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June - July, 1991

July 26, 1991

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THE WORLD BANK / IFC / MIGA

OFFICE MEMORANDUM

DATE: July 26, 1991

TO: See Distribution Below

FROM: Francis X. Colaço, Acting PRSVP

EXTENSION: 33422

SUBJECT: Revision of the Environmental Assessment Operational Directive

Enclosed is a copy of the draft revision of the Environmental Assessment Operational Directive scheduled for discussion at the OC meeting on August 5.

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THE WORLD BANK
Washington, D.C. 20433
U.S.A.

BARBER B. CONABLE
President

DRAFT
July 26, 1991

MEMORANDUM TO THE EXECUTIVE DIRECTORS

SUBJECT: Revised Environmental Assessment Operational Directive

When the Bank adopted the Operational Directive (OD) on Environmental Assessment (EA) for pilot use in October 1989, Executive Directors requested information on our experience after we had tested it. Our conclusion is that environmental assessment has proved to be an effective tool in improving the quality of economic development. So much so that we have finetuned the OD based on our experience to date. This experience is seasoned by voluminous advice, comments and criticism from Bank staff. The EA OD Steering Committee, led by ENV with major representatives from the regions and COD, have listened carefully to and benefitted from comments inside and outside the Bank. Following extensive consultations within the Bank, I recommend six main changes in the OD (roughly ranked 1 through 6 below), the revised draft of which is attached for your consideration. The other revisions are minor, editorial or self-evident clarifications with no major policy implications. A review of the Bank's experience with EAs to date is attached as a separate document.

1. **Disclosure of Information:**

The Bank's policy on disclosure is evolving, and environment is no exception. You will remember our discussion of the language proposed for the October 1989 OD. The new OD provides that as soon as the EA summary is received from the borrower, the Bank shall make it available to the Board (paras. 14 - 15). In addition, the full EA report shall be made available to you on request. As the EA remains the property of the borrower, the Bank seeks agreement from the borrower for such disclosure upon reaching the decision to prepare an EA.

The Bank recognizes that participation of affected people in decisions affecting their lives cannot be meaningful unless they have adequate information about the project. The Bank now interprets this as sharing the project description and objectives with the affected people and local NGOs for their comments and input at the outset, then subsequently making the draft EA reports available for review and comments.

2. **Bank Roles in EA Processing:**

Although the Borrower is responsible for preparing the EA, the Bank is responsible for seeing that all needed environmental work is carried out by the Borrower, and that it is adequate when received by the Bank. We have clarified responsibilities within the Bank for EA processing. The Country Department and Task Manager (TM) continue to bear the overall responsibility for projects in general. The TM raises the environmental issues, supported by and with the concurrence of the Regional Environmental Division. In turn, the RED is supported by and consults with ENV.

3. **Broadening the Scope of EA:**

The October 1989 OD specifically excluded global environmental externalities and adjustment operations from the purview of EA. Since then, global issues have risen on the Bank's agenda. In addition, now that the GEF is operational, we want to ensure that anything it finances is environmentally scrutinized. While we are not able to predict all global environmental effects, nor all those provoked by adjustment operations, we feel we must try, at least where feasible. Therefore, this OD requires that obvious effects be addressed to the extent feasible. Meanwhile, we propose to mount research to facilitate such predictions.

4. **Classification:**

We have received more criticism on the amount of EA work needed on a given project, including from yourselves, than for any other aspect of EA. We therefore propose two changes. The first is dropping the old "D" category, which did not fit into the scale of EA work needed. This simplifies project classification. All projects will be assigned to one of three categories, A through C, depending on the extent of environmental impacts, and therefore the amount of environmental analysis needed. "A" projects need a full environmental assessment. "B" projects need environmental analysis, but not a full assessment. "C" projects are categorically excluded from environmental analysis. We have added language requiring re-classification of EA categories, upwards or downwards, as soon as the project concept changes or new information becomes available.

5. **Environmental Panels:**

Long experience with the use of panels in the case of dam safety, and our experience to date with similar panels to deal with environmental aspects for major dam and reservoir projects has been salutary. Therefore, we now propose that highly risky and contentious projects with potentially serious and multi-dimensional environmental concerns should engage the services of a specialist panel, along the lines of the successful dam safety panel, to reduce environmental risks.

6. **New Annexes:**

In order to clarify and simplify the OD, we have added three brief annexes. The first defines the "area of influence" of the project as related to EA needs. The second outlines a sample mitigation or management plan for a Category B project. The third new annex systematizes EA reporting for the Monthly Operational Summary.

DRAFT
July 24, 1991

Operational Directive 4.00, ANNEX A: Environmental Assessment

Introduction

1. This annex outlines Bank policy and procedures for the environmental assessment (EA) of Bank lending operations, and related types of environmental analysis.[1/] EA is a flexible procedure, which should vary in breadth, depth, and type of analysis, depending on the project. It may be carried out at one point in time, or in discrete stages. EA is carried out during project preparation, before appraisal, and should be closely linked to the feasibility study. For the purpose of this annex, EA covers project-specific and other environmental impacts in the "area of influence" of a project (Annex A1).[2/] EAs utilize the findings of country environmental studies and action plans which cover nationwide issues, the overall policy framework, legislation, and institutional capabilities in the country.

Purpose and Nature of EA

2. The purpose of EA is to ensure that the development options under consideration are environmentally sound and sustainable.[3/] Any environmental consequences should be recognized early in the project cycle and taken into account in project siting, planning and design. EAs identify ways of improving projects environmentally, by preventing, minimizing, mitigating, or compensating for adverse impacts. By alerting project designers, implementing agencies, and borrower and Bank staff to issues early, EAs (a) enable them to address environmental issues in a timely and practical fashion, (b) reduce the need for project conditionality, because appropriate steps can be taken in advance or incorporated into project design, or alternatives to the proposed project can be considered, and (c) help avoid costs and delays in implementation due to unanticipated environmental problems. EAs also provide a formal mechanism for inter-agency coordination, and for addressing the concerns of affected groups and local nongovernmental organizations (NGOs). In addition, the EA process should play a major role in building environmental capability in the country.

3. Like economic, financial, institutional, and engineering analyses, EA is part of project preparation, and is therefore the borrower's responsibility. Close integration of EA with these other aspects of project preparation ensures that (a) environmental considerations are given adequate weight in project selection, siting, and design decisions, and (b) carrying out EAs does not delay project processing.

1/ Unless the context otherwise requires, "EA" means the environmental review process required by this OD, including the formal environmental assessment and other environmental analysis. References to the Bank include IBRD and IDA; "loans" include credits. IFC follows its own environmental assessment procedure. In addition, IFC follows all specific Bank environmental policies (eg: wildlands, indigenous peoples, involuntary resettlement, pesticides). adapted to its special needs. Bearing in mind its special circumstances, MIGA will cooperate with the Bank to ensure, to the extent possible, that the objectives of this directive are met in its operation.

2/ The Environmental Assessment Sourcebook provides guidance on all topics mentioned in this OD and should be used for guidance throughout. For Bank policies regarding related impacts, see Annex A3.

3/ More guidance on sustainability is provided in OMS 2.34, in the EA Sourcebook, and in the forthcoming OD 4.00.

Types of Environmental Analysis

Project-Specific EAs

4. Project-specific environmental assessments or other analyses are used to analyze specific investment projects (e.g., dams, factories, irrigation systems). The detail and sophistication of analysis should be commensurate with the expected impacts. When a project has been classified as a Category A (see para. 22), formal project-specific environmental assessment is required and should cover: (a) existing environmental "baseline" conditions; (b) potential environmental impacts, direct and indirect, [4] including opportunities for environmental enhancement; (c) systematic environmental comparison of alternative investments, sites, technologies, and designs; (d) preventive, mitigatory, and compensatory measures, generally in the form of an environmental mitigation or management plan; (e) environmental management and training, and (f) monitoring. To the extent possible, capital and recurrent costs, environmental staffing, training, and monitoring requirements, and the benefits of proposed alternatives and mitigation measures, should be quantified. Annex A2 outlines a project-specific environmental assessment report, and Annex A3 lists specific environmental issues to be covered where relevant.

Regional and Sectoral EAs

5. Regional EAs may be used where a number of similar but significant development activities with potentially cumulative impacts are planned for a reasonably localized area. In such cases, regional EAs are generally more efficient than a series of project-specific EAs, and may identify issues that the latter might overlook (e.g., interaction among effluents, or competition for water or land). Regional EAs compare alternative development scenarios, and recommend environmentally sustainable development and land use patterns and policies. Impacts may sometimes extend across national boundaries; however, regional EAs with an institutional focus might follow administrative boundaries. Regional EAs are particularly useful preceding the first in a series of projects or development interventions in an undeveloped region, where a region is slated for major developments, where cumulative impacts are anticipated, or in regional planning or agro-ecological zoning. The Bank is willing to consider financing regional and sectoral EAs.

6. Sectoral EAs may overlap with regional EAs. Sectoral EA should be used for the design of sector investment programs. They are particularly suitable for reviewing (a) sector investment alternatives; (b) the effect of sector policy changes; (c) institutional capacities and requirements for environmental review, implementation, and monitoring at the sectoral level; and (d) the cumulative impacts of many relatively small, similar investments which do not merit individual project-specific EAs. Sectoral EAs should strengthen the environment management capability of the sectoral or other relevant agencies.

7. Although regional or sectoral EAs facilitate the subsequent preparation of project-specific EAs, they usually do not cover all requirements of project-specific EAs. Normally, the latter are needed for major investments (see para. 16 on sector investment loans), but regional or sectoral EAs will have identified the relevant issues, collected much of the data, and, in general, greatly reduced the work needed in subsequent project-specific EAs.

4/ Indirect impacts are the induced consequences of the project which occur later or in another part of the environment, e.g., if a river is channelled or dammed, its capacity for self-purification may be reduced and the original aquatic ecosystem damaged or destroyed.

Alternatives

8. Alternative approaches to the EAs described above may occasionally be acceptable for some types of projects. Typically, these projects are smaller and not in environmentally sensitive areas and present issues that are narrow in scope, well-defined, and well-understood. These approaches may be more effective in integrating environmental concerns into the borrower's planning process, and are useful in focusing the environmental work needed. Such alternative approaches[5/] include, for example:

(a) specific environmental design criteria and pollution standards, acceptable to the Bank, for small-scale industrial plants;

(b) specific environmental design criteria and construction supervision programs for small-scale rural works projects, and

(c) specific environmental siting criteria, construction standards, and inspection procedures for housing projects.

Consideration of Global Issues

9. A number of specialized agencies -- inside and outside the U.N. system -- carry out scientific investigations of global environmental issues (ozone depletion, global warming, sea level rise, ocean dumping, transport of hazardous wastes, biodiversity, etc.) The Bank is developing its own environmental, economic, sectoral and investment policies and programs, with a view to minimizing possible adverse impacts on global systems. The Bank expects such issues to be addressed in regional, sectoral and project-specific EAs, where relevant and to the extent feasible. Where there are global issues, effort should be made to estimate for each project alternative, the relative magnitude of any contribution to global change for consideration in the selection of alternatives. The Bank's Environment Department (ENV) is available for consultation on these issues.

Institutional Aspects of Projects

Inter-Agency Coordination

10. Because environmental issues generally involve national, regional, and local government agencies, and cover a broad range of responsibilities (wildlife, health, water and land use, tourism, etc.), coordination among government agencies is crucial. This is best achieved through inter-agency meetings, convened by the proponent agency at key points, i.e, once the decision has been reached to carry out a formal environmental assessment, and once the draft EA report has been completed. The first meeting provides an opportunity to identify the issues, types of analysis required, sources of relevant expertise, responsibilities and schedule for the EA, and mitigatory measures to be considered.

Involvement of Affected Groups and Nongovernmental Organizations

11. The Bank expects the borrower to take the views of affected groups and local nongovernmental

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5/ In some cases, adherence to existing directives is an acceptable alternative to an EA (e.g., OPN 11.01, Guidelines for the Selection and Use of Pesticides in Bank-Financed Projects and their Procurement when Financed by the Bank, to be reissued as OD 4.00 Annex C, Agricultural Pest Management, and Selection and Use of Pesticides).

organizations (NGOs)[6] fully into account in project design and implementation, and in particular in the preparation of EAs. This is important in order to understand both the nature and extent of any social or environmental impact, and the acceptability of proposed mitigatory measures, particularly to affected groups. Consultations also are a valuable way to improve decision-making, to obtain feedback on the environmental assessment process and draft report, and to increase community cooperation in implementing the recommendations of the EA.

12. Such consultations should occur at least at two stages of the environmental assessment process for all projects that have been classified as Category A projects (pursuant to para. 22): a) after the EA category has been assigned, but before the terms of reference for the EA have been finalized, and b) once a draft EA has been prepared, but before it has been finalized. In addition, further consultations are encouraged at other appropriate points during EA preparation, after EA finalization and throughout project implementation. Updates and information feedback between meetings are best when systematic and routine. One approach which has proven effective in many countries for the initial consultation is to follow the first inter-agency meeting (para. 10), with a consultation session with affected groups and local NGOs. Where a Category A project has major social components which require consultations pursuant to other Bank Operational Directives[7], the socially-related consultations and environmental assessment consultations may be linked.

Disclosure of Information

13. In order for meaningful consultations to take place between the borrower and affected groups and local NGOs pursuant to paras. 11 and 12, it is necessary that the borrower provide relevant information prior to consultations in a timely manner and in a form that is meaningful for the groups being consulted. Such information should include: a) for the initial consultation, a summary of the project description and objectives, and the bases for classification of the project as a Category A, and b) once the draft EA report has been prepared, a summary of its conclusions in a form and language meaningful to the group being consulted. Any consultation should pay particular attention to those issues most likely to affect the people being consulted. In addition, both the draft and final EA reports shall be made available by the borrower at some public place reasonably accessible to affected groups and local NGOs for their review and comment. When the borrower finds it is unable to make a report available to its affected groups and local NGOs, the Bank will assess whether alternative means used to convey relevant information is sufficient to facilitate meaningful consultation for purposes of this paragraph.

14. Because an important purpose of the environmental assessment process is informed decision-making, the Task Manager for the project should ensure that when an EA report is received from a borrower, a copy is made available, without Bank endorsement, for all Executive Directors. It is Bank policy to request the borrower's advance permission for release of the report to the EDs since it is the borrower's property. The Task Manager should seek permission from the borrower for release of the report to the EDs as early as possible in the project cycle, normally when the need for an EA is identified but no later than when the terms of reference for the EA are discussed with the borrower (para. 28). If the borrower indicates that it is not prepared to release the EA report to the Executive Directors, the Bank should not proceed with further work on the project.

Strengthening Environmental Capabilities

15. The ultimate success of EA depends upon the development of environmental capability and understanding in the agencies concerned. Therefore, as part of the EA process, it is necessary to identify relevant environmental agencies and their capability for carrying out required EA activities. Projects with major potential impacts normally require the strengthening of several environmental functions, e.g., environmental monitoring, inspection, management of mitigatory measures, EA scientific and technical review,

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[6] See OD 14.70, Involving Nongovernmental Organizations in Bank-Supported Activities for the Bank's overall approach to NGOs.

[7] E.g., Involuntary Resettlement, OD 4.30, June, 1990; Indigenous Peoples, OD 4.20, expected September, 1991.

and cross-sectoral coordination. In addition, policy strengthening is often needed through the development of legal or regulatory measures, including incentives, to ensure adequate environmental performance standards. These functions are best located in one or more units and at one or more administrative levels, depending on the country and project. The first level of environmental involvement is on-site; a second, at the level of the implementing or executing agency, such as a Department of Agriculture, or Health; and a third at a central policy level, such as an environmental agency or other central policy-making body to oversee and coordinate intersectoral aspects. Early focus on institutional involvement in the EA process (a) helps ensure that the executing agency's and central policy entity's knowledge and perspectives are taken into account in the EA; (b) provides on-the-job training for staff; and (c) provides continuity for the implementation of the EA's recommendations. In addition, to help develop EA capability in the country, the Bank should (a) encourage the use of local expertise, and (b) promote EA training for local staff and consultants.[8/]

Sector and Financial Intermediary Lending

16. For sectoral investment loans and loans through financial intermediaries, subproject details may not be known at the time of project appraisal, and it therefore may not be possible for the borrower to prepare an EA as part of project preparation. In such cases, the project implementing institutions will need to screen proposed subprojects (see para. 22) and carry out appropriate environmental analyses prior to subloan approval. To ensure that this can be done, the Bank should appraise and strengthen where necessary the implementing agencies' capabilities to (a) screen subprojects, (b) obtain the necessary expertise for EA preparation, (c) review EA reports, (d) implement mitigation plans and (e) monitor environmental conditions during project implementation. The appraisal mission should develop clear arrangements with the borrower for carrying out those functions during the project, indicating the sources of required expertise and the proper division of responsibilities among the ultimate borrower, the financial intermediary or sector agency, and the agencies responsible for environmental management and regulation.[9/] These arrangements should ensure that subprojects that do not comply with accepted environmental standards are not financed under the project. In cases where subprojects are known prior to appraisal, they should be subjected to the normal procedures described in this directive.

Adjustment Lending

17. Sector and structural adjustment loans are covered by this OD. The Bank recognizes that the environmental impacts of adjustment loans may be difficult to assess, and that the speed and confidentiality of adjustment lending complicates the process. The Bank expects any obvious environmental and social implications to be analyzed to the extent possible during loan preparation. The analysis should focus on a) identification and mitigation of any obvious adverse environmental effects including cross-sectoral effects; b) identification of major negative impacts that may be suspected but are uncertain, and recommendations on how to monitor the situation; and c) identification of opportunities for environmental policy strengthening.[10/]

Global Environment Facility

18. GEF projects or GEF components of normal projects are subject to the requirement of this OD.

8/ Further guidance on institutional strengthening is in the EA Sourcebook.

9/ Further guidance is provided in the EA Sourcebook on appraising environmental aspects of sector and financial intermediary lending.

10/ Such loans also are subject to the general policies in OMS 2.36, Environmental aspects of Bank Work (to be reissued as OD 4.00, Environmental Policies).

Environmental Advisory Panels

19. For highly risky and contentious projects with serious and multi-dimensional environmental concerns, the borrower should normally engage an advisory panel of independent, internationally recognized, environmental specialists to advise on: a) key issues and methodology for preparing the EA, b) recommendations and finding of the draft EA, c) implementation of final EA recommendations and d) development of environmental capacity in the implementing agency.[11/]

EA Procedures

Overview

20. Though EA preparation is the responsibility of the borrower, the Bank's Task Manager (TM) assists and monitors the EA process, with support from the Regional Environment Division (RED), and the Environment Department (ENV) as needed. The borrower and the Bank should agree as early as possible after issuance of the Initial Executive Project Summary (IEPS) on the selection of consultants or borrower staff to prepare the EA, and the EA procedures, schedule, and outline. Major steps in the EA process include: (a) screening, (b) decisions based on the IEPS, (c) notification to the Board through the Monthly Operational Summary (MOS), (d) preparation of terms of reference (TORs) for the EA, (e) EA preparation, (f) EA review and incorporation of environmental measures into the project, (g) supervision, and (h) ex-post evaluation.

21. Since project and country conditions, national legislation, and institutional experience vary among borrowers, both the borrower and the Bank must exercise judgement in using these procedures to design and implement projects which are both environmentally and economically sound, and consistent with the environmental laws, policies, and procedures of the borrower. The Environment Department (ENV), Legal Department, and the REDs maintain information on these requirements.

Screening

22. Projects should be screened for environmental issues at identification and assigned, prior to issuance of the IEPS, to one of three categories: A, B or C, commensurate with expected environmental impacts (Annex A5).[12/]

Category A: A complete environmental assessment is required.
Category B: Although a complete EA is not required, environmental analysis is required.
Category C: No environmental analysis required.

23. The EA category should be assigned by the TM, with the concurrence of the RED, in consultation with ENV. The categorization should be based on the best judgment of Bank environmental staff.[13/] In projects with several components, those components with the most serious environmental issues should receive principal focus in the screening process and subsequent environmental assessment or other analysis. The results of the screening should be reported on a separate environmental data sheet (see Annex A6 for sample

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11/ See OD 4.00, Annex B, Environmental Policy for Dam and Reservoir Projects, para. 18, for more detail on the selection and functions of the panel.

12/ An environmental project (former Category D) may fall into any of the categories. Projects classified in Category D at the time of issue of this OD must be reclassified by the TM with concurrence from the RED.

13/ The EA Sourcebook gives further guidance on screening.

data sheet).

Revision of EA Categories

24. The EA category assigned to the project as part of the screening is based on best judgement and information then available at that early stage. TMs, with concurrence of the REDs, and in consultation with ENV, should adjust the category up or down if the project is modified or new information becomes available to justify reclassification. Reasons for any reclassification should be recorded in the environmental data sheet (see Annex 6).

Emergency Recovery Projects

25. Because emergency recovery projects need to be processed rapidly, and seek mainly to restore existing facilities, they normally would not require a formal environmental assessment. However, the extent to which the emergency was precipitated or exacerbated by inappropriate environmental practices should be determined, and corrective measures built into either the emergency project or a future lending operation. [14]

Initial Executive Project Summary (IEPS)

26. In the IEPS, the TM, in consultation with the RED and ENV, should (a) identify key environmental issues, (b) indicate the category (A-C) and the type of environmental work needed, and (c) provide a preliminary EA schedule. In exceptional cases, if an EA cannot be available prior to appraisal, the IEPS should propose special procedures to address the situation. The IEPS meeting should confirm the type, timing, and issues of environmental analysis.

Monthly Operational Summary

27. The TM should ensure that the Monthly Operational Summary (MOS), which is used to alert the Executive Directors to forthcoming projects, contains the following information in the environmental data sheet (see Annex 6): (a) the category assigned (A-C); (b) the main issues to be examined; (c) whether agreement with the borrower has been reached on EA preparation; and (d) the EA schedule. The MOS entry should be updated, as needed, to reflect changes in the environmental data sheet, including progress of the EA, any reclassification of categories, and related Bank and borrower decisions.

Preparation of TORs for the EA

28. Following the IEPS meeting, the Bank should discuss with the borrower the scope of the EA, and assist the borrower, as necessary, in preparing TORs for the EA. For this purpose, a field visit by Bank environmental staff or environmental consultants is normally required. The Bank should ensure that the TORs provide for adequate inter-agency coordination (para. 10) and consultation with affected groups and local NGOs (paras. 11 and 12). For category A projects, it is advisable for Bank staff to attend the scoping and draft EA review meetings.

EA Preparation

29. EA should be closely linked to the feasibility study or prepared in parallel. An EA for a major project typically takes 6-18 months to prepare and review. EA drafts should be available to Bank staff at key points in the project cycle, and to other groups as required in paras. 13 and 14. The final EA should be received by the Bank one month prior to departure of the appraisal mission, and a summary circulated with the FEPS/white cover SAR, to minimize the risk of project design changes and resultant delays at a late stage.

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[14] See OD 8.50. Emergency Recovery Assistance.

30. The EA should form part of the overall feasibility study, or project preparation work, so that the EA's findings are directly integrated into project design. When the EA is prepared separately by specialists, they should liaise closely with the project preparation or feasibility teams. For projects with major adverse environmental impacts, such as large dams or projects involving large scale resettlement, the borrower should retain independent EA experts not affiliated with the project. Borrowers may request Bank assistance for financing EAs through a Project Preparation Facility (PPF)[15] advance, or from the Technical Assistance Grant Program for the Environment.

31. For some projects, a full year of baseline data is essential to capture seasonal effects of certain environmental phenomena, such as rainy and dry seasons or species migrations. In contrast, other effects, e.g., hydroclimatic variation, may require multi-year data. However, so as not to delay critical project decisions in these cases, short-term monitoring should be used to provide conservative estimates of environmental impacts where such short-term data can be a surrogate for annual data, while longer-term data collection is being undertaken. Since special care in designing the baseline monitoring program is warranted, the borrower should be encouraged to discuss the matter with the Bank.

EA Review and Project Appraisal

32. For category A projects, the borrower should submit the final EA report to the Bank at least one month prior to departure of the Bank's appraisal mission. This report should follow the sample outline for project-specific EA-reports provided in Annex A2, to the extent relevant, and should include a separate English summary.

33. The Final Executive Project Summary (FEPS) should summarize the EA's status and describe how major environmental issues have been resolved or are to be addressed, noting any proposed conditionality. Prior to the FEPS meeting, the RED should review and comment on the EA, with copies to ENV. If the RED is not satisfied with the EA, it may recommend to the Country Department that a) the appraisal mission be postponed, b) the mission be considered as pre-appraisal, or c) certain issues be re-examined during the appraisal mission. The appraisal mission should review both the procedural and substantive elements of the EA with the borrower, resolve any issues, assess the adequacy of the institutions responsible for environmental management in light of the EA's findings, ensure the mitigation plan is adequately budgeted, and determine if the EA's recommendations are properly addressed in project design and economic analysis.

Loan Documents

34. The findings of the EA process should be summarized in the text of SAR, and in the Memorandum and Recommendation of the President. An SAR annex should be provided for category A projects which summarizes the EA more fully, covering, inter alia, environmental baseline conditions, alternatives considered, preventive, mitigatory and compensatory actions, capability of environmental units and measures to strengthen them, environmental monitoring arrangements, and the borrower's consultations with affected groups and NGOs. These factors will provide the basis for the RED's formal environmental clearance, in consultation with ENV, prior to the authorization of negotiations by the Regional Vice President. Measures critical to sound project implementation may require specific loan conditionality.

Supervision

35. EA recommendations provide the basis for supervising the environmental aspects of the project during implementation. Compliance with environmental commitments, the status of mitigatory measures, and the findings of monitoring programs should be part of borrower reporting requirements and project supervision. When major issues arise, special supervision missions with adequate environmental expertise should be

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15/ See OMS 2.15, Project Preparation Facility, to be reissued as OD 8.00.

programmed and budgeted, where possible, in advance.

Ex Post Evaluation

36. The project completion report[16] submitted to the Operations Evaluation Department should evaluate (a) environmental impacts, noting whether they were anticipated in the EA report, and (b) the effectiveness of mitigatory measures taken, and (c) institutional development and training.

16/ See the OPNSV memoranda, Guidelines for Preparing Project Completion Reports, June 7, 1989, and OMS 3.58, General Guidelines for Preparing Project Completion Reports, which are to be combined and reissued as OD 13.55, Project Completion Reports.

The Area of Influence of a Project

The area of influence of a project as defined for the purposes of this OD includes:

1. The catchments contributing to the project, or to any of the project's ancillary features, from water divide to the coast, and offshore.

2. All ancillary aspects of the project such as access, maintenance or inspection roads, transmission corridors, pipelines, canals, tunnels, relocation sites, borrow and disposal areas, and construction camps.

3. Offsite areas used for the project, such as for resettlement or compensation.

4. The airsheds of the above, where airborne materials, such as smoke, fumes, dust, or pollutants may enter or leave the project area.

5. Migratory or staging routes of humans, wildlife or fish, including where they relate to public health, economics or environmental quality.

6. Significant secondary, cumulative, or other induced impacts of the project and of any significant ancillary activities. Non-project activities indirectly stimulated by any part of the project are specifically included, such as squatter settlements or shanty towns adjacent to the new project area, or unplanned settlement along project-financed access roads.

7. This is an inclusive definition providing for maximum flexibility on the part of the EA specialists, who should use best judgment as to where to focus most attention.

Sample Outline of a Project-Specific EA Report

1. Formal EA reports should be concise and focussed on the significant environmental issues. The detail and sophistication of report should be commensurate with the potential impacts. The target audience should be project designers, implementing agencies, and borrower and Bank staff.

2. The EA report should include:

(a) Executive Summary. Concise discussion of significant findings and recommended actions.

(b) Policy, legal, and administrative framework within which the EA is prepared. The environmental requirements of any cofinanciers should be explained.

(c) Project description in a geographic, ecological, social, and temporal context, including any off-site investments that may be required by the project (e.g. dedicated pipelines, access roads, power plants, water supply, housing, and raw material and product storage facilities).

(d) Baseline Data. Dimensions of the study area and description of relevant physical, biological, and socio-economic conditions, including any changes anticipated before the project commences. Current and proposed development activities within the project area (but not directly connected to the project) should also be taken into account.

(e) Environmental Impacts. The positive and negative impacts likely to result from the proposed project should be identified and assessed. Mitigation measures and the residual impacts that cannot be mitigated should be identified. Opportunities for environmental enhancement should be explored. The extent and quality of available data, key data gaps, and uncertainties associated with predictions should be identified/estimated. Topics that do not require further attention should be specified.

(f) Analysis of Alternatives. Proposed investment design, site, technology, and operational alternatives should be compared systematically in terms of their potential environmental impacts; capital and recurrent costs; suitability under local conditions; and institutional, training, and monitoring requirements. To the extent possible, for each of the alternatives, the environmental costs and benefits should be quantified, and economic values attached where feasible. The basis for the selection of the alternative proposed for the project design must be stated.

(g) Mitigation Plan. Feasible and cost-effective measures which may reduce potentially significant adverse environmental impacts to acceptable levels should be proposed, and the potential environmental impacts, capital and recurrent costs, and institutional and training requirements of those measures estimated. The plan (sometimes known as an "action plan" or "environmental mitigation or management plan" outlined in annex A3) should provide details on proposed work programs and schedules, to ensure that the proposed environmental actions are in phase with engineering and other project activities throughout implementation. The plan should consider compensatory measures if mitigation measures are not feasible or cost-effective.

(h) Environmental Management and Training. The existence, role, and capability of environmental units at the on-site, agency, and ministry level should be assessed, and recommendations made concerning the establishment and/or expansion of such units, and the training of staff, to the point that EA recommendations can be implemented.

(i) Monitoring Plan regarding environmental impacts and performance. The plan should specify the type of monitoring, who would do it, how much it would cost, and what other inputs (e.g., training) are necessary.

Appendices

(i) List of EA preparers--individuals and organizations.

(ii) References--written materials used in study preparation. This is especially important given the large amount of unpublished documentation often used

(iii) Record of Inter-Agency/Forum/ Consultation Meetings, including list of both invitees and attendees. The record of consultations to obtain the informed views of the affected people and local NGOs should be included. Where the views of affected groups and local NGOs were obtained by other means, these should be specified.

Checklist of Potential Issues for an EA

1. Where applicable, EAs should address the following issues, which are subject to the Bank policies and guidelines identified below.

(a) Agrochemicals. The Bank promotes the use of integrated pest management (IPM) and the careful selection, application, and disposal of pesticides (see OPN 11.01, Guidelines for the Selection and Use of Pesticides in Bank-Financed Projects and Their Procurement when Financed by the Bank, to be reissued as OD 4.00, Annex C, Agricultural Pest Management, and Selection and Use of Pesticides). The use of fertilizers, due to their impacts on surface and groundwater quality, must also be carefully assessed.

(b) Biological Diversity. The Bank promotes conservation of endangered plant and animal species, critical habitats, and protected areas (para. 9b, OMS 2.36, Environmental Aspects of Bank Work, and OPN 11.02, Wildlands: Their Protection and Management in Economic Development, to be reissued as OD 4.00, Annex D, Wildlands: Their Protection and Management).

(c) Coastal and Marine Resources Management. Guidelines are available from the Environmental Department (ENV) on the planning and management of coastal marine resources including coral reefs, mangroves, and wetlands.

(d) Cultural Properties. OPN 11.03, Management of Cultural Property in Bank-Financed Projects (to be reissued as OD 4.50, Cultural Property), confirms the Bank's commitment to actively protect archaeological sites, historic monuments, and historic settlements.

(e) Dams and Reservoirs. OD 4.00, Annex B, Environmental Policy for Dam and Reservoir Projects, provides specific guidance for addressing environmental issues in the planning, implementation, and operation of dam and reservoir projects.

(f) Hazardous and Toxic Materials. Guidelines are available from ENV on the safe manufacture, use, transport, storage, and disposal of hazardous and toxic materials.

(g) Induced Development and Other Socio-Cultural Aspects. Secondary growth of settlements and infrastructure, often referred to as "induced development" or "boomtown" effects, can have major indirect environmental impacts, which relatively weak local governments may have difficulty addressing.

(h) Industrial Hazards. All energy and industry projects should include a formal plan to prevent and manage industrial hazards. (See Techniques of Assessing Industrial Hazards - A Manual, World Bank Technical Paper No. 55.)

(i) International Treaties and Agreements on the Environment Natural Resources EAs should review the status and application of such current and pending treaties and agreements, including their notification requirements. The Legal Department maintains a list of international treaties, and could obtain, whenever required, information on applicable law in individual countries.

(j) International Waterways. OMS 2.32, Projects on International Waterways (to be re-issued as OD 7.50), provides guidance. This OMS exempts from notification requirements rehabilitation projects which will not affect the quality or quantity of water flows.

(k) Involuntary Resettlement. OD 4.30, issued June 29, 1990. and OPN 10.08, Operations Issues in the Treatment of Involuntary Resettlement in Bank-Financed Projects, June 29, 1990.

(l) Land Settlement. Due to the complex physical, biological, socio-economic, and cultural impacts, land settlement should generally be carefully reviewed (see OD 4.31, Land Settlement, to be issued).

(m) Natural Hazards. EAs should review whether the project may be affected by natural hazards (e.g., earthquakes, floods, volcanic activity), and should propose specific measures to address these concerns when appropriate (see OD 8.50, Emergency Recovery Assistance.

(n) Occupational Health and Safety. All industry and energy projects, and projects in other sectors where relevant, should include a formal plan to promote occupational health and safety (Occupational Health and Safety Guidelines, World Bank, 1988).

(o) Indigenous Peoples. OMS 2.34, Tribal People in Bank-Financed Projects (to be reissued as OD 4.40, Indigenous People), provides specific guidance for addressing the rights of indigenous peoples, including traditional land and water rights.

(p) Tropical Forests. The Bank's July 1991 Forest Policy should be followed. OPN 11.02, Wildlands: Their Protection and Management in Economic Development (to be reissued as OD 4.00, Annex D), also addresses issues relating to tropical forests.

(q) Watersheds. Bank policy is to promote protection and management of watersheds as an element of lending operations for dams, reservoirs, and irrigation systems (OD 4.00, Annex B, Environmental Policy for Dam and Reservoir Projects, para. 6).

(r) Wetlands. The Bank promotes conservation and management of wetlands (e.g., estuaries, lakes, mangroves, marshes, and swamps). This is covered by OPN 11.02 on Wildlands (see (s) below).

(s) Wildlands. The Bank is committed to protect wildlands, including through compensatory measures when lending could result in adverse impacts (see OPN 11.02, Wildlands: Their Protection and Management in Economic Development, to be reissued as OD 4.00, Annex D, Wildlands: Their Protection and Management).

Sample Environmental Mitigation or Environmental Management Plan

1. A project's mitigation or environmental management plan consists of the set of measures to be taken during implementation and operation to eliminate or offset adverse environmental impacts or reduce them to acceptable levels, together with the actions which need to be taken to implement them. Mitigation plans are essential elements of category A projects (see Annex A5), and may on occasion be sufficient for category B projects on their own. During preparation of the mitigation plan, project sponsors and their EA design team identify the set of responses to potential adverse impacts. They determine the requirements to ensure that those responses are made effectively and in a timely manner and describe the means for meeting those requirements.

2. A mitigation or management plan should include the following items:

(a) Identification and summary of all anticipated significant adverse environmental impacts.

(b) Description and technical details for each mitigation measure, including the type of impact to which it is related, the conditions under which it is required (e.g: continuously or in the event of contingencies), together with designs, equipment descriptions, and operating procedures as appropriate;

(c) Institutional arrangements: the assignment of the various responsibilities for carrying out the mitigatory measures, including operation, supervision, enforcement, monitoring of implementation, remedial action, financing, reporting and staff training.

(d) Implementation schedule for measures which must be carried out as part of the project, showing phasing and coordination with overall project implementation plans;

(e) Monitoring and reporting procedures to ensure early detection of conditions which necessitate particular mitigation measures, and to provide information on progress and results of mitigation.

(f) Cost estimates and sources of funds for both initial investment and recurring expenses for implementing the mitigation plan should also be integrated into the total project cost tables.

3. Most mitigation plans cover one or more of the additional topics identified below, to strengthen environmental management capability in the responsible implementing agencies:

(a) technical assistance programs

(b) staff development

(c) procurement of equipment and supplies

(d) organizational changes

4. The borrower's decision to proceed with a project, and the Bank's decision to support it, will be in part predicated on the expectation that the mitigation plan will be executed effectively. Consequently, it is important that the plan be integrated into the overall project planning, design, budget, and implementation.

This should be achieved by establishing the mitigation plan as a component of the project. This ensures that the plan will receive funding and supervision along with the other investment components.

5. There should be specific links for (i) funding; (ii) management and training (strengthening local capabilities), and (iii) monitoring. The purpose of the first link is to ensure proposed actions are adequately financed. The second link helps embed training, technical assistance, staffing and other institutional strengthening needed to implement the mitigatory measures in the overall management plan. The third link is necessary to provide a critical path for implementation and to enable sponsors and the Bank to evaluate the success of mitigation as part of project supervision and as a means to improve future projects. These linkages may be part of conditionality in loan agreements or in the minutes of negotiations.

Environmental Screening

Introduction

1. Projects should be screened at identification by the TM, agreed to by the RED, in consultation with ENV, and, prior to the IEPS, assigned to one of three categories: A, B or C. The justification for the classification should be published in the MOS summary sheet (Annex 6). The EA categorization indicates the level of environmental analysis needed: best professional judgement is essential throughout.

2. ENV should be kept fully informed of screening decisions and subsequent environmental assessments or analyses, and environmental reviews. As it determines appropriate, ENV may pursue special consultations with the corresponding RED and TM on specific issues.

Screening Criteria

3. The categorization should be based on best judgment of Bank environmental staff. Four main criteria relevant in reaching judgments for "A" categories are: a) location; b) scale; c) sensitivity of the issues; and d) sector or type of project.

a) **Location**: If the project may harm an environmentally sensitive area (such as mangroves, tropical forest, conservation units, or wetlands), then the project is likely to be an A.

b) **Scale**: If the scale of the project is large, then it is likely to be an A; if the project is small it may be a B or even a C project. Determining what constitutes a large and small project, and evaluating the potential impacts of medium scale projects, requires best judgment.

c) **Sensitivity**: If the environmental issues are sensitive, then the project is likely to be an A. Thus, such issues as irreversible impacts, vulnerable ethnic minorities, involuntary resettlement, and impacts on tropical forest indicate that the project would be an A.

d) **Sector**: Bank experience indicates that projects in some sectors generally require more environmental work than projects in other sectors. The levels of environmental work required for certain sectors are indicated below. These lists stress the need for best judgment.

4. Category B is a broad category containing projects with adverse environmental impacts, but less significant than those of category A projects. Because of the adverse impacts, environmental analysis is needed. Such analysis is less detailed, shorter, and less resource-intensive than category A assessments, but is still effective in design improvements. The minimal category B project requirement is the preparation of a mitigation plan, outlined in Annex 4. Category B environmental analyses may be a separate chapter or volume of the project preparation or feasibility study. They are often the subject of a separate annex in the SAR, and should be summarized in the text of the SAR. Some Bs may require a separate environmental report. As with category A projects, project appraisal is possible only after the environmental analysis has been received by the Bank.

5. Category C projects have negligible or no adverse impacts. Environmental analysis is not required for such projects.

6. EA normally deals with the whole project, but focuses most time and attention on the components with the main negative impacts, and their links with the rest of the project. Dual categories (eg: A/C) should not be used. Projects are categorized according to the component with the greatest adverse impact. A relatively benign project with a single category A component is therefore a category A project. Any of the above three categories may contain environmentally benign components.

7. Category A Projects/Components:

A full EA is required as the project is likely to have significant adverse impacts, which may be sensitive, irreversible, difficult to quantify, and diverse. The impacts are likely to be comprehensive, broad, sector-wide, or precedent-setting. Impacts generally result from a major component of the project and affect the area as a whole or an entire sector.

(i) Aquaculture/mariculture;
(ii) Dams and reservoirs;
(iii) Electrical transmission, large scale;
(iv) Production forestry projects (those producing timber); including tree plantations (eg: for charcoal, timber, pulp)
(v) Industrial plants (large scale) and industrial estates;
(vi) Irrigation, drainage, channel training, and flood control;
(vii) Land clearance and leveling;
(viii) Mineral development (including oil and gas);
(ix) Pipelines (oil, gas, and water);
(x) Port and harbor development;
(xi) Reclamation and new land development;
(xii) Resettlement, and all projects with negative impacts on people
(xiii) River basin development;
(xiv) Rural roads, including upgrading;
(xv) Thermal and hydropower development;
(xvi) Tourism, large scale;
(xvii) Transportation (airports, railways, roads, waterways), including substantial upgrading;
(xviii) Urban development, large scale;
(xix) Urban water supply and sanitation, large scale;
(xx) Manufacture, transportation, and use of pesticides or other hazardous and/or toxic materials; and
(xxi) Projects which pose serious accident risks.

8. Category B Projects/Components:

More limited environmental analysis is required, as the project is likely to have adverse environmental impacts, but less significant than category A impacts. Few if any category B impacts are irreversible; these impacts are not as sensitive, numerous, major or diverse as category A impacts. Impacts are more localized than category A impacts, and result from a particular component, or aspect of the project, rather than from the whole operation.

(i) Agroindustries (small scale);
(ii) Electrical transmission (small scale);
(iii) Industries (small scale);

(iv) Irrigation and drainage (small scale);
(v) Mini hydro-Power;
(vi) Public facilities;
(vii) Renewable energy; small scale;
(viii) Rural electrification; small scale
(ix) Telecommunications; small scale
(x) Tourism (small scale);
(xi) Urban development (small scale); and sites and services
(xii) Rural water supply and sanitation; small scale
(xiii) Watershed projects; management or rehabilitation, small scale
(xiv) Rehabilitation, maintenance and upgrading projects, small scale.

9. Category C Projects/Components:

Environmental analysis is normally unnecessary, because the project is unlikely to have adverse impacts. Professional judgment finds the project to have negligible or insignificant environmental impacts.

(i) Education (except school construction);
(ii) Family planning;
(iii) Health (except hospital construction);
(iv) Nutrition;
(v) Institutional development;
(vi) Technical assistance;
(vii) Most human resource projects; except for large hospitals and hotels.

SAMPLE ENVIRONMENTAL DATA SHEET FOR CATEGORY A AND B PROJECTS
(To be kept up to date in the MOS)

Country : ID :
Project : Cost :
Board Date : Loan/Credit Amount :

Sector : Division :
Lending Instruments :

PROJECTED DATE FOR COMPLETION OF ENVIRONMENTAL ASSESSMENT:

Major Project Components:

[Short description of project components]

Major Environmental Issues:

[Describes major environmental issues identified or suspected in project]

Other Environmental Issues:

[Describes environmental issues of lesser scope associated with the project]

Proposed Actions:

[Describes actions proposed to mitigate environmental issues described above]

Justification/Rationale for Initial Environmental Category:

[Presents reasons for environmental categorization; e.g. "This is a B project rather than an A or C because....".]

Justification/Rationale for Any Reclassification:

[Includes explanation of any changes in environmental category (e.g., design of project mitigates or
exacerbates major issues, moving project from A to B, B to C, or reverse.]

Status of Formal Environmental Assessment [applicable to Category A]:

[Indicates expected date of completion or current status of Environmental Assessment]

Remarks:

[Status of any other environmental studies; local groups consulted; local NGOs consulted; whether Borrower has given permission to release EA, etc.]

Signed by: (Operations Chief) (Regional Environmental Chief)

Review of Bank's Experience with Environmental Assessment

Introduction

1. The purposes of this review are : a) to discover the extent to which environmental assessments (EAs) have resulted in changes in project design that avoid or mitigate the problems identified in the EA; and (b) to see what progress has been made toward operationalizing the criterion of sustainability in the EA experience (Annex 1). This review is not a detailed technical review of projects, but an overview of how environmental assessments are influencing project design. Annex 2 (available on request from ENV) consists of individual reviews of twenty projects.

2. The two main conclusions of the review are : first, that EA has frequently led to mitigatory changes in project design, and that such engineering changes have been the principal mode of dealing with environmental issues. Since design changes are usually not expensive when done very early, there is usually no impact on C/B analysis when engineering specifications are altered for environmental reasons. Resettlement is of course an exception, being both expensive and mandatory. Treating environmental issues in engineering specifications, on analogy with safety, is by and large a good procedure in that it pushes environmental considerations as far "upstream" as possible, and second, that so far there has been very little incorporation of the sustainability criterion in EA. This is not surprising, given that guidelines for operationalizing the goal of sustainability have not yet been developed. This study therefore made a first attempt at at such operational guidelines (see Annex 1). Much more remains to be done, and this work is recommended as a priority for ENV. The idea of sustainability has been incorporated indirectly in some EAs through the concept of carrying capacity applied most directly to rangelands in livestock projects, but also imaginatively extended to coal-fired power plants, and industrial activity in general in several of the EAs reviewed.

3 Of the 146 completed environmental reports listed in the ENVIS database, 20 EAs for Category A projects (i.e., projects likely to have significant major environmental impacts) were available for review, and are listed in Figure 1. Of these 20 projects, two were in LAC, four in Africa, two in EMENA, and twelve in Asia.

Figure 1: LIST OF PROJECTS REVIEWED [1] (In Annex 2)

1. Ecuador -- Lower Guayas Flood Control
2. Uganda -- Livestock Services
3. Botswana -- Tuli Block Roads
4. Uganda -- Power Project III
5. Nigeria -- OSO Condensate (offshore oil)
6. China -- Daguanba Multipurpose Project
7. China -- Shuikou Hydroelectric
8. China -- Yanshi Thermal Power
9. India -- Second Petrochemicals Project
10. India -- Private Power Utilities (Tata Electric)

11. Bangladesh -- Jamuna Multipurpose Bridge
12. Pakistan -- Fourth Karachi Port Project
13. Bolivia -- Bolivian Pipeline and Power Plant
14. Thailand -- Third Power System Development Project
15. Cyprus -- Southeast Coast Sewerage and Drainage Project
16. India -- Second Private Power Utilities -- Dahanu Station
17. China -- Ertan Hydroelectric Project
18. India -- Gas Flaring Reduction Project
19. Korea -- Seoul Solid Waste Management Program
20. Indonesia -- Java (Suralaya) Thermal Power Plant

Conclusions

Lack of Access

4. Information on EAs is difficult to extract from the Bank's system of internal records. The Bank's internal documentation system is inadequate for the following four reasons: a) some regional environmental units keep their own records, while others deposit the EAs in the regional information centers; b) regional information centers often file EAs with correspondence; c) there is no separate documentation category for EAs; and d) the project identification number used in ENVIS does not enable librarians or task managers to locate project files.

5. Clearly, the Bank's internal documentation system needs improvement. EAs should have a filing category of their own, even if they are double filed as an annex to the SAR, and should be automatically filed with the regional information centers upon receipt by the Bank, so that they become available on request. As a result, ENVAP is allocating space for a complete collection of EAs and related materials. This will form the basis fo dissemination of best practice and for subsequent reviews.

Informal Environmental Inputs.

6. In many cases (see Annex 2), EAs or less formal environmental reviews completed prior to OD 4.00 have

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[1] This sample is unlikely to be fully representative, but comprises all EA category A project reports available. Therefore, the conclusions are tentative and subject to modification as more EAs are reviewed. This review does not examine the major inter-regional inconsistencies of use of the "A" category, nor the wide variation of environmental treatment of category "B" projects. This review is based on the information in EAs and SARs, supplemented by interviews with Bank staff and consultants. No site visits were undertaken; such visits would be essential for a thorough review of the EA process, especially monitoring of compliance, which most of those interviewed feel is the key to the whole EA effort.

resulted in improvement of project design and implementation. Generally these environmentally oriented improvements are treated as a part of sound project design, as are engineering standards, and are not costed independently as separate environmental investments. This approach has the major advantage of placing environmental considerations far upstream in the project cycle. However, it is not clear whether environmental criteria should be given the same weight as safety criteria, or the extent to which they should be kept distinct and subjected to a separate auxiliary cost/benefit analysis. In many cases the costs of including an environmental correction are small and would not affect the overall cost/benefit analysis. In other cases, these costs may be large but unavoidable e.g., resettlement costs. If the environmental costs are either small or non-discretionary, including them with general project costs seems justified. If they are large and discretionary, however, they should be subjected to separate cost/benefit analysis.

Sustainability.

7. Sustainability is mandated for all Bank-supported projects by OMS 2.36 of 1984, a requirement reinforced by OD 4. This review concludes that addressing sustainability can be a fundamental contribution of a successful EA and can improve the economic development process as a whole. However, the term "sustainability" has not generally been used explicitly in project evaluation. The idea may be reflected in specific environmental recommendations, e.g., that livestock development projects include a study of carrying capacity of the rangelands. **Possibly the most important conclusion of this review is that work on defining the criteria for sustainability at the policy and project levels is required.** ENV proposes to lead on this major need. This is discussed in Annex 1.

Engineering Specifications.

8. The main observation from the experience summarized in Annex 2 is that engineering specifications defining what is an acceptable bridge, dam, road, port, etc. have long provided implicit environmental assessment. Environmental standards and safety standards are similar in many ways, particularly concerning the level of uncertainty and the need to calculate for a margin of error. For safety standards, engineers take a reasonable worst case scenario and multiply it by a safety factor. For example, they might calculate the strength required for a bridge to support all lanes filled with loaded busses during a 50-year hurricane, and then design the bridge with double or triple that strength. The use of such broad rules of thumb have resulted in great discrepancies in the amounts of money spent to save a statistical life.

9. Economists argue that to maximize the number of statistical lives saved we should equate the marginal lives saved per dollar invested in all alternatives. Although a logical approach, the information requirements for such calculations are much more severe than for the more intuitive and piecemeal approach to safety standards described above. Most people may have an intuitive notion of how safe a bridge should be, and would not need to resubmit that judgment to a cost/benefit study every time another bridge is built. However, for many environmental consequences we do not have a good intuitive feel for their severity or likelihood. One role of EA therefore would be to gain enough familiarity with environmental consequences that some of them can routinely be treated through engineering specifications, at the earliest stage of the project cycle.

Need for Environmental Cost/Benefit.

10. From the cases reviewed it is also clear that even a "clean" project in an engineering sense can affect an ecological function, and that function must be explicitly or implicitly valued and weighed against the value of the project. For example, loss of river navigability, loss of fisheries, loss of agricultural land, loss of whitewater rapids, disruption of a local community, etc., may result from the construction of a hydropower dam. These effects cannot be addressed through engineering specifications, and in some cases the benefits of the dam will not outweigh the loss of these ecological and social benefits. Here the EA must include an explicit cost/benefit analysis. Whether

the EA treats environmental considerations implicitly as engineering criteria, or explicitly as competing values in a cost/benefit study, the discipline of EA is indispensable. Allowing for the limited information available for review, and for the time required to implement and fine-tune any new procedure, experience to date suggests that EAs for Bank projects are resulting in improvements in project design and implementation.

EA Reclassification.

11. One effect of EA which this review did not address is the number of A-projects which have been reclassified as B-projects as a result of incorporating features identified in the EA (e.g., Tanzania Forestry and Nigeria Fadama Irrigation). A more thorough review of A-projects which have subsequently been reclassified to B as a result of modifications inspired by EA may assist in determining the extent to which the EA process has affected project design.

12. For example, a task manager might want to avoid the expense and time required to conduct a full EA, and may therefore design the project to reduce environmental impacts. There may well be a tacit bargaining process in which the task manager is willing to alter the project in such a way that it would be classified as a B rather than an A. Thus, the impact of requiring EAs on the total environmental sensitivity of Bank project design is more extensive than may be evident from the recommendations contained in actual completed EAs. For these reasons, the finetuned EA OD contains a new paragraph facilitating the reclassification -- up or down -- of the EA category.

13. It should also be noted that the existence of special funds earmarked to finance environmental measures may tend to create an incentive to pull specifically environmental features out of the engineering definition of an acceptable project in order to treat them as environmental "add ons" and therefore eligible for the special funds. Such funds would therefore provide a perverse incentive by pushing environmental considerations downstream and later in the project cycle.

Project-level Guides for Environmental Sustainability

14. The Bank's OD on environmental assessment states that sustainability is a requirement that Bank projects must meet. "The purpose of EA is to ensure that the development options under consideration are environmentally sound and sustainable...." (OD 4.00 para. 3, October 1989). This mandate does not treat sustainability as one value to be traded off against others in an economic analysis. Rather, it states that the "development options under consideration" must be sustainable, and that any non-sunstainable project should not even be included among the options to be ranked economically.

15. Some guidance on the operational meaning of sustainability was given in OMS 2.36, (May, 1984) in para. 9a under the general heading of The Bank's Environmental Policies: "The Bank endeavors to ensure that each project affecting renewable natural resources (e.g., as a sink for residues or as a source of raw materials) does not exceed the regenerative capacities of the environment." The following guides seek to elaborate this principle and extend it, in so far as possible, to nonrenewable resources. It is a matter of judgment for EA teams to apply the rules of thumb described below in a reasonable way to diverse projects. Where the EA team finds wide divergence from sustainability, it should work with the project designers to narrow the gap as early in the project cycle as possible.

16. The use of the terms "assimilative or regenerative capacity" does not necessarily imply that there is a discontinuous threshold of use intensity below which there is no effect on the ecosystem. Capacity may be thought of as a level of a particular ecosystem service beyond which further use will cause unacceptable (e.g., cumulative, irreversible, excessive) degradation of the ecosystem and loss of its future services. Capacity also refers to the affected ecosystem as a whole, not to individual species in isolation.

17. **Output Guide:** Waste emissions from a project should be within the assimilative capacity of the local environment to absorb without unacceptable degradation of its future waste absorptive capacity or other important services.

18. **Input Guide:** (a) harvest rates of renewable resource inputs should be within regenerative capacity of the natural system that generates them; (b) depletion rates of nonrenewable resource inputs should be equal to the rate at which renewable substitutes are developed by human invention and investment.

Discussion: Output Guide. If each project obeyed this rule then the sum of all projects would also conform to the rule. In other words, the sum of projects may obey the rule even though a particular project fails to. Of course, it is easier for earlier projects to meet this condition than for later ones, as assimilative capacities decline over time. There are several ways to approach this; once capacity has been reached, a new project might be "paired" with an old one that is removed to make room for it. Alternatively, a new project may be paired with a second new project which absorbs waste outputs up to the amount emitted by the first new project. Under the "bubble concept", such rules are enforced through trading permits, which allows for effective pairing of projects in the compensatory manner just described. The total emissions for an area must be set collectively, but the market can allocate that total among competing uses by exchange of emission permits.

19. **Input Guide.** The inputs of interest are the primary inputs from nature, not the interindustry or intermediate inputs from other firms. This rule then only applies to the extractive sector, whereas the previous rule applies to all sectors. Inputs from nature are of two kinds, renewable and nonrenewable.

20. **Renewable Inputs:** For renewable inputs, harvest rates should not exceed regeneration rates. In other words sustainable yield exploitation should be the rule. There are many difficulties in defining sustainable yield, just as there are many analogous difficulties in defining income. But to answer the unavoidable question -- How much can we consume this year without reducing our capacity to produce next year? -- requires that we at least give a prudent rule of thumb.

21. The sustainable yield concept presents two problems: measurement difficulties, and the affect of population size on sustainable yields. The measurement problem is similar to that faced by the income accountant, who must measure income in a way that keeps capital (productive capacity) intact and prevents inadvertent impoverishment by overconsumption. In both cases, a prudent rule of thumb is needed to avoid overconsumption, not to find the "theoretically unique scientifically precise number."

22. Choosing the population size that gives maximum sustainable yield does not provide sufficient guidance, although it is relevant consideration. The economically optimum yield generally does not coincide with the biological maximum yield (they coincide only when harvest costs are constant with respect to the amount harvested). One can not assume that the existing population size of an exploited species is optimal. It can be quite reasonable up to a point to cut down forest for farmland. But when we do this we must be clear that the trees from the virgin forest cut in excess of replacement represent capital consumption, not income.

23. If total capital is to be maintained intact the net receipts from the cut virgin timber should be treated as a depreciation fund to be reinvested in some alternative renewable resource that is more valuable at the margin.

24. **Nonrenewable Inputs.** Non-renewable inputs can be depleted at a rate equal to the rate of development of renewable substitutes. Thus, extractive projects based on nonrenewables must be paired with a project that develops the renewable substitute. Net receipts of nonrenewable exploitation are divided into two components (income and a capital set-aside) such that the capital set-aside, when invested in a renewable substitute each year will, by the time the nonrenewable is depleted, have grown to a stock size whose sustainable yield is equal to the income component that was being consumed all along. The capital set-side will be greater the lower the growth rate of the renewable substitute (real or biological discount rate) and the shorter the lifetime of the nonrenewable reserves (i.e., the reserve stock divided by annual depletion).

25. This has been worked out in the context of national income accounting, but apply with equal relevance to accounting at the project level. The true rate of return of the project pair would be calculated on the basis of the income component only as net revenue. Difficulties remain in the question of whether to define "substitute" narrowly or broadly. A broad definition would be indicated initially -- at least broad enough to encompass improvements in energy efficiency as a renewable substitute for petroleum depletion, and improvements in recycling as a renewable substitute for copper depletion.

26. **Further Discussion:** In the case of renewables, capital consumption is treated as depreciation of a productive asset (the sacrificed base population that was producing a permanent yield). Depreciation should be deducted from gross income to get net income. In the case of nonrenewables the reduction of stocks is treated as a liquidation of existing inventories rather than as running down of capacity for future production, and consequently should not even be a part of gross income.

27. Although the input and output rules of thumb have been treated independently, it should be noted that, thanks to the law of conservation of matter, the reduction of inputs to a sustainable yield level will help in the reduction of outputs to a sustainable absorption level. But, given the spatial separation of input production and output disposal, and especially the generation of many new and toxic substances in the production process, the output rule cannot be avoided. Nevertheless, the mere fact of mass balance would lead us to suspect that, in some cases, the input rule will be binding and the output rule redundant, and in other cases vice versa.

28. Some writers have advocated the pairing rule in theory, but have immediately backed off in practice, concluding that "at the level of each project such a requirement would be stultifying. Few projects would be feasible." They advocate applying the principle at a program (multi-project) level, so that the nondegradation of natural capital stock criterion would only hold on the average for the set of projects in the program and not for each project. This does not really help and in fact sacrifices efficiency by "socializing" the costs of sustainability among all the projects in a program instead of making each project bear its own full marginal social opportunity cost. In any event, it is not sufficient to say that sustainability is a macroeconomic criterion that is irrelevant at a project level, unless we are able and willing to limit the aggregate throughput of matter and energy (by severance taxes or depletion quotas) to a flow volume that is within gross regenerative and absorptive capacities of a

country. In this sense a macroapproach to sustainability may be the best strategy. Since all projects would have to pay the same prices, which then would reflect the cost of sustainability in the aggregate sense, there would be no cost in efficiency from socializing the costs among a program. Also, applying rules at a project level requires a large amount of micro level information and interference.

29. Although the macro approach seems better from the point of view of a country applying a national policy, the micro or project-level rules may be the more relevant from the point of view of a development bank that is committed to sustainable development as a criterion governing its own lending, but which is not in a position to dictate national policies at the macro level. Of course, imposing macroeconomic policies as a condition for making project loans, or lending directly to finance macroeconomic policy change is exactly what structural adjustment lending does. So one could indeed argue that sustainability ought to be treated as a macroeconomic goal to be attained by structural adjustment, and not as a set of project-level conditions. It could be argued that the proper way to treat sustainability is as a macroeconomic goal to be pursued through structural adjustment or through macroeconomic conditions tied to project lending, rather than as a characteristic of individual projects. Emphasis in this case would then shift from the project-level guides to some strictly analogous macro-level guides limiting the overall resource throughput to within the regenerative capacities of the larger national ecosystem. Because the EA OD focuses almost entirely on projects, this issue is not analysed further here, but will be addressed in ENV's proposal in paragraph 6.

30. Although sustainability was not usually discussed in the EA reports reviewed, there were several interesting suggestions that get at the main idea of sustainability. For example, in the Uganda livestock project the EA advocated a carrying capacity study for the rangelands to determine how many cattle could be grazed on the land without reducing the land's capacity to support grazing in the next year. The main focus of the project was to eliminate the tsetse fly, but, in a sense, the land had been protected from physical degradation by the infestation which reduced human presence. With the eradication of the tsetse fly human pressure on the land would increase, and the danger of that pressure reaching an unsustainable level was recognized. A study to establish the carrying capacity of the rangelands is a first step in avoiding unsustainable overgrazing. Also needed, of course, are institutions and laws that ensure that ranchers will not exceed that capacity.

31. Although the concept of carrying capacity has long been associated with cattle ranching, it is also applicable more generally. For example, in the Java (Suralaya) Thermal Power Project, a 1980 EA established that the site could accommodate up to 3,100 MW of generating capacity. Presumably this reflects environmental limits, although the more recent project EA did not specify how the 1980 study arrived at that figure. Nevertheless, that approximate figure was respected in the current expansion of the Suralaya generating station. It is not clear whether the limiting factor was air quality, or cooling water capacity, or capacity to dispose of ash, or some other factor, but some regional environmental factor limits the carrying capacity for coal-fired power plants, just as rainfall, soil nutrients, or temperature limits the growth of grass and thus the carrying capacity for cattle on rangelands.

32. The concept of carrying capacity also applies to industrial development in general as seen in the example of the Dahanu thermal power station in India. It was recognized that induced industrial development around the new power station would overwhelm the the environmental protection features of the project itself. To avoid exceeding the industrial "carrying capacity," part of the surrounding area was declared an "industrial exclusion zone." The point of these examples is to show that the above discussion of theoretical input and output guides based on regenerative and assimilative capacities is not impractical theory, but is in fact actually being approximated in rather ingenious ways by project designers. Such integration of concern for carrying capacity is still more the exception than the rule, but it is encouraging and instructive nonetheless.

Manual Transmittal Memorandum

October 31, 1989

Operational Directive 4.00, Annex A: Environmental Assessment

1. Attached for insertion in the new Operational Manual is OD 4.00, Annex A, which provides guidance to staff on the Bank's policies and procedures for conducting environmental assessments (EAs) of proposed projects. It standardizes and formalizes a process which is already taking place for projects with major environmental impacts.

2. This annex makes the following points:

(a) EA is a flexible procedure, whose scope, depth, and analytical techniques vary by project (para. 1);

(b) The purpose of EA is to ensure environmentally sustainable development through the timely incorporation of environmental issues into project design (para. 3);

(c) EA is part of project preparation and is therefore the borrower's responsibility (para. 4);

(d) Regional and sectoral EAs are important tools for identifying environmental issues, and can reduce the work subsequently needed on project-specific EAs (paras. 6-8);

(e) Alternatives to EA that focus on a narrower range of issues are acceptable for projects with limited potential environmental impacts (para. 9);

(f) In the EA process, inter-agency coordination and the involvement of affected groups and local NGOs are important (paras. 11-12);

(g) The EA process should be used to strengthen environmental capability in the country (para. 13);

(h) In special cases, environmental advisory panels may be needed (para. 15);

(i) In the Bank, the task manager (TM), supported by the Regional environment division (RED), assists and monitors the implementation of the EA process (para. 16);

(j) The type, timing, and main issues of environmental analysis should be confirmed at the Initial Executive Project Summary (IEPS) meeting (para. 19), and reported and updated in the Monthly Operational Summary (para. 20); and

(k) The final EA report should normally be available to the Bank prior to appraisal (para. 22), and its recommendations reviewed and incorporated into the Board documents (paras. 25-26).

3. All projects which reach the IEPS stage after October 15, 1989, are fully subject to this directive. Projects currently in advanced stages of preparation are not normally subject to this annex. For other projects already past the IEPS stage, the TM and the RED should, by December 31, 1989, review the status and recommend how to achieve the objectives of this annex within the existing time and resource constraints.

4. A systematic training program for Bank staff on the application of this directive is currently being designed under the leadership of the Environment Department.

Manual Transmittal Memorandum

5. Achieving the objectives of this directive will require close collaboration between the Bank and its borrowers, and strengthening of borrower capacity for carrying out, analyzing, and incorporating the recommendations of EAs. Country departments should therefore discuss with borrowers how to achieve smooth and efficient implementation of this annex through, e.g., EA seminars for implementing agencies' management, training programs for their environmental staff, and preparation of EA manuals (by sector) and procedures for the country.

6. As this is a new directive, progress and problems in its implementation will need to be monitored carefully. A review of experience will be prepared for Board discussion during FY91, and this directive will subsequently be modified based upon the lessons learned.

7. Questions on this annex should be referred to the Director, Environment Department.

8. Additional copies are available on a self-service basis in H 4234.

Attachment

Operational Directive 4.00, Annex A: Environmental Assessment

Introduction

1. This annex outlines Bank policy and procedures for the environmental assessment (EA) of Bank investment lending operations,[1] and related types of environmental analysis. EA is a flexible procedure, which can vary in breadth, depth, and type of analysis, depending on the project. It may be carried out at one point in time, stretched over a year to account for seasonal variations, or done in discrete stages.

2. For the purpose of this annex, EA covers also project impacts on health, cultural property, and tribal people, and the environmental impact of project-induced resettlement.[2] EAs utilize the findings of country environmental studies and action plans which cover nationwide issues, the overall policy framework, legislation, and institutional capabilities in the country.

Purpose and Nature of EA

3. The purpose of EA is to ensure that the development options under consideration are environmentally sound and sustainable, and that any environmental consequences are recognized early in the project cycle and taken into account in project design. EAs identify ways of improving projects environmentally, and minimizing, mitigating, or compensating for adverse impacts. By alerting project designers, implementing agencies, and borrower and Bank staff to issues early, EAs (a) enable them to address environmental issues in a timely and practical fashion, (b) reduce the need for project conditionality, because appropriate steps can be taken in advance or incorporated into project design, and (c) help avoid costs and delays in implementation due to unanticipated environmental problems. EAs also provide a formal mechanism for inter-agency coordination and for addressing the concerns of affected groups and local nongovernmental organizations (NGOs). In addition, they can play a major role in building environmental capability in the country.

4. Like economic, financial, institutional, and engineering analyses, EA is part of project preparation, and is therefore the borrower's responsibility. Close integration of EA with these other aspects of project preparation ensures that (a) environmental considerations are given due weight in project selection, siting, and design decisions, and (b) carrying out EAs does not unduly delay project processing.

Types of Environmental Analysis

Project-Specific EAs

5. Project-specific EAs are used to analyze specific investment projects (e.g., dams, factories, irrigation systems) with significant environmental issues. The detail and sophistication of analysis should be commensurate with the expected impacts. A project-specific EA should normally cover: (a) existing environmental "baseline" conditions; (b) potential environmental

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1. References to the Bank include IBRD and IDA; "loans" include credits. Investment lending covers specific and sector investments including rehabilitation, loans through financial intermediaries, and the investment component of hybrid loans. Sector and structural adjustment loans are not covered by this annex, but are subject to the general policies in OMS 2.36, *Environmental Aspects of Bank Work* (to be reissued as OD 4.00, *Environmental Policies*). IFC is developing similar procedures for environmental review, which reflect the special circumstances of its work. Bearing in mind its special circumstances, MIGA will cooperate with the Bank to ensure, to the extent possible, that the objectives of the directive are met in its operations.

2. For Bank policies regarding such impacts, see (a) OPN 11.03, *Management of Cultural Property in Bank-Financed Projects*, to be reissued as OD 4.50, *Cultural Property*; (b) OMS 2.34, *Tribal People in Bank-Financed Projects*, to be reissued as OD 4.40, *Tribal People*; and (c) OMS 2.33, *Social Issues Associated with Involuntary Resettlement in Bank-Financed Projects*, and OPN 10.08, *Operations Issues in the Treatment of Involuntary Resettlement in Bank-Financed Projects*, to be reissued as OD 4.30, *Involuntary Resettlement*.

impacts, direct and indirect,[3] including opportunities for environmental enhancement; (c) systematic environmental comparison of alternative investments, sites, technologies, and designs; (d) preventive, mitigatory, and compensatory measures, generally in the form of an action plan; (e) environmental management and training, and (f) monitoring. To the extent possible, capital and recurrent costs, environmental staffing, training, and monitoring requirements, and the benefits of proposed alternatives and mitigation measures, should be quantified. Annex A1 gives a sample outline for a project-specific EA report, and Annex A2 is a checklist of specific issues to be covered where relevant.

Regional and Sectoral EAs

6. Regional EAs are used where a number of significant development activities with potentially cumulative impacts are planned for a reasonably localized area. In such cases, they are generally more efficient than a series of project-specific EAs, and may identify issues that the latter might overlook (e.g., interaction among effluents, or competition for water or land). Regional EAs compare alternative development scenarios, and recommend environmentally sustainable growth rates and land use patterns and policies. The study area is normally defined on a physical and/or biological basis (e.g., airshed, habitat type, river basin), and may sometimes extend across national boundaries; however, regional EAs with an institutional focus might follow administrative boundaries instead.

7. Sectoral EAs are used for the design of sector investment programs. They are particularly suitable for reviewing (a) sector investment alternatives; (b) the effect of sector policy changes; (c) institutional capacities and requirements for environmental review, implementation, and monitoring at the sectoral level; and (d) the cumulative impacts of many relatively small, similar investments which do not merit individual project-specific EAs.

8. In some cases, regional or sectoral EAs cover all the normal requirements of project-specific EAs. More often, the latter are still needed for major investments (see para. 14 concerning sector investment loans), but the regional or sectoral EAs will have identified the relevant issues, collected much of the data, and, in general, greatly reduced the work needed in the project-specific EAs.

Alternatives to EAs

9. Alternative approaches that focus on a narrower range of issues are acceptable for many types of projects, especially smaller ones and those not in environmentally sensitive areas. These approaches may be more effective in integrating environmental concerns into the borrower's planning process. Such alternative approaches include:

(a) integrated pest management programs for many agricultural projects which do not involve major irrigation or land development;

(b) specific environmental design criteria and pollution standards for small- or medium-scale industrial plants; and

(c) specific environmental design criteria and construction supervision programs for small-scale rural works projects.

Other examples of projects for which alternative approaches are generally acceptable are listed in Annex A3, para. 3, under "Category B."

Consideration of Global Issues

10. A number of specialized agencies—inside and outside the U.N. system—carry out scientific investigations of global environmental issues (ozone depletion, global warming, hazardous wastes, etc.). The Bank keeps fully abreast of findings, primarily through its Principal Adviser, Science and Technology, and draws upon prevailing views

3. Indirect impacts are the induced consequences of the project which occur later or in another part of the environment, e.g., if a river is channelled or dammed, its capacity for self-purification may be reduced and the original aquatic ecosystem damaged or destroyed.

in developing its own environmental, economic, and sectoral policies, with a view to minimizing possible adverse impacts on global systems such as the atmosphere and oceans. While EAs should collect or refer to the relevant data, the Bank does not normally expect global environmental issues to require separate analysis in project-specific EAs. Such issues should, however, be addressed where relevant in policy and sector work.

Institutional Aspects of Projects

Inter-Agency Coordination

11. Because environmental issues generally involve national, regional, and local government agencies, and cover a broad range of responsibilities (wildlife, health, water and land use, tourism, etc.), coordination among government agencies is crucial. This is best achieved through inter-agency meetings at key points in the EA cycle. The first meeting, normally held soon after the decision to prepare an EA, identifies the issues, types of analysis required, sources of relevant expertise, responsibilities and schedule for the EA, and mitigating measures to be considered. Another meeting should normally be held when the EA report is completed and submitted for final government review.

Involvement of Affected Groups and Nongovernmental Organizations

12. The Bank expects the borrower to take the views of affected groups and local NGOs[4] fully into account in project design and implementation, and in particular in the preparation of EAs. This is important in order to understand both the nature and extent of any social or environmental impact, and the acceptability of proposed mitigation measures. An approach which has proven effective in many countries is to expand the initial inter-agency meeting (para. 11) into a "forum" or "scoping session" with representatives of affected groups and relevant NGOs. Similar consultations after the EA report is completed are also a valuable way to obtain feedback on the report and to increase community cooperation in implementing the recommendations.

Strengthening Environmental Capabilities

13. The ultimate success of EA depends upon the development of environmental capability and understanding in the agencies concerned. Projects with major potential impacts normally require the establishment or strengthening of in-house environmental units for the project (located or represented on site), the implementing agency and the ministry. Involvement of these units throughout the EA process (a) ensures that the agency's/ministry's knowledge and perspective are taken into account in the EA, (b) provides on-the-job training for the staff, and (c) provides continuity for the implementation of the EA's recommendations. Such projects normally need to include an institutional development and training component for such units. In addition, to help develop EA capability in the country, the Bank should (a) encourage the use of local expertise in EA preparation (in association with international consultants, where appropriate), and (b) help arrange EA training courses for local specialist staff and consultants.

Sector and Financial Intermediary Lending

14. For sector investment loans and loans through financial intermediaries, subproject details may not be known at the time of project appraisal. In such cases, the project implementing institutions will need to screen subprojects (see para. 18) and carry out environmental analyses consistent with this directive. To ensure that this can be done, the Bank should appraise the implementing agencies' capabilities for EA, and strengthen them where necessary. The appraisal mission should also indicate the proper division of responsibility for preparing and reviewing EAs between the ultimate borrower, the financial

4. See OD 14.70, *Involving Nongovernmental Organizations in Bank-Supported Activities* for the Bank's overall approach to NGOs.

intermediary or sector agency, and the agencies responsible for environmental regulation.

Environmental Advisory Panels

15. For major projects with serious and multidimensional environmental concerns, the Bank should explore with the borrower whether the latter needs to engage an advisory panel of independent, internationally recognized, environmental specialists, to review and advise on, *inter alia*, the terms of reference (TOR) and findings of the EA, the implementation of its recommendations, and the development of environmental capacity in the implementing agency/ministry. Such a panel should meet at least once a year until the project is operating routinely and environmental issues have been addressed satisfactorily.[5]

EA Procedures

Overview

16. Though EA preparation is the responsibility of the borrower, the task manager (TM) in the Bank assists and monitors the EA process, with support mainly from the Regional environment division (RED). The borrower and the Bank should agree as early as possible on the selection of consultants or borrower staff to prepare the EA, and the EA procedures, schedule, and outline. Major steps in the EA process normally include: (a) screening, (b) decisions based on the Initial Executive Project Summary (IEPS), (c) notification to the Board through the Monthly Operational Summary (MOS), (d) preparation of TORs for the EA, (e) EA preparation, (f) EA review and incorporation of environmental measures into the project, (g) supervision, and (h) ex post evaluation.

17. Since project and country conditions, national legislation, and institutional experience vary among borrowers, both the borrower and the Bank must exercise judgement in using these procedures to design and implement projects which are both environmentally and economically sound, and consistent with the environmental laws, policies, and procedures of the borrower. The Environment Department (ENV), Legal Department, and the REDs maintain information on these requirements.

Screening

18. Projects/components should be screened at identification by the TM, with advice from the RED, and assigned to one of the following categories based upon the nature, magnitude, and sensitivity of environmental issues:

Category A—EA is normally required as the project may have diverse and significant environmental impacts.

Category B—More limited environmental analysis is appropriate, as the project may have specific environmental impacts.

Category C—Environmental analysis is normally unnecessary.

Category D—Environmental projects, for which separate EAs may not be required, as environment would be a major focus of project preparation.

Annex 3 gives illustrative lists, to be applied flexibly, of the type of project/component in each category.

Initial Executive Project Summary

19. In the IEPS, the TM, in consultation with the RED, should (a) identify key environmental issues, (b) indicate the category (A-D) and the type of environmental analysis recommended, and (c) provide a preliminary EA schedule. If an EA is not likely to be available prior to appraisal, the

5. See OD 4.00, Annex B, *Environmental Policy for Dam and Reservoir Projects*, para. 18, for more details on the selection and functions of the panel.

IEPS should propose special procedures to address the situation. The IEPS meeting would confirm the type, timing, and issues of environmental analysis (although in the event of inadequate information, the decision may be deferred).

Monthly Operational Summary

20. The TM should ensure that the MOS, which is used to alert the executive directors to forthcoming projects, contains the following information as soon as available: (a) the category assigned (A-D); (b) the main issues to be examined; (c) whether agreement with the borrower has been reached on EA preparation; and (d) the EA schedule. The MOS entry should be updated whenever appropriate to reflect the progress of the EA, and the related Bank and borrower decisions.

Preparation of TORs for the EA

21. Following the IEPS meeting, the Bank should discuss with the borrower the scope of the EA, and assist the borrower, as necessary, in preparing TORs for the EA. For this purpose, a field visit by Bank environmental staff is generally desirable. The Bank should ensure that the TORs provide for adequate inter-agency coordination (para. 11) and consultation with affected groups and local NGOs (para. 12).

EA Preparation

22. An EA for a major project typically takes 6-18 months to prepare and review. EA drafts should be available at key points in the project cycle. The final EA should be available prior to appraisal, to minimize the risk of project design changes and resultant delays at a late stage.

23. In most cases, the EA should form part of the overall feasibility study, so that the EA's findings are directly integrated into project design. However, the EA is normally prepared separately by specialists. For projects which would have major impacts, such as large dams or projects involving large scale resettlement, it is recommended that the borrower retain independent experts not affiliated with the project. Borrowers may request Bank assistance for financing EAs through a Project Preparation Facility (PPF) advance,[6] or from the Technical Assistance Grant Program for the Environment. EAs generally account for 5-10 percent of the cost of project preparation.

24. For some projects, a full year of baseline data is desirable to capture the seasonal effects of certain environmental phenomena; however, so as not to delay critical project decisions, short-term monitoring should be used to provide conservative estimates of environmental impacts, while longer-term data collection is being undertaken. Since special care in designing the baseline monitoring program is warranted, the borrower should be encouraged to discuss the matter with the Bank.

EA Review and Project Appraisal

25. The borrower should submit the final EA report to the Bank prior to Bank appraisal. The EA report is the borrower's property, but the Bank encourages the borrower to release relevant information to appropriate interested parties. The Final Executive Project Summary should summarize the EA's status and describe how major environmental issues have been resolved or are to be addressed, noting any proposed conditionality. The appraisal mission should review both the procedural and substantive elements of the EA with the borrower, resolve any issues, assess the adequacy of the institutions responsible for environmental management in light of the EA's findings, and determine if the EA's recommendations are properly addressed in project design and economic analysis.

Loan Documents

26. The EA procedures followed and the EA's main findings should be explained briefly in the text of the Staff Appraisal Report (SAR) and the

6. See OMS 2.15, *Project Preparation Facility*, to be reissued as OD 8.00.

Memorandum and Recommendation of the President. An SAR annex should summarize the EA more fully, covering, *inter alia*, environmental baseline conditions, alternatives considered, mitigating and compensatory actions, capability of environmental units and measures to strengthen them, environmental monitoring arrangements, and the borrower's consultations with affected groups and NGOs. These factors will provide the basis for the RED's formal environmental clearance prior to the authorization of negotiations by the Regional vice president. Measures critical to sound project implementation may require specific loan conditionality.

Supervision

27. EA recommendations provide the basis for supervising the environmental aspects of project implementation. Compliance with environmental conditionality, the status of mitigating measures, and the findings of monitoring programs should be part of borrower reporting requirements and project supervision. When major issues arise, special supervision missions with adequate environmental expertise may be needed.

Ex Post Evaluation

28. The project completion report[7] submitted to the Operations Evaluation Department should evaluate (a) environmental impacts, noting whether they were anticipated in the EA report, and (b) the effectiveness of mitigating measures taken and of institutional development and training.

7. See the OPNSV memoranda, *Guidelines for Preparing Project Completion Reports*, June 7, 1989, and OMS 3.58, *General Guidelines for Preparing Project Completion Reports*, which are to be combined and reissued as OD 13.55, *Project Completion Reports*.

Operational Directive

Sample Outline of a Project-Specific EA Report

1. EA reports should be concise and limited to significant environmental issues. The detail and sophistication of analysis should be commensurate with the potential impacts. The target audience should be project designers, implementing agencies, and borrower and Bank staff.

2. The EA report should include:

(a) *Executive Summary*. Concise discussion of significant findings and recommended actions.

(b) *Policy, legal, and administrative framework* within which the EA is prepared. The environmental requirements of any cofinanciers should be explained.

(c) *Project description* in a geographic, ecological, social, and temporal context, including any off-site investments that may be required by the project (e.g., dedicated pipelines, access roads, power plants, water supply, housing, and raw material and product storage facilities).

(d) *Baseline Data*. Dimensions of the study area and description of relevant physical, biological, and socio-economic conditions, including any changes anticipated before the project commences. Current and proposed development activities within the project area (but not directly connected to the project) should also be taken into account.

(e) *Environmental Impacts*. The positive and negative impacts likely to result from the proposed project should be identified and assessed. Mitigation measures and the residual impacts that cannot be mitigated should be identified. Opportunities for environmental enhancement should be explored. The extent and quality of available data, key data gaps, and uncertainties associated with predictions should be identified/estimated. Topics that do not require further attention should be specified.

(f) *Analysis of Alternatives*. Proposed investment design, site, technology, and operational alternatives should be compared systematically in terms of their potential environmental impacts; capital and recurrent costs; suitability under local conditions; and institutional, training, and monitoring requirements. To the extent possible, for each of the alternatives, the environmental costs and benefits should be quantified, and economic values attached where feasible.

(g) *Mitigation Plan*. Feasible and cost-effective measures which may reduce potentially significant adverse environmental impacts to acceptable levels should be proposed, and the potential environmental impacts, capital and recurrent costs, and institutional and training requirements of those measures estimated. The plan (sometimes known as an "action plan" or "environmental management plan") should provide details on proposed work programs and schedules, to ensure that the proposed environmental actions are in phase with engineering activities throughout preparation. The plan should consider compensatory measures if mitigation measures are not feasible or cost-effective.

(h) *Environmental Management and Training*. The existence, role, and capability of environmental units at the on-site, agency, and ministry level should be assessed, and recommendations made concerning the establishment and/or expansion of such units, and the training of staff, to the point that EA recommendations can be implemented.

(i) *Monitoring Plan* regarding environmental impacts and performance. The plan should specify the type of monitoring, who would do it, how much it would cost, and what other inputs (e.g., training) are necessary.

Appendices

(i) *List of EA preparers*—individuals and organizations.

(ii) *References*—written materials used in study preparation. This is especially important given the large amount of unpublished documentation often used.

(iii) *Record of Inter-Agency/Forum Meeting*, including list of both invitees and attendees. Where the views of affected groups and local NGOs were obtained by other means, these should be specified.

Checklist of Potential Issues for an EA

Where applicable, EAs should address the following issues, which are subject to the Bank policies and guidelines identified below.

(a) *Agrochemicals*. The Bank promotes the use of integrated pest management (IPM) and the careful selection, application, and disposal of pesticides (see OPN 11.01, *Guidelines for the Selection and Use of Pesticides in Bank-Financed Projects and their Procurement when Financed by the Bank*, to be reissued as OD 4.00, Annex C, *Agricultural Pest Management, and Selection and Use of Pesticides*). The use of fertilizers, due to their impacts on surface and groundwater quality, must also be carefully assessed.

(b) *Biological Diversity*. The Bank promotes conservation of endangered plant and animal species, critical habitats, and protected areas (para. 9b, OMS 2.36, *Environmental Aspects of Bank Work*, and OPN 11.02, *Wildlands: Their Protection and Management in Economic Development*, to be reissued as OD 4.00, Annex D, *Wildlands: Their Protection and Management*).

(c) *Coastal and Marine Resources Management*. Guidelines are available from the Environmental Department (ENV) on the planning and management of coastal marine resources including coral reefs, mangroves, and wetlands.

(d) *Cultural Properties*. OPN 11.03, *Management of Cultural Property in Bank-Financed Projects* (to be reissued as OD 4.50, *Cultural Property*), confirms the Bank's commitment to actively protect archaeological sites, historic monuments, and historic settlements.

(e) *Dams and Reservoirs*. OD 4.00, Annex B, *Environmental Policy for Dam and Reservoir Projects*, provides specific guidance for addressing environmental issues in the planning, implementation, and operation of dam and reservoir projects.

(f) *Hazardous and Toxic Materials*. Guidelines are available from ENV on the safe manufacture, use, transport, storage, and disposal of hazardous and toxic materials.

(g) *Induced Development and Other Socio-Cultural Aspects*. Secondary growth of settlements and infrastructure, often referred to as "induced development" or "boomtown" effects, can have major indirect environmental impacts, which relatively weak local governments may have difficulty addressing.

(h) *Industrial Hazards*. All energy and industry projects should include a formal plan to prevent and manage industrial hazards. (See *Techniques of Assessing Industrial Hazards—A Manual*, World Bank Technical Paper No. 55.)

(i) *International Treaties and Agreements on the Environment and Natural Resources*. EAs should review the status and application of such current and pending treaties and agreements, including their notification requirements. The Legal Department maintains a list of international treaties, and could obtain, whenever required, information on applicable law in individual countries.

(j) *International Waterways*. OD 7.50, *Projects on International Waterways* provides guidance. This OD exempts from notification requirements rehabilitation projects which will not affect the quality or quantity of water flows.

(k) *Involuntary Resettlement*. OMS 2.33, *Social Issues Associated with Involuntary Resettlement in Bank-Financed Projects*, and OPN 10.08, *Operations Issues in the Treatment of Involuntary Resettlement in Bank-Financed Projects* (to be reissued as OD 4.30, *Involuntary Resettlement*), provide guidance.

(l) *Land Settlement*. Due to the complex physical, biological, socioeconomic, and cultural impacts, land settlement should generally be carefully reviewed (see OD 4.31, *Land Settlement*, to be issued).

(m) *Natural Hazards*. EAs should review whether the project may be affected by natural hazards (e.g., earthquakes, floods, volcanic activity), and should propose specific measures to address these concerns when appropriate (see OD 8.50, *Emergency Recovery Assistance*, to be issued).

(n) *Occupational Health and Safety*. All industry and energy projects, and projects in other sectors where relevant, should include a formal plan to promote occupational health and safety (*Occupational Health and Safety Guidelines*, World Bank, 1988).

(o) *Tribal Peoples*. OMS 2.34, *Tribal People in Bank-Financed Projects* (to be reissued as OD 4.40, *Tribal People*), provides specific guidance for addressing the rights of tribal peoples, including traditional land and water rights.

(p) *Tropical Forests*. The Bank co-authored the Tropical Forest Action Plan (published in 1984); up-to-date information is available from ENV. OPN 11.02, *Wildlands: Their Protection and Management in Economic Development* (to be reissued as OD 4.00, Annex D), also addresses issues relating to tropical forests.

(q) *Watersheds*. Bank policy is to promote protection and management of watersheds as an element of lending operations for dams, reservoirs, and irrigation systems (OD 4.00, Annex B, *Environmental Policy for Dam and Reservoir Projects*, para. 6).

(r) *Wetlands*. The Bank promotes conservation and management of wetlands (e.g., estuaries, lakes, mangroves, marshes, and swamps). This is covered by OPN 11.02 on wildlands (see (s) below).

(s) *Wildlands*. The Bank is committed to protect wildlands, including through compensatory measures when lending could result in adverse impacts (see OPN 11.02, *Wildlands: Their Protection and Management in Economic Development*, to be reissued as OD 4.00, Annex D, *Wildlands: Their Protection and Management*).

Environmental Screening

Introduction

1. The task manager, in consultation with the Regional environment division, is responsible for screening a proposed project to determine the appropriate type of environmental analysis, based on the nature, potential magnitude, and sensitivity of the issues. The categories below, based upon prior Bank staff experience, are strictly illustrative. Alternatives to EA are acceptable where they are expected to result in an environmentally sound project.

2. *Category A: Projects/Components Which May Have Diverse and Significant Environmental Impacts—Normally Require EA*[1]

(i) Aquaculture/Mariculture (large scale);

(ii) Dams and Reservoirs;[2]

(iii) Electrical Transmission (large scale);

(iv) Forestry;

(v) Industrial Plants (large scale) and Industrial Estates;

(vi) Irrigation and Drainage (large scale);

(vii) Land Clearance and Leveling;

(viii) Mineral Development (including oil and gas);

(ix) Pipelines (oil, gas, and water);

(x) Port and Harbor Development;

(xi) Reclamation and New Land Development;

(xii) Resettlement;[3]

(xiii) River Basin Development;

(xiv) Rural Roads;

(xv) Thermal and Hydropower Development;

(xvi) Tourism (large scale);

(xvii) Transportation (airports, railways, roads, waterways);

(xviii) Urban Development (large scale);

(xix) Urban Water Supply and Sanitation (large scale);

(xx) Manufacture, Transportation, and Use of Pesticides or other Hazardous and/or Toxic Materials;[4] and

(xxi) Projects which Pose Serious Accident Risks.[5]

3. *Category B: Projects/Components which may Have Specific Environmental Impacts—More Limited Environmental Analysis Appropriate*

Projects in this category normally require more limited environmental analysis than an EA.

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1. Except generally for projects directed to rehabilitation, improved operation and maintenance, and limited upgrading of facilities.
2. See OD 4.00, Annex B, *Environmental Policy for Dam and Reservoir Projects*.
3. While OMS 2.33, *Social Issues Associated with Involuntary Resettlement in Bank-Financed Projects* (to be reissued as OD 4.30, *Involuntary Resettlement*), covers the social aspects of resettlement, the environmental implications of the resettlement itself can be major.
4. In some cases, adherence to existing directives is an acceptable alternative to an EA (e.g., OPN 11.01, *Guidelines for the Selection and Use of Pesticides in Bank-Financed Projects and their Procurement when Financed by the Bank*, to be reissued as OD 4.00 Annex C, *Agricultural Pest Management, and Selection and Use of Pesticides*). Certain materials (e.g. PCBs) are not to be used in Bank projecs and other materials (e.g. asbestos) are to be used only under extremely restricted conditions. A Restricted Toxic Materials List (RTML) will be available from ENV and updated periodically.
5. See *Techniques of Assessing Industrial Hazard—A Manual*. World Bank Technical Paper No. 55.

A wide range of environmental guidelines, developed by a number of organizations, are applicable. In addition, specific environmental pollution standards or design criteria can be developed for individual projects.

(i) Agroindustries (small scale);

(ii) Aquaculture and Mariculture (small scale);

(iii) Electrical Transmission (small scale);

(iv) Industries (small scale);

(v) Irrigation and Drainage (small scale);

(vi) Mini Hydro-Power;

(vii) Public Facilities (hospitals, housing, schools, etc.);

(viii) Renewable Energy;

(ix) Rural Electrification;

(x) Telecommunications;

(xi) Tourism (small scale);

(xii) Urban Development (small scale); and

(xiii) Rural Water Supply and Sanitation.

4. *Category C: Projects/Components which Normally Do Not Result in Significant Environmental Impact—Environmental Analysis Normally Unnecessary*

Opportunities to enhance environmental benefits should be sought in these projects.

(i) Education (except school construction);

(ii) Family Planning;

(iii) Health (except hospital construction);

(iv) Nutrition;

(v) Institutional Development; and

(vi) Technical Assistance.

5. *Category D: Environmental Projects*

Projects with a major environmental focus may not require a separate EA, as environment would be a major part of the project preparation.

6. *Emergency Recovery Projects*

Because emergency recovery projects (a) need to be processed rapidly, and (b) seek mainly to restore existing facilities, they normally would not require a full EA. However, the extent to which the emergency was precipitated and/or exacerbated by inappropriate environmental practices should be determined, and corrective measures built into either the emergency project or a future lending operation.[6]

6. See OD 8.50, *Emergency Recovery Assistance*, to be issued.

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THE WORLD BANK
OPERATIONS COMMITTEE

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TRINIDAD AND TOBAGO

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COUNTRY STRATEGY PAPER

Postscript

1. The Operations Committee met on July 26, 1991, to consider the Country Strategy Paper (CSP) for Trinidad and Tobago. The discussion focussed on (a) the proposed policy agenda; (b) the relationship of the policy agenda to both the SAL and investment lending; (c) the definition and monitoring of the policy framework to judge its adequacy for proceeding with lending; and (d) the possibility of concerted action with IDB regarding public expenditure and particularly the use of petroleum revenue.

69. The economy of Trinidad and Tobago is based on oil. In the past income per capita has been as high as $6,000, but it has now declined by 50 percent. Policy distortions have so far prevented efficient diversification. The Bank was supporting the Government's program to reduce these distortions with its SAL, but during the last year progress lagged, particularly in trade and public utilities reform. It is quite possible that the second tranche of the SAL would need to be canceled. Even if the Bank were to switch to investment lending only, a possibility explicitly foreseen in the CSP, three conditions should be satisfied, in the Region's views, before proceeding with it: appropriate exchange rate management, acceptable public investment program (concerning its size, quality, and financing), and an environment conducive to development of the non-oil sectors of the economy. A project to support industrial restructuring was being prepared, for which trade reform conditionality (picking up where SAL implementation left off) would be important. Prospects for addressing the public enterprise issues in the near future (increased efficiency and financial viability which turned on staff reductions and tariff increases) were dimmer.

70. While the IMF would continue its shadow program concerned with exchange rate management and fiscal policy, the likelihood of a formal program was low. We would work with the IMF, and ensure that our concerns with these two important policy areas were taken into account. The CEM planned for this Fall, future ESW, and the Industrial Restructuring Project would in any case constitute important vehicles for direct policy discussions with the Government of Trinidad and Tobago.

71. The issue of how could the Bank monitor and keep track of agreed policy targets, was discussed at some length. The Region took the position that important aspects of the conditionality would have to be qualitative and not

quantitative, and discussed in a relatively informal setting. Adequate tracking and monitoring of the policy dialogue would have to be the Region's responsibility. In the absence of a policy stance which made sense, there was no compelling reason to lend to Trinidad and Tobago, given the country's relatively high per capita income levels. Working out the essential conditions which would allow the Bank to proceed with the proposed lending program would be a central task of the fall CEM mission, so that the Bank would be ready for an intensive policy dialogue with the government that will emerge after the next elections (to be held no later than March 1991).

72. The issue of linking investment lending to a specific policy framework was also examined at some length. A concern was expressed that planning to do so in a small country could result in discriminatory treatment, as the Bank would probably not be able to get this approach accepted by large countries. A related question was how the Bank could acquire enough information to make a judgment on whether or not to proceed with investment lending on the basis of progress in the key areas of macro and sectoral policies. Because of the long absence of the Bank from Trinidad and Tobago, the sectoral strategies had not yet been defined. This would also make it more difficult than usual to know what would constitute satisfactory performance at the sectoral level. In the opinion of the Region some greater latitude for the Bank to decide whether or not to lend was afforded by the relatively high per capita income of Trinidad and Tobago. Discrimination was not a big issue under the circumstances. The quality of policy improvements, more than any specific measure or measurement, was of the essence. Elaboration of a full-fledged macro-framework did not look like a useful approach for the purpose of sustaining a lending program such as the one proposed here. The proposed economic work in Trinidad and Tobago would increase our knowledge of the country, allow appropriate specification of policy conditions and help clarify the monitoring needs of the Bank. The Region, in any case, would have to make the assessment of sufficiency of progress in the key policy areas and of adequacy of information about it. The Region, however, would come back to the Operations Committee with a new CSP if the lending program were indeed to develop along the alternative now indicated in the CSP (i.e., to become investment lending only) and provide more specific ideas on how to link it to progress in the three key policy areas.

73. On the issue of expenditure from petroleum revenue, views were that it appeared excessive. Less expenditure (i.e., greater savings of petroleum revenues) and greater efficiency in public expenditure were both necessary. Given IDB involvement in the petroleum sector of Trinidad and Tobago (IDB has just made a $250 million loan to support investment in petroleum), close coordination between the two Banks, to increase joint leverage appeared to be desirable. Joint reviews of expenditure at regular intervals could help in attaining greater effect on government authorities. The Region noted that these were important issues in country dialogue and would feature on the agenda for the forthcoming CEM. Moving in parallel with IDB on this issue was both desirable and possible. The Bank needs to do more analytical work on this subject and offer a persuasive position. IDB would come along under these circumstances and work with us on the question of the appropriate rate of utilization of petroleum revenues.

74. The Chairman concluded that while the Bank would not have with an investment lending program the kind of leverage normally associated with an adjustment loan, it could still continue with or curtail the program in Trinidad and Tobago, depending on the acceptability of the policy framework. Political feasibility was also an important factor to be kept in mind. As long as the Region determined that the macro setting was acceptable and progress in policies adequate, then it would be satisfactory to proceed as proposed. The relatively small size of the program and the relatively low level of Bank risk and exposure in Trinidad and Tobago made this approach feasible.

EGrilli:vl
8/09/91

LIST OF PERSONS ATTENDING THE OPERATIONS COMMITTEE MEETING

TRINIDAD AND TOBAGO - COUNTRY STRATEGY PAPER

FRIDAY, JULY 26, 1991

Operations Committee

Messrs. E. Jaycox (Chairman)
S. Husain (LACVP)
R. Agarwala (ASIVP)
W. Grais (EMNVP)
J. Linn (DECVP)
D. Goldberg (LEGVP)
J. Niehuss (CFSVP)
F. Kilby (FPRVP)
D. Bock (OPNSV)

Other Attendees

Messrs. E. Grilli (EAS)
M. Lav (EAS)
J. Page (LA3DR)
G. Flood (LA3C2)
J. Sokol (LC3C2)
S. Dabbagh (LC3C2)
H. von Gersdorff (LA3C2)
Ms. K. Vasiliades (LA3DR)
F. Earwaker (PRDRA)
J. Soladay (IFC)
Ms. S. Hoffman (LEGLA)
P. Crevier (SECGE)

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THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: July 22, 1991

TO: Operations Committee

FROM: Enzo Grilli, Director, EAS

EXTENSION: 81934/5

SUBJECT: TRINIDAD AND TOBAGO - Country Strategy Paper - Agenda

1. The Operations Committee will meet on Friday, July 26, 1991, at 4:00 p.m. in Room 1243 to consider the Country Strategy Paper for Trinidad and Tobago. The following represents a proposed agenda for the meeting.

Introduction

2. Trinidad and Tobago's stabilization and adjustment programs show mixed results. Stabilization, supported by an IMF Stand-By Arrangement, has been more successful, and has greatly reduced both external and internal imbalances. The current account of the balance of payments has improved dramatically since 1986 when the deficit was equivalent to 13 % of GDP. By 1990 it reached a surplus equivalent to 8% of GDP and approximate balance is projected for 1991. The fiscal deficit, which was 6 % of GDP in both 1987 and 1988, was reduced to 1 % of GDP by 1990, although a deterioration to 3% of GDP is expected for 1991. Trinidad and Tobago has met all targets under the 1990/91 IMF Stand-By Arrangement.

3. Adjustment has proved more difficult. While many of the targets under the SAL have been achieved, the second tranche of the SAL, which was to have been released early in 1991, has not yet been released. Political considerations apparently constrain the Government from acting vigorously to address key issues, at least for the time being. Elections are to be held by March, 1992, and prior to elections, the Government may not be in a position to take hard decisions, including those needed for release of the second tranche of the SAL. This perspective, based in part on vehement opposition of the trade unions to many government policies and on the potential for violent opposition as already exhibited in the July, 1990, coup attempt, is important in shaping the Region's view that adjustment lending operations should not be programmed and that investment operations are much more appropriate.

4. The CSP notes that further progress is needed in three areas. First, the Government has not yet implemented adequate reforms for the public enterprises, particularly tariff increases and reduction of unnecessary staff. Second, while trade reform has begun as planned under the SAL, much remains to be done in lowering tariffs for manufactures, and in beginning the tariff reform in other sectors such as agriculture.

5. Petroleum and natural gas sector policies are a third adjustment priority. The Government remains to be convinced of the need to save a portion of current petroleum and natural gas revenues. The economy remains heavily dependent on petroleum and natural gas, which directly account for 30% of GDP, 80% of exports, and 40% of Government revenues. These revenues, in turn, are used to support policies and programs which inhibit diversified growth and constrain development of an efficient economy, particularly a viable tradeables sector.

6. Although unavoidable in the short run, excessive dependence on petroleum would continue to pose risks. Petroleum reserves would last for 10 years at today's production levels, but with projected production increases, might only last until 1998. While prospects for finding and developing new petroleum reserves are reported to be good, these are not yet proven. Natural gas reserves are substantially larger.

7. Efficient diversification is a high priority. Agriculture and manufacturing comprise only 11 % of GDP, and many inefficient activities in these sectors are subsidized and protected. The nongovernment and nonpetroleum portion of the economy has been decreasing by about 4% per year in real terms since 1985, although agricultural output, accounting for 3-4% of GDP, has been increasing. Private sector savings and investment are both low, with savings rates at 4-5 percent of GDP, and investment levels at 3-4 percent of GDP. Both need to be increased, by reducing public sector expenditure and by ensuring an appropriate environment for private sector activities.

8. After the CSP was finalized, a new development emerged concerning civil service remuneration and privatization. The Government had denied civil servants past cost of living and other pay increases to which they felt entitled, and the matter was pursued in court. The court ruled against the Government, implying a TT $2.5 billion burden on the treasury, equivalent to 9 % of GDP. The Government has accepted the ruling, but until recently has stated that implementation was impossible because of resource constraints. The recent development is that the government has proposed giving civil servants shares in public enterprises, which in the process would be privatized, to settle the back pay issue. While this could solve the current fiscal problem generated by the court's decision, it could leave open the issue of the Government's ability to meet future payrolls given the increased level of civil service salaries implied by the ruling.

9. Further, such an arrangement could raise an equity issue, depending on the valuation of assets which could be given to the civil servants. If valued fairly on a market basis, there should be indifference on the part of civil servants to receiving the assets or the pay increase, nor should the Government in this case find it expedient to offer such assets in lieu of increased pay. However, in the absence of a liquid market, asset valuation is difficult. While privatization is an appropriate priority, and several important enterprises have been reorganized and privatized, the question for discussion is how best to proceed in the absence of good market information in a way which is fair to government, civil servants, and the public at large.

Issues

10. Lending Strategy. To address these issues, the Region proposes a conditioned lending program following the SAL agenda (see paragraphs 4 and 5), comprising 7 projects for $165 million for FY92-96. No additional adjustment lending is proposed because of concerns about the Government's ability to follow through. Instead, the Region identifies minimum conditions, essential to adjustment, which would then be supported by the entire (investment) lending program. These minimum conditions are: (1) an appropriate exchange rate, (2) a public investment program of appropriate size and composition and financed without recourse to net borrowing from the Central Bank, and (3) an incentive framework conducive to private sector investment, including a supportive financial framework. Should these minimum conditions not be met, there would be no alternative lower case and lending would cease1/. Moreover, if the proposed policy conditions in a particular sector are not acceptable to the Government, lending in that sector would not proceed and the shortfall would not be replaced by additional lending in other sectors. Therefore, the package of operations and conditions is constructed with the key features of an adjustment lending operation but without the high profile of a SAL.

* The Region may wish to elaborate on the rationale for the proposed strategy, focussing on the following considerations. First, if the Region feels that further adjustment lending is inappropriate, what assurance is there that the Government can implement a policy framework based on the three minimum conditions posed above. If that policy framework can be implemented with a reasonable degree of assurance, would it not be a good basis for developing adjustment lending? Second, the size and timing of investment lending is often driven by factors extraneous to policy reform, and it may be difficult to link it with a financing plan which appropriately supports the country as it incurs adjustment costs associated with policy reform. Note that the proposed lending program, seen in the adjustment context, is heavily backloaded with one operation for $15 million in FY92, no operations in FY93, and then 6 operations during FY94-96 for a total of $150 million. What assurance would there be that the proposed investment lending program could adequately support the needed policy framework, and that the Government would agree that the financing package provided by investment lending would be an adequate incentive to adopt an acceptable adjustment program?

11. Government Expenditure. Important objectives of the proposed strategy are to reduce the excesses of government expenditure and increase the efficiency of the remaining public sector expenditure, and

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1/ The CSP itself presents a lower case, which, however, is obviated by Mr. Husain's covering memorandum to Mr. Qureshi dated June 13, 1991.

to improve the environment for private sector investment.2/ These are clearly appropriate, but there are aspects concerning the implementation of the proposed strategy which should be discussed.

* Is the petroleum sector problem being addressed forcefully enough? The CSP states that the Government should not spend all of the revenues from current petroleum production, that savings should be targeted, and that this position "would have to be presented to government which does not yet share the view". Further, IDB is pursuing investment lending in the petroleum sector. While the CSP notes that the economic dialogue "would be coordinated with IDB", it appears possible that IDB would proceed with investment financing even in the absence of an acceptable government policy in this sector. Is there a need to establish a firmer, jointly held view with the IDB, and to present such a jointly held view to government?

* Does the proposed lending program address the public enterprise expenditure problem in a timely fashion? The proposed lending program is designed, in part, to address public enterprise expenditure issues. However, the sectors in which public expenditure is a problem (power, transportation, water and sewerage) are slated for lending beginning only in FY 94; a transport project is proposed in FY 94, sewerage in FY 95, and power in FY 96. This is in the context of a program in which no lending is proposed for FY 93, while 2 projects per year are proposed for FY 94 through FY 96. If the lending program is to forcefully address public expenditure problems, with conditionality by sector, would not earlier projects be desirable?

* Should the proposed overall conditionality and work program address current as well as investment expenditure? Given that current expenditure, including transfers, as well as investment, has been identified as problematic, should not the proposed conditionality for the program address the budget as a whole? As currently phrased in Mr. Husain's covering memo, that conditionality concerns the size and composition of the public investment program and its financing without recourse to net borrowing from the Central Bank. However, this could be consistent with undesirable high levels of current expenditure which could pre-empt resources more appropriately used in the private sector. The proposed public sector investment program (PSIP) review scheduled for FY93/FY94 could be broadened to a public sector expenditure review (PSEP) and address the problem of current as well as investment expenditure, if this position were accepted. The PSEP could then be a useful bridge between the work initiated under the SAL, the overall

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2/ Note, however, that the macroeconomic projections (Table A, page 1) show government expenditure as a constant percentage - 31.8 percent - of GDP throughout the 1990s. This might be modified to show a decreasing role for the Government in the economy, which would be consistent with the country strategy.

conditionality for the proposed lending program, and the proposed lending operations in water and sewerage, transportation, power, and agriculture.

* Civil Service pay. The court ruling requiring payment of salary increases to civil service could put a severe strain on public finance. It can also risk an inequitable settlement if it were to involve privatization on special terms for civil servants. Could the Region comment on the current status of the civil service pay issue and the Government's recent proposal. Should other solutions be sought, such as setting up a trust fund to settle the claims over time, while proceeding with privatization in an equitable fashion, or does the Government's proposal seem equitable and affordable?

12. Private sector savings and investment. The low level of private sector savings and investment has been noted above.

* The recent Financial Sector Study contains a number of interesting proposals that could have an important impact on private savings as well as on investment. The Region may wish to elaborate upon the prospects for implementing these proposals, their likely impact on private sector savings and investment, and their relationship to the proposed Private Sector Promotion and Industrial Restructuring Project (FY92).

Operations Committee

Messrs. Qureshi, Husain, Jaycox, Karaosmanoglu, Wapenhans, Rajagopalan, Summers, Shihata, Kashiwaya, Wood, Bock.

cc: Messrs/Mss. Thahane/Burmester, SECGE; Picciotto, CPB; Goldberg, LEGOP; Wyss, COD; Sandstrom, EXC; Isenman, PRD; Linn, CEC; Stoutjesdijk, FRS; Okonjo-Iweala, OPNSV; Parry, CLID2; Parmar, IFC-CIO; Rao, IEC; Kavalsky, FRM; Pfeffermann, IFC-CEI; Liebenthal, PRD; Kilby, FRS; Shakow, EXT; Husain, Selowsky, Abe, Flood, Dabbagh, Institutional ISC.

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July 19,1991

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THE WORLD BANK

Operations Committee

CONFIDENTIAL

Minutes of the Operations Committee meeting to consider PAKISTAN - Public Sector Adjustment Program - Initiating Memorandum

Held on Friday, July 19, 1991 in Room E-1243

A. Present

Committee	Others
Messrs. M. A. Qureshi, Chairman	Messrs. P. Alba, EM1CO
W. Wapenhans, EMNVP	H. Dinh, FRSCR
E. Jaycox, AFRVP	S. El Serafy, EAS
A. Karaosmanoglu, ASIVP	I. Elwan, CFSPS
K. Kashiwaya, CFSVP	M. Fardi, PRDRA
L. Summers, DECVP	E. Grilli, EASDR
J. Wood, FPRVP	A. Hamid, LEGEM
D. Bock, OPNSV	P. Hasan, EMNVP
D. Goldberg, LEGVP	W. McCleary, EM1DR
M. Selowsky, LACVP	Mrs. N. Okonjo-Iweala, OPNSV
	C. Rajasingham, CFSPC
	M. Walton, DECVP
	M. Wiehen, EM1DR

B. Issues

1. The Operations Committee (OC) met on July 19, 1991 to consider the Initiating Memorandum for a $200 million Public Sector Adjustment Program Loan, half on IDA and half on IBRD terms. The discussion followed broadly the issues identified in the EAS agenda which included recent discussions with the government, the objectives of reform, the fiscal measures proposed, the restructuring of expenditures, the social action program, privatization and trade liberalization, Bank strategy in Pakistan, and loan amount and tranching.

C. Discussion

2. The Chairman asked the Region to update the Committee on the economic situation in Pakistan and the current discussions with the Bank and the Fund, adding that once completed, he expected a note on their outcome to the OC. The Region said that in FY91 export results were encouraging and the deficit on current account was smaller than had been expected. However, the fiscal deficit for FY91 was larger, now estimated at about 7-1/2% of GDP (compared to the PFP target of 5.5% of GDP), largely due to revenue shortfalls. The discussions currently underway with the

Bank and Fund were rather difficult: the PFP had indicated a deficit of 4.8% of GDP for FY92 but, according to current Fund/Bank estimates, this could turn out to be substantially larger in the absence of additional corrective actions.

3. The Macroeconomic Situation. A member thought that with the impact of the Gulf crisis, Pakistan was muddling rather well through a difficult situation, and if we failed to respond to its need a vicious circle might ensue. To this the Region responded that significant corrective actions would need to be put in place before the Bank could provide financial assistance. Pakistan managed last year, but development expenditures had suffered, signalling a decline that had begun some four or five years before, whereas military expenditure had risen. Not only did the pattern of expenditure need change, but revenue performance had remained short of expectations, with an apparent lack of will to reform. The new government, however, had made progress on many fronts including privatization, water-sharing among the provinces and a historic agreement for distributing revenues and responsibilities between the Federal and Provincial governments. The provinces would now be assuming a greater share than before in the social sectors. It was not clear how realistic the reduction was of the FY92 fiscal deficit from 7-1/2% of GDP to 4.8% as envisaged in the PFP.

4. The Chairman said that there were also signs of weakness in the composition of expenditure and in the social sectors, though the balance of payments was rather strong, thanks to adjustments made in the exchange rate and to measures for trade liberalization that had been introduced.

5. Past Commitments on Reform. A member said he was pleased to hear the Region's presentation, but he had the feeling of deja vu. The Region appeared to be saying that growth was not so bad, but the fiscal balance was less good: the expenditure pattern needed improvement, and revenue should be raised. For Pakistan there had been the PFP process and several adjustment operations. Some things did indeed get done, but there seemed always to be some factor that would cause the outcome to fall short of expectations. He was not concerned whether the budget deficit would be 4.8% or 5.1% of GDP, but he sensed a lack of rigor in the government's approach. He failed to see a clear government commitment to honor past undertakings before we gave more funds to Pakistan. Long-standing commitments in his view had not been fulfilled.

6. Composition of Expenditure. The Chairman agreed, stressing that tranche release conditions should be very clear. Apart from the macro aspects, he asked how the program related to past conditionality. He did not recall that the composition of expenditure was a feature of past adjustment operations. At issue now was not just resource mobilization, but the balance between military and other expenditures. He said that on this issue representations were made by the Bank and also voiced in the Aid Consortium. To this the Region added that the Consortium addressed this point with force, and as a result the FY92 budget showed a decline in military expenditure from 6.5% of GDP to 6.3% while development expenditure rose from 6.2% to 6.8%.

7. The Region went on to say that tranche releases were still pending for two adjustment operations: Energy II and the Financial Sector. In both cases, a favorable assessment of the macroeconomic situation would be a prerequisite of tranche release. For the energy operation all formal second tranche conditions had been met, with the exception of the appointment of consultants for the Basha dam. A waiver would be sought as external donors had not wished to finance a study that could involve riparian right issues (which had now largely been resolved) and because the settling of the Indus-water allocation among provinces improved the prospects for the Kalabagh dam project and therefore made the Basha study less urgent. There were also some minor actions pending which were contained in dated covenants. As to the financial operation (FSAL), there were still three actions that needed to be taken, relating to the introduction of an auction process to guide interest rate determination, the establishment of a new department in the State Bank to monitor the financial sector, and a commitment to and a timetable for privatizing the nationalized commercial banks. The Region added that the financial sector adjustment conditions would likely be met before the end of the current calendar year.

8. <u>Poverty Reduction and Conditionality</u>. A member expressed his reservations, saying that an emergency operation might fit the present situation better. Because a new government had come in, providing leadership for structural reforms, balance of payments support would be justified. The problem of poverty reduction and government commitment to it was crucial, however, considering the social indicators which, among others, showed the lowest women-to-men ratio in the world. He noted the slow progress on this front in the recent budget, adding that this kind of problem needed time. That is why an interval of six or nine months as proposed between the tranches appeared to him too short. He did not have the same sense of history the last speaker had, but he had noted the President's Council stress on the social sectors in future relations with Pakistan. Most countries had balance of payments and other macroeconomic problems, but in this case could we not concentrate our strategy and our funding on the social sectors?

9. Another member said that for countries like Pakistan there was a tendency to put all we could think of in a long list of actions and conditionality, so that inevitably some of these would not be done. As a result, attention would focus inordinately on detail, while the overall objective might get lost. In the process of agreeing with the government on specific conditionality, we might end up incorrectly defining what should be done. Another member stressed the importance of institutional reform which, if successful, would eliminate the need for some conditions, stating that institutional reform and changes in the legal framework would affect revenue and expenditure, thus indicating the usefulness of a third tranche.

10. <u>Design of the Operation</u>. The Chairman then said firstly that the proposed operation addressed four areas and asked if it was really necessary to cover all of them. If the Fund was present we might focus our attention on two areas, namely (i) public finance including the composition of expenditure (and within that, the social sectors) and perhaps (ii) trade reform and privatization. Would it not be better, he asked, to have an

intensified program covering these two areas? Secondly, he noted the absence in the IM of any explicit reference to the superb economic and sector work done by the Region, which clearly was the basis of the proposed operation. A comprehensive study had been made by the Region of the social sectors, and had received government endorsement. This came up with recommendations, including proposals for institutional reforms, which were not adequately reflected in the IM. The proposed conditionality likewise appeared not to reflect a coherent program with proper sequencing of reforms. He had the same reactions to the fiscal proposals also. Excellent work not reflected here had been done on fiscal structure, including work by a government commission on finance appointed two or three years ago. A sense of what had been done on these long-term issues needed to be given. Lastly he thought that the six-month interval between tranches was not compatible with the proposed reforms which needed a more extended operation, perhaps with a larger commitment and a longer disbursement period.

11. The Region said the operation had indeed started as an emergency one, but attention to social sector needs, absorptive capacity and use of counterpart funds indicated an adjustment operation. The Region shared the views expressed as to the need of having an overall strategy, backed by a plan of action, where the roles of the Federal Government and the Provinces were clearly defined, and donors' support committed. While it agreed that six months might not be enough for this purpose, the intention was to press for an action plan to be put in place and also to engage the participation of a large number of outside donors who had shown concern at the Consortium meeting. Whereas in the past lending to the social sectors was small, it was planned that 26% of Bank lending over the next four years would go to education, health and the alleviation of poverty.

12. Reform Matrix and Future Lending. Answering a question by the Chairman the Region agreed that the matrix of policy reform did not completely reflect the operation's design at this stage. But the proposed conditionality did reflect attention given to identified bottlenecks, removal of which would move the program forward. To succeed, commitment to reform must exist on the part of the Government, and the proposed steps proceed at the right speed. The Region preferred to monitor the program on an annual basis and reflect progress in annual reports to the Consortium. The Chairman commented that clear indications were necessary on the institutional and legal changes that would bring the reforms about, and that the nature and timing of some of the social sector reforms needed to be brought out more clearly and precisely so that they could be monitored. He had in mind for example the matrix conditions relating to revising the regulatory framework for private sector activities in education and health in order to encourage private sector participation.

13. A member returned to the social sectors, stating that whatever was wrong with the macroeconomy, there should be emphasis on restructuring expenditure and on institutional reform for the benefit of the social sectors. He asked why this was not a three-year loan that would support institutional development in the social sectors as well as alleviate resource shortage without overtaxing absorptive capacity. He found the proposed approach not very plausible, as we could be addressing the same objectives with a greater poverty focus. To this the Region said it was

not ready now to prepare a detailed multi-year program, and this operation represented a first slice which would influence policies and expenditure allocations in the social sectors for FY92 and FY93, to be followed by further operations (most likely, not adjustment operations). The present was dominated by the impact of the Gulf crisis and by the obligation on the Bank to help.

14. A member thought there was scope for using counterpart funds to help the social sectors. The Region said that Pakistan was a poor country where throughout the seventies and early eighties concern for social issues was missing. It had been hoped that with rising concern and given goodwill Pakistan would attend more to those aspects of development. Meanwhile military expenditure expanded, development expenditure fell and the social indicators stagnated. Now Pakistan was being told that its ability to mobilize external assistance was dependent on social reform. From its own perspective, the central government had to bring in the provinces since they have responsibility for primary and secondary education and for health.

15. Two Operations or One? A member thought that the discussion engendered by this operation confirmed his view that attention to poverty in the Bank was not just rhetoric since he could see major conditionality attached to poverty alleviation. He was struck, however, by both the name of this operation and the policy matrix which were both confusing to the reader with their emphasis on the macro aspects. He wondered why the dialogue with the borrower had to be "wrapped up" in macro conditionality which could be left to the Fund while we concentrated on the social sectors?

16. The Chairman agreed with the last speaker. He saw that the Region was trying to convert an emergency loan into an adjustment operation while simultaneously covering the social sectors. The government had not responded quickly enough to the Gulf crisis to make an emergency loan feasible, while it seemed still to expect an emergency operation. So his suggestion was for the Region to do what was feasible. He advised the Region to consider a separate loan that would address privatization provided there was a very good program to cover trade liberalization focusing this operation instead on the social sectors. He also urged the Region to consider the drug problem in Pakistan, maybe commissioning a study to gauge its dimensions and impact on the economy. The emphasis on containing military expenditure was warranted, he added, not per se, but because it was related to resource mobilization and the allocation of proceeds to productive expenditure. If a separate loan was to follow, focusing on privatization and trade liberalization, it could also contain conditionality on the level and composition of productive public expenditures, thus enabling us to keep the size of this operation at a modest level.

17. Tranching and Disbursement. A member recalled that there had been opposition in the Bank to using adjustment operations for the social sectors, the argument being that "materiality" could not be established in their case in terms of balance of payments requirements. The Chairman remarked that hybrids could attend to that aspect of the problem. He added that he was in sympathy with the agenda question over tranching, and

wondered what the rationale was for the proposed sequence of disbursements from IDA before IBRD. While he did not wish to get into details of the IDA-IBRD composition of the tranches, he specifically wanted IDA funds to be linked to the social sector program. A member also expressed puzzlement over the different phasing of IBRD and IDA funds, adding that this loan should be linked as well to external resource mobilization from other sources, so that by next spring when the Consortium met we would have an action program to present.

18. Macroeconomic Conditionality and Bank Strategy. The question of macro conditionality was raised again. The government might find it difficult to implement a Fund program, in which case, the Chairman said, we would still need a Fund view of the macroeconomic situation. A speaker said that even with a Fund program the Bank should have an independent view, and in the absence of a Fund program careful attention should be given to formulating macro conditionality, and the Chairman agreed. The issue of Bank lending strategy and of the share of adjustment lending in total lending was raised by a member. The Region said it was carefully considering this aspect, holding adjustment at a quarter of total lending at present, but it was prepared to change this in the light of expectations of net disbursement, and was reluctant therefore to concentrate adjustment lending in one operation.

D. Decision

19. The Chairman instructed the Region to rethink this operation along the lines contained in para. 16, taking into account the discussion of the OC as summarized above. He also expected the Region to circulate a note to the OC on the discussions being conducted in Pakistan by the Bank and the Fund. In particular he stressed that an appropriate macroeconomic framework was needed either with or independently from the Fund, together with monitoring indicators to gauge progress. The proposed operation could focus on public finance and the social sectors, leaving aside privatization and trade issues which might be covered in another operation. Focus in the present operation would then be on public resource mobilization, the level and composition of public development expenditures, and the policy, institutional and public expenditure framework needed to bring about a significant and sustained improvement in Pakistan's social conditions.

August 1, 1991

SESerafy/lcu

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

7171453 !

DATE: July 17, 1991

TO: Operations Committee

FROM: EG Enzo Grilli, Director, EAS

EXTENSION: 81934

(1)
(2) [illegible]
(3) [illegible]

SUBJECT: PAKISTAN: Public Sector Adjustment Program
Initiating Memorandum
Proposed Agenda

1. The Operations Committee (OC) will meet on Friday July 19, 1991 at 10:00 a.m. in Room E-1243 to consider a proposed Public Sector Adjustment Program Loan/Credit to Pakistan in the amount of $200 million, half each on IBRD and IDA terms. The Committee may wish to take up for discussion the following issues.

Background and Program Objectives

2. Pakistan's economy has been characterized by rapid economic expansion, but also high population growth offsetting much of the economic progress made. Economic activity is highly concentrated in agriculture, and the industrial base is narrow and slanted heavily towards agro-industry. The social indicators are extremely depressed and the economy has been prone to balance of payments crises, inflation and fiscal deficits. Efforts at structural adjustment were spearheaded by a SAL and a number of SECALs in the early and mid-eighties, but it was only in 1988 that adjustment gathered momentum with the initiation of the PFP process. This ushered IMF SAF and Stand-by arrangements (totalling SDR 546 million) and three IBRD SECALs (in agriculture, energy, and the financial sector) aggregating $600 million in FY89, supported by considerable bilateral and multilateral aid. Political upheaval, the Gulf crisis, and terms of trade deterioration, however, impeded the implementation of the program, which in turn slowed down external assistance, put a stop to a third-year SAF arrangement and caused the Stand-by to lapse last November. For the Bank, second tranches of the Second Energy sector Loan and the Financial Sector Loan, could not be released. 10-12 %

3. More recently great strides in economic management have been made by the government which assumed office in November 1990, and a renewed stress on social development responded well to a Pakistan Consortium meeting of May 1990. Bank and Fund missions visited Pakistan in December 1990 and April 1991, and as the Fund is said to be preparing for a third-year SAF and CCFF, the Bank's efforts at resuming structural adjustment have crystallized into the current operation, building on the reforms already incorporated in the FY92 budget. Although the operation is labeled a public sector adjustment loan, four policy areas are demarcated for the program: (a) macroeconomic, (b) public finance, (c) the social sectors, and (d) private sector provisions including trade liberalization.

The Macroeconomic Framework

4. Details of the macroeconomic framework will await agreement on a PFP for FY92-94 and also the Fund's program. Without these, the operation will not go forward (para. 61). Though the policy matrix does not indicate conditionality beyond the Bank being satisfied with progress, para. 12 sets out seven macroeconomic objectives (including raising development expenditure, reducing inflation, promoting exports and increasing agricultural productivity) covering a wide spectrum, some of which could be used as monitoring indicators for program implementation.

- The Region might identify a subset of these objectives as representing core reforms on which program implementation should focus.

- The Region might update the OC on the recent discussions with the Pakistani authorities and assess the chances of a Fund operation being put in place.

Public Finance

5. Reforms in public finance represent the heart of this operation and the area covered is again wide and detailed. The objective is to (a) reduce the fiscal deficit; (b) redefine Federal-Provincial resources and responsibilities; (c) improve the revenue structure and tax yields; (d) improve the pattern of expenditure (reducing subsidies, raising development expenditure and provincial expenditures on health and education,) and (e) improving fiscal monitoring. Already there has been progress on some of the above, including the limited introduction of VAT and some conversion of specific excise duties to ad valorem ones. Also some adjustment has been made in wheat support and fertilizer subsidized prices. The program aims at reducing the FY92 fiscal deficit to 4.8% of GDP; eliminating certain income tax exemptions and discretion to grant exemptions; reducing investment incentives, extending excise taxation to services, and indexing specific rates or converting them to an ad valorem basis. No 4.8?

- The Region might explain why income tax reform is not covered, considering the low yield of this tax and the dismal social indicators which have persisted despite sustained overall economic growth.

- Can some indication be made of the stages reform is expected to take during implementation?

- Why cannot all excise taxation be converted to an ad valorem basis?

Expenditure Structure

6. One objective is to restructure current expenditure by the federal government, specifically through containing the wage bill, reducing subsidies, increasing provincial current expenditures for health and education and raising and restructuring investment expenditures for development and improving its monitoring. Various expenditure increases are expected, defined in per capita terms during FY92 for education and health, and better allocation is sought under the development budget for a variety of expenditures.

- The Committee may wish to enquire to what extent the proposed changes will make an impact on the structure of expenditure, and if the three-year rolling investment program will be an adequate vehicle for sustaining the change after this operation.

The Social Action Plan

7. Not much action is expected in this area until the second tranche when the authorities will clarify procedures and criteria for ranking projects by their social worth, attracting women staff for health and education and preparing operations for delivery of family planning services. Ways will have to be devised to raise private sector participation; prepare proposals for raising user charges; initiate expansion of rural water and sanitation programs and cost recovery; prepare and adopt a social action plan to improve effectiveness of delivery of population and education services, and improve data and projections for social expenditure.

- The Region might explain if these changes could not be advanced in time rather than await the second tranche?

- Is there a blueprint in the form of an earlier study to guide these changes, or is there a study planned to guide the program?

The Private Sector and Trade Liberalization

8. Actions under the program to promote private sector interests focus on trade reform and privatizing some public entities. It seems that tariffs are still quite high, with the maximum tariff having been reduced to 95% only this year.

- The Region might give a short account of actions to be taken under the program to enhance privatization, a summary of the structure of tariff protection and QRs and some indication of the medium-term objectives of trade liberalization and privatization. What exactly is going to be achieved on these two fronts during implementation of this operation?

Bank Strategy

9. Bank strategy is summarized in two pages (21 and 22) towards the end of the IM. The great expansion in lending during the eighties is described as well as the emphasis on energy sector lending (31%) in past lending to Pakistan, as compared with only 7.5% for education and family planning.

- As a Board discussion of the strategy will be triggered by this operation, the Region might expand on the IM coverage, indicating past and prospective defense expenditures and how the lending program will be reshaped to put more emphasis on the social sectors.

Loan Amount and Tranching

10. The loan amount was determined in light of the balance of payments requirements (Table 1), which show a financing gap remaining of $784 million in FY92 -- a year when external debt service amounts to $2.8 billion. It is proposed that the loan/credit be disbursed in two tranches six months apart, with 90% of the first tranche from IDA and 90% of the second from IBRD. Why not equally stressed

6 months

- Considering that social sector reforms need time to be devised and implemented, would not a longer adjustment period altogether be more appropriate, extending perhaps to 30 months and three tranches?

- If two tranches are maintained, should not IDA and IBRD financing of the first and second tranches be reversed so that much of the first tranche be on IBRD terms and the second tranche from IDA? And should not the six months between the two tranches be extended?

- How would the rest of the financing gap be filled, and what prospects are there for aid from traditional bilateral sources?

- Is the proposed 20% retroactive financing commensurate with the actions already taken?

Operations Committee

Messrs. Qureshi, OPNSV
Husain, LACVP
Jaycox, AFRVP
Karaosmanoglu, ASIVP
Wapenhans, EMNVP
Rajagopalan/Summers, PRE
Shihata, LEGVP
Kashiwaya, CFSVP
Wood, FPRVP
Bock, OPNSV

cc: Messrs/Mmes Thahane/Burmester, Picciotto, Goldberg, Wyss, Sandstrom, Isenman, Linn, Stoutjesdijk, Okonjo-Iweala, El Serafy, Dervis, Wiehen, Hasan, Penalver-Quesada, McCleary, Parmar, Rao, Kavalsky, Pfeffermann, Liebenthal, Kilby, Robless, Walton, Khanna, Institutional ISC.

SESerafy/lcu

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

7111040

DATE: July 9, 1991

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

THROUGH: Mr. Kemal Dervis, Acting Regional Vice President, EMENA

FROM: Michael H. Wiehen, Director, EM1

EXTENSION: 33000

SUBJECT: **PAKISTAN: Public Sector Adjustment Program Initiating Memorandum**

1. Attached for your approval is the Initiating Memorandum for the proposed Pakistan Public Sector Adjustment Loan and Credit. We are seeking authorization to appraise the Loan and Credit concurrently with the discussion (jointly with the IMF) of a revised three-year PFP, for FY92-94. The IMF is also negotiating a third-year SAF arrangement for FY92 and considering the request for Pakistan's access to the CCFF. The proposed operation would include a Loan of $100 million and a Credit of $100 million with Japanese cofinancing estimated at $200 million.

Background

2. Pakistan started a program of structural adjustment in 1988, described in the first Policy Framework Paper of November, 1988. This program was initially supported by the Bank with several sector loans, and by the IMF with a SAF and a Standby arrangement. Following two years of uneven implementation (FY89 and FY90), Pakistan's adjustment program foundered in early FY91, partly as a result of the political upheavals and Government change of August 1990, and to the resulting inability to respond quickly and decisively to the external shock caused by the Gulf crisis. The slowdown in program implementation caused delays in the disbursement of external assistance, which further aggravated the financial gaps. The third-year SAF arrangement was not concluded, the Standby was allowed to lapse in November, 1990 without fully disbursing, and second tranche releases for the Bank's Energy Sector Loan and Financial Sector Loan did not take place.

3. The transitional Government appointed in August, 1990, requested Emergency Assistance from the Bank during the Annual Meetings of September 1990, and indicated its intention to put the adjustment program back on track. A mission with IMF and Bank staff participation visited Pakistan at that time, to start discussions on the program and possible assistance. Adoption of new measures, however, was delayed by the political transition, including general elections in October and a new Government taking office in early November. The new Government introduced major petroleum price increases within days of taking office, and announced a far reaching

process of opening up, deregulation and privatization of the economy. Since then, major agreements between Federal and Provincial Governments on sharing of fiscal revenues and among the Provincial Governments on sharing the Indus water were reached. Implementation of other measures, however, particularly in the areas of fiscal revenues and size and structure of public expenditures, were delayed until the preparation of the FY92 Budget that was approved in late June.

4. During this period, missions with both Bank and Fund staff visited Pakistan, in December 1990, and April 1991, to continue preparation of the program. In this process, the initially proposed Emergency Adjustment Operation evolved in its approach and contents, most importantly as a result of continuing Bank work on public expenditure issues, particularly in the area of social sector expenditures. The increasing importance given to social sector issues was further strengthened by the discussions at the Pakistan Consortium meeting in May, 1991, where most other donors insisted on the urgency of addressing social sector issues, together with achieving satisfactory macro balances, as the main challenges for achieving long-term sustainable growth in Pakistan.

Objectives and Focus of the Proposed Loan and Credit

5. The proposed PSAL, together with the possible third-year SAF and CCFF, would support the Government's expanded adjustment and structural reform program and would provide financing to close the FY92 financing gap. The policy reform measures to be supported include:

i) Economic deregulation, liberalization and privatization measures already initiated, or announced, during the second half of FY91;

ii) A macroeconomic framework consistent with the original PFP program that would reduce the overall fiscal deficit from about 6.4% of GDP in FY91 to 4.8% in FY92, increasing total Government revenues (from 18.8% to 20.2% of GDP) and development expenditures (from 6.4% to 6.9% of GDP). Non-development expenditures (including military) would be contained. On the external sector, the current account deficit would drop from 4.1% of GDP to 2.6% of GDP;

iii) Structural reforms in the areas of taxation (income tax, general sales tax and excise taxes) and of expenditure, including rationalizing federal and provincial development expenditures and introducing improved monitoring and medium-term planning of development expenditures; and

iv) Increasing the amount and improving the structure of public expenditure in the social sectors, together with adoption of measures that would encourage and facilitate private sector investment in the social sectors.

Many of the reforms under ii), iii) and iv) above were expected to be included in the Federal and Provincial Budgets for FY92, while others, particularly longer-term reforms in the social sectors, require further preparation. In fact, it now appears that the FY92 Budget as approved falls short of the targets in a number of areas. The possible shortcomings and necessary additional measures are explained in the attached Initiating Memorandum and would be taken up during the IMF mission and PSAL appraisal.

Next Steps

6. A preappraisal mission is currently in the field, jointly with the IMF, in order to (i) assess the preliminary outcome for FY91, (ii) discuss the contents of the revised PFP, and (iii) review the implications of the Federal and Provincial budgets and seek agreement on the additional measures to be taken. As noted earlier, the IMF is also discussing the contents of the third-year SAF arrangement and CCFF.

7. Further processing of the proposed PSAL would take place in parallel with preparation and approval of the PFP. The macroeconomic framework on which the IMF is seeking agreement under the third-year SAF has been prepared in close consultation by the staff of the two institutions; agreement on this framework would be a condition for both the PSAL and SAF. Assuming that agreement is reached in July, negotiations could take place in late August. Given the need for additional budgetary measures amounting to an effective "mini-budget" agreement may require another joint mission in September.

Attachment

MPeñalver:gah

July 12, 1991

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THE WORLD BANK
Operations Committee

CONFIDENTIAL

Minutes of the Operations Committee to consider
TANZANIA: Financial Sector Adjustment Credit - Initiating Memorandum (IM)
held on July 12, 1991 in Room A-1243

A. Present

Committee	Others
Operations Committee	Others
Messrs./Ms M. A. Qureshi (Chairman)	Messrs./Mss. S. Denning (AF6DR)
K. Jaycox (AFRVP)	R. Armstrong (AFRCE)
S-R. Aiyer (LACVP)	D. Cook (AF6IE)
M. Haug (ASIVP)	R. Grawe (AF6CO)
W. McCleary (EMNVP)	S. Bell (AF6IE)
B. Kavalsky (FPRVP)	K. Krumm (AF6CO)
D. Goldberg (LEGVP)	E. Adu (LEGAF)
J. Linn (DECVP)	D. Kalantzopoulos (PRD)
K. Kashiwaya (CFSVP)	L. Pritchett (CECTP)
D. Bock (OPNSV)	M. Varkie (MIGA)
	M.A. Alizai (IFC)
	G.E. Gondwe (IMF)
	E. Grilli (EAS)
	F. Levy (EAS)

B. Issues

1. The Operations Committee's discussion covered the issues raised in the agenda, prepared by EAS, and in a memorandum distributed by DEC. The Chairman asked the Regional representatives to begin the meeting by focusing on three questions: (i) the adequacy of the macroeconomic framework--in particular, whether Tanzania was moving rapidly enough to reduce the fiscal deficit and to adjust the exchange rate; (ii) whether it made sense to expend great effort to restructure the state-owned financial institutions instead of liquidating some of them and bringing in private ownership from the start; and (iii) whether satisfactory progress was being made in the restructuring of the agricultural cooperatives and marketing boards, in view of their negative fiscal and monetary impact.

Macroeconomic Framework

2. The Committee discussed the adequacy of exchange rate policy and the concern expressed in the DEC memo that the gap between the official rate and the black market rate would be supported by the large flows of donor monies through the Open General Licensing (OGL) system, and that strong incentives would exist for funds to be diverted to the black market. The Region argued that a simple comparison of the two rates overstated the extent of the gap: if import duties and cash deposit requirements on imports through the OGL were taken into account, the effective gap would be within 10-15% (rather than the 50% cited in the memo), reducing the incentive for arbitrage. The Chairman pointed out that the gap was being

kept small by the aid inflows, and the donors were, in that sense, perpetuating the Government's go-slow policy on exchange rate adjustment. In response, regional representatives underlined the importance of these external flows for growth and imports necessary to the desired supply response, and they emphasized that getting the donors to channel aid through the OGL would result in a substantial improvement in the efficiency of aid use compared to the tied aid of the past.

3. In response to the Chairman's request for IMF views, the Fund representative agreed that the exchange rate was currently overvalued and affirmed that the PFP called for correction over a three-year period. The time path of adjustment remained to be agreed, however. While it might be desirable for more rapid adjustment, the Tanzania program was not so slow compared to other African countries. The Region added that, although full correction of the exchange rate might only occur over three years, it was expected that the bulk of the adjustment needed to achieve equilibrium on the trade account would in fact occur much sooner in line with agreements reached on trade liberalization steps to be taken in January 1992 (shortening of the OGL negative list) and on a process to adjust the exchange rate accordingly.

4. The Chairman asked the Region to respond to members' questions about the fiscal deficit and the impact that bank restructuring and other financial reforms would have on it. One member asked how the situation would be managed if bank losses turned out greater than currently projected. He suggested that the appraisal mission fully cost out the fiscal impacts of the reforms, including the costs of the proposed interim financing for certain agricultural cooperatives. Another member expressed concern that the large fiscal demands of restructuring the state-owned banks would increase government borrowing and crowd out the private sector from the credit market. The Region replied that the PFP program, which targets the fiscal deficit at 6% of GDP and would require no net borrowing from the banking system, calls for increases in both revenues and expenditures. The bank restructuring is projected to cost the budget about 3-4% of GDP, which should be feasible within the budget targets, albeit with some realignment of the budget. The proposed interim financing of cooperatives would be transitional and time-bound (see also para. 8). It was acknowledged that the projections were subject to considerable uncertainty. In any event, the Government is fully aware of the fiscal difficulties they face in the future and are committed to the PFP framework. The Region expects that fiscal pressures may help to encourage the Government to undertake a more rapid process of privatization.

Restructuring of Financial Institutions

5. The Chairman noted that the proposed restructuring involved shifting the nonperforming assets of the National Bank of Commerce (NBC) onto the Ministry of Finance. He asked whether it was credible to expect the restructured NBC to function better, even after restructuring, so long as it remained in the public sector. Why not bring in private joint venture capital from the outset to provide training, managerial upgrading, etc., particularly in light of the experience elsewhere where restructuring has been found to be very expensive and not always successful in attracting new private capital? A Committee member emphasized the problem of managerial incentives and asked whether NBC would be fully autonomous in the future. He also expressed concern that LART, the agency to which bad debts would be shifted for collection or liquidation, reported to the Minister of Finance, whose primary objective would likely be asset

maintenance rather than liquidation. Another member asked whether NBC would not be more attractive to private investors if it were broken up. A third member added that it would be undesirable to privatize an institution accounting for 80% of the banking system, and that there is a strong case on those grounds to break it up. A member observed that the demand for banking services was relatively limited in Tanzania, and that a small, sound bank was likely to be more effective in meeting the need than a new, restructured NBC.

6. In response to these questions, regional representatives indicated that they would also prefer a faster privatization of NBC, but that it did not appear feasible. A recent Government declaration has opened the sector to private banks, requires state banks to operate on commercial principles, and provides an acceptable framework for bank regulation and supervision. Moreover, discussions are under way with a number of foreign private banks, which have indicated interest in entering Tanzania. Nevertheless, it will take time and experience before outsiders will feel sufficiently comfortable to enter, and it is essential to avoid a hiatus in financial services during the interim. The writing off of bad debts would result in a substantial reduction in NBC's size. Nevertheless, without NBC Tanzania would have no functioning financial sector. Meanwhile, the emphasis of the program would be on stopping government interference in commercial banks' decisions and to put the banks on a sound basis. One result of NBC's restructuring was likely to be a substantial reduction of staff, and prospective private investors preferred that government carry out this task.

7. The Chairman asked the IFC's views on the opportunities for privatization in Tanzania, what IFC was presently doing there, and what factors were lacking for attracting new private investment. The IFC representative affirmed that there was an active dialogue between Bank and IFC staff on the development of the financial sector and of the private sector generally in Tanzania. He said that foreign investors had expressed interest in merchant banking and venture capital undertakings that IFC wanted to encourage. On the other hand, IFC has found dealing in the industrial sector to be very difficult because of the negative attitudes of the relevant government officials. Negotiations over asset valuations can go on for several years, holding up new investments. In the past, IFC experienced large arrears in its activities in Tanzania and had collected only recently with the help of the Bank. As a consequence, they are only willing to enter projects where they can get a foreign exchange set aside. IFC is currently working on several such investments, which could go to the Board shortly.

Agricultural Cooperatives and Marketing Boards

8. The Chairman asked about progress under the FY90 Agricultural Adjustment Credit (TANAA) in reforming the agricultural cooperatives and marketing boards and whether they were still important sources of fiscal deficit and credit expansion. A Committee member and an observer asked why government guarantees for credit to certain cooperatives were being proposed under the present operation, and whether this might not inhibit the entry of new private marketing enterprises. The Region indicated satisfaction with the progress under the TANAA, confirming that losses from food crop and most export crop financing had been eliminated, and that much of the financing was now originating outside the banking system from informal lenders. Nevertheless, some transitional state guarantees were needed to assure adequate financing for a few export crops, for which it

was expected to take a couple of years for the private sector to become effectively engaged in marketing. The amounts of credit involved would be small.

C. Conclusions

9. In summing up the discussion, the Chairman emphasized that the appraisal mission should (a) get a clear picture of the fiscal costs of the financial sector reforms to be undertaken and how they might be accommodated under the fiscal program; and (b) elaborate a restructuring program, with monitorable benchmarks and with clear understandings regarding the incentive frameworks of NBC, LART, and the other state-owned financial institutions, leading to competitive, commercially oriented operations. He encouraged IFC to take on a greater role in Tanzania. Finally, he asked the Region to provide the Committee an opportunity to review the operation at the green-cover stage.

FDLevy
07/18/91

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: July 10, 1991

TO: Operations Committee

FROM: Enzo Grilli, Director, EAS

EXTENSION: 81934

SUBJECT: Tanzania: Financial Sector Adjustment Credit (Initiating Memorandum)

1. The Operations Committee will meet on Friday, July 12, 1991, at 4:30 p.m., (please take note of change in time) in Room E-1243, to discuss the Initiating Memorandum for a proposed US$150 million financial sector adjustment credit (FSAC) for Tanzania. Cofinancing of about US$100 million is also expected for the proposed operation. Following is a suggested agenda.

A. Background

2. Tanzania has made substantial progress under the adjustment begun in 1986. The Bank has supported the program with adjustment operations in FY86 (Multisector Rehabilitation Credit), FY88 (Industrial Rehabilitation and Trade Adjustment Credit, and FY90 (Agricultural Adjustment Credit). The Fund has also provided assistance under SAF, and a first ESAF program is scheduled for Fund Board presentation later this month. Measures introduced since 1986 have included a cumulative depreciation of the real effective exchange rate of more than 80%; the creation and expansion of an open general licensing facility; adjustment of interest rates to positive real levels; the decontrol of most prices; and reform of the agricultural marketing system.

3. Tanzania's program has received strong endorsement and support from other donors, most recently at June 24-26, 1991 Consultative Group meeting, chaired by the Bank. While lauding progress so far, however, the CG members urged the Government to move more vigorously in reforming public sector management, particularly as regards the parastatal sector. The Region proposes to support actions in this area with an industrial sector adjustment credit, to be appraised later this year, and a public sector adjustment credit, to be appraised next year.

4. As regards the financial sector, the Government has announced its intentions to permit the establishment of private domestic and foreign banks and to undertake the restructuring of the existing state-owned institutions, while refraining from interfering in their decisions. There has been close coordination with the Fund in this area, and, as indicated above, other donors have expressed interest in cofinancing the proposed operation. A follow-up FSAC is planned for FY95.

B. Issues

Macroeconomy

5. Growth in Tanzania has exceeded 4% per annum since introduction of the adjustment program. Inflation has been reduced from above 30% in 1988 to 19% in 1990, in part as a result of a sharp reduction in the fiscal

deficit (para. 2.3-2.4). Monetary growth has accelerated, however, as fiscal expenditures have been channeled through the banking system. With these quasi-fiscal expenditures included, the consolidated deficit has, in fact, been growing. The real effective exchange rate has been devalued more than 80% since 1986 (para. 2.1), and the gap between the official rate and the black market rate has been reduced from more than 800% in 1985 to about 50% currently (para. 2.6).

- **The Region may wish to elaborate on the evolution of the economy under the reform program and on the coherence of macroeconomic management.**

- **The Committee might ask the Region to discuss the growth of quasi-fiscal expenditures, their consistency with the conditionality of Bank and Fund programs, and how they are to be controlled and reversed by the reforms supported by the proposed FSAC. How high is the consolidated deficit currently, and how much will it be reduced under the program?**

- **Given the sharply reduced gap between the official and black market exchange rates, why are three more years considered necessary to reach equilibrium levels? What are the implications of this transition for inflation and interest rates?** Exch Rate

- **Does the Committee agree that the macroeconomic situation and outlook are conducive to the success of the proposed operation?**

The Reform Program and Strategy of Bank Support

6. The IM stresses the important interrelationships between policy reforms and institutional restructuring in the real sectors and those proposed in the financial sector. Particularly important has been the reform of the agricultural marketing system and the anticipated reform of fiscal management and the state industrial enterprises. Future Public Sector & State Ind Enterprises

- **The Region might be asked to explain the Bank's overall strategy of support to these reforms and to describe how the proposed program of adjustment loans (past and anticipated) fit together with the currently proposed FSAC.**

- **Are the reforms of the cooperatives and marketing boards, supported by last year's agricultural adjustment credit, being effectively implemented? Is credit to them under control? Is there a danger that the proposed Government loan guarantees, intended as a transition device to assure the continuation of credit flows until new marketing channels develop (para. 5.4), will have the opposite effect of inhibiting potential distributors who lack access to such guarantees?**

- **Does the Committee agree that the proposed operation is well integrated into, and an important element of, the country strategy?**

Financial Sector Reforms

7. The Government has indicated its intention to move from central planning of credit to a market-based financial system, in which financial institutions operate on commercial principles without government interference; interest rates are rationalized and eventually liberalized; private ownership is encouraged; monetary policy is strengthened; and a system of regulation and supervision is introduced consistent with international standards. The Committee may wish to seek clarification on a number of points. Specifically:

- The Government's emphasis so far, and that adopted by the IM, is on removing restrictions to private ownership in the financial sector and creating a conducive incentive environment for the entry of foreign and domestic private banks. **Should a more proactive stance be adopted to stimulate the privatization of existing institutions and the entry of new ones? Is there an active role for IFC to play in this regard?**

- As a first step toward interest rate liberalization, banks are to be free to set lending rates below an announced maximum (para. 5.6). Contingent on the development of new institutions and competition, this ceiling is to be eliminated by 1993/94. **What are the Region's views on how the ceiling should be set? Would a uniform ceiling be set for loans of all maturities? Is there a danger that higher-risk borrowers would be excluded by such a system? What indicators will be taken into account to determine the appropriate time for eliminating the ceiling?**

- Current interest rates are mostly positive in real terms (para. 4.7). **How do these rates compare with the interest rates prevailing in the active informal financial market? Why are real rates on government securities still negative? Are financial sector holdings of these securities mandatory? Is this an issue to be dealt with in the FSAC?**

8. Is the Committee satisfied that the IM has correctly identified, and that the proposed FSAC would appropriately attack, the most immediate problems of financial sector adjustment?

Institutional Restructuring

9. The FSAC would support a number of actions to strengthen the banking system, including (i) the divestment by the central bank (BOT) of its development lending responsibilities and of its shareholding in the Cooperative and Rural Development Bank--CRDB (para. 5.10); and (ii) the financial restructuring of the major state-owned banks. To facilitate the Committee evaluation of the proposed operation, the Region might be asked to discuss a number of issues of loan design and conditionality. Specifically:

- The amendment of the BOT Act to implement the above-mentioned divestment of developmental functions is proposed as a second tranche condition in para. 5.10, but only "introduction of the amendments" is indicated in the policy matrix (Annex I, p. 2). The Region might want to clarify this point. **Would it be desirable to have introduction of the legislation as a condition for Board presentation and adoption as a second tranche release condition?**

- As a prelude to the restructuring of the existing state banking institutions, a Loans and Advances Realization Trust (LART) has been set up to take over the bad debts of the banking system for collection or liquidation. **What safeguards are anticipated to assure that collectable debts are not fraudulently written off? Will LART have sufficient authority and incentive to seize and dispose of assets? Should a tranche condition be introduced with respect to the actual liquidation of assets?**

- It is proposed that the FSAC support the comprehensive restructuring, both financial and administrative, of the National Bank of Commerce (NBC), which accounts for more than 80% of banking system assets (paras. 5.19-5.20). **Given the objective of a more competitive financial sector, would it not be preferable to break up NBC and privatize it?**

- The Tanzania Investment Bank (TIB), with 90% of its portfolio in arrears for a year or more, is also proposed for restructuring and recapitalization (paras. 5.23-5.25). **Would it not be simpler, cheaper, and more likely to achieve the objectives just to liquidate TIB and promote the establishment of a private joint-venture investment bank? A similar question could be raised with regard to CRDB (paras. 5.21-5.22).**

- The proposed recapitalizations of the financial institutions will make heavy demands on the Government budget (paras. 5.28-5.31). **Are the amounts projected manageable within the overall macroeconomic program?**

Operations Committee

Messrs. Qureshi, Husain, Jaycox, Karaosmanoglu, Wapenhans
Rajagopalan/Summers, Shihata, Kashiwaya, Wood, Bock

cc: Messrs. Thahane/Burmester, Picciotto, Goldberg, Wyss, Sandstrom
Isenman, Linn, Stoutjesdijk, Ms. Okonjo-Iweala, Levy/Chaudhri
Parmar, Rao, Kavalsky, Pfeffermann, Liebenthal, Kilby,
Robless, Walton, Khanna, O'Brien, Denning, Patel, Grawe,
Ms. Krumm

FLevy/

MM. Yumesni

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

7/12/419

DATE: July 12, 1991

TO: Mr. Edward V.K. Jaycox, Vice President, AFR

FROM: Johannes Linn, Acting Vice President, DEC

EXTENSION: 37459

SUBJECT: Tanzania: IM for a financial sector adjustment operation (FSAC)

1. The proposed project is intended to promote reforms of the financial sector of Tanzania. While the IM presents a coherent strategic vision of a financial sector conducive to improved economic performance, I have serious reservations that the concrete actions proposed are consistent with achieving this goal. I particularly have reservations about two components, the macroeconomic framework and the plan for restructuring the major commercial bank.

Macroeconomic framework

2. I have two concerns about the adequacy of the proposed macroeconomic framework as it: i) does not incorporate the full budgetary impact of the project and ii) leaves the sustainability of the external imbalances open to question.

3. Budgetary impact. The IM does not deal adequately with the total budgetary impact of the project in two ways.

i) The required budgetary commitment for recapitalization is subject to tremendous uncertainty. The classification of the banks' portfolios by performance and risk category is still preliminary. Furthermore, no concrete plan is presented for allocating the unrecorded losses uncovered during this exercise and provisioning against the banks' remaining risk.

ii) In addition to the tentative recapitalization costs presented there are three large increases in explicit budget commitments: 1) the "interim financing" required as previously implicit subsidies are pushed, temporarily, on budget (para. 5.4), 2) the recapitalization of the Bank of Tanzania that will apparently become insolvent when its loans to NBC are written off (para. 5.31), 3) the increased explicit budgetary pressures as financial repression is eliminated and interest rates are liberalized. No total budgetary impact estimate is given.

Govt paper is placed with fin instit. at - v - rates

The conservatively estimated annual budgetary cost of just the commercial banks' restructuring appears to be 2% of GDP, while the overall deficit is programmed to fall by 3% of GDP (Annex II, table 1). Some discussion of the government's ability and willingness to undertake the resource mobilization necessary to meet these demands without resort to inflationary or distortionary (e.g. more financial repression) financing is certainly in order.

4. External imbalance and exchange rate. The second concern about the macroeconomic context is the compatibility of the liberalization of the import regime, which is proceeding apace, with the government's program to "achieve an equilibrium exchange rate within the next three years" (para 2.60). This extended transition raises two issues. First, there is the troubling fact the disequilibrium excess demand for foreign exchange that is occasioned by the government's reluctance to move rapidly on the exchange rate is financed by increased disbursements of IDA funds into the OGL. A second concern is that one-third of imports are currently financed at a parallel exchange rate 50% higher than the official rate (para 2.6). Making donor foreign exchange freely available at the official exchange rate through the OGL in this situation presents a serious risk of arbitrage pressure on the sustainability of the OGL as demand shifts from the parallel market.

Plan for commercial bank restructuring

5. The project's proposals for achieving an efficient, market oriented allocation of credit by promoting private sector entry and fostering an appropriate legal and regulatory environment are consistent with its overall strategy (although one wonders about the seriousness of the government's commitment to allow entry of private banks given the remaining serious restrictions). However, I feel that the operation's proposal to allow National Commercial Bank (NBC), which accounts for 80% of banking sector assets (para 5.19), to remain as a large, publicly owned, commercial bank, after moving the worst parts of its portfolio into a new public agency (the Loan and Advances Realization Trust, LART), is inconsistent with the project's goals.

6. The operations' present proposal for NBC has three limitations.

i) The NBC will be recapitalized but apparently retain exactly the same institutional framework and incentive structure that led into the present dire straits. The government is said to be "committed to allowing the banking system to operate autonomously" (para. 5.3). However, the project does not appear to provide either a change in the incentives of the government to use the NBC as an instrument for channeling resources to favored activities, or an institutional mechanism that allows the NBC management (should they have the incentive) to resist such pressures, or any means whereby the Bank could monitor the government's continued compliance with its present commitment.

ii) Current plans for restructuring the entire NBC entails it beginning its new life severely handicapped. First, even after the transfers into the LART "a significant portion of the banks' portfolio will be substandard and doubtful" (para. 5.18). Second, the assets transferred to the LART will be replaced on the balance sheet with long-term government bonds assumed to pay 15% (para. 5.30), less than the rate of inflation (19% in 1990/91) and half the allowed lending rate (31%, para. 4.7). As highlighted in para. 3, the government does not have the resources to fully recapitalize NBC.

iii) The immediate division of loan assets into complete losses (into LART) and those just "substandard and doubtful" (NBC) is inconsistent with the timetable for the restructuring of the industrial and agricultural sectors. Which loans are irrevocably non-performing depends on a number of factors, including decisions made about the rehabilitation of particular enterprises under the Industrial Rehabilitation Adjustment Credit. However the time scale for proposed financial restructuring of NBC is on the order of months, while industrial credit foresees a process lasting several years.

7. The current proposal for a LART seems to create a number of wrong incentives. First, actually recovering on assets would seem to require more institutional effort than "an accounting entry at the Treasury" (para 5.17). However, the proposed LART moves the assets of public enterprises entirely within the official public sector and into a ministry whose incentives may be for the perpetuation of the current institutions. This potentially reduces the threat to firms of external restructuring by creditors and may reduce the pressure on public enterprises to operate on commercial principles. Second, the anticipation of a LART encourages firms to default and the NBC to relax its collection efforts and hence exacerbates the transitional difficulties.

Debt Collection agency

8. In sum, the present proposal readily allows a medium term scenario in which the financial system still primarily consists of one large, publicly owned, government directed, financially insolvent, commercial bank.

9. An alternative is to slice off the few good parts (staff, assets, and commercial relationships) of the existing NBC into a commercial bank that would be <u>institutionally</u> autonomous from the government and have direct substantial private participation. This much smaller new bank (which could be called the NBC) would compete on equal footing with the new entrants facilitated under the legislative reform and could potentially be fully privatized after a transition

period. The remainder of the NBC would essentially remain in government hands to serve the functions of a liquidation agency (call it the LART). This institution would have the mandate to restructure or liquidate the assets and would provide necessary interim financing. This remainder would have an explicitly limited lifespan and only limited and transparent access to the budget. In the medium term the small new NBC would be fully privatized and the LART cease to exist.

cc: Messrs. Qureshi, Thalwitz, Karaosmanoglu, Wapenhans, Rajagoplan, Shihata, Kashiwaya, Wood, Bock, Summers, Grilli, Isenman

THE WORLD BANK/IFC/MIGA
OFFICE MEMORANDUM

Qureshi
E 1241

DATE: July 5, 1991

TO: Mr. Willi A. Wapenhans, Acting Senior Vice President, Operations

FROM: Callisto Madavo, Acting Vice President, Africa Region CM

EXTENSION: 34036

SUBJECT: TANZANIA: Financial Sector Adjustment Program
Initiating Memorandum

1. Attached for your approval is the Initiating Memorandum for the proposed Tanzania Financial Sector Adjustment Credit (FSAC). We are seeking authorization to appraise this credit starting July 22, 1991 with a view to Board presentation in the second quarter of FY92. The proposed credit amount is US$150 million, with cofinancing estimated at US$100 million.

Progress to Date

2. The last 18 months have witnessed striking accomplishments in the adjustment program in Tanzania and built on the steady progress made over the past five years. The scale of remaining reforms involved is ambitious. Yet commitment to reform exceeds capacity to implement. The proposed operation is critical to that policy and implementation process.

3. Since 1985, the macroeconomic framework critical for recovery and sustained economic growth largely has been put in place, with substantial devaluation of the Tanzania shilling, elimination of domestic financing of the budget deficit, progressive liberalization of the trade regime, and major tax and tariff reforms. The process of real sector reform began with fundamental changes in the structure of agricultural marketing, in particular, the winding up of National Milling Corporation operations in grain marketing, which had constituted the major drain on the banking system, and support for a multi-channel marketing system, an essential precursor to financial sector reform to ensure that the latter could proceed without putting the production base of the economy at risk.

4. Since the Tanzania Agricultural Adjustment Credit (TANAA) was presented to the OC about 18 months ago, the Government has broadened its policy agenda and taken important and sizable steps in addition to those supported by TANAA. Prominent among these are the substantial expansion of the open general licensing (OGL) system; a new policy and legislation on agricultural cooperatives; pushing through the National Investment Promotion Policy; successful initiation of the infrastructure rehabilitation programs for roads, ports, and highways; and new policies and legislation for the financial sector reform. The fourth Policy Framework Paper, endorsed by the COW on June 11 and constituting the basis for the first ESAF arrangement scheduled for IMF

Board discussion on July 29, marked further progress in agreements on policy reforms in several areas, notably, the exchange and trade regime -- long a contentious area in Tanzania; financial and monetary policies including liberalization of interest rates and cessation of directed credit and preferential interest rates; and, for the first time, an explicit statement of policies to promote the private sector. The Consultative Group (CG) meeting in Paris, June 24-26, strongly endorsed the Government's program and actions already taken, particularly in the financial sector, agricultural marketing, and cooperatives sector.

5. While its magnitude is significant to the economy, donor support has been channeled to favorite areas, often inconsistent with priorities of the adjustment program. A major output of our work on Tanzania was the recent pledging of $300 million of bilateral support for the OGL (up from zero), representing a major breakthrough in redirecting bilateral support away from administered foreign exchange and inefficient parastatals.

6. The economy has responded positively to the new and improved environment. The positive per capita income and consumption growth achieved in the first phase of the economic recovery program has continued. Agricultural production and exports, especially non-traditional exports, have increased significantly. The manufacturing sector is expanding, after a long and marked decline, with the output of efficient firms increasing very rapidly, while the outputs of inefficient enterprises continues to decline.

7. While progress on reform is now accelerating, the constraints are difficult. As outlined in the recent Country Economic Memorandum (CEM), institutional capacity is very limited, with a grossly underpaid and ineffective civil service. The consultation process for policy decisions is slow and cumbersome. The commitment to open up the economy to further private sector participation is fragile. Action in certain areas has not been taken far or fast enough, as noted in the COW discussion of the PFP and developed further at the recent CG, such as parastatals.

8. In the case of TANAA, the release of the second tranche has been delayed primarily because of lack of capacity to implement as quickly as envisaged the agreed action plans in export crop marketing reforms. The Bank is assisting by providing detailed worksheets. The process is now on track with tranche release expected during the second quarter of FY92. However, the delay implies a very tight financing plan for the OGL. Donors have indicated willingness to consider providing additional financing for the OGL should this become necessary. This episode illustrates the importance of defining a realistic financing plan for the reform program.

The Program for Continuing Reform

9. Adjustment has been working in Tanzania, albeit slowly and in some areas more than in others. The Government has come to regard the reform program as its own. This ownership of the program results in

the slow but sure pace, noted in the OED study on Tanzania. The proposed financial sector operation has been developed from a strong internal process of study and consensus building and is an interesting illustration of building commitment to adjustment. At the same time, the Government is increasingly responsive to the donor community's concerns as expressed at CGs. The major theme of last year's CG, cooperatives, has witnessed a significant shift in policy.

10. The recent elections endorsed the broadening of economic reform and transition to a more market-based economy. The new dynamic Minister of Finance was reappointed, although his ministry's implementation capacity is particularly weak. A new promising Prime Minister has taken a keen interest in the adjustment process and has effective staff under him. Even the reluctant Planning Minister is acting more supportive. While this increasing ministerial interest and support is encouraging, a decision assigning an explicit institutional home for the important responsibility for overall implementation and monitoring of the adjustment program would be sought from the Government prior to Board presentation of the proposed financial sector operation. Tanzania remains a one-party state, but the party is remarkably democratic, as reflected in the absence of donor calls for multiparty democracy.

11. As outlined in the CEM, acceleration and deepening of the reform process are the basic thrust of our strategy for long-term sustainability of the adjustment program. The CEM and CG were instrumental in delivering this message to the Tanzanians. The donors stressed the need for determined implementation, particularly in parastatal restructuring and transferring to the private sector, public sector management, and the social sectors. Combined with the donors' decision to shift assistance to the OGL, the Government clearly took note. The Government also committed itself to sorting out the obstacles to more expeditious implementation of measures already agreed; three agencies within Government, each with some merit, already are vying for the coordinating role.

12. In line with the CSP of 1989 as updated in the Business Plan for FY91, the Bank strategy relies on a sequence of sectoral adjustment operations to maintain the dialogue on macroeconomic issues while tackling key sectoral issues in a sequence appropriate to eliciting supply response and augmenting scarce Tanzanian implementation capacity. The Bank already has been successful in eliciting general support for the OGL and focusing attention on the need for acceleration and deepening of reform. Many of the policy decisions to be supported by the proposed operation in the financial sector have been taken by the Government. Restructuring of the banking sector will require continued efforts to ensure client restructuring as well. Reform of the industrial parastatal sector will be essential and is the focus of a parallel adjustment operation which will be presented in September to the OC for clearance to appraise following an upcoming pre-appraisal mission. This operation will address the broader issues of enhancing the environment for the private sector in Tanzania, including those

raised by the donors during the recent CG. During FY92 we also expect to appraise an operation to support the rationalization of the civil service, budget restructuring and other measures to narrow the role of government and improve the efficiency of the public sector. This sequence of adjustment operations supports a continued strengthening of the investment climate in Tanzania, including our own investment portfolio. A competitive, commercially viable financial sector is critical to the success of this strategy.

The Proposed Operation

13. In 1988, the President of Tanzania set up a Commission of Enquiry into the Monetary and Banking System to study the underlying weaknesses of the financial sector and to propose a blueprint for reform. IDA provided considerable technical assistance to the work of the Commission. Based on the Commission's report, which was released in July 1990, the Government is now embarking on a major reform program, which calls for a market orientation to the financial sector, and thus represents a fundamental departure from the system of centralized control in place since the 1967 Arusha Declaration. Government's "ownership" of this program has facilitated widespread political support and a strong commitment to financial sector reform.

14. The primary objective of financial sector reform in Tanzania is to create a system that operates on the basis of market-oriented principles, and is efficient in mobilizing and allocating resources, and effective in fostering long-term economic growth. Reforms needed to achieve these objectives cannot be speedily implemented, given the insolvency of the financial institutions and weaknesses of their management and staff. These largely stem from Government dominance in the system; almost all financial institutions and clients of these institutions are Government-owned or controlled, and Government interference, particularly in credit allocation decisions, is pervasive. The short-term objective of the Government, which this proposed operation supports, is to create an appropriate policy and regulatory environment conducive to private sector entry, and to develop from the existing financial institutions a core set of commercially viable institutions capable of supporting economic development. The longer-term objective, which would be supported by a follow-on operation, would promote financial deepening and diversification.

15. Government has already taken some important steps towards financial sector reform. In a policy statement issued in mid-1991, the Government announced a two-pronged strategy towards reform based on: (a) new entry, authorizing the establishment of private domestic and foreign banks; and (b) a comprehensive restructuring of existing institutions. At the same time, Government signalled its intent to refrain from interfering in the decisions of the banks, increased the banks' latitude in determining interest rates, and made a commitment to continuing the reforms in the real sectors. To support the move towards a deregulated and more liberalized financial sector, the Government introduced new banking legislation in April 1991. This legislation gives clear

guidelines on prudential regulation of financial activity in line with international standards, and defines the role of the central bank in supervising the banking system. Unlike the previous legislation, it sanctions a role for the private sector in commercial banking activities, and thus sends an important signal of Government's acceptance of an increased role for the private sector in the economy as a whole.

16. Details on the key elements of the financial sector reform program and conditionality of FSAC are shown in the attached initiating memorandum and policy matrix. The proposed credit would provide quick-disbursing foreign exchange resources to support the country's balance of payments and would be disbursed through the OGL.

Status of the Policy Dialogue for FSAC

17. The Bank, in close cooperation with the IMF, has been conducting an active policy dialogue with the Tanzanians on the proposed reforms, and most of the issues addressed in the initiating memorandum have been fully discussed with them. The collaboration between the Bank and the IMF has been particularly close on this proposed operation, given its importance for attaining macroeconomic stability and other macroeconomic objectives. In fact, the IMF has taken the lead in issues of monetary policy and central banking and has been consulted at every stage of preparation. The Bank and the IMF have also coordinated closely with the donor community and a number of donors have expressed interest in supporting the reform of the financial sector by co-financing the proposed operation and/or providing technical assistance. We are satisfied that the substantial agreements reached between the Bank, IMF, donors and Government on the proposed policy and institutional reforms in the financial sector provide sufficient grounds for appraisal.

Attachment

DISTRIBUTION:

Operations Committee Members	Messrs.: Karaosmanoglu (ASIVP); Qureshi (OPNSV) o/r; Husain (LACVP); Wood (FPRVP); Shihata (LEGVP); Rajagopalan (PRSVP); Summers (DECVP); Bock (OPNSV).
Others Outside Region:	Messrs./Mesdames: Grilli, Chaudhri (EAS) (2); Wyss (CODDR); Kashiwaya (CFSVP); Niehuss (CFSDR); Thalwitz (PRESV); Isenman (PRDDR) (2); Linn (CECDR) (3); Rao (IECDR); Adu (LEGAF); Stern (FINSV); Stoutjesdijk (FRSDR) (2); Abraham (LOAAF); Frank (CFPVP); Parmar (CIOVP); El-Rifai (MIGPA); Varkie (MIGEX); Toft, Nielsen (CFSFA).
Within the Region:	Messrs./Mesdames: Jaycox (o/r), Husain, Armstrong, Martinez, Ohri, Birnbaum (AFRVP); Serageldin (AFTDR); Derbez, Paulson (AFTEF); Sarris (AF3IE); Denning, Singh (AF6DR); Patel, Grawe, Nkojo, Krumm, Hall, Agrawal, Azad (AF6CO); Cook, Bell, Phillips (AF6IE); Helman, Olivares, Okidegbe, Christiansen, Cotlear (AF6AG); Sam, Crookes, Roome (AF6IN); De Ferranti, Jorgensen, Dock (AF6PH); Porter, Southworth, Mans (AF6TA).
	Information Centre
IMF	Messrs. Taha, Nord.

KK:kk

July 9,1991

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: July 5, 1991

TO: Operations Committee

FROM: Enzo Grilli, Director, EAS

EXTENSION: 81934

SUBJECT: GABON - Country Strategy Paper; Operations Committee Meeting Agenda

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1. The Operations Committee will meet on **Tuesday, July 9, 1991, at 4:30 p. m. in Room 1243** to consider the Country Strategy Paper for Gabon. The following represents a proposed agenda for the meeting.

Background

2. With a per capita GNP of US $3,000 and only 1.1 million people, Gabon has the highest per capita income in Sub-Saharan Africa. The country has abundant resources of petroleum and other industrial minerals (manganese, uranium and timber). As an oil-producing country, Gabon has reaped high windfalls from oil exports in the past. But it has followed unsustainable policies of high investment and high consumption financed by foreign borrowing, leading to high inflation, poor returns to investment, and persistent macroeconomic imbalances. The stabilization and structural adjustment program adopted between 1987-89 failed to bring about important gains, essentially because the Government did not adopt a full range of corrective measures. As a result, the fiscal and trade imbalances persist, together with the heavy weight of external debt service.

3. Recently, strong pressures for domestic political reforms have emerged within Gabon. Although the Government is responding to these pressures for change, it is still difficult to predict where they might lead and how the political trends now in motion would affect the economic reform process in the country.

Issues

4. Development Strategy. The CSP states that two principal objectives of the economic reform are: (a) restoration of internal and external balance to allow a resumption of growth; and (b) diversification of the non- oil economy to reduce the economy's vulnerability to the movements of the oil market. Gabon is a CFA country. In view of the constraint on exchange rate action, the main tools of adjustment are deflationary fiscal and monetary policies to reduce internal costs. Considering that the economic crisis in the country is caused mainly by governmenatl inaction with respect to the "overinflated public wage bill, inadequate control over the collection and use of public funds, and the poor choice of investment projects", the Committee might want the Region to provide a candid assessment of what the Government might be able to do in pursuit of overall

structural adjustment, especially in view of demands for political changes within the country.

5. With respect to the issue of diversification of the economy, the CSP places emphasis on the importance of reducing the dependence of the economy on oil. This would require the creation of an environment conducive to the development of entrepreneurship especially in the private sector. The Committee might want the Region to elaborate on the following points:

- Sources of Growth. What are the potential sources of growth in industry and agriculture? What are the reasons behind their relative pessimism about the possibilities of tapping the potential of these sectors within the medium term?

- Human Resources. Despite great wealth in natural resources, the country's human resources lag behind in development. What measures are needed to improve the quality and efficiency of educational and health delivery services and what steps should be taken by the Government to address this sector?

- Poverty and Income Distribution. The CSP discusses the need for the improvement of the management of the economy's resources. However, it does not discuss issues of poverty and income distribution. Considering the high incomes derived from natural resource exports and the high growth rate of the population, the issue of income distribution is significant. The proposed "Fund for Future Generations" (para.27) only deals with intergenerational equity issues. How does the development strategy expect to deal with the problem of poverty alleviation and income distribution in the shorter term?

- Private Sector Development. The Region states that "private sector policies suffer from credibility due to stalled economic reform efforts and the ... influence of special interest groups ..." (para.29). What special factors impede the development of the private sector development in Gabon and how could these be overcome? What role could the IFC play in the program?

- Environment. "Gabon offers one of the largest remaining pristine ecosystems in the world" (para.43). The Committee might want to relate the discussion of the Environment with the development of agriculture and forestry, and how the Bank might formulate its assistance strategy in this area.

6. Economic Projections and Scenarios. The base case scenario assumes a lack of adjustment. This would mean that the economic condition would deteriorate and the macroeconomic imbalances would continue to be more unsustainable. The high case scenario represents a situation in which the Government would undertake an adjustment program. As a result, macroeconomic imbalances would gradually be

reduced. This situation also assumes additional oil discoveries and improved revenues from existing oil production (see projections in Annex C.2), but that the CFA issue would not be resolved (as the projections assume a fixed CFA exchange rate). In both the base and high cases, per capita GDP growth would still be negative, and there would be a continuous decline of per capita consumption (although there would be a difference in the rate of decline). Both cases involve access to exceptional financing. The Committee might want to discuss the relative weight assigned in the high case scenario to the adoption of economic reforms as opposed to positive developments on the petroleum and commodity fronts. ?

7. Bank Lending and Risk. The Bank's lending assistance under the base case is planned at $30 million, for an Environment/Forestry Project (FY 92), at the same time that Gabon may get quick disbursing assistance from other donor agencies. For instance, the base case program assumes the likelihood of a Fund program and SAL lending from bilateral donors. Under the high case, the Region proposes a Bank lending program in the order of US $100 million, for the period up FY 92 - FY 95. This includes a Public Enterprise SECAL and the UDEAC Regional SAL, and a project loan each on Agriculture and Human Resource Development. The trigger for the high case is action on the restructuring of a government enterprise (SNBG). The Committee might want to discuss whether the actions related to the high case lending strategy are likely to be sufficient to ensure that a credible program of reforms would be put in place. Although the proposed Gabon program would not lead to a relatively high exposure, the added risks of failure of the reform program would increase the likelihood of failure to repay the Bank. Presently, Gabon is rated a high risk IBRD borrower.

8. Composition of lending: enlarging technical assistance components vs. project and fast-disbursing assistance. In view of the income and resource position of Gabon, and the general problem of absorptive capacity, the Committee might want to discuss the advisability of raising the component of lending for technical assistance, relative to lending for projects or even fast- disbursing lending in the context of adjustment. This would improve the ability of the Bank to fulfill more effectively its role as adviser, an "'honest broker' of ideas." (para.69).

9. Cost Sharing. The Region is requesting that in the case of Gabon, the Bank finance a larger share of project costs (para.70) than would be customary for middle income Bank borrowers. The projects suggested for this type of financing are those in the investment program (in which Environment and Human Resources are included). The Committee might want to discuss whether this request merits exception to the general rule.

69?

Operations Commmittee

Messrs. Qureshi, OPNSV
Shihata, LEGVP
Wood, FPRVP
Summers, DECVP/Rajagopalan, PRSVP
Kashiwaya, CFSVP
Jaycox, AFRVP
Karaosmanoglu, ASIVP
Wapenhans, EMNVP
Husain, LACVP
Bock, OPNSV

cc: Messrs./Mmes Gillette, Goldberg, Wyss, Isenman, Linn, Stoutjesdijk, Picciotto, Lietard, Burmester/ Thahane, Drysdale, Okonjo-Iweala, Tilmes, Parmar, Pfeffermann, Rao, Kavalsky, Shakow, Sandstrom, Liebenthal, Kilby, Robless, Walton, Khanna

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June 28, 1991

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

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DATE: June 26, 1991

TO: Operations Committee

FROM: Fred D. Levy, Acting Director, EAS

EXTENSION: 81947

SUBJECT: MOZAMBIQUE: Country Strategy Paper - Agenda

As announced earlier, the Operations Committee will meet on **Friday, June 28, 1991 at 5.00 p.m. in Room E-1243** to consider the Country Strategy Paper (CSP) for Mozambique, circulated to the Operations Committee by Mr. Denning on June 14, 1991.

Background

Since Mozambique joined the Bank in 1984, 14 projects involving IDA credits of about $580 million have been approved, of which approximately 38% were provided through three adjustment operations. Since 1987, the Bank and IMF have annually carried out joint missions to develop PFPs with the Government. These, in turn, have received the support of the IMF through three SAFs and one, ongoing, ESAF arrangement covering the period from mid-1990 to mid-1993. The donor community has also strongly supported the country's Economic Rehabilitation Program (ERP) by providing external assistance averaging over one billion dollars a year since 1987 in the form of grants, loans on highly concessional terms, and debt relief.

This is the first CSP for Mozambique - one of the poorest countries in the world, with an annual per capita income of around $80. The strategic components of this paper are derived from an intensive dialogue between the Bank and the Government over the last 4 years in the course of preparation of the annual PFPs and a series of economic and sector reports, including those addressing the poverty reduction and food security issues.

The approved IDA allocation for Mozambique during FY1992-94 is $134 million a year. The CSP seeks management approval of about US$135 million a year over FY91-95, rising to $175 million a year if peace is achieved "in order to assist in the settlement of the displaced population, returning refugees, and ex-military personnel and to take advantage of new investment opportunities". On the other hand, if progress on peace and political fronts is weak, the lending volume would be scaled down to $50 million a year, and assistance would be refocused on enhancing the provision of basic social services and on developing the professional and technical skills needed in the future.

Political Risks and Peace Prospects

The CSP affirms that a peace agreement is a fundamental requirement for bringing about sustainable growth and poverty reduction in Mozambique. The Front for the Liberalization of Mozambique -- FRELIMO (official government party) and the Mozambique's National Resistances - RENAMO - have recently been engaged in direct peace talks. A new constitution provides for a multiparty system and direct elections. However, despite these developments and agreements to a partial cease-fire in certain corridors, the peace process so far has moved very slowly.

- Given the uncertain political situation and difficulties of the security situation, both of which are critical for implementing the strategy, what is the probability of the country overcoming major hurdles on both fronts within the program period? Are there any strategic steps that the government should take to further strengthen and accelerate the peace process?

Stabilization Issues and Macro-Imbalances

The Government's launching of the Economic Rehabilitation Program (ERP) in early 1987 was an important step that was supported by the Bank, IMF, and other donors. Significant progress has been achieved in reforming pricing policy, adjusting the exchange rate, and achieving the agreed fiscal, monetary and credit targets, and these improvements have had a positive economic impact despite continuing security problems. However, there remain a number of issues of considerable concern:

- Following a rapid decline from 1987 to 1988, why has inflation remained at the 30-40% per annum level over the last three years, and how realistic is it to assume that it will be reduced to 10% per annum by 1994?

- Given the political and security situation, is it feasible that non-Government investment/GDP ratio will rise from about 11-12% to about 18% by 1994?

- Given the very high level of Government expenditures share in GDP (approximately 50%), why is the future effort focused only on allocation issues and not simultaneously on a gradual reduction of government, including military expenditure levels, as well as on an increase in the revenue/GDP ratio (22-23%) that shows no improvement over the program period?

- Given that the bulk of investment in Mozambique is externally financed, is the so-called mis-match between resource allocations and development priorities essentially a problem of donor's preferences and procedural (including earmarking) requirements?

- Are the projected severe imbalances between import and exports (70-80% of GDP v/s 20-30% of GDP) and B.O.P. current account deficits of about 50-60% of GDP in the 1990s sustainable? How realistic is it to assume that external assistance (excluding debt relief) will be maintained at about $760 million per annum and raised by about 1.1% p.a. on average in real terms?

Reform of the Exchange Rate and Trade System

- With major imbalances of the type mentioned above, it is not easy to establish a large Open General Licensing (OGL) system for imports as proposed. In this context are there any benefits to be derived from an accelerated pace of the exchange rate adjustment process?

Food Aid Needs and Food Production

- Food aid in cereals has increased from a negligible level 15 years ago to approximately one million tons in 1991. While it presents an enormous resource inflow for Mozambique, might it not also constitute a major disincentive to the promotion of domestic food production?

Credibility of Scenarios and Trigger Mechanisms

The paper summarizes the recommended level and composition of Bank lending and highlights basic considerations that will govern the higher and lower levels of Bank lending to Mozambique. The Committee may want to discuss the following questions:

- Despite a substantial difference in the growth rates of the economy between the base case and the policy slippage scenarios (Table 1), and an assumed reduction in foreign aid under the latter, the share of GDP devoted to fixed investment remains virtually the same in both. Why?

- What specific indicators would be used to gauge whether the Bank should adopt the base case or an alternative lending strategy?

Counterpart Funds and Technical Assistance (TA)

The paper discusses a number of issues related to the use of counterpart funds and the effectiveness of $150-200 million worth of technical assistance. However, it is not clear how realistic it is that (i) a common counterpart fund for the proceeds of commodity aid can be established, and (ii) the effectiveness of foreign TA can be enhanced by coordinating donor wage policies.

Operations Committee

Messrs. Qureshi, Husain, Jaycox, Karaosmanoglu, Wapenhans,
Rajagopalan/Summers, Shihata, Kashiwaya, Wood, Bock

cc: Messrs. Thahane/Burmester, Picciotto, Goldberg, Wyss, Sandstrom,
Isenman, Linn, Stoutjesdijk, Ms. Okonjo-Oweala, Kilby,
Liebenthal, Robless, Walton, Khanna, O'Brien, Denning,
Patel, Ms. Armitage

FMChaudhri:gs

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THE WORLD BANK
Operations Committee

CONFIDENTIAL

Minutes of the Operations Committee meeting to consider TUNISIA - Economic and Financial Reform Support Loan: Initiating Memorandum Held on Friday, June 28, 1991, in Room E-1243

A. Present

Committee	Others
Messrs. M. A. Qureshi, Chairman	Messrs. M. Ayub, EM2CO
W. Wapenhans, EMNVP	P. Bottelier, LA4DR
S. Husain, LACVP	K. Dervis, EM2DR
I. Shihata, LEGVP	F. Earwaker, PRDRA
J. Wood, FPRVP	S. El Serafy, EAS
S. Burki, ASIVP	M. El-Erian, LEGEM
S. O'Brien, AFRCE	S. Haddad, CMED2
A. Toft, CFSFA	P. Hansen, FRS
J. Linn, DECVP	P. Hasan, EMNVP
	F. Levy, EAS
	Ms. N. Okonjo-Iweala, OPNSV
	Ms. M. Pigato, EM2CO
	S. Rahim, EM2CO

B. Issues

1. The Operations Committee (OC) met on June 28, 1991 to consider the Initiating Memorandum for a $150 million Economic and Financial Reform Support Loan to Tunisia. The discussion followed broadly the EAS agenda which, inter alia, raised the issues of the exchange rate; recovery of private sector confidence; the coverage and practicality of the monitoring indicators proposed; Bank exposure and the projected capital inflows; the mechanism of reducing controls on interest rates; the timing and extent of banking sector reforms; the pace of trade liberalization; and the proposals for social protection.

C. Discussion

2. The Chairman invited the Region's comment on the impression he formed on reading the IM. While the operation appeared to cover a wide area, on close inspection the reforms turned out to be quite minor. The Region responded that Tunisia had been hit hard by the Gulf crisis. It had had a three-year EFF with the Fund which it had observed without drawing on Fund resources, but the crisis had forced Tunisia to use available Fund resources and to request the extension of the program for a fourth year. The economic regulatory system appeared worse than it was in reality: no black market existed for foreign exchange and manufactured exports had risen rapidly, but there was a general air of insecurity prevailing, deriving largely from the country's geographical location which had also

affected tourism. True, policy reforms in Tunisia had been gradual, but they also had been sustained over the longer term. Aspects of success included the low rate of inflation (7-8% per annum) and the rise in manufactured exports by 14% a year in real terms in the last three years. Private sector investment was rising, and the privatization program agreed with the Bank was ahead of schedule. Public sector investment had been curtailed, and its quality remained high. The Government had invested heavily in human resource development with the objective of building skills, and this was reflected in several social indicators including the lowest population growth rate in the region (1.9% a year). The economy, however, was fragile and highly exposed to exogenous factors. That was why trade liberalization proceeded slowly. The QRs on trade simply reflected insecurity regarding potential exposure to external shocks. The decline of import restrictions from 72% of domestic production to 40% by the second tranche of this operation would be a considerable achievement, to be followed on later.

3. A member thought Tunisia was quite unique in that after so many adjustment operations it still had this high incidence of QRs, and asked why Tunisia could not move more quickly. Two other members referred to the impact of the Gulf crisis, and one of them stressed that gradualism also characterized China's adjustment approach, to which he was sympathetic. A member added that had this been the first, not the sixth adjustment operation, he would understand, and asked for how long would gradualism go on? Another member said he himself liked a gradual approach, but noted that some of the intended tranche release conditions were formulated in terms of "reaching agreement" with the Bank. He wondered if it was not specific actions that should be conditioned, not just reaching agreement on actions.

4. The Chairman said that from his standpoint he wanted to see decisive action on reform. It was his impression that the proposed reforms did not go far enough either in the area of trade reform or banking deregulation. He did, however, understand the constraints prevailing on a small and insecure economy.

5. The Region agreed that the pace was indeed gradual, but added that the high QRs should be seen in the context of low and uniform tariff protection, and the fact that controls were applied with flexibility and transparency. As several speakers also remarked on the slowness of the reform program the Region was asked if a medium-term program could be agreed with the authorities ending with the total elimination of QRs.

6. The Chairman then referred the meeting to the matrix of policy changes, and asked if we were not merely "coasting along." Now suddenly engulfed in the Gulf crisis, the need of resources prompted a program which appeared to to him to lack focus. He agreed with the note provided by PRE before the meeting: the reform coverage should be broadened and deepened, with emphasis on the financial sector; trade liberalization should be accelerated; and there should be a fiscal cap on the incentives. A member added that he would prefer a three-tranched loan over three years, with a more comprehensive program, and another member said that he would like to see where the reform would be eventually leading. The Chairman then said he would like the Region to experiment with the approach recommended by PRE, with four tranches if need be and a larger loan, provided the eventual objectives were clarified. He knew from experience that the Tunisian

record was good, and that the Tunisians were serious in delivering what they promised so that this approach might well succeed. The Region agreed, but requested that it have discretion to explore such an approach -- a request that was accepted by the Chairman, who recommended experimentation with twice the period and twice the loan size. Once the financial sector and trade reform had been addressed, the Chairman asked, what would be the next area to tackle? To this the Region mentioned the further development of the financial sector as the reforms proposed here were just a beginning. The Chairman asked if elimination of the cap on interest rates would, in the Region's perception, induce the inflow of foreign resources and the establishment of foreign banks.

7. A member concurred with the views already expressed that a more comprehensive program was required. He asked if no Gulf crisis had occurred, would the situation be judged as satisfactory and no reform proposed? Another member wondered how much growth in exports was attributable to the exchange rate, considering that the trade regime was so constrained.

8. The Region responded that Tunisia had an excellent exchange rate policy, with only occasional lapses when the exchange rate had become temporarily overvalued, and that Tunisia had been in good standing with the IMF. The Chairman commented that Tunisia had not had a serious balance of payments problem, and that issues of interest rate policy were areas of special Fund interest and competence. A member asked if we were confident that a long-term process of adjustment could be initiated, and another enquired if there was any cofinancing. The Region said that agreeing on a longer-term program was feasible, and that the Letter of Development Policy would anyway outline a medium-term program. As to cofinancing and the effect on Bank exposure, the Region felt that exposure did not present a problem, but they would keep an eye on it.

9. The Chairman urged the Region to maintain its close cooperation with the Fund and avoid any impression of encroaching on IMF areas of responsibility. To deal with some of the problems in the financial area, the Region might wish to consider a quick-disbursing operation with a narrower sector focus, such as the financial sector. If there were any issues of coordination with the Fund, he would be prepared to take the matter up with Fund management. Alternatively, if the Region found the Fund to be in agreement, and considered that exposure was not that much of a problem, a comprehensive reform program might be attempted, with a longer period of adjustment in mind. While the Tunisians might be accustomed to using diplomacy in their relationship with us, they should also learn to face conditionality. He felt certain that the relationship would not suffer as a result.

10. A member thought that loan conditionality needed to be more concise and monitorable. He also felt there had been insufficient consultations with the Legal Department during preparation. The Region replied that they had made a special effort to involve all relevant Bank units, including the Legal Department, very early in the process, and while useful inputs were contributed by the other departments, Legal had not commented or made suggestions. Nor had the Legal Department attended the Regional review meeting for this operation, to which they had been invited. The Region was, nevertheless, anxious that the Legal Department participate in the appraisal mission and of course attend the negotiations. In

response the member said that this was not consistent with the information he had received, and called on the Region to make sure that the Legal Department be involved in the discussion of the legal framework for the sector.

11. One speaker expressed the view that the financial sector reforms proposed in the IM were a useful preparatory step to a full scale restructuring of the financial sector, but appeared to stop short of addressing the fundamental problems of non-performing portfolios and insolvency in the banking sector. It was agreed that three measures should be included in the loan:

(i) The Government should articulate clearly, in the Letter of Development Policy, its long-term objectives and strategy with respect to restructuring the financial sector.

(ii) Some provision should be made to ensure that sufficient information is furnished on the portfolio strength and financial viability of banking institutions to allow, at some future time, a clear diagnosis of their situation as well as the formulation of a restructuring program.

(iii) A legal framework should be established to facilitate the future restructuring of the banking sector.

12. The Committee then turned to the agenda question regarding the appropriateness of the proposed macroeconomic indicators. A member agreed that inflation needed to be added, stating that these indicators should not be treated as targets as under an IMF program, but merely as variables to be monitored to help assess macroeconomic progress. It was pointed out that the program might contain internal tensions such as excessive government debt or crowding-out of the private sector. The indicators should address these specific areas, rather than general aspects of the program. While the IMF would be monitoring the effective exchange rate and inflation, it was still desirable that these should be monitored by the Bank since the IMF might not be present later.

D. Decision

13. The Chairman then summed up as follows. The Region should proceed with appraisal along the lines made clear by the OC discussion, having the flexibility provided by the two alternative approaches summarized in paras. 6 and 9 above: either a narrowly focused program to complement a Fund's program, or a broader program with Fund agreement, which should go deeper into sectoral reforms, particularly for the financial sector and trade. The Region could also explore the possibility of a larger loan, covering a longer implementation period, with more tranches than proposed. The appraisal mission should stress to the authorities the need for accelerating reform and should sketch and obtain government commitment for the ultimate goal towards which the reforms would lead.

July 9, 1991

SESerafy/lcu

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: June 27, 1991

TO: Mr. Kemal Dervis, Director, EM2

FROM: Johannes F. Linn, Director, CEC

EXTENSION: 37458

SUBJECT: TUNISIA: IM for an Economic & Financial Reform Support Loan (EFRSL)

1. I understand that the primary objective of this loan is to help compensate for the foreign exchange losses incurred by Tunisia as a result of the Gulf crisis and, thereby, enable the Government to continue implementing its existing program of reforms. At the same time, we should take full advantage of this opportunity to broaden and deepen the reform process and, in that context I have the following suggestions for strengthening the proposed conditionality.

Financial Sector Reform

2. The financial sector reforms proposed under this loan are useful preparatory steps to a full scale financial sector restructuring but stop short of addressing the fundamental problems of non-performing portfolios and insolvency in the banking sector. To facilitate tackling these problems under subsequent operations, I believe we should include the following three additional measures in the proposed EFRSL.

(i) The Government should articulate clearly, in a letter of development policy, its long term objectives and strategy with respect to restructuring the financial sector.

(ii) Some provision should be made to ensure that sufficient information is furnished on the portfolio strength and financial viability of banking institutions to allow, at some future time, a clear diagnosis of their situation as well as the formulation of a program of restructuring.

(iii) A legal framework should be established to facilitate the future restructuring of the banking sector.

Trade and Competition

3. The reduction of import restrictions from 72% of domestic production in industry and agriculture to 40% is clearly a step forward. However, the prospect that 40% of industry and agriculture will continue to be protected is troublesome. A lower target would be desirable, at least as part of an agreed longer-term strategy of trade reform.

4. If I understand your proposal correctly, it would be for the Government to decide which particular 40% of industry and agriculture would continue to be protected. This does not seem to be a very satisfactory procedure. It may well lead to high levels of protection being retained for a sizeable number of very inefficient domestic producers. I believe the Bank could be more proactive in seeking agreement with the Government on the specific list of import restrictions that are to be lifted -- focussing on sectors where protection is particularly egregious.

5. I note that, under the IMF program, 25% of producer prices will still be controlled and 45% of retail distribution margins will still be controlled even after liberalization measures have been implemented. Again, faster progress towards price liberalization would appear to be desirable.

The Structure of Incentives

6. Shifting the basis of the incentive structure from sectoral criteria to functional criteria is a good idea. However, the functional objectives that are proposed in the IM -- infant industries, transfer and assimilation of technology, exports, disadvantaged areas with economic potential, and the financing of education -- seem very broad indeed. My concern is that they may lead to an incentive structure as extensive and as diverse as that which now prevails. If we are to make progress, incentives will need to be more selective and criteria must be developed to ensure that the functional objectives are strictly observed. One way to ensure progress is to set restrictive quantitative ceilings on the total amounts of fiscal incentives that may be granted.

cc: Messrs. Qureshi (OPNSV), Grilli (EAS), Rajagopalan (PRSVP), Colaco (PRSVP), Summers, Walton (DECVP), Isenman (PRDDR), Liebenthal (PRDRA), Wapenhans, Hasan (EMNVP), Ayub (EM2CO)

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

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DATE: June 26, 1991

TO: Operations Committee

FROM: Fred D. Levy, Acting Director, EAS

EXTENSION: 81947

SUBJECT: TUNISIA: Economic and Financial Reform Support Loan Initiating Memorandum - Agenda

1. The Operations Committee will meet on Friday, June 28, 1991 at 4:00 p.m. in Room E-1243 to consider the Initiating Memorandum for an Economic and Financial Reform Support Loan to Tunisia in the amount of $150 million. The Committee may wish to take up for consideration the issues identified below.

Background

2. Declining oil revenues in the latter half of the eighties and a heavy debt burden inspired a drive for structural reforms which the Bank supported by a series of policy-based loans. From an earlier concentration on agricultural investment projects, the Bank turned to structural adjustment, making two SECALs in FY87 in agriculture and industry; a SAL in FY88; a second agricultural sector adjustment loan in FY89; and a public enterprise reform loan in FY90. In recent years Bank strategy has revolved around enhancing Tunisia's creditworthiness to encourage voluntary foreign capital inflows, with emphasis still on investment lending. This operation is perceived as the last adjustment loan to Tunisia for the foreseeable future. In the next three years (IM para. 81) Bank lending would cover social and infrastructure development, resource development, and financial support for the private sector.

3. Implementing structural reforms, however, has not been easy, considering the 1988-89 droughts and the Gulf crisis which further aggravated Tunisia's economic problems. With the economic liberalization drive already underway, and the initiation of a money market under previous structural reform efforts, the urgency for financial sector adjustment has become apparent. Although the cover memorandum (para. 4) says that the main objective of this operation is to provide an "external resource cushion," the proposed loan addresses in the first instance four broad reform areas: (i) removal of the last remaining constraints on interest rate movements; development of secondary markets for financial instruments; and setting up a regulatory system for the banks; (ii) further liberalization of credit, and rationalizing the remaining incentives; (iii) more trade liberalization and better external debt management; and (iv) mitigation of some of the social costs of adjustment. Before the Gulf crisis Tunisia strove to observe all quarterly targets agreed with the IMF under an EFF arrangement without, however, drawing on Fund resources. Serious loss of tourism revenue and of Gulf Arab investment has dealt a severe blow to this prudent strategy, and Tunisia will be seeking IMF financial support under an EFF arrangement to be considered by the IMF Board next month.

4. The IM (paras. 15-18) describes a largely successful, but yet incomplete transformation of a highly protected and planned economy, enjoying windfalls of depletable hydrocarbon revenue, into a private-sector, market-oriented economy, which still contains many remnants of controls.

- The Region may wish to comment on the sequencing of previous reforms which the IM blames for some of the perceived failures of past adjustment.

- Has the exchange rate played its full part in the adjustment process, or is there a future role for it yet?

- Is it likely that private sector investment will maintain its recent recovery? And is it realistic to expect a jump in the investment ratio to 26-27% of GDP (para. 21) in the virtual absence of oil revenue?

- What have been the most successful manufactured exports, and what markets have they penetrated? What role has the private sector played in this regard?

Monitoring Macroeconomic Performance

5. The IM states (para. 25) that macroeconomic performance would be monitored on the basis of a periodically updated framework, and reviewed every six months. Performance indicators include the ratio of debt and debt service to GDP; growth of non-oil exports and of manufactured exports; relative shares in GDP of the public and private sectors; the ratio of government interest payments to government revenue.

- Is it practical to expect updated six-monthly estimates of GDP and investment as benchmarks for monitoring progress?

- In view of the expected decline in the public sector, why should the share of public sector in total borrowing remain undiminished in the projections in Table 2?

- Should inflation and some index of the real effective exchange rate be included in the set of performance indicators?

Bank Exposure

6. Owing partly to high adjustment lending in recent years, Bank exposure in Tunisia is high. The Bank held 19.2% of Tunisia's medium- and long-term debt at end-1990, and claimed 3.6% of exports in debt service and 13.8% of total debt service. Its share in preferred creditor debt service is and expected to remain at about 30%. However, if growth is achieved as projected and the macroeconomic gaps narrow, all these indicators will improve (see Key Macroeconomic Indicators Table). Though there is a paragraph on burden sharing, no figures are given. The sources are identified as "KfW, AfDB, EIB, and other bilateral sources," but balance of payments projections of the current account show only modest capital inflows.

- o The Committee may wish to discuss the consistency between the projected strategy for enhancing Tunisia's creditworthiness and the "realism" behind the modest capital inflows projected, and whether more burden-sharing may not be required.

Loan Objectives and Conditionality

7. Macroeconomic. The current account deficit is expected to be 5.6% of GDP in the current year. A restrictive monetary policy will help control inflation, and the exchange rate is perceived as an instrument of macroeoconomic policy without clarification of how this would be used. A condition of loan effectiveness would be satisfactory behavior of the macroeconomic indicators identified in para. 5 above. Second tranche release would also depend on the maintenance of satisfactory macroeconomic performance.

How in practice would we [illegible]

- o The Region might clarify what a satisfactory behavior of the indicators would mean in practice, perhaps ranking them in terms of their importance to the program, or alternatively giving them weights for the operational assessment of performance.

8. Money and Credit Provisions. The operation accepts the principle of administered interest rates, but seeks to obtain some freedom for their movements. Though apparently deregulated since 1987, there has been a cap on the spread between money market rates and commercial bank lending. A condition of effectiveness would be the elimination of the cap or replacing it by individual caps for each bank separately, while second tranche conditions in this area would depend on the effectiveness condition. Conditions of effectiveness also include liberalization of saving account interest rates; greater flexibility regarding purchase and retention by financial institutions of equipment bonds; gradual reduction of obligations on them to hold Treasury bonds; initiation of Treasury notes of more than one year maturity; and a study of the impact of financial instruments on the primary and secondary markets, to be implemented as a second tranche condition.

- o Would it not be best to remove the cap on lending rates entirely so that market forces would direct the supply and demand of loanable funds?

- o Would the Region throw more light on the differences between the various instruments of Treasury borrowing, indicating their size and the role they play in the fiscal balance and in financing investment?

9. Bank Supervision. Some progress has already been made to introduce prudential regulation of commercial banks, including exposure provisions and improving accounting practices. As conditions of effectiveness, further upgrading of the regulations is envisaged, including the issuance of a Central Bank circular on procedures, and removal of the ceiling on the cost of audits; reorganization of the Central Bank; enhancing banking supervision services; and training bank examiners. Second tranche conditions will take shape once the first tranche conditions had been agreed, but would include the introduction of mandatory external auditing; agreement on a steering committee for bank restructuring, a timetable for audits, and a banking examination manual.

o Can these reforms be advanced so that they take place before Board presentation?

10. Incentives. Fiscal incentives to various economic activities have been scrutinized in an effort to minimize their cost to the budget, improve their transparency and raise their effectiveness. A new set of adjustments to fiscal incentives is listed as conditions of effectiveness, to be amplified at second tranche release.

o The Committee may want to discuss if these adjustments are truly structural in nature; whether they are too detailed and numerous; whether there is government commitment for them; and whether the IMF is involved. Would not an early study be the appropriate vehicle for identifying the reforms, which may then be implemented as a condition of second tranche release?

11. Trade Liberalization. An effectiveness condition is to reduce import restrictions which apply to 72% of goods produced in the domestic industrial and agricultural sectors to 60%, and a second tranche condition to reduce this further to 40%? It is also envisaged that the proportion of distribution margins controlled be reduced at second tranche to 35%.

o Is not the implied pace of trade liberalization much too slow?

12. Social Protection.

o In view of the high unemployment, the active reduction of consumer subsidies and the impact of this on political and social stability, can the initiation of the studies proposed be advanced to negotiations, and actual adoption of a program to loan effectiveness rather than wait until the second tranche?

Operations Committee

Messrs. Qureshi, OPNSV
Husain, LACVP
Jaycox, AFRVP
Karaosmanoglu, ASIVP
Wapenhans, EMNVP
Rajagopalan/Summers, PRE
Shihata, LEGVP
Kashiwaya, CFSVP
Wood, FPRVP
Bock, OPNSV

cc: Messrs./Mmes: Thahane/Burmester, Picciotto, Goldberg, Wyss, Sandstrom, Isenman, Linn, Stoutjesdijk, Okonjo-Iweala, El Serafy, Parmar, Rao, Kavalsky, Pfeffermann, Liebenthal, Kilby, Robless, Walton, Khanna, Hasan, Dervis, Ayub, Ahmed, Rahim, Institutional ISC.

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THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: June 21, 1991

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

FROM: W. A. Wapenhans, Vice President, EMENA

EXTENSION: 32676

SUBJECT: TUNISIA: Economic and Financial Reform Support Loan Initiating Memorandum

1. Attached for your consideration is the Initiating Memorandum for the proposed Economic and Financial Reform Support Loan (EFRSL) for an amount of US$150 million equivalent.

Background

2. Despite the constraints imposed by steadily declining earnings from oil exports, economic management in Tunisia has been impressive, particularly since 1986. The focus of the efforts has been to make the Tunisian economy a more open economy, based increasingly on private sector initiative. The Bank has actively supported the Government's reform program through a series of sectoral adjustment loans as well as a PERL and a SAL. By and large, the reform effort has been successful in achieving its objectives, although the pace of reform slowed down somewhat, largely in response to two years of severe drought (1988-89) that had widespread macroeconomic ramifications.

3. The Gulf crisis dealt a severe blow to the momentum of the reforms. In net terms, the loss of foreign exchange earnings during 1991 is expected to be US$675 million, roughly 5 percent of GDP. There has been no compensating external bilateral assistance to make up this shortfall. The authorities responded rapidly by severely restraining demand during the first part of this year, and have requested the Bank for an adjustment operation that would help the country avoid its medium-term reform program being jeopardized by the fallout of the Gulf crisis.

Objective and Focus of the Proposed Loan

4. The main objective of the proposed loan is to provide the necessary external resource cushion to enable the Government to continue its medium-term reform program without too much social disruption. The loan would put into effect a number of remaining structural, policy and institutional improvements aimed at making the Tunisian economy a more modern, open and private sector-based economy. Many of these reforms were initiated under the previous SAL, the second tranche of which was released in January of this year, after the tranche release conditions had been satisfactorily met.

5. The proposed loan would support reforms in four broad areas:

(i) Financial Sector Reforms. The loan would address the main financial sector issues, notably the removal of the last major constraints on interest rates, the development of secondary markets for financial instruments, and the installation of a sound system of prudential regulation and supervision of banks.

(ii) Reform of Special Incentives. The loan would focus on reducing further the scope of directed credit; establishing clear objectives for special incentives; replacing the numerous investment codes with a single code that exhibits greater transparency and automaticity; and reducing the cost of incentives and simplifying their administration.

(iii) Greater Trade Liberalization and Competition. The proposed loan would go beyond what was achieved in the context of the SAL in the areas of the removal of quantitative import restrictions, the liberalization of domestic prices, and the implementation of the anti-trust mechanisms.

(iv) Social Protection. In the context of the proposed loan, a program would be developed to mitigate the social costs of reduced subsidies through better targeting, particularly for items of basic necessity such as bread, vegetable oil, sugar and milk. The loan would also help initiate the reform of the social security and insurance system, with the aim of extending coverage in a financially sound manner.

IMF Involvement

6. As a consequence of the negative impact of the Gulf crisis, the Tunisian authorities also decided to draw on the IMF resources, which had been available but hitherto not used, under the Extended Fund Facility. The authorities have also requested an extension of the arrangement to a fourth year. The IMF Board is expected to consider this request on July 17, 1991. Staff of the Bank and the Fund are working closely in the preparation of their respective operations.

Next Steps

7. Subject to the approval by Bank Management of the program outlined in this document, departure of the appraisal mission is scheduled for next week. Negotiations are tentatively scheduled for September and Board presentation for November 1991.

Distribution:

Regional	Messrs. Hasan, Blanchi, Grais, Fox (EMNVP)
Country Department	Mmes/Messrs. Dervis, Costa (2) (EM2DR); Ayub, Rahim, Pigato, Razmara, Semsarzadeh, Benner (EM2CO); Ahmed, Forestier, Kjellstrom, Doublet (EM2IE); Al-Khafaji, Veuthey (EM2IN); Krafft, Knudsen, Tuck (EM2AG); Rogerson (EM2PH)
Technical Department	Messrs. Kohli (EMTDR); Hinds, Tarr, Thorne (EMTTF); Wackman (EMTIE); Tuluy (EMTEN); Gouveia (EMTPR)
Bankwide	Regional Vice Presidents: Messrs. Husain (LACVP); Jaycox (AFRVP); Karaosmanoglu (ASIVP)
PRE	Messrs. Rajagopalan (PRSVP); Summers (DECVP)
VP & Gen. Counsel	Mr. Shihata (LEGVP)
VP - CFAS:	Mr. Kashiwaya (4) (CFSVP)
VP - FPRM:	Mr. Wood (FPRVP)
Director, Operations Staff:	Mr. Bock (OPNSV)
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IMF	Messrs. Anjaria, Morrison
For Information	Messrs. Bottelier (LA4DR); Liebenthal, Earwaker (PRDRA); Walton (DECVP); Kilby, Hansen (FRSCR); Parmer (IFC-CIO); Pfeffermann (IFC-CEI); Robless (OPNSV); Khanna (EXC)
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June 26, 1991

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

9WB 20027

DATE: June 25, 1991

TO: Operations Committee

FROM: Fred D. Levy, Acting Director, EAS

EXTENSION: 81947

SUBJECT: POLAND - Agriculture Sector Adjustment Loan Initiating Memorandum; Operations Committee Meeting Agenda

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1. The Operations Committee will meet on **Wednesday, June 26, 1991, at 10:00 a. m. in Room 1243** to consider the Agriculture Sector Adjustment Loan Initiating Memorandum for Poland. We would suggest the following as an agenda for the meeting.

Background

2. The Region is proposing consideration of an Agricultural Sector Adjustment Loan to Poland in the amount of $200 million. This quick-disbursing operation would continue the support that the Bank has been providing Poland to its far-reaching Economic Transformation Program. In FY91, the Bank approved a total of about $1.4 billion in new commitments for Poland (including an operation being considered by the Board today). Of this, $1,120 million was through quick-disbursing or hybrid operations, and of this a total of $600 million was through quick-disbursing components. The FY92 program is now being firmed-up, but would include the $200 million adjustment operation being considered today. No other quick-disbursing operations are currently planned for FY92, except a possible stand-alone operation that would support a DDSR package. There may be a $300 million SAL II in FY93, but other than this there are currently no firm plans for further quick-disbursing loans (it is possible an FY94 Power project might be developed as a SECAL).

3. Development of an overall financing program in support of Poland's Economic Transformation Program has progressed well this Spring. The IMF approved a three-year EFF Arrangement on April 18, 1991, in the amount of SDR 1,224 million (about $1,650 million equivalent). It also approved on that date access to the CCFF of up to SDR 442 million (about $600 million), of which SDR 162.6 million (about $220 million) could be drawn immediately. On April 19, the Paris Club then approved a reduction in the net present value of Poland's debt to the members of the Club (a debt equal to about $33 billion) by 50%. Of this, 30% in NPV terms would be granted immediately, while the remaining 20% would be granted upon satisfactory completion of the three-year IMF EFF program. Also, cash flow relief of 80% would be granted in the first three years. Since the Paris Club announcement, some of the Paris Club members (including the US) have announced that they will grant even more generous terms. The Paris Club debt reduction is conditioned, however, on a "comparable" reduction in commercial bank debt. Negotiations on this are now underway with the banks.

4. The agricultural policy program that would be supported by this operation has been developed over the past year and a half with the close involvement of the Bank. In particular, the analytical basis for the program was developed by a Joint Task Force (made up of representatives of the Government, the EEC, and the Bank, with the EEC providing the financial support) which submitted a report to the Government in July 1990 titled "An Agricultural Strategy for Poland". A staff-member of the Bank (Mr. Blanchi) managed the work. The key recommendations of the study were endorsed by the Council of Ministers in November 1990.

5. The agricultural policy program that would be supported by the proposed operation is comprehensive and well prepared. The specific tranche release conditions will focus on just a few of the key areas, but as the policy matrix makes clear, the program is far broader. Important actions have also already been carried out as part of the overall reform program Poland is following. In considering this operation, we would suggest that the Operations Committee might wish to focus on the following issues.

ISSUES

The Macro Context

6. To consider the macro context for this proposed quick-disbursing operation, the Region might be asked:

(a) To review briefly macro developments so far in 1991. What has been the course of inflation and the fiscal deficit, and what has been the performance so far of exports, imports, the current account, and reserves?

(b) What is the current status of the negotiations with the commercial banks on a debt reduction package? What are the current plans for financial support to such a package by the Bank and the Fund, and when is it estimated such funds will be required?

(c) What was the performance of the agricultural sector in 1990, the first year of Poland's reform program, and what is expected regarding the harvest in 1991? Has production risen or fallen, and what can any change be attributed to? Has there been a shift in the cropping mix? The IM notes that the terms of trade moved against agriculture with the general liberalization of prices in 1990. Did agriculture receive relatively favorable prices before, when prices were set centrally?

The Relationship to the Bank Program

7. As noted above, the proposed operation may be the only quick-disbursing operation planned for FY92, aside from a possible DDSR operation. Beyond FY92, only a possible SAL II planned for FY93 is

currently in the official lending program as a quick-disbursing operation.

(a) Although plans are still uncertain, the Region might be asked to discuss its current assessment of how the lending program might develop over FY92-93, with regard to the overall level of lending commitments and the share that would be quick-disbursing.

8. A $100 million Agricultural Development Project was approved by the Board earlier this month. Aside from the AgSAL being considered today, there are no further agricultural operations in the current lending program. The Region might be asked:

(a) What is the relationship between the proposed AgSAL and the recently approved Agricultural Development Project? Are they linked in some way?

(b) The IM notes that consideration might be given to a future AgSAL II which would support the continuation of the agricultural reform program. What are the plans on this? Will follow-up measures be required to complete the reform program, and if so, is direct Bank involvement through an adjustment operation envisaged?

<u>Specifics of the Proposed Operation</u>

9. <u>Directed and Subsidized Credit</u>: Directed and subsidized credit to agriculture has been identified as one of the primary financial sector distortions in Poland (along with credit to Housing). The Financial Institutions Development Loan, approved by the Board this month, explicitly left this issue to this proposed operation. The AgSAL proposes as a Board Presentation condition that there be agreement on a timetable to phase out agricultural credit subsidies over a three year period. These subsidies are expected to total Zl 3.35 trillion in 1991, or about 0.4% of GDP 1/.

(a) The Operations Committee might wish to discuss whether a three-year phase out is reasonable, and what specific annual benchmarks would be considered appropriate.

(b) At 0.4% of GDP, some might consider that these subsidies are not large, given the other subsidies in the economy. What would be an estimate of <u>total</u> subsidies to the agricultural sector, and in the economy as a whole?

(c) The issue of <u>directed</u> credit to agriculture may be as important as the issue of credit subsidies, yet this is not considered in the IM. The Region might be asked to discuss whether this is, in fact, an issue, and if so, then what should be done.

1/ Note the policy matrix gives the subsidy as Zl 1.35 trillion. This is a typo. The correct figure is given in para. 123 of the text.

10. Agricultural Pricing: The Agricultural Marketing Agency (ARR) was established in 1990 with the objective of stabilizing the prices received by farmers. It has also served as a vehicle for providing subsidies to farmers, through the price support mechanism it has operated. To limit these subsidies, the AgSAL would require as a Board Presentation condition that there be agreement with the Bank on the 1992 budget for ARR. The Region might be asked: minimum price support

(a) What is the size of the subsidy implicit in the operations of ARR in 1991, and what benchmarks will the Region use as it discusses with the Government the phasing out of this subsidy over time?

(b) It is stated that the intention is to shift the price stabilization function of ARR to the private sector over three years, through the development of private hedging mechanisms. How would this work?

(c) Are the relative prices being set by ARR broadly in line with international relative prices? If not, which crops are being favored? Is this an issue that needs to be addressed?

11. Privatization: Privatization and restructuring of state-owned agro-industrial enterprises is a focus of this operation. As a Second Tranche condition, the proposed operation would require that 50% of SOE's (weighted by processing capacity) in the three sub-sectors of cereals and feed, oilseeds, and sugar and starch, be privatized. The planning date for Second Tranche release is September 1992.

(a) Is this 50% target reasonable? Should there be such an explicit target as a tranche release condition? Should it be worded as a target to be privatized, or as a target to be brought to the point of sale? tranche condition

(b) What is meant, precisely, by the "accompanying measures" that would also be required to be prepared for Second Tranche release, in the areas of trade and price policy, antitrust guidelines, and so on? Why would these be limited to the three sub-sectors where the privatization target is set?

12. Enabling Environment: The proposed operation addresses explicitly the issue of the enabling environment for private sector development in agricultural marketing and processing, and does not limit its focus (as other operations have done) purely to issues of privatization and public enterprise restructuring. This is to be commended. However, there are no explicit tranche release conditions in this area.

(a) The Operations Committee might wish to consider whether the planned action to submit to Parliament legislation (and to issue new Government regulations) in the areas of basic contract law, the operation of brokers and commission agents, the operation of commodity exchanges, and arbitration procedures, is sufficiently important to warrant elevating it to an explicit Second Tranche condition.

Operations Committee

Messrs. Qureshi, OPNSV
Shihata, LEGVP
Wood, FPRVP
Summers, DECVP/Rajagopalan, PRSVP
Kashiwaya, CFSVP
Jaycox, AFRVP
Karaosmanoglu, ASIVP
Wapenhans, EMNVP
Husain, LACVP
Bock, OPNSV

cc: Messrs./Mmes Lari, Goldberg, Wyss, Isenman, Linn, Stoutjesdijk, Picciotto, Burmester/Thahane, O'Sullivan, Hasan, Thumm, Okonjo-Iweala, Parmar, Pfeffermann, Rao, Kavalsky, Sandstrom, Liebenthal, Kilby, Robless, Walton, Blanchi, Khanna, Dervis

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THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: June 20, 1991

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

FROM: W. A. Wapenhans, Vice President, EMENA

EXTENSION: 32676

SUBJECT: **POLAND: Agriculture Sector Adjustment Loan Initiating Memorandum**

I would be grateful for an early OC so that the appraisal can start before 7-8-91. 6/20

Please find attached for consideration by the Operations Committee the Initiating Memorandum for the proposed Agriculture Sector Adjustment Loan for an amount of $200 million equivalent. This project is part of the overall strategy for Poland outlined at the Board on June 11, 1991. It would assist in the privatization and restructuring of Poland's agricultural and agroindustrial sectors by supporting the Government's policy and institutional reform program.

Attachment

DISTRIBUTION:

Messrs. Husain (LACVP), Jaycox (AFRVP), Karaosmanoglu (ASIVP), Rajagopalan (PRSVP), Shihata (LEGVP), Kashiwaya (CFSVP) (4), Wood (FPRVP), Bock (OPNSV)

Messrs./Mme. Thahane (SECGE), Burmester (SECGE), Picciotto (CPBVP), Goldberg (LEGOP), Grilli (EASDR), Wyss (CODDR), Sandstrom (EXCDR), Isenman (PRDDR), Linn (CECDR), Stoutjesdijk (FRSDR), Gustafson (CEMDR), Okonjo-Iweala (OPNSV)

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M:\POL\ASAL\OCMEMO

June 24, 1991

THE WORLD BANK
Operations Committee

CONFIDENTIAL

Minutes of the Operations Committee to Consider the COTE D'IVOIRE - Strategy Paper and Initiating Memoranda

Held on Monday, June 24, 1991, at 4:30 p. m. in Room D10002

A. Present

Committee

Messrs./Mmes M. A. Qureshi, Chairman
D. J. Wood, FPRVP
L. Summers, DECVP
E. V. K. Jaycox, AFRVP
S. S. Husain, LACVP
H. N. Scott, LEG
M. Haug, ASI
U. R. W. Thumm, EMN
D. R. Bock, OPNSV

Others

Messrs./Mmes M. J. Gillette, AF1DR
R. M. Westebbe, AF1DR
L. E. Hinkle, AF1DR
R. S. Drysdale, AF1CO
R. W. Crown, AF1PH
M. Wormser, AF1IE
M. Guérard, AFRCE
P. Alba, AF1CO
C. François, IMF
F. D. Levy, EAS
N. Okonjo-Iweala, OPNSV
A. Rigo, LEGAF
G. P. Sicat, EAS
R. L. P. Harris, CODOP
A. Khanna, EXC
F. Kilby, FRSCR
M. Walton, DECVP
M. Muller, FRSCR
F. J. Earwaker, PRDRA
H. P. Crevier, SECGE
K. Ahmed, CCMD1
J.-P. Pinard, CA1D2
R. T. Fares, AF1CO

Strategy for Quick Disbursing Lending

1. At the outset, the Chairman said that the meeting was not to discuss devaluation as an issue. He stated that the Bank was concerned about the real effective exchange rate, and that he himself had conveyed this issue in a letter to Mr. Ouatarra. However, he had made it clear that the Bank was not committed to a specific modality in achieving the required adjustment.

Region's Case

2. The Region summarized events leading up to the present situation. Measures implemented under the water, energy, and agriculture SECALs had improved economic management in these critical areas. In particular, the two agricultural marketing boards, the agricultural development bank, and the electric power company had been restructured. Fiscal performance had also

improved. However, the economy had been in recession for five years now, and per capita GNP dropped by 25%. There was urgent need for growth, but the measures that the government had proposed were not adequate for doing so. It was therefore essential for the Bank to keep insisting on the need for a viable medium term program for restoring competitiveness, growth, and creditworthiness.

3. The Region was requesting to appraise three sector adjustment operations (namely, financial sector restructuring, competitiveness and regulatory reform, and human resources development), which were considered essential for the next phase of the program. If and when agreement could be reached with the Government on a medium term economic program that would assure a return to growth, the Region would be ready to respond quickly. The Region emphasized that it would insure that a clear message was conveyed to the Government that a credible medium term program had to be put in place before these operations could be negotiated and that the Bank was going ahead with the appraisals only to insure a quick response once the key macroeconomic issues were resolved.

4. The Region also stated that they had been working with the Government on four task forces -- the first of these was on macroeconomic issues and the other three on the three SECALs proposed. Good progress was being made on the sectoral discussions, but serious macroeconomic issues remain to be resolved. The Government's proposed program did not adequately address the critical issue of competitiveness and was not sufficient in itself to restore growth. In addition, the Government's proposed fiscal strategy was inconsistent with its inability to reduce the large public sector wage bill. Their fiscal strategy sought to cut tax rates in order to restore competitiveness, to achieve an increasing primary fiscal surplus in order to reliquify the banking system that had been immobilized by public sector arrears, and to revive public investment to support the growth of demand and the private sector. Since the loss of competitiveness has led to a continued shrinkage of the tax base due to recession, such a fiscal strategy could only succeed if the public sector wage bill could be cut dramatically.

Committee Discussion

5. At the invitation of the Chairman, the Fund representative stated that there was a commitment on the part of the Government to a medium term program of reform, even though that was not yet fully defined. There was some slippage in 1990, but it was expected that an interim program could be prepared which would be adequate and worth supporting. The Fund was discussing with the authorities a new one- year standby program which could be presented to the Board by around end- September 1991. This would be based on the assessment that the fiscal situation would continue to improve, although at a slower pace than originally envisaged. A rephasing in the restructuring of the domestic public debt would also be needed. He said that there would be no dramatic cuts in the wage bill, but that there was room for the Government to improve further the operational efficiency of tax administration and current expenditures. The Fund staff expected that there would be room for reducing the fiscal deficit and that steps would be taken to further tax reform, including property tax reform. He believed that the interim program that would be put in place would be consistent with a medium term program. He also stated that the Fund would be ready to support an interim program if it

had assurance of the availability of financing from the Bank and other major donors.

6. The Chairman stated that if the Region was convinced that proceeding with the appraisal of the three operations would help to focus on the key issues related to a credible medium term program, then he would support going ahead with appraisal. He was, however, concerned that the proposed lending strategy did not include investment projects. An investment pipeline would be useful if Cote d'Ivoire was declared eligible for IDA. Even though a core investment program under IDA would not provide significant resources, it might be helpful in demonstrating Bank support during a difficult period. He emphasized that it was important to show that the Bank was treating all client countries in the same way. Second, it was also important that the Bank fully understood the Government's policies and that these policies were consistent with a medium term program which could be implemented over time in stages. Finally, if the Fund were to go ahead with a standby arrangement in the absence of agreement on a medium term program, the Bank ought to have fully worked out its exact course of action, which could be different from that of the Fund.

7. The Region replied that competitiveness was the key issue in the medium term program. Any credible resolution of that issue would trigger Bank support. With respect to the IDA, the Region was unhappy to see any country drop back to IDA eligibility without undertaking serious structural adjustment which would help to solve its problems. To demonstrate support of the efforts of the Government, the Region was proposing to appraise the three SECALs and to continue to provide economic advice. Without a medium term program and therefore without the Bank's quick disbursing assistance, it was virtually certain that the country would be unable to meet its debt service obligations to the Bank. The consequence of this would be suspension of disbursements, in which case there would be no further lending even for an IDA core investment lending program.

8. Other Committee members expressed concern about the present situation. One member said that adjustment was not working because of fundamental constraints on the choice of policy instruments. If the Government could address neither the exchange rate nor the wage issue, there was no prospect for successful adjustment. He further added that any liberalization of imports would not produce beneficial effects without the help of an exchange rate policy change. Another member thought that the Bank had found itself almost in the same position as two years ago when an interim program was put in place in expectation of a medium term program. He felt that the Bank might have exhausted its abilities for further assistance, since the Government had not demonstrated commitment to a medium term program. He did not believe another interim program was likely to work or could be supported in the absence of a medium term program. Another member said that if further lending were to be extended without agreement on a medium term economic program that led to growth, given that two years ago a program of adjustment had already been supported, the credibility of the Bank would be adversely affected.

9. The Region's proposal to appraise the SECALs could be supported, one member stated, but he also emphasized that there was a downside risk to this strategy. By doing so, the Bank would not signal, especially to outside donors, the need for more decisive policy actions. Another member cautioned

that while action on the exchange rate was a necessary part of a medium term program, it was not a sufficient condition for success and in the absence of prior actions in complementary areas of reform, it could fail. He stressed that the CFA countries had been hit badly by adverse terms of trade, but had nevertheless maintained low inflation. He believed that there could be a focus on reforms which improved labor market flexibility, further reform of the tax system, and other measures to promote internal competition. He felt that there could be a danger in pursuing broad- based financial sector reforms ahead of devaluation. Overall financial sector reform should follow, and not lead, the adjustment in the real sector. Initial measures in this area should be sharply focused on the short- run difficulties of the banks directly relevant to the macroeconomic management of the transition.

B. Decision

10. The Chairman stated that the Region could go ahead and appraise the proposed SECALs. However, the loans could not be negotiated until there was agreement on a medium term framework which the Region should bring back to the Committee. These issues were important and would need to be raised to the President.

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June 28, 1991

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

9(062)51 0

What about the addendum? (Para 10)?

DATE: June 20, 1991

TO: Operations Committee

FROM: Fred D. Levy, Acting Director, EAS

EXTENSION: 81947

SUBJECT: COTE D'IVOIRE - Strategy for Quick Disbursing Lending and three Initiating Memoranda for Sector Adjustment Operations: (a) Financial; (b) Industrial Sector Competitiveness and Regulatory Reform; and (c) Human Resources; Operations Committee Meeting Agenda

---

1. The Operations Committee will meet on **Monday, June 24, 1991, at 4:30 p. m. in Room 1243** to consider the Strategy Note for Quick Disbursing Lending for Côte d'Ivoïre and three Initiating Memoranda for sector adjustment operations designed to help implement this strategy in the areas of (a) Financial Reform; (b) Industrial Sector Competitiveness and Regulatory Reform; and (c) Human Resources. The following represents a proposed agenda for the meeting.

Background

2. In 1989, an interim stabilization program for Côte d'Ivoïre was supported by the Bank with three sector adjustment operations for Energy, Water Services, and Agriculture. The last tranche of the $150 million Agricultural SECAL was recently disbursed, hence completing the financial support under the interim stabilization program. It was understood between the Bank and the Government at the time these SECALs were made that further quick- disbursing assistance in the future would depend on the adoption by the end of 1990 of a medium term program which could restore competitiveness, growth, and creditworthiness. There is no agreement yet with the Government on a medium term economic program. In the meantime, the IMF is pressing for Bank support of another interim program. A Fund mission recently finished its field work in Abidjan in the preparation for this interim program. (The IMF did not release the December 1990 tranche under the existing Standby program.)

3. The Africa Region submitted a strategy note (referred to herein as memo) and four separate attachments. The first attachment entitled, "Côte d'Ivoïre: Policies to Achieve Sustainable Medium Term Growth," analyzed the recent performance of the economy and the needed medium term growth strategy. Attachments 2, 3 and 4 are the draft Initiating Memoranda for the proposed sector adjustment operations.

Issues

Macroeconomic Issues

4. Performance under the Present Strategy of Stabilization. Since 1986, the economy of Côte d'Ivoïre has been in decline. Real GDP per head has fallen by 20%, consumption by even more (33%), and investment in 1990 was 8.5% of GDP, down from around 12% of GDP in 1986. Although the strategy of fiscal deflation has led to a reduction of the fiscal deficit, the latter still amounted to 8.7% of GDP in 1990. Moreover, the reduction in public expenditure had been achieved mainly through cuts in non-salary expenditures, so that the room for new investments and other productive expenditure had been severely limited (Table 1, macroeconomic indicators, page 2 of memo or page 1, Attachment 1). The Committee might want the Region to provide a review of recent developments on the macroeconomic front and to discuss whether the present deflationary strategy of adjustment has a chance of working out. Could further contraction of the economy (already in decline for six years in a row) be avoided by this approach? Could it be sustained without irreparable damage to the economic base? ?

5. Restoring Competitiveness and Growth. The Region emphasizes that the "current financial and economic crisis is the result of a 40% decline in the terms of trade since 1986 coupled with a 30% appreciation of the real effective exchange rate" (para. 4, memo; also Table 5, attachment 1, page 6, and para. 17, which report the estimates of overvaluation, utilizing four different methodologies). Against its competitors in the commodity markets, the real exchange rate has appreciated about 105% (Annex I, Table 2 [page 4 of 8] of Attachment 1). To restore competitiveness, growth and creditworthiness, it would be essential to achieve a sufficient level of real devaluation of the currency. In fact, the Region states that there is need "to address the prospect of nominal devaluation .. as the only viable policy option to restore competitiveness" (para. 11, memo). The Committee might want to ask the Region:

Who are the competitors? East Asia?

- To discuss the alternative policy options and the timeframe needed in order to achieve the objectives of restoring competitiveness, growth, and creditworthiness.
- To explain the financial implications of these strategies, both from the standpoint of the external financing that can be mobilized and the sustainability of the process from the country's viewpoint; for instance, the 1991 financing gap alone is estimated at $1 billion (para.8, memo).
- To elaborate on the Bank's strategy to cope with the international and regional dimension of the CFA problem, since any nominal devaluation, by whatever degree, requires involving other members of the CFA Zone in the process, assuming that there is no unilateral action by any country.
- To elaborate on the important complementary policy measures on the fiscal, monetary, and sector fronts (including

measures to reduce the public sector wage bill) required to make a nominal devaluation scenario successful.

- To assess the magnitude of the debt service problem and the required measures that might be undertaken on the international front -- to be supported by the Bank, and possibly IDA -- that would make it feasible to restore growth (at the end of 1990, total external debt [public and publicly guaranteed] was 125% of GDP, representing a debt service ratio of 60% over 1988-90 of exports of goods and non-factor services (Attachment 1, para.20).

6. Political Committment to Reform. The Region states that the present economic team in Côte d'Ivoïre is the best in Africa (para. 3, memo). Recent political developments led to the reelection of the President Houphouet-Boigny and the appointment of Mr. Ouatarra as Prime Minister with the task of pursuing the necessary reforms. Yet, there had been some slippage in the stabilization program of 1989, evidenced by the non-disbursement of the December 1990 tranche under the Fund standby program. Moreover, "nothing that the government is presently proposing to do adequately addresses the basic issue..." (para.7, memo). It is also likely that the difficulty of cutting civil service salaries, demonstrated by the failed attempt in 1989, embodies an incipient strong resistance against basic structural changes in policy within the Government. The Committee might want to discuss whether there appeared to be a genuine commitment to undertaking painful economic policy decisions to correct the long- standing problems in the country. In this connection, how would the Region assess the implications of an effort to stall for time prior to substantive actions on the medium term program?

7. Assessing the Risks to the Bank of Action and Inaction. The Region states that the main strategy of the Bank is to bring about "the long-awaited medium term program and to provide further fast-disbursing assistance" (para.14, memo). The Committee might want to discuss the implications of adopting the strongest possible medium term program to ensure a viable return to growth of the economy. In this connection, the Committee might want to focus on the following sub-issues:

- What would be the costs to the Bank of a default in the event that the Government was not ready to adopt a suitable medium term program?

- What would be the burden sharing implications of assistance to the adjustment program in Côte d'Ivoïre? What could be considered a realistic notional share of the burden of the the Fund and other lending institutions, including the bilateral donors? (It may be noted that over the years, the exposure of the Fund has decreased, and that of the Bank has increased, and that under the proposed interim program, it would appear that the Fund would continue to reduce its exposure.)

The Three Sector Adjustment Operations

8. The Region proposes to support the medium term adjustment program in Côte d'Ivoïre with three SECALs. The notional amount for these three SECALs implies a total new lending for adjustment in the amount of $330 million, consisting of $120 million for the Financial SECAL, $150 million for the Competitiveness/ Regulatory SECAL, and $60 million for the Human Resources SECAL; paras. 20 to 21, memo).

9. The Region is seeking authorization from the Operations Committee to appraise these sector operations "in anticipation of negotiating them if and when an agreement can be reached on a satisfactory medium term program." (para.21, memo). The Committee might want to discuss the following prior issues, pending a discussion of the design and conditionalities of these SECALs:

- Should the Bank Appraise Ahead of an Agreement on a Medium-Term Program of Adjustment? The Committee might want to discuss the merits and risks of giving approval to appraise the SECALs ahead of an agreement by the Government to adopt a medium term program. Would an action to appraise at this time signal to the Government a potential misreading of the Bank's intention with respect to an acceptable medium-term program?

- Stage of Readiness for Appraisal of the Operations. The Region notes that the three SECALs are at different stages of preparation. The Financial SECAL is the "most advanced" among them. The Committee might want to know the Region's views about the appropriate sequencing of these operations in connection with the adjustment process in Côte d'Ivoïre, and the amount of further processing and review needed before they are ready for full appraisal.

10. Sector Issues. (Note. A brief addendum to this agenda, dealing with sector issues, will be distributed later.)

Operations Commmittee

Messrs. Qureshi, OPNSV
Shihata, LEGVP
Wood, FPRVP
Summers, DECVP/Rajagopalan, PRSVP
Kashiwaya, CFSVP
Jaycox, AFRVP
Karaosmanoglu, ASIVP
Wapenhans, EMNVP
Husain, LACVP
Bock, OPNSV

Commitment –
Policy reforms on hought
all

cc: Messrs./Mmes Gillette, Goldberg, Wyss, Isenman, Linn,
Stoutjesdijk, Picciotto, Lietard, Burmester/
Thahane, Hinkle, Drysdale, Okonjo-Iweala, Parmar,
Pfeffermann, Rao, Kavalsky, Shakow, Sandstrom,
Liebenthal, Kilby, Robless, Walton, Khanna

GS
GSicat:sb

THE WORLD BANK/IFC/MIGA

Confidential

OFFICE MEMORANDUM

DATE: June 14, 1991

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

THROUGH: Mr. Edward V.K. Jaycox, Vice President, AFR

FROM: Michael J. Gillette, Director, AF1

EXTENSION: 35040

SUBJECT: Cote d'Ivoire - Strategy for Quick Disbursing Lending

1. Please find attached a memorandum to the Operations Committee setting out our proposed strategy for further quick disbursing lending to the Cote d'Ivoire, together with the initiating memoranda for the three SECALs that are ready for appraisal and our analysis of the Cote d'Ivoire's medium term prospects. It would be desirable if the Operations Committee could discuss this memorandum prior to the scheduled visit of the Prime Minister Ouattara to the Bank on June 27 so that we could have the benefit of its views prior to the meetings with him.

2. An IMF mission is currently in the Cote d'Ivoire discussing an interim program with the government. The mission is due back to Washington next week, and we would propose to brief the Operations Committee on the status of the IMF's discussions at the start of the meeting.

MJG/hc

Confidential

COTE D'IVOIRE: STRUCTURAL ADJUSTMENT PROGRAM

INITIATING MEMORANDA

INTRODUCTION

1. The Bank has just disbursed the last tranche of the $150 million agricultural Sector Adjustment Loan, thus completing its financial support to the interim stabilization program in the Cote d'Ivoire which was put in place in 1989. It was understood when that program was agreed that further fast disbursing assistance from the Bank would be contingent on the adoption by the end of 1990, at the latest, of a medium term program which would lead to a restoration of competitiveness, growth, and creditworthiness. We still do not have an agreement with government on such a medium term program; and the IMF is pressing for another interim stabilization program, for which it is assuming substantial Bank support.

2. The purpose of this memorandum is threefold. In the first instance, it is to inform the Operations Committee about the many developments, some very positive, which have taken place in the Cote d'Ivoire since the Committee last discussed the macro economic situation of the country in June 1990. Secondly, this memorandum sets out for the Operations Committee the strategy that we have been following to bring about agreement on the required medium term program and seeks its guidance as discussions with the Cote d'Ivoire enter a particularly delicate stage. Finally, the memorandum presents Initiating Memoranda for three proposed sector adjustment operations which would constitute the core of further Bank fast disbursing assistance, should the foregoing strategy result in a medium term program meeting the Bank's requirements.

RECENT DEVELOPMENTS AND ECONOMIC PERFORMANCE

3. The current economic team in Cote d'Ivoire is arguably the best in Africa. It is headed by Alassan Ouattara, former Governor of the BCEAO and former Director of the IMF's Africa Department. In April 1990, Mr. Ouattara was appointed head of an interministerial committee charged with implementing a program of far reaching reforms. His appointment followed the abandonment in March 1990 of a poorly conceived and carelessly executed policy to cut public sector wages. After the November 1990 elections, in which President Houphouet-Boigny was reelected with a popular mandate, Mr. Ouattara was appointed Prime Minister to pursue the necessary economic reforms.

4. The current financial and economic crisis is the result of a 40% decline in the terms of trade since 1986 coupled with a 30% appreciation of the real effective exchange rate. 1/ Sizable budgetary and current

---

1/ See Annex I of the attached report entitled "Cote d'Ivoire: Policies to Achieve Sustainable Medium-Term Growth" for a full discussion of the real exchange rate issue.

account deficits emerged in 1987 and reached 16 and 12 percent of GDP, respectively, in 1989 (Table 1). These deficits were financed by debt relief and fresh money from official creditors and, when these proved to be insufficient, by the accumulation of arrears. Accordingly, the debt burden has become unsustainable (114% of GDP). High internal arrears have also contributed to a severe liquidity crisis adversely affecting banking system solvency, private sector confidence, and economic recovery.

TABLE 1: MACRO-ECONOMIC INDICATORS 1986-90

	1986	1987	1988	1989	1990
Real GDP growth	3.4%	-1.6%	-2.0%	-0.7%	-3.0%
Real private consumption	-1.3%	5.2%	-4.9%	-4.7%	-7.3%
Fiscal balance/GDP	2.4%	-7.0%	-13.6%	-16.1%	-8.7%
Current Account Balance/GDP	-0.1%	-4.8%	-11.8%	-12.1%	-11.9%
Investment/GDP	11.9%	11.2%	11.0%	8.4%	8.5%
Domestic Savings/GDP	18.6%	17.1%	16.6%	11.8%	11.3%
CPI inflation	7.3%	0.4%	7.1%	1.0%	0.0%

Source: Direction de la Prevision and Bank staff estimates.

not from these figures

5. Since 1986, real GDP per capita has declined by 20% and private consumption per capita by a third. Savings and investment, have declined; export diversification has been halted; and domestic markets are being flooded with imports from neighboring countries, some of which have devalued. Social spending has been cut and the decline in coffee and cocoa producer prices has reversed the substantial improvement in the rural-urban terms of trade which occurred in the first part of the 1980's.

6. To date, the Government's reform program has consisted primarily of implementing the previously agreed sectoral adjustment programs for the agriculture, energy, and water supply sectors together with measures to stabilize public finances and reduce arrears. The program has achieved some success in that the primary fiscal deficit (i.e. excluding interest payments) was reduced from 7.4% of GDP in 1989 to less than 1% in 1990, almost all of this improvement brought about through substantial cuts in non-salary current expenditures. Lower producer prices have also led to a reduction in the stabilization fund's deficit. However, the stabilization program nevertheless failed to achieve its end-1990 arrears reduction targets, and the IMF could not release the last tranche of its standby.

7. With respect to the long awaited medium term program, some specific structural measures involving tax reform and export promotion have been incorporated in the 1991 budget. Further structural measures have been vetted internally through a highly participative (and, for the RCI, unique) public/private task force process. However, nothing that the government is presently proposing to do adequately addresses the basic issue of real exchange rate overvaluation.

8. The IMF is now preparing an interim 12 month stabilization program to cover the period from mid-1991 to mid-1992. This program is designed to continue the fiscal adjustment effort and support further internal reforms. However, the 1991 financing gap alone is presently estimated at $1.0 billion (after debt rescheduling and disbursements on project loans but before new exceptional external financing). Without a viable medium term framework in which to place its program, the Fund may have to aim at extremely large increases in revenues, which, in view of the 15% decline in revenues since 1988, are unlikely to be achievable in the face of a continuing decline in GDP and imports. Although it would include some of the structural reforms mentioned above, the proposed IMF program is, by itself, likely neither to halt the current deflationary spiral and restore growth nor to reduce the need for exceptional foreign financing to feasible levels, unless additional measures to effectively address the competitiveness issue are added to it. An indication of the Fund's commitment to this program is that its own net exposure in the Cote d'Ivoire would actually decline during the program period as repayments to the IMF would be larger than new drawings.

THE MEDIUM TERM SCENARIO

9. The economy of the Cote d'Ivoire is no longer competitive. Between 1985 and 1990, the real exchange rate has appreciated by an estimated 30% on a weighted average basis and by a staggering 105% vs. the country's principal competitors in international commodity markets.

10. Devaluation, by itself, will not suffice to restore competitiveness. A great deal must be done to remove distortions in taxes and tariffs and to clean up the system which heretofore has regulated prices to producers and

consumers and the conditions of employment in the modern sector. Further fiscal adjustment, continued implementation of the agriculture and public enterprise sector adjustment programs, reforms in the financial and human resources sectors, tax and regulatory reforms, plus depreciation of the real exchange rate (RER), will all be required components of a viable medium term program.

11. The basic issue concerns how to achieve sufficient RER depreciation to restore competitiveness, growth, and creditworthiness as quickly as possible. Government has so far opted for deflationary internal adjustment based on lower inflation rates in the RCI than in competing markets. Given the low rate of inflation already prevailing in the RCI, this is at best a slow and torturous process which can only lead to a very gradual depreciation of the RER under the most optimistic assumptions (see the attached report entitled "Cote d'Ivoire: Policies to Achieve Sustainable Medium-Term Growth" for an analysis of the government's proposed adjustment program). Moreover, the deflationary approach may not achieve the needed shift in the internal terms of trade in favor of tradable goods productions as it has been feasible thus far to reduce agricultural producer prices but not wages in the civil service and other urban non-tradable goods sectors. With the economy now in its fifth year of recession, and in the light of the failed attempt to cut nominal wages in the public sector last year, we believe that the Ivorian authorities have little choice but to address the prospect of nominal devaluation of the CFA franc as the only viable policy option to restore competitiveness.

12. Any decision to devalue must take into consideration the views of 12 other African CFA zone countries and the two central banks. 2/ France, as the guarantor of convertibility, must also be consulted. Moreover, effective implementation of a devaluation and the necessary package of accompanying measures simultaneously in 13 independent countries would pose a major challenge. For such a devaluation to have a reasonable probability of success, concerted and thorough preparatory work must be done by a handful of key players. This work cannot be visible and must be done quickly. To date, our strategy has dictated that we quietly undertake this kind of work and share the results with a limited subset of the players.

13. The Cote d'Ivoire has the largest total trade and is the most influential country in the CFA franc zone, 3/ and its economic and political stability is a major preoccupation of France. Although most of the other countries in the CFA Zone have also experienced a substantial loss of competitiveness since 1986, the Cote d'Ivoire will be the key player on

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2/ The Comoros, which left the CFA Zone in 1981 but whose exchange rate has continued to be pegged to the FF at a 50:1 rate, might also be affected.

3/ Cameroon's GDP is, however, slightly larger than the RCI's.

exchange rate reform because of its leadership position in BCEAO, which has recently been the more dynamic of the Zone's two central banks. Failure to induce fundamental policy change in the RCI would either condemn most of the CFA zone countries to low growth and excessive dependence on external assistance for the foreseeable future or lead to the break up of one or both of the monetary unions.

Bank Strategy

14. Bank Strategy has thus concentrated on the RCI, where the Bank's principal objective is to bring about the long-awaited medium term program and to provide further fast-disbursing assistance only when we are satisfied that such a program is in hand and is feasible. Hence, most of our staff effort has been devoted to the macro dialogue, the implementation of previously approved SECALs, and the preparation of three additional SECALs designed to support a comprehensive medium term program. Although we have continued to work on a few investment projects, we do not intend to lend for them until there is agreement on a medium term program. Whether or not the government will soon propose a change in parity of the CFA franc remains to be seen. There is still the deflationary option for achieving real exchange rate depreciation, but in our judgment both the economic and political feasibility of relying exclusively on that option for improving competitiveness are highly dubious.

Not correct

Must have a core program

15. To give credibility to the Bank's approach, we have been extremely rigorous with respect to the RCI's comportment, both in matters of debt service and in the execution of the ongoing SECALs. This approach has paid off as RCI has paid its debt service due to the IBRD 4/ and has substantively respected all conditions of the three SECALs in place. We have complemented this tough attitude by being more than ready to help the Ivorians through solid analytic work and preparation of the next family of fast disbursing operations. To continue the proactive approach that we have followed up to now, both with the client and with the French, we will have to appraise the latter operations soon.

What does this mean?

4/ From 1987 to 1989, the Bank took some US$130 million out of the RCI. In 1990 the net transfer was positive since the SECALs were disbursing, and the Bank's net exposure rose. The RCI's repayments to the Bank are invariably late and have hovered around the 60 day limit. The changes in Bank arrears policies which come into force on July 1 will present an additional challenge to the RCI authorities and to our strategy. On July 1, the RCI will have to pay an extra $11 million that it would not otherwise have had to pay until July 15, and all subsequent payments will similarly be accelerated by 15 days.

THE SECALS

16. A critical element of our strategy has been to maintain an active dialogue with the Ivorian authorities and our other principal partners, the IMF and France, on both macro and sectoral adjustment issues. We did not want any of our partners to get the idea that we were simply sitting and waiting. We have made a determined effort to signal our good will and readiness to work with the Ivorian authorities to prepare a medium term program. Hence, in addition to the macro-analysis referred to earlier, we have been actively helping the authorities prepare three sector adjustment programs, for which draft initiating memoranda are attached. These would cover the key areas of financial sector restructuring, competitiveness and regulatory reform, and human resources development. These, together, with improvements in public finance included in the proposed IMF program and a continuation of the reforms in the agriculture and public enterprise sectors implemented under the previous three SECALs, would tackle the priority structural issues that need to be resolved in the medium term.

17. Work is most advanced on an operation for restructuring the Cote d'Ivoire's financial system. The country's current recession and severe fiscal problems precipitated a crisis in the financial system, which also revealed serious policy, management, and oversight deficiencies. Rebuilding the commercial banks and specialized financial institutions and reestablishing a healthy system for financial resource mobilization and allocation will be essential elements of any medium term program for restoring growth. The government has already adopted, in conjunction with BCEAO, key measures concerning monetary policy, bank supervision, and the restructuring of commercial banks, the agricultural development bank, and insurance companies. The government's financial sector restructuring program would aim both at stabilizing and reliquifying the financial system and at promoting savings and lending in support of growth.

18. The second quick disbursing operation would be a Competitiveness and Regulatory Reform Loan to promote exports and efficient import substitution. The proposed program would include reforms in the regulatory framework (especially regarding competition and labor markets), taxation, transportation services, export incentives, and the judicial system. The program is based on detailed studies by public and private sector representatives, which showed that, although overvaluation is the primary cause of the loss of competitiveness, serious structural problems also result from oppressive price, wage, and other regulatory controls and from inadequate incentives for private sector production and investment. Government started to implement some of the envisaged measures in 1991.

[illegible] the Judicial System

19. The final component of the Bank's quick disbursing assistance would be an operation to support the development of human resources. Partly as a result of the government's fiscal difficulties, social indicators in the Cote d'Ivoire lag behind those of comparable Sub-Saharan African countries and have

declined during the current recession. Human resource development is a vital part of raising the productivity of the labor force. It is also critical to the welfare of the least privileged parts of the population, and experience has shown that the most effective way to address the social dimension of adjustment is to fully integrate human resource development into the medium term program. The sector is also of considerable importance for the restructuring and more efficient use of public financial resources, accounting for about half both of the current budget and of **employment** in the civil service.

20. A total $330 million is currently programmed for these three quick disbursing operations: $120 million for the financial sector, $150 million for competitiveness and regulatory reform, and $60 million for human resources development. However, these amounts are only indicative as the actual size of the loans would be determined in light of the agreed medium term macro-scenario. Similarly, the timing and content of some of the proposed reforms might be modified somewhat to reflect policy actions in the agreed medium term scenario.

21. Work on the foregoing three sector adjustment operations is being fully integrated into the preparation of a comprehensive medium term macro program, and a significant number of the planned reforms have already been initiated. We need to keep up the current level of effort and the reform momentum that these operations have developed. Hence, Operations Committee permission is hereby requested to appraise the three proposed sector loans in anticipation of negotiating them if and when an agreement can be reached on a satisfactory medium term program.

Is this for real Have these 3 ops already generated reforms

CONCLUSION

22. Since the previous three SECALs have now completed disbursing , the Bank will swing from a positive to a substantially negative net transfer position vis-a-vis the RCI this summer. As the RCI is unlikely to have the resources to repay the Bank without substantial additional assistance from France, it will be confronted shortly with the choice of either defaulting to the IBRD or of addressing the competitiveness issue. In light of the experience of other countries, the default scenario does not look viable as either a short term or long term option. Hence, the RCI will probably seek to reach some kind of understanding on the competitiveness issue.

So! The argument is that RCI will not default + that some understanding on these countries

23. The Ivorian authorities are likely to argue that additional time is required for preparing a detailed medium term program, that restructuring of the financial sector is an essential element of any program, and that therefore the Bank should go ahead now with its financial sector loan in tandem with the IMF's interim program. We agree that some additional time is required for formulating a detailed program, and the design of the reform process should allow for this. However, what has delayed the progress thus far has been the government's unwillingness to confront the basic policy

Why are you belaboring COF ?

decisions required rather than the time needed for detailed technical work. Further delay in addressing the competitiveness issue will only further postpone the restoration of economic growth and creditworthiness. Hence, as a condition for any further quick disbursing lending, the Bank should continue to insist on the need for agreement on the broad macroparameters, including the magnitude of the competitiveness problem, and the key policy measures of a medium term program and on the time frame during which these would be implemented. Should the RCI elect to default to the Bank rather than reach agreement on a medium term program, we should still try to maintain a dialogue on the need to continue the reform process and to address the competitiveness issue, while trying to work out a solution for the arrears problem.

24. In summary, we would propose to appraise now the three planned SECALs and return to the O.C. before negotiations of the first of these operations, probably financial sector restructuring, with a medium term program justifying a resumption of quick disbursing assistance and a green cover President's Report. The documents for the other two operations would be submitted to the O.C. as quickly thereafter as the government can complete required actions. The loan amounts and spacing of tranches would be determined in light of the financing requirements of the agreed medium term macro program.

25. We anticipate that Cote d'Ivoire may become eligible for IDA assistance in the coming year as per capita income fell below the cut off point in 1990 and is likely to remain below this limit in the medium term. However, since the amounts of IDA financing available are likely to be modest, the Cote d'Ivoire's creditworthiness would need to be reestablished in order to make possible continued IBRD lending in an appropriate blend with IDA. If a satisfactory medium term program is adopted, combined IBRD/IDA lending should be large enough ($300-400 million p.a.) to maintain a positive net transfer position during the critical first two years of its implementation until the economy responds to the adjustment measures and is able to start servicing its restructured external debt. On the other hand, if it proves impossible to reach agreement on a medium term program <u>and</u> the RCI does not default to the IBRD, we would need to consider whether or not to continue with a limited IDA and/or IBRD funded program of investment operations.

There is no real possibility

attachments

MJG/hc
06/13/91
RCIDOC

June 21, 1991

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: June 21, 1991

TO: Operations Committee

FROM: EG Enzo Grilli, Director, EAS

EXTENSION: 81934

SUBJECT: BURKINA FASO - Agriculture Sector Adjustment Operation
Initiating Memorandum;
Operations Committee Meeting Notice

A meeting to discuss the Initiating Memorandum for Burkina Faso will take place on **Friday, October 25, 1991, at 4:30 p. m. in Room E1243**. This document dated October 15, 1991, was circulated to you under the signature of Mr. Serageldin today. An agenda for the meeting will be issued shortly.

Operations Committee

Messrs. Qureshi, OPNSV
Shihata, LEGVP
Wood, FPRVP
Summers, DECVP/Rajagopalan, PRSVP
Kashiwaya, CFSVP
Jaycox, AFRVP
Karaosmanoglu, ASIVP
Wapenhans, EMNVP
Husain, LACVP
Bock, OPNSV

cc: Messrs./Mmes Marshall, Goldberg, Wyss, Isenman, Linn, Stoutjesdijk, Picciotto, Burmester/Thahane, Steeds, Okonjo-Iweala, Mills, Parmar, Pfeffermann, Rao, Kavalsky, El-Rifai, Niehuss, Sandstrom, Liebenthal, Kilby, Robless, Walton, Khanna

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: October 23, 1991

TO: Operations Committee

FROM: EG Enzo Grilli, Director, EAS

EXTENSION: 81934

SUBJECT: BURKINA FASO - Agriculture Sector Adjustment Operation Initiating Memorandum; Operations Committee Meeting Agenda

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1. The Operations Committee will meet on **Friday, October 25, 1991, at 4:30 p. m. in Room E1243** to consider the Agriculture Sector Adjustment Operation for Burkina Faso. The following represents a proposed agenda for the meeting.

Background and Macroeconomic Issues

2. Country Strategy. The proposed Agricultural SECAL is in line with the assistance strategy in support of an economic adjustment program in Burkina Faso. In addition to a SAL (approved in June, 1991) and a Transport Sector Adjustment/Investment Credit (scheduled shortly for Board presentation), investment credits in the agricultural sector are either in place or being planned. These projects cover fertilizer distribution, agricultural research, and agricultural services.

3. Macroeconomic Situation. The Committee might want to be apprised by the Region about the current macroeconomic situation, in view of recent political unrest that is occurring in the period before national elections. Are there any signs of deterioration of the resolve of the government to pursue the adjustment program and maintain an acceptable macroeconomic balance?

4. The CFA Issue. In a separate memorandum for the Committee's attention, the Region discusses the CFA issue. The overvaluation of the CFA from the standpoint of Burkina's economy is estimated to be in the order of 15% to 20%, but domestic labor costs in the formal sector are as high as in Cote d'Ivoire and Senegal. This memorandum (particularly, para. 3) acknowledges the difficulty of attaining competitiveness under a purely internal adjustment scenario because of the political costs involved in making cuts in nominal wages. Moreover, pursuing the internal adjustment program could worsen income distribution, since it would weaken the terms of trade of rural producers. The Committee might want to ask the Region to elaborate how it anticipates that the present approach could minimize such unwanted outcomes and still promote growth in the medium term.

Agricultural Sector Issues

5. Program Objectives and Action Program. The proposed credit would support measures to liberalize marketing and pricing policies

affecting major agricultural products, especially cereals, cotton, oilseeds, and sugar. Specific actions would include a reduction of the role of marketing agencies, restructuring (and also privatization) of public enterprises, improvement of contract plans, and the introduction of pricing mechanisms for producers of export crops, such as cotton, to enable them to benefit from international market movements.

6. The Committee might want to discuss the following:

- Which crops would remain under direct or indirect price controls? How would the tariff and domestic tax structures on agricultural commodities influence production incentives and growth in agriculture? Why would the tariff revision affecting agricultural commodities be timed only for review by the second tranche?

- How would the speed of enterprise restructurings in the agricultural sector in Burkina -- including full or partial privatization -- compare with the experience in similar Sub Saharan African countries? The process of privatization and restructuring has been sluggish in some countries, and it is often not clear whether the process is inherently difficult or it is so because there is no political will to carry it out.

- How would the food security investment component of the credit be able to target the most vulnerable groups?

- How would the public expenditure program for the agricultural sector be linked with the reform measures in the sector?

- Would there be any environmental issues in the public investment programs in agriculture that need to be addressed?

7. Aid Coordination. The Region states that aid coordination issues are important in this operation (memo para.3; IM para.4). The Committee might want to have the Region elaborate on (a) how the measures in the action program are supported by the donors, and to highlight in particular the areas in which there are differences of approach; and (b) how firm are the anticipated co-financing commitments?

8. Tranche Release Conditions and Credit Structure. The proposed credit is for $28 million (including a food security/investment component of $3 million), to be released in two tranches against a negative list. The conditions for second tranche release indicate that many actions are still vaguely identified, and some may only be implemented after release of the second tranche. The Region might be asked to describe the expected future agenda in the agricultural sector and the Committee might want to discuss whether it would be more appropriate to structure the credit in three tranches, with a longer time horizon.

Operations Commmittee

Messrs. Qureshi, OPNSV
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cc: Messrs./Mmes Marshall, Goldberg, Wyss, Isenman, Linn, Stoutjesdijk, Picciotto, Burmester/Thahane, Steeds, Mills, Parmar, Pfeffermann, Rao, Kavalsky, El-Rifai, Niehuss, Sandstrom, Liebenthal, Kilby, Robless, Walton, Khanna

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Mr. Qureshi
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THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE : June 19, 1991

TO : Operations Committee

FROM : Fred D. Levy, Acting Director, EAS

EXT. : 81947

SUBJECT: PARAGUAY: Country Strategy Paper - Agenda

1. The Operations Committee will meet on **Friday, June 21, at 4:00 p.m. in Room E-1243** to discuss the CSP for Paraguay.

2. There has been no lending to Paraguay since 1984. However, the new Government of President Rodriguez appears to be interested in borrowing again from the Bank and the Fund. Negotiations are proceeding with the Fund on a Stand-by. The CSP proposes a resumption of lending with two operations in FY92 ("cadaster and titling" in agriculture and "rural water supply"); for the FY92-96 period as a whole, the CSP proposes an average of two operations and about $50 million per year.

3. Macro-economic prospects, policy reforms, and lending levels. Macroeconomic prospects for Paraguay are illustrated in terms of a "high" case, which assumes a successful stabilization program supported by the Fund as well as across-the-board policy improvements. A disastrous downside case is also referred to briefly, but not explained or enumerated. It is suggested, but not explained, that the most likely developments would be closer to the high case than to the low case. The Region might elaborate upon:

- the most likely scenario in the near term. If the so-called high case is optimistic, what are the main areas of optimism? In explaining this, the Region might focus in particular on exchange rate and reserve management policies. What have been the principal causes of inflation and what is the stabilization policy currently in place? Why have the Paraguayan authorities preferred to hold such large reserves (about a year's worth of imports)? What is the Fund's attitude on stabilization? (the Region is revising the inflation data in Annex B; there is reportedly no acceleration in inflation rates as shown in that table, and referred to in the text).

- the case for lending. The CSP says that Paraguay has "ample reserves" - sufficient for servicing debt even though it prefers to accumulate arrears as a bargaining tactic (it is hoping to get Paris Club rescheduling). The CSP goes on to state that Paraguay has "abundant prospects" of securing financing from IDB and bilateral (mainly Japanese) sources at costs significantly lower than those of the Bank. Given that there is apparently no balance-of-payments needs, is there a case for considering quick-disbursing funds (it is proposed that the financial sector loan be a "hybrid")? What is the appropriate role for the IBRD given the country's high reserves and access to cheap credit from other sources?

- priorities in policy reforms. At the general level the CSP identifies the priority areas for reforms to be tariffs, taxes, and the financial sector:

  a) tariffs. Regarding tariffs and trade interventions, the CSP suggests that a uniform 10% import duty should be adopted; however, the current level and structure of tariffs are not clear; the impression is that whatever barriers there might be are quite irrelevant and ineffective. If so, why introduce a duty at all?

  b) taxes. Regarding taxes, the current situation appears to be the happy one of a virtually tax-free environment. Should we propose the introduction of new taxes (value-added, corporate and personal income taxes), however conventional they might be, instead of pushing for cuts in public expenditures? Would the new taxes be consistent with the sharp rises being projected in private savings and investment?

  c) financial sector. The CSP gives the highest priority to this sector. It proposes the introduction of new monetary instruments for open-market operations and new banking legislations and regulations. On monetary instruments, is it really true, as the CSP suggests, that lack of open-market papers has contributed to inflation? Will there be a competitive market for such papers? Would it be better for the Fund to handle monetary instrumentation in the context of the credit ceilings in the Stand-by? On banking legislation, the Region might elaborate what the structure of the financial sector now is and which inefficiencies need to be addressed. The Region might also comment on the availability of long-term finance (the quasi-money to GDP ratio has been falling), and on the availability of credit to small farmers and entrepreneurs. Should our dialogue focus on these aspects also?

4. Lending composition. The CSP proposes lending to promote reforms in the financial sector, and in agriculture/environment, infrastructure (transport, urban) and the social sectors. It also proposes lending to support privatization of state enterprises. The financial sector issues were raised above. Some other issues are:

- agriculture/environment. Paraguay is predominantly agricultural, and most of its exports come from this sector. There seems to be considerable scope for agro-industry as well (especially in processing soya and cotton). What is the Government's overall strategy for developing agriculture and agro-industry, and for protecting forests? Are there any distortionary pricing or regulatory policies that we should be concerned about? What is the scope for improving agricultural settlement policies?

- social sectors. It is not very clear just how important a problem poverty is in Paraguay. How much do we know about poverty and equity, and access to basic social services? While rural water supply might be a worthwhile venture in this context, what are the other priorities? Does the Government have a coherent strategy?

- public enterprise reforms and privatization. The four major public enterprises (steel, cement, maritime transport, air transport) are activities which might better be performed by the private sector. But it is not obvious that the private sector would be interested in steel and cement because of the large excess capacities. How important is it to privatize these enterprises from either the fiscal or the efficiency points of view? What is meant by the "need to wean the military away from the public enterprises (para 92)". Can the Bank contribute costructively to the process?

Operations Committee:

Messrs. Qureshi (OPNSV), Husain (LACVP), Jaycox (AFRVP), Karaosmanoglu (ASIVP), Wapenhans (EMNVP), Rajagopalan (PRSVP), Summers (DECVP), Shihata (LEGVP), Kashiwaya (CFSVP), Wood (FPRVP), Bock (OPNSV).

cc: Messrs. Thahane/Burmester, SECGE; Picciotto, CPB; Goldberg, LEGOP; Wyss, COD; Sandstrom, EXC; Isenman, PRD; Linn, CEC; Stoutjesdijk, FRS; (Ms.) Okonjo-Iweala, OPNSV; Parmar, IFC-CIO; Rao, IEC; Kavalsky, FRM; Pfeffermann, IFC-CEI; Liebenthal, PRD; Kilby, FRS; Robless, OPNSV; Walton, EXC; Khanna, EXC; Grilli (o/r), Lysy (o/r), EAS; Selowsky, LACCE; Bottelier, Bery, Dax, LA4: Institutional ISC.

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THE WORLD BANK
Operations Committee

INDONESIA

COUNTRY STRATEGY PAPER

Postscript

56. The Operations Committee met on Friday, June 21, 1991, at 5:00 p. m. in Room E1243 to discuss the Country Strategy Paper for Indonesia on the basis of an agenda prepared by EAS. The discussion focussed on macroeconomic trends, the role of government, and the case of the Regional request for a lending program of $1.7 billion for the next two years.

57. The Region introduced the discussion by noting that Indonesia was entering a new phase of development, with a dynamic private sector operating in an open economy. During the last year, this dynamism had led to a massive push towards higher levels of investment and imports. The question was whether the Government could manage this new kind of economy with the tools of indirect macroeconomic management. Tighter monetary policy had been a first step by the Government to address the problem, and at the recent IGGI meeting, the Government had confirmed that it would take whatever other measures were necessary to address the problem. The tax effort this year has been strong, and the Government has sterilized the windfall gains from higher petroleum prices stemming from the Gulf crisis. To supplement these actions, additional reforms were being prepared. This would include fiscal measures, a key componment of which would be energy price adjustment. Large-scale investment projects will be reviewed, and if appropriate, deferred. But the management of a primarily private sector economy through indirect means would be a more difficult challenge than had been the case in the past.

58. To develop efficiently, an open trade regime would be essential. As evidence of the Government's objective of further opening up the trade regime, a trade deregulation package has been introduced on June 3, 1991, in which 25% of the remaining nontariff barriers has been lifted, including some sensitive products such as steel. While NTBs for rice remained, excluding rice only 8% of domestic output was now subject to NTBs. The Government also indicated it would reduce the maximum tariff level from 40% to 30%, and the recent trade package made substantial progress in this direction. Concerning industrial policy, the problem was not so much industrial licensing but the important role played by large conglomerates which were well-connected politically.

59. The Region concluded the introduction by noting that Indonesia's economic performance had been endorsed by the Japanese and other participants

in the IGGI, and that Indonesia had obtained commitments at the last IGGI meeting for the $4.75 billion which it had sought.

60. The Chairman stated that we needed to keep encouraging Indonesia to further open its economy, particularly because of the political connections of the large conglomerates. A participant queried whether Indonesia should move more aggressively on foreign investment as a way to address this issue, since foreign capital inflows were still fairly low for a country with Indonesia's GDP. The capital market could be further developed, including such aspects as the introduction of a stock exchange. The Region agreed, but noted that while trade and industrial policy reforms have succeeded in creating a more outward oriented and competitive environment, concern remained about the role played by large conglomerate investors.

61. A Committee member raised the issue of the political links between the public and private sectors, expressing concern that the wrong kind of privatization could lead to a strengthening of the political power of vested interests. The question was how to privatize effectively taking this into account, and, while the recent CEM had focussed on private sector development, a work program was being developed with PRE to address this and related issues in detail. Defining an appropriate regulatory framework for the private sector would be important. Further, there was also a need for an improved regulatory framework for enterprises which would remain in the public sector.

62. The Committee agreed that Indonesia's performance had been impressive, but questioned the realism of the downside scenarios, which were based on a deterioration of growth, whereas it was more common to see a deterioration in the current account deficit. Further, debt already outstanding was significant, and private debt could increase rapidly, leading to a financial crisis. The Region responded that since Indonesia has an open capital account, which is not typical, that in the case of financial distress, capital outflows would impinge on growth. The Region agreed that careful management of external debt would be important, and would work with PRE on a study to address the issue. The Chairman concluded discussion of this issue by noting the importance of prudent macro management and structural reforms to tackle remaining vested interests.

63. The Chairman agreed with the Region that both Indonesia's performance and needs suggested that a substantial amount of Bank support was appropriate. However, there was the question of the justification for continuing to exceed the 10% portfolio guideline. Indonesia's performance and needs should be weighed against equity considerations in Bank lending operations. The CSP had proposed a lending program of $1.7 billion per year, which would lead to continuing breech of the 10% guideline, but had also presented a constrained program of $1.2 billion, while not indicating the considerations for switching to the lower program. Another Committee member stated that a stronger rationale for continuing lending at a level of $1.7 billion per year was needed. Now that things were going well, perhaps now was the time to move to a lower program in order to be able to increase our assistance in times of need. We should also present our program as a combined IBRD/IFC program, and take appropriate credit for cofinancing. Although improvements in debt management could be introduced, it was suggested that it was inappropriate for Indonesia to introduce these simply to address our 10 percent of portfolio guideline.

64. The Region responded that IFC lending was relatively small compared to IBRD lending, and that a combined presentation in any event would not count towards the Bank's IGGI commitment. However, commitments were crucially dependent on the level of Bank support forthcoming, and that a decrease from $1.7 billion would have a strong negative impact on commitments from other donors.

65. The Chairman noted that we had been saying for the last few years that a temporary increase in lending was justified, but each year the horizon had been extended. This did leave us in a position where we would not be able to increase our support should adverse conditions develop and additional resources be required. The Region suggested that in such a case, we could shift from straight project lending to including balance of payments support, but the Chairman noted that the 10% guideline would then be substantially overshot.

66. The Region summarized the argument for a $1.7 billion lending program by noting that increasing levels of Bank support over the years had been instrumental in Indonesia's impressive achievements, that our support for infrastructure and other sectors was essential if private sector development at an appropriate pace were to be achieved, that any deterioration in the economy would show up quickly because of the openness of the economy and, therefore, corrective measures could be quickly implemented. Our support was important for sustaining the openness of the economy, and other donors are sensitive to levels of IBRD support. Finally, Indonesia used our funds efficiently as suggested by relatively high recent disbursement rates.

67. The Chairman concluded by saying that while we did not want to give the wrong signal to either Indonesia or the IGGI, the request for $1.7 billion would constrain us from giving additional balance of payments assistance in the future. Should the Region feel it critical, the lending program could go to $1.7 billion per year, but that attempts should be made to see if a lower level could be implemented over a three year period without causing serious problems for Indonesia or the aid coordination process.

MRLav:sb
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July 10, 1991

List of persons attending the Operations Committee meeting:

Operations Committee Members

Messrs. M. A. Qureshi, Chairman
K. Kashiwaya, CFSVP
D. J. Wood, FPRVP
E. V. K. Kaycox, AFRVP
A. Karaosmanoglu, ASIVP
D. M. Goldberg, LEG
D. R. Bock, OPNSV
P. Hasan, EMN
C. Michalopoulos, DEC
M. Selowsky, LAC

Other Attendees

Messrs./Mmes M. Haug, AS5DR
A. Bhattacharya, AS5CO
R. Agarwala, ASIVP
N. Hope, Indonesia
R. A. Calkins, AS5CO
A. Ray, EAS
N. Okonjo-Iweala, OPNSV
M. R. Lav, EAS
M. Muller, FRSCR
D. A. Mead, LEGAS
G. E. Bond, CS1DR
T. L. Hutcheson, PRDRA
H. P. Crevier, SECGE

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: June 20, 1991

TO: Operations Committee

FROM: Fred D. Levy, Acting Director, EAS

EXTENSION: 81947

SUBJECT: INDONESIA - Country Strategy Paper; Operations Committee Meeting Agenda

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1. The Operations Committee will meet on **Friday, June 21, 1991, at 5:00 p. m. in Room 1243** to consider the Country Strategy Paper for Indonesia. The following represents a proposed agenda for the meeting.

Introduction

2. Indonesia has addressed difficult issues in the recent past with the assistance of a substantial IBRD program and the country is establishing a stable framework as a basis on which key development objectives can be pursued. However, a number of problems remain to be addressed. Per capita income is still at a relatively low level (per capita GNP of US $500) and 30 million people (17% of the population) are below the poverty line. Political problems are of concern, and the CSP gives a frank assessment of key issues including the growing demand for a more open political system and the question of succession, given President Suharto's age. The stable macroeconomic framework upon which development is predicated needs continuing attention, as the current account deficit has increased to about 4 percent of GDP and could increase further in the absence of new fiscal measures.

3. The policy agenda proposed in the CSP is quite rich, and reflects the considerable amount of operational work and experience which underpins the proposed program. That program is designed to achieve four main objectives: growth with stability, wider participation, human resources development and poverty reduction, and sustainable development.

Issues

4. Macroeconomic Prospects. The Base Case scenario is predicated on a substantial reduction in the current account deficit, from 3.8% and 4.1% of GDP in 1990 and 1991, respectively, to an average of 2% for 1993-1995. This reduction is to be achieved with firm macroeconomic management. However, the reduced current account deficits still require large amounts of external financing. Thus, for example, disbursements of public MLT loans are projected to increase from $5 to $6 billion annually, the levels of the recent past, to an average of $9 billion for the last half of the 1990s, of which $5 billion would be

untied commercial credits, import-related credits, and LNG expansion and LPG and paraxylene projects. This increased funding is related to the public sector investment program which is projected to grow at 7%, only slightly less than the 9 percent growth projected for the private sector investment program. With GDP growth projected at 5 to 6% per annum, public investment, relative to GDP, will increase.

- Given performance in 1990, the possibility of the economy overheating, and the need for new fiscal measures for adjustment in the base case, is the growth scenario with projected increases in investment too ambitious?

5. Licensing of Investment for Food and Other Sectors. Efficient investment will be a key to implementing the proposed strategy. As Indonesia moves towards an increasing reliance on the private sector for growth, several policies which impede private sector development remain in place. One of these is investment licensing in a variety of subsectors, including some such as food processing, which are difficult to explain.

- Would a clearer statement of conditionality for a portion of our activities be appropriate, or would the Region propose another alternative for addressing the licensing issues?

6. Trade and Adjustment. The CSP notes that tariffs are relatively low. However, there is little discussion of the dispersion of tariffs, which can cause considerable distortions even if the average rate is low, nor of the effective level of protection generated by the tariff structure. However, the existence of licensing and other restraints to free entry suggests that protection may be important.

- Given the need to continue to develop a dynamic and competitive non-oil export sector, and use domestic resources more efficiently, would some increased emphasis on this topic be warranted? (10)

7. IBRD Lending Program. The projected lending program of $1.7 billion per year, or $4.7 billion for FY 92-94 (which implies some front-loading), will support Indonesia at a time when the current account deficit has increased to about 4 percent of GDP (and which may increase further, although this is assigned a low probability by the Region under Alternative Scenario B). GDP growth has reached an estimated 7% in 1990, and the CSP notes that corrective measures are needed. Specifically, while Government has already taken strong monetary control measures, Government is now formulating complementary fiscal measures to address this excessive growth. 1.7

- Is the size of the base case lending program, and the associated investment program which it supports, reasonable in these circumstances?

8. Composition of Lending Program. The proposed program is quite broadly based and includes operations in a variety of sectors. The overview of the Bank's country assistance strategy presented in the CSP is a helpful guide to understanding how the proposed operations are related to objectives. However, the relationship between the proposed sectoral allocation of lending and strategic objectives could be strengthened.

- The Region may wish to clarify how the sectoral allocations in the lending program are related to the strategic objectives of the country assistance strategy.

9. IBRD Exposure. The proposed lending program will leave Bank exposure over the 10 percent guideline throughout the decade, and the share of IBRD debt in public and publicly guaranteed MLT debt service would rise to slightly more than 20%. The Region proposes to explore a loan sales program, and such a program would be welcome.

- Would a loan sales program be likely to have a substantial impact on exposure? If a smaller lending program than the proposed base case were approved, could some of the proposed support for infrastructure projects be cofinanced? Would this be a useful way of assisting Indonesia to develop sources to sustain the large private capital inflows projected for the future?

10. Downside Scenarios. Projected import capacity increases substantially over time partly because of a projected 16 percent improvement in the terms of trade. Should this improvement not materialize, growth prospects would be dampened. A downside scenario is developed in which terms of trade deteriorate but Indonesia maintains good policies. The CSP explicitly explores the downside risks associated with a decrease in the price of oil.

- Are any measures worth contemplating to hedge against an unforeseen terms of trade deterioration?

Operations Commmittee

Messrs. Qureshi, OPNSV
Shihata, LEGVP
Wood, FPRVP
Summers, DECVP/Rajagopalan, PRSVP
Kashiwaya, CFSVP
Jaycox, AFRVP
Karaosmanoglu, ASIVP
Wapenhans, EMNVP
Husain, LACVP
Bock, OPNSV

cc: Messrs./Mmes Haug, Goldberg, Wyss, Isenman, Linn, Stoutjesdijk, Picciotto, Quan, Burmester/Thahane, Bhattacharya, Yenal, Okonjo-Iweala, Calkins, Parmar, Pfeffermann, Rao, Kavalsky, Shakow, Sandstrom, Liebenthal, Kilby, Robless, Walton, Khanna

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The World Bank/IFC/MIGA
O F F I C E   M E M O R A N D U M

DATE: 21-Jun-1991 10:41am

TO: Ngozi Okonjo-Iweala (NGOZI OKONJO-IWEALA)

FROM: Michael Lav, EM4CO (MICHAEL LAV)

EXT.: 32556

SUBJECT: Indonesia - Food Processing licensing policy

During yesterday's discussion of the Indonesia CSP, Mr. Qureshi asked about the agenda item concerning industrial licensing requirements, and, in particular, which food products are included.

The list includes rice milling, wheat milling, sugar cane, soyabean, and a number of other products. The Region feels that rice and wheat milling are efficient activities (which could be true if licensing hasn't been too restrictive) for which licensing is not an important issue, but that sugar cane and soya bean, amoung others, are of concern.

CC: Fred Levy (FRED LEVY)

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION / MIGA

Office Memorandum

DATE: June 19, 1991

TO: Mr. Attila Karaosmanoglu, ASIVP

FROM: Koji Kashiwaya, CFSVP KK

EXT.: 80809

SUBJECT: **Indonesia CSP**

1. I would like to make the following observations with respect to the Indonesia CSP, to be discussed by the Operations Committee on June 21.

2. I am in full agreement with the recommendation that portfolio constraints play an important role in governing our assistance strategy but nevertheless, the lending program should be maintained at US$1.7 billion, or as close to that level as practical because of the large financial requirements of Indonesia to maintain its economic growth path. Thus it is important that our approach foster the broader developmental role for Indonesia to access a considerable amount of financing from external sources to continue its economic growth in the future.

Funding for Infrastructure Development

3. The level of infrastructure development to support the growth rate in Indonesia is in the order of US$8 billion per year. This magnitude of financing surpasses the public capacity to provide the required resources. For example, IGGI commitments in 1991 total US$4.8 billion. Thus, private financing of infrastructure projects will increasingly become an important factor for sustaining the projected economic growth of the country. Furthermore, many of these projects have long gestation periods, and thus require long-term financing (15-20 years), which is not readily available externally and internally. The strategy for mobilizing this private financing externally should be elaborated, given the fact that commercial bank lending to Indonesia has reached its limit, and its term lending does not go beyond 8-10 years. The issue of mobilizing domestic capital in financing infrastructure projects, given competing activities in traded sector which require less long-term financing should also be addressed.

External Capital Diversification

4. Both loan sales and the sale of bonds by GOI to prepay IBRD loans do not seem viable as means of helping maintain our proposed lending program. With respect to loan sales, I am skeptical that there is much demand, particularly because the somewhat complex composition of our loans (in terms of currency mix and also lending rate), that makes it difficult to structure a marketable program. Also, since the Bank would be the lender of record, loan sales would not establish Indonesia in the market to the same extent as direct borrowings by that country. Prepayment of Bank loans with bond issues, while effective in the context of an immediate reduction in our exposure, does not seem to be a credible way of introducing Indonesia to the capital markets in the long-term. From the standpoint of the investors, these would be "general purpose" borrowings. It would thus seem impractical to ensure they are specifically used to repay Bank loans, and that the volume of borrowings by Indonesia under this program would be limited to what is necessary to relieve the headroom pressure. There is also the danger that the capital markets might view the use of private capital to refinance our loans as a negative signal of the Bank's credit evaluation of Indonesia.

5. Establishing a market borrowing program to cofinance Bank projects is a very attractive option, and should be pursued. Among the advantages of this parallel cofinancing program are (a) that it would provide a way for the Bank to manage its direct lending over time while ensuring that project selection criteria in Indonesia are not compromised; and (b) because it provides an opportunity for Indonesia to diversify its market access and to consider various financial instruments in the context of project financing. Furthermore, direct Bank assistance to set up a borrowing program for Indonesia would be more appropriate in the context of cofinancing Bank projects, rather than for general purposes or, even worse, to prepay Bank loans.

The Use of Cofinancing Instruments

6. More generally, with respect to Indonesia's market access, it is important to note that creditworthiness is not an issue thus far, but there is a more cautious attitude developing among commercial banks for many reasons, including recent capital adequacy rules and, for Japanese banks especially, a somewhat large level of exposure. Diversification of borrowing sources is thus a key objective, with maturities that are commensurate with long-term investment projects. As you know, the use of ECOs could be instrumental in this regard, and should also be broached as a possibility with respect to market access. There is, however, no mention of ECOs in the CSP. I understand that the Indonesians are of the view (erroneously) that guarantees may be detrimental to their credit standing. At least some of this sentiment can be attributed to unfortunate counsel from their financial advisers. However, we should not be precluded from leaving ECOs on the table as a possible option especially since it would also alleviate the Bank's portfolio concentration problem because of the leverage it provides. Cofinancing instruments could also be useful in the context of the large infrastructure financing needs that Indonesia faces.

Managing External Liabilities

7. It is important that in diversifying its sources of finance, Indonesia also pay attention to the large imbalance between its external debt (40% of which is denominated in yen) and its revenues, which are largely tied to U.S. dollars. Options to deal with this mismatch--such as swaps and other hedging techniques need to be considered in the context of a broader market access strategy.

cc: OC Members:
Messrs. Qureshi, Husain, Jaycox, Wapenhans, Rajagopalan, Summers, Shihata, Wood, Bock

Thahane, Burmester, Picciotto, Goldberg, Morais, Grilli, Wyss, Sandstrom, Isenman, Linn, Stoutjesdijk, Ms. Okonjo-Iweala, Lysy, Ms. Haug, Bhattacharya, Ms. Swannack-Nunn, Koch-Weser, Lay, Niehuss, Sunamura, Ohashi, Brigish, Elwan, Rajasingham, Shimazaki, Chaffey, Shilling, Ms. Jones, Ms. Nguyen

KK/SR/MCN:mac

June 19,1991

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THE WORLD BANK
Operations Committee

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Minutes of the Operations Committee to consider
GHANA: Second Financial Sector Adjustment Credit:
Initiating Memorandum (IM)
held on June 19, 1991 in Room A-1243

A. Present

Committee	Others
Messrs. M. A. Qureshi (Chairman)	Messrs. K. G. Awunyo (LEGAF)
E. Jaycox (AFRVP)	F. Chaudhri (EAS
A. Karaosmanoglu (ASIVP)	A. Chhibber (AF4DR)
P. Hasan (EMNVP)	M. Fardi (PRDRA)
S. Rajapatirana (LACVP)	R. Faruqee (AFRCE)
I. Shihata (LEGVP)	K. Framji (AF4IE)
K. Kashiwaya (CFSVP)	M. Iskander (AF4CO)
P. Isenman (PRDDR)	F. Levy (EAS)
D. Bock (OPNSV)	E. Lim (AF4DR)
Ms. L. Yap (FRM)	Ms. M.O. Smith (AF4IE)
	I. Kapur (IMF)

B. Issues

The meeting was called to consider the IM for a proposed $100 million Second Financial Sector Adjustment Credit (FINSAC II) for Ghana. The discussion generally followed the agenda issued by EAS dated June 19, 1991. The main issues raised were as follows: (a) stabilization problems, especially inflation; (b) the role of the Fund and the rationale for a quick-disbursing operation; (c) the realism of the macroeconomic projections; (d) restructuring issues in the corporate and financial sector and the IFC's role; and (e) the nature and structure of proposed conditionality.

Discussions

The Chairman opened the meeting by inviting the regional staff to address the issue of the continuing high level of inflation in the country and its implications for restructuring in the financial sector.

The regional staff pointed out that, although the level of inflation was high in 1990, the recent trend has been downward. The difficulty in 1990 was attributed largely to cost-push pressures engendered principally by the severe draught and the tripling of petroleum prices. While there was no reason for complacency, the underlying basis of inflation i.e. the monetary growth, was going down. The IMF representative added that the April 90-91 inflation rate had been even lower than assumed in earlier assessments. He also noted that the excessive growth in the money supply in 1990 was largely the result of overperformance on the balance of payments and growing international reserves. With good rains and plentiful availability of food, as well as lower petroleum prices, the inflation was expected to fall further in 1991.

In response to the Chairman's query regarding the Fund's role after completion of the current ESAF arrangement, the Fund representative informed the Committee that the envisaged approach was to enter into an enhanced consultation similar to that adopted with respect to Columbia several years ago. (He noted that a paper was being prepared for the Fund Board proposing such an enhanced consultation procedure for post-ESAF countries. This could include the preparation of PFPs and regular monitoring and assessment of performance.) The Chairman asked whether Fund resources would be available under these arrangements, noting that it would raise a policy issue for the Bank to continue providing balance of payments support - not its normal role - if the Fund was withdrawing. He wondered if the Fund management had addressed this issue generally and with regard to Ghana.

The Fund representative clarified that it was not the Fund's judgement that Ghana did not need continued balance-of-payments support, but rather that it no longer needed "exceptional" resources, which, in Fund terms, includes the revolving resources of the Fund. He noted that Ghana has been the largest user of ESAF resources, and that repayments would remain small for the next four years. He said that the Fund supported the proposed policy-based Bank operation both for the support it gave to structural adjustment and Ghana's external resource requirements. The Chairman reiterated that quick-disbursing assistance was "exceptional" for the Bank, and indicated he would raise the general policy issue with Mr. Erb. Meanwhile, he was glad to know that the present operation was supported by the Fund and that, in their judgement, inflation was coming down.

A Committee member said that the paper did not provide a clear rationale for a quick-disbursing loan at present and expressed the view that all the stated objectives of the proposed credit could be met through a technical assistance credit or a component of a sector investment loan.

Regional staff explained that the reserve level of $500 million, equivalent to about 3.8 months imports, was not too high because of the country's heavy reliance on a single commodity like cocoa that faces considerable price fluctuations. Moreover, the financing program agreed at the CG included this operation and a subsequent agriculture SAC. With regard to the general issue of continuing Bank balance-of-payments support for Ghana regional staff said that the other donors would not provide such support to Ghana if the Bank were not doing so. The estimated external resource gap for 1992-94 was approximately $2.4 billion, and the projected aid was essential to fill the gap.

Referring to Annex I and data for the 1985-90 and 1991-95 periods, a Committee member observed that whether one looked at gross domestic savings, national savings, public sector and private savings, or direct foreign investment, one saw virtually no continuity or relationship between the past performance and the future projected trends. In his opinion the projections looked overly optimistic. Another Committee member also shared these concerns and referred to the substantial projected rise in investment with little improvement in the low level of per capita consumption, meaning that no growth dividends would be passed on to the people.

The region emphasized that major structural changes had taken place in the economy, beginning in 1987. For example, within the slowly rising export/GDP ratio the share of cocoa exports was being rapidly substituted by the growing share of non-traditional exports.

A Committee member expressed concern that, despite FSAC I, there had been no sustained improvement in the low M2/GDP ratio, suggesting that the people had little confidence in the banking system. It was not clear what was being improved in the financial system despite all the resources going into it.

The Chairman raised questions with respect to the institutional arrangements -- Non-performing Assets Recovery Trust (NPART) and the First Finance Corporation (FFC). He wondered why the IFC was not asked to set-up a private sector investment bank to play the envisaged role. In his judgement, based on experience in Ghana and elsewhere, the prospects of a government agency recovering the non-performing assets or salvaging the enterprises were not very good. Concerning the FFC, another Committee member asked whether there was clear need for it, rather than strengthening the existing banks.

The Region responded that they share this concern. It was intended that NPART be primarily a liquidation agency, but up to now the Government had not been willing to pursue liquidation to the extent warranted. Consequently, there were many willful defaulters as well as companies that could be restructured if their owners were willing to put in their own money. One of the key objectives of the proposed operation is to convince Government to start liquidating. This would induce many debtors to repay and would improve overall bank portfolios. In response to the Chairman's question of how the operation would achieve this objective, the Region indicated that clear targets would be set for liquidation. An effort would also be made to strengthen the participation of private owners - existing and new - in bank management. In response to the Chairman's observation that this effort had not been described in the IM, the Region assured him that this was an important part of the dialogue with the Government.

Another Committee member enquired how the six distressed banks, saddled with 60% non-performing assets, could be recapitalized. He noted that the budgetary costs to the government would be heavy. Regional staff explained that at the end of 1989 the Government had issued bonds and some new capital infusions had been made.

One Committee member expressed the view that requiring only the preparation of action programs, laws and regulations or studies represented a very weak set of conditionality in the proposed operation. The Chairman observed that good institutional measures were being proposed, but that a specific, monitorable program including loan writeoffs and liquidations and measures to increase competition needed to be laid out. The Region indicated that this would be done in the course of appraisal.

A Committee member questioned the criteria that would govern the setting up of FFC. There were also not enough measures to promote competition in the banking sector. While endorsing the proposed program, another Committee member also felt that the conditionality was 'squishy'. Another Committee member felt that by spelling out the program and by clarifying the objectives e.g. complete privatization of the X number of banks or substantial privatization of the Y number of banks, the Bank would be doing a favor to the Ghanaians. One Committee member asked whether the time allowed for tranche releases was long enough for a meaningful transformation of the institutional set-up. She also remarked that, that even though the idea of corporate restructuring was a good one, it was not clear what would be accomplished at the end. The Chairman also asked what the purpose was in stating the time between the tranche releases. He asked whether time itself was a conditionality; was there a reason to string out the processes? The Region clarified that the indicated time was only an estimate of how long it would take to implement the measures, given the government's implementation capacity.

The Chairman asked whether another FINSAC was envisaged at completion of the present one. The Region replied that the next operation would be more of a sector investment credit. The intention of the present operation is to achieve a complete restructuring of the banking system. The next operation then would concentrate on non-bank financial institutions such as the capital market and at corporate restructuring.

The Chairman emphasized the need for complementarity between the Bank and Fund and a clear understanding as to who does what. The Bank would defer to the Fund in providing technical assistance to the central bank, if that is an area where they intend to be active in Ghana.

In summing up the discussion the Chairman stressed that the success of proposed program would hinge on the clarification of the objectives and concreteness of the action program, given Ghana's past weak performance in bringing deficient state enterprises to resolution.

July 05, 1991
FMChaudhri/FLevy:gs

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

9106 28006 1.

DATE: June 17, 1991

TO: Operations Committee

FROM: Fred Levy, Acting Director, EAS

EXTENSION: 81947

SUBJECT: GHANA: Second Financial Sector Adjustment Credit Initiating Memorandum (IM) - AGENDA

There will be a meeting of the Operations Committee on **Wednesday, June 19, 1991 at 5.00 p.m. in Room E-1243** to consider the Region's Initiating Memorandum (IM) for a proposed Second Financial Sector Adjustment Credit (FINSAC II) to Ghana for an IDA credit of $100 million. The Credit would be released in three tranches.

Background

Ghana's Economic Recovery Program (ERP), initiated in 1983, has been supported by IDA with four adjustment credits: two Structural Adjustment Credits (SAC I & SAC II); one Financial Sector Adjustment Credit (FINSAC I); and a Credit in support of a Program to Promote Private Sector Development. FINSAC I, in the amount of $100 million, supported an initial program of urgent and fundamental structural and institutional reforms. The credit was approved in May 1988, declared effective in August 1988, and the 2nd and 3rd tranches were released in June 1990 and December 1990, respectively. Following its generally satisfactory implementation, the Region now proposes FINSAC II to consolidate the achievements of FINSAC I in a second phase of sector adjustment for the period 1992-94.

The proposed credit has two components. The first, amounting to US$85 million would support the ongoing and new policy and institutional reforms, the major thrust of which would be to: (i) strengthen further the institutional framework in the financial sector and improve the financial conditions and operational and institutional capacity of the Bank of Ghana (BOG); (ii) support ongoing bank restructuring programs to improve the financial and operational performance of distressed banks; (iii) lower intermediation costs, reduce taxation on bank profits to the level applied to other sectors, and increase competition in the banking system through a program of divestiture of government shareholdings in banks; (iv) aid the recovery of non-performing assets taken over by the Non-Performing Assets Recovery Trust (NPART); (v) examine modalities for the rehabilitation of potentially viable enterprises in the corporate sector; (v) develop a healthy and stable institutional framework for, and enhance the effectiveness of, non-bank financial institutions; (vii) carry out a study of the informal financial markets; and (viii) upgrade the professional skills of bankers and accountants. The second component, US$15 million equivalent, would finance an extensive but well defined program of studies and technical assistance for restructuring and institutional strengthening of the BOG; for operations of NPART; for management information and accounting systems of Ghana Commercial Bank (GCB); for establishing First Finance Corporation (FFC), which would essentially operate as an investment bank and take the lead in restructuring distressed but potentially viable enterprises; for review of legal framework, diagnostic study of the insurance industry and training for the new National Insurance Commission (NIC); for establishing the Banking College (BC); and for upgrading skills and effectiveness of the Auditor General's Office (AGO).

The Government of Ghana has requested IDA to help mobilize an additional $100 million in cofinancing from potential donors such as OECF (Japan) and the Swiss Government.

The Committee may wish to discuss the following:

a) Macroeconomic context: The Fourth Year PFP, discussed in early 1991, and the Fund approval of the final year of the three-year ESAF arrangement in March 1991 indicate the growing success of the Ghanaian authorities in managing macroeconomic and sectoral policies with confidence and effectiveness. However, despite considerable efforts to contain prices, the annual rate of inflation in the early months of 1991 (around 25 percent) was almost the same as that of two years ago.

   o Can effective financial sector reform and restructuring be envisaged in such an inflationary environment?

   o What is the likelihood that the inflation rate will be reduced to 5% in 1993?

macro
Econ Mg

   o What is happening to the real effective exchange rate under these inflationary conditions?

   o If this is the last year of the ESAF arrangement, how will the macro situation be monitored over the program period?

   The Government is making substantial efforts to mobilize revenue but, compared to the needs, progress seems to be slow.

   o Is the projected increase in the Government revenue/GDP ratio by just 1 percentage point between 1992 and 1995 the best that can be expected?

b) Major Thrusts of the Operation and the Fund Role. One of the main objectives of FINSAC I was to enhance the soundness of banking institutions by improving the regulatory framework and strengthening bank supervision by BOG. FINSAC II proposes to take the reform process into several new and important directions such as enhancing the BOG's autonomy, creating new organizational and management structures, developing manpower plans, etc.

- Are the proposed reforms of the BOG complementary to what the Fund is expected to do, and why should not the Bank concentrate its attention more on other components, such as corporate restructuring and recovery of non-performing assets?

c) Competitiveness in the Banking System: Competitiveness in the banking system is proposed to be increased through divestiture of government shareholdings in banks.

- What other adjustments - e.g., in the legal or regulatory framework or procedures for establishment of new banks - could be made to promote that objective?

- What indicators would help to assess progress towards enhanced competitiveness in the system over time?

d) Corporate Restructuring would be an important undertaking in the proposed FINSAC II. The proposed establishment of FFC would be one way to approach this problem.

not clear about NPART

- What other alternatives does the appraisal mission propose to examine?

- Are there any successful examples of corporate restructuring that Ghana should consider?

- Is not the infusion of managerial and technical assistance likely to be more important for corporate restructuring than providing temporary financial relief as suggested in the IM?

e) FINSAC Implementation Unit. Despite some initial delays FINSAC I was implemented quite successfully.

- Why is the implementation unit for FINSAC II necessary now, and would it become a permanent feature of the financial system?

o What would be its relationship and operational role vis-a-vis the BOG, Ministry of Finance, and commercial banks?

f) Overall Adjustment of the Financial Sector

An aggregation of elements in FINSAC I and the proposed FINSAC II represents a comprehensive program of adjustment. However, it is not entirely clear:

o What would be the state of the financial sector at the end of the proposed program?

o Would there still be some significant items that would constitute an unfinished agenda after FINSAC II?

Operations Committee

Messrs. Qureshi, Husain, Jaycox, Karaosmanoglu, Wapenhans Rajagopalan/Summers, Shihata, Kashiwaya, Wood, Bock

cc: Messrs. Thahane/Burmester, Picciotto, Goldberg, Wyss, Santstrom Isenman, Linn, Stoutjesdijk, Ms. Okonjo-Iweala, Kilby, Liebenthal, Robless, Walton, Khanna, O'Brien, Lim, Iskander, Framji

FMChaudhri:gs

tranching: 3 tranches
effectiveness
9 months after effectiveness " or sooner than 9 months"?
6 " " "

9,0614005 1,

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: June 13, 1991

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

FROM: Mr. Edward V. K. Jaycox, Vice President, Africa Region

6/13

EXTENSION: 34000

SUBJECT: GHANA : Initiating Memorandum for the Second Financial Sector Adjustment Credit (FINSAC II)

Through the attached Initiating Memorandum, we are seeking approval by the Operations Committee to appraise the second financial sector adjustment credit to Ghana in the amount of US$100 million. FINSAC II would consolidate the achievements of the first financial sector adjustment credit, as well as help the Government move towards a second phase of sector adjustment, with an enhanced program of policy and institutional reforms aimed at further deepening and strengthening the financial sector. The Credit would support policy measures for strengthening the institutional framework in the financial sector, as well as the financial condition and operational capacity of the Central Bank, increasing competition and efficiency in the banking system, developing a sound non-bank financial sector and making further progress on programs for bank restructuring and asset recovery initiated under the first financial sector adjustment operation. We believe that the content of the Government's program fully merits the proposed level of support.

Attachment: 2 copies

Distribution

Operations Committee Members:

Messrs. Summers, Husain, Karaosmanoglu, Rajagopalan, Shihata, Kashiwaya (4), Wood, Bock

Others:

Messrs./Mmes. Wyss, Grilli (2), Isenman (2), Linn (3), Stoutjesdijk, Picciotto, Thahane, Goldberg, Okonjo-Iweala, Chaudhri, Parmar, Rao, Kavalsky, Pfeffermann, Liebenthal, Kilby, Robless, Sandstrom, A. Khanna, O'Brien, A. Gore, M. Martinez, Faruqee, Serageldin (2), Thalwitz, Lim, Barrientos, Chhibber, de Merode, Smith, Seth, Iskander, Fardi, Nehru, Christoffersen, C. Cook, Lietard, Keatley, Makoni, Mirza, Derbez, Dinh, Karaoglan, Paulson, Popiel, Long, Sheng, McNaugton, Sagari, Ikramullah, Horiguchi, Framji, Connolly, Singh, Klein, Gruss, Weindler, Ijicji, Jones, Warner, Leechor, Walters, Ton, Agarwal, Bunyasi, Ghana Country Team, Capoluongo, Sigrist, Kapur, Hadjimichael (IMF), Regional ISC, Divisional BB

June 14, 1991

THE WORLD BANK

Operations Committee

CONFIDENTIAL

Minutes of the Operations Committee to Consider the

RWANDA - Initiating Memorandum for a Proposed Financial Sector Adjustment Credit

Held on Friday, June 14, 1991, at 11:00 a.m. in Room E-1243

A. PRESENT

Committee	Others
Messrs. M.A. Qureshi (Chairman)	Messrs/ F. Aguirre-Sacasa (AFR3)
D. Bock (OPNSV)	Mmes P. Crevier (SECGE)
W. Grais (EMNVP)	G. Caprio (CECFP)
S. Husain (LACVP)	M. Devaux (AF3)
P. Isenman (DECVP)	M. Fardi (PRDRA)
E. Jaycox (AFRVP)	E. Grilli (EASDR)
K. Kashiwaya (CFSVP)	K. Larrecq (FRM)
D. Ritchie (ASIVP)	H. Martinez (AF3)
H. Scott (LEGVP)	A. Ray (EAS)
E. Stoutjesdijk (FPRVP)	M. Sarris (AF3)
	K. Siraj (COD)
	G. Swamy (AF3)

B. ISSUES AND DISCUSSION

1. The Operations Committee met on June 14 to discuss the Initiating Memorandum for the proposed Financial Sector Adjustment Credit. The discussion was based on an agenda prepared by EAS. In opening the discussion, the Chairman enquired about what kind of a financial sector is envisaged over the medium-term. He also wondered about the efficacy of our dialogue and supervision in supporting the development of the financial sector. The Region said in response that an efficient and competitive financial system is essential to the kind of supply response one is hoping for to the various reforms. The financial sector in Rwanda was reviewed in a recently completed Sector report. The Bank's primary focus in the past has been on the

development finance institution, BRD. While BRD has recently developed many problems, mainly due to Government interventions, it is still better than many other comparable institutions in the Region, e.g. its collection rate of 75% is still respectable. The Region added that the objective of the proposed credit would be to make a start to the process of creating a viable, market-based system.

2. The discussion then turned to the various points listed in the agenda. On the macro-linkage, the Region said that the reduction in taxes on commercial banks would not have any perceptible effect on the overall budget; moreover, the cost of liquidating CER, which is much more significant from the budgetary standpoint, somewhat would be less than the cost of reimbursing depositors because it is expected that a portion of the portfolio can be recovered. On the question of liberalization of interest rates, the Region noted that while it still envisages complete liberalization by second-tranche it would propose to build in some checks earlier to assess the preparedness for that step. It agreed with the suggestion of a Committee member that one could consider widening the interest-rate bands halfway between the tranches to test the system. It would explore this and other options to ensure that the liberalization of interest rates does not cause a destabilizing shock.

3. On monetary instruments and credit control, the Chairman wondered whether it would be advisable to concentrate much energy on the introduction of new papers, such as the treasury bills, whose main function would be to facilitate the financing of the budget deficit. Furthermore, while the introduction of the proposed reserve requirement system might be a good thing, he wondered what the IMF views were on these matters. The Fund representative stated that the introduction of T-bills would be feasible and useful as it has proven to be in Burundi, where the T-bill rate provides a good reference point for setting the rediscount rate. The Region agreed that the development of a T-bill market was a long-term objective. The Fund representative also supported the Region's position on reserve requirements.

4. On the question of longer-term credit, the Chairman said that the development of a good system for providing credit to the small client and for mobilizing their savings should be at the heart of this operation. He wondered in this context about the status of the Special Guarantee Fund. The Region said that the Fund had been "over-administered" with too high a guarantee, and needed new operating rules. It also noted the success of the UBP in reaching the small lenders and borrowers in all areas of the country through some 100 subsidiaries; however, it needs subsidies from the Swiss Government to cover costs. In response to another question, the Region said that the tax changes in this credit would be consistent with the general tax reforms being done as a part of the Fund-supported program.

5. Finally, a Committee member asked about the propriety of lending such a high percentage of IDA in the form of quick-disbursing credits, and of the heavy share of IDA in financing the 1991-92 gap. The Region explained that the lending program it has in mind involves an adjustment credit each year during FY91-93; adjustment lending would be about 40% of total lending over this period. The amount of the credit under review, which is $40 million, had already been scaled back from $80 million due to concerns similar to those expressed by the Committee member.

6. The Chairman authorized the departure of the appraisal mission.

June 20, 1991

al

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

910611019 1,

DATE: June 11, 1991

TO: Operations Committee

FROM: Enzo Grilli, Director, EAS

EXTENSION: 81934

SUBJECT: **RWANDA--Initiating Memorandum for the Proposed Financial Sector Adjustment Credit: Agenda**

1. The Operations Committee will meet on **Friday, June 14, 1991, at 11:00 a.m. in Room E-1243** to consider the Initiating Memorandum for a Financial Sector Adjustment Credit. It is proposed that the credit amount of $40 million be disbursed in two equal tranches, the first tranche being expected towards the end of FY92. This would be the second adjustment credit supporting Rwanda's economic reform program, following the Structural Adjustment Credit which is to be presented to the Board this month. The reform program is also being supported by a SAF from the Fund.

2. The financial sector reforms to be supported by this credit are intended to complement the adjustment program discussed earlier by the Committee at the time of the Initiating Memorandum for the SAL. The Rwandan financial sector is pretty rudimentary, consisting, in addition to the central bank, of three European-run commercial banks, two savings institutions (one of which is bankrupt), a development bank, a housing finance agency (also bankrupt), and two insurance companies. The Government has significant shares in two of the commercial banks; it owns or controls the rest except for one of the insurance companies and a privately-run savings cooperatives (UBP).

3. The financial reforms being envisaged are intended to provide the basis for a sound and competitive system. A key objective would be to establish control over the growth of credit, particularly to the so-called "priority" sectors. Directed credit to the priority sectors has grown very rapidly since 1986, leading to inflation (not fully reflected in official indices) and to large depreciations of the franc in the black market. The proposed FSAL would also support liberalization of interest rates, the use of new financial instruments, restructuring of some of the financial institutions, and the creation of a stronger regulatory and supervisory framework.

4. The Committee might wish to discuss the following issues:

- overall program. The Region might provide an update on the developments since the Committee last discussed Rwanda in January. It might elaborate upon how the proposed financial sector program fits in with the rest of the program being supported by the Bank and the Fund. What would be the fiscal implications of the financial sector reforms in view of the proposed reductions in taxes on commercial banks and the cost of liquidating the public savings bank (CER)? fiscal impact

You must have minimum deposit rates

Worked out with the Fund

- policies on interest rates. Interest rates were raised last November in order to make them positive in real terms. It is proposed that a maximum lending rate be agreed prior to Board presentation (para. 82.a), and that the rates be completely liberalized by second tranche. What kind of a policy is expected to prevail this year, and what would the FSAL require during 1992? Should not agreement be sought, before Board presentation, on a minimum deposit rate as well, and also on a policy of frequent (say, quarterly) revisions? What is the Government's attitude towards fully liberalizing interest rates?

Look at Potential competition

- control of credit. In the past, the Government has tended to extend credit to the priority sectors, mainly coffee, on demand. Since last year, however, a policy of bank-by-bank overall credit ceilings have been introduced. The FSAL would support the replacement of this system by a system of reserve requirements and a mechanism for increasing "penalties" as credit begins to grów beyond predetermined targets. Would this system be compatible with IMF's overall credit ceilings? How have similar systems worked in comparable countries? Is sufficient time being allowed to phase in the new system?

Reserve reqts

- other monetary instruments. The FSAL also envisages the intróduction of an auction system for treasury bills, other short-term central bank money market instruments, and the issuance of private papers. However, the Rwandan markets are thin and an auction-based system for T-bills might be vulnerable to manipulation by the limited number of potential buyers. Would the Region elaborate the potential feasibility of these schemes in the light of experience in other relevant countries?

What should the financial system look at 3-5 yrs from now

- BRD and long-term lending. The BRD has been a development bank specializing in long-term loans. The proposed program calls for reducing government participation. In order to make it attractive to private investors, it is proposed to allow BRD to provide short-term financing, including trade financing. The Region might elaborate upon the implications for the long-term end of the market. To what extent do the problems of the BRD arise from long-term lending per se, as distinct from erratic public interventions?

BRD

- the Special Guarantee Fund and small savers/investors. The Guarantee Fund was set up to encourage commercial banks to take the higher risk of lending to small investors. To what extent has this worked and what changes are being proposed in the way the Fund is financed and operated? Should the Guarantee Fund be scrapped altogether, thereby relying exclusively on systems such as the "banques populaires (UPB)"? What does the Region propose for providing services to rural areas currently not served by the UPB? Can the UPB system be replicated without subsidies?

1 Savings Bk
1 Dev Bk
1 [illegible]
1 Pvt Savings Bk [illegible] -
Govt share
[illegible]
3 tranches -
Universal System
Treasury bills.
Small guarantee fund

What do you do for rural credit
Partly covered by Savings Bank

Operations Committee

Messrs. Qureshi, Husain, Jaycox, Karaosmanoglu, Wapenhans,
Rajagopalan/Summers, Shihata, Kashiwaya, Wood, Bock

cc: Messrs./Mmes Goldberg, Wyss, Isenman, Linn, Stoutjesdijk, Picciotto,
Burmester/Thahane, Robless, Okonjo-Iweala, Parmar,
Pfeffermann, Rao, Kavalsky, Sandstrom, Khanna,
Liebenthal, Kilby, Walton, O'Brien, Aguirre-Sacasa,
Sarris, Martinez.

ARay:cmc

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: June 7, 1991

TO: Mr. Moeen Qureshi, OPNSV

THROUGH: Mr. Michael Gillette, Acting Vice President, AFRVP

FROM: Michael Sarris, Acting Director, AF3

EXTENSION: 34380

SUBJECT: Rwanda: Proposed Financial Sector Adjustment Credit
Initiating Memorandum

1. Attached for consideration by the Operations Committee is an Initiating Memorandum requesting authorization to appraise a proposed Financial Sector Adjustment Credit (FSAL) in the amount of US$40 million in support of a Financial Sector Adjustment Program for Rwanda. Subject to the approval of the Operations Committee, the Credit will be appraised before the end of June for Board presentation in FY92.

2. The proposed FSAL will be the second quick-disbursing operation in support of Rwanda's recently-launched adjustment program. The financial sector program complements the macro-reforms under the SAL, which will be presented to the Board later this month. Despite a troubled domestic situation, the Government took significant up-front action in November 1990, and has adhered since to the timetable for the preparation of further measures with Bank and IMF support. Also, a process of national reconciliation led by President Habyarimana led to a formal cease-fire signed on March 29, 1991.

3. The reform program proposed in the attached memorandum was developed in the context of preparing and discussing with the Government a Financial Sector Review, which was recently issued in gray cover, and has been discussed extensively with the authorities. The IMF has been involved in the design of the operation, and will participate in its appraisal. The program is expected to foster the development of a strong, efficient and responsive financial sector, with an effective banking system at its core, to provide the needed support for the ongoing structural adjustment effort.

4. The timing and content of the proposed FSAL is in accordance with the agreed strategy for Rwanda and follows experience with successful sequencing of adjustment lending by the Bank. Financial sector reform, carried out within a framework of sound fiscal policies and timed either in parallel or immediately following far-reaching changes in the incentive structure, is a crucial requirement for the healthy expansion of the private sector (which is expected to be the engine of growth in Rwanda).

5. The objectives of the proposed FSAL would be achieved through a reorientation of monetary policies, particularly in the areas of interest rate and credit policies, and the development of new financial instruments. In addition, the program involves restructuring of financially distressed institutions which will increase public confidence in the financial system. Lastly, the program

envisages improvements in the legal and regulatory framework governing financial institutions, the establishment of a central bank supervision system, and the development of national accounting standards, measures which will help ensure the soundness of future banking activities.

Attachment

Distribution:

cc: Messrs./Mmes: Qureshi (2) (OPNSV); Husain (LACVP); Jaycox (AFRVP); Karaosmanoglu (ASIVP); Wapenhans (EMNVP); Rajagopalan (PRSVP); Shihata (LEGVP); Kashiwaya (4) (CFSVP); Wood (FPRVP); Bock (OPNSV); Grilli (2), Levy (EAS); Wyss (COD); Niehuss (CFS); Thalwitz (PRESV); Isenman (PRD); Linn (CEC); Rao (IEC); Shihata (LEGVP); Karanja (LEGAF); Stern (FINSV); Stoutjesdijk (FRS); Renkewitz (LOAAF); Frank (CFPVP); Parmar (CIOVP); Pfeffermann (CEI); Smith (CEIFI); M. Long, Caprio (CECFP); O'Brien, Laporte, M. Martinez, Ohri, Swamy (AFRVP); Serageldin (AFTDR); Derbez, Karaoglan, Barandiaran (AFTEF); Christoffersen (AFTEN); Chevallier, Varon (AF3DR); Gorjestani, Devaux, Hobeika (AF3CO); Sarris, Martinez, Diop, Alikhani (AF3IE); Otten (AF3AG); Blanc (AF3IN); Colliou (AF3PH); Akpa (AF3RW); Abu-zobaa, Lienert (IMF); AISC

June 13, 1991

THE WORLD BANK

Operations Committee

CONFIDENTIAL

Minutes of the Operations Committee to consider LAO PDR: Second Structural Adjustment Credit: Initiating Memorandum (IM) held on June 13, 1991 in Room A-1243

A. Present

Committee	Others
Messrs. M. A. Qureshi (Chairman)	Messrs. H. Abushakra (LEGAS)
S. Husain (LACVP)	R. Agarwal (ASIVP)
E. Jaycox (AFRVP)	F. Chaudhri (EAS)
A. Karaosmanoglu (ASIVP)	F. Earwaker (PRDRA)
P. Hasan (EMNVP)	B. Funck (AS2CO)
K. Kashiwaya (CFSVP)	K. Ikram (AS2CO)
J. Wood (FPRVP)	G. Kaji (AS2DR)
H. Scott (LEGVP)	D. Leipziger (AS2DR)
D. Bock (OPNSV)	
C. Michalopoulos (PRDDR)	U. Baumgartner (IMF)

B. Issues

The meeting was called to consider the Initiating Memorandum (IM) for a proposed Second Structural Adjustment Credit (SAC II) to Laos. The discussion focussed on: (a) the pace of reform and transformation; (b) centralized v/s decentralized mechanism for public sector management; (c) stabilization and budgetary/fiscal issues including financial sector reforms; (d) private sector development and state enterprise privatization/management; and (e) SAC II conditionality.

C. Discussion

Referring to the IM statement that "the World Bank has become, over the years, a trusted partner for the Government of the LAO PDR in the design and implementation of reforms", the Chairman asked whether the Government's adoption of a relatively moderate as against a big bang approach to reform was influenced by the Bank's advice and how the Region would look at the future course of the adjustment effort.

In response, the Regional Vice President who had recently visited the country emphasized the following points: (a) the country remains extremely poor reflected by the lack of infrastructure and a limited human resource base, (b) within a relatively short period the country had eliminated virtually all central planning; (c) several other reforms especially those related to pricing and the exchange rate had already been implemented, (d) initiatives to promote the private sector activities have been launched, and the Government was enquiring about membership in MIGA and IFC to help promote private foreign investments.

Referring to the continued presence of substantial budgetary deficits, public sector investment and consumption shares in GDP with very low inflation, the Chairman wondered whether the macroeconomic parameters were consistent and plausible.

The Regional staff highlighted the key components of the country's adjustment effort and provided a perspective to SAC II by saying: (a) the Bank supported the initial phase that was close to a big bang approach and addressed issues in exchange rate, prices and interest rate liberalization, state enterprise (SE) autonomy, reduction in subsidies etc. all of which triggered a healthy supply response, but also adversely affected the collection of tax revenue. In the next phase, the Government needs to improve the fiscal side, push towards privatization, implement certain systems like accounting, company laws etc. and rebuild the modified institutions that were broken when the command economy rapidly disappeared. The Region was confident that with the current account budget deficit moving from a position of substantial deficit to a modest surplus and foreign aid covering the investment side, the macroeconomic aggregates were improving. The tax effort would aim at raising substantial additional revenue not only by improving the collection of existing taxes but also by introducing new taxes. In addition, the Government strategy is to hold the line and stabilize Government expenditures and keep the monetary policy tight. On the state enterprise side there was a two-pronged approach assisted by technical assistance (TA) from abroad: (i) to privatize as many enterprises as feasible while improving the investment climate for the private sector and (ii) to institute performance monitoring system for SEs remaining in the public sector. The regional staff also mentioned efforts aimed at greater resource mobilization, preparation of the first public investment program (PIP) and implementation of the budget law.

The Chairman emphasized the need to ensure that the centralized mechanisms to manage the local governments and remaining SEs in the public sector would not become the Central Government departments trying to micromanage these institutions and entities. Another Committee member wanted to know more about political developments and showed concern over a different kind of centralization process that seemed to be creeping in.

The Regional staff informed the Committee that even though the control still is that of a single party, it can be characterized as 'paternalistic or participatory authoritarianism'. Nevertheless, the Party Congress of March this year had strongly committed itself to the market economy and had replaced the word 'socialism' with 'prosperity'. In response to question whether the centers of power were developing around markets, the Region stated that while the market forces were gaining momentum, the former military commanders -- the so-called warlords -- were still active in certain communities and the Government faced difficulties in accessing certain areas.

The Chairman suggested that there is a need to recognize that there are certain instruments of significance at the center e.g. monetary, fiscal, exchange rate and that there are other areas where the necessity of centralized management is not that great. Another Committee member suggested that while the macroeconomic issues could stay with the center, certain other activities e.g. health, education, could very well be handled by the provinces. The Region emphasized the point that the question of the centralized v/s the provincial activities should also keep in view the quality of the available human resources that cannot and should not be spread thinly.

Several other questions were raised by Committee members: is the financial sector where reforms are being handled by the ADB sufficiently vibrant to promote the private sector and privatization efforts? How successfully was the privatization process proceeding and what was envisaged? What is being privatized and to whom? What would be the role of the UNDP TA in this respect? What was the role of licenses for exporting and importing? Can the amount of foreign funding at 16-18% of GDP be sustained? Is not the public sector investment projected at 16% of GDP too high? Why cannot the minimum corporation tax be replaced with a tax related to assets? Is the lack of wage restraint becoming a problem? To what extent the indicated high levels of public consumption, investment etc. are consistent with the envisaged promotion of the private sector?

Responding to the questions raised, the Regional staff informed the Committee that the IMF and Bank had kept close touch with the ADB on the financial sector reforms. However, the financial sector may not contribute much to the promotion of the private sector in the near future because it is itself struggling with the many adjustment problems. Given that 65-70% of GDP originated from the agricultural sector and another 20% or so from the public enterprise sector, the private sector outside these two areas was not very large at the moment and could provide most of the financing needs itself.

The Regional staff informed the Committee that about 70 out of 200 public enterprises had been privatized. On the basis of the available data it could not be stated with any degree of certainty what was the weight of the privatized enterprises in employment or output. The enterprises being small and of rudimentary nature, the future privatization also did not envisage any spectacular steps. The UNDP TA is expected to facilitate this process by streamlining and defining the relevant procedures, auctioning systems, bid evaluation mechanisms etc. One Committee member observed that while TA will be useful, the more urgent need was a solid political commitment to the process.

On the question of the minimum corporation tax, the Committee was informed that this was a kind of turn-over tax that appeared reasonable and was recommended by the Fund because the accounting practices were weak and tax collection in general was a rather difficult phenomenon in Laos.

Given the lack of reliability and a breakdown in data by public and private investment categories, the staff felt the possible effects of the public sector's levels of investment and expenditure on the private sector activities could not be determined. The staff, however, recognized the need to do more work in this area.

The Regional staff did not feel that the wage adjustments were a major issue at the moment. There have been no increases even in nominal terms in the public sector wages. The problem of wage hikes in the state enterprise sector has now been overcome. Additionally, under SAC II the Bank will also have understanding with the Government on wage guidelines for the public enterprise sectors.

The Chairman summed up the discussion by saying that LAOS seems to be moving quite rapidly on the adjustment and reform fronts. However, since the SAC II conditionality tilted rather heavily towards the institutional measures it needed to indicate the scale of efforts involved and establish monitorable indicators for the release of the second tranche. He emphasized the need to establish benchmark on what was exactly involved and how the intensity of the Government commitment will be judged. He also advised the outgoing mission to (i) review the overall financial requirements and the Bank's contribution to them; (ii) to assess the consistency of the budgetary deficits with the balance of payment aggregates and the projected rate of inflation and (iii) to clarify the source of funds to finance the budgetary deficit.

On the basis of the comments and suggestions made above, the Region was authorized to appraise SAC II for LAO PDR as proposed by the Region.

FMChaudhri:gs
June 20, 1991

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

Confidentiality re Civil Service Privatization p 9

Para 23

PP.

DATE: June 10, 1991

TO: Operations Committee

FROM: Enzo Grilli, EG Director, EAS

EXTENSION: 81934

SUBJECT: LAO PDR - Second Structural Adjustment Credit Initiating Memorandum; Agenda

What kind of econ transformation is in prospect? E European style? or Chinese style?

Extent of Bank [illegible] assets & influence on Policy Directions?

1. The Operations Committee meeting formerly scheduled for Monday, June 10, will now take place on **Thursday, June 13, 1991, at 5:00 p. m. in Room 1243** to consider the Second Structural Adjustment Credit Initiating Memorandum for Lao PDR. The following represents a proposed agenda for the meeting.

What kind of overall financial package is there burden sharing

Background

2. Laos is one of the poorest country, attempting to transform itself from a centrally-planned and rigidly-controlled economy to a substantially decontrolled and open-market one. In this transition, the country has made considerable progress on price, exchange rate, financial, fiscal and trade reforms which, in turn, has shown favorable impact on the country's stabilization targets, growth aggregates, resource position and external situation. These efforts were supported by the Bank's SACI approved in June 1989, the IMF's SAF arrangement established in September 1989, and the AfDB's first agricultural credit approved in August 1989. The Bank's SAC I was implemented satisfactorily as were the other adjustment programs. The proposed SAC II would also be part of an effort by the multilateral institutions to further support the maturing reform process. In April 1991, the Fund support has moved into a second-year SAF arrangement and after approving a Financial Sector Loan in December 1990, the AfDB is currently preparing a Second Agricultural Adjustment Program. Extensive technical assistance programs are also in place or evolving with the support of UNDP, Sweden and Japan. ASDB?

- The Region may wish to highlight the adjustment problems confronting the country at this stage, the respective roles of the various outside supporters and the issues of coordination of action amongst them.

Stabilization and Growth

- After peaking in 1989 at 68%, inflation steadily decelerated to 22% in 1990 and the price level has remained stable in the last few months. Is the Region satisfied that despite the proposed new taxes and utility rate increases, further reduction of inflation to 5% next year can be achieved and maintained? Are the monetary management, credit and fiscal policies coherent with this objective?

- Given the informal nature of the economy, the country's vulnerability to weather uncertainties and the still weak, although growing, private sector, is the Region satisfied with the supply response to the extensive array of reforms implemented so far? If not, what more can be done to strengthen this response?

3. In order to achieve a sustained GDP growth of 5% per annum, an increase in real public investment is projected at about 16% a year on average during 1991-94 with virtually no decline in the ratio of the government's current expenditure to GDP (about 14%) and no improvement in the overall fiscal deficit/GDP (about 16%) over the 1991-94 period. Exports are also expected to grow at a fast pace (8% per annum in volume terms).

Fiscal Deficit 16% GDP!

- Are the implicit savings and private sector investment behaviors realistic and sustainable in the medium term?

Projections of Savings + Invest consistent?

- How limiting is the impact of the projected public sector expenditure growth on the investment in the private sector? Is the concomitant imperative of a robust investment response from the private sector likely to be realized? Are these projections consistent with the objective of reduction in the role of the public sector?

Whether consistent with promoting Pvt Sector?

- Given the highly volatile nature of export growth in the past, how realistic is it that exports would continue to grow faster than output?

Export projection realistic?

The Objectives and Thrust of SAC II

4. The Region believes that a basic macroeconomic framework is in place and that the price, echange rate, financial and trade reforms pursued under SAC I have laid the foundation for a resumption of growth. The key policy issue now is to strengthen savings performance to support enhanced investment efforts. The proposed SAC II, therefore, has three components: (a) the enterprise reform to further the development of a profit-oriented enterprise sector and hence indirectly also the tax base; (b) to restore fiscal resource mobilization at least to its historical levels and strengthen the budget; and (c) to achieve a more efficient deployment of public financial and human resources that could ensure a healthy public investment program, a fiscal system capable of enforcing budget-discipline, and to conduct short-term fiscal policy, a more compact and cost-effective administration and a reduced but more motivated civil service.

- Are the directions and thrust of the SAC II, as presented by the Region, apropriate? Are they sufficient to realize the objectives of the program?

- In the key program component -- enterprise reform -- would the establishment of a central supervisory agency to oversee the state-owned enterprises which will remain in the public domain an appropriate apparatus to promote?

- In the resource mobilization component, would "the imposition of a minimum corporation tax (irrespective of profit levels)" not pose problems?

- Since the planning apparatus has been dismantled, is there a mechanism that will ensure that the public sector investment will be complementary to the private sector activities and that within the public sector the scarce resources will be get allocated according to the national economic priorities?

- Is the Region confident that one (new) agency could become an effective supervisory authority for all local governments and that local governments would operate as integrated field services of the national administration?

Content of Conditionality

5. Given the direction of the proposed SAC II, most of the conditionality, as currently formulated, relates to the establishment of institutions, e.g. financial supervisions of public enterprises, creation of a department/unit for implementing privatization.

- What reforms are being sought on a priority basis and what would be the overall impact of the proposed adjustments on the major program objectives.

- Is the Committee satisfied with the heavy institutional content of the proposed conditionality? Can the Region enhance the specificity, and the monitorability of the proposed SAC conditionality?

Retroactive Financing

6. In view of the abrupt loss of the Soviet program aid, the Region expects the government to seek an exceptionally high level of retroactive financing in the context of the proposed operation.

- The Committee may wish to discuss the degree of such retroactive financing and exceptions to the guidelines that this may imply.

Operations Commmittee

Messrs. Qureshi, Husain, Jaycox, Karaosmanoglu, Wapenhans
Rajagopalan/Summers, Shihata, Kashiwaya, Wood, Bock

cc: Messrs./Mmes Kaji, Leipziger, Ikram, Funck, Goldberg, Wyss, Isenman, Linn, Stoutjesdijk, Picciotto, Burmester/ Thahane, Robless, Okonjo-Iweala, Parmar, Pfeffermann, Rao, Kavalsky, Sandstrom, Khanna, Liebenthal, Kilby, Walton, Blanchi

fc
FChaudhri:gs

THE WORLD BANK / IFC / MIGA

OFFICE MEMORANDUM

91060302 1

DATE: May 31, 1991

TO: Mr. Moeen A. Qureshi, SVPOP

FROM: Daniel Ritchie, Acting Vice President, ASIVP DR

EXTENSION: 81312

SUBJECT: Lao PDR: Second Structural Adjustment Credit
Initiating Memorandum

1. Attached for your consideration is the Initiating Memorandum for a proposed Second Structural Adjustment Credit to the Lao PDR (SAC2) for an amount of US$40 million. Performance under the first such operation (SAC1), approved in June 1989 for a similar amount, has been quite satisfactory. The Lao People's Democratic Republic has gone already a long way in its transition from central planning to a market economy. The price, exchange rate, financial, fiscal and trade reforms pursued under SAC1 have brought about the positive results which had been expected in terms of growth, resource mobilization, external situation and stabilization.

2. Building upon the achievements of SAC1, the proposed SAC2 focusses on those areas which are crucial to the consolidation of the recent successes, namely public sector policies. In the wake of our recent economic report on "Issues in Public Economics", the Government has revisited the design of its enterprise and fiscal reforms, with a view to deepening the former and broadening the latter. In this spirit, Government policy towards state enterprise now emphasizes privatization and the development of the private sector. For its part, Government is endeavoring to strengthen public finances. In most instances, the policies supported by the proposed SAC are in place. The main thrust of the program ahead is to strengthen the country's implementation capacity, to establish the institutions which can carry through these policies and to develop the enabling environment under which they will bear fruit.

3. The Government adopted a second-year PFP in early 1991 which was endorsed by the Committee of the Whole in March 1991. The Lao PDR has also entered into a second-year SAF arrangement with the IMF, which was approved by the IMF Board in April 1991.

4. We see no major issues in this credit.

Attachment

Distribution

Messrs./Mmes. Husain, LACVP; Jaycox, AFRVP; Karaosmanoglu, (o/r), ASIVP; Wapenhans, EMNVP; Rajagopalan, PRSVP; Summers, DECVP; Shihata, LEGVP; Kashiwaya, (4), CFSVP; Wood, FPRVP; Bock, OPNSV; Grilli, (2), EAS; Wyss, COD; Niehuss, CFSVP; Thalwitz, PRESV; Isenman, (2), PRD; Linn, (3), CEC; Rao, IEC; Petit, AGR; Piddington, ENV; Pouliquen, INU; Churchill, IEN; Hamilton, PHR; Abushakra, LEGAS; Stern, FINSV; Stoutjesdijk, (2) FRS; Champion, LOAAS; Frank, CFPV, Parmar, CIOVP; El-Rifai, MIGPA; Goldsbrough, IMF;

Asia Files

Funck:lt

June 10, 1991

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THE WORLD BANK

Operations Committee

CONFIDENTIAL

Minutes of the Operations Committee to Consider the

PANAMA - Initiating Memorandum for an Economic Recovery Loan

Held on Monday, June 10, 1991;, at 10:30 a.m. in Room E-1243

A. PRESENT

Committee	Others
Messrs. M.A. Qureshi (Chairman)	Messrs. Y. Baran (LA2)
D. Bock (OPNSV)	P. Crevier (SECGE)
D. De Tray (DECVP)	E. Grilli (EASDR)
S. Husain (LACVP)	T. Hutcheson (PRDRA)
W. Grais (EMNVP)	F. Molnar (LEGLA)
E. Jaycox (AFRVP)	R. Myers (LA2)
K. Kashiwaya (CFSVP)	Ms. N. Okonjo-Iweala (OPNSV)
H. Scott (LEGVP)	A. Ray (EAS)
J. Wood (FPRVP)	M. Selowsky (LACCE)
	R. Steckhan (LA2DR)
	E. Stoutjesdijk (FRSDR)
	M. Voljc (LA2)
	L. Perez (IMF)

B. ISSUES AND DISCUSSION

1. The meeting was called to discuss the Initiating Memorandum for an Economic Recovery Loan to Panama in the amount of $100 million. The discussion was based on an agenda prepared by EAS. In his opening remarks, the Chairman characterized the proposed operation as comprehensive, and enquired about the Government's commitment to the reform program, prospects for clearing arrears to the IFIs, and the role of the IMF and IDB. The Region responded that a comprehensive adjustment effort is necessary given the extent of distortions in the Panamanian economy and the authorities' inability to effect a nominal devaluation. To achieve a real devaluation, the program aims at freezing minimum wages while trade reforms would induce productivity increase in the economy. The program, however, does not cover the financial

sector, nor does it seek to modify the labor code, which would be politically difficult in the short-run.

2. With regard to arrears clearance, the Region indicated that the United States leads a Support Group which, through direct assistance and a US Treasury bridge loan of up to $150 million, plans to clear $540 million of the total of $660 million of arrears to IFIs. Panama would pay the remaining $120 million out of its own reserves. The country has been adhering to a Fund Monitored Program and is currently negotiating a Stand-by Arrangement. A separate but parallel IDB loan would finance public sector enterprise reforms. Regarding the authorities' commitment to the adjustment program, the Region said that the Government and the main opposition leaders have indicated their commitment to implement the program, although some of the issues are quite sensitive, especially in trade and agriculture.

3. A Committee member asked whether the Government has a plan to reduce the role of the public sector beyond this operation and whether foreign investors will become more active in Panama. The Region stated that employment reductions included in the program will be followed by future cutbacks in the role of the State. The privatizations included in the proposed program should attract foreign investors (especially from U.S. and Japan). The program also seeks Cabinet approval of rules for debt/equity swaps.

4. Another member suggested that a CSP be prepared to address medium-term strategies. However, given the target date for Board presentation in September/October, the Region said it will not have time to prepare a full CSP in the interim but will discuss the Bank's assistance strategy in the President's Report. In response to a question about the amount of the loan and how it fits into the Bank's assistance strategy for Panama, the Region indicated that the ultimate loan amount will reflect the depth of adjustment and arrears clearance needs. The Region is planning further policy-based operations and project investments, which will lead to the resumption of positive transfers to Panama after two years. The Bank is working with the IDB, which will remain a large creditor in Panama.

5. A Committee member questioned the feasibility of obtaining significant Social Security reforms, particularly before Board presentation. The Region explained that it sees such reforms as key to avoiding a collapse of the system. A consensus has emerged on the main elements in the Social Security reform package. The Region will push for passage of legislation before Board, but this condition may slip to the second tranche.

6. The Committee discussed whether the expected decline in real wages will be sufficient to ensure international competitiveness of the economy.

The Region indicated that wages were only 10-20% higher than in countries in Latin America with the same level of development. Given that the economy is just recovering from an almost 20% drop in real income, the projected increase in real per capita consumption is not out of line. Because of the high (20%) rate of unemployment, some of the restrictive labor rules are often not obeyed; they do not apply in any case to export processing zones. A Committee member asked about the extent to which the phase-out of quantitative restrictions for agricultural imports could be advanced to strengthen the poverty alleviation benefits of the program. The Region noted the significant benefits already anticipated through increased employment of non-skilled workers, the reallocation of expenditures towards primary health and education, maintenance of social expenditures, and expected lower food and utility prices. The Government will give severance payments to dismissed public sector employees.

7. In conclusion, the Chairman said that the proposed operation was both wide ranging and risky. While the degree of the Government's commitment is not fully clear, this was a politically opportune moment to try to implement the reforms. He urged the Appraisal Mission to be selective, and to maintain focus on the central issues in drafting conditionality. He asked that the IM be forwarded to the President with a country strategy note because Panama is a non-accrual country.

June 11, 1991

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ARay:pl

Mr. Qureshi

THE WORLD BANK/IFC/MIGA
OFFICE MEMORANDUM

Agriculture

SAL plus SECALS

DATE : June 6, 1991

TO : Operations Committee

FROM : Enzo Grilli, EG Director, EAS

EXT. : 81938

SUBJECT: **PANAMA - Initiating Memorandum for a Proposed Economic Recovery Loan - Agenda.**

Financial Plan still short $180 million

1. The Operations Committee will meet on **Monday, June 10, at 10:30 a.m. in Room E-1243** to discuss the Initiating Memorandum for the proposed Economic Recovery Loan (ERL). The proposed loan would be for $100 million, to be disbursed in three tranches. Board presentation is expected around October/November; this would follow the clearance of arrears to the IFIs, expected around August, after this loan and a Fund program have been successfully negotiated.

2. This ERL is intended to support trade reforms, privatization, public employment reduction, and reforms of policies on public enterprises, taxes and social security. A common factor in all this is the need to reduce fiscal deficits without sacrificing economic efficiency. Another concern is the need to increase the flexibility of prices and wages, which is of critical importance given the fixed exchange rate with the US dollar. The Labor Code, which has introduced rigidities in the labor market, will not, however, be modified during the period of this loan even though approval by the Cabinet of the main elements of eventual reform will be sought before Board presentation.

3. The Committee might discuss the following issues:

- clearance of arrears, the financing plan, and coordination with the IMF and IDB. The IM notes that a financial package is being prepared to enable the clearance of arrears to the IFIs but there still remains a substantial gap to be filled ($186.5 million). The Region might elaborate upon the status of financial arrangements at this time, the implications of having to postpone the Paris Club (since the IMF program cannot be in place by end-June), and upon the interdependence between the Fund and Bank programs in terms sequencing and burden-sharing. The Region might also elaborate upon the macroeconomic framework being negotiated by the IMF and how the proposed ERL fits in that framework.

- the pre-Board conditions and social security reforms. An important feature of the proposed loan is that Board presentation would be conditional on several pieces of legislation concerning tax reforms, social security reforms, privatization, elimination of import tariff exemptions and the introduction of a 10% minimum import tariff on non-competitive imports. Of these, the social security legislation is likely to be the most difficult (note that the second tranche of the last SAL in Panama could not be disbursed because of problems with social security changes). In view of the fact that this operation is part of a time-bound package involving the clearance of arrears through bridge financing, would it be wise to include social security legislation as a condition of Board presentation? How confident are we that the reform program has been properly designed (e.g. the elimination of early retirement, ceiling on contributions, etc.)? Should we instead make legislation a second-tranche condition, or remove it altogether from the legally-binding conditionality (but keeping it in the Letter of Development Policy)?

- trade reforms. The IM proposes that tariff ceilings be set at 40% (industry) and 50% (agro-industry and agriculture) by third tranche (the minimum tariff of 27.5% for competitive imports will remain unchanged). Furthermore, a 10% minimum tariff will be introduced for non-competitive imports; this condition is reportedly subject to strong resistance. Would the Region elaborate upon why the targets for tariffs should be set unevenly for industry and agriculture, and on the quantitative significance, in terms of Effective Protection Rates and revenue, of moving to a minimum of 10%, rather than a smaller amount, for non-competitive imports?

- tax reforms. The loan would support some important changes in the corporate and personal income taxes. However, the rate of the VAT is low, compared to other countries in the Region. Why can the rate not be increased, and the VAT extended to services? Should the selective consumption tax of 10% be accepted as a substitute as proposed?

- public enterprise reforms and privatization. The proposed conditionality involves a complex set of actions to reform the big four public enterprises (power, water, ports, telecoms) and promote privatization of non-utility companies. Drastic reforms are envisaged for the big four, including privatization of "non-basic" services and future capacity expansions; the telecoms is to be converted into a mixed ownership private company. Basic changes are also envisaged for their pricing and investment policies. Regarding the privatization of non-utility companies, the process will require, among other things, the development of a regulatory framework and the passage of an enabling law. All this will necessitate extensive technical assistance and supervision. In what ways does this program overlap with that of IDB? Will there be cross-conditionality? Would it be possible or desirable to shift a part of this program to the IDB?

- the social sector component. A social sector component is proposed which will put a floor on the share of health and education expenditures of the Central Government, and support a program to address the nutritional needs of lactating mothers, and young children in the poorest regions. What would be the significance of this component within the overall social sector strategy of the Government? Is there scope for strengthening this component? Should actions on the nutrition program be a part of the legally-binding conditionality?

- financial sector. The IM does not propose any conditionality for the financial sector, but the discussion in the text suggests that much remains to be done (para 67). The issue is whether some of the actions needed should be given priority over others in the package to be supported by this loan; in particular should the loan conditionality include the restructuring of at least the BHN, and preferably the BDA also, in order to tackle insolvency and limit the contingent liabilities of the Central Government?

Operations Committee:

Messrs. Qureshi (OPNSV), Husain (LACVP), Jaycox (AFRVP), Karaosmanoglu (ASIVP), Wapenhans (EMNVP), Rajagopalan (PRSVP), Summers (DECVP), Shihata (LEGVP), Kashiwaya (CFSVP), Wood (FPRVP), Bock (OPNSV).

cc: Messrs. Thahane/Burmester, SECGE; Picciotto, CPB; Goldberg, LEGOP; Wyss, COD; Sandstrom, EXC; Isenman, PRD; Linn, CEC; Stoutjesdijk, FRS; (Ms.) Okonjo-Iweala, OPNSV; Parmar, IFC-CIO; Rao, IEC; Kavalsky, FRM; Pfeffermann, IFC-CEI; Liebenthal, PRD; Kilby, FRS; Robless, OPNSV; Walton, EXC; Khanna, EXC; Selowsky, Steckhan, Voljc, Baran, Institutional ISC.

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ARay:pl

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: May 31, 1991 6:12

TO: Mr. S. Shahid Husain

FROM: Mr. Rainer B. Steckhan, ~~Director~~, LA2 Steckhan

EXTENSION: 38074

SUBJECT: Panama: Initiating Memorandum for the Proposed Economic Recovery Loan (ERL)

1. Attached please find the Initiating Memorandum (IM) for the Proposed Economic Recovery Loan (ERL) for Panama. The IM incorporates instructions of the Regional Loan Committee (RLC) meeting held on February 7, 1991, comments received at yellow cover meetings held on April 19 and 25 (minutes of both meetings are attached), the discussions with Vice-President Ford and his team in Washington in early May, and findings of a Bank mission to Panama in late May.

2. Following discussions with the Government team in Washington in May, the authorities announced a reform program, which we believe forms a good basis to launch appraisal. The announced reform program covers all the essential areas which we propose to support under the ERL: trade reform, privatization, public sector finances and public enterprise efficiency, tax and social security reforms. The program is an ambitious one, but Vice President Ford has expressed confidence in its feasibility. However, it will require determination and skill by the President of the Republic and Government to get such a package through Congress.

3. In view of the discussions with the Government, and by a recent mission with the main opposition party Christian Democrats (who hold 28 Congressional seats out of a total of 54), I would like to point out that the following major changes from the RLC meeting decisions have been introduced into the Initiating Memorandum:

Tariff reform

4. The authorities announced publicly (i) their intention to reach import tariff rates of 40% for industry and 50% for agro-industry by about January 1993 (a third tranche condition) and eliminate specific import tariff rates (a second tranche condition), and (ii) that they would continue with the trade reform program beyond 1993. However, because of the likely opposition such an announcement may encounter, they do not want to announce the final target of 10% - 20% at this time. The authorities' willingness to embark upon a major tariff reform, given the present high protection afforded to industry and agriculture, provides a sufficient basis to proceed with appraisal. However, we still intend to encourage the authorities to make a formal announcement at the latest by second tranche release on the tariff targets of 10% - 20% to be achieved before the middle of this decade.

5. Reaching an agreement on the minimum import tariff rate remains the key remaining issue of the trade reform. The authorities have announced an increase in the minimum import tariff rate from 0% to 3%; we will still insist that the Government increase the minimum import tariff rate to 10% in a gradual way: 5% before the second tranche and 10% before the third tranche.

Social Sector Component and Social Security Reforms

6. The yellow cover review meetings recommended that social sector reform actions not be legally binding conditions for the proposed ERL. However, both the Government and the opposition believe that actions contemplated in the social sector are of utmost importance and should form a main part of the program supported by the ERL. Regarding social security reforms, both the Government and the opposition wish to introduce a more comprehensive package of reforms. The policy conditionality was expanded to incorporate those concerns.

Arrears Clearance

7. Regarding the financial package to clear the arrears, US Treasury representatives were optimistic about donor support during Vice President Ford's visit to Washington. They expressed confidence that the bridge loan to complete the package could be arranged once an agreement on an economic recovery package is reached. However, there are some details of the package that will need to be worked out, in particular the maturity of the bridge loan and a possible need for additional bridge resources. Japan's contribution of about US$100 million might take the form of co-financing with us and in this case would not be available for arrears clearance. A possibility would be to use Panama's own resources, given that the country has significant cash reserves.

Disbursements and Retroactive Financing

8. A three tranche operation is proposed, with tranches tentatively set at US$30 million, $30 million, and $40 million. Final decisions on tranche size would take into account the depth of reform undertaken prior to first tranche release and the arrears clearance financing plans yet to be finalized. In order to facilitate the arrears clearance process by helping Panama repay bridge loans in a timely manner, it is proposed to make up to US$30 million under the first tranche available retroactively which would be in excess of the Bank's 20% guidelines for adjustment operations.

Timing

9. An appraisal mission would visit Panama beginning June 10. Assuming successful discussions, negotiations could take place in July/August with Board presentation tentatively in October/November 1991. I would like to receive your approval to forward the IM to the OC today for

the meeting scheduled for June 7, 1991 to enable the Appraisal mission to depart to Panama on June 10, 1991.

cc: Messrs. Aiyer, Duer, LACVP; Selowsky (o/r), Hicks, Martin, LACCE; Knotter, LA2DR; Voljc, Tuncer, Baran, Myers, Illanes, LA2C2

Attachments

June 7, 1991

91062103 4 1.

THE WORLD BANK
OPERATIONS COMMITTEE

CONFIDENTIAL

TURKEY

COUNTRY STRATEGY PAPER

Postscript

5.33 The Operations Committee met on June 7, 1991 to consider the Country Strategy Paper(CSP) for Turkey. In opening the discussion, the Chairman noted that the 1988 CSP had painted a critical picture of Turkey's economic prospects. In the event, however, with the exception of the inflation rate and the fiscal deficit, all economic indicators were quite impressive. For more than a decade, GDP growth had remained strong. Thus, before addressing the specific issues raised in the agenda prepared by EAS, he asked the Region to give its overall assessment of economic developments over the last decade.

5.34 The Region responded that the policies pursued by the Government since the early 1980s could best be described as "far reaching liberalization without stabilization." The private sector had responded in an exceptional manner with manufactured exports increasing more than ten-fold over the decade. Similarly, the tourism industry had been doing very well. Increased foreign confidence in Turkey had been demonstrated by the large increase in direct foreign investments. Because of the strength of the external sector, the key debt indicators were now much lower than what had been anticipated in the 1988 CSP.

5.35 However, the budget deficit had risen to unsustainable levels, with a primary deficit of 4 percent of GDP and a public sector borrowing requirement of 10 percent of GDP. This had put an upward pressure on inflation, that was now exceeding 55 percent, and on real interest rates. The exchange rate had also appreciated some 30 percent in real terms. The budgetary costs of the Gulf crisis had largely been off-set by increased foreign assistance. The growing fiscal problem was mainly due to the large deficits experienced by state economic enterprises, especially the grain purchasing agency, the railways, and some of the public utilities. This assessment had been shared by the participants at the recent aid group meeting sponsored by OECD, who had urged the Government to take action. Senior technocrats in the Government were concerned about the problem and were recommending appropriate corrective action but, preoccupied with the political calendar, the President had not taken action towards restoring the macroeconomic balance. The Region added, however, that it believed that the Government was pragmatic and that it would take action to reduce the budget deficit before it reached crisis proportions.

5.36 With respect to the political situation, the Region explained that, according to the constitution, parliamentary elections should be held no later than November 1992. However, there was a prospect that they might be advanced. It seemed unlikely that any party would get an absolute majority; the probable outcome was a coalition government, possibly led by the Motherland Party. There was also talk in Turkey that Mr. Ozal would seek a constitutional amendment that would create an executive Presidency.

5.37 The Committee members shared the Region's view that the large budget deficit and the high inflation were not sustainable--although the open capital account had made the situation somewhat more manageable. Although the exports of goods and services had performed exceptionally well so far, the cost of poor stabilization policies--in terms of export opportunities lost--were increasingly being felt. One member noted that there were clear signs that Turkey faced increasing difficulties in raising foreign loans. The Region mentioned that the spread over LIBOR for recent borrowings by Turkey had increased by about 50 basis points. The IFC representative noted that the private sector had been very dynamic and undergone a structural transformation. "Exits" through bankruptcies were frequent but these were more than off-set by the creation and expansion of new firms. The tourism industry was in a recession. Problems were also encountered in the textile and glass sectors that were squeezed by the real appreciation of the exchange rate and steep increases in labor costs. One member noted that the danger signals were increasing and that international experience pointed to the difficulty of breaking a downward spiral.

5.38 Summing up the first part of the discussion, the Chairman concluded that the present public sector borrowing requirement and the inflation rate were unsustainable in the long run. The Bank should continue to press the Government for strong stabilization measures. With respect to the fiscal deficit, he though that the Government would welcome ideas from the Bank on possible approaches and options to reduce it. He added, however, that the Bank's influence on macroeconomic policy overall was limited (and appeared to have declined over the last few years as the Government's access to other sources of funding had improved). Thus, he suggested that the Region should try to marshall support from European Governments which, given Turkey's desire to join the Common Market, might have a greater leverage.

5.39 The Chairman turned next to the areas where the Bank could play a constructive and effective role in promoting sectoral reforms. One priority area was the public enterprise sector where the Bank had to have the analytical basis for its policy recommendations and use its leverage through targeted lending operations. In this connection, the Chairman noted that the rationale for the high (US$1 billion), base (US$850 million) and low (US$500 million) lending scenarios was not clearly spelled out. He would have liked to see more direct linkages with the balance of payment situation and, especially, with the objectives of the Bank's lending operations in the different sectors. On the whole, resource transfers appeared to be only a minor consideration in the Turkish case. Thus, the key element of the strategy should be to support critical institutional and policy reforms at the sectoral level. If the government was unwilling to undertake reforms which we deemed essential, then Bank assistance should not merely be shifted to other sectors. In short, the

Turkish authorities should not regard Bank lending as totally fungible across sectors or projects.

5.40 The Region responded that it expected Turkey to have continued access to commercial lenders and it was difficult to provide a scientific basis for the base and low case lending scenarios. The high case--with strong stabilization and renewed emphasis on structural reforms--would justify not only an increased lending volume but also the inclusion of quick disbursing operations in the program. Thus, US$1 billion or more in annual lending would be appropriate. Given the limited stabilization measures assumed in the base case, a gradual decline in Bank exposure was judged to be appropriate. This would imply an annual lending program of 4-5 relatively large projects, each with relevant policy content. Recently negotiated lending operations included important policy changes (for example, reform of TEK, the electricity company, and abolition of the foreign exchange insurance scheme). Indeed, if the desired policy changes did not materialize, lending would fall substantially below the US$850 million assumed in the base case. A lending volume of about US$500 million under the low case scenario was regarded as the minimum level required to maintain a constructive dialogue in Turkey.

5.41 The subsequent speakers reinforced and elaborated on the points raised by the Chairman. There was a general agreement on the need to pursue the reform--and, if feasible, privatization--of state economic enterprises and restructuring of the fiscal system. Some speakers also stressed the need to support the private sector through expanded investments in basic infrastructure, especially in urban areas and in the transport sector.

5.42 Several members argued for a more differentiated lending response. If the Government adopted an effective stabilization program and pursued further structural reforms, the lending envisaged under the high case might not be enough to help remove all the impediments to rapid growth of private manufacturing and exports. On the other hand, if the Government failed to take even modest stabilization measures, the Bank should be very cautious. Indeed, if this policy scenario materialized, the Bank should not be overly concerned if it became a marginal actor in Turkey. One speaker added that an "in-between" or "muddle-through" scenario should be avoided. There was also widespread support for the notion that the Bank should attach strong conditionality to its projects and enhance its leverage by making the Turkish authorities understand that Bank assistance was not fungible across sectors or projects. If the Government did not agree with the conditions attached to a loan in a particular sector, the operation should be dropped from the program and the shortfall should not be made up through increased lending in other sectors.

5.43 In concluding the meeting, the Chairman expressed his confidence in Turkey's policy makers. The President and the economic team understood the risk associated with a mushrooming budget deficit and accelerating inflation. Thus, he expected that, to avoid a crisis, appropriate measures would be taken to bring the public sector borrowing requirements down to a more sustainable level.

5.44 However, if the Region thought that the macroeconomic situation was moving towards a crisis (as implied in the low case), Bank exposure should go down. In such a situation, the Region should not try to maintain leverage through the lending program. Consequently, even US$400-500 million in annual commitments might be too much.

5.45 The Chairman reiterated the need to elaborate further on the lending scenarios, to relate them to the balance of payments context, and better articulate the Bank's strategy for achieving further reforms at the sectoral level. The base case should outline the key areas--such as state enterprises--where the Bank would pursue policy and institutional changes. The strategy for removing impediments to private sector growth should be better articulated. In this connection, the Chairman noted that Turkey's transport and urban infrastructure was under severe strain and environmental degradation needed to be reversed.

June 21, 1991

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LIST OF PERSONS ATTENDING THE OPERATIONS COMMITTEE MEETING

TURKEY - COUNTRY STRATEGY PAPER

FRIDAY, JUNE 7, AT 10:00 A.M.

Operations Committee

Messrs. M.A. Qureshi (Chairman)
N. Hicks (LACVP)
S. O'Brien (AFRVP)
A. Karaosmanoglu (ASIVP)
M. Wiehen (EMNVP)
L. Summers (DECVP)
D. Goldberg (LEGVP)
K. Kashiwaya (CFSVP)
D. J. Wood (FPRVP)
D. Bock (OPNSV)

Other Attendees

Messrs. E. Grilli (EAS)
P. Ljung (EAS)
P. Hasan (EMNVP)
M. Penalver-Quesada (EM1CO)
W. McCleary (EM1DR)
Ms. S. Hadler (EM1CO)
Ms. S. Mehra (EM1CO)
E. Stoutjesdijk (FRS)
Ms. N. Okonjo-Iweala (OPNSV)
A. Khanna (EXC)
H. P. Crevier (SECGE)
M. Fardi (PRDRA)
A. Hamid (LEGEM)
D. Gustafson (IFC)

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Structural Instability

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: June 5, 1991

TO: Operations Committee

FROM: EG Enzo Grilli, Director, EAS

EXTENSION: 81934/5

SUBJECT: TURKEY - Country Strategy Paper - **Agenda**

1. The Operations Committee will meet on **Friday, June 7, 1991 at 10:00 a.m. in Room E-1243** to discuss the Country Strategy Paper (CSP) for Turkey. The document was circulated to you on May 28, 1991 under Mr. Wiehen's signature.

Introduction

2. Turkey is commonly regarded as one of the success stories of the 1980s. The country entered the decade with a stagnant economy, an inflation rate exceeding 100% and a balance of payments crisis. Some basic stabilization measures, a rejection of the old inward-oriented development strategy and a gradual liberalization of the economy released the energies of Turkey's private sector. Driven by manufactured exports--that increased eleven-fold between 1980 and 1990--the GDP growth rate averaged a little over 5% for the decade. The private sector has become fairly robust and competitive. Following a remarkable strengthening of the external accounts, Turkey has regained access to international capital markets.

3. Still, there are increasing signs that this performance might not be sustainable during the 1990s. Increasing macroeconomic instability--driven by a growing budget deficit--pose risks in the short term. The economic transformation in Eastern Europe, the integration of the European Community in 1992, and an unfinished agenda of structural reforms dim the medium term outlook. Past neglect of poverty, human resource development and environmental degradation jeopardize Turkey's ambition of "joining Europe" at the beginning of the next century. Furthermore, political developments might further undermine sound economic management and change the perception of Turkey's creditors.

4. Against this background, the objective of the Bank's assistance strategy--as outlined in the CSP--is to "support the Government's short-term need to restore macroeconomic balances and simultaneously increase the intensity of our efforts to assist in Turkey's longer-term economic transformation, both in the real sectors and human resource development and particularly, to focus on poverty alleviation and environmental concerns."

Issues

5. Macroeconomic Management and Risks. Fiscal discipline in Turkey has tended to fluctuate with the country's political cycle. However, it can best be described as "one step forward and two steps back." The public sector borrowing requirement (PSBR) has increased from around 5% of GDP in 1985 to 10% in 1990. The Central Bank monetized part of the Treasury's funding needs, helping to push inflation to over 55% in April 1991. At the same time, public sector borrowings pushed up domestic interest rates (at the auction market) to almost 30% in real terms when measured by past inflation.

6. After a couple of years of surpluses, the current account balance turned negative in 1990 (a deficit of 2.4% of GDP), in part fueled by rapid import growth. (A higher oil bill played only a minor part in the jump in imports). Squeezed out of the domestic capital market, private enterprises rapidly increased their short term foreign borrowings last year. Although Turkey's debt indicators fell impressively during the 1980s,1/ the debt service to exports ratio continues to hover above 30%--a level which commonly is regarded as a danger signal. Since Turkey's gross borrowing requirements remain large, there is a risk that even a modest retrenchment by some banks can set off a spiraling liquidity crunch. Consequently, to maintain reasonable internal and external balances, it is essential that the Government takes quick action to contain the budget deficit. The Committee might ask the Region to:

* review recent macroeconomic developments and assess the prospects for corrective action in the near term, taking into account the elections that will be held no later than November 1992;

* brief the Committee on the recent aid group meeting sponsored by OECD and describe the status of our present dialogue with the Government;

* analyze present political trends and their implications for prospective stabilization and adjustment policies after the election; and

* explain the reaction so far of commercial banks to the recent deterioration in economic management and assess the risk of a liquidity crunch.

7. Bank Policy Dialogue. The Bank's sector adjustment operations suffered from slippages in macroeconomic and sectoral policy reforms during the second half of the 1980s. The Government clearly feels proud of the GDP and export growth achieved during the last decade. Thus, coinciding with Turkey's increased international stature, the Government has become increasingly reluctant to accept external

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1/ For example, the debt to exports ratio fell from 330% in 1980 to 178% in 1990.

policy conditionality. However, the CSP notes that the Government "continues to value the Bank's analytical work and policy advice." Given Turkey's access to international capital markets, the CSP proposes a shift in lending strategy--under the base case--away from adjustment operations towards investment lending. Selected sectoral policy reforms would be pursued through project conditionality while the Bank would rely on its economic work and general advisory role to pursue macroeconomic issues. However, the CSP acknowledges that by maintaining the integrity of the Bank's dialogue, the delivery of the planned base lending program might be jeopardized. Since there is a clear need not only for strong stabilization efforts but also for a deepening of the structural reforms, the Region might be asked to:

* explain the nature of our dialogue with the Government and describe the areas where the Government's and the Bank's concern coincide and, thus, the purely advisory role of the Bank might be effective; and

* describe the sectoral reforms that would be pursued through investment operations and assess the risks of policy failures and consequent slippages in the lending program.

8. Economic and Lending Scenarios. The scenarios are clearly linked to the Government's policy performance. In the high case, the Government takes strong and immediate actions to contain the budget deficit and undertakes a variety of sectoral reforms over the next year or so. The Bank would respond by lending about US$1 billion, or perhaps even more. (Under this scenario, there is also a possibility that the demand for Bank lending might decline to US$600-700 million in the medium term.) Our lending would include some adjustment operations. In the base case, the Bank would lend around US$850 per year with no adjustment operations. This scenario assumes that the Government takes some immediate steps to reduce the primary deficit from 4.1% of GDP in 1990 to 2.3% this year (followed by a more serious stabilization program after the elections), addresses some of the longstanding state enterprise issues, and demonstrates a continued commitment to human resource development. However, failure by the Government to take action during the summer to contain the fiscal situation would automatically move the Bank to the low lending scenario of around US$500 million. In terms of economic performance, this scenario foresees a rapid deterioration over the next couple of years which would essentially force the Government to put in place--following the elections in 1992--a strong stabilization and adjustment program. When, and if, this occurred the Bank would respond appropriately with adjustment operations and increased lending. Under all scenarios, the Bank's exposure would decline over the 1990s and remain comfortably within the guidelines. (It is noteworthy that this is quite a different situation from the one presented in the 1988 CSP when all exposure guidelines were expected to be exceeded throughout the 1990s.) Consequently, the Committee might discuss:

* whether the lending scenarios--in terms of volume and content--and their associated triggers are appropriate to the present situation in Turkey;

9. SEE Reform and Privatization. When the Ozal Government took office in 1983, the Prime Minister became essentially the first leader from a developing country that vocally and strongly pushed for restructuring and privatization of state economic enterprises (SEEs). At that time, the SEEs dominated the economic life in Turkey. Although the SEEs have been given some autonomy and flexibility in price setting, their productivity has declined over the last five years and the financial performance of some major utilities (electricity and railways) has deteriorated. Unfortunately, virtually no progress has been made on the privatization of SEEs which has been hampered by legal, political and social obstacles. Today, the rather inefficient public sector accounts for some 40% of manufacturing value added. Although still lower than in the early 1980s, the contribution of the SEEs to the fiscal deficit is increasing. Thus the reform of the state enterprise sector remains a high priority. The Bank and IFC have recently been asked to help in formulating and implementing a new privatization strategy. The Region might be asked to explain:

* the nature of the Bank Group's anticipated support for the privatization program;
* why it is confident that the Government will be able to overcome the obstacles that has blocked past privatization efforts;
* the strategy for improving the performance of those SEEs that are unlikely to be privatized; and
* its broader efforts to promote the development of the private sector.

10. Cost Sharing. Over the past decade, the Bank has financed foreign exchange costs only, with an implicit cost-sharing of 40%. Given the shortage of counterpart funds during a period of fiscal stringency, the CSP proposes that the cost-sharing for Turkey be modified to allow financing of up to 60% of the three-year rolling investment program, with no distinction between local and foreign costs. While this might enhance the Bank's leverage in important sectors with low foreign exchange requirements (e.g., education, health and agriculture), the Committee might want to discuss:

* if this higher cost sharing ratio is justified from a resource transfer point of view; and
* if the concentration of Bank assistance on a smaller number of projects increases the risk of slippages in the lending program and reduces our opportunities for broad-ranging support of technological, managerial and policy reforms.

Operations Committee

Messrs. Qureshi, Husain, Jaycox, Karaosmanoglu, Wapenhans, Rajagopalan, Summers, Shihata, Kashiwaya, Wood, Bock.

cc: Messrs/Mss. Thahane/Burmester, SECGE; Picciotto, CPB; Goldberg, LEGOP; Wyss, COD; Sandstrom, EXC; Isenman, PRD; Linn, CEC; Stoutjesdijk, FRS; Okonjo-Iweala, OPNSV; Gustafson, IFC; El Serafy, EAS (o/r); Parmar, IFC-CIO; Rao, IEC; Kavalsky, FRM; Pfeffermann, IFC-CEI; Liebenthal, PRD; Kilby, FRS; Robless, OPNSV; Walton, DECVP; Khanna, EXC; Shakow EXT; Hasan, Wiehen, Penalver-Quesada, Mehra, Hadler, EMN; Institutional ISC.

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THE WORLD BANK / IFC / MIGA

OFFICE MEMORANDUM

DATE: June 7, 1991

TO: Mr. Willi A. Wapenhans

FROM: Lawrence H. Summers LS

EXTENSION: 33774

SUBJECT: Turkey Country Strategy Paper

1. I share the judgments expressed in the CSP that the macroeconomic situation is fragile, that the core of the problem lies in the deterioration in the performance of the public sector and that this could jeopardize structural change. However, I think the proposed overall strategy for the Bank is off track. First, I am not convinced that the base case is the most realistic basis for planning our strategy at this point. Progress on fiscal performance is already slow under this scenario. Small primary surpluses didn't slow inflation in the late 1980s, and the fiscal accounts don't get back to these levels until the late 1990s in this case. Political economy considerations would in any case suggest the low case is more realistic. It would seem to be appropriate to plan on this basis.

2. Second, I would advocate greater differentiation in lending levels between scenarios. With the difficult macroeconomic outlook and a relatively weak track record on sectoral policy dialogue, Turkey would seem to be a clear case for limited total levels of Bank lending until the situation improves and we can be confident of having a substantial impact. An added factor is that the relatively rosy outlook for Bank exposure is in part due to voluntary lending by private banks--with substantial net inflows in 1992 in the low case, for example. If the banks get worried over macroeconomic instability, this could unravel. While I would advocate planning on the basis of lower lending levels than now proposed for the low case, I have no problem with the expectation of a large subsequent increase if the Government seriously focuses on policy change, including a resumption of adjustment lending.

3. Lending levels could be linked to performance either at the aggregate or sectoral level. Since money will be relatively fungible in an economy of Turkey's sophistication and access to alternative financing sources, I have a preference for limiting the aggregate lending program. However, if a higher aggregate level is chosen ex ante, with sectoral lending linked to progress in sectoral strategy, it is obviously important that Bank money (at least) is not fungible across sectors. If current suggestions on policy reform in power do not come through, for example, I would advocate reducing lending in this sector without compensating increases elsewhere.

4. I have one comment on other issues. The CSP is articulate in arguing for the need for greater attention to distributional issues, of which regional differentiation forms a part. I think we don't have a good framework for analyzing this question in the Bank: in particular, it is not clear how far it makes sense to help

lagging regions through increased infrastructural investment and fiscal incentives as opposed to a primary emphasis on social services. I would be happy to provide support in defining the issues in this area.

cc: Messrs. M. Qureshi, W. Thalwitz, E. Jaycox, A. Karaosmanoglu, S. Husain, V. Rajagopalan, I. Shihata, K. Kashiwaya, J. Wood, D. Bock, E. Grilli, P. Isenman, M. Wiehen, M. Penalver-Quesada

Transition risks.

Debt structure

High deficits

More of a classic system.

Rely on

Go for a lending strategy – Press them.

State Enterprises –

Structural Change –

Our

Let us not try to be the Saviour

IMF – Stabilization Program – Why we should do ~~less~~ more.

Base Case

Billion $'s

Budgetary Investment :