conditional loan can be based on an interest rate, a revenue-sharing scheme, or a profit-sharing scheme, but its price should be commensurate with its increased risk.

- Convertible loans, not yet used in Bank operations, offer flexibility and the prospect of better returns than do traditional loans or equity investments.

- Subordinated debt, compensated through a higher interest rate, could be useful for companies that do not have sufficient collateral to back overall funding requirements.

Working Directly with Sound Banks

4.27 The Bank continues to rely heavily on state-owned development banks as major channels for direct credit or refinancing for long-term lending to the industrial sector. The assumption has been that commercial banks were not interested in long-term financing and did not have the capacity to appraise large, lumpy investment projects.

4.28 Yet, development banks have demonstrated poor performance and competitive weakness while commercial banks have gained attractiveness as intermediaries. Despite ostensibly superior capacity for project appraisal, development banks have lent--and lost--large sums for non-viable projects, have experienced related deterioration in portfolio quality, and have serious solvency problems. Continued government equity infusions and other subsidies are preventing bankruptcy for many.

4.29 Major commercial banks in many countries are capable of handling corporate finance and equity investments. Most successful commercial banks demonstrate strong market knowledge, financial engineering expertise, and longstanding relationships with industrial

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20/ See Elizabeth Goldstein, "Debt Capitalization Schemes in Developing Countries," 1986 draft, and Kapur and Murphy, "Mechanisms in Facilitating International Investment Know-How," 1987.

clients. In some apex operations in which commercial banks are the main channel for lending, the banks have demonstrated an interest in, and superior capacity for, financing investment projects. The commercial banks--and the small but growing group of investment banks--could become the primary channel for the Bank's financial intermediation loans, especially in industrial restructuring programs.

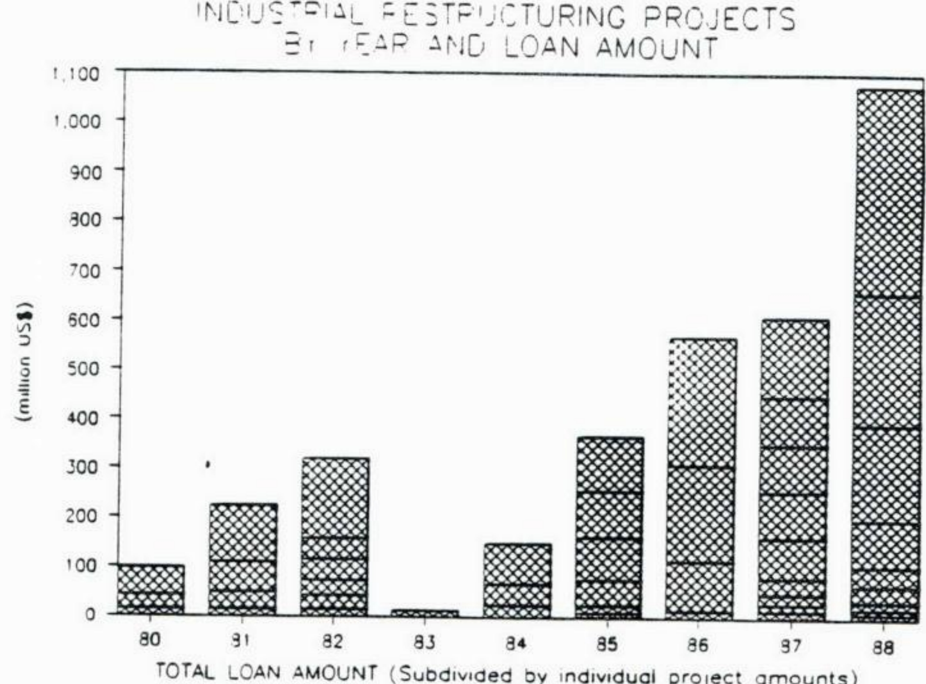
4.30 Under most industrial credit lines, the Bank requires that subloans above an agreed limit be subject to prior Bank inspection, while subloans below the limit can be approved by the apex or retail intermediary in the borrowing country. This system has shortcomings. Because the Bank does not deal directly with the industrial client, the Bank usually examines only the consistency of the client's loan application rather than the substance of the credit decision by the intermediary. Because of the lack of substantive analysis of most subprojects by the Bank, the present system causes long delays in decision-making. The Bank should introduce methods that stress the capacity of the intermediary to evaluate loans rather than have World Bank staff analyze a large number of individual subprojects. The Bank should exclude intermediaries from participating in a loan when they do not meet performance standards. Acceptable performance would become a precondition for participation in Bank loans--not a long term goal. A change in the conditions for participation also would allow reform of subloan approval procedures, to give intermediaries more independence and to concentrate scarce Bank supervisory resources on institutional performance. In particular, the Bank can stop dealing with low quality, government-owned development banks until they have implemented successful institutional reforms.

CHAPTER V

WORLD BANK EXPERIENCE WITH INDUSTRIAL RESTRUCTURING

A. Lending Patterns [21]/

5.01 Chart 5.1, which provides annual industrial restructuring operations by number and amount over the FY88 period, shows a sharp increase in the number of operations in FY87 and a major increase in lending volume in FY88. Lending for industrial restructuring overall increased from about US$550 million in the FY83 to FY85 period to US$3.3 billion in FY86 to FY88. The FY89 to FY91 pipeline reflects a further acceleration. The average size of Bank restructuring loans also increased, from US$43.3 million in FY80 to FY85 to US$121.7 million from FY86 to FY88.



Source: IENIN Industrial Restructuring Database

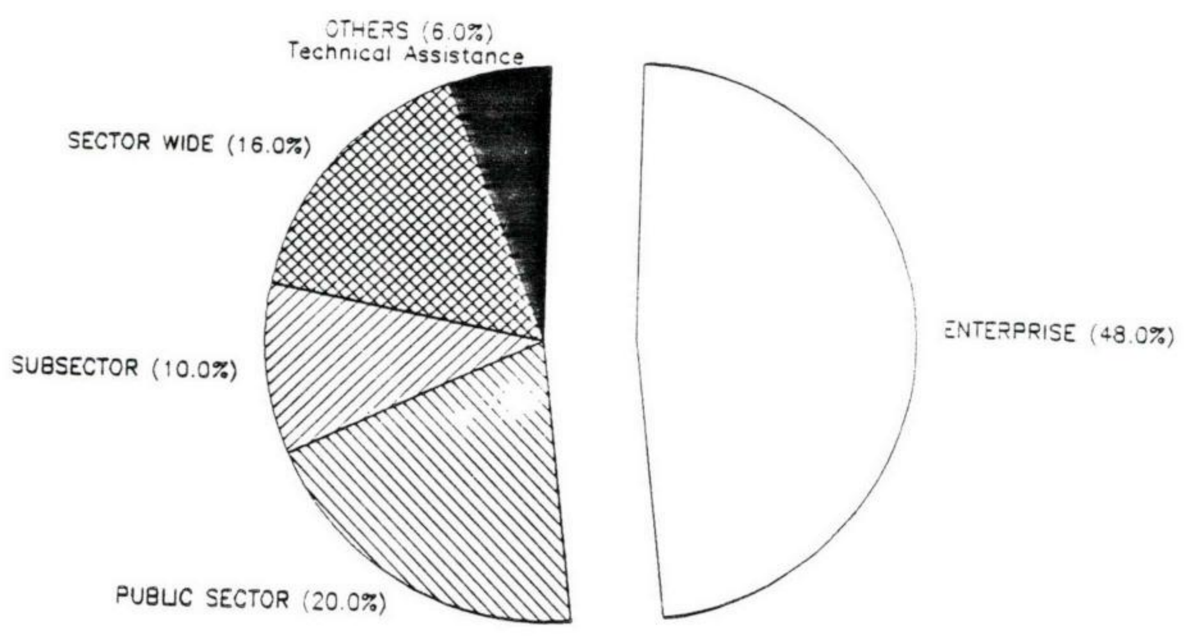
21/ This section is based on a sample of 50 rehabilitation and restructuring projects in 29 countries approved in the FY80 to FY88 period. Seventeen of these restructuring operations were appraised between FY80 and FY84 and 33 between FY85 and FY89. (See Annex 1, Matrix of Projects). The information on the 50 industrial restructuring projects was culled from project documents and interviews of past and present World Bank task managers. (The sample excludes public sector enterprise reform programs in Africa that do not have an industrial restructuring focus. It also does not include relatively minor restructuring efforts under SALs and sectoral adjustment programs.)

5.02 Lending for industrial restructuring overall increased from about US$550 million in the FY83 to FY85 period to US$3.3 billion in FY86 to FY88. The FY89 to FY91 pipeline reflects a further acceleration in industrial restructuring and subsector loans, with a projected US$5.4 billion in 41 operations. The average size of Bank restructuring loans also has increased markedly from US$43.3 million in the FY80 to FY85 period to US$121.7 million from FY86 to FY88.

5.03 The primary focus of restructuring projects in the FY80 to FY88 period is shown in Chart 5.2. The focus of earlier operations was rehabilitation of specific enterprises, with all projects dealing primarily with physical restructuring. The policy or institutional environment received little attention. Recent Bank operations reflect a shift from narrow rehabilitation efforts to operations with policy, institutional, and enterprise measures. Beginning in FY86, industrial restructuring operations increasingly were vehicles for liquidating obsolete or uncompetitive production facilities and for increasing private sector participation. In some operations, policy emphasis increased, with more attention to pricing, entry/exit, regulatory, investment, promotion, and technology. This broader scope has been facilitated by the move from an enterprise focus to subsector and sector-wide industrial restructuring operations in the FY86 to FY88 period.

CHART 5.2

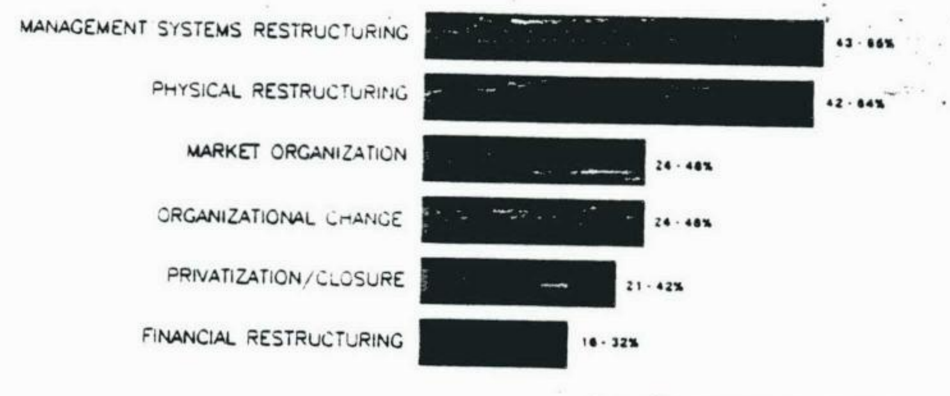
PRIMARY SCOPE OF INDUSTRIAL RESTRUCTURING PROJECTS



Source: IENIN - Industrial Restructuring Database.

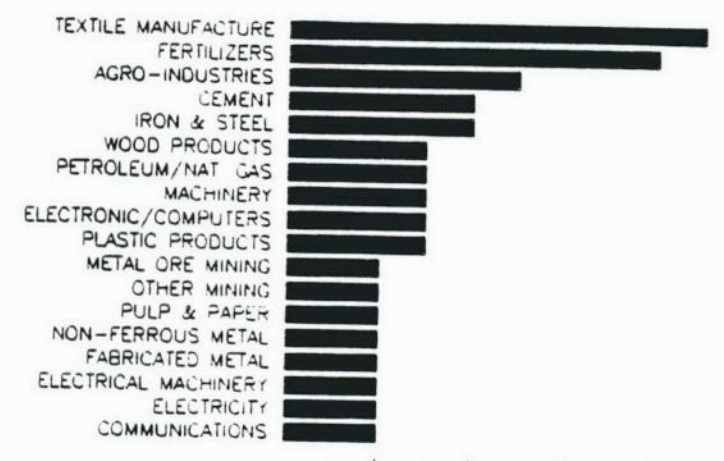
5.04 Chart 5.3 presents a list of industrial restructuring activities and their frequency in restructuring projects. Hardware restructuring components encompass capacity expansion, modernization of plant and equipment--all plant improvements. Software restructuring components include changes in training, marketing, management, labor, information systems--all involving human resources, sometimes supported by technical assistance. In addition to hardware and software restructuring, some operations dealt with privatization or closure (primarily in Africa), market reorientation, and financial restructuring.

CHART 5.3
ENTERPRISE LEVEL INDUSTRIAL RESTRUCTURING ACTIVITES



5.05 Chart 5.4 shows the subsector focus of selected industrial restructuring operations. Textiles, fertilizer, cement, and steel have been the most frequent targets of Bank-supported restructuring operations. Lending has been dominated by heavy, commodity-based industries, often in public sector enterprises. The focus on restructuring heavy industries reflects both the concentration of public ownership and traditional areas of World Bank expertise. World demand for the basic commodities declined in the seventies and eighties at the same time that developing countries were unable to make the huge capital investments needed to become competitive globally.

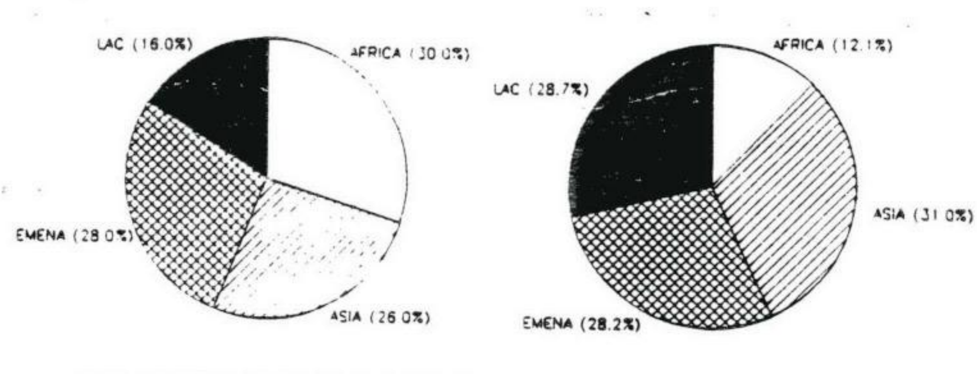
CHART 5.4
RESTRUCTURED SUBSECTORS



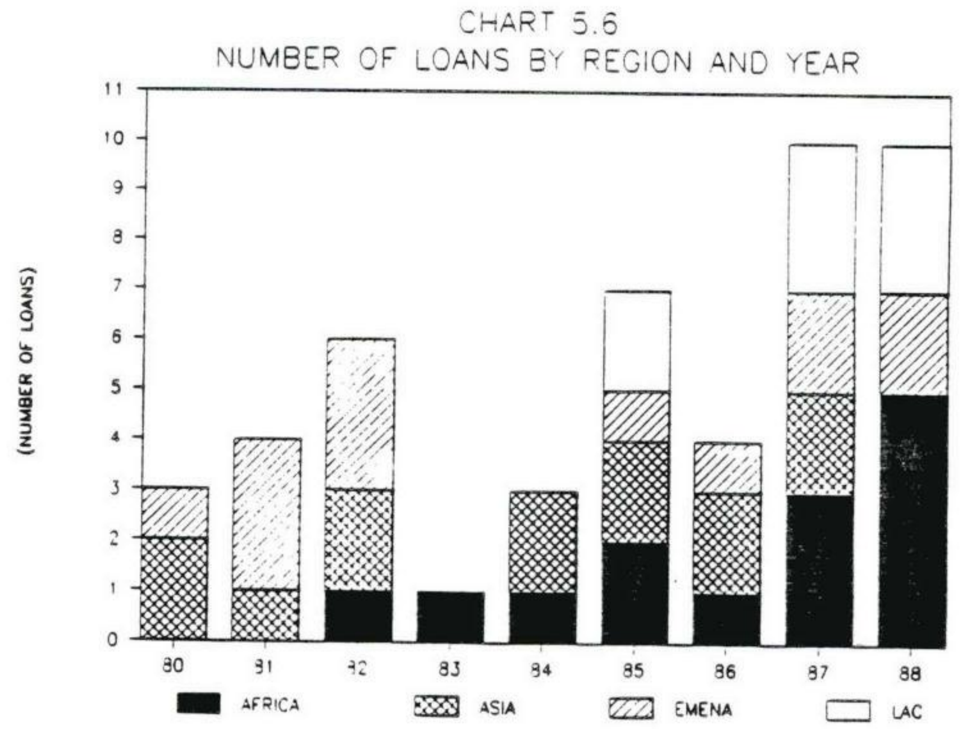
5.06 **Regional distribution of industrial restructuring loans and lending amounts, provided in Charts 5.5 and 5.6., was relatively even over the FY80 to FY88 period. Africa has had the largest number of loans (primarily public enterprise adjustment operations) but the smallest aggregate loan amount. Latin America has accounted for the smallest number of loans but mainly in large operations.**

CHART 5.5

REGIONAL DISTRIBUTION OF INDUSTRIAL RESTRUCTURING PROJECTS FY80–FY88



Source: IENIN - Industrial Restructuring Database.



Source: IENIN - Industrial Restructuring Database

B. Lessons from Industrial Restructuring

5.07 Since the Bank's experience with industrial restructuring is relatively new, with few projects completed, definitive conclusions about effectiveness are not possible. Yet the Bank does have enough experience to provide a basis for designing the next generation of industrial restructuring operations.

5.08 A number of important points emerge from the review of Bank industrial restructuring operations. First, restructuring is a dynamic, ongoing, often highly politicized process. The prospects for successful implementation can be enhanced greatly if the main participants are committed to the project's objectives, are involved in all its phases, and feel that the restructuring program fits local conditions. The Bank can help build consensus for restructuring only by identifying players who have the power and competence to mobilize the political will locally. Involvement by the government--and dissemination of information on the restructuring program to government, private enterprise, and financial leaders--are critically important. Institutional arrangements to ensure broad participation in preparing and supervising industrial restructuring operations are essential to the success of restructuring operations. Appraisal reports should assess and address these political commitment and institutional elements explicitly.

5.09 Second, industrial restructuring operations should respond explicitly to rapid changes in global markets and technology and to sharp shifts in macro and sectoral policies. Due to the uncertainties and difficulties inherent in change, the timing and dimensions of the supply response from restructuring are difficult to predict, making restructuring an inherently risky business, requiring continuous adjustment. These requirements further reinforce the need for continued Bank staff involvement during the implementation phase.

5.10 Third, global subsector studies are essential for systematic industrial subproject evaluation. Studies that cover the international business environment are vital in providing parameters for judging whether restructuring moves by enterprises are consistent with internationally competitive performance. Projects must be grounded in real-life conditions. Analysis of comparative advantage based largely on cost comparisons, an approach used in a number of Bank-supported evaluations, is necessary but insufficient in judging the ability of firms to compete in world markets. To measure competitiveness in a dynamic setting, a firm's ability to compete in world markets is key. Increasingly, this ability depends not only on factor prices and scale economies, but also on firms' flexibility and organizational, technological, and marketing strengths. Restructuring studies on the textile industry in Turkey, the rubber industry in Hungary, and the auto parts industry in Mexico compared these enterprises with leading competitors worldwide. The Bank could gain economies on subsector studies by conducting global studies that assess key cost and quality dimensions; analyze major production, marketing, and management methods used by successful enterprises; and dissect key factors for success of

emerging firms. (Annex 4 provides a representative list of subsector studies in progress or completed, by country and by subsector.)

5.11 Fourth, initial Bank restructuring projects had limited impact mainly because they dealt primarily with physical aspects--without giving adequate attention to regulatory policy issues, ownership, and organization. In recent years, the Bank has placed more emphasis on trade liberalization measures to increase economic competitiveness. It now is important for the Bank also to address other constraints to restructuring, such as protection of monopoly public enterprises, restrictions on direct foreign investment, and major barriers to entry, exit, and expansion. Improvements in management, new product development, marketing and export capabilities, product quality and service, and applied research and development are likely to yield higher returns to developing country enterprises than increased investment in plant and equipment. Most Bank industrial restructuring operations do not provide adequate treatment of these areas.

5.12 Fifth, industrial restructuring operations should reinforce competitive pressures. In the past, Bank lending operations have supported programs to improve performance of parastatal monopolies controlling a basic subsector, e.g., steel, mining, petrochemicals, fertilizers. These subsectors are critical input sources to other downstream enterprises; their monopoly status often has serious adverse effects on the competitiveness of user industries. Most monopoly parastatals are a significant drain on government budgets, and in most cases are grossly uncompetitive. Ideally, grossly inefficient basic industries should be dismantled. At a minimum, barriers to competition should be removed by liberalizing imports, breaking up monopolies, and encouraging private sector entry. If possible, efficient private producers should be lured into the market while competitive pressures are being created. It is highly questionable whether the Bank should support restructuring of parastatals without prior action by governments to promote competitive markets.[22/]

5.13 Sixth, minimum policies for competitive restructuring must be assessed prior to project appraisal. Most recent industrial restructuring operations reflect recognition of the need for regulatory, pricing, and public enterprise reform. Reform programs should be agreed upon as part of restructuring operations or supported by parallel adjustment operations. The Mexico Industrial Restructuring Project complements major import liberalization, and an industrial adjustment operation to dismantle regulatory barriers to competition is under preparation. The restructuring project supports clear policy reform

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22/ For example, the World Bank has financed restructuring operations for FERTIMEX, the parastatal fertilizer monopoly in Mexico, without a clear commitment by the government to allow domestic or import competition. In contrast, restructuring support for textile mills in Bangladesh followed reprivatization of these mills and their divestiture from BTMC, a state-owned textile holding company.

measures affecting autoparts and textiles subsector. When adequate policy measures could not be agreed upon for a segment of agroindustry (e.g., shrimp aquaculture), this component was omitted from the Bank-supported industrial restructuring project.

5.14 Seventh, industrial restructuring requires a five to ten year commitment to change. For example, the Government of Hungary, with Bank assistance, is in the midst of a five-year restructuring program, which includes phased policy reforms and subsector-specific actions, supported by a series of industrial restructuring and adjustment operations.

5.15 Eighth, a risk in complex programs--such as public sector reform--is that the industrial restructuring component will not get adequate attention. A coherent, sequenced restructuring program, phased as several back-to-back projects is more workable,[23/] such as that in Hungary. It can take into account the need for continuous adjustment of the programs in response to a changing environment.

5.16 Ninth, restructuring operations need more than usual Bank supervision. On average, about 30 staffweeks of supervision are required in the first year of operations, dropping to 20 staffweeks in the second year, settling to the more normal 10 weeks by the third year. Interviews with Bank staff reveal that current supervision time is inadequate. Appraisal reports should incorporate explicit supervision commitments--recognizing that the requirements for supporting implementation have been underestimated consistently. Restructuring is a process of change, not a discrete operation such as building a physical plant. Bank staff need to assist client governments in monitoring the process, supervising the consultants, and in providing direct technical assistance.

5.17 Tenth, the quality of financial intermediation is critical to the success of private sector restructuring projects, particularly in countries suffering from severely distorted fiscal policies and banking insolvency. In situations of severe financial sector distress, financial sector restructuring normally needs to precede restructuring of the industrial sector. Also, firms accustomed to operating in protected suppliers' markets--and their bankers--often do not have information on organization, technology, and marketing strategy needed for an effective outward-oriented supply response. Also, the Bank needs to broaden and refine financial instruments to meet the distinct needs of industrial restructuring, supporting maturity swaps, convertible debentures, and debt equity conversions.

23/ The Hungary Industrial Restructuring Program established an agenda for reforms over a defined period, with phased policy changes concurrent with a series of industrial restructuring operations.

5.18 <u>Eleventh</u>, Bank criteria for determining eligible expenditures frequently do not reflect the range of financing needed for effective restructuring. Marketing, research and development, retraining, and production system financing are important in restructuring and should be included in eligible working capital financing.

5.19 <u>Twelfth</u>, most Bank-supported restructuring projects do not address political and social aspects adequately. Too often preparation is overly elaborate, creating major delays and missing windows of opportunity for decisive government action.[24] Also, restructuring almost always has adverse short-term employment consequences It may be appropriate to make Bank financing available for worker retraining and relocation and, in selected cases, for severance payments. Innovative programs could mitigate the political barrier to restructuring that labor organizations often represent. The impact on employment, with and without restructuring, should be analyzed early in the program since employment losses without restructuring may be even more severe, as competitive pressures increase.

24/ The proposed Turkish Restructuring Project did not materialize, in part, because of the long time and complex preparation process for the project, which generated political resistance to proposals for large-scale privatization.

DRAFT

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REVIEW OF INDUSTRIAL RESTRUCTURING PROJECTS, 1980-1988

Country	Project LN/CR Number	SAR Date Current Stage	Loan Type Loan Amount	Units Restructured	Background/ Objectives	Restructuring Components	Specifics/ Features
I. AFRICA							
Benin	Public Enterprise Sector Rehabilitation Project CR-1748-BEN	1987 Implementation	NON US$15.0 million	SOE sector and selected public enterprises.	Assist Benin in rehabilitating its public enterprises.	Technical assistance to help preparation and execution of agreed sector policy reforms, enterprise diagnostic studies, liquidation plans or rehabilitation studies; Credit to finance IDA-approved emergency and full rehabilitation programs for selected enterprises; Assistance in training and redeployment of staff laid off.	The program of liquidation is progressing satisfactorily: 8 enterprises have been liquidated and some activities taken over by the private sector.
Congo	Public Enterprise Institutional Development LN-2868-COB	1988 Implementation	TAL US$15.2 million	SOE sector	Facilitate the Government's Structural Adjustment Program, with special focus on PEs: rehabilitation, rationalization, financial restructuring, strengthen monitoring, autonomy and accountability of PEs; and help elaborate further necessary macroeconomic and sectoral reforms. Liberalization of PE environment to promote efficiency and competition.	Comprehensive PE reform: support for implementation and monitoring of reform measures (privatization, liquidations, banking system reform); management training program for financial management, management information systems and personnel administration; auditing and accounting assistance, technical assistance to key PEs; studies for medium-term policies and sectoral strategies; technical units.	French financial support; essentially software components.
Ghana	Public Enterprise Project CR-1847-GH	1988 Implementation	TA US$10.5 million	SOE sector	Strengthen the State Enterprise Commission (SEC) to manage the SOE reform program; Improve management and performance in priority SOEs; Reduce the burden of the sector on Government through divestiture.	Advisory/consulting services for strengthening the SEC and for implementing the first phase of the divestiture program.	The major problem remains the limited institutional and administrative capacity of SEC to carry out the agreed work program.

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Country	Project LN/CR Number	SAR Date Current Stage	Loan Type Loan Amount	Units Restructured	Background/ Objectives	Restructuring Components	Specifics/ Features
[illegible]inea	Industrial Rehabilitation and Promotion Project CD-1234-GUI	1982 Closing date: 12/31/89	DFC US$19.0 million	Four PEs in floor tiles, soft drinks, perfumes, granite quarrying and the whole industry sector	Increase the scope of the private sector and improve the performance of public enterprises.	Complete rehabilitation of four PEs through provision of equipment, technical assistance and training; Promotion of private sector enterprises through the provision of long term credit and the expansion of the role of the Ministry of Small and Medium Size Enterprises; Provision of TA and training to CNCPI (major industrial bank) to enable it to act as the local financial intermediary; TA to GOG to improve formulation of industrial policy and strategy.	During implementation, the Government recognized the need to enforce deeper policy measures to further promote competitiveness and enhance the scope of the private sector in the economy. A trade, regulatory, pricing, fiscal and financial reform was undertaken. As a result, the project has been substantially redesigned to support the ongoing policy reform: privatization of PEs (provision of TA to the newly-formed group in charge privatization/liquidation of PEs), creation of an effective SME investment promotion structure, liquidation of the State banks and reform of the banking system. The line of credit has been transfered to BICIGUI.
[illegible]awi	Wood Industries Project LN-2486-MAI	1985 Implementation	IND US$6.4 million	The newly-formed Wood Industries Corp. (WICO)	Assist Malawi in meeting its demand for wood products, encourage privatization and develop institutions in the sector.	Technical assistance to WICO to organize and operate as a private company; Rehabilitation of three mills and purchase of critical spare parts and equipment; Technical assistance to the Government for developing alternative uses for forest resources.	

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Country	Project LN/CR Number	SAR Date Current Stage	Loan Type Loan Amount	Units Restructured	Background/ Objectives	Restructuring Components	Specifics/ Features
Mali	Public Enterprise Sector Adjustment Credit N.A.	1988 Implementation	NON US$40.0 million	Public Sector as a whole	The Public Sector in Mali has performed poorly and imposed a heavy burden on both the banking system and Government finances (because of ill-conceived investments, inappropriate economic policies and regulations, lack of financial discipline within the public sector and deficiencies in Government-enterprise relations). A Public Sector Restructuring Project was appraised in 1986 but never accepted because of political conflicts within the Government. The project has been slightly redesigned and was eventually accepted in FY88.	Reform of key economic policies concerning public resource management and the structure of economic incentives; Financial sector reform; Institutional and legal reforms redefining relations between Government and PEs; Rationalization of the sector through liquidation, privatization or restructuring of the 15 PEs.	The success of the project crucially depends on the Government's commitment; The privatization process is at a standstill: thin financial market/no potential buyers.
Mauritania	PE TA Rehabilitation Project CR-1567-MAU	1985 Implementation	NON US$16.4 million	Public Sector Reform with direct support to SONELEC (Societe Nationale d'Eau et d'Electricite), EMN (Etablissements Maritimes de Nouakchott) and OPT (Office des Postes et Telecommunications).	The effective operation of Mauritania's Public Enterprise Sector is hampered by financial, legal, political, organizational and human resources constraints. The project is therefore designed to assist the Government in articulating an appropriate medium-term plan for the sector and in gradually implementing this plan, starting with a few selected enterprises.	Studies and institutional reform on basic issues facing the PE sector, TA to "Parapublic Rehabilitation Unit," development of a medium-term rehabilitation program, external audit of the three participating PEs; Support to SONELEC and EMN: Physical rehabilitation, organizational and institutional changes, TA and training; TA to OPT to improve its financial management and prepare a detailed medium-term rehabilitation plan.	The project is progressing with no major problems.
Mauritania	SNIM Rehabilitation Project LN-2643-MAU	1986 Expected closing date: 12/31/88	IND US$20.0 million	Societe Nationale Industrielle et Miniere (SNIM), the parastatal company in charge of iron ore mining in Mauritania	Ensure the medium-term financial and economic viability of SNIM, one of the most valuable assets of the Mauritanian economy.	Purchase of equipment and supplies and provision of training and TA for the rehabilitation of SNIM; Assisting the financial restructuring of SNIM by transforming part of its short term debt/draft into long term debt.	Despite successful completion of project, cash flow could not be balanced in 1988 due to lower dollar value and low iron ore price.

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Country	Project LN/CR Number	SAR Date Current Stage	Loan Type Loan Amount	Units Restructured	Background/ Objectives	Restructuring Components	Specifics/ Features
Niger	Public Enterprise Institutional Development CR-1838-NIR	1988 Implementation	TAL US$5.5 million	SOE sector, including Radio and TV enterprise	Institutional and legal changes undertaken to increase PE efficiency; improve general policy environment and incentive systems; divestiture program, private sector encouragement; price and trade liberalization. Major goal is to strengthen PE management capabilities—currently weak and with limited comprehension for the reforms—to respond to the changed policy environment.	Institution strengthening and building: support for Government, implementation and monitoring of reforms, development for additional measures; development of management tools of enterprises, improvement of procurement practices, comprehensive training program; restructuring of ORTN, the Radio and TV PE; organization and accounting strengthening; rehabilitation; financial restructuring.	Supports the Public Enterprise Sector Adjustment Program; heavy emphasis on software strengthening and institutional support for reforms.
Niger	Public Enterprise Sector Adjustment CR-1833-NIR	1987 Implementation	CR-1833-NIR US$80.0 million		As part of SAL, comprehensive reform of SOE sector, including revision of incentive policies (price liberalization, reduction of public monopolies) improvements in legal and institutional framework (autonomy, control and monitoring, procurement), and rationalization (rehabilitation, privatization, liquidation) of SOEs.	PE Sector Adjustment Program (PESAP) to deepen these reforms, focusing on financial restructuring of PEs (analysis of cross-debt, financial discipline and self-sufficiency) and public resource management, including training and technical assistance, selected physical rehabilitation, and improvements in personnel and procurement practices, organization and operations.	Heavy software component; credit funds to finance merchandise imports and for PE financial restructuring. 1000 lay-offs expected with severance benefits, plus other social considerations.
Senegal	Industrial Sector Restructuring Project CR-1868-SE	1988 Implementation	US$33.0 million	Sector-wide, with a major emphasis on agro-industry and textile. In order to "guide" the restructuring process, a thorough study assessed the concrete impact of the policy reform on the industrial sector.	SAL II and III initiated important reforms of the protection system, export incentives and labor regulations that are expected to go a long way towards improving the industrial policy environment and promoting competitiveness. The Industrial Restructuring Project would support the Government in its effort to adjust the sector, and to help individual enterprises implement restructuring programs to adapt their operations to the new policy environment.	Line of credit to finance restructuring (through modernization of equipment, rationalization of production processes and introduction of new technologies); Technical assistance to strengthen the institutions: reinforcement of the Ministry of Industry, familiarization of the staff of the Central Bank and participating banks with lending procedures and appraisal techniques, restructuring of the Export Credit Insurance Agency and the Center for External Trade; Program of assistance to displaced workers through a retraining scheme and an entrepreneurship development program.	Sound and supportive macro and micro environment: satisfactory sequencing of reforms; The financial sector as a whole is expected to play a leading role in the restructuring process: local development and commercial banks will act as financial intermediaries under an apex arrangement; Innovative social component.

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Country	Project LN/CR Number	SAR Date Current Stage	Loan Type Loan Amount	Units Restructured	Background/ Objectives	Restructuring Components	Specifics/ Features
Tanzania	Multisector Rehabilitation Credit CR-1741-TA	1987 Implementation	US$96.2 million	Sector-wide, especially agriculture and transport and parastatals in general	Economic Recovery Program (ERP) targeted to increase capacity utilization (supply response) in the industrial sector and free resources for most efficient firms. External sector, fiscal and monetary policies changes: foreign exchange screening process, exchange rate and trade liberalization, positive interest rates, cut in subsidies and transfers. As macro environment improves, need for reforms in parastatals to make them responsive to price signals.	Foreign exchange for imports needed for rehabilitation; assistance for agenda setting of future policy changes; improvement of management and operation of parastatals, rehabilitation rather than expansion, increase quality of public expenditures; improve marketing, incentives, debottlenecking in agriculture.	Support for ERP policy reforms; essentially helps start a process for deeper restructuring of the industrial sector. African Facility Credit and Special Joint Financing (U.K., W. Germany and Switzerland).
Togo	Private Enterprise Development Project CR-1843-TO	1988 Implementation	US$11.5 million	Private industrial firms especially small and medium scale enterprises.	A structural adjustment program is underway to address reforms in the industrial policy such as price controls, tariffs and QRs. The project is designed to put in place appropriate support measures to help achieve the expected response from private industry and especially from the SME sector.	Assistance to the new private sector-oriented investment promotion/extension system; Support to the Government's ongoing parastatal privatization program; Pilot program to lead to the establishment of a credit delivery system for microenterprises; A line of credit to finance existing enterprises as well as new projects in the private sector supplemented by training the banks in project economic analysis.	All Togolese banks in compliance with the Central Bank refinancing criteria would be eligible for access to the credit line under an apex arrangement.
Togo and Ghana	Restructuring Project for CIMAO CR-1326-TO/CR-1327-GHA	1983 Closed - PPAR available	SSE US$15 million	The Ciments de l'Afrique de l'Ouest, (CIMAO), one of the first major multinational African industrial ventures by Togo, Ivory Coast and Ghana. It was designed to produce clinker for delivery to grinding stations producing cement in the three countries	The company started production in 1980. The objective of the project was to set the company on a sound operational and financial footing.	Management and technical assistance to help CIMAO to achieve full capacity utilization rapidly; Additional quarry equipment to prevent quarry operations from becoming a bottleneck; Restoration of working capital to a healthy level through provision of equity from shareholder Governments.	The credit was never used since the plant was forced to shut down in April 1984 (due to a power shortage caused by the drought in West Africa). A major factor which led to CIMAO's failure was the emergence of extremely high production costs (very large administrative and TA expenses, doubling in fuel oil costs in real terms, high indebtedness of the project, cost overruns and excessive operating expenses). Another reason is the erroneous judgement passed on prospects for cement and clinker prices and on cement consumption. The CIMAO project was one of the last "grand vision" type of projects. There is little hope for CIMAO to restart operations in the future.

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Country	Project LN/CR Number	SAR Date Current Stage	Loan Type Loan Amount	Units Restructured	Background/ Objectives	Restructuring Components	Specifics/ Features
Zambia	Export Rehabilitation and Diversification LN-2391-ZA	1984 Implementation	IND US$75.0 million	One main SOIE in subsector copper mining with strong linkages to rest of economy	Improve operations and competitiveness of company.	Replacement and physical rehabilitation; spare parts; extensive training program, and building of managerial skills; technical studies for rationalization of operations and strategy (including mine closure).	Severe implementation problems: foreign exchange availability and allocation, adverse copper prices, low managerial capacity, need for major financial restructuring, political interests, adverse microeconomic environment.
2. ASIA							
Bangladesh	Second Textile Industry Rehabilitation CR-1477-BD/SF-22-BD	1984 Implementation	DPC US$45.0 million	Seven public and 15 recently privatized mills in textile sector	The Government has denationalized a total of 22 mills. 1982: New Industrial Policy to encourage private sector participation. Need for higher capacity utilization, efficiency and price deregulation.	Balancing, modernization and rehabilitation, spares; institutional mechanisms to strengthen strategy for changing markets; training for managerial and technical staff.	Loans to private mills through two state-owned banks; financial restructuring of the privatized beneficiaries by the Government as a loan condition. Implementation has found many obstacles: need for autonomy to mills managers and adequate incentive structure; failure to complete financial restructurings; increased competition in market from imports and smuggled goods. In the end, public mills substituted for private firms that were to be the major target of the operation. Broad instability, bad sequencing: macro framework not considered, and constraints were not properly removed. Good effect on production. Software as important as hardware.
Bangladesh	Textile Industry Rehabilitation CR-1205-BD	1982 Cancelled	IND US$30.0 million	One SOE (holding) in the textile sector	Expand output and quality, and operational and financial performance of mills.	Rehabilitation through balancing, modernization and replacement of equipment of 15 mills; technical assistance to strengthen management system of holding and its mills; project implementation cell; quality controls.	Intended rehabilitation of 50 SOE mills split into three-phase projects, 1982-85; after appraisal, 9 of the 15 mills were privatized, and nine other mills replaced them in the project; intermill asset swaps; delays in implementation. Only six mills rehabilitated.
Bangladesh	Fertilizer Industry Rehabilitation CR-1023-BD	1980 Completed	IND US$29.0 million	Three plants of the SOE	Improve production and performance (increase capacity utilization). To support this: price deregulation, foreign exchange availability, skilled work force.	Debottlenecking, physical rehabilitation, replacement, improvements in instrumentation, training center, imported plant spares, corporate and organizational restructuring (subsector-wide holding).	Holding company concept; privatization of downstream activities; relies on hardware restructuring, complemented with software and institutional elements.
Bangladesh	Jute Industry Rehabilitation CR-1032-BD	1980 Completed	SSE US$20.0 million	One SOE in the subsector jute	Increase production efficiency in the jute industry, Bangladesh's most important in terms of employment, value added and total exports. A major goal is to stay competitive with polypropylene fabrics producers.	Physical rehabilitation, maintenance, balancing, intermill transfer of machinery, spares for maintenance; training centers; incentive systems, management information and accounting systems, regionalization of authority; third shift; industry reorganization; government debt to equity conversions and cash infusions.	In 1980, six specialized mills had been divested, but no further privatization was being discussed. In 1982-83, 28 of the 66 public mills were (re)privatized. Cash infusion were planned to be reduced by any profits over the following years. Combination of software, hardware and institutional elements.

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Country	Project LN/CR Number	SAR Date Current Stage	Loan Type Loan Amount	Units Restructured	Background/ Objectives	Restructuring Components	Specifics/ Features
Burma	Wood Industries I Project CR-1114-BA	1981 Closed	AGR US$32.0 million	The publicly-owned Timber Corporation, a monopoly in the wood processing activity	The project forms part of the Government's development strategy which emphasizes higher export earnings through better capacity utilization and efficiency in Burma's teak sawmills and plywood operations.	Reconstruction and modernization of two sawmills, rehabilitation of two plywood and veneer mills and of the existing furniture factory, improvement of log storage and handling, construction of a central workshop, strengthening of administrative, marketing, monitoring and construction facilities, training and technical assistance.	Full utilization of investments made has been constrained by shortages of manpower, logs and imported materials.
Burma	Textile Finishing Plant Project CR-1425-BA	1984 Expected closing date: 12/31/88	IND US$29.7 million	Construction of a textile finishing plant to be operated under the Textile Industries Corporation (TIC, a State economic enterprise)	Expand Burma's limited fabric finishing capacity to match grey fabric output and partially replace the obsolete and uneconomical finishing facilities in some of the small weaving plants.	Construction of a new textile finishing plant	The rate of disbursement has been slow, mainly because SDR 2.0 million of the credit released by the Bank remains under control of the Ministry of Finance and Planning and the project has no authority to use the funds directly.
China	Shanghai Machine Tool Project LN-2784-CHA	1987 Implementation	IND US$100.0 million	SMTC and SWTC, two machine tool enterprises which account for 80% of the Shanghai province machine tool output	In order to quantitatively increase the industrial output and improve its quality, the modernization of the machine tool industry has been assigned high priority by the Government. The restructuring of two large enterprises is expected to create a demonstration effect.	Plant modernization rehabilitation/ mergers/closures; Technology transfer; Introduction of a comprehensive management system with the assistance of foreign consultants; Training program to improve management and design capabilities.	Restructuring takes place at the enterprise level and leaves little room to individual/management initiative. The subsector as a whole will be affected only indirectly; Due to their exorbitant cost by local standards, local managers have been reluctant to use consultants; Most of the signals remain distorted (pricing, exposure to the outside world) which hampers the restructuring process and its sustainability.
China	Fertilizer Rationalization LN-2838-CHA	1987 Implementation	IND US$97.4 million	Five SOE's and subsector as a whole	Ongoing economic reforms have led to changes in fertilizer and allocation policy. A two-tier pricing system has emerged: controlled (state quota) and market determined (partial liberalization). Increased management autonomy under the reforms to help plants "grow out of state plan." Also, marketing decentralization: plants market directly.	Five plants: conversion to high nutrient fertilizer, improve operations, energy savings, modernization, rationalization, expansion, organization changes, management information system, quality improvements. Subsector: training, management efficiency study to strengthen sector wide institutional efficiency by introducing improved enterprise-level systems for organizational structure and effective management.	Representative medium-size enterprises. Demonstration effect. Energy saving technologies also permit the production of improved, higher-grade fertilizer.

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Country	Project LN/CR Number	SAR Date Current Stage	Loan Type Loan Amount	Units Restructured	Background/ Objectives	Restructuring Components	Specifics/ Features
China	Fertilizer Rehabilitation and Energy Saving LN-2541-CHA	1985 Implementation	IND US$97.0 million	Five SOE plants in fertilizer subsector	Price reforms: increase role of market forces in determining product prices. Demonstration effect to prepare industrial enterprises for the new incentive regime of the price structure by improving energy efficiency and reducing production costs.	Physical rehabilitation, modernization, energy saving measures; financial management and implementation capacity, staff training, technology development and research, studies for modernization strategies; assistance for international procurement.	Projects sequencing in the subsector.
India	Cement Industry Project LN-2660/1-IN	1985 Implementation	IND US$200.0 million	One SOE and six private sector plants	Help enterprises cope with an environment without price controls (dual pricing will be phased out); efficiency and quality improvements; demonstration effect.	Modernization: technical conversion (wet to dry process), assistance and training for the seven companies; credit line for minor modernizations of others; strategy and management development for subsector.	Environmental considerations; two state-owned financial intermediaries to help select private beneficiaries; marketing and distribution improvements; two plants—one SOE—pulled out, substitutes identified; cross sector impact (drop in coal quality); advances in price decontrol.
India	Industrial Export Project—Engineering Products LN-2629-IN	1986 Implementation	DFC US$250 million	Engineering products subsector and ancillaries, and export-oriented activities	Significant changes in regulatory policies to reduce barriers to entry and expansion made prior to the loan.	Term lending by ICICI to medium and large enterprises, with 60% earmarked for export-oriented investments by firms manufacturing engineering products; Line of credit made available to engineering ancillaries through selected commercial banks; Establishment of a Productivity Fund and an Export Marketing Fund.	Broad and far-reaching industrial policy measures were taken by GOI in 1985; the project provided complementary institutional support and finance to accelerate the supply response.
Philippines	Textile Sector Restructuring Project LN-2127-PH	1982 Implementation	IND US$157.4 million	Private industries in the textile subsector	In 1980, the Government introduced a comprehensive industrial reform program that involved phased tariff reductions, import liberalization, investment and export incentive measures. This loan was designed to provide TA and training to improve industrial operations and finance for rehabilitation of equipment in order to ensure that the adjustment takes place at the industry level smoothly and with minimum disruption.	Physical rehabilitation, modernization and expansion of the various industries in the textile subsector; Training and TA to individual firms to improve operations and management; Setting up of training facilities/programs; Consulting services to assist the Government.	The line of credit was made available to DBP (Development Bank of Philippines) to finance eligible subprojects. The textile industry has faced serious difficulties due to rapid and continued decline of domestic demand. To alleviate this negative impact, a number of schemes are being developed to increase the industry's exports: an "Advance Tax Credit Scheme" is being promoted and a pilot scheme for Commodity Financing Facility may be financed by the remaining funds under the Bank loan.

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Country	Project LN/CR Number	SAR Date Current Stage	Loan Type Loan Amount	Units Restructured	Background/ Objectives	Restructuring Components	Specifics/ Features
Thailand	Bangchak Oil Refinery Restructuring Project LN-2548-TH	1985 **Implementation**	US$85.0 million	Bangchak refinery, which had been run in the past as a Government dependency under the Ministry of Defense and was in 1985 established as a fully autonomous and commercial company (Bangchak Petroleum Company).	Rehabilitate the refinery and make it financially viable in the objective of meeting the new profile of internal demand for petroleum products and attracting private participation in the company.	Physical, legal, organizational and financial restructuring of Bangchak Oil Refinery; Provision of engineering and management assistance; Carrying out of a technical and economic study to determine further modifications required to insure that the yield pattern of refineries in Thailand be in balance with the demand profile for petroleum products in the country.	Main focus on the physical rehabilitation. Creation of an autonomous SOE no longer dependent on the Ministry of Defense.

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Country	Project LN/CR Number	SAR Date Current Stage	Loan Type Loan Amount	Units Restructured	Background/ Objectives	Restructuring Components	Specifics/ Features
EMENA							
Egypt	HADISOLB Steel Rehabilitation Project LN-2002-EGT	1987 Closing date: September 30, 1980	IND US$64.0 million	The Egyptian Iron and Steel Company (HADISOLB), the only integrated steel plant and the largest steel producer in Egypt.	More effectively utilize existing facilities through rehabilitation together with operational and management improvement.	Removal of production bottlenecks through introduction of improved operating and maintenance practices, improved process control and instrumentation; assure reliable transportation between the mine and the steel plant; agreement with the Egyptian Electrical Authorities to assure that its expanding needs for electric power will be met efficiently. Technical assistance for improvement in operations and management. In-plant training and retraining of the surplus manpower.	Overall delay in implementation of 5 years due to inherent difficulties in HADISOLB's management system. The completion of "software" elements—management information system, training program, job classification and incentive system, program of pollution control and safety—has not been fully achieved.
Egypt	Pulp and Paper Project LN-1849-EGT	1980 Completed - PCR available	IND US$50.0 million	The largest two pulp and paper companies (National and RAKTA, both publicly-owned), whose output accounts for 70% of domestic paper production.	Increase capacity to lessen the country's requirements for imported paper and improve product quality to be better able to compete with imports.	Much machinery revamping. Technical assistance program to improve maintenance and operating practices. Agreement with the Government to let the two companies operate under Law 43, which frees the companies from the restrictive regulations of the public sector, particularly those related to product pricing or compensation of skilled workers, engineers and management.	The implementation of the project was delayed due to a change in Government which led to a change in policy. The new Government refused to let the companies operate under Law 43. National achieved about 40% of the additional output anticipated at appraisal, and Rakta 70%. Differences between the performance of the companies can clearly be traced to differences in the management and particularly the chairmen of the companies. Unfavorable microeconomic environment: companies must still buy pulp at full international prices on the world market and sell paper domestically at prices which are fixed lower than international prices. Lack of adequate attention paid to ensuring the availability of critical non-project inputs: shortage of fibrous raw material from domestic sources.

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Country	Project LN/CR Number	SAR Date Current Stage	Loan Type Loan Amount	Units Restructured	Background/ Objectives	Restructuring Components	Specifics/ Features
Hungary	Industrial Restructuring Project I LN-2700-HU	1986 Implementation	IND US$100.0 million	"Hybrid" project: provides support to both the industrial policy reform program and the specific restructuring strategy for the plastic subsector.	Starting in 1985, the Government began to introduce a reform program affecting the entire economic management system of Hungary. This policy reform needed to be reinforced by specific actions and measures to ensure an accelerated supply response in the short-term, by developing further the requisite institutions to support market mechanism, by restructuring enterprises and subsectors and by creating a demonstration effect on the rest of the sector.	Industry-wide restructuring: provides finance to meet to incremental working capital requirements of eligible enterprises, provide T.A. and training to institutions, strengthen the role of innovation finance institutions, introduce training programs for executive management and provide support to the banking system to help implement the separation of NBH into a central bank and two competing commercial banks. Specific subsector restructuring component: line of credit for the restructuring of specific enterprises and facilities established at NBH to finance the restructuring of non-selected enterprises.	Series of loans to help maintain the momentum of the reform. Action on the policy/regulatory environment, the financial system and at the subsector and enterprise level. The subsector approach, which was justified by the degree of distortion in the Hungarian economy at the eve of the reform, has evolved towards a sector-wide approach, with the newly-created banks acting as financial intermediaries, while in parallel further reducing distortions in the policy environment. The sequencing and magnitude of the reform was dictated by the search for "second/best" solutions: the economy was not ready for drastic and immediate measures, and the need for reforms had to be recognized to ensure Government's commitment. Gradual but sustained exposure to competition--favorable to the change in management/ investors' attitude--is coupled with pilot schemes at the enterprise level to expedite the supply response. The vehicles used--hybrid loans followed by an ISAL coupled with a restructuring project--were in line with the degree of leverage needed to ensure the enactment of the policy reform program.
Hungary	Second Industrial Restructuring project LN-2834-HU	1987 Implementation	IND US$150.0 million	Four subsectors (rubber processing, agricultural machinery, food processing machinery and plastic processing), feeder industries and industry sector.	Help maintain the momentum of the reform process and further restructure the industry. Like the first project, it supports both the industrial policy reform and a subsector specific restructuring strategy.	Industry-wide restructuring component: specific support for industry-wide restructuring (US$40 million), support for feeder industries (US$50 million), T.A. to support the reform program, to restructure the banking system and to formulate strategies for restructuring. Subsector restructuring component: development of technical infrastructure (establishment of quality control, standardization and marketing and information centers), restructuring of enterprises in the selected subsector and technical assistance for the preparation of restructuring programs.	
Hungary	Industrial Adjustment Loan N.A.	1988 Implementation	- US$200.0 million	-	Accelerate the reform process while further strengthening the microeconomic and sector policy content of lending policy.	Major policy reforms: further reduce budgetary support to inefficient enterprises and stringent application of the liquidation framework, strengthened incentives for convertible currency exports, facilitate entry of new enterprises and private entrepreneurship, further reform taxation, pricing and wage systems and reduction of producer and consumer subsidies. The loan would finance all goods to be imported into Hungary except a specific list of excluded goods.	
Hungary	Third Industrial Restructuring Project N.A.	1989 -	- -	Sector-wide with an emphasis on export oriented firms, feeder industries and SMEs.	Complement the Bank's support under the ISAL and help accelerate the managerial, technological and financial restructuring of Hungarian industrial enterprises and the development of small businesses.	Enterprises credit component: Lines of credit to export-oriented enterprises, feeder industries and small and medium size enterprises. T.A. component: T.A. to participating banks to strengthen their operations, carrying out of enterprise subsector restructuring studies by MOI, strengthening of the analytical framework for the small business sector.	

REVIEW OF INDUSTRIAL RESTRUCTURING PROJECTS 1980-1988

Country	Project LN/CR Number	SAR Date Current Stage	Loan Type Loan Amount	Units Restructured	Background/ Objectives	Restructuring Components	Specifics/ Features
Jordan	Second Arab Potash LN-2786-JO	1987 Implementation	IND US$12.0 million	One large, state-owned export company.	Raise production and expand design capacity.	Refinery modifications, technological improvements; physical debottlenecking; plant expansion; technical assistance for studies on market prospects and business growth; training; financial restructuring.	Careful consideration of marketing arrangements and patterns; cofinancing by USAID and Islamic Development Bank.
Pakistan	Fertilizer Industry Rehabilitation Project LN-2172-PAK	1982 Completed - PCR available	IND US$38.5 million	The National Fertilizer Corporation of Pakistan Ltd., the State-owned holding company of several production and marketing companies.	Help assure the continued availability and increase the supply of domestically produced fertilizers, thereby contributing to satisfy a growing demand which otherwise would have been met by imports.	Physical rehabilitation, rationalization and expansion of production facilities. Improve the NFC Groups' capability to operate and manage these facilities and assist GOP in undertaking a study for the establishment of additional fertilizer production capacity.	Major lessons learned: A competent, adequately staffed project team must be established in the early stage of project execution. Cumbersome government/company procedures need to be streamlined for early clearance of project design. Adequate training of personnel is necessary to ensure smooth plant start-up and operation.
Pakistan	Cement Industry Modernization LN-2884-PAK	1988 Implementation	IND US$96.0 million	Public holding company in cement subsector, and whole subsector.	Price and import liberalization; reentry of private sector to subsector. Hence, need for modernization, scale, location and commercial practices improvements, particularly in public plants (private plants at full capacity), in the wake of increasingly competitive market environment.	Physical rehabilitation and wet-to-dry conversion of one public plant; physical rehabilitation, balancing and modernization of five other plants; corporate strategy and planning; management information system; operations improvements; training and technical assistance, and research institute with private sector participation.	Environmental and energy savings considerations. Combines software, hardware, and institutional reforms.

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REVIEW OF INDUSTRIAL RESTRUCTURING PROJECTS 1980-1988

Country	Project LN/CR Number	SAR Date Current Stage	Loan Type Loan Amount	Units Restructured	Background/ Objectives	Restructuring Components	Specifics/ Features
Tunisia	Electrical and Mechanical Industries Projects (I and II) LN-2113-TUN LN-2554-TUN	1982 (EMI I) 1985 (EMI II) Implementation of EMI II	IND US$80.0 million US$54.0 million	The electrical and mechanical subsector, with a major emphasis on private sector enterprises.	Substantial opportunities have been identified in the EMI subsector for both import-substitution and export, for job creation and the achievement of sound industrial linkages. Rationale for EMI II: the relative demand from investors for financing further EMI subprojects.	Financing of new and modernization/rehabilitation projects in the EMI subsector. Institutional building: establishment of an institute for standardization and quality control (INNORPI) and creation of a technical center (CETIME) to increase the delivery of technical assistance to EMIs. Help implement changes in incentives specific to EMIs in the areas of protection, export and financing.	Diversification of the financial intermediaries under the second project: BDET under EMI I; BDET, BTKD and STUSID under EMI II. Even though EMI I was a success, the implementation of EMI II is on the slow side (US$22.5 million of the line of credit have been cancelled) due to the collapse of the car assembly industry and the over estimation of demand. Tunisia is moving towards a broader approach of industrial restructuring and may allow any restructuring project to be eligible for financing under both the export and EMI lines.
Tunisia	SOGITEX Textile Rehabilitation - SITEX Subsidiary LN-2012-TUN	1981 Completed.	IND US$18.6 million	Largest textile group, publicly-owned.	Improve quality and increase export capacity to boost competitiveness in EEC market.	Physic... rehabilitation, modernization and expansion; debottlenecking; training and technical assistance: management and accounting systems, assessment of marketing potentials; spare parts and imported raw materials; institutional development.	Very successful; environmental and workplace conditions considered; excellent analysis of demand and technology trends was crucial; close monitoring from Bank, good marketing arrangements; groundwork for further restructuring and privatization; all inputs imported; managerial and operational improvements achieved; great demonstration effect.
Turkey	Fertilizer Rationalization and Energy Saving Project LN-1985-TU	1981 Closing date: 12/31/88	IND US$110.0 million	Three fertilizer complexes—the Kutahya II and Samsun complexes of TUGSAS and the Yarimca Complex of GUBRE	Increase fertilizer production.	Rehabilitation of the three selected enterprises. Expansion of training facilities of AZOT and IGSAS. Technical/management services to improve corporate and plant level management. Consulting services for a fertilizer marketing and pricing study.	The IGSAS and TUGSAS subprojects have been physically completed but TUGSAS and GUBRE are not meeting financial covenants due to depressed world prices.

REVIEW OF INDUSTRIAL RESTRUCTURING PROJECTS 1980-1988

Country	Project LN/CR Number	SAR Date Current Stage	Loan Type Loan Amount	Units Restructured	Background/ Objectives	Restructuring Components	Specifics/ Features
Turkey	Second Fertilizer Industry Rationalization and Energy Saving Project LN-2131-TU	1982 Implementation	IND US$44.1 million	1 public, 2 private companies in the fertilizer subsector (GUBRE, AKGUBRE and EGE) and 1 public company in the copper subsector (KBI)	Increase fertilizer production.	Rehabilitation of 4 complexes. Preparation of fertilizer raw material resource study.	

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REVIEW OF INDUSTRIAL RESTRUCTURING PROJECTS 1980-1988

Country	Project LN/CR Number	SAR Date Current Stage	Loan Type Loan Amount	Units Restructured	Background/ Objectives	Restructuring Components	Specifics/ Features
4. LAC							
Chile	Industrial Finance Restructuring LN-2606-CH	1985 Completed	DPC US$100.0 million	Industrial corporations, particularly large ones.	Previous banks-firms incestuousness. Provide fresh resources to indebted firms to expand production.	Financial restructuring (banks and companies); institutional framework; working capital and equipment.	General credit line; apex structure (central bank and commercial banks); loan lost window of opportunity and had slow disbursement: amended to broaden the scope to include already or non-restructured firms.
Ecuador	Public Sector Management LN-2516-EC	1985 Implementation	TAL US$8.0 million	SOE sector, including monopolies in telecommunications, mining and petro-industry.	Improve efficiency and management of the public sector; gain control over budget process and execution of capital investments; promote private sector participation in economy.	Improvements in national budget process: including strengthening macroeconomic framework and investments monitoring, pilot financial information system, training of professionals. Comprehensive SOE management and organization reforms, particularly in three public monopolies, with expenditures monitoring systems, decentralization, streamlining of procurement and administrative practices; and incentive system to attract private participation to mining sector.	Targeted to software strengthening; mostly "standard" components of public sector management projects.
Guyana	TA Project for the Bauxite Industry CR-1729-GUA	1987 Implementation	IND US$7.0 million	Guymine, the bauxite mining/ marketing company	Strengthen the bauxite industry's management and marketing capabilities as well as provide a framework for assessing the potential benefits to be derived from new product development.	Product development program which would include a market study for new products and a pilot plant for new refractory products; Cost control program; Marketing support, TA, and training; Alternative fuel study.	The credit was approved by the Board in August 86 but has not yet been signed due to GOC arrears on IBRD loans and credits. In the meantime, the Government and Guymine had fulfilled many of the commitments which were part of the credit agreement.

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REVIEW OF INDUSTRIAL RESTRUCTURING PROJECTS 1980-1988

Country	Project LN/CR Number	SAR Date Current Stage	Loan Type Loan Amount	Units Restructured	Background/ Objectives	Restructuring Components	Specifics/ Features
Jamaica	Second Sugar Rehabilitation Project LN-2850-JM	1987 Implementation	AGR US$34.0 million	Jamaican Sugar Holding, regrouping two public enterprises: Frome and Monimusk.	Rationalize sugar production on efficient units (Frome and Monimusk), raise sugar production to a level sufficient to satisfy the domestic market and those export markets which Jamaica has access under special arrangements (EEC and US) and improve the overall efficiency and financial viability of the industry.	Rehabilitate and modernize factory equipment, purchase new agricultural equipment for the cane estates, restore the estate irrigation and road infrastructure. Technical and managerial assistance under a ten-year contract with Tate and Lyle. Rehabilitation of the public irrigation system. Upgrading of the capacities of SIRI (research institute).	Delayed enforcement of revised tariffs for the use of public irrigation water as a consequence of political pressure for maintaining the status quo. The critical factor of this operation is management: good management has been achieved through the appointment of local managers paid expatriate salaries. The major issue pending now is the transferring of NSH to the private sector.
Jamaica	Public Enterprise Sector Adjustment Operation LN-2849-JM	1987 Implementation	Non US$20.0 million	SOE Sector	Rehabilitate the SOE Sector.	Support the Government's aim of reducing the size of the public sector in the economy via sale or lease of assets. Improve the legal framework to enhance supervision, monitoring and control of public enterprises by the central government. Strengthen the financial performance of selected public enterprises.	Success in some divestitures.

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REVIEW OF INDUSTRIAL RESTRUCTURING PROJECTS 1980-1988

Country	Project LN/CR Number	SAR Date Current Stage	Loan Type Loan Amount	Units Restructured	Background/ Objectives	Restructuring Components	Specifics/ Features
Mexico	Fertilizer Sector Adjustment Loan LN-2919-ME	1988 Implementation	IND US$265.0 million	FERTIMEX, parastatal which has the monopoly of producing and marketing fertilizer products.	Part of the overall objective of structural adjustment through increased efficiency of Mexican industry and enhanced reliance on market forces.	Rationalization of existing viable production plants, organizational and financial restructuring, closure of inefficient plants, construction of new plants which can economically replace closed-down plants. Rationalization of the fertilizer distribution system and of the distribution infrastructure. Improving coordination between PEMEX (ammonia producer) and FERTIMEX. Progressively increase fertilizer prices to reach import parity or financial independence. Free fertilizer imports of restrictions and tariffs.	The project consists in an hybrid policy and investment loan. It moreover assesses and addresses the social impact of restructuring in terms of poverty alleviation (Food stamps under a government program), and aid to displaced workers (severance benefits under this project and retraining scheme under a Bank's Manpower Training Program). Project has stalled due to initial lack of management commitment; frequent turnover of senior management; failure of the GOM to raise fertilizer prices to world market prices so that FERTIMEX is sustainable financially and economically.
Mexico	Steel Sector Restructuring Project LN-2916-ME	1988 Implementation	IND US$400.0 million	Steel subsector, focusing on three large SOEs and two major private firms.	Improve quality and shift in product mix required to meet demand of downstream users; help cope with international competition and policy reforms: trade and pricing liberalization, elimination of distorting regulations and practices. FMSA (SOE) closed with 8000 lay-offs. All SOEs in the sector supervised by SIDERMEX, which undertook subsidiary spin-offs, liquidations and transfer. The major private company, HYLSA, to negotiate financial restructuring concurrently with project.	Steel-related import financing; management improvements; restructuring of operations financially, organizationally and administratively, shift to flat products, rehabilitation, rationalization, enhancement of systems and training, maintenance, debottlenecking, increase in quality, increase productivity, technical assistance; investments in cost reduction and modernization; technical studies for sector strategy, and marketing study to evaluate long-term demand for diverse steel products.	Expected lay-offs: 3000-4000. NAFIN receives the funds and distributes them as agreed; also makes available credits to other private producers (including TAMSA). Slow start; pricing policy under the "pacto" has not affected firms negatively, but some revisions are necessary, especially for the private HYLSA. Balance between software and hardware.

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REVIEW OF INDUSTRIAL RESTRUCTURING PROJECTS 1980–1988

Country	Project LN/CR Number	SAR Date Current Stage	Loan Type Loan Amount	Units Restructured	Background/ Objectives	Restructuring Components	Specifics/ Features
Mexico	Industrial Restructuring Project N/A	1988 Negotiations.	N/A US$250.0 million	Three subsectors dominated by private sector participation, and with high export potential: agroindustry (cut flowers), textiles and autoparts; open for other specified sub-sectors whenever their strategy is defined, and liberalized non-specified subsectors.	Trade and price liberalization and other macroeconomic reforms (exchange rate, fiscal incentives, tax system, capital financing); project would help sub-sectors—heavily protected in the past—to adjust to new policy environment that has increased competition and outward-looking opport-unities. Government has restructured or divested of a number of parastatal industries and has made deregulation efforts.	Physical and financial restructuring, and technical assistance (subsector restructuring studies, computer equipment and software for project monitoring, training); subsector-specific investments and financial assistance for working capital and consultants,policy adjustments, as well as infrastructure (e.g., training, technical, information, strategy centers); industry-wide financial and institutional framework the development and implementation of company-specific restructuring plans; improvements in management, distribution and marketing (including commercial promotion programs), quality, capacity and productivity; policy coordinating committee.	Component for investments and working capital in non-specified sectors, which are also being liberalized; apex structure, NAFIN coordinator, BANCOMEXT and FONEI co-executing agencies, broad participation of financial intermediaries; financial instruments offered to enterprises; focus on private sector activities. Project has stalled due to policy negotiations between the Bank and the GOM.

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Country: HUNGARY
Project: Industrial Restructuring Project I
Loan Number: 2700-HU
SAR: 1986
Type: Industrial and Subsector Restructuring

Background

1. Hungary has faced a critical need to transform the economy, beginning with economic stabilization and moving toward structural adjustment with growth. In this context, one of the principal objectives of the Government is industrial restructuring to improve productivity, performance, and international competitiveness of the industrial sector.

Constraints in the Industrial Sector

2. (a) Restricted domestic and international competition

(b) Limited efficient resource mobility

- lack of worker incentives
- lack of capital mobility
- free market pricing has not yet been achieved and
- constraints on direct foreign investment

(c) Lack of financial discipline and weak autonomy of enterprises: little premium is attached to profitability, financial prudence, innovation and productivity improvement.

3. Starting in 1985, the Government began to introduce a reform program affecting the entire economic management system of Hungary. This policy reform needed to be reinforced by specific measures to ensure an accelerated supply response in the short term, by support for market mechanisms, by restructuring enterprises and subsectors, and by creating a demonstration effect for the rest of the sector.

The Project

4. The first restructuring project was multi-component and complex in nature. It provided support to both the industrial policy reform program and the specific restructuring strategy for the plastic processing subsector. (The economic viability of plastic production in Hungary was established in the context of earlier Bank sector analysis).

Industry-wide Restructuring Component

5. (a) US$30 million quick disbursing segment to meet incremental working capital requirements of eligible enterprises;

(b) technical assistance and technical training to institutions;

(c) strengthening in institutional finance for innovations;

(d) training programs for enterprise managers; and

(e) the banking system reforms: support for separation of the National Bank of Hungary (NBH) into a central bank and two competing commercial banks.

Specific Subsector Restructuring Component

6. (a) establishment of mold and die production capacities;

(b) enhancement of quality control and testing;

(c) support to RD&E programs;

(d) support for information data center;

(e) specific line of credit (US$39 million for the restructuring of selected enterprises that have been preappraised by the Bank; 6 major plastics processing enterprises, some of which are basic resin producers); and

(f) facilities established at NBH (US$15.5 million) to finance the restructuring of enterprises outside the plastics subsector.

Country: HUNGARY
Project: Industrial Restructuring Project II
Loan Number: 2834-HU
SAR: 1987
Type: Industrial and Subsector Restructuring

Background

1. Unfortunate Macro-Economic Developments. Deterioration of macroeconomic equilibrium (current account and central state budget deficit) due to weak economic macro management during 1985-86 threatened to slow down the reform.

2. Progress Under the First Industrial Restructuring Project. The Government made satisfactory progress in implementing the reforms agreed under the first project. However, the actions taken had not yet produced the desired supply response by enterprises for a number of reasons: continued availability of Government subsidies, uncertainty among managers regarding the intent and future course of the reform, weak implementation of bankruptcy legislation, and lack of a safety net for dislocated laborers.

The Project

3. The second industrial restructuring project was designed to help maintain the momentum of the reform process and to further restructure industry. As with the first project, it supported both the industrial policy reform program and a subsector-specific restructuring strategy--in this case for four subsectors: rubber processing, agricultural machinery, food processing machinery and continued support to plastic processing subsectors.

Industry-wide Restructuring Component

4. (a) support for industry-wide policy reform: quick disbursing component of US$40 million;

(b) support for feeder industries (US$50 million);

(c) technical assistance:

- specific support for the reform program;
- support for the banking system (information systems; T.A. to the newly created commercial banks);
- studies to formulate the strategies for restructuring.

Subsector Restructuring Component

5. (a) Development of technical infrastructure:

- establishment of a quality control center in the rubber subsector;

- establishment of a standardization center in the agricultural and food machinery subsector;

- establishment of a marketing and technical information center and development of export promotion measures in the plastic processing subsector;

(b) restructuring of enterprises in the selected subsectors; focus on seven pre-appraised companies; and

(c) technical assistance in the preparation of enterprise restructuring programs.

Country: HUNGARY
Project: Industrial Sector Adjustment Loan
Loan Number: N/A
SAR: 1988
Type: Industrial Adjustment/Restructuring

Background

1. In the first two restructuring projects in Hungary, the Bank has focussed on supporting Hungary's program of structural adjustment in the economy to make it more efficient, flexible, market responsive and competitive in external markets. The macroeconomic environment in which the reforms were implemented, however, was inadequate.

2. The Bank therefore advised the Government to accelerate the reform process, while further strengthening the macroeconomic and sector policy content of Bank operations.

3. This loan, with its explicit coupling of the economic stabilization and structural reform objectives, reflects the evolution of this process, and responds to the current economic situation.

The Operation

4. The program aims to ensure a supportive macroeconomic environment for consistent implementation of industrial policy reforms. The industrial reforms will address all eleven industrial policy reform areas, but the highest priorities will be accorded to those areas which are most likely to have an immediate macroeconomic impact:

(a) further reduction in budgetary support to inefficient enterprises and stringent application of the liquidation framework;

(b) strengthened incentives for convertible currency exports;

(c) facilitation of entry of new enterprises and private enterpreneurship;

(d) further reform of taxation, pricing and wage systems; and

(e) reduction of producer and consumer subsidies.

5. The loan will finance all goods to be imported into Hungary except those financed by other sources and a specific list of excluded goods.

6. The end users of the foreign exchange made available would be enterprises. They would raise the local currency equivalent of their foreign currency needs either out of their own resources or by borrowing from commercial banks.

Country: HUNGARY
Project: Third Industrial Restructuring Project
Loan Number: N/A
SAR: 1989
Type: Industrial Restructuring

Background

1. This project would complement the Bank's support under the ISAL, and help to accelerate the managerial, technological, and financial restructuring of Hungarian industrial enterprises, the development of small businesses, and the private sector, and government initiatives to alleviate the adverse employment impact of restructuring.

2. While in the earlier projects a large share of loan proceeds were earmarked for preappraised restructuring investments in selected priority subsectors, this project will move further towards industry-wide restructuring support and devolve decision making and resource allocation authority to the banking system.

The Project

The Enterprises Credit Component

3. (a) Export-Oriented Enterprise Restructuring. A US$110 million credit line will be made available to support the preparation and implementation of restructuring programs of manufacturing enterprises with a focus on activities that involve competitive direct and indirect exports to convertible currency markets. Each enterprise will be required to prepare a business plan or restructuring program for its overall operations.

(b) Small Business Development. A US$10 million refinancing facility will be provided for the establishment and growth of small businesses in Hungary, including in the private sector. The SME sector is one of the most dynamic in the Hungarian economy and suffers from limited access to finance and infrastructure facilities.

(c) Alleviating Unemployment Impact of Industrial Restructuring. A US$15 million credit line to finance investments to create new employment in regions badly affected by job losses due to enterprise restructuring.

The T.A. Component

4. (a) TA to participating banks to strengthen their credit operations;

(b) carrying out of enterprise and subsector restructuring studies, by MOI and eligible enterprises;

(c) strengthening of the analytical framework for the small business sector; and

(d) strengthening institutional framework for promotion of investment for job creation and for delivery of employment and retraining services for dislocated workers.

Project Benefits

5. The project would help increase competitive exports and thus improve the country's trade balance and stimulate the development of a more balanced structure of the sector by facilitating the growth of SMIs which would also contribute to domestic competition and exports.

6. The restructuring approach at the enterprise level would help to change the attitudes of enterprise managers by focusing on the strategic issues of the firms, while stimulating a more market/client oriented approach. The Bank involvement in preparing detailed restructuring programs for a number of subsectors and enterprises under the previous projects has provided several models for such restructuring at subsector and enterprise level.

7. The main risk concerns the uncertainties perceived by enterprise managers related to the future macroeconomic situation of the country and to the continued changes in the industrial policy reform framework, and its impact and the required stimulus for enterprise restructuring and on the level of credit demand under the project. Consistent signals in the economy are critical.

Table 1: HUNGARY - INDUSTRIAL REFORM 1986-90
MAJOR AREAS OF POLICY AND REGULATORY CHANGE

- Entry of enterprises
- Liquidation of enterprise
- International trade
- Pricing of industrial products
- Wage differentiation and worker mobility
- Taxation
- Banking system
- Capital market development
- Enterprise management system
- Direct foreign investment
- Technology development

Country: INDIA
Project: Industrial Export Project - Engineering Products
Loan Number: 2629-IN
SAR: 1986

Background

1. India's poor export growth performance can be explained in large part by the strategy and policy that have prevailed: control over capacity expansion, over imports and investment flows, protection of small industries.

2. Preparation of the project was preceded by major sector work. Over 120 engineering firms were analyzed, to assess performance, policy effects on firm level decision making, and the role of exports in the strategies of firms in different size and product segments. Firm-level structure, technology, price, and quality capabilities were compared with best international practice to ascertain typical restructuring requirements. Export patterns and trends were analyzed; forty U.S. and European importers were interviewed to ascertain how their experience with price, quality, and reliability with Indian engineering products differed from alternative sources.

3. Industrial regulations and incentives, trade and export policies were analyzed to determine binding constraints to efficient outputs and sustained export growth. The sector team worked closely with leading industry associations and with two Government of India Commissions, one on export strategies overall and the other focusing on exports of engineering products. The sector team presented a major white cover report which presented the industry, export, and policy analyses and recommended specific policy change and institutional programs to improve the competitiveness of engineering products. This report and numerous short policy notes became the instruments for policy dialogue, and constituted important inputs into the final reports of the two Government of India Commissions.

4. Simultaneously, the institutional components for the Industrial Export Project-Engineering Products were developed. It was made clear that such a project would not have the desired impact on firm-level competitiveness unless major changes, particularly in industrial regulatory policies, were made first. Consensus was developed that key policy changes needed to include:

(a) delicensing of capacity, capital goods, technology and raw material inputs;

(b) relaxation of controls on growth of large firms, medium scale by international standards;

(c) removal of reserved status for engineering products for exclusive production by small scale industries; and

(d) opening up of steel and other imports for exporting industries, with removal of price disadvantage due to high cost local steel.

These changes were made prior to negotiation on the Industrial Export Project.

The Project

5. With these major policy steps taken by the Government to enable more competitive industrial structure, reduce anti-export biases, and increase access to imported inputs, capital goods, and technology, the project focused on complementary institutional support. Arrangements were made to finance export-oriented enterprises and the ancillaries and to promote firm-level improvement in productivity and export-marketing. The project embodied a set of institutional measures by ICICI, the commercial banks and Ex-Im Bank to support engineering and other firms in increasing competitiveness and exports.

6. The total cost of the Industrial Export Project was US$1 billion equivalent, with US$250 million in IBRD financing to cover foreign exchange portions of the four project components:

(a) Term Lending by ICICI. US$160 million of IBRD funding was lent to ICICI for term financing of medium and large enterprises which meet agreed eligibility criteria, with 60% earmarked for export-oriented investments by firms making engineering products.

(b) Ancillary Financing Component. US$70 million was made available through GOI to selected commercial banks for financing expansion and upgrading investments of engineering ancillaries. This represented the first involvement by commercial banks in Bank-supported industrial lending.

(c) Productivity Fund. ICICI managed a US$10 million Productivity Fund to help finance consultants and technicians needed by larger engineering firms and ancillaries in improving productivity and quality.

(d) Export Marketing Fund. Ex-Im Bank managed a US$10 million Export Marketing Fund to be utilized in supporting strategic export marketing moves, mainly by individual companies.

The Productivity and Export Marketing Funds were successful in aiding firm level restructuring measures, and in building institutional capacity by ICICI and Ex-Im Bank in assessing viable export-oriented projects.

Country: MEXICO
Project: Fertilizer Sector Adjustment Loan
Loan Number: 2919-ME
SAR: 1988
Type: Subsector Restructuring

Background

1. In 1985, the Government of Mexico launched a set of structural reforms needed to deal with Mexico's long-term development problems. At the heart of this reform was the government's desire to increase the efficiency of Mexican industry through greater exposure to international competition.

The Fertilizer Sector

2. With exceptions of small quantities of specialty fertilizers, all fertilizer production is in the public sector. PEMEX produces all ammonia-based fertilizer, and FERTIMEX produces all other fertilizers.

3. The potential for continued increase in domestic fertilizer use is still significant. However, the quality of the supplied products needs to be upgraded.

The Policy Environment

4. The fertilizer subsector is burdened by:

(a) lack of competition;

(b) the pricing system: prices are centrally fixed and unrelated to FERTIMEX' production and distribution costs or to international prices;

(c) ammonia production: PEMEX and FERTIMEX are operated as completely separate concerns so that urea plants in Mexico are non-integrated facilities, while in the rest of the world these facilities operate as integrated plants;

(d) the heavy indebtedness of FERTIMEX; and

(e) heavy government intervention in management of the company.

The Proposed Restructuring Program (see diagram)

Policy Measures

5. (a) implementation of the 1988 plant closure program (closure of 938,000 tons of finished product capacity and 178,000 tons of associated intermediate product capacity);

(b) fertilizer distribution: FERTIMEX would reduce its present operation and supervision of about 2,600 sales outlets to no more than 120 wholesale warehouses;

(c) pricing policy: prices will be progressively increased to reach import parity or financial independence of FERTIMEX, whichever comes first.[1] Prices below the level of FERTIMEX' 120 wholesale warehouses will be determined by market forces;

(d) fertilizer imports are and will remain free of restrictions and tariffs;

(e) several steps will be taken to facilitate closer operating coordination between PEMEX and FERTIMEX;

(f) organizational and financial restructuring will be undertaken; and

(g) rational investment criteria will be set.

The Investment Program

6. (a) rationalizing the distribution infrastructure and the existing viable production plants;

(b) supporting the rationalization of existing viable production plants; and

(c) a follow-on project would provide funds for constructing new plants which can economically replace closed-down plants in line with the projected increases in domestic demand.

The Project

7. (a) US$200 million to finance fertilizer and fertilizer raw material imports (US$150 million) and other imports (US$50 million);

(b) US$63.6 million to finance priority rationalization investment in existing, viable production facilities and in distribution infrastructure and the completion of an ammonium nitrate plant; and

(c) US$1.4 million for the financing of technical and training assistance to study the required changes in the organization of FERTIMEX, the modalities of FERTIMEX' withdrawal from retail and consignment operations and the upgrading of the planning capabilities of FERTIMEX.

1/ Mexico's austerity program, the Pacto Solidaridad, has frozen price increases to restrain inflation. This has resulted in a widening gap between domestic and world market prices and an increase in negative effective protection for the industry. The price freeze has stalled the project.

8. NAFIN would borrow from the Bank and onlend to FERTIMEX for the investment component (US$65 million) and to the Government for the import financing component (US$200 million).

Impact on the Agricultural Sector

9. Fertilizer price increases will be compensated for by the producer pricing measures agreed upon in the context of the proposed Agricultural Sector Loan.

Comments

Hybrid Policy and Investment Loan

10. Multilevel Project. At the enterprise level, the project identifies and addresses physical as well as organizational and distribution problems. At the subsector level, it seeks to improve coordination between PEMEX and FERTIMEX and to ease the heavy regulatory framework. It also assesses and addresses the social cost in terms of poverty alleviation and aid to displaced workers. An Agricultural Sector Loan was to be implemented in parallel with the fertilizer project; a Manpower Training Project will address the social impact on laid-off workers.

Problems/Lessons Learned

11. The project has been human resource intensive because of the complexity of the project, the institutional overlap within the government and between FERTIMEX and PEMEX, and the general unwillingness of responsible government institutions to support necessary policy change.

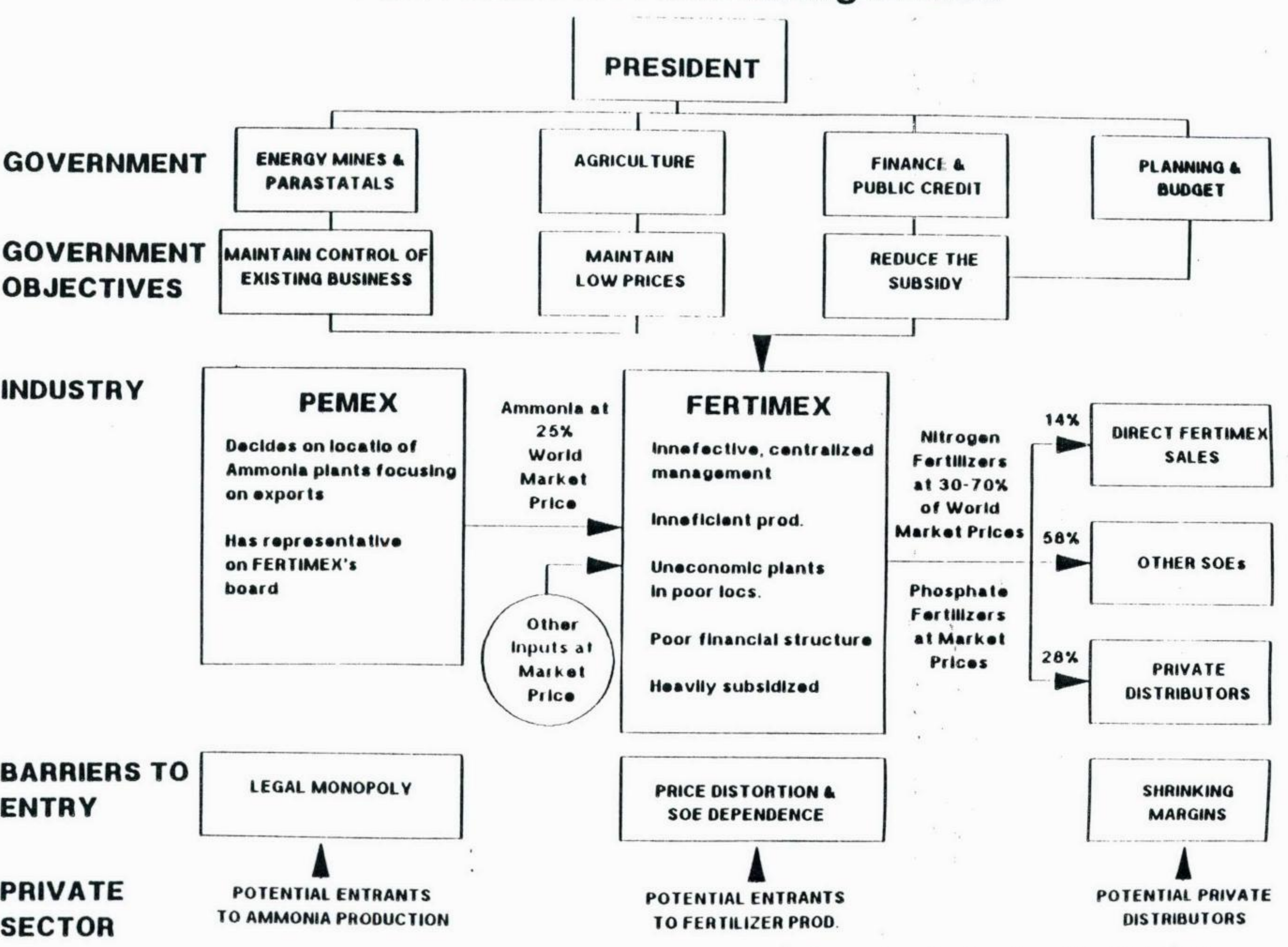
12. The project was delayed by resistance from FERTIMEX' top management. Final processing was possible only after management changed. With the end of the presidential term (the Sexeino), new management has been appointed to FERTIMEX, thereby further delaying the restructuring process.

13. The subsector remains a parastatal monopoly, and real restructuring is unlikely unless competitive pressure emerges. Because of controlled domestic prices, import competition is unlikely. The government should be forced to break up the monopoly.

14. The unnatural division between PEMEX's production of ammonia and FERTIMEX's production of urea continues to perpetuate inefficiency in the Mexican fertilizer industry.

15. The project does not address the operation of FERTIMEX's major new facility in Lazaro Cardenas.

FERTIMEX Restructuring Issues



Source: Booze, allen, Hamilton Report for World Bank on Restructuring and Privatization Strategies (1986)

Country: MEXICO
Project: Steel Sector Restructuring Project
Loan Number: 2916-ME
SAR: 1988
Type: Subsector Restructuring

Background

1. In Mexico, domestic output roughly equals local demand, with modest net exports in recent years. Output quality is low, prejudicing competitiveness of downstream users. Also, a significant shift in product mix is required to meet projected demand patterns.

2. The major state-owned enterprises in the steel subsector are: AHMSA, SICARTSA and FMSA. The latter was closed in 1986, with the lay-off of about 8,000 workers. In addition, CMC is the enterprise responsible for the operation of important raw material mines. All these SOEs operate as subsidiaries of the public company, SIDERMEX. In 1985, the Government of Mexico appointed a strong new Managing Director of SIDERMEX in the middle of the six year presidential cycle to push the Steel Restructuring Program. In 1986 and 1987, SIDERMEX was reorganized with large numbers of its subsidiary companies sold, liquidated, or transferred.

3. The two private sector major enterprises are HYLSA and TAMSA.

The Project

General Objectives

4. (a) help restructure the Mexican steel industry; and

(b) support policy reforms that will substantially alter the manner in which steel producers do business in the coming years.

Financing

5. A total of US$400 million allocated to three parts:

(a) **Part A.** US$100 million; Government is recipient. Implementation of wide-ranging policy measures with specific emphasis on exposing the industry to international competition; will finance steel-related imports, which are expected to increase during the adjustment period.

(b) **Part B.** US$225 million; financing of the restructuring program of SIDERMEX to alter the product mix and aggregate output in a form compatible with projected international demand patterns and areas of potential competitive advantage. Correct the low

utilization of capacity. Link the parastatal sector efficiently to the external market.

Components

- SIDERMEX. US$5 million; mainly for strategic planning studies implementation of restructuring program, and management improvements.

- AHMSA. US$170 million; shift of product mix to flat products (where there is comparative advantage), rehabilitate, improve quality and productivity of the hot strip mill. Enhancement of systems and training. Investments in catch-up maintenance, debottlenecking and quality improvement of facilities. Interest in international competitive products. Funding also allocated to project management.

- CMC. US$50 million; to raise productivity in coal mining and strengthening iron ore operations. Includes investments for debottlenecking, operations improvements, technical assistance for project management.

(c) Part C. US$75 million; financing the restructuring program of HYLSA. Focus on improving competitive advantage of flat products through investments in cost reduction, productivity and quality improvement, and on debottlenecking. Bank support in parallel with the financial restructuring package under negotiation with creditor banks.

Role of NAFIN

6. Receives the funds and distributes them as agreed. Also makes available credits to other private sector producers (including TAMSA). Administers the provision of technical assistance services.

Industrial Restructuring Issues

7. See attached matrix of issues, measures and actions.

8. The Government responded to the 1985/86 crisis by intensifying stabilization measures and introducing significant structural changes focusing on trade liberalization, encouraging private sector activity and reducing the role of the public sector while increasing its efficiency. Implementation of trade liberalization measures was accelerated in 1987.

9. The most fundamental policy reform is the shift from inward-oriented protected growth towards an outward-oriented, open market development strategy, based on gradually declining protection and eliminating price controls to improve the efficiency and export competitiveness of the economy. Such a shift is particularly significant to the steel sector in terms of trade liberalization, elimination of

domestic price controls and the role of external competition in bringing efficiency and market response to the sector.

10. The second fundamental structural change is the decision to clarify the role of the public sector in production by improving the performance, reducing the influence of state-owned enterprises and actively stimulating the private sector. Along these lines, the Government has intensified its efforts in divestiture, selling, merging, closing and/or transferring of several public sector firms, and industrial restructuring. In particular, in the steel sector substantial progress along these lines was made in 1986. FMSA was closed after unsuccessful efforts to restore its viability, and SIDERMEX sold, liquidated or transferred other subsidiaries and affiliates to the Government.

11. The steel sector is an important part of Mexico's manufacturing sector and has significant impact on the availability, cost and quality of material inputs for downstream manufacturing, particularly engineering and capital goods industries. Over the past two decades, the Government has created and applied a policy framework which was successful in creating a steel industry able to meet the steel demand of the country in quantitative terms, but one that is now unable to satisfy the expectations of supplying low-cost and high quality steel products to the marketplace. The highly protectionist trade policies before 1985 included quotas, high tariffs, extremely high official reference prices, domestic content requirements for capital goods and automotive industries, and public sector practices which gave preference to domestic products over imports.

12. The key policy issue addressed in the restructuring project and the loan has been the decontrol of steel prices which have been set in the last two years below the total cost of the efficient Mexican producers and below the CIF price of imports (w/o tariffs). The price control offsets the resource generating benefit of the protection while all the negative impact of the protection remains in full effect both for the steel industry and for the downstream users.

13. Price decontrol would permit the rise of domestic steel prices to their opportunity cost levels, and eventually, as quality improves with the project, to the level of CIF plus tariff. This measure would also allow the steel producers to obtain the financial benefits of the announced tariff policy and, thereby, generate the funds necessary for adequate maintenance of facilities, upgrading of technology and servicing the debt. It would also allow the Government to eliminate budgetary transfers to public companies and indirect subsidies to the industry as a whole.1/

1/ Mexico's austerity program, the Pacto Solidaridad, has frozen price increases to restrain inflation. This has resulted in a widening gap between domestic and world market prices and an increase in negative effective protection for the industry. The price freeze has stalled the project.

14. Despite the increasing clarity on the public sector's investment strategy, Mexico lacks a global steel policy and long-term strategy clearly defining the respective roles of the public and the private sector and assuring the conformity between the development plans and the expected needs of the market. The present situation discourages major investments in the private sector and makes it very difficult to develop optimal investment programs in both sectors.

15. Domestic producers are presently unable to supply high-quality steel to the domestic market, particularly for the rapidly growing capital goods and manufactured metal products subsectors. Although overall demand growth is expected to be slow, there are major opportunities for the Mexican steel industry in diversification of the product mix and improvement of product quality to capture a greater share of the specialized market segments that show higher than average growth potential.

16. The strategic thrust derived from the analysis is that, in the short- and medium-term, Mexico should:

(a) concentrate on improving the quality and cost factors in the flat product lines; and

(b) focus its most modern non-flat facilities on the internal markets to service a demand for higher-quality products.

17. Objectives of the Restructuring Program. Maintain, enhance and restore the sector's competitiveness and restructure its technical, financial and organizational characteristics:

(a) on the policy side by:

- eliminating domestic price controls, reducing and making uniform tariffs on steel products and eliminating official reference prices in line with the agreed calendar of trade policy reforms, so as to assure competitiveness in the marketplace; and

- reducing and eventually eliminating government subsidies to producers.

(b) on the technical side by:

- closing down uneconomic operations, reducing or eliminating production inefficiencies, and optimizing existing and planned new facilities in terms of the product mix and markets served;

- carrying out economically justified immediate and urgent investments in catch-up maintenance, debottlenecking of existing facilities, quality control and productivity improvements; and

- undertaking the market and technical studies needed to plan for the longer-term investment needs of the sector.

(c) on the organizational side by: improving the management and organization of SIDERMEX by decentralizing the decision-making process and devolving operating responsibilities to the steel mining and other operational units, placing particular emphasis on their market responsiveness; and

(d) on the financial side by: improving the financial condition of SIDERMEX, the major private producers, HYLSA and TAMSA, and other semi-interrelated producers by undertaking needed financial restructuring and financial engineering of their balance sheets. The financial restructuring package for HYLSA was negotiated, allowing for conversion of up to US$375 million of HYLSA's debt into equity, and for implementing its capital expenditure program aimed at restoring its competitivenss.

MEXICO - STEEL SECTOR RESTRUCTURING PROJECT

Matrix of Issues, Measures and Action

Sectora-wide Problems	Action Taken	Actions To Be Taken	Monitoring Actions and Timing
I. Structural Issues			
1. Pricing Policy			
Controlled domestic prices below international opportunity cost; adjustment for inflation on an ad hoc basis.	Monthly adjustment based on domestic inflation index. Price increases in December 1987 and January 1988 to reach or exceed equivalent landed price levels.	Elimination of price controls. Continued adjustments of price in real terms based on anticipated changes in the Consumer Price Index until completion of price liberalization.	Complete elimination of price controls by December 31, 1988 (Tranche 2 release). Monthly adjustments of prices in real terms until that date.
2. Trade Policy			
High tariffs and high official references price (ORP) do not allow external competition.	ORP eliminated in December 1987. Tariffs reduced on all steel products to 0-15% in December 1987.	No further actions are needed or planned at present.	Continued maintenance of reduced tariff levels without further new restrictions and/or reintroduction of Reference Prices.
3. Global Subsector Policy			
Lack of definition of public sector scope and role.	Evaluation of the production and investment strategy of SIDERMEX. Preliminary conclusions led to actions under SIDERMEX Restructuring below.	Continue evaluation of longer term production and investment of SIDERMEX.	Preparacion of SIDERMEX long-term Strategic Plan by March 1988.
Lack of long-term policy framework.	Outline of Global Steel Sector Policy presented in January 1988 as the Steel Sector Policy Letter. Market and Product Mix Study completed in September 1987.	Determine the long-term tariff, pricing, and tax/incentive policy for the sector such that no resersals occur on the agreed policy package.	Preparation of Global Steel Sector Policy Statement by July 31, 1988, based substantially on the Policy Letter (Tranche 2 Release).
4. Quantitative Import Restrictions			
Domestic content requirements on steel users.	Further evaluation underway as part of subsector studies for proposed Industrial Restructuring Loan.	Gradual elimination of some restrictions.	Under the proposed Industrial Restructuring Loan.
II. SIDERMEX Restructuring			
1. Organization			
Inefficient, centralized management.	Reorganization along five profit centers under SIDERMEX departments and functions reduced to only those necessary by a holding company and staff reduced by 700.	Complete formation of five independent companies under SIDERMEX acting as a holding company. Formalize holding company reltionships.	During 1988.
		Develop management control and operating systems and procedures for holding company and profit centers.	During 1988 as part of the project.

Subsector-wide Problems	Actions Taken	Actions To Be Taken	Monitoring Actions and Timing
Centralized marketing with service centers led to a breakdown of service to clients.	Sales responsibility devolved to plants and service centers converted from cost to profit centers.	Determine function of service centers, incorporate, and decide whether to privatize.	During 1988 as part of the project.
Inefficient facilities.	Shutdown of FMSA and associated mines, and tentative decision to discontinue non-flats at AHMSA; 12,000 workers laid off.	Further rationalization of the AHMSA product line, including possible lay-off of 4,000 additional workers.	During 1988 as part of the project.
2. Financial Structure			
Inefficient organization brought lower productivity, maintenance, marketing and product mix problems that ended up in financial restrictions that made it impossible for the group to recover financial health without debt restructuring.	Signature of Convenio with Government under which about US$883 million equivalent, or 50% of the total debt on SIDERMIX's books will be converted to equity. SIDERMEX agrees to follow a technical restructuring plan with specific targets to receive this debt relief during 1986, 1987 and 1988.	SIDERMEX to take steps to fulfill the targets specified by the Convenio.	During 1988 as part of the project implementation.
3. Technical Aspects			
Maintenance backlog, inefficient product-mix low quality in existing production capacity.	Studies and formulation of a technical program for rehabilitation of SIDERMEX operating plants and utilization of FMSA facilities.	Completion of ongoing studies, implementation of first phase rehabilitation investments.	1988 to 1990, as part of the project.
Capacity expansion in light of optimization (balancing) of existing and proposed new facilities including completion of the SICARTSA II investments.	Preliminary evaluation of SICARTSA II feasibility. Consultant study of SIDERMEX long-term strategy completed in October 1987.	Completion technical and economic evaluations of alternative routes for SIDERMEX long-term development, including a final decision on the scope of the SICARTSA II plant.	SIDERMEX Strategic Plan to be completed by March 1988.
III. Private Sector			
1. HYLSA can contribute to debt service but cannot be financially viable without a debt restructuring.	Presentation of a comprehensive debt restructuring plan based on study by Morgan Bank to determine payment capacity. Completion of negotiations on a debt restructuring package with commercial banks.	Formalization of Restructuring Agreements in 1988.	Condition of disbursement of HYLSA component.
2. Mini-mills have restricted product quality because they are scrap based. Good potential clients for sponge iron.	Decision to complete SICARTSA II investment through sponge iron plant stage to provide source of primary iron to feed domestic demand.	Review SICARTSA II decision, and complete plant through spronge iron stage.	Studies completed during 1987; sponge iron plant will be commissioned in late 1988, following review of SIDERMEX Long-term Strategic Plan in March 1988.
3. Credit Availability			
Difficulties of private mini-mills to get credit lines for working and investment capital.	Onlending procedures of intermediaries of existing loans being reviewed.	Adjustment of existing industrial credit lines and preparation of proposed Industrial Restructuring Loan.	Under Existing Credit Lines and the proposed Industrial Restructuring Loan.

Country: SENEGAL
Project: Industrial Sector Restructuring Project
Credit Number: 1868-SE
SAR: 1988
Type: Industrial Restructuring

Background

1. Senegal's industrial sector is still dominated by the processing of traditional local resources for export (groundnuts, fish, phosphate) and by manufacturing activities based on imported intermediate inputs.

Constraints on Sector Development

2. (a) Country's adverse environment (contraction after independence of the size of the market, international price vagaries, successive droughts).

   (b) High production costs (obsolete equipment and technology, heavy social regulations, high cost of energy).

   (c) Industry policy constraints (reforms underway).

SAL Reforms

3. SAL II initiated important reforms of the protection system, export incentives and labor regulations. These reforms are expected to go a long way toward improving the industrial policy environment and promoting competitiveness. To consolidate and deepen policy achievements under SAL II, another structural adjustment program (SAL III) was implemented in May 1987.

4. At the same time, financial assistance is required to support the Government in its efforts to implement sector adjustment and to help individual enterprises implement restructuring programs to adapt their operations to the new policy environment. The Industrial Restructuring Project is devised to meet this need.

Rationale for the Project

5. A study on the impact of the reform on the industrial sector and the restructuring potential of existing enterprises was carried out by a major international consulting firm. This study indicated that:

   (a) new growth opportunities and export potential would materialize under the reformed incentive system, particularly in the agro-industrial, textile and chemical subsectors, should financial help be provided to restructure their operations;

(b) a new generation of viable industries should emerge; and

(c) a number of inefficient activities would be phased out.

The Project

6. To facilitate the adjustment of industries to the new incentive system, the project has set up:

(a) a line of credit to help finance restructuring (US$25 million) which should help potentially viable enterprises to restructure their operations through modernization investments, rationalization of production processes and introduction of new technologies. The agro-industrial and textile subsectors are expected to account for over 90% of financial requirements;

(b) a program of assistance to displaced workers through:

- a retraining scheme;
- financing of small enterprises.

(c) technical assistance to strengthen the institutions supporting the reorientation of industrial activities:

- reinforcement of the Ministry of Industry;
- familiarization of the staff of the Central Bank and participating banks with lending procedures and appraisal techniques; and
- restructuring of the Export Credit Insurance Agency (ASACE) and the Center for External Trade (CICES).

Comments

7. This restructuring project follows a wide-ranging, sound structural adjustment reform that should create a competitive environment and thus pave the way for a stable long-term industrial development.

8. The Government has shown strong commitment to the reform. The new realism of Senegal's economic policy and the openness of its political institutions have become in many ways a model for other African countries.

9. Restructuring is industry-wide. This should help avoid the risk of non-economic resource allocation, provide stronger linkages across industry groups and allow financial intermediaries to maintain diversified loan portfolios. Owing to the strong commitment of the authorities, the diversity of industry, and the propensity of the enterprises to adjust, there is apparently no need to target a particular subsector.

10. High involvement and training of all local economic agents, and greater reliance on market forces and private initiative:

(a) TA provided to the Ministry of Industry (should reduce the gap between policy pronouncement and implementation);

(b) the line of credit is made available to the banking system as a whole, under an APEX system (the greater reliance on commercial banks combined with a good supervision reflects the need for high degree of market know-how, financial engineering expertise and long-standing relationships with industrial clients);

(c) at market oriented lending terms; and

(d) the final initiative rests in the hands of the enterprises.

11. Innovative social component which should help preempt political opposition and enhance the reform's sustainability. Studies have been key to identifying the areas of immediate need in terms of employment which should ensure the efficiency of the retraining scheme.

12. Good information dissemination through "Association du Patronariat Senegalais".

Issues

13. The main problem lies in the implementation phase.

14. Because of the initial uncertainty caused by the reform incentive framework and the lower effective protection in the sector: the banking system may be reluctant to increase its financial exposure to the industry sector, which is perceived as risky; and new investment in the industrial sector may be slow to materialize.

15. Major constraints have not been addressed yet:

(a) heavy "socialistic oriented" labor law;

(b) rigid pricing policy.

16. The main constraint remains the inadequacy of the financial sector, an issue that should be addressed in the near future.

Country: EGYPT
Project: Pulp and Paper Project
Loan Number: 1849-EGT
SAR: 1980

Background

1. In the 1960s, the public sector took over or established many industrial enterprises to support objectives of national self-sufficiency in basic industrial goods. Even though the Government has endeavoured to provide an "open door policy", significant government regulations and substantial control over the public sector persist.

The Pulp and Paper Subsector

2. Between 1973 and 1979, total mill output fell from more than 140,000 tons to fewer than 120,000 tons. As a result of this and the high level of paper imports after import liberalization, Egypt's paper industry has seen its contribution to the country's paper supply decline from 70% in 1973 to around 40% in recent years. NATIONAL and RAKTA, the two sponsors of this project, are the largest pulp and paper companies in Egypt and account for 70% of domestic paper production.

3. The major constraints the pulp and paper industry faced were the managerial and operational problems at all mills, the strong influence of the public sector companies' financial and investment decisions, and a general lack of overall policy guidance and common direction.

The Project

Objectives

4. The main objectives of the project were to provides financial facilities and technical assistance to:

(a) increase capacity by revamping existing machines, which would improve the financial viability of the companies and lessen the country's requirements for imported paper;

(b) improve product quality to be able to compete better with imports through additional investment, T.A., upgraded inputs, and improvement of instrumentation; and

(c) reduce operating costs through a technically-assisted program of reducing raw material consumption and improving operating efficiency through the introduction of improved maintenance and operating practices.

5. The project consisted of two distinctly different components of the NATIONAL and RAKTA companies and a third component for studies to assist the further rational development of the sector.

6. The Government agreed to permit the two companies to operate under Law 43, which frees the companies from the restrictive regulations of the public sector, particularly those related to produce pricing and compensation of skilled workers, engineers, and management. It was hoped that removal of the regulations would improve the efficiency of project implementation and operation of the company and also serve as a useful precedent for modernizing and expanding other public sector enterprises.

7. The US$50.0 million Bank loan would be made to the Government and would be onlent directly to NATIONAL (US$23 million) and RAKTA (US$27 million) at a 10% interest rate. The companies would assume the foreign risk.

Project Implementation

8. A project implementation unit was to be established within each company. However, implementation of the project was delayed due to a change in Government, which led to a change in policy. The new Government opposed the enactment of Law 43 and requested waiver of this requirement; the Bank eventually agreed.

9. Production. The improved paper machines have the capacity to achieve close to 100% of the projected increase in production. Nevertheless, despite this apparent technical success, it is unlikely that NATIONAL or RAKTA will operate at the highest level in the forseeable future because of a shortage of fibrous raw material from domestic sources--NATIONAL achieved about 40% of the additional output anticipated at appraisal, and RAKTA achieved 70%. However, both mills have achieved significant quality improvement.

10. Project Management. Differences between the performance of the companies clearly can be traced to differences in the management and, particularly, to differences between the chairmen of the companies. RAKTA has had a strong and continuous management under the same chairman since 1975, whereas NATIONAL had a succession of chairmen of varying aptitude and capability.

11. Capital Costs. Actual total financing was US$96.3 compared to an appraised estimate of US$75.9. The major causes of this overrun were the increase in local costs (custom duties and inflationary increases) and in the costs of imported material (declining exchange rate, increase in international price).

12. Financial Results. As long as the companies must buy pulp on the world market at full international prices and sell paper domestically at prices fixed lower than international prices, the companies will not be profitable.

Lessons Learned

13. (a) The recurring problem of underestimating local costs;

    (b) The importance of qualified management in determining the level of success in project implementation;

    (c) The lack of adequate attention toward ensuring the availability of critical non-project inputs (pulp, in this case);

    (d) The rollback by the GOE of a major policy commitment, Enactment of Law 43, significantly decreasing the opportunity for success; and

    (e) The controlled prices adversely affecting enterprise and project viability.

Country: BANGLADESH
Project: Second Textile Industry Rehabilitation Project
Credit Number: 1477-BD SF-22-BD
SAR: 1984
Type: Subsector Restructuring - Reprivatization, Rehabilitation

Background

1. Credit 1205-BD was designed mainly to rehabilitate selected public sector textile mills. After Credit 1205-BD was approved, GOB reprivatized 22 BTMC mills, including 9 of the 15 considered in that credit. Substitute public sector mills were chosen for rehabilitation under Credit 1205-BD.

2, The textile industry subsector has priority in a GOB program to review and reform trade and industrial policy.

3. 1982: New Industrial Policy of GOB, with emphasis on increased private sector participation, leaving public sector in basic, heavy and strategic sectors.

4. Public sector corporation restructuring required to enable effective restructuring of textile mills. Profitability of enterprises--which was poor--was expected to increase with higher capacity utilization and efficiency, and lower input prices. Measures needed to achieve all this included free-market pricing, removal of sales tax, and better distribution arrangements.

The Project

5. US$23.0 million IDA credit and US$22.0 million Special Fund Credit. Continuation of CR-1205-BD seeking increases in efficiency and capacity utilization--and thus output to catch up with domestic demand and ultimately to succeed in international markets--of existing textile mills in both the public sector (7 mills under the control of BTMC) and the private sector (15 mills). BTMC was to relend the funds to the public mills. The Bangladesh Shilpa Bank (BSB) and the Bangladesh Shilpa Rin Sangstha (BSRS) were to serve as administrative agents of GOB to appraise projects and pass loan fund along for private sector mill rehabilitation. Part of the credit was for technical assistance to the Ministry of Industries and Commerce.

6. The project included funds to assist in the preparation of GOB's textile sector development strategy studies, and to train technical and managerial staff. For the private sector, the project included a component for assistance in procurement and commissioning of equipment and machinery.

Objectives

7. To increase technical efficiency--and thus address the problem of lost capacity due to machinery breakdown--the project intended to finance

balancing, modernization and replacement (BMR) investments in public and private mills through purchase and installation of equipment, machinery and spares.

8. To ensure that the incentive structure would reward efficient performance through proper policy environment. The project also intends to strengthen institutional mechanisms that formulate strategy for changing markets.

9. Overall, the project was targeted to support privatization efforts by GOB, as well as competitiveness improvements and export capacity increases.

Problems and Lessons Learned 2/

10. Disappointment: objectives of restructuring project are abandoned, since now it is largely a public sector rehabilitation project.

11. The first project (CR-1205-BD) was cancelled with only six mills rehabilitated. This second project explicitly intended an emphasis on the rehabilitation of private sector mills. However, the private sector withdrew from participation in the credit because of: informal imports (smuggling), political instability (e.g., labor unions were highly combatant), high credit costs (cheaper to borrow with domestic interest rates and via suppliers' credits). Thus, remaining funds were transferred to the public sector.

12. BTMC (a government-owned holding company) is still predominant in the textile sector of Bangladesh. It has a virtual monopoly on finishing. BTMC has taken hold of the credit. There are still undisbursed amounts as certain conditions have not been met: as a result, more project delays and the necessity of extensions.

13. Operating autonomy was granted to BTMC and down to the mill managers. Some managers did not accept the autonomy; others were more entrepreneurial, particularly on the pricing policy issue. Political factors still seem to be behind lack of autonomy of textile mills.

14. Macro instability makes restructuring a difficult process. Sequencing was done wrongly in Bangladesh. The project had a narrow rehabilitation approach, without treating important sectoral, intersectoral and macroeconomic aspects. The broad, macro framework should have been strongly considered: balance of payments, exchange rate, efficiency of the Government's financial policy. It seems necessary to remove the constraints first, i.e. to prepare the ground for sectoral restructuring. Project implementation also showed that Government orders do not translate into real operation if the overall policy framework is not adequate.

2/ Based on various supervision reports, 1984-88, and an interview with the project officer.

15. The narrow rehabilitation and balancing done, however, seem to have been effective, as shown by a 20% increase in capacity utilization (i.e., good supply response), increase in product quality, and reduction in waste levels. Energy efficiency apparently also has improved. The capital stock is very deteriorated; two-third of it is more than 25 years old. Hence, rehabilitation is crucial for a supply response.

16. The Government of Bangladesh (GOB) refuses to undertake closure or liquidations of inefficient BTMC mills.

17. In general, attention to software seems at least as important as hardware.

Country: JAMAICA
Project: Second Sugar Rehabilitation Project
Loan Number: 2850-JM
SAR: 1987
Type: Subsector Restructuring

Background

1. The decline in export earnings and employment from the bauxite-alumina industry and the vulnerability of the economy to the external sector have underscored the need for a revitalization of the agricultural sector, and especially the sugar subsector. Sugar is the dominant agricultural export crop and presents a substantial potential for further development.

Status of the Sugar Industry

2. Since 1970, sugar output has steadily declined due to:

(a) decline in the supply and quality of cane (insufficient and untimely provision of agricultural inputs and credits, outbreak of diseases, discontent with prices received for cane);

(b) neglect in the irrigation network, salinity and drainage problems;

(c) excessive unit production costs in the public sector; and

(d) squeeze on the incomes of the sugar factories and farmers resulting from revenue distribution under the guaranteed price administered by SIA (a government agency).

3. Principal Sugar Entities

(a) 4 privately-owned factories which still operate profitably and work close to their nominal capacities; and

(b) 5 public sector factories and estates: Frome, Monymusk, Bernard Lodge, Duckenfield, and Long Pond.

4. The Government has declared its intention to stop sugar production in Bernard Lodge and Duckenfield and to substitute ethanol production. These firms already have been successfully divested.

5. The Long Pond factory, managed by farmers and factory personnel, would continue to produce sugar.

6. The First Sugar Rehabilitation Project became effective at an unfavorable time: the Government planned to nationalize the industry and distribute the land to rural communities. Essentially due to mismanagement, sugar production in the National Sugar Company (NSC) was cut in half, the equipment purchased was not installed and NSC was declared bankrupt.

7. In 1983, after a change in government, NSC was replaced by National Sugar Holding (NSH) under a Tate and Lyle management contract.

Main Objectives of the Project

8. (a) Rationalize sugar production of efficient units (Frome and Monymusk).

(b) Raise sugar production in the country to a level sufficient to satisfy the domestic market and those export markets which Jamaica has access under special arrangements (EEC and US).

(c) Improve the overall efficiency and financial viability of the industry.

9. Nevertheless, the project's rationale is not based on macro-economic criteria: in view of the prevailing sugar prices on the world market, the sugar industry is bound to be an unviable activity. The whole project is also based on the assumption that Jamaica will keep its privileged access to the EEC market and will benefit from the artificially set prices. The justification for the project ultimately lay in the fact that the sugar industry is the largest employer of the country and that no alternative employment potential was seen to exist.

The Project

10. The principal components to be financed by the project were:

(a) rehabilitation of Frome and Monymusk factories and estates:

(i) rehabilitate and modernize factory equipment;

(ii) purchase new agricultural equipment for the cane estates;

(iii) restore the estate irrigation and road infrastructure;

(b) technical and managerial assistance under a 10-year management contract with Tate and Lyle Technical Services (TLTS) to be provided to JSH;

(c) rehabilitation of the public irrigation systems in the Southern Plains area under the supervision of the Underground Water Authority;

(d) upgrading of the capacities of SIRI (research institute) by providing training and equipment; and

(e) strengthening of the project monitoring and coordination unit already established in the Ministry of Agriculture (MINAG).

11. To implement the project, MINAG would onlend loan funds to JSH on the same terms and conditions as the Bank loan and transfer loan funds as grants to the Sugar Industry Authority for the SIRI part of the project.

Benefits

12. (a) Stabilization of employment level in the sugar industry;

(b) Elimination of public subsidies, contributing to a reduction in the government budgetary deficit; and

(c) Improvement in the balance of payments.

Status of the Project in July 1988

13. Considerable increase of sugar production in 1988. Production reached 113,000 tons, i.e., 13% above last year's production. Original output projections per factory are being revised: more for Frome and less for Monymusk. Cane juices have generally been of poor quality. The two factories officially converted to ethanol found it more profitable to produce sugar: they produced 22,000 tons of sugar which had to be sold on the world market.

14. Monymusk's situation is rather difficult because of a drought and the lack of good quality water for irrigation.

Implementation Problems

15. (a) Government's budget restrictions;

(b) Delays in the implementation of the irrigation rehabilitation program and in the reorganization of SIRI as a consequence of delayed recruitment of a research coordinator; and

(c) Delayed enforcement of revised tariffs for the use of public irrigation water as a consequence of political pressure for maintaining the status quo.

16. The critical factor of this operation is management. Good management has been achieved through the appointment of local people paid expatriate salaries.

17. The major issue pending now is the transferring of NSH to the private sector. NSH, in view of its poor performance is not ready for divestment yet. However, if it becomes profitable, the Government may not seek to privatize it.

Country: THAILAND
Project: Bangchak Oil Refinery Restructuring Project
Loan Number: 2548-TH
SAR: 1985

Background

1. In 1980, the import bill for petroleum represented 31% of Thailand's total imports, 45% of the economy's export earnings. The Royal Thai Government (RTG) decided, therefore, to attach the highest priority to investment in the energy sector to promote the efficient use of available resources and reduce the country's dependence on energy imports.

2. RTG initiated a series of steps aimed at:

(a) expanding development of indigenous energy resources such as natural gas, lignite and hydro power;

(b) continuing to pursue rational pricing policies. (Until 1978, Thailand's domestic energy price adjustments were restrained in order to encourage economic development. Since then the Government has increased energy prices to reflect international price developments); and

(c) enforcing conservation programs.

Projected Energy Balance

3. Relatively modest growth in energy consumption is expected along with a significant structural shift in the composition of energy sources. The most significant change would be the increased availability of domestic natural gas, which will displace petroleum sources used by industry and for electricity generation.

4. The resulting change in demand profile for petroleum products could not be met economically by the existing refineries unless they made appropriate changes in their production. The project was devised to address this problem.

The Sponsor

5. In 1984, Bangchak Oil Refinery was operating at 78% of its rated capacity under obsolete processing facilities and weak management.

6. As a first step, Bangchak Refinery--which had been a Government dependency under the Ministry of Defense--was established in 1984 as a fully autonomous and commercial company: Bangchak Petroleum Company (BPC). After this project rehabilitates the refinery and makes it financially viable, it is expected that the private sector will participate in a subsequent project involving the installation of secondary conversion facilities.

The Project

Objectives

7. The main objectives of the project were to:

(a) assist the Government in carrying out a program of physical, legal, organizational, management, and financial restructuring of the state-owned Bangchak Oil Refinery;

(b) reduce the cost of meeting the petroleum requirements of Thailand in the short- to medium-term; and

(c) determine the modifications required in Thailand's refineries to balance national supply and demand of petroleum products in the long run.

Description

8. (a) physical rehabilitation of the Bangchak Refinery to increase capacity utilization and improve its operations;

(b) implementation of energy conservation measures to optimize process unit operations;

(c) improvement of the refinery infrastructure including provision for flood protection;

(d) assistance for project engineering, supervision and management; and

(e) carrying out a technical and economic study to determine further modifications required to ensure that the yield pattern of refineries in Thailand will be in balance with the demand profile for petroleum products in the country.

9. The loan was made directly to BPC.

Country: MALI
Project: Public Enterprise Sector Adjustment Program
Loan Number: N/A
SAR: 1988
Type: Public Enterprise Adjustment

Background

1. The public sector in Mali has performed poorly and imposed a heavy burden on both the banking system and Government finances because of ill-conceived investments, inappropriate economic policies and regulations, lack of financial discipline within the public sector and deficiencies in Government-enterprise relations.

Objectives

2. The aims of the first PE project initiated in 1984 and negotiated in 1986 were to:

(a) liquidate, privatize or restructure the 35 PEs, based on a financial analysis;

(b) revise the institutional environment and policy framework in which PEs operate;

(c) restructure the financial sector. This component received increasing emphasis as BDM, the unique development bank of Mali, was found to be financially bankrupt; and

(d) provide institutional support to better implement the reform program.

3. The program, as it appeared in 1986, was very ambitious but received little support from the Government. Lack of agreement within the Government and strong opposition by labor unions to the liquidation of SOMIEX and Air Mali stalled action on most issues.

Political Ramifications

4. The Bank located the project implementation agency in the Ministry which was at the time the most powerful and had showed the highest commitment: the Ministry of Plan. During negotiations, however, the Government was reshuffled and the newly-appointed Minister of Plan proved to be a weak advocate of the reform. The main elements of the reform were therefore not approved by the Council of Ministers. Nevertheless, the Prime Minister remained very much in favor of the project and, in June 1987, he requested that a high level Bank mission visit Bamako to help resolve problems blocking implementation of the program.

5. A Public Enterprise Institutional Development Project was initiated to provide the institutional support needed by the Government. In parallel, a Public Sector Adjustment Program was approved to ease the strain during the adjustment period, not only with respect to external capital requirements, but also with increasing budgetary resources available for the financial restructuring of the PE sector.

6. The Prime Minister was to play a leading role in these new projects. However, another Government reshuffle occurred recently and the position of Prime Minister has been waived. The President himself is now the ruling leader. Nevertheless, no major impediment should block the project implementation since the President has already demonstrated his strong commitment.

Project Status

7. The Government has recently formulated and begun implementation of a comprehensive Public Enterprise Sector Adjustment Program:

(a) reform of key economic policies concerning public resource management and the structure of economic incentives;

(b) financial sector reforms;

(c) institutional and legal reforms redefining relationships between Government and PEs; and

(d) rationalization of the sector through restructuring and divestiture.

8. The major problem lies in the privatization phase: BDM has been successfully divested and taken over by a French bank (Banque Populaire de France). However, no private investors have yet shown interest in buying the manufacturing companies.

Social Impact of Restructuring

9. An estimated 2,000 workers are expected to lose their jobs as a result of the proposed restructuring. A special fund has been created directly by the Government to help firms provide severance payment to laid-off workers.

Lessons Learned

10. Government's commitment is a key factor.

11. Privatization is an intricate process. Liquidation of most PEs in parallel with enhanced reliance on the private sector may constitute a better strategy.

Country: CHINA
Project: Fertilizer Rehabilitation and Energy Saving Project
Loan Number: 2541-CHA
SAR: 1985
Type: Subsector Restructuring

Background

1. Improved irrigation, better crop varieties and higher levels of chemical fertilizer use have been the most important material inputs behind China's good agriculture performance in recent years.

2. Annual fertilizer consumption growth was among the fastest of LDCs. Nitrogen fertilizer demand, however, is expected to have a slower growth pace due to already high levels of application. Fertilizer use has been stimulated by greater availability (higher domestic production and higher imports) and improvements in the level and structure of agricultural prices.

3. China is the world's third largest producer of chemical fertilizers. Most plants are small and medium scale, with outdated technologies. Energy consumption in nitrogenous fertilizer plants is relatively high compared to today's modern plants, mainly due to age and obsolescence.

4. High energy consumption is a big problem, which causes energy shortages, and constitutes a severe constraint to China's future economic growth. It can be solved through capital investments in new technologies and some restructuring in the industry. The Government has applied administrative and price incentives to improve energy efficiency.

5. Price reforms are of particular importance in the fertilizer sector, as ex-factory prices should reflect adjustments in the prices of energy. The adjustment in fertilizer prices is in line with the October 1984 Reforms. While prices play a limited role in resource allocation and consumers' decisions, the Government has become increasingly aware that without overall price reforms and an increased role for market forces, efforts to revitalize enterprises through management and financial reforms cannot succeed. The two main elements of the Government's October 1984 decision to reform the economic structure related to overall price reforms and a reduction in the Government's direct control of the economy. But due to the importance of fertilizer production, the Government will continue to control planning in this subsector and administer its prices.

6. The project was designed to provide a model on how industrial enterprises can prepare themselves for the new incentive regime, particularly a change in pricing structure, by improving their energy efficiency and reducing production costs.

The Project

Major Objectives

7. (a) Rehabilitate, modernize and save energy in selected facilities.

(b) Strengthen capabilities in project implementation, plant operations and financial management in selected facilities.

(c) Improve research and engineering capabilities at the China Fertilizer Development Center (CFDC).

(d) Support strategy planning for modernization of medium-size fertilizer plants.

8. The rehabilitation and energy-saving measures are expected to have a significant demonstration effect for developing and implementing similar programs in other medium- and large-size plants.

Project Components

9. (a) Rehabilitation and energy-saving modification in the operating plants of five companies and training of their staff.

(b) Support for fertilizer research and development through equipment, data processing facilities and training to CFDC and 8 fertilizer and research institutes affiliated to CFDC.

(c) Technical assistance in international procurement for the project implementation coordination unit of the Ministry of Chemical Industry (MCI).

(d) Study conducted by MCI of nitrogenous fertilizer production costs, to help formulate strategies in the modernization of other medium-size nitrogen fertilizer plants.

Country: CHINA
Project: Fertilizer Rationalization Project
Loan Number: 2838-CHA
SAR: 1987
Type: Subsector Rehabilitation

Background
(Follow-on Project to the first Fertilizer Rehabilitation and Energy Saving Project)

1. Ongoing economic reforms have led to changes in fertilizer policy that, with changes in the allocation policy, have enabled market prices to play an increasing role in determining fertilizer production and allocation, so as to improve efficiency. A two-tier pricing system has emerged:

(a) controlled (ex-factory) prices for the state plan quota; and

(b) flexible market-influenced prices for outside the state plan quota, marketed directly by fertilizer producers. The ultimate goal is to allow the economy to "grow out of the plan." Fertilizer companies have been given increasing management autonomy under the reforms.

2. The Government's priorities in the fertilizer sector are to:

(a) increase high-grade fertilizer production by building new capacities and rationalizing the existing low-grade fertilizer facilities;

(b) increase production efficiency of existing medium- and small-size fertilizer plants through technical renovation, energy saving measures, and product quality improvements;

(c) reduce the nutrient imbalance of fertilizers by rapidly expanding the capacity of phosphate fertilizers based on locally-available phosphate rock, and developing potash facilities; and

(d) raise efficiency of enterprise operations through improvements in operational and financial management, with modern systems and techniques.

The Project

3. The project builds upon experience gained in the design of the ongoing Loan 2541-CHA, the first Bank-supported fertilizer project in China. While the previous project concentrated on efficiency improvements of large-size nitrogenous fertilizer plants, the new project was designed to have a broader impact in line with the country's current sectoral strategy.

4. The project was designed to:

(a) establish the country's first major phosphate fertilizer production facilities;

(b) rationalize and expand four medium-size nitrogenous fertilizer plants while improving operating efficiency and converting their products to higher-grade fertilizer with modern technologies; and

(c) based on a management efficiency study--the cost of which was shared evenly among the five companies--strengthen sector-wide institutional efficiency by introducing improved enterprise-level systems for organizational structure, information and cost management, and upgrading sector-wide management training capabilities. This last component is the first example of a comprehensive sectoral approach to adapting organizational management of enterprises to the increasingly commercial operating environment. Its successful implementation is expected to have a strong demonstration effect on the fertilizer sector.

5. The project also was designed to help the five companies to reduce their energy consumption.

Country: TUNISIA
Project: SOGITEX Textile Rehabilitation Project
Loan Number: 2012-TUN
SAR: 1981
Type: Comprehensive Enterprise Restructuring

Background

1. Since the early 1970s, the Tunisian manufacturing sector, and the public segment in particular, has been characterized by: (a) increasing capital intensity, weak management capability, and employment creation beyond efficiency levels, resulting in deteriorating productivity; (b) overinvestment in subsectors serving the domestic market in consumer goods and intermediate components for their fabrication; and (c) inadequate capacity in, and incentives for, subsectors oriented towards exports and some segments of the domestic capital goods market, where local production could be efficient.

2. The textile subsector has played an important part in the realization of Tunisia's development objectives because of its relatively low capital intensity and its ability to generate employment and exports and to attract new investment. However, almost all the subsector's raw materials are imported.

3. SOGITEX is the largest textile group in Tunisia and the only one publicly owned. The SOGITEX Group consists of SITEX (the largest subsidiary), SITER, SOMOTEX, TISSMOK, SOPIC, and the holding company, SOGITEX Holding.

4. At the time of project preparation, SITEX had already invested in spinning equipment to improve its yarn quality for denim exports. Complementary investment was needed to obtain maximum quality and to produce broader fabric widths, which were necessary for SITEX to improve its position in the highly competitive European market (Tunisia is an associate member of EEC). Since no civil works would be required, there were few risks of delay in project implementation.

The Project

5. The project had three components:

(a) rehabilitation, modernization, and expansion of SITEX's production facilities;

(b) investment in "debottlenecking" and in essential spares for SITER, SIMOTEX and TISSMOK; and

(c) technical assistance for all four main subsidiaries (SITEX, SITER, SOMOTEX and TISSMOK) as well as SOGITEX Holding.

6. Investment in SITEX. The objective was to expand and to improve the quality of SITEX's denim production for export. Spinning and winding equipment would be reconditioned and service facilities upgraded. Although the mill specialized in the production of denim and pocketing material, new looms included accessories for the production of other types of fabrics (e.g. sheeting, shirting). This flexibility would allow SITEX effectively to absorb fluctuations in demand for denim or to meet potentially profitable market requirements for other fabrics.

7. Investment in SITER, SOMOTEX, and TISSMOK. Although the rehabilitation and expansion of SITER and SOMOTEX were envisaged for the second phase of the project, certain minor investments (e.g., upgrading in the capacity and quality performance of machines for SITER, provision of new cards to balance production lines for SOMOTEX, and reconditioning of existing looms in TISSMOK) were required immediately to prevent the deterioration of the technical and financial situation of these subsidiaries. Physical investment in SITER, SOMOTEX, and TISSMOK included essential spare parts and aimed at balancing the existing production facilities with urgent overhauling of certain equipment to maintain productivity.

8. Technical Assistance. The activities covered by this component were: (a) upgrading, with the help of consultants, the Group's management and accounting systems to the requirements of modern mills (the SITEX component did not require hiring of new staff); (b) assisting SITEX in detailed preparation and implementation of its rehabilitation and modernization program, which was being covered under the project; (c) assessing potential markets for SITER, SOMOTEX, and TISSMOK, as well as strengthening their marketing capabilities; and subsequently (d) preparing rehabilitation and modernization investment proposals for SITER, SOMOTEX, and TISSMOK for implementation during the second phaseof the project.

9. The project also provided for major modifications of the air conditioning systems in the spinning and weaving plants for better operational efficiency and working environment and incorporated ecological and occupational safety considerations. Overall plant and equipment specifications were designed to ensure that all wastes be within international limits, taking into account environmental aspects.

10. The Bank loan financed: (a) the consultants' services and training; (b) all machinery, equipment, and spares; and (c) the imported component of incremental working capital requirements (initial raw materials) and spare parts. (An additional portion of the loan was unallocated initially.) Funds were onlent by the Government to SITEX (US$14.4 million) and SOGITEX Holding (US$4.2 million) at a higher-than-Bank interest rate, with ultimate beneficiaries beeing the foreign exchange risk.

11. Swiss credit to SITEX (as end-user) had the foreign exchange risk borne by the Government (no commitment fee) but in unsubsidized terms.

Project Performance

12. Despite some delay in Bank loan effectiveness, disbursements accelerated, and the loan closing date (December 31, 1984) did not need to be extended.

13. During implementation, SITEX management and the cooperating foreign firm, Swift, became convinced that emerging market demand for denim required that a higher proportion of planned output be produced on wide shuttleless looms. Consequently, it was proposed--and accepted by the Bank--to modify the scope of the project to increase the number of such looms. The new looms added sufficient open-end rotors to raise the production of yarn output with the new technology to 90% of total. Part of this change permitted an innovation in weaving technology that was to make SITEX one of the leading denim producers of the world. SITEX also is a major supplier to the EEC market. Employment has been maintained and foreign exchange earnings expanded. Machine efficiency also has increased significantly.

14. Regarding institutional development, a principal achievement of the Bank project has been the strengthening of SITEX. This involved not only the major rehabilitation of productive facilities but also the further development of technical capacities and the formation of a strong management team.

15. Rehabilitation programs prepared with technical assistance funds now are being implemented for SITER and SOMOTEX. The goal is to modernize the finishing facilities of the plants in order to raise the quality of the cloth production and permit substantial exports.

16. The project has fully achieved its major objectives of selected rehabilitation of plant and strengthening of technical and managerial capacities of the participating companies. In the context of the Government's policy for divestment in non-strategic economic activities, the stage has been set for privatization of the enterprises concerned. Given the record of achievement and further progress in the various follow-up activities, benefits are likely to increase progressively.

Lessons Learned

17. (a) The Bank must provide support for operations in productive sectors where technology and demand are subject to rapid change;

(b) Rapid changes in supply and demand or technological conditions require flexibility in design of projects and close monitoring during implementation;

(c) The Bank can play a role in helping financially weak public sector enterprises undergo the technical and managerial improvements and the financial restructuring required before privatization is attempted.

18. A particularly good element in the project was the close involvement of the foreign firm Swift, in marketing the output, a task that would have been extremely difficult for a Tunisian enterprise. Tunisia offered considerably lower labor costs than other sources with which it was dealing and had preferred access, as well as proximity, to the EEC market. The project's success depended largely on exports of denim to Western Europe, therefore and its scope has been geared toward improving the export competitiveness of SITEX. The Swiss firm, Swift, has served as marketing intermediary. Due to a strong marketing effort, along with the flexibility of the SITEX plant, SITEX has been able to increase its market share despite an overall depressed denim market. It has done this because of its cost competitiveness, good product quality, locational advantage, and duty-free access to markets.

19 A second important element was the choice of technology. The export market would not have accepted the denim cloth produced by the traditional processes without a substantial price discount, which would have reduced sharply the foreign exchange earnings from the project. Initially the Bank was concerned about adopting the newest technologies, which were less capital intensive and thus appeared not appropriate to the resources of the country. The success at the project has demonstrated that although factor proportions should be considered in the choice of technology, export-oriented activities must be designed to meet the needs of the markets, and this may require the most advanced technologies.

20. However, there are doubts about the net advantage to Tunisia of an export-oriented textile industry based on 100% imported inputs. Bank studies suggest that large-scale exports would most likely also require a substantial domestic market to provide the basis for scale economies and the development of necessary skills. In this instance, the prior experience of SOGITEX as a domestic market-oriented enterprise with an accumulation of production skills was the basis for confidence in the success of the export industry, while the involvement of a foreign marketing partner assured quick access to external markets.

Project Completion Report

Project Scope Changes

21. For SITEX, a supplemental program was undertaken in consultation with the Bank. Its estimated cost was US$10.6 million, and it included the acquisition of open-end spinning rotors and wide looms to meet the demand for exports. In addition to the Bank loan, SITEX obtained long-term loan financing from Switzerland and the joint Tuniso-Saudi Development Bank (STUSID). The Swiss credit was increased from the appraisal estimate amount, and the STUSID loan financed part of SITEX's supplemental investment program.

22. Because of the prior experience of the SOGITEX Group and the technical and development department of SOGITEX Holding in managing the Group's investments, the Bank agreed that no expatriate consulting services were needed for tendering and bid evaluation for the relatively small investment programs of SOMOTEX, TISSMOK, and SITER.

23. The overstaffing at SITEX has been reduced relative to increased production, which has been attained through modern equipment, debottlenecking, renovation, and more efficient utilization of existing facilities; total employment has been maintained at about 1,800 through training programs established by the SOGITEX Group with the assistance of consultants.

24. SITEX's operations have gained considerably from technical assistance provided outside the project. The quality of SITEX's management is outstanding, and management has been particularly successful in establishing an adequate organizational structure and modern operational and managerial systems.

25. Based on the marketing study, consultants developed the outline of an investment program for further rehabilitation and modernization of the SOGITEX companies.

26. The project has been instrumental in laying the groundwork for further restructuring and privatization of the SOGITEX companies, a process underway with the assistance and participation of IFC.

27. There has been a considerable spillover of SITEX's benefits to the other companies in the SOGITEX Group and even to some private companies. This has occurred through the movement of competent staff and the demonstration effect of successful marketing and project preparation and implementation.

28. SITEX management believes that without the project such successful restructuring would not have taken place. For the SOGITEX companies, the exposure to foreign technical assistance has been beneficial in improving their operations and product quality and has laid the groundwork for their further restructuring.

CONCEPTUAL FRAMEWORK FOR SUBSECTOR RESTRUCTURING

1. Policy, Regulatory, and Institutional Environment. As discussed in Chapter III, policy reform and industrial regulatory reforms are increasingly important features of subsector restructuring projects. The policy framework establishes the business environment in which firms make decisions to invest, divest, diversify, and compete internationally. Critical to this environment is the incentive system, including the trade regime, pricing and interest rate policies, and fiscal benefits and subsidies that alter the returns to enterprises in the subsector.

2. The regulatory system refers to the body of regulations that affect evolution of the subsector's structure. Industrial subsectors are affected by exit limitations, licensing of business entry and expansion of capacity, and specific sectoral programs that confer unique benefits or impose specific burdens.[1/] These include domestic content or mandatory parts regulations.

3. The institutional environment refers to a variety of business, social, and political institutions as well as physical infrastructure that can affect enterprise development within a subsector. Included are:

(a) Industry information, industry associations, market research and export promotion services, and organization of the government bureaucracy and its interaction with the subsector; and

(b) Facilities for training and retraining, for research and development, and for quality control, testing, and monitoring of industry standards.

4. It is important to note that because it is a process of change, restructuring requires more attention than previous Bank operations to infrastructure, institutional issues, and policy environment. For example, the industrial restructuring program in China has emphasized enterprise autonomy and independence from bureaucratic intervention. The Mexican Subsector Restructuring Project has defined several important industry-level investments such as dedicated communications and technical centers for the auto parts subsector and a fashion and design institute for the textile industry.

1/ Poland's limit of private enterprises to 50 employees and its progressive taxation of these enterprises has limited optimal firm size to 15 or fewer workers. Firms are thereby confined primarily to the service sector. In December 1988, the government of Poland announced reform measures to lift these restrictions on firm size.

5. Definition of a Subsector. The key criterion in defining a subsector is competition, with subsector's boundaries and characteristics determining the scope of restructuring. A subsector comprises competing enterprises--producers of similar or substitute products, actual and potential international competitors, and firms competing at particular points in the production process. All these participants should be considered when a restructuring operation is planned. This is not possible in many developing countries because of "protected" or "strategic" subsectors in which a parastatal monopoly comprises the subsector, or when a high degree of subsector concentration (e.g., cartels) limits competition by ensuring that each firm occupies a unique, non-overlapping niche, and when pressures to improve performance do not exist.2/ This absence of real competition undermines the chances for long-term successful restructuring.

6. Subsector Characteristics. Industry structure and its response to competitive pressure are strongly affected by a subsector's characteristics. Product and process technologies may require economies of scale. The nature of the product--weight, value, quality, and function--affects the potential for product differentiation and the dimensions within which firms compete. (The Table depicts Subsector Structure-Industry Characteristics).

7. The Bank's subsector economic analysis often uses factor costs (labor, energy and raw materials) to measure international competitiveness. However, product quality, design, reliability, and a firm's ability to market its products and to service its customers are becoming more important determinants of competitiveness for many non-commodity industrial products. Textile firms in Hong Kong have used value-added components (e.g., fashion design and product quality) to increase the value of unit exports in response to unit quotas set under the Multi-Fibre Agreements. Competition with lower cost labor in Asia has led many firms in the U.S. garment and auto industry to establish off-shore (maquila) assembly operations in Mexico and the Caribbean. Fragmented subsectors such as textiles, with distinct segments (spinning, weaving, knitting, finishing, and confection), may include many small and medium-size firms that compete fiercely within their segments. Many segments are virtually cartels, such as synthetic fibers production.

2/ In Poland, for example, industrial firms cooperate through "voluntary" industry associations and rarely compete. At least two of these voluntary organizations have been transformed into industry-wide holding companies, Elmet in electronics and Polmag in mining equipment, thus assuring lack of domestic competition in these subsectors. The question remains whether Polmag's export orientation will keep it competitive in the absence of either domestic or import competition.

Table 3.1: SUBSECTOR STRUCTURE—INDUSTRY CHARACTERISTICS

Subsector Characteristics

- Subsector segmentation: The number, relative scale and types of business activities
- Ownership composition in terms of private, public or mixed; domestic, foreign or joint ownership; small, medium and large enterprises; and concentration of enterprises into business groups
- Allocation and characteristics of fixed assets and their location, capacity or scale, age, flexibility and technology, e.g., intensity of labor, capital, scale, skill, energy, waste
- International configuration, i.e., locations and coordination of the various value-adding activities
- Integration or interfirm cooperation with respect to interrelated business activities, especially diversification and vertical horizontal integration
- Length of the vertical chain within or across subsectors. For example, there are at least five stages plus distribution in the textile industry, each with different competitive advantages. Therefore, subsector restructuring within the textile industry must look at the complex chain of interrelated industries

Enterprise Characteristics

- Competitive market strategies and product mix of individual firms: Focus on design, branding, marketing, product specialization vs. commodity-focused, cost-differentiated industries
- Organizational structures and management systems, including autonomy and accountability/incentives of management, as well as corporate culture and prevailing orientation (such as domestic or outward), and production or marketing perspective
- Financial performance and balance sheet structure, especially capitalization, liquidity and debt service burden
- Human resources, in terms of both the number of personnel and human capital (knowledge, skills, experience, business attitudes)
- Innovative capacity, technology development, applied research and development
- Distribution channels in both the domestic and export markets, customer relations and brand reputation

Support Structures

- Support structures, either from public institutions or from subsector-wide enterprise cooperation, such as standard-setting and quality control; market analyses and forecasts and their dissemination; innovation financing; basic research; export assistance; and education and training

8. **Enterprise Strategy**. Enterprise strategy is another variable component in subsector structure. Enterprises are the key activators in restructuring--changes in the real economy can occur only at the enterprise level (see Chapter V, Enterprise Restructuring). In making investment decisions and in developing strategies for investments and divestitures, enterprises consider the basic characteristics, policies, and institutions that govern their subsector. The outcome involves decisions on markets, products, and activities for developing and maintaining competitive advantage. These strategic decisions by major enterprises in a subsector in turn shape a subsector's structure.

9. An enterprise's strategy and resulting behaviour aim directly at the enterprise's objectives. In market economies, objectives such as profit maximization, market share, return on shareholders' equity, and return on investment are the forces shaping firm-level strategy. In command economies, centrally-planned production targets govern enterprise decision-making, with investment and increased production as the targets. In subsectors dominated by large parastatal enterprises, political intervention may create mixed objectives such as maintaining maximum employment, producing basic goods regardless of costs, or increasing transfers to government. Often such mixed objectives lead to the creation of highly inefficient public enterprises that are responsible for large public deficits and that undermine competitive prospects for downstream industries, for example, in many Latin American countries.

10. Subsector structure, enterprise behavior, and enterprise performance represent major components of subsector restructuring. These features are outputs of a competitive process but also shape future competitive decisions. Bank-supported restructuring studies have focused on subsector structures, comparing them among competing countries as a guide to international competitiveness.

11. The behavior of enterprises within a subsector relates mainly to the degree of competition encountered. Competitive behavior forms an important link between structure and performance. For instance, a high degree of industrial concentration, supported by barriers to entry, might enable firms to engage in collusive behavior,[3] reducing the pressures for efficient performance.

12. The absence of competition directly affects performance. The performance of a subsector usually is evaluated by objective measures such as increases in productivity, exports, employment,[4] and investment returns. Few Bank-supported restructuring programs have defined their aims in terms of objective performance. Consequently, supervision reports and evaluations of project results usually provide only qualitative assessments of project performance.

3/ In Colombia, for example, the industrial sector has become increasingly concentrated in ownership. Large industrial groups with strong regional orientation own an increasing percentage of the industry sector.

4/ Many subsector restructuring programs lead to reduced employment in their initial stages, however.

SUBSECTOR RESTRUCTURING

RESTRUCTURING PROGRAM

EVOLUTION OF INDUSTRY STRUCTURE

POLICY REFORM & INSTITUTIONAL DEVELOPMENT (SECTORAL & SUBSECTORAL

POLICIES & INSTITUTIONS
INCENTIVE SYSTEM
MACRO POLICIES
FINANCIAL SYSTEM
REGULATORY SYSTEM
INSTITUTIONAL FRAMEWORK

SUBSECTORS' BASIC CHARACTERISTICS
PRODUCT & PROCESS TECHNOLOGIES, PRODUCT TYPE (COMMODITY, DIFFERENTIATED), MATERIAL, ENERGY & LABOR INPUTS, NATURE OF MARKET, ETC.

INVESTMENT IN SUBSECTOR (PUBLIC & PRIVATE)

AVAILABLE RESOURCES

ENTERPRISE STRATEGY & OBJECTIVES

SUBSECTORS' STRUCTURES
& SIZE OF FIRMS, COMPETITIVE SCOPE (PRODUCTS, VERTICAL, GEOGRAPHIC), OWNERSHIP COMPOSITION, LINKAGES BETWEEN FIRMS, ETC.

SUBSECTOR BEHAVIOR
INTENSITY OF COMPETITION

SOCIAL ADJUSTMENT PROGRAM

SUBSECTOR PERFORMANCE
ECONOMIC: GROWTH, EXPORTS, PORFITABILITY
SOCIAL: EMPLOYMENT, ENVIRONMENT

INDICATIVE LIST OF INDUSTRIAL SUBSECTOR STUDIES

Country	Subsector	Supporting Studies/Programs
Turkey	. Fertilizer . Cement . Textiles	. Master Privatization Plan . Public Enterprise Reform . Industrial Policy Reform
Hungary	. Plastics Processing . Rubber Industry . Agricultural Equipment . Food Processing Machinery . Vacuum Technology	. Economic Policy Reform . Banking Reform
Mexico	. Autoparts . Textiles . Agroindustry . Wood Furniture . Shoes . Steel . Fertilizer	. Trade Liberalization Program . Industrial Sector Report . Industrial Competitiveness . Direct Foreign Investment
Colombia (In process of consultant selection)	. Textiles . Shoes . Steel . Agroindustry	. Industrial Sector Report
Poland (In process of selection)	. Components . Packaging	. Industrial Sector Report
Senegal	. Textiles . Agroindustry	

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February 22, 1989

89022401 Mr. Qureshi
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THE WORLD BANK

Operations Committee

CONFIDENTIAL

Minutes of Operations Committee Meeting to Consider Board Paper on "IBRD Role in Financial Intermediation Services: Expanded Cofinancing Operations

Held on February 22, 1989 in Room E-1243

A. Present

	Committee		Others
Messrs.	M.A. Qureshi (Chairman)	Messrs.	K. Inakage (VPCOF)
	I. Shihata (VPLEG)		C. Ludvik (VPCOF)
	S. Husain (LACVP)		P. Vieillescazes (COFAU)
	S. Fischer (VPDEC)		D. Bock (DFS)
	D.C. Rao (VPFPR)		J. Taylor (DFS)
	M. Wiehen (ASIVP)		S. Rajasingham (DFS)
	P. Hasan (EMNVP)		E. Grilli (EAS)
	H. Vergin (SVPOP)		A. Steer (FRS)
			R. Johannes (FRS)
			A. Heron (CODOP)
			A. Watkins (SPRSP)
			H. Morais (LEGOP)
			T. Baudon (SVPOP)
			J. Tanaka (EXC)

B. Proceedings

1. The meeting generally endorsed the approach taken in the draft Board Paper for the introduction of a pilot program of Expanded Cofinancing Operations. With regard to the 17 heavily indebted countries, it was again stressed that special care must be taken to ensure that ECOs were not used in concerted lending or debt reduction packages. It was therefore agreed that the language in the paper would be clarified to say that ECOs would primarily be used outside the HICs and that in the HICs, special care would be taken to restrict ECOs to accessing capital market transactions and new forms of project financing.

2. The meeting particularly endorsed the need for flexibility at the startup of the pilot program, since the Bank should be able to adapt its credit enhancement to the specific circumstances affecting its borrowers as well as the specific market instruments that would be of most benefit to its borrowers.

3. In discussing the preliminary operational guidelines for the pilot program, the Committee thought that these guidelines would be acceptable so long as it was recognized that they were only objectives which the Bank should strive for and not be seen as rigid rules. It was further agreed that the wording changes to the guidelines proposed in paras. 11 through 14

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of Mr. D.C. Rao's memorandum of February 21, 1989 were acceptable, with the exception that the guideline on near-term exposure (vi) would be reworded to make clear the distinction between direct guarantee exposure and payment sharing arrangements.[1] To the extent it is appropriate, these guidelines would be included in the Board Paper.

4. The Chairman made clear that while transactions under this program must be fully integrated into the Bank's country assistance strategy, transaction design and negotiations with private lenders should be managed in a centralized fashion especially in regard to the risk factors inherent in such a program. Moreover, during the pilot program, each proposed transaction would be reviewed in the Operations Committee to ensure its acceptability.

JLTaylor/SRajasingham:mac
February 23, 1989

1/ The revised guidelines are set out in the Annex to this Minute.

OPERATIONAL GUIDELINES FOR PILOT PROGRAM

Specific operational guidelines designed to ensure that expanded cofinancing operations do not expose the Bank to excessive risk, are set out as follows:

(i) Associated Bank loan. Expanded cofinancing operations (ECOs) for financing investments will be undertaken in conjunction with direct loans by the Bank, except in exceptional cases. ECOs designed to provide general (balance-of-payments) financing will be used only in association with Bank adjustment loans; or for countries that are exceptionally creditworthy and have had a satisfactory macro-framework for the previous three years.

(ii) Country exposure. Guarantees and equivalent forms of credit enhancement made under the expanded cofinancing program will be continuously counted on a present value basis, assuming the guarantee is called on the earliest possible date, for the purpose of country exposure limits.

(iii) Size of Bank participation on commercial bank loans. In a particular ECO, the Bank's guarantee, or other credit enhancement, will not normally exceed the corresponding country exposure incurred by commercial banks, or other lenders associated with that transaction, on a present value basis.

(iv) Degree of Bank credit enhancement of bonds. In order to avoid confusion with the Bank's own bonds, the Bank's guarantee, or other credit enhancement, in capital market operations will be limited so as to cause the bond issue or other marketable security to attain a credit standing which, by reasonable estimation, falls below the equivalent of AA/Aa.

(v) Statutory lending limit. The amount of each Bank guarantee will be counted at its full face value at the time it becomes callable with regard to the Bank's Statutory Lending Limit.

(vi) Near-term exposure. The Bank will not normally provide near-term support for commercial bank finance.

(vii) Payment-sharing arrangements. Consistent with the practice adopted for direct participation B-loans, in the case of ECOs that involve payment sharing arrangements, the whole financing (i.e. including the private source funding) will be counted as preferred-creditor exposure for the purposes of the Bank's exposure guidelines.

(viii) Adjustment lending allocation. Guarantees, or other credit enhancement, made under ECOs associated with adjustment loans will be counted on a present value basis (assuming the earliest possible call date) as adjustment lending in regard to the guideline that adjustment lending should normally not exceed 25% of IBRD commitments.

(ix) <u>Conditions for near-term exposure</u>. ECOs that involve near-term exposure will be normally undertaken only if the following conditions are satisfied:

(a) The adequacy of external financing is fully assured or has a very low risk of falling short of the country's requirements;

(b) The borrower has a good record of servicing external creditors (specifically, there have been no material arrears in interest payments in the past three years); and

(c) For ECOs associated with adjustment loans, the borrower has sustained a strong adjustment program and satisfactory macro-framework for at least the previous three years.

(x) <u>Conditions for accelerability</u>. The Bank will agree to an acceleration of its guarantees in association with commercial lending only when the loan has been declared by the private creditors to be in default and immediately due.

(xi) <u>Conditions for options</u>. Options to "put" loans or bonds to the Bank in the absence of borrower arrears, and option-related instruments, should be granted only to borrowers which satisfy the same conditions as those for near-term exposure (guideline (ix)).

FRS/DFS

2/23/89

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: February 22, 1989

TO: Mr. Moeen A. Qureshi

FROM: John L. Taylor JLT

EXTENSION: 73125

SUBJECT: **Expanded Cofinancing Operations:**
<u>Operations Committee Meeting (February 22, 1989)</u>

1. As you know, the above paper has been subject to very wide comment throughout the Bank (more than 50 staff in the major complexes and in the Regions were asked for their comments). We have tried to incorporate most of those comments in the draft which will be discussed this afternoon.

2. The main issue that remains outstanding is that of the degree of flexibility that we would have in structuring the program. We believe that without sufficient flexibility it will be difficult to tap specific market opportunities successfully. Virtually all comments that we have received have supported us in this respect. However, the Finance Complex (D.C. Rao and to some extent Ernie Stern) have been anxious to develop guidelines that would constrain the program.

3. We have negotiated long and hard with D.C. Rao to keep his guidelines as flexible as possible but yesterday afternoon Ernie also added further constraints. Ernie is concerned that the result of not including firm guidelines in the paper would be a barrage of unacceptable requests for Bank support from both private lenders and the Regional staff themselves. Two concerns are particularly noteworthy in this respect:

(a) Finance believes that in commercial bank lending (not capital markets transactions), the Bank should not guarantee interest, nor should it guarantee short (i.e. three to five year) maturities of principal. The rationale for this constraint is that the Bank is apparently better able to judge long-term risk and should use its leverage at the long end. Moreover, in Ernie's view, interest guarantees amount to a de facto means of interest capitalization and would drag the Bank too directly into disputes between the borrower and the commercial bank lenders.

Our position is that such guidelines may be valid in countries that are having difficulties restructuring their debt. We also concur that commercial banks should be capable of bearing short-term risk and would look to primarily providing support on late maturities in the context of financing provided by commercial banks. However, an overall rule for the program precluding such support would be a needless constraint especially at the inception of the program.

(b) Finance would want to deny the possibility of credit enhancement for the issuance of medium- or short-term notes or commercial paper (para. 47(c) of our paper) in the context of a long-term financing facility.

We have argued strongly for the inclusion of this option, since note issuance facilities and the like may still be an attractive form of financing for our borrowers.

4. As a quid pro quo for increased flexibility, you may wish to stress that while the proposed framework must be integrated in the Bank's country strategy, in terms of transaction design and negotiation with commercial lenders, it must be managed in a centralized fashion, especially in regard to the risk factors inherent in such a program.

5. Please find attached a draft summary which we hope will be of assistance in your summing up of the OC meeting on the Expanded Cofinancing Operations paper, taking into account the concerns set out above.

cc: Messrs. Vergin, Grilli, Bock, Rajasingham, Baudon

JLT/SR:mac

EXPANDED COFINANCING OPERATIONS

Draft Summary of Operations Committee Meeting Discussion

- The meeting generally endorsed the approach taken in the draft Board Paper for the introduction of a pilot program of Expanded Cofinancing Operations as proposed in the paper.

- The meeting particularly endorsed the need for flexibility at the startup of the pilot program, since the Bank should be able to adapt its credit enhancement to the specific circumstances affecting its borrowers as well as the specific market instruments that would be of most benefit to its borrowers.

- In discussing the preliminary operational risk guidelines prepared by the Finance Complex, the Committee generally thought that these guidelines would be acceptable so long as it was recognized that they were only objectives which the Bank should strive for and not be seen as rigid rules to be applied in all circumstances. Certain of the premises upon which the draft guidelines had been prepared were challenged, in particular the premise that the Bank should not guarantee short dated maturities or interest payments on commercial lending.

  The Committee acknowledged that there are special risks associated with interest guarantees in countries that are restructuring their debt, and that such guarantees (or other mechanisms) that may erode the Bank's negotiating position should be discouraged especially in the context of heavily indebted countries. The Committee noted that in any event, some design flexibility is required especially at the inception of the program, and that these issues would need to be looked at very carefully in the context of any specific transaction.

- [The Chairman made clear that while transactions under this program must be fully integrated into the Bank's country assistance strategy, transaction design and negotiations with private lenders should be managed in a centralized fashion especially in regard to the risk factors inherent in such a program.]

Mrs. Qureshi

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE February 21, 1989

TO Operations Committee Members

FROM D.C. Rao, Director, FRS DCR

EXTENSION 75456

SUBJECT Risk Guidelines for Expanded Cofinancing Operations

1. The purpose of this paper is to provide a basis for discussion of possible guidelines which would govern cofinancing operations under the proposed expanded program, to be discussed on February 22, 1989. A preliminary set of prudential guidelines has been developed by Risk Management and Financial Policy (FRS), in consultation with Debt Management and Financial Advisory Services (DFS). We have reached broad agreement with DFS on most of this set of guidelines (the list in the Attachment, which has also been circulated to you with Mr. Bock's Agenda); a few areas remain, however, where there is some disagreement, and these areas are described and discussed in section D below (paragraph 10ff). Accordingly, we regard the set of guidelines as preliminary and subject to further refinement.

2. Assessment of cofinancing proposals should not become a mechanistic process, but there are several financial factors characteristic of guarantee operations which can be evaluated in the light of the Bank's developmental purpose, its comparative advantage over commercial lenders, and its perception of the risk characteristics of the country concerned. This paper outlines that process of evaluation and, in conclusion, draws up a set of guidelines for expanded cofinancing operations.

A. Developmental Purpose

3. As a development advisor and as a long-term creditor, the Bank should reach its own evaluation of the benefits and costs of the proposal, not only in a financial but also in an economic and developmental sense, and after consideration of feasible alternatives. The Bank should assess whether a proposed cofinancing operation is in the best developmental interests of the country; and balance this against the risks to which the Bank would be exposed.

4. For expanded cofinancing operations (ECO's), a major consideration for the Bank's involvement will be the extent to which the transaction enhances the country's ability to attract new voluntary flows from private creditors; and particularly whether the additional flows of new money are sufficient to assure adequate financing of the country's development program.

B. The Bank's Comparative Advantage

5. The economic and financial design of expanded cofinancing operations ought to reflect the Bank's comparative advantage over

commercial lenders (in particular, commercial banks) if the Bank is to use to best advantage its capacity to bear country risk. The Bank may reasonably expect to hold a comparative advantage over commercial lenders in the following ways:

- Perception of longer-term risk
- Influence on country's economic management
- Role in project selection, design and implementation
- Tolerance for country exposure
- Leadership on collective interests

The Bank is able to make a more measured judgement than commercial banks of country risk in the long run; and through its policy advice, adjustment lending, and capacity to enforce conditionality, it can influence and improve a country's economic prospects in the medium- to longer- term. Additionally, the Bank is less averse than are commercial banks to increasing country exposure, thanks to its preferred creditor status. Thus it is free to act upon its judgements of comparative creditworthiness and the viability of adjustment efforts and can insist on a subordination of individual to collective interests as a condition for providing a guarantee. In project lending, the Bank has a sustained relationship with the borrower and an opportunity to make qualitative contributions towards their developmental goals.

6. A consequence of the Bank's comparative advantage is that it will generally prefer longer-dated guarantees over shorter ones, and guarantees associated with project lending over those of program lending, other things being equal. To the extent that guarantee operations are divorced from the Bank's direct lending procedures for appraisal and implementation, there will be a need for a special assessment of risk. Hence, we are led to the premises that:

They should not be

- Guarantees bear special risks (such as entanglement in commercial creditor/debtor relations and weakening of supervision procedures) that are not present in direct lending; and

- Guarantees associated with adjustment or other forms of non-project lending bear special risks that are not present in guarantees of project loans.

The implication is that these kinds of guarantee operations should be subject to special risk criteria and guidelines.

C. Country Risk and Financial Criteria

7. The financial structure of a particular guarantee operation should be tailored to match the risk characteristics (facing the Bank) and the needs of the country. These characteristics include (a) the probability that the guarantee will be called, (b) circumstances of the call and implications for the Bank's response, and (c) Bank exposure to that country. A country's short-term risk, longer-term risk, and attitude to creditors will be major determinants of the probability of a call on the

guarantee. For example, the Bank would be reluctant to expose itself to near term risk in a country which has recently used interest arrears as an instrument of negotiation. The conditions under which creditors are permitted to call on the Bank's guarantee can greatly affect the likelihood of the call being made. Careful attention should be paid, therefore, to such conditions, which should be judged in conjunction with the country concerned. Similarly, the Bank will examine the level and time profile of its exposure, net flows, and transfers to the country. If projected exposure were high or flows were negative, the amount and timing of the guarantee would receive special scrutiny.

8. There are many possible types of guarantee instrument, but most will share several basic financial characteristics, as follows:

- o Country's funding access and leverage of Bank guarantee
- o Timing of guarantee exposure
- o Whether principal or interest is guaranteed
- o Conditions governing call of guarantee and Bank's response
- o Incentives to service debt (e.g. degree of self-insurance)
- o Adequacy of guarantee fees.

The appraisal of a specific cofinancing transaction, therefore, should evaluate these financial factors in the light of the Bank's comparative advantage, and needs and risks associated with the country concerned, in order to arrive at financial criteria. The foregoing list is not, of course, exhaustive and will generally need to be supplemented according to the transaction in hand.

9. An illustration of how these factors might be evaluated is furnished by the conditions governing the call on the Bank's credit support in a put option on a loan. Put options, in distinction to conventional guarantees, allow a guarantee to be exercised in the absence of arrears and without requiring the loan to be accelerated. Thus, they bear special risks and should be limited to the least risky of the Bank's borrowers.

D. <u>Operational Guidelines</u>

10. Based on the foregoing considerations,specific operational guidelines can be designed so as to ensure that expanded cofinancing operations do not expose the Bank to excessive risk. We have reached broad agreement in discussions with DFS on several guidelines (see Attachment). There are, however, three guidelines (including parts in square brackets of two of the attached) as follows where we have differences of view:

- o Associated Bank loan (attached guideline (i)
- o Near-term exposure (attached guideline (vi))
- o Conditions for options (see below)

11. <u>Need for Bank A-loan</u>. The issue here relates to operations for investment projects and concerns the degree to which the absence of an A-loan should be considered exceptional in guarantees of B-loans. Our view is that the presence of an A-loan, with all its associated procedures, offers substantial safeguards, especially during supervision, which cannot be easily duplicated through, for example, special disbursement accounts.

Therefore, we conclude that dispensing with an A-loan in project guarantees should be an exceptional event, and we prefer this wording for the guideline:

> Associated Bank loan. Expanded cofinancing operations (ECO's) for financing investments will be undertaken in conjunction with direct loans by the Bank, except in exceptional cases. ECO's designed to provide general (balance-of-payments) financing will be used only in association with Bank adjustment loans; or for countries that are exceptionally creditworthy and have had a satisfactory macro-framework for the previous three years.

12. Near-term exposure and preferred creditor guidelines. What is at issue here is whether the full amount of a commercial bank loan should be counted in our preferred creditor exposure guidelines, if the loan benefits from near-term (up to 3 years) IBRD credit enhancement. Such a counting of the full B-loan amount in preferred-creditor exposure is already the Bank's practice for direct participation B-loans. We argue that, because of the risk of Bank entanglement in creditor/debtor relations arising from near-term exposure, the prudent course for the Bank is to reckon the whole commercial loan as preferred-creditor debt. This view does not rest on the presumption that the full B-loan will necessarily be accorded unquestioned preferred-creditor status by the borrower, but rather that the debt will enjoy a degree of seniority which requires special attention in relation to the Bank's exposure guidelines. Thus we favour the guideline wording:

> Near-term exposure. As in direct participation B-loans, for ECO's in the context of commercial bank finance that involve payment sharing arrangements or those that involve near-term exposure, the whole financing (i.e. including the private source funding) will be counted as preferred-creditor exposure for the application of the Bank's exposure guidelines.

13. Additionally, it is necessary to distinguish between guarantees of interest and guarantees of principal in commercial bank lending. When the Bank guarantees principal, its guarantee falls away if the principal is rescheduled. Thus, there exists a "decoupling" mechanism which permits the country and commercial banks to disengage from the Bank. By contrast, since interest payments cannot be rescheduled, a Bank guarantee of interest, if called, is tantamount to a backdoor means of interest capitalization. Therefore, we do not believe that the Bank should undertake near-term guarantees of interest, unless some legal mechanism is put in place to permit the borrower and creditors to disengage from the guarantor when appropriate.

14. Country eligibility for option-related instruments. The issue surrounding options is whether their riskiness to the Bank makes it desirable to place creditworthiness limits on the type of borrowing country that may be covered. Options and related instruments would typically permit the creditors to put all or part of a loan to the Bank at a predetermined price and on a predetermined date. Such put options relax a key condition required for a call of a conventional guarantee: the option can be exercised in the absence of arrears. Additionally, unlike

accelerable guarantees of late maturities, the option can be exercised in the absence of an acceleration of the loan. The ability to call a guarantee in the absence of arrears enables commercial banks or bondholders to protect themselves against a deterioration in country creditworthiness which has not yet reached the point of default on servicing obligations. It also enables creditors to give vent to their strong risk aversion in the event of short-term fluctuations in a country's economic performance. Hence, the probability of call upon the Bank as guarantor is multiplied. Consequently, we argue that put options are riskier to the Bank than conventional guarantees, and should be restricted to the least risky countries. We suggest the following guideline:

> Conditions for options. Options to "put" loans to the Bank in the absence of borrower arrears, and option-related instruments, will only be granted in respect to borrowers which satisfy the same conditions as those for near-term exposure (guideline (viii)).

Distribution

Messrs. Qureshi, Husain, Jaycox, Karaosmanoglu, Thalwitz, Rajagopalan, Fischer, Shihata, Wood, Vergin

cc: Mesdames & Messrs. Lee, Dubey, Shakow, Holsen, Rao, Burmester, Liebenthal, Steer, Baudon, Hopper, Bock, Goldberg, Frank, Parmar, Pfeffermann, Baneth, Kavalsky, Haug, Tanaka, Robless, Inakage, Ludvik, Vieillescazes, Taylor, Opper, Johannes.

RLJ/gz/htt

Mr. Qureshi

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: February 17, 1989

TO: Operations Committee Members

FROM: David R. Bock, Director, DFS

EXTENSION: 72942

SUBJECT: Board Paper on Expanded Cofinancing Operations - Agenda

1. As you have been informed, a discussion of the draft Board paper on Expanded Cofinancing Operations (ECOs) is scheduled for February 22, 1989. This memorandum describes the backdrop for the paper and lays out the key issues on which the Committee may wish to focus.

Background

2. At the Board discussion of existing cofinancing instruments in September 1988, many Directors expressed dissatisfaction with the slow progress that had been made with regard to expanding the Bank's efforts to attract private financial flows to developing countries. They requested that a paper proposing new ways to attract private financial flows be prepared before the spring Development Committee meeting. This paper is in response to that request.

3. The proposals in the paper are structured as an expansion of the existing commercial cofinancing program and are especially targetted at improving the voluntary access of developing countries to private markets. The recommended program is based on DFS and COF discussions on the subject of new financial instruments with institutions in New York, Tokyo, London and Paris; at least in preliminary form, the structures that are set out in the paper represent feasible transactions.

4. The paper has been subject, during its drafting, to reviews from an intercomplex Steering Group consisting of IEC, FRS, EAS, LEG and FOD. It has also been reviewed by a group of staff in each Region and incorporates their comments. In addition, work is continuing to develop guidelines that would help Management in assessing the viability of individual transactions (see attached preliminary operational guidelines).

Issues on which the Committee's Guidance is Sought

5. There are six key issues which the Committee may wish to consider:

(a) Does the Committee agree on the need at this time for a flexible Expanded Cofinancing Operations program, as proposed in the paper?

(b) Where should we concentrate Expanded Cofinancing Operations? In particular, is it agreed that these operations should not be used in conjunction with the Bank's strategy in the heavily indebted countries to catalyze concerted new money flows or foster debt reduction (see paragraph 6 of the paper)?

(c) Are the procedures for identifying and processing ECOs as set forth in Part IV of the paper adequate?

(d) Are the priorities for the development of the pilot program as set forth in the paper correct? In particular:

(i) the paper proposes the possibility of guarantee operations, without direct lending, to finance investment projects, which have been appraised and approved in line with normal Bank procedures. Is this acceptable (in terms of risk, quality of project supervision, etc.)?

(ii) the paper proposes that ECOs would be used in cofinancing adjustment programs, only if there is also direct Bank lending for that purpose. Is this acceptable? What is the likely demand for IBRD credit enhancement of adjustment financing in non-concerted lending circumstances? Apart from the existence of the IBRD loan, would additional criteria be appropriate for the ECO?

(e) Are there any special steps which should be taken to secure shareholder approval of the pilot program?

(f) If the pilot program is introduced, how can Regional staff be encouraged to use ECOs in appropriate cases?

Distribution:

Messrs. Qureshi, Husain, Jaycox, Karaosmanoglu, Thalwitz, Rajagopalan, Fischer, Shihata, Wood, Vergin

cc: Messrs. Lee, Dubey, Shakow, Holsen, Rao, Burmester, Liebenthal, Steer, Baudon, Hopper, Bock, Goldberg, Frank, Parmar, Pfeffermann, Baneth, Kavalsky, Ms. Haug, Tanaka, Robless

Cleared w/and cc: Mr. Inakage
cc: Messrs. Ludvik, Vieillescazes

SRajasingham/JTaylor:mac

Attachment

PRELIMINARY OPERATIONAL GUIDELINES

Specific operational guidelines designed to ensure that expanded cofinancing operations do not expose the Bank to excessive risk, are set out as follows:

(i) Associated Bank loan. Expanded cofinancing operations (ECOs) for financing investments will be [normally] undertaken in conjunction with direct loans by the Bank [except in exceptional cases]. ECOs designed to provide general (balance-of-payments) financing will be used only in association with Bank adjustment loans; or for countries that are exceptionally creditworthy and have had a satisfactory macro-framework for the previous three years.

(ii) Country exposure. Guarantees and equivalent forms of credit enhancement made under the expanded cofinancing program will be continuously counted on a present value basis, assuming the earliest possible call date, for the purpose of country exposure limits.

(iii) Size of Bank participation on commercial bank loans. The Bank's guarantee, or other credit enhancement, will not normally exceed the corresponding country exposure incurred by commercial banks, or other lenders associated with that transaction, on a present value basis in a particular ECO.

(iv) Degree of Bank credit enhancement of bonds. In order to avoid confusion with the Bank's own bonds, the Bank's guarantee, or other credit enhancement, in capital market operations will be limited so as to cause the bond issue or other marketable security to attain a credit standing which, by reasonable estimation, falls below the equivalent of AA/Aa.

(v) Statutory Lending Limit. The amount of each Bank guarantee will be counted at its full face value at the time it becomes callable with regard to the Bank's Statutory Lending Limit.

(vi) Near-term exposure. As in direct participation B-loans, ECOs in the context of commercial bank finance that involve payment sharing arrangements [or those that involve near-term exposure], the whole financing (i.e. including the private source funding) will be counted as preferred-creditor exposure.

(vii) Adjustment lending allocation. Guarantees, or other credit enhancement, made under ECOs associated with adjustment loans will be counted on a present value basis (assuming the earliest possible call date) as adjustment lending in regard to the guideline that adjustment lending should normally not exceed 25% of IBRD commitments.

(viii) Conditions for near-term exposure. ECOs that involve near-term exposure will be normally undertaken only if the following conditions are satisfied:

(a) The adequacy of external financing is fully assured or has a very low risk of falling short of the country's requirements;

(b) The borrower has a good record of servicing external creditors (specifically, there have been no material arrears in interest payments in the past three years); and

(c) For ECOs associated with adjustment loans, the borrower has sustained a strong adjustment program and satisfactory macro-framework for at least the previous three years.

(ix) Conditions for accelerability. The Bank will agree to accelerable guarantees in association with commercial lending only if the conditions of accelerability include the loan being declared by the private creditors to be in default and immediately due.

FRS/DFS

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February 17, 1989

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The World Bank
OPERATIONS COMMITTEE

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Minutes of the Operations Committee Meeting to Consider
CAMEROON - Country Strategy Paper cum Initiating
Memorandum for Structural Adjustment Loan

Held on February 17, 1989 in Room E-1243

A. Present

Committee

Messrs. M. Qureshi (Chairman)
I. Serageldin (AFRVP)
O. Yenal (ASIVP)
W. Thalwitz (EMNVP)
P. Loh (LACVP)
J. Linn (VPDEC)
H. Scott (VPLEG)
J. Wood (VPFPR)
H. Vergin (SVPOP)

Others

Messrs. E. Grilli (EAS)
U. Thumm (EAS)
S. Rajapatirana (EAS)
R. Westebbe (AF1DR)
P. Hansen (AF1CO)
Ms. M. Guerard (AFRCE)
L. de Wulf (AF1CO)
C. Poortman (AF1IE)
P. Clawson (AF1CO)
D. C. Rao (FRS)
A. Steer (FRS)
R. McPheeters (FRS)
Y. Jones (DFS)
J. Tanaka (EXC)
T. Baudon (SVPOP)
M. Fardi (SPRPA)
A. Hovaguimian (CA1DR)
Ms. C. Morin (LEGAF)

B. Issues

1. The meeting was called on the CSP cum IM for a proposed Structural Adjustment Loan (SAL) to Cameroon in an amount of $75 million. The discussion broadly followed the agenda prepared by the Economic Advisory Staff. The central issues of the discussion were (i) the realism of the economic scenario on which the proposed country assistance strategy and the SAL were based and (ii) creditworthiness and Bank exposure.

Country Strategy

2. The Chairman opened the meeting by inviting the Region to explain the rationale for the adjustment-cum-growth scenario presented in the CSP. The Region pointed out that Cameroon managed to preserve its agricultural basis through the petroleum bonanza of the 1970s and 1980s and that, while diminishing petroleum production was a drag on future economic growth, agriculture and manufacturing led by exports would be sufficiently dynamic to generate overall economic growth over the medium to longer term in the

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3-4 percent range. The Region also mentioned that Cameroon was not saddled with high debt-service obligations which would hold down investment.

3. Several speakers focused on the need for a marked change of the real exchange rate as a precondition for the envisaged structural changes and growth. In view of this, it would be important to discuss in the CSP the extent to which real exchange rate adjustment has already occurred and how much more would be required to achieve competitiveness for Cameroon. It was commented that in the absence of a nominal exchange rate change, continuation of the present recession was a more likely outcome, instead of the growth and progressive re-establishment of balance of payments viability projected by the Region. The reason for this outcome was that, barring a devaluation, the adjustment in factor prices necessary to establish adequate incentives to production for exports could only come from reduction in real wages--caused by restrictive credit and fiscal policies and by deregulation of labor markets. While the Region agreed that lack of nominal exchange rate flexibility was a serious constraint, it explained that some adjustments have already taken place. Real wages in Cameroon have dropped, mainly by shifts from the formal to the informal sector. Moreover, the Government has started to curb civil service benefits equivalent to about 10% of total compensation and, through a number of decrees adopted last November, to deregulate the economy. At the same time, inflation is very low. The Region considered Cameroon's growth potential good, with reasonable prospects for new oil discoveries (which are not reflected in the projections it presented).

4. A committee member expressed concern with regard to the implications of the proposed country assistance strategy for Bank exposure. He considered the strategy to be a high-risk proposal, in the absence of more favorable export growth prospects for the country. He felt that the structural impediments to a sustained improvement in non-oil exports were not sufficiently addressed in the draft paper, nor was the need for burden sharing and debt relief. It was agreed that a revised CSP would have to deal more explicitly with the risks present in the current and expected situation through alternative scenarios directly linked to alternative Bank lending responses. In this context, it was also agreed that the specific questions raised in paragraph 6 of the agenda should also be addressed.

5. Questions were also raised regarding the status of the IMF program and the IMF's role in supporting the adjustment program. The Region explained that the Government secured political support for drastic adjustments through the April 1988 elections and subsequently asked for Fund and Bank support. The 18-month Fund SB arrangement had been optimistic and did not foresee the need for debt rescheduling and relief. The program went off track, and arrears began to build up. The need for debt rescheduling is now being recognized. There was agreement that renewed Fund support would be required before going ahead with the proposed SAL.

6. The Chairman summarized this part of the discussion as follows:

- to better illustrate the risks involved for the Bank, different (at least two) scenarios should be worked out in a revised CSP with a clear link to alternative lending responses. Debt

rescheduling as well as the probability of oil should also be explicitly factored in;

- the potential sources of growth (particularly of exports) were to be further elaborated and the sector issues raised in paragraph 6 of the agenda were to be addressed; and

- there should be a more thorough discussion in the next draft CSP of deregulation issues, particularly the labor market. The discussion could also include consideration of the impact of an adjustment in the nominal exchange rate.

All of the above should be thoroughly assessed so as to allow a judgment on the risks the Bank would face. Given the high degree of uncertainty inherent in the country situation and prospects, the Bank could not commit itself, on the basis of the proposed strategy, to a long-term lending program.

Structural Adjustment Loan

7. The SAL discussion mainly focused on questions of creditworthiness and the size of the SAL. The Chairman asked the Region to work with the Fund on the rescheduling question and to make the proposed SAL as small as possible, as creditworthiness had not clearly been demonstrated for an operation of the size of $150 million. A committee member stressed that a loan of $150 million would require a markedly different adjustment and growth scenario from the one included in the CSP draft.

8. Another committee member thought that creditworthiness could not be re-established in the absence of a devaluation. However, he felt that the Bank should be able to support reform efforts which would result in greater efficiency, if not in re-established creditworthiness. He added that the question of the adequate loan size boiled down to a judgment on risk vs critical minimum support for changes towards greater efficiency (involving high social cost).

9. Other committee members raised questions regarding the strength of required prior actions, such as labor market deregulation and the restructuring of the public investment program (and even an exchange rate devaluation). A devaluation was ruled out as being beyond Cameroon's control, and the other aspects were left to the Region to judge the appropriateness of corresponding actions. However, the Region confirmed that agreement on the public investment program would be based on project-specific actions and that great emphasis would be given to domestic efforts leading to a depreciation of the real exchange rate.

10. Regarding the size of the loan, the Region wanted to maintain sufficient flexibility in response to government action in the critical fields of banking sector reform and improved agricultural marketing and progress with the Fund and the Paris Club. The Chairman noted that in the absence of an exchange rate devaluation a loan of $150 million would not be appropriate. While he reserved a final position for the green-cover stage, he instructed the Region to conduct appraisal on the hypothesis that the SAL would not be larger than $75 million.

Decisions

11. The Chairman asked the Region to prepare a revised CSP along the lines of paragraph 6 above. The revised CSP would have to be resubmitted to the OC and would also be considered by the President's Council. He also said that in the future he would like CSPs and IMs to be separated to bring out more clearly the different kinds of issues. The Region was authorized to go ahead with the appraisal of the SAL for an amount not larger than $75 million.

UThumm:vlw
February 21, 1989

·Mr. Qureshi

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: February 17, 1989

TO: Operations Committee

FROM: Ulrich Thumm, Adviser, EAS

EXTENSION: 78074

SUBJECT: CAMEROON: Country Strategy Paper cum Initiating Memorandum for a Proposed $75 million Structural Adjustment Loan - Agenda

At the beginning of paragraph 6 of the Agenda, a sentence is missing. Paragraph 6 of the Agenda should read as follows:

The proposed assistance strategy is built around a core of adjustment operations and complementary investment projects in key sectors. The Committee may raise questions in regard of four sectors. (i) Human Resources. Why does the Region limit Bank support to the SDA approach rather than proposing a more elaborate human resources development strategy, especially given Cameroon's high population growth? (ii) Energy Sector. The Region proposes only one power project. How does the Region plan to pursue the dialogue on oil exploration incentives and questions concerning the management of future revenues from oil extraction? (iii) Environment. A forestry project is proposed to deal with environmental issues. While forestry questions seem to be at the heart of the problem, is there not a need to tackle the environment in a more comprehensive way, including population and natural resource management in a broader sense. (iv) Urban Sector. This sector enjoys a high priority in the proposed assistance strategy (with the second urban project already approved). The key question is how the proposed urban sector activities (mostly non traded) would support the overall strategy striving for a change of the real exchange rate and diversification of exports.

cc: Messrs: Lee, Dubey, Shakow, Holsen, Rao, Burmester/Thahane, Steer, Baudon, Hopper, Bock, Goldberg, Frank, Parmar, Pfeffermann, Baneth, Kavalsky, Tanaka, Robless, Aguirre-Sacasa, Agarwala, O'Brien, Serageldin, Westebbe, Landell-Mills, Kaps, Hansen, Ms. Haug.

UThumm:eg:vlw

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

1.

DATE: February 14, 1989

TO: Operations Committee

FROM: Enzo Grilli, Acting Director, EAS

EXTENSION: 78061

SUBJECT: CAMEROON: Country Strategy Paper cum Initiating Memorandum for a Proposed $75 million Structural Adjustment Loan - Agenda

1. The Operations Committee will meet on Friday, February 17, 1989 at 3:30 p.m. in Room E-1243 to discuss the CSP cum IM for a $75 million SAL to Cameroon. The Operations Committee may wish to discuss the issues as set out in paras. 4 to 13.

Background

2. Cameroon has enjoyed sustained development with high growth during most of the 1970s and the first half of the 1980s, based on a diversified resource base including petroleum. The decline in petroleum prices and production levels has resulted in major fiscal and general financial difficulties and has also exposed serious structural problems including a gravely distorted system of incentives (with trade restrictions, price controls, and pervasive government interventions). Adjustment has been postponed for too long as reserves built up from petroleum revenues provided a financial cushion and the seriousness of the problems, particularly their structural nature, had been misjudged. Late last year, Cameroon got into an 18-month standby arrangement with the IMF which currently, however, is inoperational. (Regarding the implications for the Bank, see paragraph 10.) The proposed strategy and SAL program try to address the medium-term structural aspects of the current financial crisis to help Cameroon to diversify its economy, make it more efficient and competitive, and put it back on a growth path.

3. The proposed agenda is divided into two sections: a first part dealing with the proposed country strategy and the underlying medium-term economic framework; and a second part dealing with specific issues of the proposed SAL.

Country Strategy

4. The proposed country strategy is built around a core program of macroeconomic and sector adjustments complemented by support for specific investment efforts in a few key sectors. The ultimate goal is to overcome Cameroon's financial difficulties and to restore economic growth, based on diversification and more efficient resource use, with a greater role for private sector initiative. The key question to be asked is whether the proposed strategy is realistic and has a chance of achieving its goal given the multiple constraints Cameroon's economy is facing. More specifically, what are the prospects to achieve a change of the real exchange rate of a sufficient magnitude to change the economy in the direction of the projected growth course? To overcome its current financial and medium-term economic difficulties, Cameroon has to diversify and export more (also to

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compensate falling oil exports), which requires a major change in the real exchange rate--probably by a larger magnitude than in other CFAF countries. The country, however, is not only facing the rigidity of the nominal exchange rate which it shares with the other countries of the CFAF zone but also major rigidities in goods and factor markets which will make nominal price reductions of non traded goods difficult in the absence of a major reduction of absorption (i.e. a recession). The Committee may ask the Region to elaborate on the underlying assumptions of the proposed strategy and projections.

5. The situation described before would seem to pose considerable downside risks. While paragraph 104 briefly touches upon the risks, the Committee may ask the Region to elaborate on the likelihood of the downside scenario (with policy backsliding or failures in the presence of serious constraints to macromanagement, e.g., change of the real exchange rate). The Committee may also ask the Region to work out an alternative assistance strategy to deal with these downside risks.

6. However, the Committee may raise questions in regard of four sectors. (i) Human Resources. Why does the Region limit Bank support to the SDA approach rather than proposing a more elaborate human resources development strategy, especially given Cameroon's high population growth? (ii) Energy Sector. The Region proposes only one power project. How does the Region plan to pursue the dialogue on oil exploration incentives and questions concerning the management of future revenues from oil extraction? (iii) Environment. A forestry project is proposed to deal with environmental issues. While forestry questions seem to be at the heart of the problem, is there not a need to tackle the environment in a more comprehensive way, including population and natural resource management in a broader sense. (iv) Urban Sector. This sector enjoys a high priority in the proposed assistance strategy (with the second urban project already approved). The key question is how the proposed urban sector activities (mostly non traded) would support the overall strategy striving for a change of the real exchange rate and diversification of exports.

7. Bank Group exposure in Cameroon in relation to the country's DOD is relatively high (over 20 percent), mainly because of a relatively low level of DOD. However, debt-service payments to the Bank Group, currently at about four percent of Cameroon's export earnings, are projected to rise fast to reach about seven percent as a result of the proposed assistance strategy. The key question to be raised is whether the proposed strategy for burden sharing with other creditors is adequate. In particular, the possible need for debt rescheduling and other ways of debt alleviation could be discussed in greater depth (even though this would have "perverse" results on the quantitative indicators of Bank Group exposure). The question of burden sharing is also of immediate relevance in the context of the proposed SAL as the adoption of a medium-term financing strategy is required as a precondition.

8. In light of the country's financial difficulties and investment needs, the Region proposes cost sharing of 80 percent for Bank project lending during a transition period of three years. From the fiscal projections it is not really clear what the public sector's savings capacity amounts to. It seems rather that a certain public investment

level (about six percent of GDP) is postulated and confronted with likely disbursements from external loans which happen to approach 80 percent. Exposure considerations as well as the public sector's savings potential, however, would suggest lower cost sharing, even during the period of transition. The Committee may wish to ask the Region to elaborate on the justification for the proposed cost sharing.

Proposed SAL

9. The Region proposes to tackle the multiple and complex structural problems through a series of about three SALs. The first two actually form one operation of $150 million which currently is proposed to be split into two segments of $75 million each as actions to restructure the banking system and to improve the marketing and support price system for export crops seem to require more time to be prepared. From the Region's analysis it appears that both areas are crucial for the success of any adjustment program, and the Region therefore proposes to get firm government commitment on the broad elements of a multi-year reform program in the form of specific loan conditions. The Committee may want to reconfirm specifically these proposed conditions to provide a link between the different operations. The Committee may also ask how the Region proposes to deal with the financial sector issues that need to be tackled at the level of the BEAC.

10. While Cameroon entered into a SB arrangement with the Fund in September 1988, this arrangement is currently inoperational. Could the Region elaborate on how it proposes to deal with this question in the processing of the proposed SAL?

11. The public investment program is a key area in which adjustment and procedural reforms are needed. There seem to be several projects of doubtful economic merit. The Committee could ask the Region to elaborate on the criteria which would have to be met to reach satisfactory agreement with the Government on a three-year investment program. More specifically, what action do we expect the Government to take regarding some of the doubtful projects, e.g., the Yaounde airport?

12. As suggested in paragraph 4, the required change in the real exchange rate may be difficult to achieve. The Committee may ask the Region to elaborate on specific actions to deregulate goods and factor markets. While removal of some QRs accompanied by price decontrol is proposed as prior condition, should there not also be prior action on wages (and possibly also interest rates)?

13. As suggested in paragraph 7, a medium-term external financing strategy with adequate burden sharing is crucial for the success of the adjustment program. The Region could be asked to elaborate on the key elements of the financing strategy to be pursued. Moreover, as a precondition for the proposed SAL one might expect Cameroon to initiate talks with other creditors based on the agreed strategy, and to make substantive progress as a condition for second tranche release.

14. The adjustment program requires major changes in relative prices and cuts in spending programs with far-reaching consequences for employment and welfare. While the Region proposes a separate SDA project (in reserve for FY90), the Committee may wish to ask the Region to elaborate on this aspect and perhaps to strengthen the SAL conditionality in that respect in seeking specific government commitments.

SDA

cc: Messrs: Lee, Dubey, Shakow, Holsen, Rao, Burmester/Thahane, Steer, Baudon, Hopper, Bock, Goldberg, Frank, Parmar, Pfeffermann, Baneth, Kavalsky, Tanaka, Robless, Aguirre-Sacasa, Agarwala, O'Brien, Serageldin, Westebbe, Landell-Mills, Kaps, Hansen, Ms. Haug.

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE : February 15, 1989

TO : Mr. Moeen Qureshi

Through: Mr. Enzo Grilli, EG Acting Director, EAS

FROM : Ulrich Thumm, Adviser, EAS UT

EXT. : 78074

SUBJECT: CAMEROON - CSP cum IM for $75 million SAL

I prepared the agenda for Friday's OC meeting on Cameroon. While the agenda raises a number of issues regarding the proposed country assistance strategy and the SAL, I feel particularly strongly about two issues:

- The country assistance strategy is not sufficiently thought through and requires additional work to address the issues raised in the agenda. The Region should be asked to come back with a revised CSP (including revised projections); and

- The success of the proposed SAL (and indeed the whole country strategy) critically depends on a significant change of the real exchange rate. SAL processing should only be authorized if the OC is reasonably satisfied that the proposed adjustment measures would produce such a result.

cc Mr. Dubey o/r

Labor Market.

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Minutes of the Operations Committee to consider INDONESIA - Country Strategy Paper and The Private Sector Development Loan held on February 17, 1989 in Room E-1243

A. Present

Committee

Messrs. M.A. Qureshi (Chairman)
A. Karaosmanoglu (ASIVP)
P. Loh (LA3DR)
J. Linn (DECVP)
H. Scott (LEGVP)
W. Thalwitz (EMNVP)
J. Wood (VPFPR)
H. Vergin (SVPOP)

Others

Messrs./Mss. T. Baudon (SVPOP)
D. Bock (DFS)
A. Bhattacharya (AS5CO)
S. Burmester (SEC)
R. Calderisi (AS5CO)
R. Calkins (AS5CO)
R. Cheetham (AS5DR)
E. Grilli (EAS)
M. Guerard (AFRCE)
F. Kilby (FRS)
S. Kupasrimonkol (CS1D1)
D. Mead (LEGAS)
C. Obidegwu (SPRPA)
S. Rajapatirana (EAS)
D.C. Rao (FRS)
C. Robless (OPNMS)
K. Siraj (COD)
J. Tanaka (EXC)
O. Yenal (ASIVP)

B. Issues

The meeting was called to discuss the Indonesia Country Strategy Paper and the Initiating Memorandum (IM) for a Private Sector Development Loan. The main issues discussed on the Country Strategy Paper were the pace of reforms and country risk and burden sharing. In the discussion of the IM on the Private Sector Development loan, the main issues discussed were the agenda for reforms and the size and nature of the proposed loan.

C. The Discussion

The Pace of Reforms

The Chairman raised the issue of the pace of reforms in Indonesia, particularly in the field of trade. The Region responded that Indonesia's pace of reform was comparable to, if not better than, many other countries facing similar problems, and pointed out that in the field of trade, reforms in Indonesia were comparable to those of Korea, usually considered as a success. The Government of Indonesia had reduced import controls rapidly. within 4 years. Consequently, the average level of tariffs at present was around 20-22%. only slightly

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higher than countries such as Mexico. Of the remaining import quotas, which amounted to around 29% in terms of the value of domestic production, some 16% were on rice imports and a further reduction in import quotas is expected on non-rice agricultural and manufacturing product imports over the coming year. The Region said that it was fully satisfied with the pace of reform in Indonesia. The reforms began in 1983 and could possibly be completed in the early 1990s. Two additional rounds of reforms are expected in late 1989 and late 1990 to complete the major elements of the reform agenda. With these reforms, Indonesia would be well placed to achieve around 6% per year GDP growth in the years to come (a growth rate comparable to that of Thailand). The Region explained that a ten-year time horizon for a major restructuring of an economy such as that of Indonesia compared well with the pace followed in countries such as Thailand and Korea.

A Committee member suggested that the rate of progress of reforms should be considered in several areas. The rate at which non-oil revenues were being increased could probably be raised. On the other hand, there was a need to recognize that progress on decentralization of administration could be slower, while the pace of agricultural diversification and the overall rate of progress would probably have to be quickened in order to address poverty reduction effectively. The Region responded that the Government was moving aggressively on the revenue mobilization front. Over the last five years, non-oil revenues have been increased by 23% per year while nominal GDP has increased by 12-13% per year. In regard to issues relating to decentralization of administration, the Region recognized that this was a slow process. The Region also indicated that more analytical work was needed to define poverty issues and agricultural sector strategies with greater precision. Some were already under way within the economic and sector work program for the country.

Country Risk and Burden Sharing

The Chairman directed the discussion towards the issue of country risks and burden sharing, noting the good performance of the country.

A member of the committee raised the issue of increased Bank exposure and the high burden sharing proposed in the country strategy paper. He felt that the Bank should hold back some lending power "in reserve". Another member, while complementing the Region on the high quality of the analysis of country risk in the paper, asked why our strategy did not call for a somewhat slower growth in Bank exposure and a somewhat slower reduction in commercial bank exposure over the next few years. He felt that country risks on Indonesia were not high given the country's good economic performance, the strong relationship it maintained with the Bank and the country's debt structure. He also raised the question as to why quick disbursing loans were needed at the present time, given that Indonesia appeared to be adequately financed. The Region responded that the proposed increase in Bank exposure and volume of fast disbursing loans were needed by Indonesia because Japan was not prepared to provide as much quick disbursing finance to the country as it has in the past, unless the Bank takes a greater share, particularly of fast disbursing loans. Elaborating on the need for

greater burden sharing and the need for fast disbursing loans, the Region indicated that Japan felt that its share of quick disbursing loans was too high and the Bank's share too low.

The Chairman asked for a justification of the quick disbursing loans to Indonesia from the Bank, independent of the burden sharing aspect. The Region responded that the country needed these loans from official sources, while it was completing the adjustment process. Indonesia could depend on private sources in the 1990s, but not now. This has been the Bank's advice to Indonesia following from the Region's analysis of Indonesia's debt. A Committee member asked about risks to exceeding exposure limits. The Region responded that the risk will decline over time as the country completes its adjustment process. The Chairman suggested that a faster opening up of the economy would help to reduce the overall country risk.

A Committee member suggested that the contribution of private direct investment may have been underestimated by the Region in the projections on external resources. The Region responded that the decline in private net flows was in large part due to strict controls on export credits linked to large public investment projects. At the same time, as a result of the relaxation in foreign investment regulations, foreign investment inflows have been increasing rapidly improving the debt/equity structure of the private sector.

Commenting on the overall thrust of the CSP, a committee member felt that the special areas of emphasis have been well integrated into the CSP. Looking ahead he suggested that as new financial instruments were developed, these could be integrated into the assistance strategy. Responding to a related question on the issue of exchange rate risk in the present debt profile of Indonesia, the Region responded that a Bank debt mission drawing on expertise from PPR and the finance complex visited Indonesia last June to advise the Government on the issue, and the Government has requested follow-up assistance from the Bank in this area.

PRIVATE SECTOR DEVELOPMENT LOAN

Size and Nature of the Loan

Taking up the IM on the Private Sector Development Loan, the Chairman raised the issue of the increased size of the loan ($350 million) compared to the two $300 million loans extended under the Trade Policy Adjustment Loans I and II. The Region responded that the size of the Loan was determined by taking into account the financial gap that has to be filled, after factoring in Japanese, ADB and other commitments on quick disbursement assistance; in response to the Japanese request for better burden sharing with the Bank and, taking into account the substantive reform package that was undertaken in October- November 1988 by the Government of Indonesia.

In response to a question by a committee member on the nature of the loan, the Chairman explained why these loans to Indonesia were different from our usual adjustment operations. As in the past the proposed loan would be disbursed in one tranche, for actions already

taken upfront. Hence, each loan can be considered as a part of a multi-tranched operation. For this, the Bank needs to be satisfied that the actions already taken are consistent with the thrust of our policy dialogue with the country and fall within the boundaries of the agreed agenda for reforms. The policy actions taken in October-November 1988 are judged to fully conform to our expectations. The Chairman emphasized that this type of operation was the exception and not the rule. The Bank could adopt this mode of operation in Indonesia because of the country's good record in keeping to its commitments and the prior agreements reached with us on the direction and content of reforms.

A question was raised as to the possibility of extending loans of this type in the future. It was noted in this regard that the base case projections in the CSP did not include another fast disbursing loan beyond the current one proposed. The Region indicated that it was not committed to extend another fast disbursing loan, but it would like to keep the situation under review in the next twelve months and keep its options open. As to the possibility of another operation the Region would take into account such developments as oil prices, overall export performance and the availability of assistance from other donors, to judge if the need for such a loan would arise again. While agreeing to grant the Region the flexibility it sought, the Chairman indicated that he would like to see a revised base case analyzed and presented to the Committee if such a need arose.

The Reform Agenda

The Committee raised a number of questions regarding the reform agenda associated with the loan. The extent of reforms recently undertaken, and the likely future policy reforms received the major focus of attention of the Committee. The Chairman noted the stringency of restrictions imposed on private direct foreign investment (described in the strategy paper) and questioned whether the reforms recently undertaken substantially reduced the extent of the existing restrictions. The Region agreed that investment licensing regulations, including those applied to foreign direct investment in the past had been very stringent, but there had recently been significant movement towards liberalizing the licensing system. Also the proposed movement towards a negative investment licensing (DSP) list, and reducing the list to a few items, would constitute a significant departure from the past. This would make private direct investment in Indonesia much easier than in the past. There was a clear commitment by the Government to loosening up the system. Even though some industries were owned by powerful political interest, there had been progress in de-regulating investments: textile and plastics industries were cited as examples of government commitment to deregulation. On the deregulation and privatizing of public enterprises, progress was somewhat slow but these were a number of quite legitimate domestic concerns about moving too quickly. The Region has enlisted the support of the IFC to help identify the issues and the mode of privatization. Hotels for example were already being studied for privatization. On the overall deregulation plans, the Region felt that manufacturing would move faster than other areas.

A Committee member raised the question as to what specific guidance or parameters were to be given to the appraisal team regarding further actions to be included in a letter of development policy. The Region responded that in public enterprise reform the Region was interested in establishing the principles at this stage rather than identifying specific actions given the stage of reform. However in regard to the other elements of a development policy letter, the Region would include a number of priority elements: The macroeconomic situation is to be maintained satisfactorily. In trade, the extent of import quotas is to be further reduced. In investment licensing, the system will be changed to a negative and a reduced list. In banking, prudential regulations will be introduced while liquidity credits (which subsidize some borrowers) would be reduced.

In summarizing the discussions, the Chairman indicated that the following aspects be kept in mind in further processing of the loan: (a) while noting that the Region was still discussing with Government the appropriate amount of the loan, and while recognizing the issue of burden sharing raised by the Japanese, the Chairman pointed out the reservations of the Board concerning untranched loans, and the difficulties that should be expected if this is third in the series of untranched adjustment loans to Indonesia were increased from the $300 million provided under TPAL I and II, and advised that the Region should be very cautious about exceeding that amount; and (b) he also noted that, while the Region did not see at the moment a definite need for a further loan of this type, he was prepared to give the Region the flexibility to extend such a loan on the basis of need. In the event, the Region would have to make the case for such a loan in the context of the country strategy endorsed by the Committee and taking into account the circumstances prevailing at that time. The Chairman indicated that no commitment be made for a future fast disbursing loan at this time.

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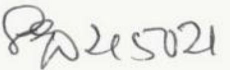

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: February 15, 1989

TO: Operations Committee

FROM: Enzo Grilli, Acting Director, EAS

EXTENSION: 78061

SUBJECT: INDONESIA: Country Strategy Paper and Initiating Memorandum for a Proposed Private Sector Development Loan - Agenda

1. The Operations Committee will meet on Friday, February 17, 1989 at 4.30 p.m. in Room E-1243 to discuss the Country Strategy Paper for Indonesia and the Initiating Memorandum (IM) for a proposed Private Sector Adjustment Loan (PSDL) to the country.

2. In response to the negative and cumulative oil shocks since 1982, Indonesia pursued a strong macroeconomic stabilization program and succeeded in reducing the fiscal deficit, the current account deficit in the balance of payments and the inflation rate. These macroeconomic adjustments have implied lower GDP growth, reduced public expenditures on the social sectors and increased foreign borrowing. However, Indonesia's response to negative external shocks has been exemplary in comparison to other countries that were subject to similar shocks. Along with these macroeconomic adjustments, the country had initiated structural adjustment policies aimed at improving the incentive structure. These incentive structure related reforms began with a comprehensive reform of the tax system, and trade related reforms that comprised an across-the-board reduction in tariffs and a complete overall of customs procedures. These were followed by two strong devaluations of the Rupiah, a conversion of a major part of the quantitative restrictions into tariffs, providing free trade status to input purchases of some exporters, deregulation of interest rates and a reduction of subsidized credits, a part reform of the investment licensing system and the regulatory environment by the end of 1986. A more recent package of reforms (November 1988) extended the financial sector reforms of 1983 and included a major reform of the maritime sector.

3. Despite its exemplary record on macroeconomic stabilization and steady, if slow, progress in undertaking incentive reforms, Indonesia has still to undergo a significant structural transformation to move its sources of growth from oil exports to manufactured exports, from rice self-sufficiency to a more broad based agriculture, from the relative concentration of development in Java to greater progress in the outer islands and from public expenditure based expansion of the economy to private sector based growth in the 1990s. Such structural transformation and growth imperatives are underscored by the incidence of absolute poverty, a third of the population (55 million), the need to provide employment to some 2 million new entrants to the labor force each year in the next 5-7 years, to provide health, education and nutrition to a large population, specially the young, and at the same time meet external debt obligations in the medium term. These

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imperatives indicate that the challenge for the Indonesian policy makers and Bank country assistance strategy remain formidable. The main objective of the Bank's country assistance strategy is to provide effective support for dealing with four major elements of Indonesia's development agenda, namely, the restoration of growth with stability, ensuring wider participation in the development process, the reduction of poverty and the promotion of sustainable growth.

4. The Operations Committee might consider the following issues for discussion of the CSP: the pace of reforms, poverty reduction, agricultural sector strategy, and country risk management and burden sharing. The Committee might consider the issues relating to the policy agenda, the framework for monitoring progress, the size of the loan and tranching for the discussion of the IM on the Private Sector Development Loan.

The pace of reforms

5. Even though the direction of reforms in Indonesia is well established, the pace of reforms becomes an important issue for country dialogue and assistance, given the need to raise Indonesia's GDP growth to 5% per year, to alter the sources of growth and reduce poverty.

- The Region may wish to comment on the adequacy of the current pace of reforms given that a significant unfinished agenda for policy reforms exist. These relate to the trade regime, the investment licensing system, the financial sector, public sector pricing and the regulatory environment.

- The Region may wish to elaborate on what it sees as the priorities in assistance strategy, given that different elements identified in the strategy set out in the paper could conflict with each other and taking into account the Bank's own comparative advantage in supporting these different elements.

Poverty Reduction

6. Significant progress has been made by Indonesia in poverty reduction since the 1970s. Yet the number of absolute poor remains large. In the meantime the large oil revenues that were available in the 1970s to undertake strong distributive policies are no longer available.

- The Region may wish to comment on the specific distributive and targeting policies that may be needed to reach segments of the very poor who could fall outside the ambit of general distributive policies.

- The Region may also wish to comment on the access to social sector services by the poor, particularly those in the outer islands, and the strategies to reach and improve quality of services to them.

Agricultural Sector Strategy

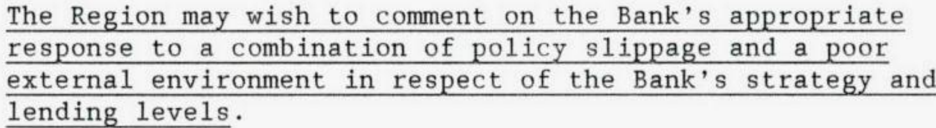
7. Because Indonesia has now reached its avowed goal of rice self sufficiency, a shift in agricultural strategy seems clearly warranted. This is recognized in the CSP.

- The Region may wish to elaborate on an agricultural sector strategy that seeks new sources of growth and one that is compatible with greater poverty alleviation opportunities (i.e. to reach small farmers and to provide off-farm employment for the landless).

- The Region may also wish to comment on the extent and degree of access of farmers to fertilizer, credit, research and other inputs that are needed for a basic shift in agricultural sector strategy.

Country Risk Management and Burden Sharing

8. The CSP has clearly identified the major sources of country risk, attempted to quantify the extent of the country's vulnerability to these risks in terms of principal economic variable and has evaluated the alternative policy responses to exogenous events. The Region attributes very low probability to the combination of an adverse external environment and policy slippage, based on the country's past track record. However, given that the issue of a successor to President Suharto remains unsettled and that the technocrats who successfully managed the economy for nearly two decades may not be easily replaced, policy slippage in the face of an adverse external environment cannot be too heavily discounted.



- The Region may wish to comment on the Bank's appropriate response to a combination of policy slippage and a poor external environment in respect of the Bank's strategy and lending levels.

- The Region may wish to comment on the increased share of Bank's disbursements in total disbursement in the early 1990s (57% of total long term disbursements in 1990) and the decline in the Bank's share beyond the mid 1990 (41% of total long term disbursements in 1995) in light of the need to smoothen the disbursement profile over the period (1989-2000) so as to maintain a good basis for policy dialogue and to achieve a balanced burden sharing throughout the period.

- THE PRIVATE SECTOR DEVELOPMENT LOAN (IM)

Reform Agenda

9. The proposed Private Sector Development Loan (PSDL) for $350 million is to be disbursed in one tranche, following the practice of the Trade Policy Adjustment Loans I and II. The loan supports policy actions already taken by the Government. The main rationale for the

PSDL is that progress to date on the earlier operations - Trade Policy Adjustment Loans I and II, logically leads to the need to address broad areas of reform that cannot be subsumed under the trade policy reforms. The objective is to extend the areas of reform in such a way that they re-inforce each other and to address particularly objectives such as improvements of specific aspects of the enabling environment for private sector activities, including the legal framework, property rights, competitition, labor market, privatization of public enterprises.

Reform Agenda

- Given the wide range of reforms attempted, the Region could be asked to establish priorities for policy actions on further reforms of the trade regime, the investment licensing system, reduction of subsidies and institutional reform. In particular, could the Region spell out more specifically what additional prior actions in the different areas of reform could be expected?

- The Region may also wish to comment as to why there are significant limits to the extent of policy reforms in such key areas as the reduction of quantitative restrictions, the continuation of some export bans and the presence of limits on capacity expansion even after the proposed adoption of a negative DSP (Licensing) List.

A Framework for Monitoring Progress

10. Given that the proposed PSDL widens the scope of reforms to encourage both policy and institutional reforms, an issue arises as to the appropriate framework for monitoring progress and in which respects measurement of progress under the proposed loan is similar to or different from a SAL.

- The Region may wish to brief the Committee on its plans to monitor progress under the loan.

The Size of the Loan and Tranching

11. . The Region may wish to elaborate on the justification for the size of the loan and its disbursement in a single tranche.

cc: Messrs. Lee (COD), Shakow (SPR), Holsen (CEC), Rao (FRS), Burmester/Thahane (SEC), Liebenthal (SPRPA), Steer (FRS), Baudon (SVPOP), Hopper (SVPPR), Bock (DFS), Goldberg (VPLEG) Frank (CFP), Parmar (CIO), Pfeffermann (CEI), Baneth (IEC), Kavalsky (FRM), Tanaka (EXC), Robless (OPNMS), Yenal, Fleisig (ASIVP), Cheetham (AS5DR), Calderisi, Bhattacharya (AS5CO)
Ms. Haug

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February 15, 1989

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Minutes of the Operations Committee to Consider
BENIN - Policy Framework Paper

Held on February 15, 1989 in Conference Room E-1243

A. Present

Committee		Others	
Messrs.	S. S. Husain (Chairman)	Messrs.	E. Grilli (EAS)
	E. Jaycox (AFRVP)		I. Serageldin (AF1DR)
	H, Vergin (SVPOP)		R. Westebbe (AF1DR)
	J. Linn (VPDEC)		L. De Wulf (AF1CO)
	B. Kavalsky (VPFPR)		G. Sicat (EAS)
	D. Goldberg (VPLEG)		F. Earwaker (SPRPA)
			W. Schwermer (COD)
			I. Kapur (IMF)
		Ms.	M. Guerard (AFRCE)
		Ms.	M. Van Beek (LEGAF)

B. Issues

1. In discussing the PFP for Benin, the OC followed the Agenda prepared by the EAS.

C. Discussion

2. At the opening of the discussion the Region mentioned that a structural adjustment credit for Benin had already been taken up in the OC. The PFP under discussion contained the policy changes that had been negotiated in the SAC. The Chairman suggested that the PFP and the SAC could be brought up to Board presentation at the same time.

3. On the macroeconomic adjustment program, the Region explained that major fiscal expenditure cuts had been made, including large ones in the civil service. A technical assistance program was currently assisting the reorganization of the Ministry of Finance to improve the budgeting process. There was no scope for further reductions in expenditure in the program. An expected program shortfall of $50 million would be proposed for financing in a donor's conference. Benin's eligibility for pledges would come after the PFP had been negotiated.

4. Responding to the Chairman's query, the Region said that no backup measures were available, and they would not be credible in present circumstances. As a result, the Region characterized the proposed program

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as very fragile. The Region also explained that the fiscal deficits in the program represented consolidated accounts and included both losses of public enterprises and of the banking sector.

5. Responding to the Chairman's query on the development strategy, the Region explained that a series of measures had already been taken prior to the SAC. These consisted of price liberalization and deregulation of trade and industrial regime. Out of 66 original items under price control, the list had now been pared down to 22 at present. Import licensing was to be eliminated as a tranche release condition in the SAC. Moreover, in the absence of flexibility of the exchange rate, given the CFAF arrangements, a tight monetary and credit policy was being used to induce a reduction in real domestic absorption.

6. The Chairman asked about the sustainability of the structural reform program and the commitment of the Government to it. The Region replied that the Government had made a fundamental change of policies. As to sustainability, the country was faced with massive unemployment and the Government was in arrears in civil service wages. These conditions had recently led to riots in the country. Without external assistance, the Government would not be able to sustain the program. Its position was already quite shaky.

7. In view of the limited capacity of the Government to sustain the program, it was suggested that there might be need to establish priority or focus in the policy interventions instead of fielding actions at many fronts. In particular, the problem of the banking sector was acute and needed immediate attention. The Region explained that its focus on interventions had been in three major areas: public expenditure cuts, restoration of confidence in the banking sector, public sector deregulation and liberalization. To illustrate the difficulty faced in the resolution of these issues, the Region cited the effort of the Government to invite a reputable private foreign bank to take over a bankrupt domestic bank as a means of reviving the currently non-functioning banking system. This effort was not succeeding since the foreign bank was very hesitant to start operating in Benin at this juncture. The Region said that it might take stronger actions by a concerned Part I donor country to achieve that end and, also, to mobilize the needed external economic assistance to support Benin. An interim solution using a window of the existing bank under liquidation might be required pending a decision by other foreign banks or by the Central Bank to operate in Benin.

8. Concerning the size of the public sector envisioned in the program, the Region mentioned that a public enterprise project loan of the Bank had been helping to trim the number of public enterprises and that the current plan included commitment of the Government not to set up any new public enterprises at least during the adjustment period. Of the 40 enterprises left in Government control, 10 enterprises were being examined for possible future disposition and 2 enterprises were to be reprivatized. About 25 enterprises were to remain as public enterprises by the end of the first SAC. As to who would buy these enterprises, the Region noted that in other countries in the same position, such as Togo, foreigners had bought the public enterprises put up for sale.

9. On invitation by the Chairman to comment on the issue of tax reform and the room for further domestic tax effort, the IMF representative stressed that there were no alternatives for raising additional revenues other than the ones suggested in the program. He, however, mentioned that there was scope for improved collection of revenues from existing taxes. He also confirmed the Region's impression that there was not much margin for maneuver in Benin, given the problems already discussed.

10. In connection with the problem of social impact of the adjustment program, the Region said that the EEC had made a grant that would defray the cost of voluntary departures from the civil service. A program for retraining of workers for a two-year period and a forthcoming health services project were also scheduled. The Bank was working with other donors to launch a labor intensive public works program in Cotonou. Thus, the Region said that the program included a rather comprehensive effort to address the problems of the most vulnerable groups in the country that were affected by it.

11. The Chairman noted the difficult circumstances faced by the country and that the limited room for actions were contained in the proposed PFP. He then authorized negotiation of the PFP with the country authorities.

February 24, 1989
GSicat:eg

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: February 10, 1989

TO: Operations Committee

EG

FROM: Enzo Grilli, Acting Director, EAS

EXTENSION: 78061

SUBJECT: BENIN - Policy Framework Paper - Agenda

1. The Operations Committee will meet on Wednesday, February 15, 1989 at 4:00 p.m. in Room E-1243 to discuss the PFP for Benin. The Operations Committee may wish to raise the issues that are identified below.

2. Background. Benin experienced poor economic performance in recent years. As a result of inadequate management in a highly state-dominated economic environment and of adverse external circumstances, the economy's macroeconomic imbalances, both domestic and external, deepened. This caused the government to reassess its development strategy and corresponding to seek a policy dialogue with the Bank and the Fund.

3. Macroeconomic adjustments. Benin's economy is subject to large external trade shocks in addition to the adverse economic policies pursued in the past. In recent years, fiscal adjustments were undertaken while the macroeconomic balances still worsened.

- The major tools for adjustment, in the context of a stable exchange rate, are fiscal and monetary policy in addition to debt rescheduling and external assistance. Can the Region elaborate on the extent of fiscal contraction or of additional external assistance that could be further undertaken if the revenue and other expenditure projections are not fully realized? Are there any back-up measures designed to maintain the spending required to achieve the program?

- Are the losses of the many public enterprises, including those of government banks, included in the measure of the government fiscal deficits that are programmed for reduction? Is it possible that the magnitude of the task of deficit reduction is not adequately taken into account?

4. Development strategy and incentives. The current program covers the liberalization of prices, reform in trade and tariff regimes and in investment incentives and regulations for the private sector. Some of these reforms have already been adopted but most of them still are to be undertaken. The effort has to be closely coordinated in order to succeed.

- Can the Region comment on the steps still to be taken in some of these areas? Which of these reforms are contemplated to represent up-front actions and which related to future adjustment operations? Is the timing of the steps to be taken related to a sequencing strategy?

5. These changes in policy are designed to reduce the overall role of the government, considering past policies. Yet, some of these changes are complex and will require a degree of government capacity for implementation and policy coordination.

- Can the Region comment on the current capacity of government institutions to implement the policy changes and on their sustainability? Are there technical assistance components designed to improve this capacity within the program.

6. Public sector management.

- Can the Region comment on the nature of public enterprise reform? After the mergers, closures, and privatization planned in the future, how large will the public sector be?

- On tax reform, the projection of tax revenues is based on a high level of performance of new taxes and other administrative measures. Yet, the tax system will remain very highly dependent on trade taxes, thus placing a degree of volatility outside the control of domestic policy. Is there any further room for improvement of domestic tax effort?

7. Social impact. The success of the reform depends on the transitional steps designed to alleviate some of the consequences on unemployment in the major sectors affected, partly to stimulate acceptance of the policies.

- What are the steps undertaken to alleviate the dislocations in employment, especially in the public sector? Are the budgetary costs of reducing the civil service factored into the future budgets?

- What programs are being planned in the social sectors to help reduce poverty? Should Bank assistance be more directed at improving the social sector related to education, health, food production, and population?

8. External finance requirement. The external financing gap is dependent on an optimistic forecast of export revenues and the balance of payments. The plan is highly dependent on external assistance, including the financing of all public investment. Considering the volatility of export revenues, these balance of payments targets may not be fulfilled. If this financing gap widens, what adjustments in investment plans and on domestic saving effort are contemplated?

cc: Messrs. Qureshi (SVPOP) (o/r), Lee (COD), Shakow (SPR), Holsen (CEC)
Rao (FRS), Burmester/Thahane (SEC), Liebenthal (SPRPA),
Steer (FRS), Baudon (SVPOP), Hopper (SVPPR), Bock (DFS),
Goldberg (VPLEG), Frank (CFP), Parmar (CIO), Pfeffermann (CEI)
Baneth (IEC), Kavalsky (FRM), Tanaka (EXC), Robless (OPNMS),
Ms. Haug (EXC), Landell-Mills (AF1CO), O'Brien (AFRCE),
Serageldin (AF1DR), Akpa (AF1CO)

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February 8, 1989

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The World Bank
OPERATIONS COMMITTEE

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February 15, 1989

Minutes of the Operations Committee Meeting to consider LAO PDR: Structural Adjustment Credit held on February 8, 1989 at 11 a.m. in Room E-1243

A. Present

Committee		Others	
Messrs.	W. Thalwitz (Chairman)	Messrs/Mss	R. Bonnel (AS2CO)
	A. Karaosmanoglu (ASIVP)		F. Chaudhri (EAS)
	C. Koch-Weser (AF4DR)		J. da Silva (LEGSA)
	H. Vergin (SVPOP)		K. Di Tullio (AS2CO)
	B. Kavalsky (FRM)		B. Funck (AS2CO)
	J. Linn (VPDEC)		E. Grilli (EAS)
	D. Goldberg (VPLEG)		K. Ikram (AS2CO)
	E. Barandiaran (LACVP)		K. Jay (SPRPA)
			G. Kaji (AS2DR)
			D. Lee (COD)
			D. Leipziger (AS2DR)
			W. Schwermer (COD)
			O. Yenal (ASIVP)
			E. Milne (Fund)
			W. Tilakaratna (Fund)

B. Issues

The meeting was called to consider the Initiating Memorandum (IM) for the Structural Adjustment Credit. The amount proposed in support of the credit is US$30 million to be disbursed in two equal instalments. The discussion focussed on the macroeconomic framework enveloping the proposed credit and the mandate/nature of the outgoing mission.

At the outset the Chairman recognized the wide-ranging spectrum of past policy actions which provided a prima facie case for support of the ongoing reform process in LAO PDR. He observed, however, that the IM did not offer a clear enough statement on the macro priorities and policy actions to be supported by the proposed operation, and, as a consequence, he was not sure that the mandate requested by the outgoing mission was appropriate at this stage.

In response, the Region pointed out that the Bank staff was actively collaborating with the IMF, but there were severe data limitation in quantifying and delineating the next steps in the reform process due primarily to the rapid pace of policy changes in Laos and the uncertain nature of the available statistics partly reflecting

major changes in domestic prices and the exchange rate. The Region also pointed out that the IMF had some difficulty in the past in adequately staffing the PFP mission. In light of these difficulties, the Region saw the need for a mission that would at the same time define the macroeconomic framework (with concurrence from the Fund) and design a support operation for it. The Fund representative confirmed that the available statistical knowledge regarding key macroeconomic parameters was very limited and that the working assumptions on which the working draft of the PFP were based were very tentative. He further confirmed that the forthcoming Fund mission would clarify several technical issues and would advance the preparation of the PFP in time for Government's reaction in April 1989, finalizing the PFP and SAF during another visit sometime in May 1989. At this stage, the Chairman reiterated his query on the nature of the mandate the outgoing mission should be given to do its work.

Noting the general nature of conditions laid out on page 16 for tax reform, one committee member stressed that the mission should identify key fiscal parameters which would underlay the envisioned tax reforms: revenue targets and the structure/thrust of the future tax system. He felt this would avoid misunderstanding and debate at the time of the tranche release, over the adequacy of the tax reform, which an open-ended condition might engender. The Chairman also stressed that it should be clarified that the second tranche release condition regarding the interest rate meant the achievement and maintenance of positive real interest rates. Several Committee members expressed the opinion that the issues of public sector current and investment expenditures, including the magnitude of resources going to the operations and maintenance and the civil service wage bill, constituted important elements of the future macroeconomic scenario on which the mission's attention should be focussed. The proposed mission should have a good assessment of the public sector expenditures and the feasibility of the proposed civil service retrenchment.

Some Committee members raised questions regarding the small size of the private sector and the medium-term growth prospects of the economy. The realism in the prospective $200 million annual aid inflow for the years to come and the basis for the expected high export growth were also questioned. The importance of the constraints on trading relationships of a landlocked country like Laos was also highlighted in the discussion, together with the issue of the persisting high balance of payments gap. Another Committee member observed that Laos was slightly ahead of many countries at the similar stage of development in terms of macro reforms. As such, certain points of 'quick actions' can be identified.

Responding to some of the questions raised by committee members, the Regional staff pointed out that in the most critical tax reform area certain steps have already been taken (like the recent electricity price increase) and the Ministry of Finance of Laos proposes to reinforce these actions with import duties and profit taxes in the short run. In the medium-to-long run, the French Government's technical assistance will review the overall tax system. The Regional management and staff were also confident that the projected aid flows and export growth goals were well within the feasible range. They also

felt that the supply response from the private sector especially in the agricultural sector and commercial activities - was reasonably encouraging. In the case of the public sector investments, however, the Region's knowledge was admittedly limited - except in the agricultural and transportation sectors - but there was expectation of building it up through the Bank's gradual involvement in other sectors. Finally, the Region stressed that the process of reform in LAO PDR did not rest on actions taken in the context of a SAC, but was driven by the quality of the dialogue that the Region has been able to initiate and sustain in the last two years.

While recognizing the existence of certain positive elements in the adjustment program - e.g. far-reaching prior actions and important second tranche conditions - the Chairman re-emphasized the critical importance of specific policy conditions and a clearer and upfront macro policy framework to which the adjustment program could be anchored. He suggested that the Government be informed of the importance that we attach to macro policy issues both for the preparation of the PFP and the proposed SAC. He also felt that the forthcoming mission had at this stage to look more like a preparatory than an appraisal mission.

Conclusion

The Region was authorized to send out a mission with the purpose of firming up the macroeconomic framework and of delineating a specific action program constituting a clear basis for an adjustment loan. The mission was authorized to work on the definition of a specific operation, if progress on the macro framework was sufficient. The Operations Committee will be presented with the results upon return of the mission for evaluation of the proposed operation.

FMChaudhri/EGrilli:gs

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

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1.

OFFICE MEMORANDUM

DATE: February 2, 1989

TO: Operations Committee

FROM: Enzo Grilli, Acting Director, EAS

EXTENSION: 78061

SUBJECT: LAO PDR: Structural Adjustment Credit - Initiating Memorandum (Agenda)

The Operations Committee will meet on Wednesday, February 8, 1989 at 9.00 a.m. in Room E-1243 to consider the Initiating Memorandum (IM) for the proposed Structural Adjustment Credit (SAC) to Lao PDR for an IDA Credit of US$30.0 million, to be disbursed in two equal tranches.

Background

After its independence in 1975, the Lao PDR relied mainly on socialistic principles to manage the economy but following a decade-long experimentation with nationalization, state farms, government monopolies, rigid control of prices and over-valued exchange rate, the Government felt that overall economic achievements were well below the expected levels and widespread distortions and shortages had gripped the economy. Consequently during 1987-88 the Government pursued a vigorous program of reforms on several important fronts, the highlights of which were: devaluation and unification of commerical and representative exchange rates from 35 and 10 respectively to 450 kips per US dollar; sharp reduction of tariff rates from 0-200% to 0-60%; elimination of most of the quantitative restrictions; increase in agricultural procurement prices to market levels; drastic reduction in the number of industrial goods under state price controls; cost-based official transport pricing together with free movement of goods in domestic markets; granting autonomy to the majority of state enterprises (SEs) and elimination of budget subsidies to SES. There were also some changes in taxation, and a decision was taken to reduce the number of civil servants by 50%.

The SAC is intended to give credit to these efforts and to support future reform. The Region proposes in fact that the first tranche of the SAC be released without any specific conditions of effectiveness.

Macroeconomic Management and Resource Mobilization

Despite substantial positive results, however, several structural weaknesses remain in the economy of LAO PDR, particularly in the budgetary, private investments and balance of payment areas. The budget deficit is high and expected to remain so. The current account

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deficit is large and it is expected to remain at best constant in nominal dollar, financed largely by bilateral credits. The private sector is minuscule and expected to remain that way. Several worrisome aspects of macroeconomic management are: credit and budgetary policies are emerging as crucial problems; fiscal revenues are rising less rapidly than expected and the earlier tax reforms (especially a single tax on profits) were ill-conceived; interest rate structure needs major revision with current rates on deposits exceeding those on loans and the many problems concerning export promotion and foreign investment remain unresolved. The Committee may wish to consider the following questions in the area of macroeconomic management.

- Inflation has been slowed down, but in light of the state enterprises' price adjustments, prospective increases in civil servants wages, and liberalization of prices, what steps will be taken to contain it to levels that are consistent with sustainable budgetary and balance of payment parameters?

- The budget deficit has worsened in the short-term (from 15% of GDP in 1987 to 25% in 1988), but even in 1993 projections show that it is not expected to improve beyond the 1987 level. Is this a realistic reform scenario? Is such deficit sustainable in a framework of macroeconomic stability?

- Since tariff rates have been reduced, the paddy tax is small, and fiscal revenues appear not to have risen despite a substantial increase in log exports, what other specific sources of revenue are likely to emerge in the medium term? More generally, how the savings performance and resource mobilization are to be improved?

- Improvement in the balance of payment is projected to rely heavily on the 9.5% per annum increase in exports in real terms. If log exports are likely to be banned or reduced in the near future and if electricity export remains uncertain, what other items of exports are likely to generate the projected high growth rate?

Relationship between the SAC and the PFP/SAF program

The Region proposes to "fit" this SAC in the structural adjustment programs now being worked out in the framework of a PFP and to complement the expected IMF SAF program. The proposed conditions for second tranche release include "sound macro management, as defined in the (future) PFP".

The Committee may wish to consider the following questions:

- What are the key macro priorities that will be identified in the PFP?

- Is there agreement between Bank and Fund staffs on the macro-framework?

- Finally, if the IMF SAF does not materialize or gets delayed, what would happen to macroeconomic management which is essential and central part of the proposed SAC? To what extent has the Region considered and addressed the "downside" risks in this operation?

Private Sector and the Privatization Process

In this area the Committee may wish to consider the following questions:

- As the share of private sector investment in GDP is expected to be only 1.5% even in 1993, can such private sector be expected to be ready, willing and able to promote the SE privatization process?

- If the partially privatized SEs remain weak and the budgetary subsidies are removed, is not there a danger that enterprises might become a 'drag' on the growth and development of the newly established commercial banking system?

Program Benefits and the Social Impact

The IM asserts that "with income per capita growing steadily by 2.7% per year on average, the impact of the structural adjustment program is expected to have positive effects for nearly all economic groups". The projected increase in per capita income is derived from 5.3% per annum GDP increase expected during 1989-97. But the average annual growth rate of GDP in the previous 1982-87 period was also around 5.4%. The following questions arise:

- How can all groups to be impacted more favorably now than in the past?

- What characteristics of the projected growth rate would make it qualitatively better and socially more acceptable now than the comparable growth in the first half of the 1980s?

- Given the 'thinness' of the private sector, what mechanisms/programs would be used to absorb a 50 percent reduction in the country's civil service?

The Bank's Country Assistance Strategy and the Proposed Operation

In further developing the proposed operation, it would be necessary to pay special attention to the key features of the Bank's country assistance and lending strategy and how the proposed SAC supports that strategy.

cc: Messrs. Qureshi (SVPOP) (o/r), Lee (COD), Shakow (SPR), Holsen (CEC), Linn (DECVP), Rao (FRS), Burmester/Thahane (SEC), Liebenthal (SPRPA), Steer (FRS), Baudon (SVPOP), Hopper(SVPPR), Bock (DFS), Goldberg (VPLEG), Frank (CFP), Parmar (CIO), Pfeffermann (CEI), Baneth (IEC), Kavalsky (FRM), Tanaka (EXC), Robless (OPNMS), Yenal, Fleising (ASIVP), Alisbah (AS4DR), Kaji, Leipziger (AS2DR), Ikram (AS2CO)
Mss. Haug (EXC), Di Tullio (AS2CO)

FMChaudhri:gs

February 1, 1989

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The World Bank
OPERATIONS COMMITTEE

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Minutes of the Operations Committee Meeting to Consider NEPAL - SAC II - Initiating Memorandum

Held on February 1, 1989 in Conference Room E-1243

A. Present

Committee

Messrs. W. Thalwitz (Chairman)
B. Alisbah (ASIVP)
J. Holsen (VPDEC)
B. Kavalsky (FRS)
C. Koch-Weser (AFRVP)
M. Michaely (LACVP)
H. Scott (VPLEG)
H. Vergin (SVPOP)

Others

Messrs. E. Grilli (EAS)
A. Ray (EAS)
S. Rajapatirana (EAS)
S. Burmester (SECGE)
I. Christie (AS1IN)
C. Escudero (LEGAS)
Y. Huang (AS1CO)
T. Hutcheson (SPRPA)
W. Schwermer (COD)
H. Shishido (AS1CO)
M. Thobani (AS1CO)
O. Yenal (ASIVP)
H. Vittas (IMF)

B. Discussion

1. The Operations Committee met on February 1, 1989 to consider the Initiating Memorandum for Nepal - SAC II, dated January 23, 1989.

2. The Chairman opened the discussion by suggesting that the meeting focus on the extent to which we can expect improvements in performance over the medium term, the extent to which the proposed content of the credit would restructure domestic production, and the reasonableness of the proposed size of the credit. The Region explained in its opening remarks that Nepal's performance has shown significant improvements after decades of stagnation; many problems remained, however, due to structural weaknesses, policy distortions and scarcity of good physical and human resources. The Government has reduced the fiscal deficit significantly and the deficit is now being financed in a non-inflationary manner through concessionary foreign aid and modest levels of domestic borrowing. A foreign financing gap, however, does arise if account is taken of the additional import demand to be generated by the proposed program. The adjustment program would assist changes in the structure of domestic production through its emphasis on agriculture (especially on irrigation and fertilizers) and on the identifiable areas of export potential such as carpets. A third source of growth would be hydro-power which, however, is not directly linked to this program. In response to the question on the

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credit size and burden-sharing, the Region noted the enhanced interest of other donors in providing commodity and program-type lending. Finally, the Region emphasized that the country is still at the early stages of adjustment and that this SAC would need to be followed-up, perhaps with a "hybrid" credit.

3. The Chairman reemphasized the question of whether the SAC would go far enough in reducing the deficit. A speaker suggested that since the deficit was financed primarily by concessional aid, one needed to focus on the effectiveness of project lending. At the same time he suggested greater emphasis on domestic resource mobilization. Another member followed up by asking about the role of the Bank in improving the public investment program; he also asked whether an appropriate framework was in place to deal with the financial sector issues. In the absence of a typical adjustment program, the case for a fast disbursing credit with sector lending conditionalities was also questioned. The Region responded by saying that in the past, project lending had proved relatively ineffective in dealing with major policy distortions; it was only with SAC I that the government focussed successfully on the needed institutional and policy reforms. The packaging of the reform measures was very important in obtaining the necessary political commitment at the highest levels of government. It was also noted that while the set of sectoral conditions being proposed for SAC II is quite broad it is nonetheless narrower than in the successful SAC I. The major new issue added are financial sector reforms to which the government is now committed. The basis for the financial sector component comes from an earlier sector study. SAC II will deal with a number of structural problems which have adversely affected the sector.The Chairman welcomed the expansion of the program into the financial area.

4. The Region explained that the Government had been fairly successful in raising revenues and that the priority now was on improving the efficiency of expenditures. While recognizing the need to improve the quality of expenditures, the Chairman endorsed a suggestion that the proposed credit give increased importance to domestic resource mobilization in order to assist Nepal in gradually reducing its dependence on balance-of-payments support and increasing the generation of the counterpart financing needed to accompany concessional project finance. While the revenue-to-GDP ratio has improved over the last three years, this was largely the result of the replacement of import licenses by tariffs and auctioning of import licenses rather than changes in the basic tax system. A target of increasing revenues by perhaps 0.4-0.5 percent of GDP for next year was recommended for the Region's consideration.

5. It was also suggested that the Bank's role in guiding public expenditures be enhanced. The Region said that lack of information on public expenditures, especially on current expenditures, has been a serious constraint to analysis of allocation issues. Nonetheless, it agreed that covenants can be developed to protect recurrent expenditures on operation and maintenance in those sectors where sufficient information has by now become available.

6. On trade reforms several speakers noted the limited range of options for Nepal due to the open border with India. The Chairman

expressed sympathy with the problems of liberalization noted in the paragraph 28 of the Initiating Memorandum. Regarding direct measures to address poverty alleviation, the Region referred to the recent review of the country's basic-needs program. The program was far too ambitious, and it was not yet possible to distill specific conditionalities from it.

7. In concluding the meeting the Chairman reiterated the need to consider additional conditionalities on domestic resource mobilization and on protection of O&M expenditures. He also suggested that the proposed size of the SAC II may be too high given the availability of assistance from other sources and urged the Region to review its justification.

ARay:vlw
February 6, 1989

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: January 30, 1989

TO: Operations Committee

FROM: Enzo Grilli, Acting Director, EAS

EXTENSION: 78061

SUBJECT: NEPAL: Structural Adjustment Credit II - Initiating Memorandum

The Operations Committee will meet on Wednesday, February 1, 1989 at 2.30 p.m. in Room E-1243 to discuss the NEPAL - Initiating Memorandum for a Second Structural Adjustment Credit (SAC) for $60 million. The Committee may wish to take up the following issues for discussion (a) the macroeconomic situation; (b) implementation issues; (c) trade reforms and (d) poverty focus.

Introduction

The proposed structural adjustment credit follows the first structural adjustment credit (April 1987) and the drawing from the IMF Structural Adjustment Facility (FY88). The second tranche of SAC I was released in April 1988. These operations were intended to lay the foundation for more rapid and sustainable output growth by reducing the large fiscal and balance of payments imbalances that had arisen since 1985, by re-orienting policies and strengthening institutions to support increased agricultural and industrial production and improve public sector efficiency. His Majesty's Government (HMG) of Nepal has undertaken a number of measures under the reform program. These have included expenditure controls, revenue measures, new taxes to provide equal incentives for export and import substitution, and initiated a liberalization of the domestic distribution of fertilizers. The Region has expressed cautious optimism about the prospects for continuing and expanding these efforts in a second operation. Viewed from a number of indicators, macroeconomic performance has improved under the reform program. GDP growth has averaged 4% a year, (FY86-FY88), investment has remained at around 19-20% and national savings rose from 11% in FY83 to 13% in FY88. Following the tax and expenditure measures, the fiscal deficit decreased from 12% of GDP in FY83 to 8% of GDP in FY88, with domestic financing of the deficit declining from 6.0 to 0.9% of GDP. Inflation decreased from 16% in FY86 to 11% in FY88. Non-traditional exports rose sharply while a steady increase in imports has also taken place. Although there was some delay in adjusting fertilizer prices which held up the release of the second tranche, the overall performance has been satisfactory.

The Region proposes to extend a SAC II with the following components: (a) Fiscal management: rationalize the revenue system and improve expenditure management by extending program budgeting and monitoring capacity beyond the present level; (b) Trade reforms: extend the coverage of the OGL and passbook system (annual import license system) beyond industrial raw materials to include intermediate inputs and capital goods; (c) Agricultural reforms: increase fertilizer

imports, improve supply management and distribution of fertilizer, as well as institute cost recovery; (d) financial sector reforms: prevent the two largest government owned commercial banks from running into unsolvable portfolio problems by initiating an external audit and studies to recommend actions for possible restructuring of the banks and improve debt recovery.

Macroeconomic Situation

Despite the improvements in overall macroeconomic performance following the initiation of the 1985 stabilization program and the SAC I and SAF, the macroeconomic situations continues to be worrisome. The fiscal deficit remains large at 8% of GDP and so does the current account deficit in the balance of payments at 9% of GDP in FY88. Meanwhile inflation stood at 11% in FY88.

- The Region may wish to comment on the elements of the SAC II or associated programs aimed at addressing specifically the issue of further reduction of these serious macroeconomic imbalances.

- The Region may wish to comment on the need for a fast disbursing loan, given that most of the proposed reform measures are long term in nature and domestic resource mobilization efforts remain limited.

Implementation Issues

The rationale for SAC I was based on the need to coordinate reform efforts better and to deal with a variety of structural and cross-sectoral problems and weaknesses of institutions that could not be addressed through traditional investment credits:

- The Region may wish to comment on the continuing validity of the above rationale and in particular of the proposal to extend this effort to new sectors such as the financial sector.

- Since over-centralization of decision making has been a major weakness of implementation of projects and programs in Nepal, the Region may wish to explain what specific measures are proposed to institute a more decentralized decision making process and to avoid such delays as those experienced in the case fertilizer price adjustments.

The Trade Reforms

Under SAC I, HMG of Nepal has initiated measures to reduce quantitative restrictions and to increase reliance on a simplified system of tariffs and trade taxes. The Region however feels that further trade liberalization must proceed cautiously, given the common border with India, and the possible deflection of third country imports to India.

- The Region may wish to elaborate on its claim as to why the common border with India necessitates slower progress in trade liberalization, given that exchange rates and trade measures are instruments that can be used to influence the flow of exports and imports.

- The Region may wish to comment on the proposed sequence of trade liberalization, that is, the liberalization of imported inputs and capital goods before final goods which would increase effective rates of protection and also as to why the liberalization has to be highly selective.

Poverty Focus

The proposed adjustment program is expected to have a positive impact on the poor. It is claimed that the program's focus on output growth, particularly on agricultural incentives and reduction of economic rents, would have a beneficial impact on the poor, while measures such as the financial sector reforms would imply a neutral effect on the poor.

- The Region may wish to elaborate on possible safety nets that could be provided to the poor against price increases and in particular on how to target health, education and nutrition benefits to the very poor.

- The Region may also wish to comment on the relationship of the adjustment program to His Majesty's high profile Basic Needs Program which has an ambitious plan to alleviate poverty by year 2000.

cc: Messrs. Lee (COD), Shakow (SPR), Holsen (CEC), Rao (FRS), Burmester/Thahane (SEC), Liebenthal (SPRPA), Steer (FRS), Baudon (SVPOP), Hopper (SVPPR), Bock (DFS), Goldberg (VPLEG), Frank (CFP), Parmar (CIO), Pfeffermann (CEI), Baneth (IEC), Kavalsky (FRM), Tanaka (EXC), Robless (OPNMS), Yenal (ASIVP), Alisbah (AS4DR), Asanuma (AS1DR), Clift, Huang, Shishido (AS1CO)
Ms. Haug

January 13, 1989

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The World Bank
OPERATIONS COMMITTEE

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Minutes of the Operations Committee meeting to consider the Initiating Memorandum for TUNISIA: Public Enterprise Reform Loan, held on January 13, 1989 in Room E-1243.

A. Present

Committee		Others	
Messrs.	M. A. Qureshi, Chairman	Messrs.	T. Baudon, SVPOP
	W. Thalwitz, EMNVP		K. Dervis, EM2
	J. Holsen, CEC	Ms.	P. Donovan, EM2
	H. Vergin, SVPOP		S. El Serafy, EAS
	D. C. Rao, VPFPR	Ms.	S. Engelhard, LEGEM
	H. Scott, LEGVP		W. Grais, EM2
	R. Steckhan, LACVP		E. Grilli, EAS
	R. Amoako, AFRVP		P. Hasan, EMNVP
			A. Hovaguimian, CAIDR
			S. Kebet-Koulibaly, EM2
			D. Lee, CODDR
			O. Rahkonen, SECGE
			G. Reif, SPRPA
			K. Siraj, CODOP
			R. Taylor, EMTTF

B. Issues

1. The Operations Committee met on Friday, January 13, 1989 to discuss the Initiating Memorandum (IM) for a Public Enterprise Reform Loan (PERL) in the amount of $100-130 million. The discussion followed broadly the Agenda prepared by the Economic Advisory Staff, which included an update of the macroeconomic situation and the process of adjustment; the proposed Government approval of a new law for public enterprise reform; performance contracts; workers' redundancy and deployment under the PERL; the workability of the tranching arrangement suggested; and how cofinancing would be integrated in the PERL.

C. Discussion

2. The Chairman invited an introductory statement by the region in order to clarify the innovative tranching arrangement proposed in the IM. The Region said that in processing this operation the Region was strongly motivated by the need to enhance the role of the private sector and reduce the dominance of the public sector. The loan would support institutional reforms, a privatization program and restructuring some major public enterprises, including the railways. After the first tranche, which would rely on a number of conditions that have to be satisfied before Board

presentation, disbursement would be modulated to reflect progress on privatization of specific entities. Rather than have one set of conditions governing a general tranche release at a point in time, and in view of the fact that not all factors affecting privatization were within government control, the IM aimed at tailoring disbursements to progress in implementation and the budgetary needs of the privatizing entities. In its totality, however, such an arrangement would amount to a second tranche. Besides, there would be a six-monthly review of progress addressing implementation of the institutional reforms and of performance contracts of selected enterprises.

3. The Chairman observed that the proposed disbursement arrangement seemed to parallel arrangements ordinarily made to disburse investment loans made to finance foreign exchange costs of specific imports as they occurred. For this operation he saw an opportunity to bring about a change in the present situation leading to greater efficiency of the public sector. We seemed to envisage the passage of a law that would provide a framework for the reforms. Performance criteria would be established for a number of entities according to performance contracts, and disbursement would be tied to progress made on the privatization program in addition to satisfactory progress on certain conditions to be reviewed every six months. In this regard he asked if a substantial change would be associated with releasing the first tranche; also if during implementation we found that one performance contract was moving ahead while the rest lagged, in what sense then would this be a quick-disbursing loan, providing balance of payments support to redress a balance of payments cost?

4. A speaker said that the conditions proposed appeared to him to be too easy. He thought that what the Region was suggesting was similar to a SAL, albeit incomplete as no reference was made to macroeconomic conditions, but with a number of sub-projects. He found the disbursement arrangement complicated and legally unsatisfactory. The Chairman returned to his question, asking if there was a substantial initial step to justify first tranche release. He thought that nothing had already been done though an institutional base would be established. It was not a good analogy to say that the operation was made up of numerous sub-projects.

5. The Region said that what was being supported was nothing less than changing the entire framework and modus operandi for public enterprises as well as a privatization program and specific reforms to raise the efficiency of major public enterprises. While the Region could not define precise balance of payments objectives for the operation, it saw it as making a major macroeconomic impact with implications for the balance of payments. The new law, the actions to be taken on individual enterprises and the privatization process represented substantial change. The Region added that, once the new law was enacted, some 100 public sector enterprises would be privatized de facto in being subjected to the commercial code, and that would be "up front."

6. Another speaker thought that the series of releases proposed left the impression that we would be buying "small package" actions piecemeal. Unlike a DFC operation, the entity implementing the project would not be directly benefiting from the disbursements released, but the Region responded that it would certainly benefit indirectly since privatization could not proceed without budgetary support.

7. The IFC representative voiced strong support for the operation, adding that the reforms proposed indicated a relatively rare case of a country that was serious about privatization. Already two IFC supported companies in textiles had been privatized and a third might follow. Tunisia had a government which was responding positively to the notion of privatization despite the fact that redundant labor to be shed was not just 10-15% of employment but much larger, and in a situation where the labor unions were strong. He observed that there were indeed difficulties including land titles which were lacking, thereby rendering ownership-transfer difficult, and also the virtual absence of a functioning stock exchange, which was hindering the process of privatization. The focus of the operation on railways, the chemical group and phosphates was right, in addition to the privatization measures for which a joint effort by IFC and the Bank was necessary.

8. A speaker thought this was a reasonable and well packaged operation which he could support. The approach suggested for releasing the second tranche appeared to him interesting, though he was not quite sure it would work in practice. Another speaker noted that there were eleven conditions for second tranche release, including "satisfactory progress" to be judged by the Bank.

9. The Chairman returned to the subject of the loan amount in relation to the cost of reform, and the Region stressed the resources necessary to meet liabilities in excess of receipts from asset sales and to compensate redundant labor to be displaced. The entire second tranche, the Region said, was needed to meet the costs of divestiture which, over a three-year perspective, may cover about a dozen companies, but it was difficult to judge this before appraisal. The original proposal was to make disbursements in parallel with the implementation of the privatization program. At the time budgetary arrangements were made, every agency would submit its financial needs for reimbursement in order to meet its labor compensation and debt regularization. Disbursement would only be made if the overall conditions for institutional reforms were also met. The reforms were not confined to implementing performance contracts, but covered also major policy change.

10. Take a specific case, the Chairman said. For a company to be restructured, was it necessary that it should first clear its debts, get its balance sheet in working order, ensure that its financial statements be accepted, thus making it attractive either to keep in the public sector or sell? Would it not be simpler for the government to sell the company in its present condition at a cut price? The Region said that the latter approach reflected precisely its intentions. However, it still left the excess workers to be compensated and the debts to be paid by the government, and that was why the loan proceeds were needed. A speaker went back to what he counted as 15 or 20 mini-tranches, to be disbursed against a negative list, and wondered if it was still possible that no breakthrough would be made on general tranche conditions. The chairman suggested that instead of looking at the reforming companies individually, the Region might consider specifying a certain percentage of the total assets of all the companies combined, so that disbursement is made once such a percentage was reached and reforms were accomplished in companies making up the percentage indicated. This would cut down on work, and would ensure

progress in implementation. The Region acknowledged the fact that the disbursement arrangement proposed involved more work, but that it provided a direct link between implementation and disbursements and put more constraints on the government. A more traditional tranching arrangement could easily be worked out instead.

11. The Chairman then asked if the performance contracts would be precise enough to provide a monitorable program. The Region responded that the conditions specified in the program did not simply relate to performance contracts, but to a variety of monitorable institutional changes as well. Under a more conventional tranching arrangement the second tranche would be disbursed independently of any itemized budgetary cost incurred. To this the Chairman said that it should be done in a way that could be simply administered, making sure that it would be implemented. Even if you had good laws, nothing would happen if nobody picked up the firms to be divested. A speaker said a floor should be set on the number of companies to be privatized before disbursement, and the Chairman stated that alternatively a minimum percentage of assets could be defined. The Chairman added that if the Bank stood ready to finance the budget cost of privatization, that might lead to overcompensation, and we should guard against this. Returning to the performance contracts he asked who was working them out, and the Region responded that experts in each sector were involved for the three priority enterprises, and that the Japanese might provide technical assistance for the second group of enterprises to introduce performance contracts under the loan. The IFC, the Chairman said, could also help, and the region said the _contrat plans_ would be simple.

12. As to the balance of payments impact, the Chairman said it need not be direct since we would in effect provide local cost financing, but the case for raising efficiency and enhancing productivity of the public sector should be stressed. The Region stated that the balance of payments was not in a crisis situation, although it was still vulnerable. It added, in reaction to a comment, that once the new law was passed, many reforms in government-public enterprise relations would ensue, e.g., in procurement requirements.

13. A speaker mentioned Bank exposure and that in the period 1987-91 IBRD was providing half of the net inflows, and the Region said it had adjusted the lending program in an effort to reduce exposure. Growth and investment had remained slow, but the flow situation would improve once the balance of payments improved.

14. As to the amount of the loan and whether it would be $100 million or $130 million, this would be determined during appraisal. The Region would try to keep the loan as low as possible, and would utilize the Japanese and the African Development Bank financing to the extent possible. The Chairman urged the Region to try to get cofinancing for this operation, but did not rule out the upper limit proposed for the loan amount.

15. A speaker said the role of the state should not be executive or supervisory, but should provide oversight. Targets should be established for divestiture in terms of share of ownership of portfolio or in terms of assets. The Chairman then asked to what extent was IFC involved in

determining the divestiture process and the IFC representative said they would be glad to participate. IFC, the Region added have been very helpful and would participate in the appraisal mission.

D. Decision

16. In conclusion the Chairman gave sanction for the operation to be appraised in the light of the discussion summarized above and subject to the caveats made. He said that the tranches should be clearly indicated, to be triggered by specified progress which would allow us to maintain flexibility during supervision.

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February 8, 1989

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The World Bank
OPERATIONS COMMITTEE

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Minutes of the Operations Committee Meeting to consider the Initiating Memorandum for PAKISTAN: Energy Sector Loan II, held on January 13, 1989 in Room E-1243.

A. Present

Committee		Others	
Messrs.	M. A. Qureshi, Chairman	Messrs.	T. Baudon, SVPOP
	W. Thalwitz, EMNVP		M. Cohen, EM1
	V. Rajagopalan, VPPRE		L. de Azcarate, RESREP
	H. Vergin, SVPOP		S. El Serafy, EAS
	D. C. Rao, FRS		I. Elwan, EM1
	H. Scott, LEGVP		E. Grilli, EAS
	R. Steckhan, LACVP		A. Hamid, LEGEM
	K. Amoako, AFRVP		P. Hasan, EMNVP
			K. Krishna, EM1
			D. Lee, CODDR
			S. Lintner, EMTEN
			O. Rahkonen, SECGE
			G. Reif, SPRPA
			W. Schwermer, CODOP
			D. Von Stauffenberg, CS2D2
		Ms.	L. Yap, EM1

B. Issues

1. The Operations Committee met on Friday, January 13, 1989 to discuss the Initiating Memorandum (IM) for a Second Energy Sector Loan for Pakistan in the amount of $150 million. The discussion followed broadly the agenda prepared by the Economic Advisory Staff which raised *inter alia* the issues of the appropriateness of the loan providing balance of payments support; the ability of the appraisal mission to cover the elaborate program of tasks set for it; the Kalabagh project; electricity pricing; environmental considerations and their effect on the least-cost expansion path; procurement by a negative list; and retroactive financing.

C. Discussion

2. The Chairman said he was impressed by the Region's knowledge of the sector as reflected in the IM, but wondered why this was being processed as a hybrid loan, with a quick-disbursing component, rather than as an energy sector investment loan. Conceptionally, he added, in order for quick disbursement to be justified, it should be related to policy change. The Bank was not in the business of giving balance of payments support unless it was on the basis of policy change. He said he missed a

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clear-cut policy component to which quick disbursement was related. For quick disbursement to be justified it also should be offsetting to the adjustment cost to the country, and asked if in fact such a cost would be incurred. A quick-disbursing component, he added, should be commensurate with the policy change and linked to such key policies as pricing.

3. The Region said that private investors in the energy sector were experiencing difficulties with securing financing to pay for custom duties and special levies which, according to Regional projections, amounted to some US$100 million (Rs. 1.8 billion). These, if borrowed on the local market, would crowd out other private sector capital requirements. In view of the fact that the government had counted on such import taxation as part of its fiscal resources, the mission would seek the levying of a tax on the sales of electricity by both the public and private sectors, that would compensate for the removal of import taxes on electrical equipment and machinery. The proposed loan would finance, with the Japan Export-Import Bank, the shortfall resulting from the import tax removal.

4. A speaker said that this operation was a continuation of the first sector adjustment loan, and that it could be so structured as to be able to finance petroleum imports so that a positive rather than a negative list would be financed. The Chairman added that whether the list was negative or positive did not make much difference. Another speaker wondered, in case of a positive list that would include petroleum imports, if it were acceptable that loan proceeds would be absorbed by one item. The Chairman said that the strongest argument against financing petroleum imports was the difficulty of applying international competitive bidding procedures in a situation where Pakistan had access to petroleum on special terms. The Region said that the core investment program (CIP) with identifiable imports would be on the positive list. The same speaker enquired if there were hydropower investments on the CIP and if they involved riparian issues. The Region responded that whatever hydroprojects to be covered would be small scale, and would be identified later with indication also of their sources of finance -- this being merely an IM.

5. A member said that environmental issues in energy development were important and that we needed to obtain safeguards that environmental costs were incorporated in the analysis. The Region responded that the formulation of the long-term least-cost development program for power generation was constrained by the capacity of implementation and by environmental concerns.

6. A speaker stated that he found "hybrid" a useful concept, with the quick-disbursing fraction justified, and with a core investment program. The Chairman then raised the issue of retroactive financing. The agenda had doubted the justification of retroactive financing as this was a follow-up operation, but the Region explained that it was necessitated by the delay in the Seventh Plan. Another speaker stressed that retroactive financing should be confined to $20 million, not $25 million as requested, as the guidelines limit such financing to 10% in the case of investments, i.e. $10 million plus 20% in the case of quick-disbursing adjustment components, i.e. $10 million. Any retroactive financing exceeding four months prior to loan signing, the Chairman said, needed special

justification. The Region responded that the retroactive financing would not exceed US$40 million, of which US$20 million would be covered by the Japan Export-Import Bank, and would be within four months prior to loan signing.

7. The Chairman then turned to the subject of the Basha hydroproject, saying that it was probably as controversial as Kalabagh, and asked whether we should get into this controversy. The Region responded that the least-cost development program for power called for the exploitation of 6000 MW (Kalabagh and Basha) by the year 2010. However, because of the delays in the approval of Kalabagh, Basha's preparation had also been delayed. Consequently it was now impossible to implement the two projects as originally planned. The covenant proposed under the loan is intended to initiate the preparation of Basha which is now three years behind schedule. The Region added that it was necessary for the Bank to encourage implementation of Basha as the donors were seriously considering it, since it was clearly next to Kalabagh in priority.

8. A speaker said that para. 60 of the IM describing WAPDA's shortcomings was too critical, and the Chairman asked if there had been any recent improvements in WAPDA management. To this the Region replied in the affirmative, mentioning a USAID training program and reductions in distribution losses. The Chairman asked if we could leverage further improvements by loan conditionality. The Region responded that WAPDA had no new investments in the CIP, only ongoing projects being covered under the Seventh Plan investment program for WAPDA. Serious loss reduction in distribution would probably cost $4 billion and would take a long time, and should not be viewed as feasible in five years. Other donors, notably Japan, USAID, Canada, Britain and the ADB were interested in rehabilitation and distribution. As to the power price increases envisaged, these were carefully tied to the budgetary process.

9. A speaker said, and the Chairman concurred, that reference should have been made in the IM to several investment loans made by the Bank in the sector prior to the first Energy Sector Adjustment Loan. The Chairman added that the President's Report should clearly convey the message that we expect improvement in sectoral management, particularly of the larger organizations, such as WAPDA, and indicate selected areas of special emphasis.

D. Decision

10. The Chairman gave sanction to the Region to appraise this operation, keeping in mind the concerns expressed and in the light of the foregoing discussion.

January 26, 1989

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OFFICE MEMORANDUM

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DATE: January 12, 1989

TO: Operations Committee

FROM: Enzo Grilli, Acting Director, EAS

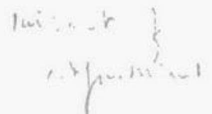
EXTENSION: 78061

SUBJECT: TUNISIA: Initiating Memorandum for a Public Enterprise Reform Loan (PERL) Proposed Agenda

1. The Operations Committee will meet on Friday, January 13, at 3.30 p.m. in Room E-1243 to consider a proposed loan to Tunisia in the amount of $100 million for public enterprise reform. The Committee might wish to take up the following issues in its discussion.

The Macroeconomy

2. The OC reviewed a CSP for Tunisia in October 1988 and approved the lending program of which this operation is part. During the 1960s and 1970s the economy expanded rapidly, making use of its hydrocarbon resources which are now on the point of exhaustion. Thanks to generally sound economic management, the debt situation is not intolerable, and GDP growth is projected at 4-4.5% a year until the early 1990s, as compared with an average of 6.6% expansion in the period 1965-80 and 3.7% between 1980 and 1986. Poor performance in the first half of the eighties reflected politically motivated capital intensive long-gestating investments, as well as drought and worsened terms of trade. The current account deficit averaged 9% of GDP in 1982-86, and this led to the growth of external debt. Two special problems have persisted, namely rapid population growth and high unemployment -- probably in excess of 15%. There has been a recent but strong trend towards opening up the economy to the forces of competition, and deregulating domestic markets. This has been supported by a number of adjustment operations (an Agricultural Sector Adjustment Loan and an Industry and Trade Adjustment Loan in FY87, and a SAL in FY88, with a second Agricultural Sector Adjustment Loan now in an advanced state of preparation). The private sector, however, remains small and in fact the CSP had drawn attention to the decline of private investment from 26-27% of GDP in the early 1980s to 17% in 1987.



- The Region might update the Committee on the process of adjustment, indicating more recent developments affecting unemployment, workers' remittances, debt service and the private sector.

PERL Objectives and Conditionality

3. The IM describes how the public sector, whose roots extend back to 1956 when Tunisia gained independence, mirrored the poor performance of the economy during the sixth plan (1982-86), absorbing large capital intensive projects in fertilizer, cement, sugar, automobile assembly, a foundry and a steel mill besides unwarranted infrastructural investments, particularly in

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the railways. The public enterprises (PE) debt soared, their wage bills rapidly rose under liberal pay policies, and they took on more workers than they could economically support on account of the rising unemployment. The recent drive for liberalization, the IM argues, is radically changing the operating environment of the public enterprises which increasingly have to face market prices for their inputs and outputs, borrow on market terms, and generally work in competitive conditions. The PERL aims at enabling public enterprises to "adapt to these new competitive conditions by rationalizing state/enterprise institutional and financial relations and by divesting, restructuring or liquidating PEs as warranted" (para. 2.04). The objectives of the PERL may be summed up as follows: (a) rationalizing Government-PE institutional and financial relations; (b) raising PE autonomy and efficiency; (c) divesting government holdings in PEs in competitive sectors while addressing the social implications of divestiture in railways, phosphate mining and fertilizers.

4. Institutional Reform: The IM proposes that by loan negotiations, the Government should have approved a new law which would reduce the number of PEs under direct Government supervision, clarifying the extent and nature of such supervision, reforming the Boards of Directors, relaxing procurement constraints, and simplifying procedures for restructuring and divestiture. It also proposes that by Board presentation adequate liquidity provisions for 1990 should have been agreed.

- The Region might clarify the legislative process involved in Government approval of such a law; whether the "approval" of such a law would be sufficient for the reforms envisaged, and explain how the adequacy of the financial provisions to cover divestiture and restructuring will be determined beforehand.

5. Restructuring Priority PEs: The PERL focuses on restructuring priority PEs. By Board presentation a Performance Contract should have been signed for phosphates, defining a mining strategy with gradual mine closures, confining new investments to viable mines, with an agreed program for reduction of the work force. For the chemical group an agreement should have been reached by Board presentation on an adequate budgetary provision for 1990 to cover arrears to suppliers and working capital necessary for efficient operation, simultaneously with closing down uneconomic plants, merging four companies into one and redeploying or dismissing surplus workers after compensating them. For the railways, also by Board presentation a Performance Contract should have been signed, with agreement to be reached on general transport strategy, an investment program, tariff structures, financial and efficiency targets, and labor force reductions.

- The Committee may enquire as to whether we know enough about the operations of the PEs under consideration to be able to judge the adequacy of the performance contracts that have to be agreed by Board presentation, and whether studies might not be necessary to indicate the reforms planned and define the levels of financing required from the Treasury.

- Can the Region give a rough estimate of the number of workers likely to become redundant under the PERL program, and estimate the financial implications of compensation to workers made redundant, or the cost of retraining and redeploying them?

redundant workers

Loan Tranching, Implementation and Disbursement

6. The IM stresses Government commitment to the reforms to be covered by the PERL, but throws doubt on the pace of its implementation. It therefore sets five key conditions for Board presentation paving the way to first tranche release. Later disbursements would be modulated to the pace of implementation, with a monitoring process set up to review progress twice annually. The IM mentions as possible impediments to progress the time necessary for and problems surrounding asset valuation; reluctance to sell such assets at the prices indicated or lack of buyers; the problems of labor redundancies and deployment; and the cost of all this. The conditions for release of funds after the first tranche are detailed in Attachment I, p. 3 and would clarify further during appraisal, but many of them center on satisfactory implementation of performance contracts.

- The Committee might consider if this tranching arrangement would be workable.

- In view of the slow disbursement out of adjustment loans to Tunisia, might not the real impediments mentioned in the IM defeat some of the PERL's objectives?

- The Region might also clarify the amount of the loan ($100 million or $130 million?) and the likely size of the first tranche.

- How would the parallel financing and cofinancing expected from the African Development Bank and the Japanese be coordinated with implementation of the PERL?

cc: Messrs. Lee, COD; Shakow, SPR; Holsen, CEC; Rao, FRS; Burmester/ Thahane, SEC; Liebenthal, SPRPA; Steer, FRS; Baudon, SVPOP; Hasan, El Maaroufi, EMNVP; Dervis, Ms. Donovan, Grais, EM.

For Information Only:

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

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: January 11, 1989

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

EXTENSION: 78051

SUBJECT: PAKISTAN: Initiating Memorandum for Energy Sector Loan II - Proposed Agenda

42

1. The Operations Committee will meet on Friday January 13, 1989 at 4.30 p.m., in Room E-1243, to consider a proposed Second Energy Sector Loan to Pakistan in the amount of $150 million. This would be a follow up on Energy Sector Loan I, whose second tranche was released in March 1987 after satisfactory compliance with loan conditions. The Committee may wish to take up the following issues in its discussion.

The Setting

2. Pakistan's overall economic performance has been good, with growth averaging 6.5% a year between FY80-FY87, and only moderate inflation. Export expansion has been rapid, encouraged by exchange rate adjustments and a significant tendency towards reliance on market forces. The Achilles Heel of macroeconomic policy, however, has been fiscal policy, with public revenue not keeping up with rising expenditure, and this has reflected itself in pressures on the balance of payments and resort to domestic borrowing that has bypassed the banking sector but raised the cost of borrowing. The fiscal deficit, 7.7% of GDP in 1987, rose to 8.6% in FY88, and as it is increasingly being monetized, is feeding inflation. Workers' remittances have been declining, and the current account deficit in FY88, at $1.6 billion, was 4.1% of GDP, and foreign exchange reserves are critically low. The proposed loan is a hybrid one seeking to continue the momentum of Policy reform in the sector and also supports a core investment program, covering the first three years of the current seventh Five-Year Development Plan (FY89-FY93). The macroeconomic context is defined by a medium-term policy framework which has been incorporated in a 3-year PFP, approved by the Board last month and also by the Fund, which in December 1988 approved a SAF arrangement (FY89-91) as well as a 15-month Stand-by.

- The Region might elaborate on the prospects of fiscal reform outlining any likely impact on the fiscal situation of the divestitures and privatization provisions of the proposed loan.

Loan Objectives

3. The IM defines four objectives for this operation viz (a) continuing the sectoral adjustment begun under the first loan; (b) supporting the core investment program, both for ongoing and new projects; (c) mobilizing resources for the sector; and (d) providing balance of payments support.

- The Committee may wish to consider the appropriateness of setting up balance of payments support and strengthening the Central Bank's foreign reserve position as an objective of this operation.

Loan Design

4. The IM reflects a detailed Regional knowledge of the sector, which serves well the definition of the proposed loan objectives and design. It is supported by a projected profile of long-term least-cost investments in power generation extending to FY2010. On the core investment program, it is suggested that during appraisal a review is made of the Seventh Plan's energy sector investments, phasing expenditures for each entity, the sources of financing, cash generation, assessing the capacity of the Government to review private sector investments, allocations under the Annual Development Plan and mobilization of resources through price reforms and loans and credits.

- Is such an ambitious program feasible during appraisal? Has preparatory work in these areas been started, and if the tasks are not covered during appraisal, can they be completed before effectiveness?

- In the hydropower subsector, the emphasis on encouraging Basha implementation by loan conditionality is not matched by an equal effort to expedite Kalabagh. Has the Region given up on the latter project?

- Do the administrative provisions spelled out for coal institutions (creation of a coal development corporation by December 1990, approval by GOP of putting the Lakhra Central Block coal reserves for development by a joint venture) imply too detailed interference by the Bank in sector management? Cannot broad-brush agreements on principles be established instead?

- Can the price rationalization provisions for electricity consumption and gas exploitation be advanced from effectiveness to negotiations or even appraisal? After all these provisions amount to Government commitment to fundamental principles of cost-recovery and LRMC and need not await effectiveness.

- Could the Region elaborate on the Environmental Action Plan to be agreed at negotiations? And if such a plan has not been formulated, what is the value of the so-called least-cost generation expansion plan in Annex I?

Loan Amount, Tranching and Procurement

5. The proposed "hybrid" loan is proposed at $150 million, to be matched by an equal loan from the Export-Import Bank of Japan and administered by the Bank. Both loans would have two equal tranches (expected in July/August 1989 and July/August 1990). It is proposed that a third of both loans proceeds would finance general imports with a negative

list, and two thirds a positive list of imports needed by the sector. In order to expedite disbursement the IM proposes, on the basis of experience gained under the previous sector loan, establishing special accounts for each entity to cover its investments under the loan.

- The Committee might consider if the negative list approach is justified, and if only a positive list was considered more appropriate if petroleum product imports could be financed from the proceeds of the proposed loan. The Committee may also wish to discuss the appropriateness of using the special account device proposed.

6. The IM expects that up to $50 million in retroactive financing would be required, and states that contracts needing such financing would have been made under Bank procurement guidelines. As this could be shared equally with the Japanese, the requirement for retroactive financing reduces to $25 million or one-sixth of the loan.

- The Committee might consider if adequate justification has been made for retroactive financing, considering that the present operation is a follow-up on a similar one. It might also set a time limit on the period to be covered prior to the expected date of loan signing.

cc: Messrs. Lee, COD; Shakow, SPR; Holsen, CEC; Rao, FRS; Burmester/ Thahane, SEC; Liebenthal, SPRPA; Steer, FRS; Baudon, SVPOP; Hasan, El Maaroufi, EMNVP; Kopp, Cohen, Elwan, EM1.

For Information Only:

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

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Minutes of the Operations Committee meeting to consider ALGERIA - Country Strategy Paper and Agrarian Reform Support Loan Initiating Memorandum, held on January 9, 1989 in Room E-1243.

A. Present

Committee		Others	
Messrs.	M. A. Qureshi, Chairman	Messrs.	D. Bock, DFS
	W. Thalwitz, EMNVP		I. Christin, CA1
	A. Karaosmanoglu, ASIVP		K. Dervis, EM2
	S. Fischer, VPDEC		V. Dubey, EASDR
	I. Shihata, VPLEG		S. El Serafy, EAS
	H. Vergin, OPSVP		F. Fornasari, EM2
	J. Wood, VPFPR		W. Grais, EM2
	A. Noman, AFRVP	Ms.	C. Gray, VPDEC
	R. Steckhan, LACVP	Ms.	S. Hadler, FRS
			N. Krafft, EM2
			D. Lee, CODDR
			C. Michalopoulos, EM
			H. Molineus, EM2
			G. Reif, SPRPA
			J. M. Swetye, CA1
			S. Anjaria, IMF
			E. Bornemann, IMF

B. Issues

1. The Operations Committee met on Monday, January 9, 1989 to discuss the Country Strategy Paper (CSP) for Algeria together with the Initiating Memorandum (IM) for an Agrarian Reform Support Loan in the amount of $125 million. The discussion followed broadly the agenda prepared by the Economic Advisory Staff which covered inter alia the macroeconomic situation, the role of adjustment lending, the financial reforms envisaged under a forthcoming adjustment operation; the lack in the CSP of sector issues and of programs of emphasis; the IMF country relations; debt strategy and export diversification; and cost sharing. For the Agrarian Reform Support Loan, the issues included loan design and conditionality, the agrarian reforms already accomplished and the pace and sequencing of future reforms.

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C. Discussion

2. The Region began by stressing the fact that the CSP was not a full-fledged one, but was produced to indicate the strategy required to meet Algeria's present situation. An update was foreseen in six months time, which would flesh out the sectoral issues now missing. Clearly Algeria needs the IMF considering its high debt service ratio, the lack of a complete medium-term macroeconomic framework, the relative position of oil in the economy, the slack supply response and high ICORs. But the Region sees in the reforms initiated a window of opportunity which might not last. The reforms include a national credit plan, autonomy of the banking system and public enterprises, and liberalization and privatization for agriculture -- all indicating a structural change that is worthy of support. The IM offered two options, with preference for the first, namely a smaller loan (a one-tranche operation) with no formal loan conditionality as the reforms were already done and might have warranted a conditioned operation had one been done 1-1/2 years earlier; future progress would be a condition of a follow-up adjustment operation in the sector. Alternatively we could go in with a larger tranched loan where the second tranche is conditioned on further reforms.

3. The Chairman invited the meeting to focus first on the CSP and added that it was necessary that we should have a comprehensive CSP that would address key sectoral issues including a careful analysis of employment, poverty, the environment and other programs of of special emphasis, and asked the Region if it would be able to cover these in the updated version indicated in a few months. The Region said that even in the updated version, there would still be gaps, but the main purpose of the update would be to clarify the basis for going into association with the country, considering that the Country Director was planning to go to Algeria next week. The Region further stressed the limited time available for the Bank to react, since Algeria needed broad and comprehensive support. While our knowledge of the country was not good, the Region expected things to move fast. More work was needed on the labor market, but a great deal of work has been done on the environment and this would be reflected in the updated version.

4. The Chairman recognized the interim nature of the present CSP, at least to outline the macroeconomic strategy for the agricultural loan. He advised the Region to be transparent on what we knew and what we did not know about Algeria, highlighting the issues yet to be investigated. The Chairman went back to the macroeconomic situation, saying that clearly the exchange rate was extremely distorted and asked the Region how it saw the evolution of macroeconomic policy, leading to a more adequate macroeconomic framework. The Region once again emphasized the magnitude of the change that has taken place in Algeria, the dramatic privatization of the agricultural sector, and the impact of all this on the social scene. Farmers, though they could not sell their tenancies, held the land for life and could bequeath tenure to their children. Such systemic changes had been unthinkable in Algeria whose economy was even more centralized and controlled than those of Eastern Europe five years ago, particularly as the worsening of the terms of trade by perhaps close to 18% of GDP has made the adjustment difficult. Price liberalization, exchange rate reform and trade liberalization are bound to come later. Already rules have changed for enterprises and new banking laws have been issued. The exchange rate was

the heart of macroeconomic adjustment, and the Region has pressed its importance on the authorities, but their view was that priority should be given to fiscal and monetary policy and that devaluation should not precede the other reforms. The Algerians have meanwhile asked for technical assistance from the Fund as well as the Bank. Clearly a change in the atmosphere had occurred.

5. The Region added that the small ($125 million) loan proposed reflected caution, but it would attract cofinancing, especially if the Fund were to come in. Clearly the Bank could not go at it alone, but the Region was starting early, with no illusions about absence of problems, but anxious to show that it sided with the reformers.

6. The Chairman observed that it was not only external capital that faced price distortions in the shape of the exchange rate, but also internal capital on account of the interest rate. The Region responded that interest rates ranged from 6 to 10% as compared with inflation, officially estimated at 12%. Obviously interest rates have to rise, but the distortion in the exchange rate was far more pronounced, and a commitment is being sought to reduce the 4:1 gap between the official and parallel rates to 3:1 -- an initial adjustment of 25%. At this point the Chairman invited IMF comment. The IMF representative said that they had kept close contacts with EMENA and provided some technical assistance to Algeria in the areas of taxation and budgetary operations, but like the Bank, their relations with Algeria had not been all that close. However, there has been agreement on directions for change, but not its quantification as the IMF did not have enough facts. However, the Algerians have requested acceleration of Article IV Consultations and the IMF has advanced its mission to February. The Fund shared with the Bank the view that Algeria's position was difficult on account of the fiscal situation, money and banking issues and the external debt service.

7. The Chairman said that on debt strategy the projections shown do not separate possible debt rescheduling from the low oil price scenario and asked why a traditional debt rescheduling could not be considered independently of oil prices as this would make a major contribution to the financing gap. The Region said they sided with the Algerians who believe they need not seek rescheduling as they could weather the storm with Bank and Fund support, relying on flexible financing without formal rescheduling. France was particularly supportive of this stance. Once a rescheduling route is taken, the price of Algerian debt on the secondary market would drop, no new money would be forthcoming, and a repeated rescheduling would become necessary. Only if the price of oil dropped further -- perhaps by $2 -- would the rescheduling option become inevitable. A discussion then ensued on what oil prices were used in the projected scenario and the Region said that they were following Bank projections and have used $15.50 a barrel for 1989 and $16.50 for 1990, but speakers thought that these levels might be too high.

8. A speaker enquired if the inflation rate, projected in a table in the CSP to increase from 10% to 21.4% between 1988 and 1989 was in fact a typographical error or was it a reflection perhaps of an anticipated

devaluation? The Region said it simply reflected its realistic assessment of inflation whereas the Government insisted on inflation being currently at 10-12%. The Chairman commented that unless there is repressed inflation, you could not get the 20% in one year, but the Region responded that indeed there was repressed inflation, and that the ratio of m_1 GDP was exceptionally high. The same speaker said that with inflation so high, the two percentage points move in the interest rates indicated could not make interest rates positive. While he supported the strategy of attempting to engage Algeria in a dialogue for reform, and recognized the realism of having to make a down-payment for this, he was concerned that the reform process was complex and difficult, and both the micro and macro situations were in a mess. Although adjustment lending is being proposed in agriculture this year, with a financial sector adjustment operation next year, our knowledge is still incomplete and a full set of indicators to monitor performance, particularly of the fiscal situation, is not yet in place. While he liked the notion of engagement, he asked if adjustment lending should not be delayed until the macro situation was brought under control and the Fund came in to give us a handle on the situation and our understanding of the financial sector clarified before we processed the large loan envisaged. Rather than jump in with both feet, he said, engagement could be satisfied by a smaller investment loan.

9. The Region responded that the conditionality to be attached to financial reforms would not be minor, and would include the exchange and interest rates. Only $125 million is requested for this agricultural operation, but by the next operation, the whole macroeconomic situation would be fully covered, hopefully after the IMF had come in. All the Region was asking now was not to wait six months and miss a golden opportunity to influence change. Algeria needed adjustment lending and not investment lending. The next six months were important as we needed to save Algeria from being pushed into rescheduling its debt.

10. The discussion then returned to the foreign exchange market and a speaker asked how significant the "black" market was. The reply was that it was substantial, and that it was not a black market, but a "gray" one, tolerated by the authorities. If appropriate measures were taken, a 25% reduction in the gap would result, but only as a first step, with other steps to follow. The Region was anxious not to get in the way of the Fund on this issue, and agreed with the speaker that narrowing the ratio of the market to parallel rate from 4:1 to 3:1 was still inadequate. The same speaker repeated his view that the Bank should be financing investments and in the process gaining sectoral knowledge before adjustment lending was attempted, but the Chairman commented that that was what the Region had been doing for a long time. The Region added that too much investment had already been undertaken in Algeria, and fresh investment would not be very useful without major adjustments in prices, including the exchange and interest rates.

11. Another speaker reiterated support for the engagement argument, but thought the macroeconomic situation did not warrant adjustment lending. In particular he was concerned about Bank exposure. Though in itself exposure did not present a serious problem, he did not like the projected reduction in private creditors' exposure. If there are hurdles against private capital inflow, such hurdles should be eliminated.

12. He observed that private creditors' exposure declined significantly between 1980 and 1984 then rose rapidly until 1987, and is projected to fall gradually afterwards. Where, he enquired, was the catalytic role of the Bank? He thought that oil prices might decline further and this would make a difficult situation even more risky. The Region said the Italians were interested in cofinancing, providing guarantees for commercial bank lending to Algeria. The French and Japanese were also supportive. The decline in private creditors' exposure in the early eighties reflected repayments at a time of high foreign exchange reserves, but oil prices began to decline seriously after 1985, and the decline in private exposure foreseen is realistic and reflects the impact of the riots and other events on future lenders. The financial community was slow to appreciate the deterioration of Algeria's position, impressed by Algeria's good record of meeting its service obligations.

13. The Chairman said we should be very clear about the strategy in the short versus the long term. We have been attempting to improve the dialogue during a time of high commercial borrowing, and this strategy had been productive. As the Bank moves to an incremental adjustment strategy, this would necessitate a closer involvement and engagement in policy change. For the proposed agricultural operation, he observed that except for privatization, there is little change "up front." Many of the reforms indicated took place a while ago. Future reforms might be regarded merely as promises -- and delayed promises at that -- and these were inadequate. The important question is one of strategy: can we still gain a dialogue and engagement through sector investment rather than adjustment lending since he envisaged great difficulty in taking this operation forward. In all similar situations, a track record had existed for reform, with a momentum established for macro policy change including prices, the exchange rate, the interest rate and above all trade liberalization. He understood that trade was very strictly controlled with prevalent quantitative restrictions. The situation was clearly a very difficult one. He thought the agricultural reform effected over the past few years was quite impressive and deserving of support, but the problem remained how to structure our operation to justify the lending proposed.

14. The Region pointed out that agrarian reform was by no means over. A law has been passed, but the change needed to be supported for it to succeed. Another speaker expressed dissatisfaction over the loan seeking to finance general imports with full disbursement occurring before any conditionality could apply. All the conditionality he saw was future promises. If the intention of the loan was to provide balance of payments support, he said, it should not be dressed up as a sector adjustment operation. Setting such a precedent would create problems. He saw options, either to tranche the operation, advancing the second tranche conditions in time provided they were truly meaningful, or else process the operation as a sector investment or a hybrid loan.

15. Another speaker asked about the linkage, if any, between the credit operation, already approved by the Board, and the operation under review. The Region said that, in all, four agricultural operations were being processed, including one for irrigation and research and extension. At this point the Chairman asked if each operation had a separate life or

did they fall under a common sectoral umbrella. Are we just providing money for the balance of payments, or is there a coherent sector strategy?

16. Yet another speaker expressed sympathy for EMENA's position. He thought a one tranche operation might not gain Board support, mentioning the cases of loans to China, India, Indonesia and Thailand which attracted criticism. A tranched operation would benefit longer term change, especially if it also identified key macroeconomic adjustments. What was missing was defining the changes needed and the steps that have to be taken, acting on a few of these to be incorporated in the operation under review. He agreed with the Chairman that a two percentage points adjustment in the interest rate at a time of a 20% inflation was not meaningful.

17. The Chairman said that there was no question that the relationship with Algeria was important and should be fostered. He sensed general support for working with Algeria among Committee members, but the question is how to do it and the modalities for doing it. If the approach set out by the Region is followed, some of the conditionalities in macro policy need to be "up front" not at the end. The linkage between agriculture and the balance of payments, and the need for quick disbursing funds require greater justification. Cofinancing also should be integrated into the operation. He had the sense that the agrarian operation predated the October riots. He appreciated the fact that the situation was fragile and that the Government might not be in a position to change policy quickly. He added that it seemed that we could only get policy change through quick-disbursing lending. This was not right. Excessive reliance on quick disbursing-lending would put us in an impossible situation because our leverage could quickly diminish while the need for structural adjustment would persist. We should find ways to increasingly associate sectoral and macro conditionality with our investment lending through a more effective dialogue.

18. The Region offered to go for the other option they had proposed, namely a larger loan with two tranches. This option had appeared less preferable as it would delay processing. Investment lending would disburse too slowly, and constituted no real option since input imports were urgently needed. That left the problem of macro policy. If we waited until the IMF came in with a Stand-by that would mean at least nine months delay, and we would have missed the opportunity to help agriculture to adjust. There is no problem with a $250 million loan and longer conditionality, but incorporating macroeconomic adjustment would result in delay.

19. A speaker saw the possibility of a number of macroeconomic conditions, not all of which were at the same level: the credit plan (the fiscal situation); credit policy and interest rates; the exchange rate and the debt position. Another speaker thought that waiting nine months for the macro adjustment seemed to him acceptable, but the Chairman said that the reform might lose momentum in the process. We should be more imaginative in attracting cofinance, the speaker added. It was not too late even to seek cofinancing for the agricultural credit operation already sent to the Board.

Decision

20. The Chairman then attempted to summarize the discussion. He thought that the overall size of total lending proposed did not bother him, but it should be made conditional on a macroeconomic framework and movement on policy; otherwise it would not be justified. We should be in a position, through adequate economic and sector work, to provide the necessary analysis. The CSP should include more sectoral coverage and he would like the President to review it. In its present shape the CSP is not ready for such a review. He himself had encouraged the Region to bring this operation together with the CSP to the Committee. He thought that the option of a larger operation with two tranches might possibly work. But conditionality has to be tightened and brought up front. Only then would this warrant support. But as proposed the operation cannot be supported. Even if the Region came back with a Credit Plan, some more effective action on macropolicy needed to be demonstrated before we could go ahead. The modest adjustment effort indicated was not enough, and adjustment proposed after 12 months looked too distant. On cost sharing he did not object to financing all foreign exchange up to 50% of total project cost, but for the sake of consistency we should keep to the ratios established for countries with comparable income.

21. Should it look as if Algeria were not able to initiate effective improvements in macro-policy -- and this may in fact be the case -- we should swallow the pill and realize that an adjustment loan could not be made under these circumstances. We have just put together a policy paper on adjustment lending and taken it to the Board. For our own credibility we should abide by its conclusions. While that policy paper does not exclude the possibility of one-tranched operations, there are many Board members who have reservations about them, and the operation must support substantive reforms, including macroeconomic reforms. Although the Chairman had encouraged the Region to put its case to the Committee, he now saw that the proposed conditionality would not work. In reaction to a question by the Region he said that he was concerned about the absence of trade liberalization: why not remove controls on agricultural exports for the benefit of diversification? This would not have to await the advent of the IMF or a drastic adjustment of the exchange rate. Not much more work needed be done on agricultural sectoral reforms except that steps to be taken in the future have to be clear enough and some timetable has to be established. The macroeconomic framework, however, needs to be worked on, including the interest rate, the exchange rate, credit plans and prices. When this is done, the Region could come back to the Operations Committee; meanwhile he was always available for advice and moral support.

January 18, 1989

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Debriefing

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

$ 125 million

CSP.

medium term Financing Plan.

IMF - No forward looking conditionality

Interest Rates

Ibrahim

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Debt Strategy

25%

$ 125 million

3 of the 4 criteria

2% interest rate.

250 m

(1) Agreement on a national Credit Plan

1 Assum - Exchange Rate

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: January 5, 1989

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

EXTENSION: 78051

SUBJECT: ALGERIA - CSP and IM for an Agrarian Reform Support Loan - Proposed Agenda

1. The Operations Committee will meet on Monday, January 9, 1989 at 5.00 p.m. (note change in time) in Room E-1243 to discuss a Country Strategy Paper for Algeria as well as an Initiating Memorandum for an Agrarian Reform Support Loan in the amount of $125 million (but see below). The Committee may wish to take up the following issues for discussion.

I. THE CSP

Background

2. The last strategy paper for Algeria (a CPP) was reviewed by Senior Management in April 1982. A FY83-87 lending program, averaging $600 million a year, was agreed, less than half what was earlier authorized for the period FY81-85. Projects in Algeria proved difficult to prepare, and disbursement from the loans made were slow (which led to many cancellations). Algeria was flush with oil money, had access to commercial credit and operated an economic system that was not very responsive to Bank advice. In 1986 the Region initiated a strategy paper, which was ready for review by Senior Management in May 1987, proposing a lending program of $1.2-1.9 billion in the quinquenium FY88-92, but the review process was aborted and the CSP shelved.

3. Reflecting a difficult relationship, the actual record of lending to Algeria has been uneven with no commitments made in FYs 1982, 1983 and 1986. Lending in FY85-88 averaged some $280 million a year, and was heavily concentrated in infrastructural projects (highways, water supply, irrigation and railways). Owing largely to Algeria's deteriorating situation, and also to Regional efforts at improving the dialogue, Algeria now offers a good opportunity for a much larger Bank role.

4. This CSP is being presented as an interim document, to be updated by mid-1989, in view of the uncertain political climate outlined in Mr. Thalwitz's covering memorandum. In view also of the country's onerous debt obligations, the price collapse of its major export, and the precarious, but highly supportable, nascent trend towards liberalizing Algeria's hitherto over-controlled economy, the Region is recommending an increased Bank involvement, prompted by a special request from the Government subsequent to the October riots. The Region, however, remains cautious over the possibility of serious policy reversals. The Paper makes a good case for a lending program of $500-700 million a year ($1.5 billion in FY89-91 over 18 operations),

with a measure of fast-disbursing adjustment operations, both to provide critically needed foreign exchange, and to support the reform tendencies underway.

- The Region might explain the rationale behind producing a CSP now if its life would cover only a six-month period, or alternatively if the projected mid-1989 CSP should not be delayed.

Adjustment Lending and the Financial Sector

5. The argument the Region makes for including adjustment operations in the lending program is convincing, but only two operations are indicated: for agrarian reform in FY89, and the financial sector in FY90. The number and amounts of such operations appear to be limited in comparison with Algeria's need for policy reform, and also relative to the financing gap. There may be a case for raising the policy-based content of Bank lending in order to increase our policy impact. Moreover, beyond some vague references to inflation, interest rates and government financing of investments, no indication is given in the CSP of the sort of reforms we might expect from the projected $200 million Financial Sector Adjustment Loan.

- The Region might outline the financial reforms it has in mind; whether this could be accomplished over one or more operations; and explain why the recently approved $110 million Agricultural Credit Project did not touch on any economy-wide financial reforms.

Programs of Emphasis and ESW

6. Issues of special emphasis in Bank work such as poverty, women's participation, private sector development and above all the environment are absent or nearly absent. Some of the work done in the context of the Mediterranean Environment Project might usefully be reflected in the CSP and integrated with ESW and prospective Bank operations.

- The Committee might wish to discuss the inadequate assessment of sectoral issues in the CSP which seems to be dominated by macroeconomic developments, without a sufficient underpinning of the sectors involved.

- The Region might also be asked to elaborate on the tasks to be undertaken under the ESW which the CSP recommends to be expanded and indicate where the resources needed could come from.

Income, Welfare and Bank Strategy

7. Although per capita income is estimated at $2,760 for 1987, this, however, derives to a great extent from the liquidation of natural resources rather than from value added, and is therefore unsustainable over time. This "income" is also critically sensitive to the terms of

trade which have sharply worsened, and a very high proportion of it has been devoted to less productive investments (in the neighborhood of 40% of GDP during most of the period from the mid-seventies to the mid-eighties) and ICOR has been very high (12.5 in 1980-87; projected at 10.0 in 1987-92 as depicted in Annex B1 p. 33; and shown -- on a 5-year average basis -- at 28.2, 27.2 and 29.4 in 1988, 1989 and 1990, respectively, in Annex A p. 30). With also the heavy burden of debt service and the disturbances of October 1988, the following issues may be raised:

- How long will the hydrocarbon base of the Algerian economy last at current extraction rates?

- Why has not the CSP addressed the high population growth (3.1% a year), the rapid growth of the labor force, the likely increase in unemployment (22% in 1988, see p. 17) and the low female participation rate?

- Could the Region throw some light on income distribution? The latest figure cited for poverty incidence in the Social Indicators Data Sheet (p. 46) shows 20% of urban population living below the absolute poverty income level.

Debt, the IMF and Cofinance

8. "The problem is not one of overall size of debt" (CSP, para. 7) but the debt service ratio, now about 70% [Annex B4, p. 42 puts this at 76.3% for 1988, but see various reservations on the data on p. 19, note 1.]. While Algeria is said to have continued to meet its debt service obligations, such a high debt service ratio is bound to lead to arrears, if not default, and a role for the Fund seems inevitable, not just to monitor macroeconomic developments (which the CSP argues could be done by the Bank: para. 10) and as a source of foreign exchange which to date Algeria has never tapped, but in order also to prepare for debt rescheduling which Algeria has so far avoided. Fund presence would seem also to be required for correcting the highly overvalued exchange rate (the gap between the official and parallel rates is said to be 1:4, para. 43) which would be needed for promoting non-petroleum exports, and for the interest rate and other financial reforms indicated. While potential cofinancing sources might be explored, no serious effort for that purpose appears to have been initiated. Italy, France and Spain are mentioned without substantiation as possible prime candidates for cofinancing (para. 83). The Committee may wish to discuss:

- Whether an IMF role is not absolutely essential for the success of the Bank strategy proposed, not just desirable, as stated in para. 11.

- Whether the projected large inflows of foreign capital (Annex B4, p. 39) from official creditors and particularly from private creditors (the latter about $4 billion a year rising to $6.2 billion in 1997) are consistent with the dim picture of political instability, slow economic progress and uncertainty of reform as depicted in the CSP?

- What steps if any have been taken to investigate likely sources of cofinance as hinted at in para. 38?

- The shadow exchange rate (para. 7, note 1) used to calculate the debt burden indicators used in the CSP in view of the wide gap between the official and parallel rates.

Export Diversification

9. The CSP argues that the improved structure of incentives, if it materializes, would eventually reorient production away from the hydrocarbon sector and traditional heavy industry towards more labor-intensive manufacturing and widen Algeria's export base. Projected export growth is realistically kept modest (5% a year throughout the 1990s), with non-hydrocarbon exports rising from the current 3% to 10% of total exports by 1997 (para. 75).

- The Region might indicate the likely exports to be developed, their potential markets and whether diversification could not be pursued more actively, especially with the help of exchange rate policy reform.

- Can these exports be promoted through a focused program of incentive and institutional reforms?

Cost Sharing

10. In the past the Bank has covered up to 100% of the foreign exchange cost of projects financed by the Bank, partly because of the development difficulties facing Algeria, and in an attempt to improve the dialogue. The CSP emphasizes (para. 87) that the essence of the Bank assistance strategy "hinges on the critical role of foreign exchange availability" and recommends, over the next three years, the continuation of financing all the foreign exchange cost of Bank projects up to a maximum of 50% of total project costs. Countries with comparable per capita income levels such as Yugoslavia and Portugal are treated similarly, but with a maximum of 35%.

- The Committee might consider if this recommendation is appropriate.

II. THE AGRARIAN REFORM SUPPORT LOAN

Background

11. Agricultural reform constitutes the first major reform in Algeria's drive to decentralize and liberalize its economy, which has resulted in the "virtual privatization" of the state farm sector that accounted for 60% of Algeria's agriculture. To consolidate the improvements already achieved, and to enlist farmers' support for the reformist movement, the IM stresses the need to provide foreign exchange for the importation of agricultural inputs, currently in short supply. Despite large scale investments, made possible by huge petroleum earnings, agricultural growth over the past 20 years has averaged only 2.8% a year, i.e. below population growth, with stagnation evidenced in

yields, as well as production of staple foods. Reforms that began about 1982 to privatize the socialist agricultural sector, have improved the situation, but 1988 production was severely set back by drought and locust infestation. [A $58 million loan to Algeria for desert locust control will shortly be taken to the Board.] Recent growth has come from the movement of private production into higher value crops such as fruits, vegetables and livestock. But, owing to fast growth of consumption, Algeria's self-sufficiency ratio for cereals has fallen to 25% and scarce foreign exchange has now to be devoted to imports of food. The importance of agriculture is highlighted by the fact that it absorbs a quarter of the labor force, and rural areas house half of the population. An indication of the relative poverty of farmers is that the share of agriculture in GDP is about 7% (para. 16) which suggests that farmers' average income is less than a quarter of that of the non-farmers.

12. Major constraints on the growth of the sector identified in Bank sector work included fragmentation of holdings of state farms, low productivity, high level of indebtedness, lack of clear responsibilities, dull incentives, lack of technical staff and excessive centralization of decision making (para. 20). Little by little a program of agricultural reforms has emerged, raising producer prices of essential staples, strengthening agricultural credit arrangements with the establishment in 1982 of the Bank of Agriculture and Rural Development (BADR), decentralizing of marketing agencies and the cooperative system, strengthening extension services and intensifying cereal production. The IM, while recognizing the importance of these reforms, points out that they did not address the basic problem of agriculture, namely the structure of the sector and the lack of private enterprise and ownership (para. 28).

Loan Objectives and Conditionality

13. The IM offers two options for proceeding with this loan: (a) a non-tranched loan of $125 million, followed by a subsequent operation in the sector of the same magnitude; and (b) a loan of $250 million in two tranches, with the second tranche due about end-1989. The Region's preference is for option (a).

14. The IM does not set out clearly the objectives of this operation and lacks a matrix of reforms and a timetable for implementing the proposed conditionality. From the text, however, the following major reforms/conditions can be identified:

(a) A development plan to be received by December 31, 1989 from BADR to delineate its medium-term strategy for decentralization of its activities, mobilizing resources, and expanding credit to private farmers;

(b) By the same date reforming the administration process of interest rate determination and credit allocation by devolving these responsibilities to the banking system with a strengthened role to be played by the Central Bank;

(c) Also by December 1989, a rise by two percentage points in the rediscount rate and lending interest rates;

(d) By negotiations, reviewing the investment program in irrigation (which makes up the bulk of public investment in agriculture) in order to agree on investment priorities. Satisfactory completion of the program would be a condition for a subsequent operation;

(e) By December 1989 agreeing on a timetable for full cost recovery for O&M in irrigation;

(f) Retention by agricultural exporters of 20% of their foreign exchange earnings (no date specified);

(g) By December 1989, abolition of the public sector monopoly to procure and distribute agricultural inputs;

(h) Initiating a study prior to the next operation to indicate the proper support prices for strategic crops;

(i) Total elimination of input subsidies before initiation of the next operation.

- While the program seems substantive and well directed towards crucial reforms, the conditionality date of December 31, 1989 appears later than necessary for the desired pace of change. The Region might explain why some of the conditionality could not be advanced while clarifying the priorities and sequencing of the reforms.

- Are not the financial reforms being sought too general to be incorporated under such a sector operation?

- As the proposed loan amount is estimated at about a quarter of annual agricultural input imports, would procurement be confined to a positive list with no retroactive financing?

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

For Information Only:

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

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: December 16, 1988

TO: Members of the Operations Committee

FROM: Wilfried P. Thalwitz, Vice President, EMENA

EXT: 32676

SUBJECT: ALGERIA - Country Strategy Paper (CSP) and Initiating Memorandum (IM) for an Agrarian Reform Support Loan

1. Attached for your consideration are the documents mentioned above. A meeting to discuss both papers is scheduled for January 11, 1989, at 3:30 p.m.

2. Since the attached CSP and the IM were finalized, the process of political and economic change in Algiers has, if anything, accelerated.

3. Ever since he took over from H. Boumedienne nine years ago, President Chadli Bendjedid has been trying to liberalize the economy and soften the FLN one-party rule. Progress, however, was slow and uncertain until recently. In 1987, under increasing pressure from the oil-price collapse, the economic reform gathered momentum. Many institutional changes were designed, and legal texts prepared. The reform aims at virtually privatizing agriculture,

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liberalizing most prices, transforming the centrally planned industrial sector into one of autonomous public enterprises "Hungarian" style, and devolving many government decisions to the regional level. 1988 was a year of transition with many of these reforms, starting with privatization in agriculture, in their first stage of implementation. Unfortunately, for Algeria, 1988 was also a year of drought, locust infestation, and further declines in the price of oil. Imports had to be cut dramatically. Even the most basic necessities became scarce. Algeria remained current, however, on her debt payments, trying to preserve her status as a country that has never rescheduled. Debt service in 1988 will account for more than 60% of export earnings.

4. At the political level, a special Party Congress was convened for the end of the year by President Chadli. It was no secret that major changes in leadership were desired by the President on that occasion. On September 29, in a speech to Party members, the President announced the intensification of reforms and changes even among "high-placed" bureaucrats and party leaders "who tried to stop them". In a move reminiscent of Gorbachev, President Chadli took on the old party guard, but made the mistake of announcing their demise without, at that moment, actually getting rid of them.

5. A few days after that speech, unprecedented violence erupted in Algiers and quickly spread across the country. The commonly agreed interpretation of the riots is that they were due to a <u>spontaneous</u> movement of revolt against worsening living conditions, unemployment, and lack of political freedom of expression. However, most observers now also believe that orthodox elements in the party originally encouraged the movement in the hope of creating a dynamic that would stall the liberalization and perhaps even lead to Chadli's resignation. At one point, it seems Chadli was indeed ready to resign. But when the violence reached new heights, with inexperienced and panicked soldiers shooting people in the streets, his advisors and some key military commanders pledged allegiance. In an emotional televised speech, the President asked for calm in the streets and announced (a) the speeding-up of economic reform; and (b) political reforms that would end rigid one-party rule by the FLN.

6. Next morning, the uprising was over. On October 29, President Chadli dismissed M.C. Messaadia (the until-then powerful head of the FLN) and the Chief of Military Security, nominating two respected moderates in their place. In the following days, an amazing change in style and content was visible in the Press. Opposition groups that had never even been named, published statements reported in the newspapers. On November 3, in a referendum with an 80% participation rate, the Algerians overwhelmingly endorsed wide-ranging changes proposed by the President. On November 3, Kasdi Merbah, a man noted for his competence as a manager, was appointed Prime Minister. On November 8, a new government was formed. On November 27, the special Party Congress met in Algiers. After four days of active debate, President Chadli was renominated for the Presidency. On December 22, he is expected to be formally reelected.

7. In early November, after the riots but before the new government was formed, we were asked by the General Secretary of the Presidency for support in the form of:

(a) intensified economic and sector work to help in the design and implementation of the reform;

(b) financial support in the form of quick-disbursing adjustment lending;

(c) mobilization of official cofinancing; and

(d) help vis-à-vis the commercial banks in the form of supportive "marketing" of the reform program.

8. The CSP reflects the strategy we recommend in response to this request. We propose an active, supportive, but incrementalist and cautious approach.

9. While we were prepared for a gradually increasing involvement with the Algerian authorities on development strategy and macroeconomic policy issues, the magnitude and suddenness of their request, no doubt prompted by the October riots, was surprising. We would like to offer prompt support to the reformist team in Algiers and we realize that they need our support urgently in the months to come. On the other hand, we must carefully modulate our support, depending on key guideposts in the reform process, condition it on the realization of specific macroeconomic targets, and associate ourselves with Algeria's main economic partners, notably France and Italy. We must also ensure that we share with the new economic management emerging in Algiers, a detailed common perspective and we must continue to test the strength of our relationship. We cannot rule out temporary or even more serious reversals, given a political situation that is still full of uncertainties.

9. In view of the circumstances, this CSP should be considered an interim document, to be updated by mid-1989, in light of the rapidly evolving political and economic events in Algeria.

Attachments
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