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ISAD Reference Code: WB IBRD/IDA LC-06

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Loan Committee: Chile - General

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A1990-229 Other #: 24 Box # 213288B

Chile - General - Loan Committee Project File

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PD (o/r)
file

Date: August 21, 1986
To: Mr. Kunihiro Inakage, VPCOF
From: Ernest Stern, SVP, Operations
Subject: CHILE: Debt Conversion

This is an excellent report. If you agree, I would like to circulate this to the OVPs for information and discussion on September 17. I would like you and/or Mr. Vibert to provide the background to the items listed in para. 3 of the cover memo, which should be the focus of the discussion.

Thereafter I would like to circulate this note to the Board for information. It should be reviewed with that objective in mind. Para. 2 of the cover note would serve as an excellent summary.

cc: Mr. Vibert
Mr. Clements ✓
Ms. Donovan o/r

OFFICE MEMORANDUM

DATE: April 5, 1985

TO: Mr. Andre Gue, Acting Regional Vice President, LAC

THROUGH: Mr. Gunter Koenig, Acting Director, LCIDR

FROM: Peter Eigen, Division Chief, LCIPA

EXTENSION: 75791

SUBJECT: CHILE - Lending Tactics for FY85-86CONFIDENTIAL
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APR 30 2021

WBG ARCHIVES

1. On March 6, the Loan Committee approved an Initiating Memorandum proposing a \$250 million Structural Adjustment Loan. The Committee also approved a major increase in Bank lending; from only \$42 million yearly during FY82-84 to \$250 million in FY85 and \$500 million in FY86. The approved Minutes of the meeting are attached.

2. Such a major increase in lending usually requires a CPP, but an RVP review of a CPP cannot be undertaken until July 1985 if we are, as approved by Senior Management, to produce a timely SAL, respond to the recent earthquake, and go forward with a major lending program. A working draft CPP, proposing a far more modest lending increase was suspended in October 1984, when CPD and P&B had serious concerns over Chile's creditworthiness. They have agreed, however, to the present program only because of the SAL-supported medium-term recovery package, and have asked us to link much of the increased lending to the Government's efforts to improve its own policies while marshalling sufficient external support for a feasible continuance of the program over the next few years.

3. Following two loans totalling \$136 million in December 1984, we lent \$11 million to Chile in March 1985. It may be useful to list the loans which we expect for the remainder of CY85:

<u>Loan:</u>	<u>Amount:</u>	<u>Tentative Board Date:</u>
Industrial Finance Reconstruction	\$100 million	May 28, 1985
Highway Sub-sector Loan	\$170 million	June 18, 1985
SAL	\$250 million	September 1985
Small and Medium Industries	\$40 million	August 6, 1985
Santiago Water	\$40 million	November 19, 1985
<u>Total:</u>	<u>\$600 million</u>	

This excludes a possible earthquake reconstruction project which an emergency mission -- recently returned from Chile -- might also propose for CY1985.

4. The decision of the Loan Committee was partly based on the favorable response of the authorities to the policy advice of both the IMF and IBRD. Subsequent to our SAL preparation mission the authorities deferred indefinitely the major white elephant in their investment program, and dropped import tariffs to the level agreed to be undertaken by July 1. Our decision, however, was made in spite of Chile's marginal creditworthiness. Not only is Chile's foreign debt equal to its GDP and 5 times its exports, interest payments on this debt are almost half the value of exports. The Bank is

projecting real copper prices -- which affect half of Chile's exports -- to remain as low in real terms during the 1980s as they were in the 1930s. Moreover, much of the private debt is owed by now bankrupt banks and corporations, and the modalities of repaying even that portion the Government guaranteed during 1983-84 are still unknown. Even optimistic projections reveal that Chile will have to accrue unprecedented domestic savings levels while suffering austere consumption levels during the next three to four years. To support Chile's efforts, a \$750 million 3-year EFF has been approved by the Managing Director of the IMF and will be forwarded to its Board when Chile's creditors agree to substantial new monies sufficient to fill an IMF-estimated US\$1 billion gap for 1985.

5. A chief concern of the Loan Committee -- and that of the IMF -- remains the ability of Chile to marshal these new funds from its commercial creditors. We have, therefore, indicated both to the Government and the commercial banks that much of our support for CY1985-86 would be contingent on timely agreement by the banks to these new monies. Left unsaid, but equally clear, is that without major new money from its commercial creditors, Chile would either suffer from financial chaos or an unsustainable, if initially orderly, deflation. Moreover, the Fund and the Bank, if we increased our non-project support without insisting on prior significant concessions by the banks, would be bailing out the commercial banks from a responsibility they should -- at the least -- share.

6. Until a CPP with a longer-term strategy can be reviewed, we propose the following tactics be adopted to ensure our large lending program provides the leverage needed to assist our client: While continuing to process all loans -- in particular the Industrial Finance Restructuring Project, the Highway sector loan, and SAL (totalling \$520 million) -- we would not go to the Board with them unless satisfactory progress were being made by Chile and the creditors in agreement on a viable financial package, including agreement for significant new funds for at least 1985.

7. The timing of the various processes is as important as loan size. On April 22, we will have a SAL appraisal mission; there has been a "technical meeting" of Chile's bank Steering Committee on April 1-3, and informal meetings of the Government with the banks are now scheduled for the week of April 15. It is expected that the Steering Committee will make its first proposal to the Government only in a more formal meeting after return of the SAL appraisal mission, i.e. in mid-May. Visits by the Chairperson of the Steering Committee to Senior IMF and IBRD staff around end-March have informed us that the Committee presently believes that far less than the \$1 billion in new money can be realistically obtained. Indeed, they have asked us both to increase our financial support to Chile above the ambitious programs already planned. In any event, the period April-June will be crucial to the Steering Committee's deliberations.

8. We propose, therefore, the Bank should both reiterate and clarify our position to the banks. "Progress" is, of course, very difficult to define, but the banks' present unrealistic attitude (informal mention of \$300-500 million has been made) seems to require clear statements from the Fund and Bank that any major commitments on our part depend on the condition that the banks and Chile come to terms. Given the dynamics of the present situation, however, we should continue to process internally all of these loans in a rapid manner, but would approve distribution of Board documents in mid-May only when convinced of the measure of agreement.

9. This strategy means we may risk deferral of the first major Chile loans if we are to have a credible position with the banks. But to continue unconditionally with our lending program, particularly with the two large non-SAL loans now proposed for May and June, if the commercial banks have not agreed to new loans of a significant size, could reduce our leverage in a vital area. It could also lead to the embarrassment -- if the bank agreement is not reached by August and no "bridge" financing is made available -- of approval of \$270 million in loans to Chile only months before a breakdown in negotiations with the commercial banks and possible non-payment of debt service occurs.

10. In consequence, as we indicated in the Covering Memorandum to the Industrial Finance Restructuring Loan Committee package, we plan to link Board distribution of the loan to the status of Chile's negotiations with the banks. The earliest this latter can be clarified would be in mid-May, after the return of the SAL appraisal mission and Chile has received its first offer of new funds from its Steering Committee. To facilitate this approach it would be useful if a Board slot for the Industrial Finance Restructuring Project could be reserved in late June.

Attachment

Cleared with and cc: Messrs. Pfeiffermann, LCNVP; Wessels, Jennings, LCPDR

Cleared in substance and cc with: Mr. Steckhan, LCI (o/r)

cc: Messrs. Knox (o/r); van der Meer, Finzi, LCPDR; Meo, LCI; Schultz, Hinds, LCPI2; Cruikshank, LCIPA; Mrs. Martinez, LCIPA

LEDerbez:ab

LOAN COMMITTEE

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LC/M/85/6

March 20, 1985

Minutes of Loan Committee Meeting to consider
CHILE - Structural Adjustment Loan
held on March 6, 1985 in conference Room E-1208

A. Present**Committee:**

Messrs./ E. Stern (Chairman)
Mmes. M. Qureshi (SPVFI)
S. Husain (OPSVP)
A. D. Knox (LCNVP)
D. Goldberg (LEGVP)
C. Michalopoulos (VPERS)

Others:

Messrs./ H. Kopp (SVPOP)
Mmes. R. Clements (SVPOP)
P. Donovan (SVPOP)
G. Pfeffermann (LCNVP)
R. Steckhan (LCI)
P. Meo (LCI)
S.M.L. van der Meer (LCPDR)
P. Eigen (LCIPA)
E. Cruikshank (LCIPA)
L. Derbez (LCIPA)
N. De Souza (LEGLC)
J. Edelman (CPDDR)

B. Issues

1. The meeting was called to consider issues emerging from an Initiating Memorandum submitted to the Loan Committee under cover of Mr. Knox's memorandum of March 1, 1985, for approval to appraise a proposed USS250 million Structural Adjustment Loan (SAL) for Chile. The following issues were discussed:

- (a) the strength of the Government's commitment to an Economic Adjustment Program and its ability to carry it out given the magnitude of the adjustment problem;

100-100

100-100 page 1

March 20, 1985

- (b) the effectiveness of the Government's approach with respect to export promotion policies;
- (c) the Government's position vis-a-vis the commercial banks, particularly on guaranteeing heretofore unguaranteed private debt, and the Bank's position towards it;
- (d) the consistency between the Government's macroeconomic projections, and the 1985-1987 public finances, public investment and monetary programs; and
- (e) the Government's solution to the domestic banking situation.

C. Discussions

2. Government's Commitment. The Region explained that after initial conversations with Bank staff, the Chilean Government was now fully aware of the magnitude of the economic problems it faces in the form of severe external constraints and cost of the domestic financial disarray. There exists agreement within the Government on the adjustment policies required to create a sustainable export-led economic recovery. The Region also explained that an initial agreement had been reached to have published in the Government's 1985-87 Development Program, those policies agreed under the SAL. In particular, those underlining the Government's commitment to an export-led economic adjustment program. The Region believed the Government has so far demonstrated the will and ability to successfully enforce such an adjustment program. A proof of it was given by the recent 5-point import tariff decrease and 9 percent step-devaluation announced on February 26, 1985.

3. Export Promotion Policies. Three issues were discussed: the adequacy of the exchange rate policy; the tariff regime; and additional export incentives required. With regard to exchange rate policy, the Region indicated that the September 1984 and February 1985 step-devaluations clearly underline the Government's intention to maintain an aggressive exchange rate policy favoring export promotion and efficient import substitution. Nevertheless, as part of the SAL, the Region would also monitor the exchange rate adjustment focussing on the achievement of a predetermined annual noncopper export target and the implementation of a copper stabilization fund. The Chairman requested that Board documents stress the "export incentive structure" rather than the exchange rate. Insofar as the tariff regime was concerned, the Region explained that during appraisal of the SAL a schedule would be specified for the reduction from the current 30 percent import duties rate to 25 percent. Finally, the Region described the additional export promotion measures discussed with the Authorities. It was stated that after the initial SAL conversations, devolution of the 20 percent VAT to exporters had been accelerated. Moreover, further export support measures through PROCHILE -- the Chileans official export promotion agency -- were being analyzed to improve marketing and financing support for medium- and small-sized exporters.

March 20, 1985

4. External Debt Burden. In response to queries, the Region responded that the Chilean Government is aware of the medium- and long-term growth implications of assuming responsibility for the private sector's external debt. During the 1982-83 external debt renegotiations, the Chilean Government had been forced to extend public guarantees for all of the private financial sector's amortization payments falling due in that period as a condition for the provision of new funds. The Government, however, is not willing to continue this policy, and it has indicated to us that it will not guarantee any new or rescheduled private sector debt. A member noted that a firm position by the Government on this issue was essential to achieving a viable financial program. The Chairman asked what would be the Bank's position on this during our upcoming presentation before Chile's commercial creditors Steering Committee on March 13. The Region responded that the Bank agrees with the IMF support of the Government's negotiating position as indicated in the institution's EFF documents. The Chairman agreed with this, but suggested that implications of trade-offs between concessions on additional guarantees or additional new money be considered.

5. Projections. The Chairman asked if the macroeconomic projections that the Government will present to its creditors will match the Bank's projections. The Region indicated that while we are closer now on noncopper exports and the future copper price, our projections remain more pessimistic than recent ones made by the Chilean Central Bank. The Region also indicated that during appraisal of the SAL, estimates close to the Bank's copper price and volume assumptions will be used, forcing the Government to attain an overall consistency between its macroeconomic projections and projections on its monetary and public finance programs. In particular, Chile's three-year Public Investment Program would respond to the economy's main priorities. The Chairman indicated that the SAL should have as a condition a Public Investment Program that avoids investments with low macroeconomic priority such as the proposed Santiago subway extension.

6. Domestic Financial Crisis. Some members expressed concern that Chile's domestic banking crisis may hamper the country's economic recovery. The Region responded that resolution of the banking crisis is essential in order to revive private sector economic activity and in order for the country to achieve significant write-downs from commercial international banks. In this regard, the Region repeated its support for the Government's current negotiation position on its external debt. Another source of concern derives from the unclear bankruptcy status of many banking institutions in Chile. In this regard, the Region indicated that an agreement had been achieved with the Government to end the Central Bank's across-the-board financial relief programs. Together with the newly acquired Government awareness on the cost of the 1983-84 financial relief program -- near US\$5 billion -- the Region expected that a financial program could be devised to slowly bring back financial soundness to Chile's banking system.

D. Decisions

7. The Loan Committee gave initial approval to the proposed US\$250 million SAL for Chile. It was agreed that a Bank appraisal mission would visit Chile in April 1985 to continue preparation of the loan.

Cleared with and cc: Messrs. M. Qureshi, S. Husain, A.D. Knox,
D. Goldberg, C. Michalopoulos, H. Kopp

LEDerbez:ab

OK
9 Oct 8 '85

For approval on
non-objection basis
by October 22, 1985

FROM: The President

Ref.

October 8, 1985

CHILE: B-Loan Cofinancing for the Proposed Road Sector Project *

1. On June 20, 1985, the Executive Directors considered the President's memorandum entitled: Chile: Possible Cofinancing through the B-Loan Program for the Proposed Road Sector Project (R85-184), and agreed in principle to further action being taken as proposed in the memorandum. On June 27, 1985, the Executive Directors were informed of the outcome of negotiations for the Road Sector cofinancing operation in Chile (Sec.M85-771); it was reported there that significant improvements in the terms of the proposed B-Loan had been negotiated and that the final approval for the Bank to sign the B-Loan would be sought when the full text of the cofinancing agreement would be available.

2. I am now pleased to inform you that the negotiations of the cofinancing loan documentation have been completed along the lines approved by you. It reflects changes reported to the Executive Directors on June 27, 1985. It also includes an Indemnity Agreement, according to which the Republic of Chile would reimburse the Bank for any payments made under the guarantee and would fully indemnify the Bank for any other costs which it may incur.

Distribution

Executive Directors and Alternates
Senior Vice Presidents
Senior Management Council
Vice Presidents, IFC
Directors and Department Heads, Bank and IFC

*Questions on this
document may be
referred to
Mr. Eigen (Ext. 75791)
or Mr. Steckhan (in Seoul)

3. Chile has completed its negotiations with the commercial banks for the restructuring of its external debt maturing in 1985-1987 and on commitments on trade credits, as well as for the new money package required for 1985-1986, amounting to a total of US\$1085 million, including the US\$300 million cofinancing facility with a maximum US\$150 million Bank guarantee. The terms and conditions of the proposed cofinancing facility with the commercial banks, the respective Bank guarantee, including the Indemnity Agreement between the Bank and the Republic of Chile are set out in the Annex. I am satisfied that the proposed partial guarantee would comply with the Articles of Agreement of the Bank.

4. The consent required by Article IV, Section 1(b) of the Articles of Agreement of the Bank will be obtained prior to signature of the cofinancing facility.

5. The Republic of Chile and the commercial banks are planning to sign the agreements pertaining to the facilities referred to in para. 3 above on October 30, 1985. In order for the Bank to be able to sign the cofinancing facility on the same date, I recommend that the Executive Directors give the necessary approval for the proposed cofinancing facility and the respective Bank guarantee, as negotiated. If no objection to this recommendation will have been received by close of business on October 22, 1985, the recommendation shall be deemed as having been adopted; and will be recorded in the Minutes of an upcoming meeting of the Executive Directors.

A. W. Clausen
President

by

R. Picciotto

Attachment

CHILE

ROAD SECTOR PROJECT
PROPOSED TERMS FOR A US\$300 MILLION SYNDICATED LOAN
INCLUDING A GUARANTEE OF UP TO US\$150 MILLION
("CHILE B COFINANCING FACILITY")

Borrower: The Republic of Chile.

Lenders: The banks which would be lenders under the US\$785,000,000 new money facility with the Banco Central of Chile (the "New Money Facility"). The Lenders under the New Money Facility shall participate in the Chile B Cofinancing Facility on a pro rata basis. Participation in the New Money Facility shall be a precondition to participation by a Lender in the Chile B Cofinancing Facility.

Beneficiary: Ministry of Public Works.

Principal Amount: US\$300 million. 50% of the total principal amount drawn down, up to US\$150 million, would be guaranteed by IBRD (see World Bank Guarantee Provisions below).

Currency: US Dollars.

Purpose: To finance part of the foreign and local currency expenditures under the 1986-88 Road Investment and Maintenance Program ("Program").

Procurement: Goods and services to be financed out of the proceeds of the loan will be procured under local procedures, which are satisfactory to IBRD with due regard to economy and efficiency.

Drawdown: The borrower will be able to, and will be required to, avail itself of the proceeds of the Chile B Cofinancing Facility according to the following procedure:

(a) the conditions precedent to the initial disbursement under the New Money Facility shall have been fulfilled;

(b) the first disbursement under the Chile B Cofinancing Facility shall take place after the first disbursement under the New Money Facility provided (i) the first tranche of the World Bank Structural Adjustment Loan ("SAL", the availability of which being subject to the approval of the Board of Directors of IBRD) shall have taken place; (ii) the related Road Sector Loan provided by IBRD (the "A-Loan") shall be effective; and, (iii) the Indemnity Agreement between the borrower and IBRD (see below) shall be effective. The initial disbursement under the Chile B Cofinancing Facility would be in the amount of US\$194,000,000;

(c) the second, the third and fourth disbursements under the Chile B Cofinancing Facility shall take place simultaneously with the second, third and fourth disbursements under the New Money Facility, provided that prior to the fourth disbursement under the Chile B Cofinancing Facility, the second tranche under the SAL shall have been disbursed. The aforesaid disbursements shall be made in three equal amounts; and

(d) any commitment not drawn down by December 31, 1987 (the Commitment Termination Date) would be cancelled.

Banco Central de Chile will maintain a Dollar-denominated account into which the loan proceeds will be deposited for use against Program expenditures.

Term: 12 years.

Interest Rate: 2 pricing alternatives, LIBO pricing or higher of Prime/Reference Rate and Adjusted CD Rate pricing; each lender to make a onetime election. LIBO and Prime/Reference Rate to be determined in accordance with procedures prescribed in the New Money Facility:

LIBO Margin - 1-5/8% per annum.

Prime/Reference Rate Margin - 1-1/4% per annum.

Facility Commission: 1/2% of the amount of each Lender's Commitment drawn down in each tranche to be paid ratably to all Lenders on the date of each tranche.

Commitment Commission: 1/2% per annum on the unutilized amount of the Chile B Cofinancing Facility, payable quarterly in arrears, commencing as to the amount available for: the first tranche from the earlier of signing and December 15, 1985; and for the second tranche from February 15, 1986; for the third tranche from May 15, 1986; and for the fourth tranche from August 15, 1986.

Foreign Exchange
Availability:

Banco Central de Chile will agree to provide the foreign exchange availability in the same manner as under the 1984 Restructuring Agreement for the borrower.

Taxes and Other
Deductions:

The loan will be tax exempt. All payments to be made under or in connection with the Chile B Cofinancing Facility would be free and clear of any future taxes, withholdings or other deductions whatsoever.

Repayments:

To be repaid in four semiannual installments, the first of which shall be 10-1/2 years after the date of the Agreement evidencing the Chile B Cofinancing Facility.

Prepayment:

Permitted on a ratable basis with the outstanding loans under (i) the New Money Facility (ii) the IMF Stand-By Facility, extended Fund Facility and Compensatory Financing Facility and (iii) any SAL and the A-Loan. Prepayments on account of the Chile B Cofinancing Facility shall be applied ratably on account of all outstanding installments of principal of the loan.

Documentation:

Syndicated credit provisions substantially the same as those contained in the New Money Facility documentation. Additional provisions designed to reflect IBRD participation in the proposed operation are as follows:

Cross-Default Clause:

- (a) The cross-default to IBRD loans is limited (i) to payment defaults over the equivalent of US\$5,000,000 which shall have continued for not less than 45 consecutive days; or (ii) to acceleration by IBRD under the relevant loan;
- (b) See World Bank Guarantee Provisions below; and
- (c) A payment default under the Chile B Cofinancing Facility, or any other default under such Facility which results in suspension or acceleration of the loan under that Facility, shall constitute an event which would give IBRD the option to suspend disbursements or accelerate maturities under the A-Loan.

Information Sharing: Non-confidential information concerning the project and the borrower, of the type normally exchanged in cofinancing, to be shared by IBRD with the Agent.

Acceleration: This loan can be accelerated at any time if a default occurs. The IBRD guarantee, however, would only be callable under the conditions noted below.

World Bank
Guarantee
Provisions:

Scope: The IBRD guarantee would cover an amount of

US\$150,000,000 of principal or 50% of the total amount drawn down under the Chile B Cofinancing Facility, whichever is lower. The amount of the guarantee will only be reduced by payment by the Bank (e.g., if the borrower pays the first \$75,000,000 installment, the remaining installments will continue to have the benefit of the full guarantee).

Acceleration:

- (a) If payment of the guaranteed portion of the loan shall be accelerated to a date prior to the sixth anniversary date of the execution of the agreement establishing the Chile B Cofinancing Facility, without the consent of IBRD having first been obtained, then the guarantee of IBRD shall terminate.
- (b) If payment of the guaranteed portion of the loan under the Chile B Cofinancing Facility shall be accelerated at any time without also accelerating the outstanding loans, if any, under the New Money Facility, the guarantee of IBRD shall terminate unless (i) IBRD consents to such acceleration or (ii) such acceleration has been declared at the request of, or with the consent of, the holders of 66-2/3% of the outstanding amount of such loan.
- (c) The unguaranteed portion of the loan may be accelerated at any time without affecting the guarantee.

Requisite Authorizations: All requisite authorizations and approvals required to make the guarantee effective will be obtained and shall be in full force and effect before the execution of the agreement establishing the Chile B Cofinancing Facility.

Subrogation and Indemnification: In the event that IBRD is required to pay all or any part of the Chile B Cofinancing Facility loan under the terms of its guarantee, IBRD would become subrogated to the rights of the Lenders against, and would be entitled to seek reimbursement from the borrower. In addition, under an Indemnity Agreement the borrower would undertake an obligation to reimburse IBRD, on demand, or as IBRD may otherwise determine, for any payments made in respect of all actions, proceedings, liabilities, claims, losses, damages, costs and expenses suffered or incurred by the Bank, directly or indirectly in relation to, or arising out of, the IBRD guarantee.

Guarantee Fee: 1-1/8% per annum on the average outstanding amount of the guaranteed portion of the loan for the first six years, and 1-1/4% per annum thereafter, payable in arrears by each Lender.

Option to Release: Provisions expressly enabling the Lenders to release the guarantee would be included.

Amendment: Any amendment to the terms of the agreement with respect to the B Cofinancing Facility would require the consent of the borrower, the Lenders and IBRD.

Governing Law
and Jurisdiction:

The agreement with respect to the Chile B Cofinancing Facility would be governed by New York law and provide for the non-exclusive jurisdiction of the State and Federal courts in New York and the courts in England.

The Indemnity Agreement would follow the legal regimen and include dispute settlement provisions which are customary in agreements between member countries and IBRD.

Assignability:

The Lenders' rights under the Agreement shall be assignable to the same extent as provided in the New Money Facility.

Agent:

The Agent for the Lenders will be Manufacturers Hanover Trust Company.

International Bank for Reconstruction and Development

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APR 30 2021

WBG ARCHIVES

R84-14

January 24, 1984

FROM: The President

CHILE: Second Agricultural Credit Project
(Loan 1902-CH)
Second Amendment to the Loan Agreement *

1. This loan of US\$36.0 million to Chile was approved on September 9, 1980, and became effective on January 30, 1981. It was subsequently amended on April 29, 1983 by Board approval on a "no-objection" basis to include: (i) extension services for the benefit of small farmers; and (ii) use of about US\$3 million from the loan for incremental short-term credit, to supplement longer-term investment credits provided under the project. Without increasing the loan amount, it also raised the Bank's cost sharing for the project from 40 percent to 48 percent (raising the Bank's disbursement rate for subloans from 50 percent to 60 percent) to compensate for increased foreign exchange costs resulting from exchange rate movements in Chile. This memorandum, in response to worsened economic conditions in Chile, recommends a further modification that would: (i) permit the National Agricultural Development Institute (INDAP) and other participating financial institutions to use up to US\$12 million from the loan for short-term credit for farmers without requiring that they also have ongoing or new long-term subloans under the project; and (ii) permit reallocation of US\$1.0 million from the disbursement category for subloans to medium-scale farmers and agroindustries to a new category for the purchase of computer hardware and software to be used for electronic data processing (EDP) within INDAP. No change in the loan amount is proposed.

PART I - HISTORICAL BACKGROUND

2. The project's main objectives were to increase agricultural output in Chile and to help its small agricultural producers increase their earnings, improve their standard of living, and develop into commercially viable farmers and ranchers. It was estimated that about 40 percent of the increased output generated by the project upon completion would be exported.

3. To support project objectives, the loan was originally structured to finance investment credits to: (i) about 2,570 small farmers and ranchers owning less than the equivalent of 12 hectares of irrigated land; (ii) about 750 farmers with holdings larger than the 12 irrigated hectares equivalent; and (iii) about 90 agroindustries.

*Questions on this document may be referred to Mr. Cruikshank (ext. 72710).

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4. The Central Bank, acting on behalf of the Borrower, rediscounts subloans made to the three above-mentioned categories of beneficiaries by financial institutions participating in the credit operation. The latter consist of several commercial banks and INDAP. Subloans have terms up to 12 years with up to four years grace. The outstanding principal on all subloans is indexed in accordance with the CPI. Interest is positive in real terms with nine percent charged to small farmers and 11 percent charged to other farmers and agroindustries on outstanding loan amounts adjusted for inflation. One-third of project funds (US\$24 million) has been earmarked for lending to small farmers.

5. The loan became effective in early 1981 and a total of US\$12 million was disbursed, principally to small farmers, in 1981 and 1982. In 1983, disbursements were very slow with only US\$2.8 million having been drawn down during the year. At that rate, it would take three more years to fully utilize the US\$20.0 million undisbursed balance of the loan. The problem is that Chile has been going through a severe economic depression; GDP declined 14 percent in 1982, and a further decline of 2.5 percent occurred in 1983. The banking system is near insolvency; many private firms are bankrupt or close to bankruptcy; and unemployment stands at 18 percent. As a result, demand for medium- and long-term investment in all sectors, including agriculture, has fallen.

6. In response to the lagging disbursement rate, in April 1983, an amendment to the Loan Agreement was introduced which included: (i) a technical assistance component primarily to provide extension services to small farmers (\$4 million was financed -- \$2 million was reallocated from the commercial farmer/agroindustry credit component of the Bank loan and \$2 million was furnished by the Central Bank); and (ii) incremental short-term credit, accounting for about \$3 million of the loan's proceeds, to supplement longer-term investment credits provided under the project. Without increasing the loan amount, it also raised the Bank's cost sharing for the project from 40 percent to 48 percent (raising the Bank's disbursement rate for sub-loans from 50 to 60 percent) to compensate for increased foreign exchange costs resulting from exchange rate movements in Chile.

7. A recent Bank mission found that the increase in disbursements which was expected to result from these amendments had not materialized, primarily owing to the requirement that short-term credit be provided only in conjunction with ongoing or new long-term subloans. The reality is that in the present period of economic uncertainty there is little demand for long-term investment credits. Most farmers are already heavily indebted. They do not expect their future earnings to be sufficiently high to warrant incurring additional medium-to-longer-term debt that is fully indexed to inflation with high real interest charges. Rather, most of Chile's farmers now need short-term production credits to improve their farming systems and management to maintain production levels. In the absence of such credits being available, agricultural production can be expected to contract with serious disinvestment in the sector.

8. INDAP, the institution providing most short-term credit for small farmers (and 85 percent of financing under the project to date), forecasts a US\$14 million financing gap (1984 new lending less 1983 lending recoveries) for 1984. The commercial banks are also encountering demand for short-term funds in excess of their present low levels of liquidity.

PART II - PROPOSED REVISION OF THE PROJECT

Short-Term Credit

9. The proposed amendment would permit INDAP and other participating financial institutions to extend short-term credit to farmers without requiring that sub-borrowers have ongoing or new long-term subloans under the project. Existing restrictions on individual subloan ceilings would still apply, as would the present Bank disbursement percentage of 60 percent of each subloan. Out of the remaining undisbursed loan amount of about US\$20 million, a total of US\$12 million would be made available for short-term credit financing. Of this amount, US\$9.6 million (80 percent) would be reserved for small farmers served by INDAP. Funds would be used to finance production inputs justified on the basis of analysis of individual farm operations and would not be used for purposes of refinancing existing debts. Farmers receiving such credit would have to meet all of the lending institutions' existing criteria for creditworthiness. Provisions would be made for funds recuperated in subsequent years to be applied for productive investment purposes in agriculture by participating financial institutions. Both the application of lending criteria by participating financial institutions and the use of recuperated short-term funds would be carefully supervised with reviews being made at least twice a year.

Computerization of INDAP's Accounts

10. The April amendment provided for about 35 staff-years of consultants' services for INDAP to: (i) strengthen its internal administration and carry out its training effort; and (ii) help design, supervise and execute its extension program. The Central Bank and INDAP were required to execute a new agreement, satisfactory to the Bank, as a condition of disbursement under the new project component pertaining to extension services. This was done. INDAP's target for the crop year 1983/84 was to provide extension services to about 14,000 small farmers. This target has been essentially met and a recent Bank supervision mission found the quality of the assistance to be highly satisfactory.

11. INDAP is making a commendable effort to improve the efficiency of its operations. Part of this effort has involved studies and plans to computerize its accounts. Currently INDAP staff have to process manually the information obtained from visits to farms involving more than 50,000 farm registers annually. This information must be collected and processed at INDAP's regional offices and sent back to the central office.

12. The proposed modification to computerize INDAP's accounts, under a program satisfactory to the Bank, would be made possible through reallocation of US\$1.0 million from the disbursement category for subloans to medium-scale farmers and agroindustries to a new category for the purchase of EDP hardware and some software. This modification would greatly enhance the effectiveness of INDAP's technical assistance monitoring and portfolio management.

13. The proposed amendments in the project are fully justified. They are responses to a set of special and demanding circumstances prevailing in the sector and the country. They would provide a means for beneficiaries to continue their present operations during the current period of economic difficulty. Moreover, they would permit INDAP to improve materially its capability to assist small farmers in attaining the project's objectives. The amendments would not change the original objectives of the project and Bank financing would continue to be in the amount of the estimated foreign exchange costs of the project. They would also result in a faster disbursement of the loan, with loan closing forecast for June 1985.

Recommendation

14. I recommend that the Executive Directors agree to the proposed amendments to the project. In the absence of objection (which should be notified to the Vice-President and Secretary or Deputy Secretary by the close of business on February 6, 1984), amendments to the loan documents to reflect the adjustments as described above will be executed.

A.W. Clausen
by
Ernest Stern

OFFICE MEMORANDUM

DATE: December 27, 1984

TO: Mr. Ernest Stern

FROM: Rainer B. Steckhan, Acting RVP

SUBJECT: CHILE: Government's Request for SAL Assistance

EXTENSION: 74621

DECLASSIFIED

CONFIDENTIAL

APR 30 2021

WBG ARCHIVES

R. Steckhan

Thank you. Let's be sure our mission goes at the same time as the IMF's; that the initiating memo gets done before the Steering Group meeting; and that we and the Fund have a common strategy for necessary actions in 1985 and in 1986-87.

es
12/31

1. We would like to bring you up-to-date on the proposed Chile SAL. A long-scheduled mission headed by Luis Ernesto Derbez (Country Economist) visited Chile from November 18 to December 8, to review the Government's Public Investment Program. Paul Meo joined Mr. Derbez November 19-21 to initiate conversations with the Chilean Authorities on a possible SAL, and Peter Eigen attended the mission's final discussions with the Chilean Ministers of Economy and Finance. A summary of the conversations, as well as of the Chilean measures already announced as part of the Government's adjustment program is presented below.

Structural Adjustment Loan

2. Bank's Position: Our staff stressed that Bank support would only be possible if the Government presented a coherent program of economic measures dealing with the domestic financial crisis, stimulating export growth and diversification and providing a reasonable short-term reactivation led by the public sector. The Authorities found the Bank's position a very positive one. Mr. Collados, Minister of Economy, requested a short Aide Memoire (attached) from the staff, where substantive points of a first SAL would be briefly described, stating that he would use it to discuss the Bank's position with President Pinochet. On December 7, both Ministers Escobar and Collados expressed to Mr. Eigen the President's agreement to start a formal exploration of a SAL; Mr. Escobar put this request in writing. Unfortunately, Mr. Collados announced the proposed loan to the press, which quoted a misleading loan amount (\$600 million). Mr. Eigen subsequently corrected this sum in a statement to the press.

The Government's Program

3. Trade Related Policies: During our conversations we expressed our concern at last September's increase in import tariffs, from 20 to 35 percent, which had created expectations that further raises and exceptions would soon be announced. We found some disagreement on this issue between the Ministries of Finance and Economy, with the Minister of Economy fully accepting our arguments. A subsequent IMF mission supported our tariff views and encouraged action. This joint representation had good effect: on December 17, a tariff reduction schedule was officially announced by both Ministers in a joint statement. An initial 5 percentage point reduction (from 35 to 30 percent) will occur on July 1, 1985; a second 5 percentage point reduction on January 1, 1986.

4. Domestic Debt Policies: Our concern derives from the apparent open-ended nature of the Government's 1983-84 domestic debt relief programs. A recent ruling from the Superintendency of Banks may have terminated this. Presently, debtors of more than US\$3 million equivalent can only have access to rescheduling after proving (to the Superintendency's

satisfaction) their operational viability. Nevertheless, this area remains in dire need of an adequate set of measures to recapitalize or sell insolvent banks and firms. If the Government is to encourage more Chilean firms and banks to enter bankruptcy, foreign, as well as domestic, creditors will be asked to write-down or transform their loans into equity. These, however, are the same creditors the Government may be asking to increase their exposure. The situation promises to be difficult and delicate; for the Government, for the IMF, and for the Bank. The Chile bank Steering Group Chairman has hinted the banks might agree to write-down the debt owed by the private corporate sector, but would strongly resist writing down debt owed by private, but now intervened, banks.

5. Public Investment Program: The public investment mission was well received and information on public investment projects, programs and plans was made readily available. Preliminary conclusions of the mission indicate that with few exceptions (a new subway line for Santiago, a small port for Easter Island and the Pinochet-Austral Highway) the program is sound and well oriented. Most investments will produce productive employment, export earnings and encourage a reactivation of the private sector.

6. Our major concern lies on the recurrent expenditure side. Major commitments on social expenditures could cause a nonfinanciable public deficit unless their growth is limited. The Director of the Budget shares our concern and is highly supportive of any Bank effort to produce coherent medium-term budget projections combining investment and current expenditure outlays required for different growth scenarios.

Other Issues

7. We requested the Authorities form a unit to prepare the Government's proposed adjustment program and to follow through on the analysis and implementation of it.

8. The recent IMF Stand-by negotiating mission did not reach agreement and will likely return in mid-January for further negotiations. We are programming a SAL preparation mission to visit Santiago at about the same time. Likely prospects are for agreement with the IMF before February and a possible Steering Group meeting of Chile's commercial creditors by late February or early March. We hope to have a draft Initiating Memorandum by late February.

Attachment

Cleared with and cc: Messrs. Meo, LC1; Eigen, LC1PA

cc: Messrs. Knox (o/r); Pfeiffermann, LCNVP; Bock, FPADR

LEDerbez:ab

CHILE

AIDE MEMOIRE

(Unofficial Translation)

An IBRD mission comprised of Messrs. Paul Meo and Luis Ernesto Derbez explored with the Chilean Economic Authorities the possibility of initiating a medium-term adjustment program supported by a Bank loan. The mission hereby requests of the Government that, after evaluating the costs and benefits of such an approach, the Government indicate its decision on the development of the aforesaid program/loan.

In the coming years, Chile will need to follow an economic program that increases its foreign exchange earnings and domestic savings to support an adequate economic growth and resolve its balance-of-payments problems. Chile's current economic problems are no longer of a transitory nature; therefore, it must define a program with well-targeted economic policies that will take the country to its chosen goals. Such a program would complement any IMF support that the Chilean Government could obtain.

At the request of Chile's Economic Authorities, the mission provides below a brief description of the main areas and economic measures that would be touched on in any initial Structural Adjustment Loan. It is understood that much more work would be needed before both parties could define the specific details of such a program.

Investment, Domestic Savings and Financial Policies

Credibility in Chile's financial institutions must be restored. The banking system needs to be recapitalized, and general across-the-board debt renegotiations need to be transformed into sound financial programs directed to support operationally-viable firms. At the same time, a realistic exchange rate policy and positive real interest rates should continue. These policies, however, will not suffice to increase domestic savings. Fiscal and monetary policies that stimulate reinvestment of profits and a regulatory framework to avoid financial/economic concentration must be put in place to further stimulate savings and investment.

Export Policies

Commercial policies that guarantee the competitiveness of noncopper exports are essential to generate productive employment. The exchange rate must be realistically maintained to accelerate the growth of such exports. In the short term, nontraditional exports will be agriculturally-based, with little import content; thus, exchange policy must be complemented by a low and uniform tariff system to stimulate investment in such activities. Additional measures such as institutional incentives (e.g., credit, marketing, etc.) to stimulate exports by medium-size producers should also be instituted to increase the labor content of Chile's exports.

Public Investment and Expenditure

Chile's private sector is currently in a depressed condition. A short-term economic reactivation depends, therefore, on a well-defined public expenditure and investment program. The public sector should therefore use its resources in ways that generate increased national savings, stimulate export growth and improve the conditions for private sector reactivation. This requires a program of public expenditures and investment which maximizes productive employment and exports by public enterprises as well as a recovery of aggregate demand and national savings.

Some other sectoral adjustments will be useful, although they may not have the same macroeconomic impact. The World Bank proposes to analyze them in an effort to assist the Government in the creation of as many productive jobs as possible within the next few years. In this regard, the technical assistance loan under Bank preparation will be useful for studies that would explore practical actions that would continue the impact of its program and could be supported by the Bank with other, future loans.

Mr. Derbez, who will stay another two weeks in Chile, will remain at the disposition of the Authorities to receive their answer once a decision has been made.

ROUTING SLIP		DATE: September 10, 1984	
NAME		ROOM NO.	
Mr. Stern			
ing file			
APPROPRIATE DISPOSITION		NOTE AND RETURN	
APPROVAL		NOTE AND SEND ON	
CLEARANCE		PER OUR CONVERSATION	
COMMENT		PER YOUR REQUEST	
FOR ACTION		PREPARE REPLY	
<input checked="" type="checkbox"/> INFORMATION		RECOMMENDATION	
INITIAL		SIGNATURE	
NOTE AND FILE		URGENT	
REMARKS: Re: CHILE - Proposed Small and Medium Industry Project			
Attached for your information is a copy of a telex sent to Finance Minister Escobar in response to his letter to Mr. Clausen of August 9, 1984, which we received August 28.			
FROM: Peter Eigen		ROOM NO.: A 912	EXTENSION: 75791

WORLD BANK OUTGOING MESSAGE FORM Cable, Telex
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HERE

BOOK OF FIVE

1. SR. LUIS ESCOBAR CERDA
MINISTRO DE HACIENDA
MINISTERIO DE HACIENDA
TEATINOS 120
SANTIAGO, CHILE
2. SR. MODESTO COLLADOS NUNEZ
MINISTRO DE ECONOMIA
MINISTERIO DE ECONOMIA
TEATINOS 120
SANTIAGO, CHILE
3. SR. JORGE OBRECHT ADRIASOLA
ASESORIA ECONOMICA
MINISTERIO DE ECONOMIA
TEATINOS 120
SANTIAGO, CHILE
4. SR. JOSE CARBALLAL PARODI
GERENTE GENERAL
SERVICIO DE COOPERACION TECNICA
MINISTERIO DE ECONOMIA
TEATINOS 120
SANTIAGO, CHILE
5. SR. LUIS ARTURO FUENZALIDA
DIRECTOR DE PRESUPUESTO
MINISTERIO DE HACIENDA
TEATINOS 120
SANTIAGO, CHILE

PLEASE START CABLES 2 THROUGH 5 WITH FOLLOWING:

HOY DIA ENVIAMOS SIGUIENTE CABLE A MINISTRO ESCOBAR CERDA
COMILLAS FIN DE COMILLAS ATENTAMENTE, PETER EIGEN, JEFE
DE DIVISION, DEPARTAMENTO DE PROGRAMAS, OFICINA REGIONAL, AMERICA
LATINA Y EL CARIBE, INTBAFRAD

END
OF
TEXT

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INFORMATION BELOW NOT TO BE TRANSMITTED

CLASS OF SERVICE:	CABLE	TELEX NO.:	SEE ADDRESSES	DATE:	9/7/84
SUBJECT:	CHILE INDUSTRY PROJECT		DRAFTED BY:	EDCRUIKSHANK:AB	
CLEARANCES AND COPY DISTRIBUTION:			EXTENSION:		
CLEARED W/CC: MR. SCHULTZ, LCPI2			72710		
CC: MESSRS. CLAUSEN, STERN			AUTHORIZED BY (Name and Signature):		
STECKHAN, LC1; DERBEZ, LC1PA;			A. DAVID KNOX		
EIGEN, LC1PA; HUGHES, LCPI2			DEPARTMENT:		
			LC1		
SECTION BELOW FOR USE OF CABLE SECTION					
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DE ACUERDO A LA SOLICITUD CURSADA POR USTED ANTE EL SENOR
CLAUSEN, Y TRAS EXAMINAR DE MANERA CUIDADOSA LA FORMA MAS
CONCRETA Y RAPIDA EN QUE PODEMOS RESPONDER A SU PETICION PARA EL
ENVIO DE UNA MISION PRE-EVALUACION DEL BANCO MUNDIAL QUE ESTUDIE
LOS PROGRAMAS DE APOYO A LA MEDIANA Y PEQUENA EMPRESA DE VUESTRO
PAIS, TENGO EL AGRADO DE INFORMARLE QUE EL BANCO MUNDIAL ENVIARA
UNA MISION A CHILE EN LA SEMANA DE SETIEMBRE 17 CON EL
PROPOSITO DE REALIZAR ESTE TRABAJO. LE SALUDO CORDIALMENTE, A.
DAVID KNOX, VICEPRESIDENTE REGIONAL, AMERICA LATINA Y EL CARIBE,
INTBAFRAD

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OF
TEXT

PINK AREA TO BE LEFT BLANK AT ALL TIMES

INFORMATION BELOW NOT TO BE TRANSMITTED

CLASS OF SERVICE: CABLE		TELEX NO.: SEE ADDRESSES	DATE: 9/7/84
SUBJECT: CHILE INDUSTRY PROJECT		DRAFTED BY: EDCRUIKSHANK:AB	EXTENSION: 72710
CLEARANCES AND COPY DISTRIBUTION: CLEARED W/CC: MR. SCHULTZ, LCPI2 CC: MESSRS. CLAUSEN, STERN STECKHAN, LC1; DERBEZ, LC1PA; HUGHES, LCPI2; EIGEN, LC1PA		AUTHORIZED BY (Name and Signature): A. DAVID KNOX	
		DEPARTMENT: LC1	
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TRANSLATION OF TELEX SENT MINISTER ESCOBAR CERDA, CHILE

PURSUANT TO YOUR LETTER TO MR. CLAUSEN AND AFTER CONSIDERING THE
MOST CONCRETE AND PROMPT RESPONSE TO YOUR REQUEST OF A PRE-
EVALUATION MISSION FROM THE WORLD BANK TO STUDY SUPPORT PROGRAMS TO
THE MEDIUM AND SMALL ENTERPRISES, I AM PLEASED TO INFORM YOU THAT
WE WILL SEND A MISSION TO CHILE THE WEEK OF SEPTEMBER 17. REGARDS
A.DAVID KNOX, REGIONAL VICE PRESIDENT. LATIN AMERICA AND THE
CARIBBEAN. INTBAFRAD

Sept.7,1984

SUMMARY TRANSLATION OF LETTER TO
MR. CLAUSEN BY MINISTER ESCOBAR CERDA, CHILE

DATED AUGUST 9, 1984

The Economic team submitted Triennial Program (1984-1986) to President of the Republic. This Program covers all productive national sectors.

The Triennial Program awards priority to the industrial sector and to development of medium and small enterprises. In this context, Minister Escobar Cerda requests to the World Bank, prior to submitting a request for financial assistance, that a pre-evaluation mission from the Bank be sent to Chile to study Programs of Support to Medium and Small Enterprises, which are part of the Triennial Program.

(signed) Luis Escobar Cerda
Minister of Finance
Governor for Chile to the World
Bank

Nº 1181 / 1083

Santiago, - 9 AGO. 1984

Ref.: Solicita misión de pre-evaluación.

Señor
W.A. Clausen
Banco Internacional de
Reconstrucción y Fomento (BIRF)
Washington D.C. 20433
U.S.A.

Señor Presidente:

Como una consecuencia de los esfuerzos que se realizan para la reactivación económica del país, las autoridades económicas han entregado recientemente al Presidente de la República, los documentos que contienen el Programa Trienal 1984-1986, el cual es fundamentalmente de carácter indicativo y su formulación comprende a todos los sectores nacionales de producción.

De acuerdo a dicho Programa, se espera una importante contribución del sector industrial al proceso de crecimiento económico que se postula para el trienio. Para lograr ese aporte el Programa Trienal contempla -entre otras- políticas de desarrollo de los subsectores de la mediana y pequeña industria nacional.

La atención prioritaria que se desea dar a las pequeñas y medianas empresas industriales del país, demanda un apoyo financiero que es difícil satisfacer mediante recursos obtenibles únicamente de fuentes internas de ahorro. La circunstancia indicada anteriormente, motiva al Ministro infrascrito a solicitar de Ud., como paso previo a una probable solicitud de asistencia financiera, el envío de una misión de pre-evaluación de ese Banco que estudie los Programas de Apoyo a la Mediana y Pequeña Empresas, que forman parte del Programa Trienal ya mencionado.

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De prosperar la presente solicitud, los especialistas que conformen el grupo en misión deberán contactarse con la contraparte nacional, cuya representación compete a funcionarios de la Secretaría y Administración General del Ministerio de Economía, Fomento y Reconstrucción, que por determinación del Presidente de la República están encargados de todos los aspectos normativos relacionados con el subsector de medianas y pequeñas empresas industriales.

El suscrito agradece desde ya su atención a la presente solicitud y aprovecha la oportunidad para expresarle sus sentimientos de la más alta consideración y estima.



Luis Escobar Cerda
Ministro de Hacienda
Gobernador por Chile ante el Banco
Internacional de Reconstrucción y Fomento





Mr. Stern

I think this is important enough to be discussed in a meeting with the Regs., OPS, Industry and Legal.

I do not quite understand the mechanism that is proposed. Do they want to provide at once the whole FE proceeds to the pool. for sale so that pesos can be generated (para. 11)? They say that a regular AFC loan would disturb too slowly to generate those pesos.

Who would receive the pesos and how to buy bankrupt firms?

Do we really want to get in the middle of a most sensitive political / special interest group issue? I have my doubts.

→ E. ~~W. N.~~ 9/23

E 1227

LAC ROUTING SLIP FOR DOCUMENTS TO RVP AND DIRECTORS		DATE: September 20, 1983			
DOCUMENTS ROUTED TO	ROOM	ACTION/ APPR.	COMM.	INFO.	
1. Mr. N. Ardito Barletta					
2. Mr. E. Stern					
3.					
4.					
CC:					
SECTIONS FOR SPECIAL ATTENTION		PRIORITY			
Director _____ <input type="checkbox"/> RVP _____ <input type="checkbox"/> (Mark <input type="checkbox"/> if whole document is to be reviewed)		Immediate Attention <input checked="" type="checkbox"/> Early Attention <input type="checkbox"/> Regular Handling <input type="checkbox"/> Deadline (if any) _____			
SUBJECT/REMARKS: <u>CHILE: Proposed Industrial Finance Restructuring Loan</u> Attached please find a memorandum on the above loan. We would like to have a reaction in time for the Annual Meetings.					
FROM: RBS Rainer B. Steckhan	DEPT./DIV.: LACI	ROOM NO.: B905	EXTENSION: 74621		

OFFICE MEMORANDUM

DATE: September 20, 1983

TO: Mr. Ernest Stern
(through Mr. Nicolas Ardito Barletta)

FROM: Rainer Steckhan, Director, LAC I

EXTENSION: 74621

SUBJECT: CHILE - Proposed Industrial Finance Restructuring Loan

1. ... Stern decided
that we should not be
involved in this project.

2. Mr. Steckhan informed

3. ~~RC~~
JP

4. File

EK 9123

1. During a visit to Washington in May, Finance Minister Carlos Caceres requested Bank assistance in helping Chile restructure its insolvent financial sector. A Programs/Projects mission was sent to Chile in July to further these discussions. After a quick review of the problem and a very frank interchange of ideas and approaches, the Minister and the mission agreed that any Bank approach to help restructure the finances of the private sector should: (a) be selective as to choice of firms assisted; extending assistance only to individual enterprises that can demonstrate potential viability (this is in contrast to the Government's recent program of unconditional debt rescheduling); (b) particularly emphasize sectors involved in the production of tradeable goods (agriculture, industry, and mining); and (c) provide financing for the transfer among private individuals and entities of productive assets now idle or underutilized because of illiquidity or insolvency. The mission promised to explore, upon its return, the extent to which Bank assistance could be provided to meet this request. It was agreed with the Chileans that the Bank would give an indication of its position regarding assistance along these lines at the Bank/Fund Annual Meetings.

2. To obtain your guidance, a brief statement of the background, the issues, and our proposal is provided for your consideration.

Background

3. Financial insolvency among Chile's private banks and corporations has reached epidemic proportions. Many banks, thought to have portfolio arrears of 3-5 percent, were more recently discovered to be up to 60 percent in arrears. Contrary to the earlier assertions made by the banks that their portfolios were fairly sound, we now know that by late 1982 more than half of the private banks' assets were in either bad or problem loans. To prevent widespread catastrophe, the Central Bank is bailing out (at least temporarily) the banking system. Several banks have been liquidated and many intervened.

4. Less than 60 percent of bank assets are generating revenues. The number of bad loans in domestic bank portfolios and the aversion by foreign banks to increase their country exposure, are inducing Chile's banks to keep interest rates high on new loans, partly to compensate for the bad part of their portfolios. This compensatory pricing behavior is further motivated by their onerous burden of foreign interest obligations. The total foreign debt of domestic banks is in excess of \$6 billion.

5. Higher interest costs, combined with the absence of conditions that will permit liquidation of insolvent firms (tight credit and lack of investor confidence make it virtually impossible to find buyers for liquidated assets), give rise to a self-perpetuating need for "distress" financing. The Authorities have greatly reduced interlocking ownership among banks and corporations that partly

led to the original problem, but the desperate condition of many firms and banks has probably contributed to the continued demand for (and approval of) loans at 20 percent and higher real rates of interest.

6. Chile's macroeconomic policies are greatly improved. Its exchange rate is attractive for exporters; the infamous "groups" are being broken up; and Chile has been able to comply with its IMF standby. This last achievement required considerable effort, since new tax and credit constraints had to be applied to both comply with mid-year IMF targets and provide the banking system with liquidity. Chile's determined actions to confront its crisis have made it eligible for the Special Action Program. Open unemployment and real interest rates dropped slightly recently, but both are still extremely high. Nevertheless, the Government is concerned -- as are we -- that until the bank/corporate insolvency problem is resolved, Chile's recovery will be extremely slow.

Issues

7. The following are the main issues we believe the Government must address in dealing with the current internal financial problems of the country:

- (1) The expansion of established business groups and the emergence of new ones during 1975-81 vastly increased the economic power of relatively few private interests. The Government has acted to reorganize the two largest interests (Cruzat-Larrain, which agreed to reorganization, and Vial, which did not and hence is tied up in litigation proceedings). The question remains as to how much more reduction of economic concentration is necessary in order to encourage effective competition and how excessive economic concentration can be avoided in the future.
- (2) What should be the principles for providing financial relief; specifically, how much relief and to whom. On the one hand, there is dire need for economic recovery; on the other, excessive or unconditional relief could completely subvert the discipline of the market by providing absolution of responsibility for private sector risk-taking. Compounding this problem is the acute sensitivity, shared by many Chileans including Government officials, regarding absolution of some stockholders viewed most responsible for the current financial problems -- the large business groups.
- (3) The treatment of external debt obligations of the private corporate sector (the Government has already guaranteed the debt of the public sector and -- temporarily -- the banking sector). Many of the same concerns and caveats apply in this case as in the case of domestic stockholders -- some foreign lenders were imprudent, and none of the private debt was guaranteed. The Government is obviously not eager to assume this private debt service. A private debt moratorium, however, would adversely affect Chile's creditworthiness and prospects for external capital flows.
- (4) The issue of who should pay for the financial adjustment is an important one. To some extent the amount and incidence of burden are interrelated. Options include creditors either writing-off

or discounting some portion of their loans; bank depositors realizing losses; taxpayers providing resources for financial relief; or Government diluting the real value of deposits and loans through hyperinflation.

- (5) For financial relief to the private sector to work, real interest rates must be brought down. Otherwise, high financial costs will impede the process of financial (and economic) repair. Given the high foreign interest obligations of the Chilean private sector, reducing real interest rates will be a relatively slow process.

Proposed Lending Approach

8. Areas in which action is needed for financial restructuring to succeed include:

- (1) Commercial banks need to be recapitalized and put back in a sound financial position; this may involve a combination of taking appropriate loan losses, some dilution of previous shareholder equity and infusions of new equity;
- (2) To keep the banks on a sound footing they need to be able to invoke bankruptcy proceedings; this would not only involve improvement in the legal and administrative procedures for dissolution and liquidation of unviable borrowing companies, but the presence of buyers for the liquidated assets;
- (3) Bankers' decisions need to be freed of the undue influence that owner/clients had placed on them in the past. Thus ownership linkages of a controlling nature between banks and corporations need to be severed; and
- (4) Monetary policies must be brought in line with other policy measures to get real interest rates down sufficiently to permit sustained financial recovery but without producing perverse effects.

9. The Government is fully aware of these issues. It has convoked a special commission to review antitrust and banking legislation to ensure excessive concentration does not recur. It has dissolved two of the largest groups and intervened most private banks. It has undertaken -- at great cost -- to provide liquidity to the banking system. It is now studying the formidable problem of recapitalizing the bankrupt banking system in the middle of a depression with very limited access to external funds. Finally, the Government is fully aware that politically it cannot permit high real interest rates to continue.

10. Our mission was impressed with the actions taken and under consideration by the Authorities. But we cautioned them that the magnitude of the problem, the small financial contribution of any potential Bank loan (the cash needs of only the current, inadequate liquidity programs for banks in 1984 exceed US\$650 million), and the sensitive political decisions to be made on who benefits and who pays for liquidity and/or recapitalization programs together would prevent the Bank from becoming closely associated with a program-type loan linked to the total effort of the Government.

11. Nevertheless, we have agreed with the Government that if they continue to address the issues above, we would consider a sector loan that could provide assistance to the agriculture, mining and industrial sectors. The loan would generate pesos from the sale of foreign exchange proceeds to enterprises in these sectors for the purchase of mostly intermediate and some capital imports. The pesos would then be used to finance acceptable Financial Restructuring Plans of enterprises in those same sectors. Ironically, Chile needs the local currency financing that our lending could generate and our institutional help more than our foreign exchange (a more traditional IDB industrial development loan is disbursing slowly because the demand for imported capital goods is low). The assistance would be provided through a program whereby peso financing generated would be applied to case-by-case financial restructuring of productive enterprises within a global restructuring framework that was satisfactory to the Bank.

12. We believe Bank assistance along the lines described would help Chile address its most acute economic problem. First, we would salvage existing operations that are potentially viable. Second, our financing would encourage a more rapid recourse to bankruptcy by insolvent firms, since we would be providing credit for purchasing their assets. Third, the recovery of some firms and liquidation of the worst would speed up the adjustment process and tend to lower interest rates by ending distress financing. Finally, the entrance of IMF, IBRD, and IFC into the restructuring process (the IMF has encouraged us in our proposal and will be needed to assist in reviewing the total financial program; IFC has also been assisting us) may reduce the present uncertainty in Chile's financial sector.

13. We recognize the risks involved, and would therefore require appropriate safeguards. We would ensure that the criteria for financing eligibility (i.e., the demonstration of potential viability) are well developed and appropriately applied. Furthermore, mechanisms for monitoring performance and enforcing sound management practices in restructured firms would need to be applied. Macroeconomic policies (particularly monetary policy) will be so vital to the success of an internal financial restructuring that we would ensure that the Bank, the IMF, and the Authorities were in agreement on key financial policies and legislative changes to avoid reconcentration of asset ownership. Thus conditionality would be required not only on the efficiency of each financial restructuring but also on the overall framework of financial policies and legislative and institutional changes.

14. We would like your reaction, however, on two matters. First, given the history of Bank/Chile relations, would a sector loan in this area be appropriate at this time? Second, Finance Minister Caceres and our mission agreed that what needs to be explored is if the bulk of the pesos generated by the Bank loan could be channeled into long-term loans for viable (or restructured) agricultural, industrial, or mining firms whose Financial Restructuring Plans could include the purchase of inventories or fixed assets already owned by insolvent enterprises in Chile. Such an operation, if successful, would permit firms producing tradeables to expand while encouraging a more rapid bankruptcy process and speeding the ultimate domestic financial adjustment. While the foreign exchange of our loan would be used for imports by firms in the three key sectors, the development and financing of Financial Restructuring Plans with local funds would be unique. Thus we would like to have your reaction before proceeding further and in time for the Annual Meetings, if this is feasible despite your heavy schedule.

Cleared with and cc: Messrs. Eigen, LC1D; Meo, LAC I; Challa/Hinds, LCP
cc: Messrs. Pfeiffermann, LCNVP; van der Meer, LCP; Glaessner, LCP; Dewey, IND;
de Azcarate, CPD
EDCruikshank:ab

July 21, 1983

Mr. Stern

Ernie,

If you find this type of one page Executive Summary on key countries useful, we will provide this at irregular intervals to keep top managers briefed.

Rainer
Rainer B. Steckhan

Attachment

Rainer -

Thanks. This is a useful summary. At the risk of adding two lines, & not identifying two to cut, I think an identification of the principal policy issues we'll focus on would be useful too.

(9)

7/23/83

OFFICE MEMORANDUM

DATE: July 21, 1983

CONFIDENTIAL

DECLASSIFIED

APR 30 2021

WBG ARCHIVES

TO: Mr. Ernest Stern

(through Mr. Enrique Lerday, Acting Regional Vice President, LAC)

FROM: Rainer Steckhan, Director, LAC I *Steckhan*SUBJECT: CHILE: An Executive Summary (Based on July 6-16 Mission)Political Situation

1. Chile's depression and the Government policies that exacerbated it have greatly weakened the Pinochet regime; only the Army remains a strong supporter. The Christian Democrat and some Conservative/Center parties have joined in monthly street demonstrations to encourage Pinochet to resign. The July 12 demonstration was preceded by the arrest of Gabriel Valdes, the top Christian Democrat leader, but an emergency curfew avoided large riots; while the Government rode out this challenge, if the economic situation continues to deteriorate, civilian (and, possibly, military) opposition will likely strengthen.

Economic Situation

2. Real GDP fell 14% in 1982, and is unlikely to grow in 1983. Open unemployment stands at 19.5%, but this excludes 500,000 jobs provided through emergency Government programs at salaries of \$26 a month; if included, they would increase unemployment to 31%. Interest payments on Chile's \$17 billion external debt (private and public) are equal to 10% of GDP. About 60% of the debt is owed by banks and private companies. Many banks are insolvent; and a large number of Chile's firms are also bankrupt.

3. To cope with this situation, exacerbated by tight capital markets, the Government was forced to temporarily take over most banks, follow severe austerity measures, and devalue significantly to encourage exports. An IMF standby, however, was impaired in early 1983, when the bank intervention required massive credit expansion and foreign banks reduced their exposure rapidly. Nevertheless, the Government has recently surpassed the targets of a "shadow program" developed with the IMF, and IMF staff will be reporting favorably to its Board next week. The foreign banks are then committed to roll over \$2.1 billion in 1983/84 amortization (four years grace, eight years maturity) and provide the first tranche of \$1.3 billion in new funds for 1983 (four years grace, seven years maturity).

Prospects

4. Recovery in the industrialized countries (which would increase copper prices; over half Chile's exports are copper) will provide better export prospects in 1984. The recession now seems to have bottomed out, but recovery may be slow. In spite of the deferred 1983 and 1984 commercial debt amortizations, foreign interest payments (half 1983 exports) will retard income recovery. Real domestic interest rates are high (20%); they may remain so until an internal debt restructuring is completed. The limited Government credibility will also defer recovery, but this has been partially restored by Carlos Caceres, the Finance Minister appointed last January. A slower recovery, of course, will delay vitally important employment generation.

Bank-Country Relations

5. Normalization of relations continues. The recent \$128 million road loan served to create an openness in Government officials who gave a warm reception to the July 6-16 mission whose findings are summarized above. New projects were discussed and it was agreed a November economic mission would concentrate on ways to accelerate recovery and Bank operations would emphasize export or employment goals (electricity, housing, export sector, copper).

LEDerbez:ab

OFFICE MEMORANDUM

DATE: June 3, 1983

TO: Mr. Ernest Stern

FROM: Nicolas Ardito Barletta

SUBJECT: CHILE: Proposed Bank Consideration of Lending for the
Colbun Hydroelectric Power Project

EXTENSION: 75901

1. In Mr. Aguirre-Sacasa's April 21 memorandum (attached), we requested your authorization to explore the possibility of a Bank loan for the Colbun hydroelectric power project in Chile. Your reaction was negative. Before closing the book on Colbun, I would like you to consider the following points, which I hope will cause you to reconsider your decision regarding our prospective involvement in the project.

The Project's Preparation and Role of the Bank

2. As you correctly observed in your May 2 note on Colbun (attached), we have not had an influence on the specific design of the project. We have, however, had a long relationship with ENDESA, which has included active involvement in that company's planning process. We have also commented extensively in the past on the Chilean power sector's expansion program and Colbun emerged from that process as the least-cost solution to meet future demand. Thus, we have had an influence on the general framework in which Colbun has been designed and believe it to be a good project.

3. While Bank financing of Colbun would, of course, be preceded by an in-depth analysis of the project, we are convinced that it will prove to be a sound operation. This is based on our confidence in ENDESA's capability in power system planning and project preparation and execution (the bulk of the preparatory work to bring Colbun to execution was, in fact, done by ENDESA's staff). We also have confidence in the technical services and advice provided by their consultants, ELECTROWATT of Switzerland and KAISER ENGINEERING of the US as well as their project review panel of engineering experts (Messrs. Cook, Wilson and Deere). I believe, therefore, that the project has enjoyed the benefit of high level expertise in project design, review, and execution to date.

ENDESA, Sector Policy Issues and Prospective Bank Role

4. At no time did the Region agree to graduate ENDESA. At the Government's request, we did cancel \$23 million of the \$35 million Sixth Power loan to ENDESA in November 1981. This was, however, not meant in any way to signal that there were no longer any meaningful sector issues to resolve. Quite to the contrary, our disengagement from the sector was due: (i) to our inability to get the Government to authorize the tariff increases needed to allow ENDESA to comply with the loan's financial covenants; and (ii) to disagreements on other financial issues.

5. In asking us to become involved in Colbun, Chile has opened the door once again for us to help the country develop and execute a sound plan for the power sector's financial and organizational development. Any new loan for Colbun would be conditioned on a satisfactory program of tariff actions designed not only to provide Colbun S.A. with a sound financial basis but also to strengthen the deteriorating finances of ENDESA.

RC
For info/for
I had no objection to
the sending of a
mission. The purpose
of which is said to
be to deal with the
issues in my 5/2 note
That is what I
mean. eg
6/17

6. There is also a role for us to play in determining the sector's organization and ownership pattern. For years the Government has been attempting to sell ENDESA to private investors. Although some of the power company's small, isolated facilities have been sold off, the privatization scheme has been largely a failure. Moreover, the uncertainty surrounding the utility's future has had negative repercussions within the company. Morale is down as the result of the prolonged privatization process, sector planning has been set back and sector finances have been weakened. I believe that in remedying this situation our experience with institution building in the power sector (both public and private) would be of value to Chile as it grapples with the issue of whether to continue privatizing all or part of ENDESA and how to go about it. As in the case of sector finances, we would, of course, assure ourselves of the Government's willingness to enter into dialogue with the Bank on this important issue as a condition of financing Colbun.

7. During an 18 month period, the Chilean Government did refuse to guarantee loans for public sector agencies. This view was a corollary of former Finance Minister de Castro's belief that State companies should be treated no differently from private firms. Even during Mr. de Castro's tenure in office, however, this "purist" approach was hotly debated in Chile -- even within the economic team. As you know, Mr. de Castro was replaced as Finance Minister in April of 1982. Since then, the Government has re-examined the guarantee issue and Finance Minister Caceres has advised me that the Government is now prepared to offer the guarantee to State-owned enterprises. Against this background, Mr. de Castro's preference to leave State-owned companies to their own resources was a short-lived departure from Chile's traditional stance. The willingness of the current economic team to resume Government guarantees of debt by autonomous Government agencies is, in contrast, a return to the conventional Chilean posture.

Recommendation

8. I am confident that the Bank's potential role in Colbun would amount to more than a mere transfer of resources. It is clear that Chile needs assistance in sector organization, finances and planning and we would emphasize these matters in dealing with the case. Thus, while the Chileans clearly need Bank money and look to international agencies for major support in the coming difficult years, the need for institutional and policy improvement in the sector exists and there would be an important role for the Bank to play in this regard. The Chileans understand this and welcome our advice on the broad sector issues I have mentioned above.

9. In view of these additional points, I recommend that we be authorized to explore further Bank assistance to the Chilean power sector, initially in the form of cofinancing of Colbun with the IDB. Specifically, we propose to send a joint Program and Projects Mission to identify more precisely the need for non-financial Bank assistance, and to assess how willing Chilean authorities are to take action on the most important sector issues. If our non-financial role is found to be marginal, or if it appears that the authorities are not prepared to take action, we would not pursue the matter further. In conducting these discussions, it would be helpful to know that we are, in principle, authorized to consider a loan. May I have your concurrence, please.

attachment

Cleared with and cc: Mr. Moscote, LCP

cc: Mr. Steckhan, LAC I (o/r); Meo, LAC I; van der Meer, LCP; Jennings, LCP;
Bowron, LCP (o/r); Mr. Eigen, WA2; Collell, LEG; De Souza, LEG

EDCruikshank/Faguirre-Sacasa:ab

May 2, 1983

Mr. Ardito-Barletta

Nick:

I cannot concur in the proposal. Participation cannot be justified on any of our normal criteria:

- the project is in implementation and we will have had no influence on design;
- we have long since graduated ENDESA and do not expect to re-enter the power sector. We therefore will have no influence on sector policy issues;
- the government, as a matter of principle, does not issue guarantees for commercial enterprises. It is only driven to do so by current circumstances. Policy involvement is explicitly not wanted.

Whether or not the contracts have been let on ICB is immaterial. We have said repeatedly - most recently in the paper on "lender of last resort" - which you no doubt have read, that we will not do a project if our only role is financial. We mean that.

Ernest Stern

OFFICE MEMORANDUM

DATE: April 21, 1983

TO: Mr. Ernest Stern
(Through Mr. Nicolás Ardito Barletta)

FROM: Francisco Aguirre-Sacasa, Acting Director, LAC 1 *JAS*

EXTENSION: 75791

SUBJECT: CHILE: Inquiry on Bank Lending for the Colbun Machicura Hydroelectric Power Project

Background

1. We have been asked by the Empresa Eléctrica Colbun Machicura S. A. (Colbun S. A.), a Government-owned company in Chile in charge of the Colbun Machicura Hydroelectric Power project, about possible Bank participation in the financing of the project.
2. The project, located south of Santiago, is one of the major hydroelectric schemes on which Chile will rely to meet its future needs for electric power. In its first stage of development, the project would have 490 MW of power generating capacity and would store water for improved irrigation of 331,000 ha and new irrigation of 125,000 ha of agricultural land. Project execution started in 1980. By end-1982, about 40 per cent of the works were completed. Further progress is now adversely affected by a shortage of funds, and Colbun S. A. would like the Bank to participate in the financing.
3. The total cost for the first stage of development is estimated by Colbun S. A. at \$984 million (including interest during construction), with an estimated foreign exchange component of \$340 million. Originally, the Government had not planned for a Bank loan for the project, expecting to obtain the foreign currency needed from commercial sources and the IDB. An early approach to IDB for its participation, however, proved abortive due to the Chilean Government's unwillingness to guarantee, as a matter of principle, any new lending for the power sector at that time. After some early success in obtaining suppliers credits, prospects for additional foreign commercial financing dried up because of Chile's economic difficulties and the general retrenchment in commercial lending to Latin America.
4. As of end-1982, about \$355 million had been spent on the project, secured mainly from domestic Chilean sources and from suppliers' credits. About \$80 million equivalent in foreign currency remains available in suppliers credit, for use in project execution. There is still, however, an estimated \$163 million financing gap to cover the remaining foreign cost. Colbun S. A.-- with the Government's blessing-- would now like us and the IDB

to consider funding the project's remaining foreign exchange costs. We understand that the Government would either be the borrower for the Bank loan for Colbun, or would offer its guarantee for such a loan.

5. ENDESA, the national power company, is the major shareholder in Colbun S. A. and has been closely involved in the execution of the Colbun project. The Bank in the past has made six loans to ENDESA and our procurement requirements are well known to it. The General Manager of Colbun S. A., who is a former ENDESA staff member, has advised us that most of the contracts for the Colbun project have been awarded. Six major civil works and equipment contracts, involving a total expenditure of nearly \$600 million, have been placed with suppliers in the U. S., France, Spain, Germany and Japan, most of them in association with Chilean partners. Colbun S. A. has also advised us that the awarding of these contracts has been done in compliance with the Bank's ICB rules. In view of the company's familiarity with the Bank's procedures, it may well be right in its opinion.

The Issue

6. The immediate question for us at this time is whether the Bank should be willing to consider co-financing with IDB the remaining foreign exchange needs of a project, such as Colbun, which is well advanced in implementation and for which all or most of the major civil works and procurement contracts have been awarded.

Discussion/Recommendation

7. Hydropower is among Chile's most important domestic sources of energy. It currently accounts for approximately 55 percent of Chile's installed electricity generation capacity of 3,200 MW. The Colbun project, we believe, is the least-cost solution to meet the country's future demand for electricity. The project was originally scheduled for completion in 1985, with heavy project expenditures in 1983 and 1984. As we have reported to you in connection with the proposed Second Highway Reconstruction project loan, Chile at present is experiencing a deep economic recession and its ability to finance major projects such as Colbun is strictly limited. With support of Bank and IDB loans, execution of the Colbun project can be completed within the next few years, enabling Chile to meet its power demands and to avoid increasing its need for energy imports at the cost of scarce foreign exchange.

8. Considering these factors related to the project and to the economy in general, I believe that the Bank should explore possible participation in financing of the Colbun project. Before including it in our lending program for Chile, we would, of course, have to satisfy ourselves on the conformity of the existing procurement contracts to the Bank's ICB rules. If satisfied, we would thereafter consider the project on its merits, examining questions such as power sector organization, financial returns and other sector and project-specific issues.

9. I recommend that, in responding to the inquiry by Colbun S. A., we indicate willingness to explore possible Bank support of the Colbun project. May I have your concurrence, please?

Cleared with and cc: Mr. Moscote, LCP

cc: Messrs.: van der Meer, LCP
Jennings, LCP
Meo, LAC1
Collell/Bertao, LEG
Cruikshank, LAC1D

cel
OHC:alika/PBowron/FAguirre-Sacasa:ma

OFFICE MEMORANDUM

DATE: June 3, 1983

TO: Mr. Ernest Stern

FROM: Nicolas Ardito Barletta

SUBJECT: CHILE: Proposed Bank Consideration of Lending for the
Colbun Hydroelectric Power Project

EXTENSION: 75901

1. In Mr. Aguirre-Sacasa's April 21 memorandum (attached), we requested your authorization to explore the possibility of a Bank loan for the Colbun hydroelectric power project in Chile. Your reaction was negative. Before closing the book on Colbun, I would like you to consider the following points, which I hope will cause you to reconsider your decision regarding our prospective involvement in the project.

The Project's Preparation and Role of the Bank

2. As you correctly observed in your May 2 note on Colbun (attached), we have not had an influence on the specific design of the project. We have, however, had a long relationship with ENDESA, which has included active involvement in that company's planning process. We have also commented extensively in the past on the Chilean power sector's expansion program and Colbun emerged from that process as the least-cost solution to meet future demand. Thus, we have had an influence on the general framework in which Colbun has been designed and believe it to be a good project.

3. While Bank financing of Colbun would, of course, be preceded by an in-depth analysis of the project, we are convinced that it will prove to be a sound operation. This is based on our confidence in ENDESA's capability in power system planning and project preparation and execution (the bulk of the preparatory work to bring Colbun to execution was, in fact, done by ENDESA's staff). We also have confidence in the technical services and advice provided by their consultants, ELECTROWATT of Switzerland and KAISER ENGINEERING of the US as well as their project review panel of engineering experts (Messrs. Cook, Wilson and Deere). I believe, therefore, that the project has enjoyed the benefit of high level expertise in project design, review, and execution to date.

ENDESA, Sector Policy Issues and Prospective Bank Role

4. At no time did the Region agree to graduate ENDESA. At the Government's request, we did cancel \$23 million of the \$35 million Sixth Power loan to ENDESA in November 1981. This was, however, not meant in any way to signal that there were no longer any meaningful sector issues to resolve. Quite to the contrary, our disengagement from the sector was due: (i) to our inability to get the Government to authorize the tariff increases needed to allow ENDESA to comply with the loan's financial covenants; and (ii) to disagreements on other financial issues.

5. In asking us to become involved in Colbun, Chile has opened the door once again for us to help the country develop and execute a sound plan for the power sector's financial and organizational development. Any new loan for Colbun would be conditioned on a satisfactory program of tariff actions designed not only to provide Colbun S.A. with a sound financial basis but also to strengthen the deteriorating finances of ENDESA.

6. There is also a role for us to play in determining the sector's organization and ownership pattern. For years the Government has been attempting to sell ENDESA to private investors. Although some of the power company's small, isolated facilities have been sold off, the privatization scheme has been largely a failure. Moreover, the uncertainty surrounding the utility's future has had negative repercussions within the company. Morale is down as the result of the prolonged privatization process, sector planning has been set back and sector finances have been weakened. I believe that in remedying this situation our experience with institution building in the power sector (both public and private) would be of value to Chile as it grapples with the issue of whether to continue privatizing all or part of ENDESA and how to go about it. As in the case of sector finances, we would, of course, assure ourselves of the Government's willingness to enter into dialogue with the Bank on this important issue as a condition of financing Colbun.

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attachment

Cleared with and cc: Mr. Moscote, LCP

cc: Mr. Steckhan, LAC I (o/r); Meo, LAC I; van der Meer, LCP; Jennings, LCP;
Bowron, LCP (o/r); Mr. Eigen, WA2; Collell, LEG; De Souza, LEG

EDCruikshank/Faguirre-Sacasa:ab

May 2, 1983

Mr. Ardito-Barletta

Nick:

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- the project is in implementation and we will have had no influence on design;
- we have long since graduated ENDESA and do not expect to re-enter the power sector. We therefore will have no influence on sector policy issues;
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Ernest Stern

OFFICE MEMORANDUM

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(Through Mr. Nicolás Ardito Barletta)

FROM: Francisco Aguirre-Sacasa, Acting Director, LAC 1 *JAS*

EXTENSION: 75791

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Cleared with and cc: Mr. Moscote, LCP

cc: Messrs.: van der Meer, LCP
Jennings, LCP
Meo, LAC1
Collell/Bertao, LEG
Cruikshank, LAC1D

100
OH/Eliza/PBowron/FAguirre-Sacasa:ma

File

May 2, 1983

Mr. Ardito-Barletta

Nick:

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- we have long since graduated ENDESA and do not expect to re-enter the power sector. We therefore will have no influence on sector policy issues;
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Ernest Stern

bcc: Mr. K8pp ✓

ES:ls

OFFICE MEMORANDUM

DATE: April 21, 1983

TO: Mr. Ernest Stern
(Through Mr. Nicolás Ardito Barletta) *NB*

FROM: Francisco Aguirre-Sacasa, Acting Director, LAC 1 *JAS*

EXTENSION: 75791

SUBJECT: CHILE: Inquiry on Bank Lending for the Colbun Machicura Hydroelectric Power Project

Background

1. We have been asked by the Empresa Eléctrica Colbun Machicura S. A. (Colbun S. A.), a Government-owned company in Chile in charge of the Colbun Machicura Hydroelectric Power project, about possible Bank participation in the financing of the project.

2. The project, located south of Santiago, is one of the major hydroelectric schemes on which Chile will rely to meet its future needs for electric power. In its first stage of development, the project would have 490 MW of power generating capacity and would store water for improved irrigation of 331,000 ha and new irrigation of 125,000 ha of agricultural land. Project execution started in 1980. By end-1982, about 40 per cent of the works were completed. Further progress is now adversely affected by a shortage of funds, and Colbun S. A. would like the Bank to participate in the financing.

3. The total cost for the first stage of development is estimated by Colbun S. A. at \$984 million (including interest during construction), with an estimated foreign exchange component of \$340 million. Originally, the Government had not planned for a Bank loan for the project, expecting to obtain the foreign currency needed from commercial sources and the IDB. An early approach to IDB for its participation, however, proved abortive due to the Chilean Government's unwillingness to guarantee, as a matter of principle, any new lending for the power sector at that time. After some early success in obtaining suppliers credits, prospects for additional foreign commercial financing dried up because of Chile's economic difficulties and the general retrenchment in commercial lending to Latin America.

4. As of end-1982, about \$355 million had been spent on the project, secured mainly from domestic Chilean sources and from suppliers' credits. About \$80 million equivalent in foreign currency remains available in suppliers credit, for use in project execution. There is still, however, an estimated \$163 million financing gap to cover the remaining foreign cost. Colbun S. A.-- with the Government's blessing-- would now like us and the IDB

to consider funding the project's remaining foreign exchange costs. We understand that the Government would either be the borrower for the Bank loan for Colbun, or would offer its guarantee for such a loan.

5. ENDESA, the national power company, is the major shareholder in Colbun S. A. and has been closely involved in the execution of the Colbun project. The Bank in the past has made six loans to ENDESA and our procurement requirements are well known to it. The General Manager of Colbun S. A., who is a former ENDESA staff member, has advised us that most of the contracts for the Colbun project have been awarded. Six major civil works and equipment contracts, involving a total expenditure of nearly \$600 million, have been placed with suppliers in the U. S., France, Spain, Germany and Japan, most of them in association with Chilean partners. Colbun S. A. has also advised us that the awarding of these contracts has been done in compliance with the Bank's ICB rules. In view of the company's familiarity with the Bank's procedures, it may well be right in its opinion.

The Issue

6. The immediate question for us at this time is whether the Bank should be willing to consider co-financing with IDB the remaining foreign exchange needs of a project, such as Colbun, which is well advanced in implementation and for which all or most of the major civil works and procurement contracts have been awarded.

Discussion/Recommendation

7. Hydropower is among Chile's most important domestic sources of energy. It currently accounts for approximately 55 percent of Chile's installed electricity generation capacity of 3,200 MW. The Colbun project, we believe, is the least-cost solution to meet the country's future demand for electricity. The project was originally scheduled for completion in 1985, with heavy project expenditures in 1983 and 1984. As we have reported to you in connection with the proposed Second Highway Reconstruction project loan, Chile at present is experiencing a deep economic recession and its ability to finance major projects such as Colbun is strictly limited. With support of Bank and IDB loans, execution of the Colbun project can be completed within the next few years, enabling Chile to meet its power demands and to avoid increasing its need for energy imports at the cost of scarce foreign exchange.

8. Considering these factors related to the project and to the economy in general, I believe that the Bank should explore possible participation in financing of the Colbun project. Before including it in our lending program for Chile, we would, of course, have to satisfy ourselves on the conformity of the existing procurement contracts to the Bank's ICB rules. If satisfied, we would thereafter consider the project on its merits, examining questions such as power sector organization, financial returns and other sector and project-specific issues.

9. I recommend that, in responding to the inquiry by Colbun S. A., we indicate willingness to explore possible Bank support of the Colbun project. May I have your concurrence, please?

Cleared with and cc: Mr. Moscote, LCP

cc: Messrs.: van der Meer, LCP
Jennings, LCP
Meo, LAC1
Collell/Bertao, LEG
Cruikshank, LAC1D

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OHC:alika/PBowron/FAguirre-Sacasa:ma

International Bank for Reconstruction and Development

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R83-106

FROM: The President

APR 30 2021

April 19, 1983

WBG ARCHIVES

CHILE: Second Agricultural Credit Project (Ln. 1902-CH) Amendment to the Loan Agreement

1. This loan of US\$ 36.0 million to Chile was approved on September 9, 1980 and became effective on January 30, 1981. As of February 28, 1983, a total of US\$ 14.0 million had been disbursed. This memorandum recommends a broadening in the scope of the project by including: (i) extension services for the benefit of small farmers; and (ii) incremental short-term credit, to supplement longer-term investment credits already provided for under the project. It also recommends raising the Bank's cost sharing for the project from the current 40 percent to 48 percent in view of increased foreign exchange costs of the project as a result of recent exchange rate movements in Chile. No change in the loan amount is proposed.

PART I - HISTORICAL BACKGROUND

2. The project's primary objectives were to increase agricultural output in Chile, including several export crops, and to help its small farmers to increase their earnings, improve their living conditions and develop into commercially viable farmers and ranchers. An estimated 40 percent of the increased output generated by the project upon completion would be exported -- mainly selected fruits, wines and processed agricultural produce -- for which Chile has a comparative advantage due to its soils and Mediterranean climate and its ability to harvest these crops during the northern hemisphere's winter months.

3. In support of the project objectives, the loan was to finance investment credits to:

- (a) approximately 2,570 small farmers and ranchers who, either individually or as members of cooperatives, own 12 ha of land or less. Most of these small beneficiaries have never before had access to investment credit;
- (b) about 750 farmers who own more than 12 basic ha and have established agricultural operations but need financing for modernization or expansion; and

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- (c) subloans for the establishment, expansion or modernization of about 90 agroindustries or cooperatives engaged in storing, marketing or processing of farm products.

4. Acting on the Borrower's behalf, the Central Bank of Chile undertook to rediscount sub-loans made to the above beneficiaries by financial institutions participating in the credit operation. These institutions consisted of several commercial banks and the National Agricultural Development Institute (INDAP), a Government agency for extending credit and technical assistance to small farmers. The Central Bank agreed to charge participating financial institutions interest at rates, indexed to compensate for inflation, of up to 10.5 percent on sub-loans to small farmers and up to 12.5 percent on their sub-loans to medium- and large-scale farmers and agroindustry enterprises. The financial institutions were, in turn, allowed a margin of 3.5 percent in their onlendings to the beneficiaries. The sub-loans were to have terms of up to 12 years, including up to four years of grace, depending upon the type of investment to be financed. To assure access by small farmers to the project, Chile and the Bank agreed to earmark at least one-third of project funds (US\$24 million) for these farmers.

5. The project's execution has been slower than forecast when the loan was made. About 40 percent of the loan's proceeds were disbursed as of the end of February 1983, approximately half of what was originally forecast. Mainly as a result of recessionary conditions which have prevailed in the Chilean economy since mid-1981, farmers' demand for investment credit has been low. The lag in sub-loan commitments has been particularly accentuated in the case of medium-scale farmers and agroindustry enterprises. This reflects difficulties in Chilean commercial banks, which were expected to take the lead in this type of lending, and the concern of commercial farmers and agroindustries about the general investment climate and their increased indebtedness. The table below summarizes the details of the loan disbursements and commitments under the project as of February 28, 1983 (in US\$ millions):

	<u>Lending Program</u>			<u>Bank Loan Proceeds</u>		
	<u>Small Farmers</u>	<u>Others</u>	<u>Total</u>	<u>Small Farmers</u>	<u>Others</u>	<u>Total</u>
Allocated	<u>40.0</u>	<u>32.0</u>	<u>72.0</u>	<u>20.0</u>	<u>16.0</u>	<u>36.0</u>
Disbursed	25.6	2.4	28.0	12.8	1.2	14.0
Committed	<u>1.7</u>	<u>1.3</u>	<u>3.0</u>	<u>0.9</u>	<u>0.6</u>	<u>1.5</u>
Total	<u>27.3</u>	<u>3.7</u>	<u>31.0</u>	<u>13.7</u>	<u>1.8</u>	<u>15.5</u>
Remaining to be committed	<u>12.7</u>	<u>28.3</u>	<u>41.0</u>	<u>6.3</u>	<u>14.2</u>	<u>20.5</u>

About 2,000 small- and medium-scale farmers had been granted sub-loans under the project by February 28, 1983. All but about 50 of these beneficiaries had been small farmers who, in fact, had received over 90 percent of project funds disbursed. Their heavier-than-expected participation in the project has, in turn, been partly due to aggressive promotion of the project by

INDAP, which has accounted for about 93 percent of sub-loans to small farmers. To accommodate small farmers' demand for credit, in mid-1982 the Bank increased the small farmer credit disbursement category under the loan from US\$12 million (the original level) to US\$20 million.

6. As the foregoing data show, despite the slowdown in general economic activity and the uncertainties which have prevailed in the farming sector in Chile during the last two years, many small farmers have shown a willingness to invest to improve their farming methods and to diversify their production, by availing themselves of the financial resources available under the Bank-financed project. INDAP has played a key role in support of this process.

7. The experience over the last two years has also shown, however, that many potential investors -- including a large number of small farmers -- have been hesitant to invest in farming mainly because of their lack of know-how on planning of investments most suitable for their type of farming and for the ecological zone where their farming properties are located. Many farmers have also been reluctant to make slow-maturing investments because of a shortage of working capital to carry on their farming operations until their long-term investments reach fruition. Therefore, a broadening of the Bank-financed project is advisable to make it more responsive to the farmers' present needs, taking into account the current investment climate within the country. To assess these needs, Bank missions visited Chile late in 1982 and again in February of 1983. These missions reviewed the progress of this project and discussed with INDAP, the Central Bank and the Ministry of Agriculture ways to better tailor the project to the changed circumstances. The recommendations in the following section reflect the findings of these missions.

PART II - PROPOSED REVISION OF THE PROJECT

8. The amendments to the project, which have been proposed to the Bank by the Chilean Ministry of Agriculture and Central Bank, are discussed below.

Extension Services Program

9. To guide and support small farmers, INDAP is launching a new agricultural extension services program and has requested Bank financing under Loan 1902-CH for the program's first year of execution (April 1983-April 1984). The program would enable small farmers to obtain farm development assistance in accordance with their needs. The assistance to farmers would be rendered by private sector extension enterprises under contract with INDAP. The cost of the services rendered would be split on a 20-80 basis by the farmer and INDAP, which would also be responsible for planning of the assistance to be rendered and the control of its execution. In subsequent years, the farmers' contributions to the cost of the technical assistance would gradually increase to 100 percent.

10. Under the proposed component, INDAP would: (i) determine, with the help of consultants, homogeneous agroecological zones and development of basic farm models especially adapted to each agroecological zone; (ii) develop, with the assistance of consultants, suitable technical assistance

"packages" consisting of visits to farmers to provide them with technical "back-up". Private extension agents would then deliver these "packages" to some 14,000 small farmers over the next twelve months; and (iii) train selected private extension agents and participating farmers, mainly through arranged programs with research institutions. In addition to the preceeding, under the proposed technical assistance component INDAP would contract consultants' services to study its administrative management systems and to design improvements in it aimed at freeing technicians from administrative work in field offices and to achieve more efficient loan portfolio management.

11. INDAP would contract about 35 staff-years of consultants' services to: (i) strengthen its internal administration, carry out its training efforts; and (ii) help design its extension program and help supervise its execution. Most of these services would be provided by local consultants, many of whom would come from local universities or research institutes. The qualificataions and terms and conditions of employment of these consultants would be satisfactory to the Bank.

12. At present the Central Bank and INDAP have a subsidiary loan agreement between them, which sets forth their responsibilities in implementation of the project. Since this agreement does not cover the new extension services program, execution of the necessary agreement between them, satisfactory to the Bank, would be a condition of disbursement for this new component.

13. The technical assistance component would have an estimated total cost of US\$4.65 million. Approximately US\$3.4 million of this amount would be for extension services to farmers during the next year. INDAP would cover US\$2.75 million of this and farmers would pay for the balance (US\$650,000). The component's remaining costs -- abut US\$1.25 million -- would be associated with the consultants' services retained by INDAP. To finance INDAP's total share of the component (US\$4 million), US\$2.0 million would be provided from proceeds of the Bank loan and the other US\$2.0 million would be furnished by the Central Bank. INDAP would receive the US\$4.0 million in the form of a loan from the Central Bank, under the same terms and conditions as that of the subsidiary loans provided to it for on-lending to small farmers. The Bank's share of this component would be covered by reallocating US\$2.0 million for this purpose from the ongoing loan's commercial farmer/agro-industry credit category.

Short-Term Credit

14. To assist qualified farmers who are undertaking slow-maturing investments under the project until their investments reach fruition, Loan 1902-CH would be modified to make provision for incremental short-term working capital credits up to 30 percent over the investment subloans granted to them. This short-term credit, which is expected to account for about US\$3 million of the loan's proceeds, would finance purchase of seeds, fertilizers, fodder, etc. for annual crops and cattle fattening. Before extending such short-term credits, INDAP and other participating financial institutions would require operating budgets and other supporting data from farmers and agroindustry enterprises. To accommodate this change, the present ceilings under the project for size of sub-loans would be raised by approximately 30 percent (to US\$250,000 for farmers, and US\$400,000 for agroindustries).

Increase in the Bank's Disbursement Ratio

15. Imported equipment and supplies for farm investments under the project are purchased by farmers from various suppliers in Chile. Since June 1982, the Chilean currency has undergone a series of devaluations. With provision for domestic inflation, the real devaluation during 1982 was about 50 percent. This change has resulted in increased costs of imports required for the project relative to its domestic costs. Consequently, the project's overall foreign exchange component is now estimated at 48 percent, up from 40 percent at the time of loan approval. The Government has requested that the Bank's share of project financing be brought up to the level of the project's present foreign exchange component. This would entail raising the loan's disbursement percentage from the current 50 percent to 60 percent for individual sub-loans. In the case of the new extension services program component (paras. 9 to 13), the Bank would disburse for 50 percent of costs because of this component's lower foreign exchange component.

16. The proposed amendments in the project are fully justified. The recommended agricultural extension services and working capital credit for farmers would increase potential beneficiaries' absorptive capacities for investment credits and assist in attainment of the project's objectives (greater production and improved living conditions for project beneficiaries, especially small farmers) in the near future. The amendments would also result in quicker disbursement of the loan. At present, Chile is making efforts to increase its agricultural exports to achieve enduring improvements in its balance of payments. Early attainment of the Bank project's objectives -- something which the proposed amendments would help achieve -- would make a significant contribution towards this end.

17. In view of the pressing need for the changes described above, the proposed amendments would go into effect retroactively to finance expenditures made by the Borrower after April 1, 1983, the start of Chile's agricultural year.

Recommendation

18. I recommend that the Executive Directors agree to the proposed amendments to the project. In the absence of objection (which should be notified to the Vice President and Secretary or Deputy Secretary by the close of business on April 29, 1983), amendments to the loan documents to reflect the adjustments as described above will be executed.

A. W. Clausen
by
Ernest Stern

Mr. Stern

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Per our conversation - Luke

Now this reached me also through your office and properly logged.

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OFFICE MEMORANDUM

DATE: March 31, 1983

TO: Mr. Sidney Chernick
(through Mr. Nicolas Ardito Barletta)FROM: Francisco Aguirre-Sacasa, Acting Director, LAC I *FAS*SUBJECT: CHILE: Note on Eligibility for Special Assistance

EXTENSION: 75791

1. Chile is in the throes of a depression, the worst economic downturn to hit the country since the 1930s. A discussion of events leading up to Chile's current economic difficulties as well as an examination of the magnitude of the economic downturn is contained in Part I of a just-completed green cover President's Report (attached). The purpose of this note is to summarize recent economic developments, to assess Chile's overall policy framework and to present the case for the country's participation in the Bank's special action program.

Summary of Recent Developments

2. Following five years (1977-81) in which economic growth averaged nearly 8 percent per annum and in which virtually all economic and social indicators showed healthy -- and, in some cases, even spectacular -- movement in the right direction, GDP collapsed by 14 percent in 1982. In some sectors the fall was even sharper. Manufacturing and construction, for example, contracted by 22 and 29 percent, respectively.

3. The depression has exacted a severe cost in human and financial terms. Combined with a major real devaluation in 1982, it has drastically lowered the country's per capita GNP. Open unemployment, which had hovered around 8 percent in mid-1981, climbed to nearly 22 percent by end-1982. This latter figure excludes over 335,000 workers (eight percent of the labor force) enrolled in the Government's minimum employment program. Bankruptcies of private firms in 1982 also reached record levels and arrears in repayment of loans by businesses is widespread; over half of the banking system's loans are in default. The privately-owned domestic financial system is in a shambles. As a result, the State has been forced to liquidate two banks. It has also intervened most Chilean-owned private banks and financieras, including the the country's three largest private banks.

4. Chile's economic troubles were, in great part, triggered by the prolonged world recession. The country was especially hurt by the low world price for copper, which accounts for one half of Chilean exports. In the second half of 1982, world copper prices averaged only 68 cents per pound, putting them at their most depressed level, in real terms, since the 1930s. Other Chilean exports also suffered with world prices for wood products, which constitute about 15 percent of Chile's exports, being particularly soft.

5. While slack demand and low prices for Chilean exports were important causes for the 1982 downturn, the Government's adherence to a fixed exchange rate from mid-1979 to mid-1982 exacerbated the economy's problems. The objective of the exchange rate policy was to break, once and for all, the back of inflation and establish a monetary policy virtually independent of Government intervention. With regard to inflation the strategy worked. In

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the first half of 1982, Chilean inflation was virtually zero. However, during the first 2-1/2 years that the fixed exchange rate was in effect, Chilean inflation had run well above international levels. This, coupled with the appreciation of the U.S. dollar, led to a seriously overvalued peso. As a result, Chile's non-traditional exports slumped, imports shot up and the Chilean private sector went on an external borrowing spree which helped fuel an unsustainable boom. This was followed by the 1982 collapse.

6. Several private groups, which had a controlling interest in part of the Chilean financial system, were at the forefront of the borrowing referred to above. These groups, in turn, used external resources and the domestic financial system to buy up -- in highly leveraged operations -- an important and ever expanding share of Chile's assets. They also established a complex interlocking network of banks and corporations.

7. In 1980 and 1981, Bank staff cautioned the Authorities of the potential perils posed by these groups. However, Government efforts to introduce minimal capital market, banking and antitrust regulations came too late; the groups' finances began to unravel in 1981 and 1982 as external financing dried up for Chile as in other hemisphere countries. Subsequently, the groups' financial houses of cards caved in. Because of their size and prominence, the groups' undoing contributed greatly to the wave of bankruptcies and bank failures cited in paragraph three.

8. Chile's public finances and its external position have suffered. As Government revenues fell with diminished economic activity and copper prices, Government outlays -- particularly for the safety net social programs -- were difficult to cut. As a result, Chile's public sector went from a surplus in 1981 to a deficit equivalent to 2.7 percent of GDP in 1982. Moreover, despite a one-third drop in imports in real terms in 1982, lower Chilean export earnings together with high interest payments on Chile's large public and private sector external indebtedness (\$17 billion), resulted in a current account deficit equal to \$2.4 billion (or 10 percent of GDP) in 1982. Concurrently, as in the case of other Latin American countries, commercial lenders grew increasingly leery of maintaining -- let alone expanding -- their exposure in the country. Consequently, Chile's net reserves fell by \$1.2 billion in 1982 to \$2.6 billion by year's end. In the first ten weeks of 1983, reserves dropped an additional \$1 billion, finally forcing the Government -- with the consent of its creditors -- to declare a "standstill" on amortization payments of external debt until late April, 1983.

Relations with the IMF

9. After protracted negotiations with the Fund -- drawn out mainly by frequent changes in Chile's economic team and by the rapid deterioration of the economic situation -- the country entered into a SDR 795 million standby-cum-compensatory financing facility with the Fund in January 1983. The standby's goal was to reduce the 1983 current account deficit of the balance of payments to \$1.6 billion and to hold reserve losses for the year to \$600 million. In view of the heavy outflow of capital early this year and the extent of corporate bankruptcy and bank illiquidity, the program is no longer viable.

10. A Fund mission visited Santiago in March. The Government presented it with a "shadow program" of austerity actions which consist mainly of additional revenue measures (including an across-the-board increase in tariffs from their present level, 10 percent, to 20 percent). Moreover, the

salaries of public sector employees are being cut in real terms. Finally, in an attempt to stem capital flight, the Government has taken steps to shut down the parallel foreign exchange market. This program, which was announced on March 22, is expected to raise fiscal revenues by an amount equivalent to over two percent of GDP for the balance of 1983. These new revenues -- as well as part of the already agreed-upon credit program -- will be transferred to the banking system to provide it with much-needed liquidity. Fund staff hope that the new program will enable Chile to move back into compliance with the standby targets by late 1983. Until then, Chile will not make any additional drawings under the standby.

11. The Chilean Authorities are in New York this week to attempt to work out a rescheduling of external debt with the commercial banks. The new "shadow program" worked out with the Fund will be presented to the bankers on the occasion of these rescheduling talks. The Government's rescheduling strategy is summarized in paragraph 16.

Policy Framework and Future Prospects

12. Confidence in the workings of the Chilean economy has waned in the wake of this past year's developments. Since early 1982, Chile has had four different finance ministers and criticism of the open, market-oriented policies in effect since the mid-1970s is widespread. Some industrialists, for example, have lobbied strongly for a return to high and varied protection. Other groups have been calling for greater intervention by the State in the market place in the form of higher producer support prices, consumer subsidies and more regulation. The Government, however, still remains committed to the structural reforms introduced in the 1974-76 period. Despite recent setbacks, therefore, the country arguably still possesses the soundest macro policy framework in the LAC region.

13. Price signals in Chile are now fully satisfactory. In June of 1982 the exchange rate, which had been fixed at 39 pesos to the dollar since mid-1979, was substantially devalued. During the remainder of the year, it was allowed to float downwards. The Government is now managing the float within certain margins and the peso is devaluing vis-a-vis the dollar at a pace that roughly reflects the difference between domestic and international inflation. As of this writing the official exchange rate is about 75 pesos to the dollar. Since inflation since August has been only 25 percent, the real devaluation has been about 50 percent. Other prices in the Chilean economy (e.g., interest rates and wages) continue to be virtually free and set by the market. This includes prices for goods and services provided by the Government and State-owned companies. There are in today's Chile still virtually no producer or consumer price subsidies. In this, as in other areas, Government policies continue to be consistent with advice long offered to Chile by the Bank and other international institutions.

14. Chile's trade policies are also sound. As is noted above, the exchange rate is no longer an issue. Moreover, although the Government has just doubled tariffs as an emergency revenue-raising measure, Chilean tariffs continue to be among the lowest and the least dispersed in the LAC region. Moreover, the Government has announced its intention to reduce tariffs to 10 percent, once again, by the end of 1984. It is encouraging to note that the Government has steadfastly refused to reintroduce most of the absolute prohibitions and differential tariffs which some spokesmen for industry and agriculture have been advocating and which would mean a return to the

inward-looking import-substitution policies of the past. It is also noteworthy that the more realistic exchange rate policy now being followed has "de-fused" much of the protectionist sentiment which had built up in Chile.

15. Chile's total external indebtedness (public and private, short, medium and long term) stands at approximately \$17 billion. Total medium-and long-term indebtedness is about \$13.6 billion, more than twice the \$6 billion figure as of end-1978. Despite the fast growth of Chile's external debt, the Government's debt management has been careful. In fact, total public and publicly-guaranteed debt now stands at about \$5.8 billion, only a third of the country's total international indebtedness. This figure is virtually the same, in nominal terms, as it was as of end-1978. Chile's debt service ratio for public and publicly-guaranteed term debt is projected at only 18 percent for 1983 and is projected to hold steady through the mid-1980s.

16. The real external debt problem in Chile centers around the private sector's indebtedness. Altogether, foreign banks have loaned Chilean businesses and financial institutions about \$11 billion, with \$2.2 billion of this being short term. This is more than eight times the levels of private sector external indebtedness at year end-1977 and Chile's private sector is clearly unable to service this debt under existing terms. The Government has, therefore, reluctantly become increasingly active in the rescheduling of Chile's private sector debt. At this week's meetings with commercial bankers, the Government delegation will ask banks to maintain short-term credit lines to the private sector at their present levels while rescheduling private medium- and long-term obligations. Chile's private sector owes principal payments totalling about \$2 billion in 1983 and 1984 and the Government is expected to propose a rescheduling of this amount over eight years, including five years of grace.

17. As was noted in para. three, almost all Chile's locally-owned banks and financieras are insolvent. Moreover, arrears in debt service payments are wide-spread amongst industrialists, contractors, commercial establishments and farmers. To deal with this situation, the Government has intervened in the privately-owned financial system. It has also announced a series of non-inflationary credit lines -- financed by additional revenue measures announced in 1983 -- to pump much needed liquidity into the financial system and give the country's small-and medium-size debtors some relief. At the Government's request, the Bank and IFC have provided technical assistance to Chile aimed at helping to clear away the flotsam left by the financial crash of 1982 and to put Chile's productive apparatus back to work again. This technical assistance will continue in the coming months.

18. Chile's public sector finances continue to be relatively well-managed. For reasons cited in para. eight, the Chilean public sector ran a deficit in 1982 for the first time in seven years. It was equivalent to 2.7 percent of GDP. Thus, while a deficit occurred in 1982 and is likely again in 1983, they are small ones and are directly due to the severity of Chile's economic downturn. The Government's goal is to reduce the public sector's deficit to 2.3 percent of GDP for 1983 and to bring it into balance in 1984. To this end, in addition to the recently taken revenue measures, the Government is carefully husbanding scarce resources by cutting back recurrent expenditures and taking a hard look at public investment, which already reflects clearly established priorities. On this last point, the Government has, over the years, set in place a demanding approval mechanism

to screen Government and public sector investment. Those projects that go ahead have, therefore, generally met rigorous rate of return and social benefit criteria.

19. Until recently, Chile's monetary policy was inconsistent with some developmental goals. The fixed exchange rate-cum-open capital account linked Chile's money supply to volatile private capital flows. When foreign capital grew scarcer in 1982 the real money supply dropped substantially; domestic credit expansion in 1982 -- required to save floundering banks and companies -- only exacerbated the volatility of the monetary flows. The Government's recent "shadow program", however, removes much of this volatility since it, at last, provides the Authorities with an action plan for domestic credit allocation consistent with a restructuring of the corporate and banking sector and external viability.

20. As in the past, the financial performance of Chile's public enterprises remains amongst the finest in the Region. Despite the depression, most public enterprises are well run and operate in the black. Measures are also being introduced to tighten up still further on the management and finances of the few State enterprises still operating at a deficit (e.g., LANCHILE airlines and the national coal company).

21. The Government's supportive attitude towards the private sector continues unchanged. Despite the recent Government involvement in the banking system -- which was necessitated by its imminent collapse -- the Government continues to view itself in a subsidiary role and favors an open, market-oriented economy in which the private sector will take the lead unfettered by excessive regulations and public sector interference. This stance has been reiterated repeatedly by President Pinochet including, most recently, in a major address to the country in March.

Conclusion

22. Since 1982, the Government has attempted to deal pragmatically with one of the most severe and complex economic crises in Chile's history. While the country's economic and financial situation is extremely delicate, the Chilean Government has so far rejected the hyper-inflation "solution" to the current malaise affecting the country's financial system and its private sector. Instead, it has put through a series of revenue raising measures in the midst of a major depression which will enable it to transfer resources to the private sector to recapitalize bankrupt firms and banks.

23. To its credit, despite vociferous criticisms from certain interest groups within the country (e.g., some industrialists) Chile retains an open, market-oriented economy with a minimum of economic distortions. The recent tariff increase is temporary and has been designed in a manner which will keep to a minimum its distortionary impact. Moreover, the Government is responsibly taking measures to enable it to eventually balance public finances while maintaining social outlays at a high level. Chile's enlarged Minimum Employment Program and a new jobs program for heads of households are good examples of the State's commitment to ease the cost of the depression on the neediest groups.

24. Against this background, we recommend that Chile be given access to the Bank's Special Action Program. The responsible way in which the Government is trying to weather the country's current economic crisis -- coupled with the generally sound policies in place there -- warrant Bank support. Initially, the Region recommends modest front-end loading of the proposed second highway reconstruction project which is scheduled for Board approval in late May. This will result in \$18 million in additional disbursements under this high-priority rehabilitation-~~cum~~-maintanance loan through 1985. Providing this front-end loading will help ensure that this project, whose aim is to preserve the country's infrastructure base, goes ahead in a timely manner. The Region is also considering other forms of special assistance for Chile, and will be recommending them to Management in the coming weeks.

Cleared with and cc: Mr. Lari, LAC I, Pfeffermann, LCNVP

F. Aguirre-Sacasa/P. Meo:ab

ROUTING SLIP

DATE

11/3/80

FROM THE OFFICE OF THE
REGIONAL VICE PRESIDENT

NAME

ROOM NO.

Mr. Sken

APPROPRIATE DISPOSITION

NOTE AND RETURN

APPROVAL

NOTE AND SEND ON

COMMENT

PER OUR CONVERSATION

FOR ACTION

PER YOUR REQUEST

INFORMATION

PREPARE REPLY

INITIAL

RECOMMENDATION

NOTE AND FILE

SIGNATURE

REMARKS

Ernie - I spoke like
much to "big" thing. He
saw no problems for a Chile
Board presentation in early
December. In fact, he said
that if the social aspects of
the project could be made more
evident, he might even be able
to adopt a more neutral position

FROM

18

file

OFFICE MEMORANDUM

CONFIDENTIAL

TO: Mr. Nicolas Ardito Barletta
FROM: Eugenio F. Lari, Director LAC I
SUBJECT: CHILE - Proposed Highway Reconstruction Loan

DATE: November 3, 1980

DECLASSIFIED

APR 30 2021

WBG ARCHIVES

1. I spoke today with Mr. Looijen about this project. He feels that there should be no problem and that it could go as smoothly as the last two loans to Chile. He would call me if any major problem appears in the horizon.

2. It seems clear that two actions may change the situation, i.e.
(a) active lobbying against the project on the part of the US and
(b) a request, perhaps by the Nordic countries, for a formal vote at the Board. You may wish to talk about this with Mr. Stern and see that all is done to avoid these two possibilities. As you know, I have not spoken with either the US Executive Director or the Nordic countries Executive Director.

EFLari:nsp

cc: Mr. Aguirre-Sacasa, LAC I

OFFICE MEMORANDUM


TO: Mr. Mervyn L. Weiner, DGO
FROM: S. M. L. van der Meer, Acting Regional Vice President, LCN
SUBJECT: CHILE - Third Education Project (Loan 668-CH)
Project Performance Audit Report

DATE: January 23, 1979

The Regional Office has reviewed the revised draft of the Project Performance Audit Report on the Chile Third Education Project, dated January 15, 1979, and has no objection to its release in final form.

Cleared with and cc: Mr. Varallyay, LC1DD

cc: Messrs. Stern, VPO
Glaessner, LCPDR
Aguirre-Sacasa, LC1DD
Weissman, LC1DD

 Thint:ts

Mr. Horsley for file

Mr. McNamara

September 6, 1978

P. N. Damry

Chile - Proposed Amendment to the Copper Sector Project
(Loan 1200-CH) (R78-204)

1. The President's Memorandum proposing modifications to the loan approved in 1976 was issued on August 28 for approval by our Board on a lapse of time basis, expiring September 7th evening (copy appended).

2. Mr. Magnussen informed me over the telephone today as follows: He had been instructed by the whole of his constituency to inform the Secretary officially that the Nordic attitude towards lending to Chile, which he had explained at the time the original loan was discussed in the Board, remained unchanged, and that, in the event of the present "lapse of time proposal" actually coming before the Board, he was to repeat the same general statement of views on lending to Chile. However, as Mr. Magnussen did not anticipate that the present proposal would be formally brought onto the Board agenda, he said he would carry out his instructions by informing me officially, albeit orally, that he had received such instructions from his whole constituency.

3. No action will be called for unless some Director, before close of business tomorrow, asks for the matter to be brought to the Board -- something Mr. Magnussen does not ask for. However, I shall keep a copy of this Memorandum on our record of the Loan in the Secretary's Department, sending copies to the Vice President, Operations, and the Vice President, LAC.

Attachment

cc: Mr. Stern ✓
Mr. Aidito Barletta

PNDAMRY/cb