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M- QURESHI'S
OPERATIONS CMTE

June - July 1988

July 25, 1988

880802011 Mr. Qureshi

The World Bank
OPERATIONS COMMITTEE

CONFIDENTIAL

Minutes of the Operations Committee to consider
TURKEY - Country Strategy Paper
held on July 25, 1988 in Room E-1243

A. Present

Committee

Messrs. M.A. Qureshi (Chairman)
E. Barandiaran (LADR)
S. Fischer (VPDEC)
S. Hassan (LEGEM)
E. Jaycox (AFRVP)
E. Lari (EM4DR)
O. Yenal (ASIVP)
H. Vergin (SVPOP)
J. Wood (VPFPR)

Others

Messrs. Y. Abe (EM1IN)
T. Baudon (SVPOP)
F.M. Chaudhri (EAS)
M. Cohen (EM1CO)
S. Dhar (EM1CO)
V. Dubey (EAS)
J. Hamid (CEI)
P. Hasan (EMNVP)
C. Michalopoulos (EMNVP)
G. Pfeffermann (CIO)
K. Siraj (CODOP)
T. Yoon (EM1AG)

B. Issues

The principal issues on which the Committee focused its attention were: macro-policy and fiscal deficits; inflation and monetary management; problems of short-term debt and risks of arrears; issues of burden-sharing; questions of long-term productivity enhancement; and funding for social sectors.

C. Discussion

At the Chairman's invitation, the Region elaborated a few important points in the CSP by stating that in its judgement (a) the Turkish authorities remain committed to reducing the macro imbalance even though the target of 5.7% fiscal deficit to GDP ratio now looks ambitious; (b) while the base case scenario is likely to be met, the execution of the program especially in the areas of local government financing and extra-budgetary funds remains difficult; (c) the Region's CEM, which will be ready for discussion in September 1988 will be an important document in the on-going dialogue on macro-policy management. The Region also mentioned two possible dangers. First, the authorities' unwillingness to adopt adequate corrective measures if the macro situation is not on track. In this case the volume of lending may be reduced to around $300 million a year. This will result in negative net flows by 1991, reducing net disbursements by $500 million below the planned level over the next three years. Quick disbursing lending will be linked directly to the satisfactory macro-economic framework. There may be need for flexibility

because co-financing with our policy lending has been a major source of support for the Turkish balance of payments. Second, the Government may implement required measures but they may not have the anticipated effect on macro stability. It is for example possible that the fiscal deficit may be reduced as planned but inflation may not go down as expected. A satisfactory solution of the fiscal deficit is a top priority but there are constraints: if export incentives are reduced, it would adversely affect exports and if savings are made by adjusting investment incentives, it would affect growth and employment. In order to further investigate these and other issues, an intensive economic and sector work was required in the next few years. This would have implications for staff resources.

The Chairman opened the discussion by saying that the document under consideration was a good paper but he did not get the precise idea what would be the Bank strategy if satisfactory macro-economic performance was not forthcoming. He wanted to have the links between Bank lending and macro-performance clarified and asked, "if there is slippage in performance, what will be scaled down and how"?

The Region readily agreed that getting the macro policies right was fundamental to the Bank's support envisaged in the Base Case scenario. In the Region's judgement, however, the country's room for maneuverability was small. If the situation deteriorated, given the need for resources and the balooning of debt service, reschduling may be unavoidable. Then the IMF would have to be involved to reinforce the action for corrective measures. The Government was keen on avoiding both these eventualities and therefore, the Region believed, it would be responsive to the need for strengthening the macro-economic program.

A Committee member observed that a large part of the fiscal deficit was coming from state enterprises, local Governments and extra-budgetary funds but the CSP does not talk about the strategy to tackle this source of difficulty. The Region's response was that there was an active dialogue on these issues which are addressed in the forthcoming CEM.

Another Committee member had the impression that while the Turkish authorities did reasonably well on the exchange rate management, the monetary policy had been lax throughout, reflecting persistent domestic disequilibrium. It was therefore important to watch both the external and domestic disequilibria.

The Chairman drew the Region's attention to para 5.03 and remarked that in addition to issues of macro policy there was reason to be concerned about sectoral issues. The Region had appraised operations in agriculture and transport but had deferred these operations because of failure to reach agreement on the associated policy actions. He observed that progress on sectoral issues were as important as that in the area of macro-policy. The Region felt that it was already doing that by demanding actions before moving further on sectoral programs. In the discussion that followed it became clear that some of the sectoral issues in agriculture e.g., interest rates were being handled in the context of the financial sector operation. The Chairman suggested that in that case the perspective on sectoral issues be brought upto date when revising the CSP.

The Chairman referred to table 2 of the CSP and wondered whether Turkey would be expected to have two digit inflation for the forseeable future. The Region said that that the figures in the table probably simply reflected the difficulty of projecting inflation several years ahead. A member pointed out that the assumed inflation was necessary for extracting resources to meet the fiscal deficit. Another Committee member stressed the importance of monetary discipline and a careful attention to expansionary policy both in the public and private sector, especially since 1985.

The question of short-term debt and realism of projected external financing came up for discussion next. A Committee member observed that the need to reduce the country's dependence on the short term debt was given high visibility in the previous CSP discussed in early 1987, but not this year. He wondered why. He also felt that the sharp reduction projected in the absolute level of exposure of official bilateral sources was worrisome and wondered whether we had options other than the B-loan to induce greater commercial bank financing. B loan participations are a very risky tool in a country where interest arrears to commercial banks could well arise in the event stabilization goals are not met. The Region responded by saying that the Bank should not overplay the risks of short-term debt. It should be viewed in the context of the rapidly increasing foreign trade that would provide room for greater short-term commercial credits. In any case the Government was now more aware of the problem of excessive dependence on short-term debt, had reduced reliance on it, and was also planning substantial build up of foreign exchange reserves. The reduction of net bilateral flows reflected the effects of the rescheduling of 1979 and 1980.

On the question of burden sharing the Region felt that a lot was going on. Turkey had received cofinancing of $500 million from Japan last year and $700 million was expected this year. Turkey had also raised about $600 million in Germany. With the gradually declining inflation, the commercial banks' confidence in the country would further enhance and enable them to lend more. Finally, the Region planned to compress the proportion of quick disbursing loans substantially (though perhaps reduction to the 7% of lending suggested in the CSP may not be appropriate) - precisely to reduce the exposure problem. The Region also said that while the Bank was not the first one in the queue for receipt of payments, Government had not allowed delays in payment to the Bank to extend beyond 60 days. On the question of B loans the Chairman said that the discussion in the paper should reflect the fact that the Bank had informed the Government that no more B loans to Turkey were planned. However, there were other instruments of credit enhancement whose role needed to be explored further. He also felt that the projected bilateral flows in the CSP needed another careful look.

Finally, the Chairman drew the Region's attention to a few other points raised in paras. 8, 9 and 10 in the agenda prepared by the EAS, namely, the issue of productivity growth in the long-run, and the Government's own perception of longer term issues confronting the economy;

the relative neglect of the social cost of the adjustment process and the feasibility of the proposed doubling of lending in politically sensitive sectors such as agriculture.

In responding to these questions the Region stated that the Government and Bank have reasonably clear understanding of the longer-term challenges but the Government was too much absorbed in managing the short and medium-term issues and imbalances; more attention is now being devoted to the costs of the adjustment process than before (e.g. renewed Government interest in education and training, health projects etc.) and that impediments to lending in agriculture are being gradually removed.

The Chairman concluded the discussion by stressing that the revised CSP should clearly set out the Bank's expectation of what was to be regarded as adequate macro-performance; the linkage of the Bank's lending program to performance on macro and sectoral issues as well as issues in the state enterprises, extra-budgetary funds etc. should be clarified; and the Bank response if slippage in policies occurred should be clearly spelled out and the implications in terms of net transfers should be drawn out. He further emphasized the importance of bringing the IMF into the picture, particularly if the macro-policy adjustment turned out to be inadequate.

The Chairman closed the meeting by remarking that following the various revisions suggested above, the CSP be conveyed to the President for the next round of discussions on the Bank strategy for Turkey.

August 1, 1988

FMC

FMChaudhri:gs

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

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1.

DATE: July 19, 1988

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

EXTENSION: 78051

SUBJECT: Turkey: Country Strategy Paper - Agenda

1. The Operations Committee will meet on ~~Friday, July 22, 1988 at 10~~ Monday 25 4:00 a.m. in Room E-1243 to discuss the Turkey Country Strategy Paper.

Introduction

2. Turkey is widely considered to have successfully pursued a policy of adjustment with growth since 1980, supported by the Bank (which provided 9 adjustment loans totalling nearly $3 billion during 1980-1988). GDP growth average 5.5% during 1980-87, and export of goods and non-factor services increased at an average annual rate of about 25%. During the same period investment increased from 22% to 25% of GDP and gross national savings from about 16% to nearly 24%. This performance has been based on a major change from the previously existing inward-oriented growth polices and an increased reliance on market and incentives in place of administrative intervention and controls. The role of the state has been reoriented. Public consumption was cut by more than 3% of GDP and public investment was restructured away from manufacturing to infrastructure--complementing instead of competing with the private sector. However, as the paper points out, there are a number of problems which could endanger the adjustment process that are becoming increasingly evident.

Macro-economic Issues

3. Like in many other countries, the external adjustment has proceeded faster than internal adjustment. In particular, fiscal discipline has fluctuated with the country's political cycle. The public sector borrowing requirement (PSBR) declined from 9% of GDP in 1980 to about 5% in 1985. However, with eyes towards the next election the Government adopted more expansionary policies and also initiated a process of fiscal decentralization with extra budgetary funds (EBFs) and local governments being granted access to large volumes of resources. Public investment exploded and in 1987 the PSBR in relation to GNP was back at the 1980 level. A tightening external resource situation and large fiscal deficits have led to very high real interest rates and a surge of inflation. Inflation, which had declined from 107% in 1980 to 25% in 1986 rose to 49% in 1987 and is expected to be around 65% in 1988. High real interest rates and inflation distort private sector incentives and a complicated system of investment and export incentives exists to redirect private investment into desired sectors.

4. The Government, therefore, faces an urgent challenge to restore macro-economic balances. A number of measures were taken this year (para 3.13). However, the paper points out that (a) these measures are not enough to achieve the planned reduction in the PSBR, and more importantly, (b) the Government's medium-term targets for the fiscal deficit are not consistent with its stated growth and inflation objectives. There is also some concern on the basis of the first five months of the year about the implementation of the Government's stabilization efforts, in particular, the restraints on expenditure by the EBF's and the municipalities. The paper also indicates that political support for the Government has eroded and its position has become much weaker. In this context, the Committee may wish to be apprised of the current expectations of outcomes for 1988 and the judgement about the likelihood of the present macro-economic framework being strengthened, more in line with the Region's base case scenario. In this context, what is the probability of the Government acting decisively in the short term, since under this scenario the bulk of the primary fiscal adjustment required through 1992 would have been achieved in 1988?

5. A second problem, not unrelated to the persistence of the macro imbalances, is the very large external capital requirements, projected to average about $5.5 billion annually for 1988-92, and reflecting the sharp increase in debt servicing requirements. (Amortization payments are expected to average over $4 billion a year in the period). The net capital inflows are projected to be about the same level as during 1985-87, when gross inflows averaged about $4.4 billion and amortization payments $2.8 billion. The level of external resources needed is an issue because (a) about 25% of the gross inflows and 50% of the net inflows during 1985-87 were short term in nature. Since the share of short-term debt in total debt has increased to 22%, the reliance on short-term funds needs to be sharply curtailed. In 1988 such borrowing is projected to account for half of the net capital inflow, but the average for 1988-92 is expected to be 28%; (b) the ratio of debt outstanding to exports which was about 195 in 1984 rose to around 250 in 1987, and the commercial banks "appear to be increasingly wary of Turkey's recent debt accumulation and higher inflation". The paper, after outlining the "innovative financing tools" the Turkish Government has used in recent years, concludes correctly that increased flows from commercial banks are a key requirement (para 3.14). The Government intends to rely to a greater extent on balance of payments financing from commercial banks (para 4.11). How realistic is this external financing strategy and if there is a shortfall in external resources, what are the nature of adjustments in the scenario that are plausible? likely?

Bank Assistance Strategy

6. The Bank's assistance strategy aims to support the Government in the short term need to restore macro-economic balance, complemented by CESW and lending intended to develop the basis for long-term development. A lending program for 1989-1993 of 36 projects totalling $5.1 billion is presented (33 projects, $4.68 billion in 1984-88). The share of adjustment lending is expected to decline to less than 7% as compared to 28% in the previous quinquennial and 40% during 1980-88. Quick-disbursing SECALs are

expected to end in 1990, but an exception will be considered if the Government is prepared to make significant efforts in the social sectors. The share of lending allocated to agriculture is expected to nearly double, and to social sectors to increase by nearly 50%, at the expense of the shares of industry, energy and transport. The broad thrust of the strategy as summarized in Annexes D and E appears to be sound, but a number of questions remain.

7. The most important issue is the relationship of the lending program to policy performance. The paper states that the "level and composition of Bank assistance would be contingent on sustained sound macro-economic management" (para 1.07). It goes on to state that the "number and amounts of adjustment operations would depend on the soundness of macro-economic management, in addition to the sectoral policies proposed" (para 5.11). Since SECALs account for only $350 million of the proposed five-year lending program, does this mean that if macro performance is poor the lending program would still be about $4.7 billion? Given the pressing nature of the macro-economic issues is there a case for a more explicit discussion of the range of lending volume and the enabling conditions?

8. The paper views the acceleration of productivity growth as the long-term challenge and puts forward a strategy based on (a) strengthening the human resource base, through improving the quality, quantity and accessibility of health and education services; (b) increased market orientation, especially for the public sector; and (c) increased Government role in managing technological development (paras 3.20 to 3.32). To what extent is this view of the long-term challenge and of the strategic approach to meeting it outlined by the paper shared by the Government? In particular, is not the Government's ambivalent approach to greater market orientation, as evidenced by the slow pace of the reduction of distortions and interventions in recent years and by lack of progress in increasing the autonomy and financial discipline of SEEs, a cause for concern?

Jet on employment mission cuts Turkey.

9. The Government's relative neglect of the social costs of the adjustment process has been a weakness. This has recently generated acrimonious political debate on the inequitable distribution of the burdens of adjustment and the fruits of growth. Popular discontent has shown up in widespread strikes. Are there indications of change in the Government's social orientation to justify the sharp planned increase in lending for social sectors? Are these projects likely to have a large poverty amelioration objective?

Social orientation

10. The paper points out the difficulties in policy dialogue faced in a number of areas, particularly in transport and agriculture. In agriculture, the Government lowered interest rates and increased input subsidies in violation of agreements with the Bank. Efforts under the agricultural sector adjustment loan to strengthen the policy and capabilities under the Ministry of Agriculture were also a failure (para 5.18). Further, the paper warns that "progress in this highly politicized sector will be slow". Given these factors, is it realistic to plan a doubling of lending to agriculture? and is such lending likely to have expected impact on productivity (increase) and poverty (reduction)?

Para 5.03

Policy Reversals in Agri

Agri. Loan ~~[illegible]~~ put on the shelf

Bank Exposure

11. All the three exposure guidelines are expected to be exceeded in 1988. The Bank's share of DOD is 20.2% and is projected to rise to 22% in 1991. Its share in total debt service is 14.5% and is projected to rise to 21% in 1991. Debt service to the Bank amounts to 4.5% of exports, increasing to 5.3% in 1988 and 6% in 1990. The Region's exposure management strategy envisages a reduction of Bank exposure over a longer time frame by (a) shifting to primarily project lending, and (b) following an aggressive policy on cofinancing of Bank loans. (Two or three SECALs are to be maintained in the program for the next two years to help meet the current "hump" in the country's financing needs). The strategy is dependent on the Government's successful implementation of stabilization and agreement on sectoral policy issues. The Region may be asked to elaborate the alternative approaches to exposure management which would have to be explored if the country's macro performance fails to improve and early agreement on sector policies is not reached.

cc: Messrs Lee, Shakow, Holsen, Rao, Burmester/Thahane, Liebenthal, Steer, Baudon, Hopper, Bock, Goldberg, Frank, Parmar, Pfeffermann, Baneth, Aguirre-Sacasa, Robless, El-Maaroufi, Tanaka, Kopp, Michalopoulos, Cohen, Balkind, Ms. Haug

VD:eg

July 15, 1988

P8072B004 Mr. Qureshi

1.

The World Bank
OPERATIONS COMMITTEE

Minutes of Operations Committee to Consider
Bangladesh - Financial Sector Credit Initiating Memorandum

Held on July 15, 1988 in Conference Room E-1243

A. Present

Committee

Messrs. M. Qureshi (Chairman)
S. Husain (LACVP)
A. Karaosmanoglu (ASIVP)
C. Michalopoulos (EMNVP)
H. Vergin (SVPOP)
I. Shihata (VPLEG)
J. Linn (VPDEC)
M. Gillette (AFRVP)

Others

Messrs. V. Dubey (EAS)
A. Ray (EAS)
C. Robless (OPNMS)
S. Asanuma (ASIDR)
O. Yenal (ASIVP)
Y. Huang (ASICO)
F. Temple (AS1IE)
P. Murgatroyd (AS1IE)
T. Baudon (SVPOP)
K. Siraj (COD)
C. Browne (IMF)
S. Choi (SECGE)
Ms. K. Nordlander (LEGAS)

B. Issues

1. The meeting was called to consider the Initiating Memorandum for a proposed Financial Sector Credit to Bangladesh. The discussion mainly followed the agenda prepared by the Economic Advisory Staff.

C. The Discussion

2. The Chairman opened the discussion by saying that several major issues needed to be seriously addressed in evaluating this operation. The financial sector in Bangladesh is rudimentary, highly regulated and inefficient, and dependent on substantial subsidies. Does the proposal represent an adequate first step? Is the proposed size of the credit warranted? Would the proposed credit prop up inefficient institutions rather than restructure them? He also questioned the efficacy of the proposed interest rate bands which seemed to him to be too narrow.

3. The Region said that this credit, which would be the second sectoral adjustment credit to Bangladesh, would address a fundamental problem in Bangladesh, namely dismal credit recovery. We no longer finance industrial and agricultural credit operations because of this problem. The proposed approach is derived from the comprehensive financial sector report prepared two years ago. The proposed operation would represent the first phase in a fundamental restructuring of the financial system. Therefore, at this juncture we need to improve the basic financial infrastructure, that is such things as accounting, supervision, debt recovery and provisioning. The Region emphasized the importance of starting slowly at

first, and of focusing the reforms on the Bangladesh Bank and on the Nationalized Commercial Banks (NCBs). The public part of the financial sector is not commercially oriented at this point, and there is considerable resistance to change throughout the institutions. The public part also pursues "public utility" functions. However, the system is privatizing; the private share has gone up from 8 to 30% in 7 years. The share of the private sector would be speeded up by the credit as lending to priority sectors would become more attractive after interest rates are increased. While two NCBs have thus far been privatized, one is not functioning efficiently, and the other is controlled by a wealthy industrial group.

4. With respect to interest rates, the Region envisaged very significant changes relative to the present. The proposed deposit rate band, in addition to giving the banks flexibility, would be more than twice the existing band; on the lending side also there would be much greater variation. At present the high-risk sectors often carry lower rates; that would change. The Region agreed with a suggestion from the Chairman that the rates should eventually be opened up completely. But it noted that at this time the NCBs--which represent about 75% of the system--have no proven capacity to set interest rates. The NCBs do not want any flexibility. This credit would provide technical assistance so that wider bands become more feasible in a follow-up sectoral credit. A Committee member said that it would be important to set these short-term objectives into a longer-term perspective, which should include substantial denationalization.

5. The Chairman stressed the central importance of overhauling the management system of the NCBs so that they can operate independently from the Government. Another member added that in low-income countries privatization by itself was not necessarily the answer if it did not bring about a change in the management system. The Region said that the cleaning up of the accounting system, recapitalization, introduction of penalties for making bad loans, etc., are steps towards the institution of a better management system.

6. A Committee member asked about the possibility of making this a hybrid operation, linking a part of the disbursements to the recapitalization process. He also asked about what could be done to reduce the "public utility" role of the banks. The Region said that the operation would have a lot of front-end actions; recapitalization would be done before Board presentation, the technical assistance component being the only one that would drag on. Apex operations would not be desirable since the banking system had no shortage of funds at this time. Regarding the public utility role, the proposal would gradually bring about a separation of the Jute corporations; we would also try to persuade the Government that loans to the rural poor should be paying propositions.

7. Regarding the adequacy of macro-economic policies, the Region referred to the IMF Stand-by during 1985-87, the current three-year PPF/SAF program which has proceeded satisfactorily during its first two years, and the possibility of an ESAF. As these programs indicate, the overall macro framework continues to be adequate. However, Bangladesh has settled into a low-level equilibrium with a very high aid-dependency. There continue to be major structural problems. The rise of foreign exchange reserves at this point need to be discounted both because the booms in workers'

remittances and in garment exports are unlikely to last and also because there is a need to stimulate growth and imports. Import demand will in any case pick up as a consequence of the on-going trade liberalization. While Bangladesh does not currently have a financial crisis with a liquidity problem, this operation will improve the efficiency of resource allocation, and also improve domestic savings in the medium-term. With respect to impact on fiscal and monetary variables, it was suggested that the issue was not simply one of making the various subsidies transparent; one must also check whether there would be any incremental expenditures and if so how they would be financed.

Decision

8. The Chairman agreed with the Region's view that we would have to try to agree with the Government on the basic principles and approach, clearly identifying the future steps and putting the currently proposed operation in that context. We would need to be able to envisage where the financial sector would be in three to five years, what the structure of interest rates would be, and the degree of autonomy in decision-making or privatization that the system would enjoy. There would need to be a very clearly articulated policy on management. As far as interest rate bands are concerned, we should make them as wide as possible and we should also make them conditions for Board presentation.

9. The Chairman added that we must ensure there is a perception on the part of the Government that the credit disbursements are linked to reforms. If possible, he would like some part of the credit to be linked to recapitalization. Finally, he noted that the proposed size of the credit is rather large which could only be justified if the quality of the improvements and the time-phasing we get are strong. We should not have any adjustment loans unless there is a clear desire on the part of the Government to move forcefully.

ARay:
vlw
July 19, 1988

THE WORLD BANK INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: July 13, 1988

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

EXT: 78051

SUBJECT: Bangladesh - Proposed Financial Sector Credit
Initiating Memorandum - Agenda

1. The Operations Committee will meet on Friday, July 15, 1988 at 10.00 a.m. in Room E-1243 to consider the IM for a Financial Sector Credit to Bangladesh in the amount of US$175 million. This credit is to be disbursed in two tranches against general imports other than those in a negative list. The primary implementing agency would be the Bangladesh Bank (BB). This would be the second sector adjustment credit in Bangladesh; the second-tranche release of the first one, that is the Industrial Sector Credit, was recently authorized. All the key trade-related conditionalities were successfully met.

Macro-economic Framework

2. The first issue that the Committee might wish to consider concerns the macro-economic framework for an adjustment operation of this size. The Region might wish to elaborate upon this framework with reference to the medium-term objectives in the PFP, current estimates of resource requirements, and the feasibility of using other lending techniques.

Program Design

3. As in most developing countries, there have been extensive administrative controls in the financial sector in Bangladesh, which has been dominated by nationalized commercial banks (NCBs). The NCBs have functioned more as budget transfer mechanisms than as financial intermediaries. The resultant problems bear a family resemblance to those encountered elsewhere--rigid and inappropriately differentiated nominal rates, poor collection performance, distorted real rates, and imbalances between savings mobilization and credit demand. While the GOB has already taken some actions to strengthen the financial sector through denationalization, the proposed credit would support further liberalization within the present organizational set up. Among the issues the Committee might consider are:

- whether we should help GOB map out a privatization strategy that can be supported through this and subsequent loans;

- whether it is possible to calculate "shadow interest rates" with any degree of precision. In a competitive market one would expect substantial rate differentials related to risks that are hard to estimate; in any event the 2-3% band proposed for free movements seems too narrow. The Region might elaborate upon the lending rate structure it envisages by the

principal categories of lending, and the provisions for revising both the levels and the structure of rates that it wants to have instituted. The Region might also explain the relatively narrow range proposed for movements in the deposit rates. Should we seek an explicit strategy for moving towards a flexible rate system?

- whether we should propose a phase-out of the subsidized credit lines as distinct from merely asking for greater transparency. Most of the portfolios of the NCBs consist of subsidized lending to agriculture, jute, non-traditional exports, small-scale industry and public enterprises. If the subsidized lines were only few, creating a special reimbursable account might have been relatively easy. However, some 60-70% of the portfolios of the NCBs involve priority lending of one type of another, implying complexity in the estimation of "shadow" losses and the extent to which the losses are not reimbursable because they reflect "inefficient" collection performance. In any case, if the subsidies cannot be phased out, one might consider separating them completely from the NCBs. In the case of the Jute corporations, for example, would it not be better to separate them from the NCBs since they rely essentially on budget transfers?

Subsidy

- whether the commitment of the GOB to the proposed reforms is likely to be strong and sustainable. The Region might comment on the risks with reference to such factors as the success of the technical assistance program, and the passage of the new law needed to facilitate debt recovery. Another question is the importance we should give in this operation to collecting past debts in view of the great difficulties experienced in the past.

cc: Messrs. Lee, COD; Shakow, Liebenthal, SPR; Holsen, CEC; Rao, Steer, FRS; Steer, FRS; Burmester/Thahane, SEC; Baudon, SVPOP; Asanunma, Yenal, Temple, Murgatroyd, ASI.

For Information

cc: Messrs. Hopper, SVPPR; Bock, DFS; Goldberg, VPLEG; Frank, Parmar, Pfeffermann, IFC; Baneth, IEC; Tanaka, (Ms.) Haug, EXC; Robless, OPNMS.

ARay:vlw

Approval conditioning

Restructure the wish lists

Reduce

"He who has never Faisted bitter will never know sweetness"

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: July 8, 1988

TO: Mr. Moeen A. Qureshi

FROM: Shinji Asanunma, Acting Vice President, Asia Region

EXTENSION: 73383

SUBJECT: BANGLADESH--Proposed Financial Sector Credit Initiating Memorandum

1. Attached is the Initiating Memorandum for the proposed Bangladesh Financial Sector Credit tentatively scheduled for a July 27-August 12 appraisal. It has been reviewed by regional, PPR, and IMF staff and, while there is agreement with all of the proposed conditions, I wish to draw your attention to two issues.

Credit Discipline

2. The proposed credit addresses critical financial sector issues which have constrained IDA's ability to support private agricultural and industrial development in Bangladesh through credit operations. Until 1986, IDA had supported 14 industrial subsector and small industries projects and 9 agricultural credit operations in which most project funds were channeled to private borrowers through financial intermediaries. Since then, however, IDA has not approved any new industrial or agricultural credit operations 1/ primarily because of the poor credit recovery performance.

3. Agricultural and industrial term loan recovery targets were established as second tranche release conditions for the 13th Imports Program Credit (IPC 13) and the Industrial Sector Credit (ISC), respectively. Release of the IPC 13 funds was delayed in 1986-87 partly because of unsatisfactory agricultural credit recovery levels. The ISC debt recovery target for 1987 was also not met, although the tranche was released because overall performance was considered satisfactory. Our experience has shown that establishing recovery targets provides short-term incentives for intensive recovery efforts but is not an adequate response to the underlying problems. The inadequacy of the banks' information on their loans has made it difficult to establish meaningful targets and consequently to assess whether shortfalls were due to poor performance or inappropriate targets. The targets also encouraged decisions to write off interest and principal in return for payments which, while maximizing short-term collections, rewarded defaulters for not having paid earlier and may have been suboptimal from a longer term perspective. They did not assist in improving the institutions' policies and procedures for enhancing collections on an ongoing basis.

1/ With the exception of the small, recently approved Industrial Energy Efficiency Project, which is to be implemented under an agency arrangement rather than as a normal credit operation.

4. The proposed credit adopts a more fundamental approach to financial sector reform. The problems of credit discipline will be approached through: (a) development of detailed debt collection strategies and monitorable targets for the 100 largest defaulters and for new loans in each nationalized commercial bank (NCB); (b) improving NCB loan accounting, management and information systems necessary to improve their ability to collect; (c) instituting interest suspension and provisions policies to create disincentives for making bad loans and failing to collect; (d) setting up a credit bureau function in the central bank; and (e) enacting a new debt recovery law. While the package of reforms should significantly improve the banks' ability to collect debt, political commitment is also essential with respect to enactment of new debt recovery legislation and getting tough on defaulters.

5. Our lending program assumes that sufficient progress will be made under the proposed operation to enable IDA to resume support for credit projects. The program therefore includes a 2nd Agricultural Credit Project in FY90 and a 4th Small Industries Project in FY92. The collection performance of the main industrial DFC is being monitored separately, and significant improvement as well as successful implementation of UNDP technical assistance in the areas of loan accounting, portfolio and collection monitoring are preconditions for an FY91(S) Industrial Investment Project.

Credit Amount

6. Bangladesh's recently improved foreign reserves position (now equal to about four months' imports) raises an issue about the proposed amount of the credit (US$175 million). We view the credit amount as appropriate in relation to the strength and breadth of the policy package and because Bangladesh has had, and will undoubtedly continue to have, a structural balance of payments problem, although reserves have temporarily risen significantly. This has occurred largely because of an upsurge in worker remittances (which have increased by 60% over the past few years) and repressed import demand consequent to the recent political instability and poor harvests. Counterpart funds, however, continue to be needed to augment inadequate budgetary revenues to cover local currency funding for the investment program and project maintenance requirements.

7. Bangladesh will need about US$6 billion in external financing over the three year period FY89-91. Total IDA disbursements are expected to be about US$1.7 billion during that period, of which US$0.7 billion is espected from adjustment operations and the balance from a diversified portfolio of investment operations. Non-project lending in the five year program for Bangladesh accounts for 42% of the total. As reflected in the long history of program lending to Bangladesh, the proportion is relatively high because of the country's dependence on substantial aid inflows to cover structural weaknesses in the country's external and internal resource position. Exports continue to finance less than 50% of imports and foreign resources finance nearly half of

total public expenditures. In view of the slowdown in GDP growth in FY88 (estimated at about 2%) and the improved external reserve position, the Bank has been discussing a more expansionary fiscal program with the Government. This position, and the proposed levels of quick-disbursing program aid, was presented in the last CEM, broadly endorsed at the April Aid Group Meeting, and is consistent with the PFP framework. The recent budget provides for a 25% real increase in development expenditures and an overall real increase of 6% (14% at current prices) in total public expenditures. Combined with further trade liberalization under the ongoing Industrial Sector Credit I and a proposed ISC II, these actions should lead to a revival in import demand for which the temporarily improved reserve position would provide a limited cushion. We project that the reserve ratio for the two year period FY89-FY90 will fall to slightly over three months.

Other Matters

8. In accord with your recent directive relating to inclusion of discussion of previous policy performance in adjustment operations, please find attached a matrix providing more detail with respect to performance under the only other structural adjustment operation in Bangladesh, the 1986 Industrial Sector Credit (ISC).

9. I would be grateful if you would consider scheduling the meeting to review this Initiating Memorandum for Friday, July 15, 1988 as that will be the last day Mr. Karaosmanoglu and Fred Temple, the concerned Division Chief, will be in the office prior to overseas travel.

cc: Messrs. Shihata (VPLEG), Rajagapolan (VPPRE), Wood (VPFPR), Vergin (SVPOP), Karaosmanoglu (ASIVP, o/r), Dubey (EAS), Lee (COD), Holsen (CEC) Shakow, Liebenthal (SPR), Baneth (IEC), Picciotto (PBD), Yenal, Fleisig (ASIVP), Asanuma (AS1DR), Temple (AS1IE), Clift, Huang (AS1CO), Quintos (LOASS)
Mmes. Koch (AS1CO), Nordlander (LEGAS), McNaughton (CECFP)

Attachments: Appendix A
Initiating Memorandum
Annex 1
Annex 2
Annex 3
Annex 4

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INDUSTRIAL SECTOR CREDIT

STATUS OF CONDITIONS FOR RELEASE OF SECOND TRANCHE

	CONDITION	REFERENCE	AGENCY/MINISTRY	STATUS	REMARKS
I.	EXPORT POLICY AND ADMINISTRATION				
1.	Establish a Duty Exemption-Drawback Office (DEDO)	DCA Schedule 4 Para 1; Agreed Minutes Para 2;	NBR	Drawback of Duty and Sales Tax Department established in December 1987 and Director appointed.	Condition fulfilled.
2.	DEDO to prepare administrative circulars setting forth input co-efficients and specifying guidelines for duty exemptions, duty drawbacks at flat rates and individual drawbacks covering imports required by the garment industry, including the import of inputs required by the suppliers to the garment industry.	DCA Schedule 4 Para 1; Agreed Minutes Para 2.	NBR	In February 1988, NBR issued SROs on drawbacks and on extending drawbacks to indirect exporters. DEDO has calculated 30 input coefficients by May 1988.	Condition fulfilled.
3.	Bangladesh Bank to issue an administrative circular and detailed operational guidelines for establishing an inland back-to-back L/C system.	DCA Schedule 4 Para 2; Agreed Minutes Para 3.	Bangladesh Bank	Bangladesh Bank issued circular establishing inland back-to-back L/C system in April 1987, and detailed guidelines in March 1988.	Condition fulfilled.
4.	Issue orders for duty free imports and income tax exemptions for indirect exporters.	DCA Schedule 4 Para 3; Agreed Minutes Para 3.	NBR	Tax benefits to indirect exports introduced in the Finance Act 1987. NBR issued SRO in February 1988 to extend duty-free imports to indirect exporters.	Condition fulfilled.
5.	Issue orders for the import of banned or restricted items by indirect exporters.	DCA Schedule 4 Para 3; Agreed Minutes Para 3.	CCIE Ministry of Commerce	Provision has been made in the IPOs for 1986/87 and 1987/88 for direct exporters. CCIE issued orders to include indirect exporters in May 1988.	Condition fulfilled.
6.	Complete for IDA review a study of the Export Credit Guarantee Scheme (ECGS). Take measures to modernize and strengthen the Scheme, including provision of necessary capital, staff and management.	DCA Schedule 4 Para 2; Agreed Minutes Para 4.	SBC Ministry of Commerce	Study of ECGS provided to IDA in November 1987. Export Credit Guarantee Wing of SBC converted into a department and capital increased along with authorized staff strength.	Condition fulfilled.

	CONDITION	REFERENCE	AGENCY/MINISTRY	STATUS	REMARKS
II.	TARIFF and IMPORT REGIME				
1.	Reduce duties on luxury items to a maximum of 150% by July 31, 1987, except for whisky and luxury cars (300%), and cigarettes, precious and semi-precious stones, beverage concentrates, perfumes and furs (200%).	DCA Schedule 4 Para 6; Agreed Minutes Para 6.	NBR	Tariffs on luxury items should be reduced to a maximum of 100% in May 1988, satisfying both FY87 and FY88 conditions.	Condition fulfilled.
2.	Restructure tariffs in the textiles and steel and engineering sectors so as to reduce total nominal staff tariff (custom duty, sales tax, development surcharge and licensing fees) for final goods to a maximum of 125% and make consequential downward adjustment to rates for the raw materials and intermediate products.	DCA Schedule 4 Para 7; Agreed Minutes Para 7.	NBR	Tariffs in the textiles and steel and engineering sectors reduced and rationalized in the 1987/88 budget as agreed.	Condition fulfilled.
3.	Reduce the number of items in the Negative List by about 20% each year beginning FY88 (defined as 20% of the number of four-digit (SITC) categories; should any item within a SITC category remain banned, then the entire category will be considered to remain on the list).	DCA Schedule 4 Para 8 (a); Agreed Minutes Para 7.	Ministry of Commerce	The IPO for 1987/88 has reduced the Negative List by about 13 categories, equivalent to a reduction of less than 4%. A revised IPO issued in May 1988 indicated that GOB has reduced the Negative List by 79 4-digit ITC categories, or 22%.	Condition fulfilled.
4.	Reduce the number of items relating to industrial inputs in the Restricted List by 33% each year beginning FY88 so that the restrictions are completely removed and such items become commercially importable by FY90.	DCA Schedule 4 Para 8 (b); Agreed Minutes	Ministry of Commerce	12 categories removed from the Restricted List in the IPO for 1987/88, equivalent to a reduction of about 17%. The interim revised IPO issued in May 1988 indicates that 50 4-digit ITC categories have been removed, of which 21 categories were categorized were clearly industrial.	Condition fulfilled.
5.	Implement reform measures to simplify customs procedures on the basis of the recommendations of the Report of Martial Law Committee on Revision/Review of Custom Laws, Rules, Regulations and Procedures.	DCA Schedule 4 Para 9; Agreed Minutes Para 8.	NBR	A large number of recommendations pertaining to customs procedures have been implemented. Others are in the process of being implemented.	Condition fulfilled.

	CONDITION	REFERENCE	AGENCY/MINISTRY	STATUS	REMARKS
III.	PUBLIC SECTOR INDUSTRIAL ENTERPRISES				
1.	Strengthen the ABW in the Ministry of Finance by assigning staff to the seven additional professional posts created within the ABW.	DCA Schedule 4 Para 10; Agreed Minutes Para 9.	ABW/Finance Division	Although seven slots have been sanctioned, their recruitment still awaits Presidential approval. Their work is currently being carried on by ABW.	Condition considered fulfilled.
2.	Establish performance contracts with three additional industrial enterprises during FY88.	DCA Schedule 4 Para 10; Agreed Minutes Para 9.	ABW	Contract with two enterprises (Karnaphuli Paper and Mubarakganj Sugar) established in July 1987 and with the Third (National Tubes) in December 1987.	Condition fulfilled.
3.	Furnish mid-year evaluation reports in respect of the three	Agreed Minutes Para 9.	ABW	Mid-year evaluation reports received in February 1988.	Condition fulfilled.
IV.	FINANCIAL SECTOR				
1.	The two DFIs (BSB and BSRS) to achieve the minimum collection target for the period of Jan. 1 through Dec. 31, 1987 of Tk 1,370 million.	DCA Schedule 4 Para 11; Agreed Minutes Para 10.	BSB, BSRS Finance Div.	The two DFIs collected about Tk 1,250 million during Jan.-Dec. 1987 period.	Cash Collections during 1987 were equivalent to about 91% of the agreed target. Condition considered fulfilled.
2.	The three NCBs (Sonali, Janata and Agrani) to achieve the minimum collection target for the period of Jan. 1 - Dec. 31, 1987 of Tk 136 million.	DCA Schedule 4 Para 11; Agreed Minutes Para 10.	Sonali, Janata Agrani Finance Division	The three NCBs collected about Tk 64 million during Jan.-Dec. 1987.	Cash collections during 1987 were equivalent to only 47% of the agreed target. Condition not fulfilled. Finance Div. provided IDA with action plan on continuing collections. Matter will be taken up in proposed Financial Sector Credit.
3.	GOB to substantially eliminate arrears due to BSRS from public sector enterprises.	DCA Schedule 4 Para 12; Agreed Minute Para 10.	Finance Div.	Public enterprise arrears to BSRS of about Tk 584.4 million reduced to about Tk 295.8 million.	Condition partially fulfilled. Finance Div. provided IDA action program on how the rest of the arrears will be eliminated.
4.	DFIs to increase their provisions for bad and doubtful debts in their FY87 financial statements; reschedule/write-off individual loans as appropriate; and, maintain D/E ratio at no more than 3 to 1.	DCA Schedule 4 Para 13; Agreed Minutes Para 11.	BSB, BSRS Finance Div.	Provisions made as agreed and D/E ratio maintained within agreed limits. Information on rescheduling/write-off provided to IDA in February 1988.	Condition fulfilled.
5.	Initiate the program of technical assistance to strengthen the DFIs.	DCA Schedule 4 Para 14; Agreed Minutes Para 12.	BSB, BSRS, UNDP, ADB	PRODOC for technical assistance signed by GOB and UNDP, and ADB Board approved proposed. ADB has submitted shortlist of consultants and selection process under way.	Condition considered to be fulfilled.

July 1, 1988

The World Bank
OPERATIONS COMMITTEE

CONFIDENTIAL

The Operations Committee met on July 1, 1988 to discuss the China-Country Strategy Paper. The meeting was held at 3:00 p.m. in Room E-1243.

A. Attendance

Committee

Messrs. M. Qureshi (Chairman)
S. Fischer (VPDEC)
D. Goldberg (VPLEG)
S. Husain (LACVP)
E. Jaycox (AFRVP)
A. Karaosmanoglu (ASIVP)
W. Thalwitz (EMNVP)
H. Vergin (SVPOP)
J. Wood (VPFPR)

T. Baudon (SVPOP)
P. Cadario (AF3CO)
V. Dubey (EAS)
W. Fleisig (ASIVP)
J. Goldberg (AS3AG)
D. Hanna (FRS)
K. Jay (SPRPA)
F. Levy (EAS)
B. Merghoub (AS3CO)
S. Rajasingham (DFS)
G. Tidrick (AS3CO)
A. Vorkink (LEG)
S. Yusuf (AS3CO)

B. Issues

The discussion followed the agenda prepared by the Economic Advisory Staff. The principal issues concerned economic management and its implications for Bank lending.

C. Discussion

The Region began the discussion with a brief history of the Bank's relationship with China, noting that there is still much to be learned about the country and what needs to be done there. A comprehensive long-term strategy is thus not feasible; rather the Region would continue to learn and to monitor the reforms and the development of the economy as they progress and recommend any consequent needed changes in the Bank's program.

The Chairman commended the brevity of the CSP but indicated that some issues and their implications for the Bank could have been given a fuller discussion. Specifically, he asked to what extent China's macroeconomic management put the progress of its economic reforms and the Bank's own lending program at risk. He noted that inflation was inhibiting more aggressive price reform, which, in turn, was essential to the effectiveness of other elements of reform. Another member of the Committee observed that some "turbulence" was to be expected in China's economic management under the present circumstances and urged that the Bank persuade the Government to allow the resultant inflation to be open rather than to hide it with price subsidies which would only compound the inflationary pressures.

The Region pointed out that China's fiscal deficit was not out of line for a rapidly growing economy, but that, nevertheless, the Government did not have full control of macroeconomic policy. Part of the problem derives from the decentralization of authority over state enterprise revenues and investments to the provincial and local governments without a matching reduction in the expenditure responsibilities of the central government. Moreover, the provincial and local governments often have more influence over the credit decisions of the banking system, including the local branches of the central bank, than do the central authorities. At the same time, state enterprises are still not effectively responsible for their losses, and so their demand for credit is relatively unconstrained. To some extent, the problem is one of political will, and the central authorities have so far not faced the task of taking back some of the power that was previously decentralized. As a consequence of these factors, the money supply has been growing rapidly, and inflation has accelerated. The central authorities can always reinstitute direct controls and slam on the breaks, if need be. That has been their tendency in the face of inflationary pressures in the past, but they are currently more willing to take a calculated risk and go forward with price reforms despite the likely acceleration of inflation. At the same time, they have sought the advice of the Bank and Fund regarding aggregate demand management, recognizing the danger that accelerating inflation could represent. Several major Bank ESW tasks are currently focussing on macroeconomic management issues.

One member expressed concern that the CSP seemed to lack a strategic vision of the sequence and priority of the reform measures that need to be taken in China. Having determined the country to be creditworthy, the paper appears to have adopted a rather passive stance, not using the lending program as way of dealing with strategic issues. He remarked that, given China's very high investment rate and high capital-output ratio, there must be substantial allocation problems to be resolved. The Region pointed out the difficulty of clearly identifying an optimal sequencing of reforms, given the magnitude of the change China has undertaken. The problem is not one of leverage; the Chinese authorities have been unusually open to Bank advice. In general, the Bank has focussed on those reform elements where it had a comparative advantage to offer--e.g., financial sector, agriculture, and enterprise reforms--and has been able to make a wide range of recommendations, many of which are being implemented. The Region also explained that the sequencing decision is not made in a vacuum but depends on the opportunities and demands of a changing economic and political situation. Moreover, there is a need to be cautious in the face of our limited knowledge--it is only in the last 2-3 years that the Bank has been able to do intensive sector work in China--and the great diversity of conditions from one part of the country to another.

The Chairman pointed to a few areas where he thought the Bank might be a bit more active in its advice; viz., the importance of price reform, the need to restore central management to credit expansion, and the rationalization of foreign exchange allocation. He emphasized also the need to push the IMF more actively into the picture. He asked whether debt management was still a problem. The Region indicated that there was still some problem in the coordination and execution of debt policy, with both the People's Bank and the Ministry of Finance claiming competing responsibilities.

The Chairman asked about internal barriers to trade in China and whether market entry continued to be circumscribed. The Region indicated that a major study had been launched on this issue, and that the forthcoming CEM would have several chapters devoted to it. The segmentation of the domestic market is beginning to break down as a result of improving infrastructure and enterprise and price reforms, but it remained a serious problem. The Government's policy to emphasize coastal development conflicted in some respects with internal market integration, and there is no domestic consensus on the issue. The general problem, however, is not one of national laws and policies but rather of local power and tradition. Meanwhile, the Bank is contributing to integration through infrastructure projects and improving local competitive bidding procedures. It was pointed out that the tax system gives local governments the incentive to prevent resources from leaving the locality and new enterprises from entering it. The foreign exchange retention system provides similar incentives. The Bank is working on these issues through ESW and policy advice.

A member remarked that the CSP seemed to promote greater external borrowing by China, and he questioned whether this was wise in view of the institutional and macroeconomic management issues. The country's creditworthiness could deteriorate very quickly. Another member disagreed, however, noting that China was directing borrowed funds to highly productive investments, that it was basically a very conservative country enjoying high rates of growth of output and exports and a high savings rate, leading him to conclude that it is difficult to see a creditworthiness problem. The Chairman agreed that creditworthiness was not an imminent problem, but that the authorities could lose macroeconomic control given their present lack of adequate policy instruments. The CSP therefore needed to give greater attention to the questions of risk analysis, country creditworthiness, and the Bank's options in this regard.

A member noted the paradox that in order for the Bank to remain a small relative creditor, it could be tempted to encourage a country to borrow more from others. He pointed out that holding a small portion of a large debt is not necessarily less risky than holding a larger portion of a smaller debt. Another member added that the Bank's exposure guidelines were not concerned only with the issue of risk but also the concentration of resources in a single country. He argued that high concentration needs to carry with it important developmental implications, and he did not get an impression from the CSP that the proposed Bank lending level was related to any particular development goals. The Region responded that, given China's size, it would necessarily be difficult to demonstrate a major Bank impact on any particular sector of the economy. The lending level is explained chiefly by the fact that China is one of the lowest-income countries in the world, and that it is able to absorb a high volume of resources with very high returns. Moreover, the recent Communist Party Conference made a clear decision to push forward with the economic reforms, and the Government sees Bank lending as offering concrete support to our reform recommendations.

In response to a question regarding which activities would be affected if the total program were to be reduced, the Region described the Bank's lending to China as spread widely across sectors and regions, in a pilot fashion, with the expectation that the Chinese themselves would carry out the repeater operations in other regions. Given the high priority of all the sectors, it is difficult to identify a core program, except on a project-by-project rate of return basis.

A member cited a reference in the CSP to the problem of deteriorating agricultural infrastructure, which he characterized as very worrisome and wondered what is being done about it. The Chairman affirmed that this should be a major aspect of the Bank's work in the agricultural sector. The Region agreed and indicated that the Government had recently asked the Bank to study the problem.

The Chairman summed up the meeting by noting that China is certainly one of the large member countries where the Bank is playing a major role in influencing Government thinking. He instructed that the CSP be modified with greater focus on the role the Bank has played and will continue to play with regard to the economic reforms. He specifically asked that the sections on debt management and creditworthiness be treated in a more comprehensive fashion, and that a greater sense be given to how the economy's performance will affect the Bank's lending posture and role.

F.D. Levy, EAS
July 13, 1988

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: June 28, 1988

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

EXT: 78051

SUBJECT: China - Country Strategy Paper - Agenda

1. The Operations Committee will meet on Friday, July 1, 1988, at 3:00 p.m., in Room E-1243 to consider the China CSP. The Committee may wish to discuss the issues outlined in paragraphs 5-10 below.

Background

2. Ten years ago, China embarked upon an far-reaching program of reforms, aimed at decentralizing economic decision making away from the central administration and toward farm households, enterprise managers, and provincial and local governments. Resource allocation decisions have increasingly responded to market forces in place of administrative command and fixed prices, and material incentives are rapidly supplanting strict egalitarianism. The reforms were introduced first and have proceeded the fastest in the rural economy, with the result of substantial shifts in land use and explosive growth of rural industries. Reforms have been slower and more uneven in the bureaucratically, politically, and technically more complicated urban industrial sector. Nevertheless, the multiplication and diversification of financial instruments and institutions and of service enterprises generally, the gradual commercialization of housing, cautious steps toward allowing greater labor mobility, the introduction of a bankruptcy law, active debate over property rights, etc. all attest to the dynamism of the reform process.

3. The growth of output over the decade has been unusually rapid. Investment rates have remained very high, financed in part by credit expansion and increased foreign borrowing. Indeed, increasing concern has been expressed over growing inflationary pressures and the apparent difficulty of constraining domestic credit, external borrowing, and the level of investment during the present incomplete state of reforms. Although substantial price adjustments and liberalization have occurred, crucial actions on this front continue to be inhibited both by the resistance of the potentially injured parties and by the fear of setting off a cost-price spiral in the absence of effective monetary control.

4. In the meantime, an unusually close and active policy dialogue has evolved between the Chinese authorities and the Bank, placing particularly heavy demands on Bank staff for high quality economic and sector work, the orchestration and, in some cases, the direct management of broad-ranging technical assistance, as well as a large and fast growing lending program.

Issues

Economic Management

5. Inflation has accelerated in recent years partly as a result of rapid monetary expansion, which may reflect in turn the continuing weakness of the People's Bank vis a vis central, provincial and local government spending authorities. Also contributing to inflationary pressures are a growing budget deficit, including the food and other subsidies the Government has felt compelled to provide to consumers rather than pass on the increases in producer prices. Views within the Government seem to differ now on the urgency of curbing inflation and on the degree to which other reforms, especially price reforms, must await progress against inflation. The Region may wish to comment on:

- The current "state of play". Does the Government have a clear understanding of these issues and a coherent strategy for dealing them?

- The prospects, therefore, for aggregate demand management over the next few years and the implications for the progress of reforms more generally. Specifically, does it make sense for China to proceed with trade and financial sector liberalization before further substantial progress is made in macroeconomic management and price reform?

- The status of demand management issues in our policy dialogue with China. What progress has been made in these areas under the Fund Stand-by?

- The assumption that reforms at the sectoral level (and, hence, Bank sector lending) can be effective in a context of weak macroeconomic management?

6. Although China's external debt and creditworthiness indicators remain strong, debt has grown rapidly in recent years, and concern has been expressed by the international agencies and others with regard to the decentralization of borrowing authority and incompleteness of debt data available to the authorities. Meanwhile, responsibility for debt management has been contested between the People's Bank and the Ministry of Finance.

- What progress is being made in external debt management? Has the issue of authority over the formulation, execution, and monitoring of external debt policy been satisfactorily resolved?

7. Integration of China's vast domestic market is important to creating a competitive environment, taking advantage of regional comparative advantages, and thus raising the efficiency of the industrial sector. However, the Central Government's policy of creating foreign trade zones seems to run counter to this objective. At the same time, provincial and local governments have erected barriers to trade to protect their own industries and assure them cheap raw material supplies.

- What is the nature of the Bank's dialogue with the authorities on this issue? Is policy conditionality in this regard called for in proposed lending in the industrial sector and to provincial governments? At a minimum, what will be done to assure that our operations do not contribute to market segmentation?

8. The CSP stresses the importance of maintaining China's relatively generous social security system. Its funding will have to change radically, however, as a prerequisite of enterprise reforms and increased labor mobility. Moreover, the current one-child policy and its impact on the age profile of the population have important implications for the future finances of the present or any successor system.

- What are the implications of the economic reforms for the quality of the social safety net in China?

- What must be done to prevent social security from becoming a major fiscal burden?

- What are the implications for the one-child policy, and of any changes in the latter on other social expenditures?

Bank Strategy

9. The CSP proposes a rapid growth of the Bank's exposure in China over the next several years, noting that the country will remain creditworthy, provided that economic reforms are continued and macroeconomic stability is maintained. Neither of these assumptions, however, is assured. The Region may want to clarify:

- How the size and composition of the proposed lending program would be modified in the event that the reforms falter or proceed more slowly than presently foreseen, and/or macroeconomic management weakens. Has the Region defined a "core" program?

- The kinds of conditionalities expected to apply to the various elements of the lending program, and how they are to be handled in the China situation. What is meant by the CSP's reference to adapting "SECAL procedures and features to China's unique conditions, but in a way that does not compromise their applicability to other borrowers or in future situations with China" (para. 33)?

10. China's demand for technical assistance is large and growing, and the Bank has been playing a central role in orchestrating and finding grant funding for various technical assistance activities. The Region proposes to add a new technical assistance unit to the China Department as a focal point for these activities.

- Is this a proper role for the Bank to play? What are the pros and cons of the Bank staffing such an effort, in contrast, say, to UNDP, or to using a loan vehicle such as the recent special credit to strengthen China's own capabilities in this regard?

cc: Messrs. Lee, Shakow, Holsen, Rao, Burmester/Thahane, Liebenthal, Steer, Baudon, Hopper, Bock, Goldberg, Frank, Parmar, Pfeffermann, Baneth, Aguirre-Sacasa, Tanaka, Robless, Burki, Merghoub, Tidrick, Cadario, Ms. Haug

F. Levy, EAS

June 24, 1988

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1.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: June 20, 1988

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

SUBJ: The Bank's Experience with Public Investment/Expenditure Reviews--Proposed Agenda

1. The Operations Committee will meet on Friday, June 24, 1988, at 3:00 p.m. to discuss Public Investment/Expenditure Reviews: The Bank's Experience.

Background

2. This paper, prepared by the Public Economics Division of CEC, considers recent Bank experience in conducting Public Investment or Expenditure Reviews (PI/ERs). It is the first such effort with a Bank-wide perspective and is based on 22 PI/ERs that reached green or gray cover between January 1985 and January 1987. It incorporates the views of mission leaders and other knowledgeable Bank staff. An earlier draft was discussed in a Bank-wide seminar; a subsequent draft was discussed more recently by PPR Management.

3. The first part of the paper reviews the Bank's experience under four headings: (i) objectives and benefits; (ii) coverage of topics; (iii) organization and costs; and (iv) interaction with the government, IMF, and aid donors. Drawing on this experience, the second part of the paper offers recommendations for the Bank's approach to PI/ERs in the future. An annex describes analytical practices currently in use as revealed in the reports reviewed.

4. The main findings of the paper are as follows. PI/ERs are used for several purposes, including lending development. Recommendations are often incorporated into SALs and SECALs as conditionality, and this linkage with the lending program is important to assure PI/ER benefits. Substantial resources are used in PI/ERs; yet dissemination is limited. Average recorded staffweeks per report were 101, and an average of 19 staff/consultants contributed to each report, although such figures reflect the overlap with sector work. Processing time is lengthy. Nevertheless, less than half the green cover reports are processed to gray, and conclusions are often shared with aid donors in only abbreviated form. The coverage of topics in PI/ERs tends to be broad and does not clearly reflect country circumstances. Until recently, relatively little work on expenditures has been included in background sector work, and there is often little comparability in the sectoral approach. For these and other reasons, contributions to PI/ERs from Bank staff and consultants can be deficient.

Discussion Agenda

5. The paper's recommendations are aimed at improving PI/ERs and making them more cost effective. Do members of the Operations Committee find the contents of the paper and its recommendations generally consistent with their views of the appropriate Bank approach to PI/ERs?

6. What are the operational implications of the recommendations, and how should the recommendations feed into the operational cycle? For example, one recommendation is to strengthen the background sector work for PI/ERs--thereby reducing the need for large PI/ER missions and permitting a more effective response at short notice. Assuming general agreement that this is desirable, OC members may wish to discuss what prevents better background sector work for PI/ERs at present and whether and how it can be given higher priority in the work program. In principle, it could be done through formal or informal sector expenditure reviews, as part of more general sector reports, or in conjunction with project identification and/or supervision missions. How might the background sector work be coordinated so that cross-sectoral problems are identified and explored?

7. Another recommendation of the paper is to assure a strong link between the PI/ER and the lending program--through conditionality and also by requiring staff undertaking PI/ERs to formulate explicit recommendations for improving the Bank's on-going program. How might this affect the design and timing of PI/ERs so that they can feed in better to the CSP and the CAM? And how might other recommendations--such as, practicing greater selectivity in coverage of issues to permit more in-depth analysis and concrete recommendations, drawing on alternative options for report format and mission organization, and adhering more strictly to time guidelines in report processing--affect the timing and content of the Issues Paper for PI/ERs? These managerial decisions will need to be faced at the Departmental, or perhaps Regional, level.

8. Regarding dessimination of the findings and recommendations, PPR proposes to distribute the paper Bank-wide. What additional role might EAS and/or COD play in raising the issues addressed in the paper as country activities are carried out? How might this differ from or complement the role of Regional Chief Economists and Lead Economists? What need might there be to take the findings of this paper into account in regional guidelines on economic and sector work?

Including Review ~~Re~~ meeting
Oversight function
How to accomplish the objectives of the mission

OC Members

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

cc: Messrs. Lee, Shakow, Holsen, Rao, Burmester/Thahane, Liebenthal, Steer, Baudon, Hopper, Bock, Goldberg, Frank, Parmar, Pfeffermann, Baneth, Robless, Ms. Haug

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: June 2, 1988

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

THROUGH: Mr. W. David Hopper, Senior Vice President, PPR

FROM: John A. Holsen, Director, CECEM

SUBJECT: Discussion by the Operations Committee of the Bank's Experience with Public Investment/Expenditure Reviews

1. We would like to submit the attached paper, entitled "Public Investment/Expenditure Reviews: The Bank's Experience", for discussion at a meeting of the Operations Committee. After taking into account the comments provided, we propose to distribute the paper Bank-wide.

2. The paper, prepared by the Public Economics Division of CEC, considers recent Bank experience in conducting Public Investment or Expenditure Reviews (PI/ERs). It is the first such effort with a Bank-wide perspective and is based on 22 PI/ERs that reached green or gray cover between January 1985 and January 1987. It incorporates the views of mission leaders and other knowledgeable Bank staff. An earlier draft was discussed in a Bank-wide seminar; a subsequent draft was discussed more recently by PPR Management.

3. The first part of the paper reviews the Bank's experience under four headings: (i) objectives and benefits; (ii) coverage of topics; (iii) organization and costs; and (iv) interaction with the government, IMF, and aid donors. Drawing on this experience, the second part of the paper offers recommendations for the Bank's approach to PI/ERs in the future. An annex describes analytical practices currently in use as revealed in the reports reviewed.

4. The paper makes a number of recommendations for improving PI/ERs and rendering them more cost effective. These include (i) strengthening the background sector work for PI/ERs but exercising more restraint in committing Bank resources to a major study; (ii) formulating explicit recommendations in PI/ERs for improving the Bank's on-going and proposed lending programs; (iii) assigning staff responsibility within Country Departments for sector and overall PI/ER work; (iv) practicing greater selectivity in coverage of issues to permit more in-depth analysis and concrete recommendations; and (v) adhering more strictly to time guidelines in report processing.

5. The purpose of the discussion by the Operations Committee would be to elicit comments on the substance of the paper's findings and recommendations. We would appreciate your scheduling a time for discussion at your earliest convenience.

cc: Messrs. Fischer (VPDEC), Dubey (EAS)
Khalilzadeh-Shirazi, Mrs. de Melo (CECEM)

June 23, 1988

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The World Bank
OPERATIONS COMMITTEE

CONFIDENTIAL

June 29, 1988

Minutes of the Operations Committee Meeting to consider MOZAMBIQUE: Third Rehabilitation Credit-Initiating Memorandum, held on June 23, 1988, in Conference Room, E-1244.

A. Present

Committee		Others	
Messrs.	M. A. Qureshi (Chairman)	Messrs.	T. Baudon (SVPOP)
	H. Fleisig (ASIVP)		J. Biderman (AF6CO)
	D. Goldberg (VPLEG)		F. Levy (EAS)
	J. Holsen (VPDEC)		C. Obidegwu (SPRPA)
	E. Jaycox (AFRVP)		O. Rahkonen (SEC)
	M. Selowsky (LACVP)		I. Sam (AF6IN)
	A. Steer (VPFPR)		N. Tcheyan (AF6CO)
	H. Vergin (SVPOP)		M. Walton (AF6CO)
Ms.	M. Nishimizu (EMNVP)		R. Williams (IMF)

B. Issues

1. The Operations Committee met on June 23, 1988 to consider the Initiating Memorandum (IM) for a Third Rehabilitation Credit to Mozambique in the amount of $90 million. The discussion broadly followed the agenda prepared by the Economic Advisory Staff. The issues raised included: the adequacy of the proposed policy reforms and their relationship with the parallel Fund program, assumptions underlying the macroeconomic analysis and projections, constraints imposed by the security situation, loan size and the mix of policy-based and investment lending to Mozambique, and retroactive financing.

C. The Discussion

2. The Region presented a broad overview of Mozambique's economic situation and the country's adjustment efforts over the past two years in the face of limited human resources, civil war, and the distortions created by past economic policies. After several years of sharp decline of output and consumption, the economy achieved a modest turnaround in 1987, GDP growing by some 3-4%, with substantial support from the Bank, Fund, and bilateral donors. Although significant distortions still remain, substantial reform measures have been introduced by the Government, which is now fully committed to the adjustment program. These measures and the additional policy actions to be taken under the proposed operation will help to establish a base for more rapid growth, once the security problem is resolved. Sustained adjustment, however, will require continued support from external donors, who are expected to provide more than 100% of investment financing over the next several years.

3. The Chairman asked whether the reforms to be supported by the proposed credit represented sufficient progress; in particular, why faster adjustment of the exchange rate was not being pursued to support more rapid liberalization of the trade regime. The Region responded that further action on the exchange rate was anticipated under Mozambique's agreement with the Fund, and that the Region was working closely with the Fund in coordinating exchange rate and trade conditionality. In response to a question from the Chair, the IMF representative indicated that they have not defined a specific exchange rate target, inasmuch as an equilibrium rate is practically impossible to define in Mozambique's present environment. They are working instead toward an agreed process of exchange rate adjustment, probably on a monthly basis, in accordance with a basket of indicators and intended to reduce the differential with the parallel market rate. The Chairman emphasized the importance of maintaining the competitiveness of exports and the incentives of exporters, while moving forward with trade liberalization. As a general point, he noted that it would be helpful for IMs to mention the conditions regarding exchange rate, monetary and fiscal targets, etc. contained in Fund programs, so that the readers can understand and evaluate the overall macroeconomic scenario being presented.

4. In this latter regard, the Chairman asked for further clarification of the macroeconomic framework of the operation, particularly the significance and interrelationships of the budgetary and current account deficits and projected inflation. The Region explained that although the fiscal deficit remained very high, its impact on domestic inflation had been considerably reduced by the shift from domestic to external financing. In addition, there had been a sharp cut in subsidies and restraint of public sector wages. Inflation in 1987 had been caused principally by exchange rate devaluation and administered price adjustments, and the projected 1988 inflation reflected the further expected devaluation and price adjustments. The Region also mentioned that public expenditure review had been undertaken, and the report would analyze prospects for further reducing the fiscal deficit. The Chairman noted the importance of timely completion of that report to provide a basis for the related conditionality of the proposed operation. The Region indicated that the report's preliminary conclusions had already been discussed with the Government, and that a draft would be ready by negotiations.

5. A member expressed doubts that trade liberalization should be undertaken at all at this time in view of the highly unstable macroeconomic situation. He noted that if the Government were forced to withdraw the proposed OGL window, after having introduced it, it would make later liberalizing measures more difficult. He asked if consideration had been given to an auction mechanism as an alternative. The Chair noted that the proposed OGL was very small in any event, so that little was in fact being risked. The Region agreed but argued that it will lay the basis for more ambitious reforms in the future and, in the meantime, will provide information to the policymakers on the demand for imports that does not presently exist. It was also explained that, in addition to the resources to be committed to the OGL window, the Region was discussing with cofinancers the untying of aid resources that would be necessary to support a broader liberalization of the foreign exchange allocation process.

6. The Chairman agreed that an auction mechanism might be considered as an alternative to the OGL. In any event, other policy reforms could not be considered apart from the contemplated adjustment of the exchange rate. Moving on to another topic, he asked why the progress anticipated regarding domestic price decontrol, where risks were less than with trade liberalization, was so slow. He noted parenthetically that the IM's focus on the number of goods to be liberalized was not very helpful in understanding the extent of liberalization involved. The Region agreed with this latter point but explained that the limited data available in Mozambique did not permit reliable estimates of the importance of the various goods in consumption or GDP. They explained further that the Government was very cautious with regard to price decontrol because of a number of factors, including the security situation, the possible impact of food aid on producer incentives, the monopsony power of some exporters, and their desire to assure supplies to specific regions unable to get the goods through normal marketing channels. The Region considered there to be little scope for further substantial price decontrol until the security situation improved. Emphasis would be given to selective decontrol in areas of greatest potential production response. Responding to the Chairman's question, they clarified that the type of goods to be decontrolled could include milk, fish, and meat products, or other goods produced by family farmers.

7. A member asked the dimensions of the security problem in terms of control over production and the Government's administrative "reach". The Region explained that the rebels tended not to hold defined areas for very long but rather to keep moving, disrupting the local economies, displacing population, and destroying infrastructure as they go. The cities are now generally secure. The Government estimates that about 40% of total expenditures are directed to the war effort. Despite the problems caused, however, the economy is responding positively to the adjustment program.

8. A member noted that the macroeconomic scenario emphasizes foreign financing instead of domestic saving, which is in fact negative. He asked whether it is sound to base public expenditures on foreign financing. Another member added that even at the end of the projection period there would still be large negative national saving and asked whether this was the best that could be done. The Region responded that the need for foreign financing is driven by import requirements and the question, therefore, is whether the projected imports are necessary to the adjustment process. The Region estimates that about 40% of imports go to consumption. Public sector dissaving is being eliminated over the projection period, but household dissaving continues to be large because of the need to maintain consumption levels in the face of war-related disruptions in production. The level of real investment will still reach only about half of what it had been in the early 1980s.

9. The Chairman noted that the proposed credit is larger than the previous Rehabilitation Credit and asked whether it might not be preferable to put the increment into investment lending instead, particularly in view of the increased availability of cofinancing for the proposed operation and its relatively modest conditionality. This comment was also reiterated by another speaker, who pointed out that the projected current account deficit on the balance of payments was equivalent to 60% of GDP and wondered

whether the economy could productively absorb such a volume of external financing. Another speaker asked whether a positive list might not be appropriate for use of the proposed credit to assure their proper use. The Region responded that policy reforms, especially on the macroeconomic side, are being carried out remarkably fast under the unusually difficult circumstances of Mozambique, and that such untied lending was essential given the country's foreign exchange requirements for wage goods, spare parts, etc.; the large extent to which other sources of foreign exchange were tied to specific projects and imports; and the country's limited ability to generate projects. Moreover, available evidence suggests that the bulk of incremental free foreign exchange is going to the spare parts, raw materials and wage goods on which the recovery of production depends. The Region also pointed out that the proposed operation is a rehabilitation credit, not a SAL, which would go beyond what is permitted by the present situation.

10. The Chairman accepted this argument but cautioned that Mozambique not become excessively dependent on budgetary support and that the Bank's support must move them in a sustainable direction that emphasizes raising the country's productive potential. He concluded that the IM should have presented the operation differently. It should be viewed as a continuation of rehabilitation efforts in a very difficult security situation, emphasizing macroeconomic objectives, rather than as a major step toward liberalizing the economy. It should be made clear that only measured, yet steady progress can be made toward this latter objective, and that within this context emphasis will be given to products that offer the greatest potential for supply response. He also reiterated the importance of linking trade liberalization to progress on exchange rate adjustment.

11. On the question of retroactive financing, the Chairman indicated that a clear case, not presented in the IM, would have to be made.

FDLevy/cpf

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

8806 20 001

DATE: June 17, 1988

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

EXTN: 78051

SUBJ: MOZAMBIQUE: Third Rehabilitation Credit - Initiating Memorandum

The Operations Committee will meet on Thursday, June 23, 1988 at 3.00 p.m. in Room E-1244 to discuss the Mozambique - Initiating Memorandum for a Third Rehabilitation Credit for $90 million.

Introduction

The proposed credit supports the continuation of the reform process initiated in 1987 under the Government's Economic Recovery program to restore growth through increased efficiency by reducing the degree of administrative controls, reduction of financial imbalances and the restoration of orderly relationships between trading partners and creditors. The Second Rehabilitation Credit of $70 million was approved in August 1987 and its second tranche was released in February 1988. The Third Rehabilitation Credit, has as its aims the phased reduction of the administrative allocation of foreign exchange through the opening of a Open General License window; reform of tariffs, removal of price controls, reduction of controls over the administrative allocation of goods, and improvements in public expenditure allocation.

Since the adoption of the Economic Recovery Program, there has been a modest recovery of output, an increase of 3-4% in GDP in 1987 mainly arising from increased production in light industry due to the greater availability of raw material imports, and spare parts, and from an increase in family sector crop production. As regards, external balance, the current account deficit increased from US$140 million to US$767 million between 1986 and 1987 and the overall fiscal deficit remained at 50% of total expenditures despite the reduction of many components of recurrent expenditure reflecting the aid related capital inflow. Inflation has been reduced to 60-70% in 1988 declining by some 150% in the previous year and the exchange rate has been devalued from 39 Meticals per US dollar to 450 Meticals at the end of 1987. The exchange rate remains over-valued despite the significant devaluations since 1987. In the meantime even after generous debt relief, Mozambique debt service ratio was 45% in 1987. The Government's reform program and strategy has been discussed in the context of a Economic Policy Framework paper by the Committee of the Whole in March 1988 while a second year Structural Adjustment Facility has been authorized by the Fund Board in March 1988.

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Macroeconomic Imbalances

Despite the significant progress in the recovery of the economy, the underlying macroeconomic situation remains one of concern. The Region may be asked to:

(a) comment on the underlying macroeconomic situation and the prospects for further reduction in imbalances in the next three years.

(b) elaborate on the assumptions that underlie the projections. The current account deficit is expected to increase by about $460 million (60%) between 1987-92. This is offset by an assumed increase in government grants of about $300 million and increases in external borrowing. A large uncovered financing gap is also projected. How realistic are these assumptions?

The very large volumes of external assistance together with a high investment rate (which jumped from 9% of GDP in 1986 to 20% in 1987) make the ongoing public expenditure review and the conditionality deriving from it very important.

- The Region may be asked to inform the committee of the preliminary findings of the review.

Implementation Issues

The Mozambique Government has a dearth of qualified public officials. The recovery program aims at decentralization of economic decisions so as to redirect the efforts of public officials towards medium to long run policy-making.

- The Region may wish to elaborate as to how it sees implementation of the Third Rehabilitation Credit given the above constraint and from the lessons of the previous two credits.

The Open General License Window

The credit proposes to establish a small Open General License window to reduce the extent of administrative allocation of foreign exchange, provide automatic access to enterprises to direct imports and provide incentives for exporters. The Region may wish to comment on:

(a) the proposal by the Government of establishing a Market Fund and Small and Medium Enterprise Fund, the former providing access to all enterprises for a narrow range of inputs and the latter to all inputs to a restricted group of enterprises.

(b) the implications for the exchange rate of adopting even a small OGL window given that the persistence of macroeconomic imbalances is likely to keep the exchange rate over-valued.

Why not more devaluation

Price De-control

The credit also proposes to support a program of domestic price de-controls so as to increase incentives for production and distribution and to decentralize economic decision making.

- The Region may wish to comment on the pace of the price de-control taking into account the expected level of the exchange rate and the continuance of many price controls relating to crops and other items.

Retroactive Financing

Retroactive financing of $20 million, from four months before the planned date of Board approval is being proposed.

Why?

- The Committee may wish to be informed of the rationale for such financing.

cc: Messrs. Lee (COD), Shakow (SPR), Holsen (CEC), Rao (FRS), Baneth IEC), Thahane/Burmester (SEC), Liebenthal (SPR), Steer (FRS), Baudon (SVPOP), Bock (DFA), Frank, Parmar (IFC) Hopper (PPR), Goldberg (VPLEG), O'Brien, Koch-Weser, Sandstrom, Messenger, Tcyeyan (AFR)
Mss. Haug (EXC)

Results?

SRajapatirana/VDubey:gs

Program

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

880609013
1.

DATE: June 9, 1988

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

FROM: Edward V.K. Jaycox, Vice President, Africa Region

EXTENSION: 34000

SUBJECT: MOZAMBIQUE: Third Rehabilitation Credit - Initiating Memorandum

1. The attached Initiating Memorandum seeks approval to appraise an IDA US$90 million Third Rehabilitation Credit for Mozambique, aiming at Board Presentation in October, 1988. The Credit is expected to be cofinanced by a number of donors, totalling US$81.3 million equivalent, mobilized through the Special Program of Assistance for Low Income Debt Distressed Sub-Saharan African Countries.

2. The proposed operation would support the Government's Economic Rehabilitation Program (ERP), initiated in January, 1987. The ERP objectives and strategy have been set out in the Economic Policy Framework Paper, 1988-90 which received support from the Committee of the Whole last March. The ERP is also supported by the IMF, and a second year program under the Structural Adjustment Facility was authorized last March. The staff of the Bank and the IMF have worked closely together in supporting Government efforts to define the key policy adjustments under the ERP, and to monitor its implementation. The IMF is satisfied with the Government's performance under the SAF to date; an Article IV Consultation mission, during which performance would be reviewed, is scheduled for August.

3. Five policy goals would be pursued through the Credit, consistent with the timing of the overall implementation of the ERP. These goals include: (i) phased reduction in the administrative allocation of foreign exchange through opening of an Open General License window; (ii) review and reform of the trade tariff structure; (iii) continued removal of price controls; (iv) reduction of controls over domestic allocation of goods; and, (v) improvements in the use of public expenditures. The actions to be taken by the Government in each of these areas represent significant steps in eliminating administrative controls over economic activity while providing economic incentives to producers. The momentum of this process is crucial for the success of the ERP.

4. The financing provided by the Credit would be an important ingredient in ensuring that the anticipated supply response to the improved incentives for production will indeed be forthcoming. The Bank's support for the ERP has been an important factor in mobilizing the significant flows of external assistance on which Mozambique must rely during its protracted period of conflict and reform. During FY88, we have undertaken substantial macroeconomic and sector work (including a Public Expenditure Review; Agricultural Sector Survey; Population, Health and Nutrition Survey; and initiation of an Industrial Sector Survey) in order to define in greater detail the strategy to resolve key economic issues. A Country Strategy Paper is scheduled for completion in FY89. A Second Consultative Group Meeting for Mozambique is currently scheduled for September.

Attachment

Distribution

Operations Committee Members:

Messrs./Mesdames: Qureshi (SVPOP)(2); Husain (LACVP); Karaosmanoglu (ASIVP); Thalwitz (EMNVP); Rajagopalan (VPPRE); Shihata (VPLEG); Wood (VPFPR); Fischer (VPDEC); Vergin (SVPOP)

Outside the Region:

Messrs./Mesdames: Hopper (SVPPR); Stern (SVPFI); Frank (CFPVP); Parmar (CIOVP); Dubey, Rajapatirana (2), Chaudri (EASDR); Bock (DFSDR); Lee (COD); Baudon (SVPOP); Liebenthal, Obidegwu (SPRPA); Shakow (SPRDR)(2); Holsen (CECDR)(3); Baneth (IECDR); Rao, Steer (FRSDR); Kavalsky (FRM); Burmester (SECGE); Leechor (CTRAC); Goldberg (VPLEG); Haug (EXC); Robless (OPNMS)

Within the Region:

Messrs./Mesdames: Denning, Ohri, Birnbaum (AFRVP); Wyss (AFTDR); O'Brien, Armstrong, Agarwala (AFRCE); Christoffersen (AFTEN); Sandstrom, Singh (AF6DR); De Ferranti, Innes, Martinez (AF6PH); Cook, Daffern, Rague, Phillips (AF6IE); Sam, Graham (AF6IN); Ali, Armitage, Keynan (AF6AG); Messenger, Grawe, Tcheyan, Goudie, Biderman, Funck (AF6CO); Sarris (AFTTF); Genta-Fons (LEG); Reinke (LOAAF)

IMF:

Messrs.: Borneman, Williams

NTcheyan/eg
<NILS:kj-imemo:eg>

June 22, 1988

Mr Quesada

880621007

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: June 20, 1988

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

EXT: 78051

SUBJECT: BENIN - Country Strategy Paper cum Initiating Memorandum for a Proposed $40 Million Structural Adjustment Credit - Agenda

1. The Operations Committee will meet on Wednesday, June 22, 1988 at 2:30 p.m. in Room E-1243 to discuss the CSP for Benin and the IM for the proposed $40 million SAC. The Operations Committee may wish to discuss the CSP related issues raised in paragraphs 3 and 4 and those specifically related to the proposed SAC raised in paragraphs 5 - 8.

Country Strategy

2. Background. For many years, Benin experienced stagnating per-capita GDP, with a marked decline most recently, as a result of an unfavorable external environment and, more importantly, misguided domestic economic policies with heavy-handed state intervention. Inadequate economic management and performance have translated into mounting external financing difficulties, with debt-service arrears equivalent to 20 percent of GDP. In late 1987, the Government, in realizing the severity of the crisis, started to re-think its economic policies and opened up to a policy dialogue with the Bank and the Fund, thus preparing the ground for an adjustment program and corresponding lending support.

3. Strategy Orientation. The CSP gives the impression that it has been written mainly under the influence of the recent change in the Government's macroeconomic policy stance. It stresses the need for adjustment and macro and sector policy action while longer-term development constraints in the human resources and (agricultural and industrial) technology areas are perhaps not sufficiently covered. The policy changes discussed in the CSP are certainly necessary, but probably not sufficient for more adequate economic and social development. The Region could be asked to elaborate on the longer-term issues and, in the light of these issues, reconsider the proposed content, structure, and timing of the planned lending operations.

4. Lending Program and Cost Sharing. The Region proposes a $129 million lending program for FY88-92 which is far in excess of the approved program of SDR 71 million (about $96 million) but close to the norm of SDR 104 (about $140 million). Given the IDA resource constraint two basic questions arise:

(i) whether more external resources could or should be raised through cofinancing thus permitting to cover additional priority areas or the inclusion of a second SAC (perhaps replacing/comprising the private sector development credit) which seems to be needed to strengthen the adjustment process; and

(ii) whether one could not expect a greater public sector savings effort thus permitting the reduction of the proposed 95 percent cost-sharing to a more reasonable level.

Structural Adjustment Credit

5. Institutional Capacity and Conditionality. The policy matrix attached to the IM lists a total of 89 actions (or areas of action) which are translated into a list of formal conditions prior to Board approval (55) and prior to second tranche release (12-15). This raises a number of questions:

- how does the Region assess the Government's institutional capacity regarding the implementation of such a complex program? The statement in paragraph 78 is somewhat cryptic;

- how important are the measures/conditions spelled out in the matrix and in paragraph 70? Why do we need to cover food security, transport, and education related issues in the SAC? On the other hand, should fiscal substitutes for an exchange rate adjustment be included? And, if private sector promotion and labor market regulations are important issues, should they be formally included? and

- could a TA program complement the SAC and enhance the chances of its success?

6. The spirit of the proposed SAC points towards broad liberalization and deregulation of Benin's economy. Yet, as part of the proposed food security improvements (paragraph 69), the Region proposes to retain periodic export licensing. This seems to run counter to the general thrust of the program and may introduce undesirable elements into the concept of food security. The Committee may wish to discuss this issue.

7. Magnitude of Adjustment Effort. While the projections in Annex I are preliminary and will be revised and refined as part of the PFP process, the question arises whether the projected adjustment effort--as reflected e.g. by the virtual lack of adjustment in total consumption or the savings-investment gap (Table 1)--could be considered adequate? Government consumption is projected to shrink as a share of GDP which may not necessarily be desirable. The savings-investment gap increases from a projected 8.1 percent of GDP in 1988 to 8.7 percent in 1995, after some slight initial decline. A more plausible course of adjustment could be some initial increase (or possibly maintenance of current level) and a longer-term reduction towards a more sustainable level.

8. Financing Plan. The external financing plan for 1988/89-1990/91 has yet to be worked out through the PFP process. The question, however, arises whether the SAC could not be reduced by perhaps $10-15 million, with correspondingly larger cofinancing, and whether the saved resources could not be better used for a second SAC, together with resources that are

slated in the proposed lending program for other purposes (e.g., the private sector development project or telecommunication).

cc: Messrs. Lee, COD; Shakow, SPR; Holsen, CEC; Rao, Steer, FRS; Burmester/Thahane, SEC; Liebenthal, SPRPA; Baudon, SVPOP; Serageldin, O'Brien, Landell-Mills, Westebbe, Akpa, AFR.

For Information

cc: Messrs. Hopper, SVPPR; Bock, DFS; Goldberg, VPLEG; Frank, Parmar, IFC; Pfeffermann, CEI; Baneth, IEC; Aguirre-Sacasa, EXT; (Ms.) Haug, EXC; Robless, OPNMS; Agarwala, AFR.

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June 17, 1988

The World Bank
OPERATIONS COMMITTEE

CONFIDENTIAL

Minutes of the Operations Committee to Consider
COMOROS - Proposed Macroeconomic Management Credit
Initiating Memorandum

Held on Friday, June 17, 1988 at 11:00 a.m. in Conference Room E-1243

A. Present

Committee	Others
Messrs. M. Qureshi (Chairman)	Messrs. T. Baudon (SVPOP)
J. Burki (ASIVP)	V. Dubey (EAS)
A. Choksi (LACVP)	M. Devaux (AF3CO)
V. Corbo (VPDEC)	N. Gorjestani (AF3CO)
H. Scott (LEGVP)	P. Isenman (AF3DR)
I. Serageldin (AFRVP)	T. Jones (LEGAF)
H. Vergin (SVPOP)	E. Makonnen (SPRPA)
J. Wood (VPFPR)	S. O'Brien (AFRVP)
	G. Pohl (EAS)
	W. Schwermer (COD)
	T. Thahane (SEC)
	B. Varon (AF3CO)
	Ms. P. Eap (AF3CO)
	S. Kimaro (IMF)

B. Issues

1. The meeting was called to discuss the Initiating Memorandum for the Proposed Macroeconomic Management Credit of US$7 million equivalent for Comoros. The main issues raised during the discussion were: (i) the rationale for IDA involvement in Comoros, given the apparent withdrawal of some traditional donors (Arab, France, ADB); (ii) the realism of the proposed import tariff/export subsidy scheme instead of a straightforward exchange rate adjustment; and (iii) the need for clear measures to reduce the large fiscal deficit by increasing tax revenues and reducing public expenditure.

C. Discussion

2. Rationale for IDA involvement. The Committee noted that since Comoros faced severe constraints and the Government had affirmed at the highest level its determination to engage in a serious reform process, the Bank should be prepared to help and support it in a suitable way. The

Chairman indicated, however, that the majority of the proposed measures in the IM fell into the category of macroeconomic management, and enquired about the rationale for extending financial support instead of a technical assistance operation, especially given: (i) the possibility that such support would replace aid by the traditional donors; and (ii) the near-certainty that the major beneficiaries, at least indirectly, would be the few families that controlled a disproportionate share of the country's wealth. Concern was also expressed about the political instability and weak administration of the country. The Region clarified that the major donors were not withdrawing; France, in particular, intended to increase its aid to Comoros. The donors were looking to the Bank not to replace them but, rather, to play a catalytic role in ensuring proper implementation of the reform measures and in coordinating increased assistance to support the Government's program.

3. The Region also noted that, despite weak administrations, adjustment operations in a number of small African countries had been, in general, quite satisfactory. The Chairman agreed that the Bank should assist Comoros, particularly in improving macroeconomic management. The Chairman expressed concern over the size of the financial assistance and indicated that he would prefer to see a somewhat smaller amount. However, he left the size to the discretion of the Region, provided that: (i) the operation is set and presented without diverting attention from the importance of the macroeconomic management issue; and (ii) the IMF is involved in the reform process through more than the PFP.

4. Realism of Import Tariff/Export Subsidy Scheme. The Committee discussed the relative merit of the proposed import tariff/export subsidy scheme as the second best solution to the straightforward currency devaluation. It was emphasized that a direct devaluation would be preferable and easier to implement than the import tariff/export subsidy scheme, given the weak administration in Comoros. This solution might be possible since the case of Comoros was different from that of other Franc-zone countries; the agreement on the exchange rate with France being a bilateral one, the change in parity should not affect other CFA countries. The Region noted that nonetheless the French had already indicated a concern about the precedent for the Franc-zone. It was strongly recommended that the appraisal mission seek a specific agreement on an adjustment of the currency.

5. Fiscal Reforms. It was recognized that the key issue facing Comoros was the size of the fiscal deficit and that the reform program could only be operative and effective if this was addressed in an adequate fashion with the active support of the IMF. The Chairman urged that the appraisal team and IMF agree with the Government on a clear and comprehensive financial program to increase government revenue and reduce public expenditure.

6. The Chairman concluded the discussion by highlighting three points: (i) the proposal in the Macroeconomic Management Credit is endorsed in principle, but the Bank should work out the adjustment program hand-in-hand with the IMF and proceed only if the IMF undertakes a financial involvement (no matter how small) in the country; (ii) the financial role

of the operation should be de-emphasized; the amount of the credit (US$7 million or US$5 million), though left to the Region, should be modest; and (iii) a major objective and a condition for further processing is to agree on a program to cut the fiscal deficit to a more sustainable level and to do so in close collaboration with the IMF.

July 5, 1988

The World Bank
OPERATIONS COMMITTEE

CONFIDENTIAL

Minutes of the Operations Committee to Consider
YUGOSLAVIA - SAL II - Initiating Memorandum

Held on Friday, June 17, 1988 at 10:00 a.m. in Conference Room E-1243

A. Present

Committee		Others	
Messrs.	M. Qureshi (Chairman)	Messrs.	T. Baudon (SVPOP)
	J. Burki (ASIVP)		V. Dubey (EAS)
	A. Choksi (LACVP)		A. El Maaroufi (EMNVP)
	S. Fischer (VPDEC)		J. Harrison (EM4CO)
	H. Scott (VPLEG)		P. Hasan (EMNVP)
	I. Serageldin (AFRVP)		E. Lari (EM4DR)
	W. Thalwitz (EMNVP)		S. Mitra (FRS)
	H. Vergin (SVPOP)		R. Myers (EM4CO)
	D.J. Wood (VPFPR)		P. Nouvel (EM4CO)
			G. Pohl (EAS)
			G. Reif (SPRPA)
			K. Siraj (COD)
			A. Sood (EM4IE)
			T. Thahane (SEC)

B. Issues

1. An Operations Committee Meeting was held on Friday, June 17, at 10:00 a.m. to consider the Yugoslavia Initiating Memorandum for SAL II. The meeting followed the Agenda questions, focussing particularly on stabilization and enterprise reform and on the credibility of the present reform effort. In its opening statement, the Region stressed that there were reasons to believe that this time the Government of Yugoslavia was serious about reform. These included less ideological and more pragmatic attitudes, a general perception of the seriousness of the country's economic problems, the discredit in which the current system had fallen, strong political pressures to introduce radical systemic changes, pervasive modifications already introduced or being introduced in the legal framework, the reform trend in the external environment, the strong desire to associate if not integrate Yugoslavia in the EC, and the front-loaded nature of the reforms. Changes had already been introduced in many areas such as financial discipline, interest rates and foreign exchange allocation. Significant additional reforms were likely to take place in the fiscal

system and there were constitutional amendments under consideration which would affect the nature and the goals of enterprises and banks. He concluded, however, recognizing the substantial risk element of the proposed operation.

2. The Chairman noted that in the past Yugoslavia had followed a cyclical patterns of reform and backsliding so that it never seemed to make any real progress in reforming the economy. The Region emphasized the new and pervasive outward orientation of Yugoslavians, particularly due to returned guest workers, and an intense desire to harmonize with the EC, and to become more clearly a European economy. Furthermore, this time the pressure to reform comes not only from the Federal Government but also from the Republics and Provinces. However, it should be recognized that the proposed SAL II could not alone support all the changes needed to affect the real economy. Other operations would also be needed. Several other members of the Operations Committee, while expressing doubts about the seriousness of Yugoslavia's reform intentions and/or ability, were inclined to take the view that the risks associated with this loan were worth taking, given the likely beneficial impact that such support would have on the country's reform effort.

3. A member then raised specific questions about the stabilization program. The thrust of his comments was that the fiscal and monetary policy measures to stabilize the economy were not clear. The representative of the IMF described the variety of measures included in the recently agreed IMF Standby. Due to the complexity of the Yugoslavian economy, she noted that a broad brush approach was needed. Therefore, the program included measures of monetary and fiscal policy, incomes policy and interest rate and exchange rate policy, as well as institutional reform. The member was only partially convinced and stressed that making the National Bank of Yugoslavia (NBY) a more effective central bank was a necessary important first step. He also noted that a policy of fixing the real interest rate, even at a positive level, does not necessarily reduce the inflation rate. There was a general concern that as in the past when the adjustment measures started to bite enterprises would find ways and means to avoid the consequences. It was important to ensure that the adjustment process was not aborted in this fashion. Conditionalilty, therefore, needed to be designed and monitoring mechanisms put in place to prevent this happening.

4. The focus of the meeting then shifted to the questions on the proposed reform in the areas of foreign exchange allocation and trade and price liberalization. The Region stated that given the way the interbank meetings are structured, and the enhanced role of NBY as a central bank, it would be difficult for the Government and enterprises to interfere with foreign exchange allocation directly. In monitoring the market, the Bank intended to look at both macro and micro indicators. Macro indicators would involve comparing the volumes of foreign exchange to demand and supply, the size of the gaps and the extent of the exchange rate movement. At the micro level the aim was to analyze developments in selected enterprises to see if enterprises encounter any artificial restrictions on the demand for and supply of

foreign exchange. It was noted that at present, the market seemed to be working well. Because of the high interest rates people were most concerned about obtaining Dinar coverage for foreign exchange - a good sign. Regarding trade liberalization, the Region acknowledged that actually measuring liberalization is extremely difficult but that if the projections of total imports are accurate, the liberalization should be substantial unless the composition of trade shifts dramatically. It stressed, however, that the most important thing to realize about the reform effort is the Yugoslavians' desire to liberalize in order to be compatible with GATT and the EC.

5. Regarding price liberalization, the Region stated that decontrol of 80% of prices is significant. Decontrol is also intended to apply to items in the retail price index. In addition, it was expected that the Government would agree to adjust prices of major infrastructural services (railways, energy) so that real prices reach appropriate levels. The Chairman stressed, that if possible, we should try to get the Government to agree to push reforms, particularly price liberalization, even faster than proposed. In addition, he noted the importance of SAL II's proposals with respect to investment allocation and the social cost of adjustment. The Region added that those relating to the social cost of adjustment were crucial and, in fact, were a constituent part of the reform effort which the Bank should be ready to support. The Chairman agreed and added that encouraging SSI's was an important element in this.

6. Additional comments concerned the need for a clearer financing plan and for an early Country Strategy Paper (CSP).

C. Conclusion

7. In conclusion, the Chairman approved the departure of the appraisal mission. He said he did not consider that a larger loan amount was justified. He instructed the appraisal mission to deepen and spell out in greater detail the medium-term macroeconomic stabilization policies, discuss them carefully with the IMF colleagues, and review them with the PPR. It is also important to establish effective monitoring mechanisms. In addition, a clearer picture of the financing plan was indeed needed, with the roles of the different sources of finance spelled out, and a CSP should be prepared within six months.

Amended: June 27, 1988

PNouvel/VDubey:pl

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

880615013

1.

DATE : June 14, 1988

TO : Operations Committee

FROM : Vinod Dubey, Director, EAS

SUBJECT: COMOROS - Proposed Macroeconomic Management Credit - Initiating Memorandum - Agenda.

The Operations Committee will meet on Friday, June 17, 1988 at 11:00 a.m. in Room E-1243 to discuss the Initiating Memorandum for the Proposed Macroeconomic Management Credit of US$ 7 million equivalent for Comoros.

Background

The Comoros include three small tropical islands with a total population of 410,000 and a per-capita GNP of US$320. Health conditions are poor, malnutrition is widespread, population growth is explosive, and economic prospects are very limited. The Comoros gained independence in 1975 and, as a relatively new nation, has a very weak administration. The situation has improved somewhat since the early 1980s when relations with France were normalized and some expatriate personnel returned.

Comoros is facing severe economic and financial difficulties. Agriculture production has not kept up with population growth and economic growth has recently slowed down as major investments in infrastructure, financed primarily by the African Development Bank and several Arab Funds, have been completed or suspended. Due to these large capital inflows during 1982-87, the current account deficit of the balance of payments has fluctuated around 28% of GDP. Despite this assistance, the Government has experienced chronic shortages of funds that have led to arrears in external and internal payments. Arrears on external debt reached $12.4 million at end 1987.

Against this background, a new Cabinet, appointed in late 1985 has started to take some remedial measures. A more realistic budget was prepared in 1986 and the civil service has been reduced by 5%. In March 1987, the Government prepared a program of financial austerity, to be supported by increased budgetary assistance from France (about 20% of GDP). Tax collection has been improved in 1987 and the public finance deficit was reduced from 38% in 1985 to 22% in 1987. However, the French authorities have indicated that further support would be contingent upon reaching agreement on a stabilization and structural adjustment program with the Bank and the IMF.

Issues

The Committee may wish to discuss the following:

Public Finances

Given the large fiscal deficit and the high import/GDP ratio, why do the projections assume only a marginal improvement in the tax/GDP ratio (from 14.7% in 1986 to 14.9% in 1992)?

Agriculture/Environment

Are the measures indicated in this section sufficient, or is more drastic action called for, particularly on the island of Anjouan?

Is the Region confident that the import tariff/export subsidy scheme will work? Can it be circumvented by smuggling?

Is it realistic to assume that the import tariff cum export subsidy scheme will work efficiently (i.e. with sufficient automaticity) in this regard?

How realistic is a halt in food aid imports of edible oil and maize, given donor agency interests?

Industrial Development Policy

14-15. Tax exhibitions

Given the limited prospects in agriculture, the Comoros face either continued dependency on budgetary aid or would have to develop an alternative economic base. How does the Region view the prospects for light industry exports given the Comoros resource endowment?

Social Adjustment

How does the Region intend to address the urgent long-term problem of rapid and unsustainable population growth?

cc: D. Lee, A. Shakow, J. Holsen, D.C. Rao, Burmester/Thahane, R. Liebenthal, A. Steer, T. Baudon, S. O'Brien, P. Isenman, N. Gorjestani, B. Varon.

Is it enough?

For Information Only

D. Hopper, D. Bock, D. Goldberg, R. Frank, J. Parmar, G. Pfeffermann, J. Baneth, M. Haug, C. Robless, R. Agarwala.

GPohl:pl

Industrial Development
Technical assistance program

Environment

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: June 3, 1988

TO: Mr. Moeen A. Qureshi, SVPOP
Through: Mr. E.V.K. Jaycox, AFRVP
FROM: Paul Isenman, AF3DR

EXTENSION: 34380

SUBJECT: **COMOROS:** MACROECONOMIC MANAGEMENT CREDIT - INITIATING MEMORANDUM

1. This memorandum requests approval to appraise a Macroeconomic Management Credit (MMC) for Comoros on the basis of the attached Initiating Memorandum. Subject to your approval, a mission will visit Comoros in the second half of June to appraise the Government's program.

2. The main objectives of the proposed operation are to: (i) bring about structural improvements in public finance management and resource allocation; (ii) initiate actions to restore the competitiveness of Comorian exports which has been eroded by the overvaluation of the national currency; and (iii) strengthen the administrative capacity to implement reforms. In addition, the operation would support initial steps to improve the production prospects in agriculture, protect the environment, explore the possibility of developing export-oriented labor-intensive manufacturing, as well as a number of studies to prepare action plans for the next stage of the reform process which would be supported by a subsequent adjustment operation. Our strategy in this initial operation is to tailor the measures to what is technically and, given the weak administrative capacity, politically feasible, although with some substantial political "stretching" by the Government.

3. The exchange rate issue is particularly delicate since, as a member of the Franc Zone, Comoros cannot adjust the parity of its currency without agreement of the French authorities. The Comorian franc is tied to the French franc at the same rate as the CFA franc, but in the context of a bilateral agreement between Comoros and France; an adjustment in the exchange rate of the Comorian franc requires, therefore, the agreement of only France and Comoros. Nevertheless, France is concerned about the psychological effect that any action on the Comorian franc might have in other parts of the Franc Zone. Accordingly, we have explored the possibility of a second-best solution, namely an import tariff/export subsidy scheme similar to that in place in some West African countries. The French authorities have informally indicated to us that this approach would be acceptable to them. While our preferred approach is still an adjustment in the exchange rate, we would be prepared under the circumstances to accept the second-best solution as a temporary stop-gap measure.

4. The proposed operation is the outcome of a policy dialogue initiated during the preparation of the last economic memorandum entitled: "Comoros: The Arduous Path to Economic Growth - The Need for Adjustment", which was issued in Grey Cover in August 1987. It took some time for this timid and rather inexperienced Government team to build a consensus. The political commitment was not yet clear during the Annual Meetings or in December, at the end of the preparation mission. The French government,

which is the major donor with important political ties, has informed the Comorian authorities that continued French budgetary support is conditional on the successful negotiation of a reform program with the Bank/IMF. During a follow-up mission last February, the President expressed his personal commitment to the program and appointed the Minister of Finance as the coordinator of a committee (including the Ministers of Plan and Production) to oversee the preparation and implementation of the reform program. Technical working groups have been created to prepare the various components of the program on the basis of a work plan discussed with the last mission.

5. The Government has been reluctant to deal with the IMF because: (i) the resources available in the context of a Standby arrangement (less than US$1 million) are insignificant in relation to the financing requirements, and (ii) the repayment period of the SAF is considered too short in the context of Comoros's debt service burden. The Government nevertheless accepted the participation of two IMF staff members in our preparation mission, and, after some hesitation, has finally invited the IMF to send an Article IV consultation mission at the same time as the appraisal mission for the proposed operation. However, due to staffing constraints, the IMF has difficulty in mounting a full mission at short notice, and envisages sending a senior staff member for the latter part of the appraisal mission. The objective is for the Bank and the Fund missions to also discuss an initial draft of the PFP. The Bank has prepared such a draft which will be presented to the Operations Committee for review after the appraisal mission. Negotiation of the PFP will take place probably in Washington during the eventual negotiation of the proposed operation.

6. A provisional amount of US$7 million is included for this operation in the approved lending program. The AfDB has indicated its intention to cofinance the proposed operation for up to about 13 million units of account (about US$15 million). Furthermore, the EEC is prepared to cofinance the operation up to US$3 million as part of the Debt Initiative, once the country has been declared eligible.

cc: Messrs: OC Members: Karaosmanoglu, Thalwitz, Husain, Shihata (VPLEG), Rajagopalan (VPPRE), J. Wood (VPFPR), Fisher (VPDEC), Rovani (DGO)

Messrs/Mmes: O'Brien, Denning, Ohri, Armstrong, Guérard (AFR), Sarbib (AF3DR), Wyss, Christoffersen, Alexander, Sarris (AFT), Gorjestani, Varon, Eap, Devaux, Hill, Ibrahim (AF3CO), Peñalver, Schmidt (AF3IE), Colliou, Blay, Castadot, Lair, Schneidman, (AF3PH), Blanc, Raoul, Bostrom ((AF3IN), Otten, Weijenberg, Magnusson (AF3AG), Dubey, Pohl (EAS), Baneth (IEC), Picciotto (PBD), Peloschek (LEG), Meyer, Renkewitz, Khoury (AFTIN), Del Buono (IENES), Carstens, Kimaro (IMF)

Attachment.

COMOROS

Initiating Memorandum for a Macroeconomic Management Credit

I. Introduction and Background

1. This memorandum seeks authorization from the Operations Committee to appraise a Macroeconomic Management Credit (MMC) to Comoros. A provisional amount of US$7 million is included for this operation in the approved five-year lending program. This operation is an initial adjustment credit in a small Franc-zone country with a simple economy.

2. With a GNP per capita of about US$320 in 1986 and a population of 410,000, Comoros, which gained independence in 1975, is among the smallest and least-developed countries in the world. Health conditions are poor and malnutrition is widespread. It is still a relatively new nation with a weak administration, limited growth potential, explosive population growth, high unemployment, and serious degradation of the environment.

3. During the colonial period, France administered Comoros from Madagascar and the Comorian islands were relatively neglected until Madagascar became independent. At Independence, Comoros found itself with virtually no infrastructure and only a handful of qualified personnel. The abrupt and disruptive withdrawal of French civil servants crippled the administrative services, which have remained very weak, despite the return of some expatriate personnel when relations with France were normalized in the early 1980s. The division of Comoros' territory among three islands exacerbates the problem common to all small countries: each island has its own characteristics and traditions, and the issue of bringing the country out of isolation has both local and national dimensions. Separatist temptations are ever-present and can easily be exploited by outside political powers in a period of economic recession. Despite several attempts to overthrow him, President Ahmed Abdallah has succeeded in holding the country together with the help of France and a small number of mercenaries financed by South Africa.

4. The focus of the proposed operation is on improving the efficiency of public finances and the management of public enterprises, as well as on restoring the competitiveness of Comorian exports, with accompanying improvements in agriculture and industry and protection of the natural resource base. In public finances, the proposed operation would build on the austerity measures currently being taken with assistance from France. In agriculture, the program aims at moving closer to apparent production potential, although this potential appears quite limited. In industry, it is easy to argue why Comoros cannot make much progress, but efforts in this area, especially in labor-intensive manufacturing, will be included in the proposed operation not only to test the waters but to improve resource allocation and production incentives. The above focus is indicated by the urgency of achieving concrete results in those priority areas--not an easy task given the understandable timidity of this young country's leaders and severe institutional weaknesses. We hope to learn enough through the

experience and studies under this first operation, and to strengthen the institutional base sufficiently, to broaden the policy reform focus in a subsequent adjustment operation.

5. The Government has been slow in adopting the reforms needed to address the weaknesses of the economy. Moreover, since the potential resources available from the IMF were small vis-à-vis the financial deficit, it had been reluctant to deal with the Fund. Policy dialogue on the need for a reform program was initiated during the last economic mission in December 1986 and intensified during the discussion of the Economic Memorandum entitled: "Comoros: The Arduous Path to Economic Growth--The Need for Adjustment". Although the Government gave the report wide publicity and involved a large number of civil servants in the policy discussions, it was only during the 1987 Annual Meeting that the Minister of Finance requested the Bank to take the lead in organizing a joint mission (December 1987) with the IMF and the African Development Bank to help prepare a reform program. It appears that a political consensus for economic reform is emerging. This was confirmed by the President in meetings with a follow-up Bank mission in late February 1988 when he clearly indicated his personal commitment to the reform program. The authorities have finally agreed to receive an IMF mission to discuss a draft PFP at the same time as the appraisal mission of MMC and invited the Bank to send a joint team with the AfDB to appraise the proposed operation. However, due to staff constraints, the IMF has difficulty in mounting a full mission at short notice and envisages sending a senior staff member to participate in the latter part of the appraisal mission. In the meantime, the Government has prepared a program of financial austerity to be supported by increased budgetary assistance from France and has decided to prepare an integrated agricultural development strategy with the assistance of the UNDP and the other main donors.

6. Our strategy in this initial operation is to limit conditionality to what--with some political "stretching" by the Government--seems feasible. However, the proposed changes in fiscal management, plus the initial steps in agriculture, industry and public enterprises, would themselves constitute considerable accomplishments in the Comorian context. In addition, the contemplated measures to protect the environment constitute a long-term investment in the welfare of the country. Again, the second adjustment operation would go considerably further in all these areas.

7. Since the late 1970s, Comoros has developed a close relationship with France; it depends on France for the financing of 25-30% of its current budgetary expenditures and draws heavily on French technical assistance. The fact of being in the Franc-zone limits Comoros' ability to increase its competitiveness through exchange rate adjustment. In this operation, we propose to introduce initial measures to achieve an interim second-best solution for improving the competitiveness of Comoros' exports through an import tariff/export subsidy scheme (similar to the one currently being experimented with in some Western African Franc-zone countries). This appears to be the most feasible alternative while we continue to dialogue with France and the Comorian Government on the preferred longer-term solution.

8. In view of Comoros's very small size and the large number of adjustment operations in the Department and Region, this operation is being carried out with a minimum budget. Well over half the budgetary costs are being financed by trust funds and other interested donors; the proposed operation is being developed collaboratively with the IMF, France, and the African Development Bank. AfDB has agreed to participate in financing this operation up to 13 million units of account (about US$16-17 million equivalent). Cofinancing is also expected from IFAD and FED, and other sources might be identified. Although Comoros is not currently on the list of "debt-distressed countries" under the Debt Initiative, once its reform program picks up momentum, the country would qualify to be included.

9. To succeed, the Bank assistance strategy in Comoros has to be closely coordinated with France and other major donors. Our strategy aims at helping the Government to improve the management of its public finances, promoting growth through the productive sectors, and coordinating donor assistance. The priority objectives are to develop an effective dialogue with the Government on a program of policy reforms, and to mobilize both financial and human resources from other donors. The current five-year lending program for Comoros includes a second adjustment operation (FY91) to consolidate and broaden the reform process, a second agricultural services project (FY91S) to underpin the agricultural component of the reform program, and a population and health project (FY93) to support the social dimension of development.

II. Economic Developments and Prospects

Recent Economic Developments

10. Comoros is facing severe economic and financial difficulties. In recent years, GDP growth has slowed down considerably (from 4.2% in 1984 to 2.5% in 1987), bringing about a decline in per capita income. Agricultural production has not kept up with population growth (3.5% per annum). The industrial sector, though still very small, has been expanding rapidly (by about 7% per year). However, the construction sector has contracted, following the completion of major investments in infrastructure.

11. Export earnings have been adversely affected by a sluggish world demand for Comorian main export products (vanilla, ylang-ylang and cloves) and the appreciation of the Comorian franc (pegged to the French franc) vis-à-vis the US Dollar. In contrast, imports have continued to grow in line with the demand for food and energy and investments in infrastructure. This has resulted in large current account deficits fluctuating around 28% of GDP, which have been financed largely by foreign aid and an accumulation of arrears. The continued appreciation of the Comorian franc has further compounded the distortions in the economy.

12. The overall public finance deficit grew from 26% of GDP in 1982 to 38% in 1985. This was caused largely by insufficient budgetary revenue which is attributable, in turn, to the prevailing under-collection of taxes. Measures to improve tax collection in 1986 helped to reduce the deficit to around 22% in 1987. Capital expenditures were cut by nearly 70%

in 1987 due, in part, to the suspension of disbursements from certain donors following the accumulation of arrears. Despite considerable external budgetary support from France (around 20% of GDP), the chronic shortage of funds has resulted in arrears on internal debt as well, in delays in meeting civil servants' salaries, and in continued shortfalls in the allocation of local funds for the execution of externally-funded projects. The stock of arrears on external debt reached US$12.4 million at the end of 1987 (of which nearly US$5 million was with AfDB).

13. External borrowings have increased rapidly in recent years, as a consequence of the surge in investment outlays. The total debt, outstanding and disbursed, rose from US$68 million in 1982 to US$184 million at the end of 1987 (about 95% of GDP). The undisbursed amount (US$48 million) can be expected to be drawn down rapidly over the next three years. Among the multilateral development aid agencies, the African Development Bank is the largest creditor, with 20% of the current debt. IDA ranks second with 18%, followed by BADEA (9%). The two largest bilateral creditors are the Kuwait Fund and the Saudi Fund, which hold 14% and 10% of the total debt, respectively. The Caisse Centrale de Coopération Economique (CCCE) shares about 14% of the debt. The financial institutions of the Arab countries hold nearly 40% of the outstanding debt, and less than 15% is owed to countries and institutions participating in the Paris or the London Clubs. A donors meeting is planned in late 1988 to agree on rescheduling of the debt owed to institutions in Arab countries (see para. 53). 35

14. Most of the external loans are on concessional terms. The majority of the loans are long-term, with maturities of 15 to 50 years and interest below 2%. The loans with the hardest terms are from the CCCE for public enterprises (14 years maturity with 5-year grace period and 5% interest), and a loan from the African Development Bank for the financing of the port of Mutsamudu (16 years maturity with 4-year grace period and 7% interest). The service on the debt contracted for the port of Mutsamudu alone amounts to US$1.3 million, or nearly 5% of export earnings.

15. As a result of increased borrowing, debt service obligations rose steadily from US$0.9 million in 1982 to US$9 million in 1987. The contractual debt service ratio is estimated to have reached more than 50% in 1987 (against 20% in 1986) due in part to the slump in vanilla exports caused by the Government decision not to authorize exports of vanilla at a price below the price agreed with Madagascar and major firms importing vanilla in Europe and the United States in the framework of the vanilla agreement. With improved export earnings expected in 1988 as a result of a larger quota under the vanilla agreement and the Government decision to resume vanilla exports, the debt service ratio has been estimated to drop to 31%. It is, however, projected to rise above 40% in five years before declining to more sustainable levels.

The Adjustment Process

16. Against the background of serious deterioration in the economic and financial situation, a new Cabinet appointed in September 1985 has started to take remedial measures, with priority given to financial stabilization. The Government has made substantial efforts to prepare

realistic and complete budgets (including the capital budget) since 1986 and to contain recurrent expenditures by reducing the number of unnecessary public service positions as well as fringe benefits. About 360 civil servants (roughly 5% of the total) were laid off during the course of 1986 in the Ministries of Education and Production. A systematic review of all employees on public payroll is being carried out with French assistance, in order to reduce further the number of unnecessary positions in the administration. Missions abroad are being cut and scholarships abroad are being limited only to those financed by external donors. Although these measures are in the right direction, they need to be followed up by more comprehensive reform measures (outlined in Part IV).

17. In March 1987, the Government prepared a program of financial austerity to be supported by increased budgetary assistance from France. Key features of the program include: (i) intensification of the Government's effort to improve tax collection through reorganization of the customs office; (ii) limiting the recruitment of civil servants; (iii) establishment of a system of financial audits; (iv) consolidation of the domestic debt; (v) comprehensive listing of all Government debts, including arrears and Treasury bonds; and (vi) abolishing the practice of the "Bons de Caisse". However, the implementation of this program has been somewhat disappointing and France is insisting that Comoros agree on a program with the Bank and the IMF.

Medium-Term Prospects and Financing Requirements

18. The outlook of the Comorian economy will depend largely on the Government's efforts to pursue financial discipline and its willingness to engage in a comprehensive adjustment program. Policy reform measures should focus on diversification of export-crops, improvements in crop productivity and marketing systems, and promotion of export-oriented industrialization which constitutes the main possible source of economic growth in the long-term, although given the great shortage of qualified manpower, it will require a vigorous effort--and time--to materialize. Tourism has some potential, but its economic impact may not be promising due to the large investments that would be necessary and the low value-added for the country. Should the Government adopt a series of measures to promote export-oriented industrialization and actively encourage diversification of cash crops, economic growth could gradually accelerate from an estimated 2.5% in 1987 to around 4% by 1994-95--a level exceeded in the early 1980s. According to the projections in the Annex, GDP growth is expected to fluctuate from year to year because of the impact of the cloves cycle on the economy and per capita growth would be negative in some years. However, the impact of the adjustment policy has not been fully reflected in the attached projections which tend to translate mechanically the underlying assumptions at this stage. The adjustment program should set the stage for economic development to take place, but, in a small country like Comoros, adjustment measures need to be complemented by other development actions, such as upgrading the labor force, which take a longer time to yield fruit.

19. The financial situation is projected to improve owing to the implementation of the already-adopted financial austerity program. The overall deficit of consolidated public finances is projected to decline

from 22% in 1987 to 19% by 1992, reflecting the Government's effort to improve tax collection, to trim down expenditure, and to improve efficiency in services.

20. The balance of payments prospects for the coming years remain difficult. World demand for Comoros' traditional exports is not expected to rebound, and export diversification--which should also help to reduce year-to-year fluctuations in GDP--would take some time to show results. Imports of food, intermediate and capital goods are projected to rise in line with population growth and investment. As a result, the adjustment effort will require substantial external assistance. With the projected increase in debt service payments and the clearing of arrears, capital requirements are estimated to rise to US$65-75 million a year in 1988-1992 (compared to about US$50-55 million in 1985 and 1986). It will be possible to obtain this financing by drawing on the proceeds of loans already contracted (about US$6 million a year), continued public transfers (US$35-40 million as against US$30 million in 1985-86), and drawing on new loans to be contracted under very concessional terms (US$20 million, a level comparable to 1985-86). The balance (US$5-6 million) will have to come from debt relief.

21. The above debt-relief assumption is not unrealistic. Comoros' contractual debt service ratio is projected to increase from about 30% in 1988 to about 40% by 1992, which exceeds by far the long-term repayment capacity. With this debt service ratio, Comoros would clearly qualify for Debt-Distressed Country status and would benefit from the concessional flows of aid available for such countries, once the adjustment program has been negotiated with the Bank and the IMF. This could also prompt a number of Arab Funds to take initiatives to alleviate Comoros' debt burden, (through partial cancellation, if possible) and resolve the problem of arrears accumulated on external debt. These funds have not received payments for the last several years.

III. The Policy Components of the Proposed Reform Program

22. The structural problems facing Comoros are not, by their nature, susceptible to rapid solution. While stabilization measures are essential for restoring public finance equilibria, longer-term structural reforms--supported by a series of operations--are needed to create the conditions for sustainable economic development. The proposed operation would address the most urgent issues (and initiate studies, where needed) to: (i) improve public finance management; (ii) develop a medium-term incentives program to diversify exports and to promote growth in the agricultural and industrial sectors; (iii) protect the environment; and (iv) address the social dimensions of development. The studies will, in turn, lead to action programs which will be implemented under the next adjustment operation.

A. Improving Public Finance Management

23. The objective is to bring about structural improvements in public finance management and resource allocation, and to gradually strengthen the administrative capacity to implement the reform measures. The immediate priority is to set up a budgetary system which would provide an overall

view of the financial situation. A pilot consolidated budget would be prepared for 1989 with clear indication of sources of financing for the overall deficit. This would provide a basis for programming the needed financing from both the domestic and external sources. Short-term technical assistance would be needed to help the Government in setting up this financial system. The fiscal program for 1989 would be agreed with the Bank and the IMF as a condition of Board presentation of the proposed credit. In the absence of a SAF program, specific fiscal targets would be incoporated in the Letter of Development Policy. Monitoring of the financial program would be done with the help of the IMF staff in the context of the supervision of the proposed operation.

Increasing Government Revenue

24. Tax revenue is significantly below the current potential. The main problems include inadequate assessment of the tax base and weak tax collection. The recent reform of the General Tax Administration and the improvement of the Customs Administration are steps in the right direction, but these efforts will need to be intensified. Since most of the tax rates are already very high, raising them would only increase tax evasion. The most promising way of increasing tax revenue is to strengthen tax collection by improving Tax Administration, imposing strict penalties, increasing the transparency of tax obligations, and simplifying the Tax Code by abolishing obsolete taxes and ill-defined tax exemptions.

- Improvement in tax collection. The Government would take measures to enforce an effective tax return system and institute systematic audits of the tax returns. The administrative procedures would be improved and a systematic monitoring of tax collection established. Individual files would be set up for each taxpayer showing the status of tax returns. The President has indicated his broad support for this approach and has recently intimated to selected large taxpayers that they have to comply with their obligations.

- Effective management of the Tax Administration. The Minister of Finance is determined, to replace the head of the Tax Administration with a more competent individual. With the help of a technical assistant, the new head of the Tax Administration would ensure the proper functioning of the administration (application of the tax regime, adherence to procedures, assessment of results as declared by tax payers or prepared by agents). The Government would also undertake to improve the qualifications of agents working on audits by attracting better qualified personnel; compensation would be increased within the budgetary possibilities, and adequate office technology would be provided to the Tax Administration.

- Strengthening the Customs Administration. Measures taken recently to improve the functioning of the Customs Administration would be reinforced. The implementation of a computerized management information system would be accelerated. Smuggling would be cut down by intensifying the collaboration with the French Customs authorities in Mayotte.

- Reforms of selected taxes on external trade. The Government would reduce the mark-up on imported rice (at present 200%) and instead levy an import tax of 75-100% on rice imports to mop up part of the windfall profits of ONICOR, the state rice import monopoly. Similarly, a uniform tariff and windfalls tax combination would be applied to the imports of gasoline, diesel and kerosene. This issue was discussed with the Government during the preparation mission. The head of the petroleum company is convinced of the soundness of this recommendation. The head of ONICOR has been resisting it, however, on the grounds that the profits are used in any case (de facto a slush fund) to finance emergency expenditures of the Government. Introducing the above changes would be a condition for negotiation.

- Introduction of an import tariff-export subsidy scheme. (See para. 35.)

Better Allocation of Government Expenditures

25. The objectives of the proposed program are not so much to reduce Government expenditures as they are to ensure allocation of resources according to predetermined priorities and greater efficiency in their use. There is little or no room to reduce the expenditures on goods and services; under current conditions, the Government cannot even provide minimum office equipment and supplies to the civil servants and basic school supplies and health facilities to its population. As for the wage bill, salaries have been frozen since 1978 and, therefore, the Government is under pressure to proceed with a general salary increase, but systematic measures have been agreed with the French government to limit the overall increase in wages and salaries. The modalities are outlined below:

- Ensuring proper resource allocation. The Government would analyze the structure of expenditures in the main spending ministries, i.e., production, transport, health, and education, and ensure budget allocation according to priorities within the defined strategy. This process is already underway: the Government has already undertaken to review its expenditures program in agriculture as part of its action program to implement the agricultural study (see para. 33).

- Abolishing the "Caisse de Stabilisation". As the "Caisse de Stabilisation" has not been properly functioning to help stabilize the fluctuation of the prices of export-crops, it should be abolished and its staff redeployed. This issue has been discussed with Government, but no agreement has yet been reached. We hope to reach agreement, with the support of the French Mission de Coopération, during the appraisal mission.

- Restricting expenditures. The Government would ensure that budget appropriations mark an absolute spending limit and abandon the practice of "Bons de Caisse" (cash vouchers).

Expenditure by the governorates would be strictly limited to their revenues. These form part of the conditionality for the French Supplementary Budget assistance.

- Consolidating the payroll system. The payroll of all governorate agents would be consolidated and a computerized payroll management system would be put in place for the better monitoring of expenditures. The Minister of Finance agrees with the proposal, but resistance might be encountered from the governorates.

- Reviewing civil service status. The Government would complete the current review of the existing civil service regulations as well as the compensation policy. An action plan would then be prepared to phase out the temporary personnel and fixed-term staff, gradually reduce the number of unnecessary civil servants, and limit new recruitments to specific requirements for the effective functioning of the administration. During appraisal, a timetable will be established with the Government.

A Three-Year Rolling Public Investment Program (PIP)

26. Although some progress has been made in the preparation of the public investment program, further steps are needed to develop a multi-year programming process and link the PIP more closely to the current budget. The President has agreed to give high priority to investment projects in productive sectors and to cut back on investments in infrastructure. The 1988-1990 PIP currently under preparation would be assessed during appraisal. In addition, we would request the Government to (i) update the PIP annually in consultation with the Bank; and (ii) conduct a technical, financial, and economic evaluation satisfactory to the Bank on any new project costing more than US$2 million. This has been considered by some civil servants as an interference in national sovereignty. Agreement on these two issues would, however, be a condition for negotiations.

Improving the Management of the Public Enterprises

27. Comoros' public enterprise sector suffers from an inadequate administrative structure and lack of managerial staff. The sector is rather small and consists of 12 public enterprises: five in public utilities and services (water and electricity, Post Office, air transport, airport, and maritime port), four in import monopolies (rice, petroleum products, meat, and cigarettes), and three in the hotel, printing and publishing activities. The Post Office and the hotel company have in the past been consistently in deficit, while the rice and petroleum import monopolies generate sizable profits. The financial situation of the meat import monopoly has been precarious. The existence of the cigarette import monopoly seems to encourage smuggling of cigarettes, causing substantial loss in fiscal revenue.

28. The Government has recently taken a number of measures to improve the management of some public enterprises. Technical assistance agreements have been signed with France for the strengthening of the management of the

Post Office and the electricity company, both of which will become financially autonomous. The financial situation of the hotel company (financed by the CCCE) appears to have improved under new management. In the context of the proposed operation the Government would, as a first step:

- Improve the administrative structure of the enterprises:

  (i) clearly define the legal framework of the enterprises and their relationship with the Government;

  (ii) formulate adequate personnel policies for the sector;

  (iii) introduce a uniform accounting system with regular external audits; agreement should be reached during appraisal on the implementation timetable.

- Undertake the rehabilitation program for the Post Office and the water and electricity company with assistance from France. Agreement would be reached during appraisal on the date they should become financially autonomous.

- Abolish the meat import monopoly of SOCOVIA and transform it into a company managing the refrigeration facilities.

- Abolish STAC (cigarette import monopoly); this is already under consideration by the Government.

- Divest from COMOTEL (hotel company). The President has welcomed the proposal and would like guidance on how to proceed. The mechanism for divestiture will be discussed at appraisal.

- Undertake a study of the other enterprises in order to decide how to improve their management.

Improving Debt Management

29. The Government has recently signed an agreement with France on assistance regarding the consolidation of the domestic debt. As a first step, a national committee has been established to prepare a comprehensive listing of all Government debts, including arrears and Treasury bonds. Based on the outcome of this work, an action program on the consolidation would be prepared in consultation with the French Evaluation Mission in 1988. As for external debt, the Government would establish a debt management system which enables the close monitoring of the evolution of debt service payments and evaluates the financial impact of new foreign borrowings.

B. Policy Reforms in the Agriculture Sector

Main Constraints for Agricultural Development

30. Decline in export earnings from traditional export-crops. Over the last decade, despite massive donor support, export earnings from agriculture have declined and food-crop production has not kept up with population growth. Commercial food imports (mainly rice) and food aid (mainly edible oil, maize and milk powder) have increased substantially. World market prices for traditional export-crops (cloves, vanilla and copra) have declined steadily, with the exception of ylang-ylang for which prices have recently increased possibly as a result of a reduction in the global supply since 1985. The export of copra has ceased, and the vanilla trade has been seriously hurt by the recent depreciation of the US dollar.

31. Stagnation of domestic food-crop production and lack of liquidity in the rural sector. Domestic markets for locally produced food-crops are the exclusive domain of small traders. Little is known about domestic trade volumes, but they are likely to be limited, as suggested by the small volume of inter-island trade. This may reflect a severe liquidity shortage, hindering a normal circulation of goods in the rural sector. Other factors limiting domestic trade are, in order of importance: a weak formal banking system, an insufficiently developed small trade sector, and inadequate infrastructure, which limits access to areas with a potential for surplus production.

32. Inappropriate food imports and food aid policies. Government policies with respect to food imports and food aid have affected food-crop production and marketing. Comoros has no potential for economically viable production of rice, which has become the basic staple. Rainfed rice, currently grown on steep slopes, is seriously eroding the top soil. Comoros imports through ONICOR approximately 25,000 tons of rice annually, or about 80% of total consumption. The consumer price of rice is set at about three times the import parity price. Consumer prices of locally produced foods - other than rice, edible oil and maize - tend to adjust to the rice price level, a common phenomenon in countries with one predominant staple food. Maize and edible oil distributed through "food for work" programs have seriously distorted the domestic markets for these products; coconut oil is no longer locally produced. Maize retains good production potential and demand for green maize is extremely strong. However, subsidized imports of broken maize tend to discourage local production of dried maize which is used as chicken feed.

33. Inadequate agricultural institutions and support services. Services to farmers are provided through CEFADER/CADER, an institution within the Ministry of Production that fulfills the role of a ministry of agriculture. Originally, these services consisted of agricultural extension, research and the production and sales of inputs. Over time, the CEFADER/CADER role has expanded and now also includes agricultural credit, food-crop marketing, the distribution of food aid, the implementation of the food-for-work program, population control activities, erosion control, etc. These activities, financed by a multitude of donors, are generally not sustainable with the limited resources available from the Government budget, and their impact on agricultural production has at best been

marginal. As a result, field extension workers have a multitude of tasks and farmers expect to receive food aid for applying innovations on their own farms (erosion control measures, tree planting, etc.).

34. Rapid degradation of the natural resource base. Whereas the Comorians have, for centuries, been able to live off the land, over the last two to three decades arable land has become extremely scarce as a result of growing population pressure. The worst situation exists on the island of Anjouan, where the natural forest cover has alarmingly disappeared and the available land on steep slopes is cultivated with annual food-crops (mainly rice), mostly totally unprotected by any soil conservation measures. This would undoubtedly lead over twenty to thirty years to the quasi-disappearance of an important part of the natural resource base and the agricultural land on which 80% of the 175,000 inhabitants of Anjouan depend for their livelihood. The situation is aggravated by a complex land tenure system which has led to an extreme fragmentation of holdings. Although the situation on the islands of Grande Comore and Mohéli is less serious, with the continuing population increase, they may reach within a few decades the same critical state in which Anjouan finds itself today.

Proposed Short-Term Action Program

35. Agriculture may be the only sector which has the potential for growth in the short- and medium-term, although its potential for longer-term growth is limited. The decline or stagnation of domestic and international trade in agricultural commodities may, in part, be a result of a lack of liquidity--as noted earlier--and may also point to an inappropriate exchange rate. Specifically, as a first step, the Government would:

(i) establish an import tariff/export subsidy scheme; exchange rate adjustments as a tool of monetary policy to stimulate trade is not, in the short term, available to Comoros, as it is part of the Franc zone system. Second-best solutions will be pursued: import taxes will be adjusted to finance an export subsidy scheme. The actual level of the subsidy and the tariff would be defined during appraisal in collaboration with the French authorities. Introduction of the tariff/export subsidy scheme would be a condition of Board presentation, and its satisfactory implementation a condition of second tranche release.

(ii) introduce a tax on imported cereals, meat and edible oil; in rice, this would mean transforming part of the profits of ONICOR into a straight forward import tax (see para. 24);

(iii) lower the consumer price of imported rice by further reducing the profit margin of ONICOR to discourage local rice production which causes serious soil erosion, and improve the nutrition intake of the population;

(iv) undertake a study of domestic commercial and financial transactions, including the pattern of household expenditures, to prepare an action plan to be supported by the next adjustment operation;

(v) undertake a study on inter-islands transport;

(vi) halt food aid imports of edible oil and maize and request food aid agencies to provide the equivalent in rice;

(vii) monetize food aid wherever possible. This implies that the "food for work" program be strictly limited to payment for investments (rural roads, village water supply, or erosion control works insofar as this would lead to temporarily idling the land) and not be used as a substitute for government salaries as is often the case. Targeted food aid programs (aimed at schools, hospitals, nursing mothers) would be designed so as to avoid market disruption and alleviate the short-term impact of adjustment on the poor; and

(viii) create an export-crop promotion office.

36. The proposed operation would also support the Government's initiative in reorganizing CEFADER and in changing its approach to external assistance in the agriculture sector. The Government recognizes that a "project-by-project" approach leads to a dispersion of efforts, waste in the utilization of limited human resources, and consequently to inefficiency in the allocation of limited budgetary resources. However, a change to program support would only be feasible within the framework of a clearly defined and coherent sector strategy, which does not now exist.

37. Accordingly, the Government will prepare, with donor assistance, an agricultural sector strategy focusing on: export-crop diversification, development and promotion of the domestic food-crop market and financial mediation systems; promotion of the production and distribution of agricultural inputs by the private sector; research, human resource development and training; and environmental protection aiming at bringing about a sustainable agricultural production system. Terms of reference have already been drafted and a UNDP-financed project is under preparation. Given the importance of the study, the World Bank would be the executing agency. An action plan and an institutional reform program geared towards a financially sustainable system of farmer services would serve as a basis for the preparation of the second agricultural services project (FY92S).

Protection of the Environment

38. An area of immediate concern is environmental protection. The Government is working on a forestry policy and accompanying legislation that would provide for full protection of selected remaining natural forests, sustainable exploitation of designated national forests and commercial wood lots, and the promotion of on-farm planting of woody

species. The legislation would include stumpage fees, regulatory measures for charcoaling, wood processing (saw logs), and replanting by the private sector. The Government would also embark on preparing a soil conservation program for Anjouan, including legislation for reallotment of agricultural lands and institutional arrangements (creation of a soil conservation service) for the implementation of such a program. Fuelwood constitutes the major source of energy for cooking and ylang-ylang distillation. Energy requirements combined with demand for agricultural land has resulted in major deforestation and serious soil erosion problems. The calcination of lime derived from the coral reef for artisanal cement production not only increases the demand for fuelwood but also destroys the marine environment and the protection of the seashore. In addition, the following specific measures would be taken to protect the environment:

- lower the price of imported rice to discourage local rice production which is responsible in large part for soil erosion.

- The price of petroleum products would be reviewed with the aim of lowering the price of kerosene so as to encourage its use for cooking instead of fuelwood. The Government has agreed with the general recommendations of the Energy Assessment report and will undertake a study to determine the price of petroleum products.

- At the same time, artisanal production of lime from coral calcination would be prohibited so as to protect the marine flora and fauna and to reduce the demand for fuelwood, and measures will be taken to break the de facto ***** of cement importers.

oligopoly

C. Industrial Development Policy

39. Government wishes to promote labor-intensive industries that use imported raw materials (garments) and to study the possibilities of attracting export industries that would add value to local agricultural products. It is recognized that the success of such a strategy is uncertain, but this seems to be the only potential for a long-term source of growth, as agriculture could provide only limited opportunities.

40. While Comoros faces the constraints of geographical isolation, high transportation and energy costs, and poor infrastructure and telecommunications systems, as an ACP country,[2] it offers foreign investors quota access to various international markets. Comoros has an open and liberal economy and an abundant manpower which can be trained to perform tasks which are not excessively complex. Wages appear to be competitive with those prevailing in countries where labor-intensive industries are already established. A number of systematic reforms should offset some constraints and make the establishment of labor-intensive export-oriented industries plausible:

2/ Countries of the Africa, Caribbean and Pacific regions associated with the European Community.

- Creation of an attractive and stable climate for investors. Legislation and regulations governing export-oriented industries would be adopted.

- Revision and simplification of the Investment Code. The Code would be revised to focus on promotion of export-oriented industries capable of creating a large number of permanent jobs. Administrative formalities would be streamlined; the period for issue of notification of approval or rejection would be reduced to 45 days.

- Reform of electricity tariffs. Tariffs would be restructured to achieve greater use of existing daytime surplus power production capacity, while encouraging industrial consumption (as per the recommendation set out in the recent Bank report on the Energy Assessment).

- Maintenance of labor costs at competitive levels. The draft Decree setting the general guaranteed minimum wage would be studied in the light of the wage levels prevailing in neighboring countries.

- Strengthening of the operations and promotional capacity of the Directorate General of Industry and Artisanal Production. Two young graduates will be recruited to assist the present director.

- Study the possibility of creating an export processing zone. Recently, the Government requested assistance from the European Development Fund to finance preliminary studies on the possibility of an EPZ in Comoros. The Government has agreed to consult the Bank on the outcome of the studies which could be used to develop an action program to be supported by the next adjustment operation.

D. Social Aspects of the Adjustment Process

41. The proposed adjustment program is expected to have significant social benefits in the form of: (i) higher revenue for farmers through a shift to higher value crops and increased crop productivity; and (ii) expanded and better allocated Government outlays in social services, i.e., health and education. The part of food aid which will not be marketed through commercial channels, but rather earmarked for public distribution, will be limited to the most vulnerable groups (nursing mothers, the unhealthy and the school children). Discussions with the WFP have already been initiated.

42. The adjustment program entails, nevertheless, some sacrifices from the population. Prices of food imports would rise as a result of the combined changes in tariff and subsidy policies. However, this would be compensated over the medium term by the expected increase in revenue through higher export earnings, in a country where everyone is directly or

indirectly affected by the fortunes of exports. To mitigate the adverse effect of labor retrenchment in the public sector, lay-offs will be phased and an appropriate compensation package will be designed. This will be discussed with Government during the appraisal mission.

43. Although there has been a major breakthrough in the attitude of the Comorian authorities toward family planning, population growth remains an important problem in Comoros. Owing to efforts by the United Nations agencies working in this field and the World Bank Health project, the religious authorities are now encouraging the spacing of births and high-level political officials are emphasizing the need to control population growth. The dialogue through the adjustment operation would reemphasize the urgent need to pursue stricter family planning, to be supported by a social development credit scheduled for FY93S.

44. Finally, the program for protecting the natural environment will benefit the population by protecting the resource base of the economy. Although it will take several years to be completed, the program for reforestation and soil conservation in Anjouan will, starting now, prevent an acceleration of the deforestation process. The interdiction of mining the coral reef for lime production will reduce the need for fuelwood, thus slowing the pace of the deforestation and regenerate marine life along the coast, which is critical to the survival of artisanal fishing - a major source of food for the population.

E. The Next Phase of the Adjustment

45. The second adjustment operation scheduled for FY91 would go considerably further with the implementation of policy reforms. Following a public expenditure review scheduled for FY90, we would condition the release of funds on the implementation of an agreed public expenditure program in key sectors of the economy. The operation will support an action program to improve the marketing of agricultural products based on the study of domestic commercial and financial transactions (para. 35) to be undertaken by the Government, and further measures to improve the competitiveness of Comoros' exports. Based on the results of the agricultural development strategy financed under a UNDP-financed project, a program of policy reforms to increase agricultural production and promote export diversification will also be elaborated.

IV. The Proposed Operation

Opportunities and Risks

46. The proposed operation is expected to lead to an improvement in fiscal revenues and in the efficiency of resource allocation and utilization. It is expected, furthermore, to initiate an incentive program to promote growth in agriculture and industry, which should help to alleviate poverty and to generate employment. However, there are major risks regarding implementation of the reform program, at the political and technical levels.

47. Enforcing tax collection might prove difficult, given the weakness of the administration and the power of some of the prominent businessmen who will be directly affected. However, the French government is willing to provide technical assistance to the Tax Administration as it already has for the Customs Administration. Furthermore, a consensus is building up in the ruling class about the need to improve the delivery of basic services; at the same time, they are becoming conscious that it might be preferable to pay more taxes than to risk losing their sources of income altogether. A key factor will be the success of the revival of traditional exports and the development of new export possibilities which will somehow mitigate the higher tax burden.

48. Conscious of the weak administration, the Government has requested the Bank to provide two technical advisers (on secondment) to strengthen the Office of the Presidency during the implementation period of the adjustment program. The functions of these senior advisers would be to assist in formulating recommendations on investment projects and in elaborating macromanagement policies. The Bank could second a staff member under the IDA technical assistance program, and the IMF is considering secondment of an adviser.

49. Institutional support to key ministries remains a priority in the context of the proposed adjustment operation. Significant technical assistance has been provided by various donors but not much progress is observed. There is at present a Bank-executed UNDP technical assistance project to support the preparation of the Macroeconomic Management Credit; and another Bank-executed UNDP technical assistance project to help the Government to formulate their agricultural strategy is at an advanced stage of preparation. The Government has also requested an upgrading in the quality of technical assistance and stronger on-the-job training programs for Comorian nationals. A program of technical assistance needed to carry the reform process and its financing will be discussed during appraisal.

50. To summarize, there are risks in implementing this program but these risks can be minimized by a strong technical assistance program to strengthen the administrative capability of the Government. At the political level, France's decision to link its budgetary assistance to a reform program supported by the Bank and the IMF would provide added insurance against the possibility of Government backtracking on its commitment to the program. Furthermore, the prospect of a second adjustment credit and progress in alleviating the external debt burden and improving relations with major aid agencies in the Arab world might also induce the President and its entourage to implement the program as intended.

Monitoring and Conditionality

51. The proposed credit will be cofinanced by AfDB and will be disbursed in two tranches. The disbursement of the first tranche of the AfDB credit will only take place after Comoros has become current on its debt service due to the AfDB. Disbursements would be against imports of goods and services. A negative list will indicate which imports will not be eligible for financing. The proposed specific conditions attached to the processing of the credit and to tranche release are listed below.

(a) Before negotiations:

- Agreement on annual Bank reviews of the PIP and consultation with the Bank on all projects in excess of US$2 million (para. 26).
- Agreement on the principle of introducing a tariff and export subsidy scheme (para. 35).
- Introduce taxes on rice and petroleum products (para 24).
- Agreement on the principle of monetizing food aid (para. 35).

(b) Before Board presentation:

- Introduce import tariff/export subsidy scheme.
- Agreement on a macroeconomic framework including PIP for 1988-90 and the fiscal and monetary program for 1989.
- Agreement on retrenchment program of civil servants.
- Elimination of the "Caisse de Stabilisation".
- Creation of an inspection team in the Tax Office.
- Decree preventing governorates from spending more than their budget.
- Creation of a committee to review the financial situation and decide on priorities for payments.
- Selection of consultants for agricultural strategy.
- Liberalization of imports of cement.
- Recruitment of consultants for study of electricity tariffs.

(c) Before the release of the second tranche:

- Satisfactory implementation of the FY89 fiscal program and agreement on a macroframework including PIP for 1990-91 fiscal and monetary program for 1990.
- Automatic tax assessment for individuals failing to submit tax returns and enforced collection of tax.
- Lowering the mark-up on imported rice.
- Satisfactory implementation of the import tariff/export subsidy scheme.
- Complete tax audits for ten of the largest tax payers.
- Integration of employees of governorates into the civil service.
- Redefine the role of SOCOVIA, abolish STAC, and initiative steps to divest from COMOTEL.
- Agreement on expenditures program in agriculture, education, health, and transport.
- Prepare satisfactory consolidated budget for 1990.
- Implementation of the revised tariff for electricity and petroleum products.

V. Other Matters

Aid Coordination

52. The Bank staff has cooperated closely with the IMF in developing the policy package. Two IMF staff members participated in the preparation mission. However, due to staffing constraints, the IMF cannot send a full mission but will participate in the appraisal mission. Discussions are under way with IMF staff on the preparation of a PFP to be negotiated in parallel with the negotiation of the proposed operation. The African Development Bank also participated actively in the preparation mission and contributed to the elaboration of the program of reform in agriculture. Plans have been made for their participation in the appraisal mission. Frequent and close coordination has also been established with France, both in Moroni and in Paris; the scope and content of the adjustment operation have been discussed in detail with the staff from the Ministry of Finance, the FAC and CCCE by mission members on their way to and from Comoros. The French Trust Fund financed the consultant fees of two of the mission members. Close contacts have also been established with UNDP, both in the field and at the New York Headquarters, and a technical assistance program to support the adjustment program is under preparation.

Round Table

53. The Arab institutions which own most of the debt contracted by Comoros have declined the offer to participate in the preparation mission, but have indicated their interest in being kept informed. It is therefore essential that, after the proposed operation has been negotiated, a donors' meeting be organized to seek a major rescheduling effort on the part of the Arab institutions. UNDP has indicated its willingness to organize such a meeting at the end of 1988 and to assist the Government in its preparation.

Processing Schedule

The processing schedule of the proposed adjustment operation is as follows:

Appraisal	:	2nd half June 1988
Negotiations	:	September 1988
Board	:	October/November 1988
First tranche	:	January/February 1989
Second tranche	:	December 1989

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COMOROS: Macroeconomic Management Budget
Matrix of Policy Measures and Time Frame for Implementation

Policy Areas and Objectives	Measures recently taken by Government	Measures to be taken under MMC	Time Frame	Monitoring Responsibility
I. External Trade Policy				
A. External trade promotion.		- Introduce an import tariff/ export subsidy scheme.	Board	IMF/IBRD
The depreciation of the US dollar vis-à-vis the French franc has reduced the competitivity of traditional products.		- Implement the above scheme.	2nd tranche	IMF/IBRD
		- Eliminate "Caisse de Stabilisation".	Board	IBRD
		- Create an "Export-Crops Promotion Office"	2nd tranche	IBRD
B. Trade liberalization		- Liberalize cement imports (see Environment).	Board	IBRD
II. Improving Public Finance Management				
A. Increasing Government revenue.	- Restructured the General Tax Administration; reinforced the Customs Administration through appointment of an expatriate as Director; studied possibility of computerizing management information system with assistance from France; agreed with neighboring countries to control smuggling.	- Measures to enforce tax returns through systematic setting-up of individual files and creation of an inspection team in tax administration.	Board	France, IBRD
Despite a budget deficit financed by external assistance, budget resources are not sufficient to finance the operations of Government services.		- Implementation of the computerized management information system in the Customs Administration.	End 1988	France
	- Increased price of rice from CF 160/kg to CF185/kg.	- Establish an import tax on rice (75% to 100%) and petroleum products (ad valorem).	Board	IBRD
		- Revise price of petroleum products.	2nd tranche	IBRD
		- Eliminate temporary ad hoc tax exemptions for investment imports.	End 1988	IBRD

B. Better allocation of Government expenditures. Because of successive budgetary cuts, the budget of several Government services has been reduced severely and is limited to the wages and salaries of civil servants.	- Prepared more realistic and complete budget since 1986 (including capital expenditures).	- Analyze expenditure program in the main spending ministries (production, transport, health and education) and allocate resources according to agreed priorities.	1990 budget	IBRD
	- Contained recurrent expenditures: laid off 360 civil servants in 1986; reduced fringe benefits (housing, cars and gasoline); cut missions abroad; downgrades mission travel; limited scholarships abroad to external financing.	- Consolidate all payroll including governorate agents and establish computerized payroll management system under the 1989 budget.	End 1988	IBRD, France
	- Conducted systematic review of all employees on public payroll with assistance from France.	- Prepare an action plan to phase out unnecessary civil servants; limit new recruitments to specific requirements under 1989 budget.	End 1988	IBRD
C. Three-year rolling Public Investment Program. In the past, projects have been decided and started without proper economic analysis.	- Reduced public investment program to priority projects and prepared a three-year rolling PIP.	- Prepare satisfactory three-year 1988-1990 PIP	Board	IBRD
		- Agree to consult with World Bank on any new project costing more than US$2 million.	Negotiations	IBRD
	- Obtained TA from main donors to reinforce the planning unit.	Prepare satisfactory 1990-1992 PIP.	2nd tranche	IBRD
D. Improving the efficiency of the public enterprises.	- Organized seminar on public enterprises in 1986; created a public enterprise unit in the Ministry of Finance.			
	- Liquidated SONATRAM (transport company).	- Implement the rehabilitation program for the Post Office and water and electricity company.	2nd tranche	France
		- Redefine role of SOCOVIA.	2nd tranche	IBRD
		- Divest COMOTEL, abolish STAC.	2nd tranche	IBRD

E. Improving debt management.	- Signed an agreement with France on the consolidation of the domestic debt; created a national committee to prepare a comprehensive listing of all government debt (arrears and treasury bonds). - Abolished the use of "Cashier Bonds". - Computerized the external debt data base in the Ministry of Finance.			
F. Improve management of public sector finance.		- Set up a financial planning system with short-term technical assistance financed by UNDP.	End 1988	IBRD
		- Prepare consolidated budget for 1990.	End 1989	IMF
III. <u>Agriculture Sector Policy</u>				
A. Second best solution to the exchange rate adjustment to revitalize exports.		(See measures in Part I on trade promotion.)		
B. Formulate an integrated agricultural development strategy aiming at increasing food-crop production and diversifying export-crops.	- Approached main donors to undertake studies to formulate a development strategy in the sector. - Drafted terms of reference of the studies.	- Finalize terms of reference of agriculture strategy.	June 1988	IBRD
		- Signature of UNDP financing agreement for strategy study.	July 1988	UNDP
		- Complete strategy study.	July 1989	UNDP/IBRD
C. Improve food-crop distribution.		- Undertake study of domestic markets, financial transactions and household surveys (including in the strategy study).	July 1989	UNDP/IBRD

D. Minimize interference of food aid program in domestic market.		- Agree on program/process to monetize food aid to the extent possible and shift from edible oil and maize to rice in the framework of the new WFP program.	Board	IBRD, WFP, USAID, FED
E. Discourage rice cultivation.		- Lower the price of imported rice.	2nd tranche	IBRD
IV. Environmental Protection				
Protect the natural resource base.	- Engaged in soil conservation measures supported with donors' assistance; prepared an action program to protect soil from erosion in Anjouan; started process to formulate a forestry policy and accompanying legislation.	- Complete work on formulation of forestry policy.	End 1988	IBRD
		- Implement soil conservation program in Anjouan.	2nd tranche	IBRD
		- Prohibit local production of lime from coral calcination.		IBRD
		- Liberalize imports of cement.	Board	IBRD
V. Industrial Sector Policy				
Promote export processing industries to sustain long-term economic growth and create employment.	- Created the Development Bank of Comoros and encouraged its active role in promoting small scale industries. Revised Investment Code of 1984.	- Undertake study on possibilities of developing a Free Industrial Zone.	Mid-1988	IBRD, FED
		- Revise and simplify the Investment Code.	End 1988	IBRD, FED
	- Organized local seminar on industry in early 1988.	- Review electricity tariffs in consultation with Bank.	Jan. 1989	IBRD
		- Implement new electricity tariffs.	2nd tranche	IBRD, France

COMOROS: E ce of Payments *
(In millions of , at current prices)

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
A. Exports of Goods and NFS	19.9	26.7	16.6	30.3	33.2	32.9	34.0	34.9	35.6	37.1	39.9
1. Merchandise (FOB)	15.7	20.0	9.5	22.5	24.6	24.2	25.0	25.4	25.5	26.4	28.6
2. Non-Factor Services	4.2	6.8	7.1	7.8	8.6	8.7	9.0	9.5	10.0	10.6	11.3
B. Imports of Goods and NFS	64.5	70.8	67.0	80.3	82.9	86.1	92.8	95.4	99.0	109.6	116.2
1. Merchandise (FOB)	25.7	26.2	22.3	30.1	30.9	34.2	38.4	39.4	39.5	46.0	47.5
2. Non-Factor Services	38.7	44.7	44.7	50.2	52.0	51.9	54.4	56.1	59.5	63.6	68.7
C. Resource Balance	-44.5	-44.1	-50.4	-50.0	-49.8	-53.2	-58.8	-60.5	-63.4	-72.5	-76.3
D. Net Factor Income	-1.2	-0.9	-2.3	-2.3	-2.4	-2.5	-2.7	-3.0	-3.3	-3.4	-3.5
1. Factor Receipts	0.6	1.4	1.0	1.1	1.2	1.3	1.4	1.4	1.3	1.4	1.4
2. Factor Payments (Interest payments)	-1.7	-2.3	-3.3	-3.4	-3.6	-3.8	-4.1	-4.4	-4.6	-4.7	-4.9
E. Net Private Transfers	-0.7	-1.2	-1.2	-1.2	-1.3	-1.3	-1.3	-1.3	-1.3	-1.4	-1.4
F. Current Account Balance	-46.4	-46.1	-53.9	-53.6	-53.4	-56.9	-62.8	-64.9	-68.0	-77.3	-81.2
Amortization	-1.4	-3.3	-5.7	-6.1	-7.0	-7.7	-8.1	-9.2	-10.2	-11.2	-12.2
Reserve Requirement	-7.6	-3.8	-1.1	-1.2	-1.4	-1.0	0.1	0.5	-0.3	-1.0	-1.2
Arrears Payments	0.0	0.0	0.0	-5.0	-4.0	-4.0	0.0	0.0	0.0	0.0	0.0
G. Financing	-55.4	-53.1	-60.7	-65.9	-65.8	-69.7	-70.8	-73.6	-78.5	-89.6	-94.6
Transfers (Public)	32.1	29.6	40.0	37.9	36.8	38.8	35.8	37.5	41.3	51.8	54.8
Other	0.3	-1.8	1.2	1.6	1.6	2.0	2.0	2.5	2.5	3.0	3.0
Disbursements from Pipeline	21.9	21.5	19.0	15.0	7.8	4.1	2.6	2.3	0.3	0.0	0.0
Disbursements from New Commitments	0.0	0.0	0.0	6.6	13.5	18.5	24.1	25.1	28.2	28.9	31.0
Partial Debt Cancellation 1	0.0	0.0	0.0	4.8	6.2	6.3	6.3	6.2	6.1	5.9	5.8
Arrears	1.1	3.8	0.5	-	-	-	-	-	-	-	-
Memo Items:											
Debt Service Ratio 2/	15.8	20.8	54.2	31.4	32.0	35.0	35.7	39.0	41.6	43.1	42.8
Debt Service Ratio after Debt Cancellation	15.8	20.8	54.2	15.6	13.5	16.0	17.3	21.2	24.4	27.1	28.2

Note: * Provisional data based on information in the CEM; will be revised during appraisal in collaboration with the IMF.
See also footnotes in previous table on Key Macroeconomic Indicators
1/ Possible debt cancellation from the Arab donors.
2/ Contractual

COMOROS
...Y MACROECONOMIC INDICATORS

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
GDP growth rate 1/	2.1%	2.5%	2.7%	4.5%	3.2%	3.0%	2.6%	3.0%	3.4%	4.9%
GDP per capita growth rate	-1.4%	-0.8%	-0.6%	1.2%	-0.1%	-0.3%	-0.7%	-0.3%	0.1%	1.6%
Consumption p.c. growth rate	-6.3%	1.4%	1.6%	-0.1%	1.0%	-1.1%	1.0%	0.2%	0.5%	1.4%
Debt service (in million US$)	5.6	9.0	9.5	10.6	11.5	12.1	13.6	14.8	16.0	17.1
Debt service/XGS	20.8%	54.2%	31.4%	32.0%	35.0%	35.7%	39.0%	41.6%	43.1%	42.8%
Debt Service/XGS after Debt Cancellation 2/	20.8%	54.2%	15.6%	13.5%	16.0%	17.3%	21.2%	24.4%	27.1%	28.2%
Debt service/GDP	3.3%	4.3%	4.1%	4.1%	4.0%	3.9%	3.9%	3.9%	3.8%	3.6%
Gross Investment/GDY	25.0%	20.5%	20.4%	20.0%	20.0%	20.0%	20.0%	20.0%	21.0%	21.7%
Domestic Savings/GDY	-0.7%	-2.9%	-5.3%	-3.4%	-5.0%	-3.8%	-5.6%	-5.4%	-5.0%	-4.5%
National Savings/GNY	-1.9%	-4.6%	-7.1%	-5.2%	-6.7%	-5.6%	-7.5%	-7.2%	-6.9%	-6.4%
Government Revenues/GDP	14.7%	13.0%	13.3%	13.5%	13.9%	14.4%	14.9%	..	..	..
Government Expenditures/GDP	46.9%	35.0%	36.1%	35.8%	35.8%	34.9%	33.9%	..	..	..
Deficit (-)/GDP	-32.2%	-22.0%	-22.8%	-22.3%	-21.9%	-20.5%	-19.0%	..	..	..
Export (GNFS) Growth Rate 3/	28.7%	-19.0%	26.8%	5.5%	1.6%	0.8%	0.2%	4.9%	6.5%	7.0%
Exports/GDP	15.4%	7.9%	15.3%	15.3%	15.1%	14.7%	14.4%	14.8%	15.3%	15.6%
Import (GNFS) Growth rate 4/	-14.6%	-3.2%	7.7%	-0.4%	5.6%	-0.4%	5.8%	-0.8%	7.8%	6.1%
Imports/GDP	42.8%	40.4%	42.4%	40.2%	41.1%	39.7%	40.9%	40.5%	41.4%	41.8%
Current Account (in million US$)	-46.1	-53.9	-53.6	-53.4	-56.9	-62.8	-64.9	-68.0	-77.3	-81.2
Current Account /GDP	-27.6%	-23.9%	-23.3%	-20.7%	-20.0%	-19.9%	-18.7%	-17.9%	-18.4%	-17.3%

Note: Provisional data based on information in the CEM; will be completed and revised during appraisal in collaboration with the IMF.

1/ GDP growth rate fluctuates with clove cycle (excellent crop every six years);
Average annual growth rate for the periods 1985-1987 = 2.7%, 1988-1991: 3.5%, and 1992-1995 = 3.7%

2/ Possible debt cancellation from Arab donors which have not received any service payments from Comoros for the past few years.

3/ In constant prices and also fluctuates with clove cycle (about 6 years). In 1987, exports dropped sharply because of the slump in vanilla prices and export volume. However, the scenario assumes that the unsold 1987 vanilla crop would be exported in 1988, in addition to the crop of the current year, producing a sharp increase in total exports that year.

4/ In constant prices and reflects the fluctuations in rice imports which vary from year to year according to the ship arrivals (normal cycle = 1 ship in one year and 2 ships next year).

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

8806.5012

DATE : June 14, 1988

TO : Operations Committee

FROM : Vinod Dubey, Director, EAS

SUBJECT: YUGOSLAVIA - Proposed SAL II - Initiating Memorandum - Agenda

The Operations Committee will meet on Friday, June 17, 1988 at 10:00 a.m. in Room E-1243 to discuss the proposed Second Structural Adjustment loan to Yugoslavia.

Background

Yugoslavia's present economic difficulties have their origins in the 1970s. Heavy reliance on external borrowing made it possible to delay adjustments that were necessary to cope with a sustained deterioration in the terms of trade, while many of the investment projects undertaken during that period proved ill-considered and did not contribute sufficiently to growth and development. By the early 1980s, Yugoslavia's external position had become unsustainable.

An adjustment program was introduced in 1982-83 to restrain domestic demand and re-establish external competitiveness through a depreciation and adoption of a more flexible exchange rate policy. The Long-term Stabilization Program of 1983 also endorsed the move towards a more market-oriented economy. The program was supported by official and bank creditors, the IMF, and the Bank (under SAL I). However, the program met with only very limited success, in large part because the Government lost momentum in implementing the reforms and large macro-economic imbalances appeared, particularly after 1985, with inflation accelerating to well over 100% in 1987, savings and investment declining, and economic growth stagnating.

The severity of the economic deterioration was finally recognized in mid-1987 and the Government strengthened its resolve to deal with the crisis, stabilize the economy and to tackle needed structural reforms. Initial discussions were held with a joint Bank/Fund mission in October 1987, and an IMF Stand-By was approved recently, based on considerable prior action, implemented in May 1988.

Issues

The Committee may wish to discuss the following:

The Stabilization Program

A number of attempts have been made by the Yugoslav authorities over the past few years to reduce inflation and to stabilize the economy. During 1987, broad money and domestic credit declined substantially in real terms, but inflation accelerated to over 160%. How confident is the Region that the stabilization program will

succeed this time? Which elements of this stabilization program make the difference? In the past, restrictions on credit, price, wage increases have been circumvented by Yugoslav enterprises. How does the proposed stabilization program guard against this?

What is new & different about this effort.

Structural Adjustment Measures

Foreign Exchange Allocation. The largely administrative allocation of foreign exchange is an important source of inefficiency in the Yugoslav economy. The Government has proposed to use the interbank meetings as a vehicle for market allocation of foreign exchange, rather than introduce a foreign exchange auction market where other parties can participate as well. How confident is the Region that the interbank meetings will be free from administrative interference by local governments and enterprise groups? How does the Region propose to monitor the functioning of the foreign exchange market?

Interbank meetings?

Trade Liberalization. Assuming that the foreign exchange market will be permitted to work without administrative interference, the quantitative import control system will then become the predominant source of industrial protection--and inefficiency. The proposed target under SAL II is to increase imports under the freely importable (LB) category from 35% to 82.8% of convertible currency by 1990, and to phase-out the conditionally free (LBO) category by that time. These targets are formulated in terms of actual, but highly distorted, trade patterns. Does the Region have an estimate of the extent of the proposed liberalization relative to potential imports? How does the Region propose to formulate trade liberalization targets beyond these initial measures?

Target is to increase free imports from 35 to 82.8%. How important is this. Monitoring. When do we go beyond this.

Price liberalization. Inflation has been running at well above 100%, and is likely to remain in the upper double digit ranges for a considerable time to come. Does the Region feel the target of price decontrol of 80% of the categories of the producer price index by 1990 is sufficient? What about products and services outside the producer price index?

How important are controlled U.S. Em

Interest Rates. An important element of the stabilization program is the indexation of a wide range of financial instruments to achieve a significantly positive real rate of interest. What is the total coverage of this indexation? Does the Region have any targets in mind with respect to reduction or elimination of credits at preferential interest rates? Given that credit controls have been circumvented in the past, how can one ensure that these higher real rates of interest are actually paid by enterprises?

Indexation of a wide range of instruments

Do we have mechanisms to ensure effective application of interest rates

Enterprise Reform

The success of the structural adjustment measures will crucially depend on radical changes in the behavior of Yugoslav enterprises. What are the elements in the program that will bring about such a dramatic change? What changes in economic institutions and incentives will bring about the proposed shift from wage to profit maximization (para 6.)?

What will change the present attitude of enterprises

Investment Allocation

Investment patterns in Yugoslavia have been characterized by extreme inefficiency. Does the Region have confidence that the measures proposed in paras 40-43 will bring about a coherent national public investment program? Or are more fundamental constitutional changes called for? What criteria will the Region use in deciding on the appropriateness of the public investment program?

Social Costs of Adjustment

Increased financial discipline of enterprises--if implemented--is likely to lead to significant redundancies in poorly managed enterprises. The Region may elaborate what specific measures are proposed to enhance labor mobility?

cc: D. Lee, A. Shakow, J. Holsen, D.C. Rao, Burmester/Thahane, R. Liebenthal, A. Steer, T. Baudon, P. Hasan, E. Lari, P. Nouvel, J. Harrison, R. Myers, A. Kanaan.

For Information Only:

D. Hopper, D. Bock, D. Goldberg, R. Frank, J. Parmar, G. Pfeffermann, J. Baneth, M. Haug, C. Robless, A. El-Maaroufi.

GPohl:pl

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: June 10, 1988

TO: Mr. Moeen A. Qureshi, SVPOP

THROUGH: Mr. Kemal Dervis, Acting EMNVP

FROM: Eugenio F. Lari, Director, EM4

EXT: 32552

SUBJECT: YUGOSLAVIA: Structural Adjustment Loan II - Initiating Memorandum

1. I attach for your approval the Initiating Memorandum for the proposed SAL II to Yugoslavia in the amount of $300 million equivalent. The loan would support the Government's reform program which aims, ultimately, at freeing up the economy by introducing more competition and increasing the mobility of factors of production throughout the economy. This SAL II proposal was preceded by a first SAL in 1983 which met with limited success, in large part because the Government lost momentum in implementing the reform and in maintaining macroeconomic equilibrium, particularly after 1985. By 1987, inflation was above 100% and accelerating, foreign exchange reserves dropped sharply, severe external liquidity problems emerged, and GDP fell. From this emerging crisis a new, strong and comprehensive program for macro stabilization and structural reform emerged which this proposed SAL II would

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Attachment

Distribution:

Members of the Operations Committee:

Messrs. Husain (LACVP); Jaycox (AFRVP); Karaosmanoglu (ASIVP); Fischer (VPDEC); Shihata (VPLEG); Wood (VPFPR); Vergin (SVPOP)

cc: Messrs./Mdms. Thalwitz (o/r), Hasan (o/r), El Maaroufi, Michalopoulos, Roa (EMNVP); Rajagopalan (VPRE)
Zaidan (EM4DR); Nouvel, Harrison, Myers, Kanaan, Farsad, Pant, Ding, Bacon (EM4CO);
Ramasubbu (EM4AG); Sood (EM4IE); Apitz (EM4IN);
Hinds, Manes (EMTTF); Nadkarni (EMTIE); Schweitzer (EMTPH); Whitford (EMTEN);
Dubey, Pohl (EAS); Baneth (IEC); Picciotto (PBD);
Holsen (CEC); Rao, Hadler (FRS); Bock (DFS); Lee (COD);
Shakow, Liebenthal (SPRPA); Churchill, Barry, Nagaoka (IEN); Steer (FRS); Naseem, Sehgal (CEN);
Frank (CFPVP); Parmar (CIOVP); Hassan, Al Jabri (LEGEM);
Williams (LOA)
Ripley (IMF) (9-404)

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support. The Government has already started to implement a reform of the foreign exchange allocation system and has taken the first important steps in trade and price liberalization. While uncertainties remain and downward risks are substantial, the Government program--if vigorously implemented--should provide the needed tight demand management and elicit the equally needed supply response, both essential ingredients to achieve the stated development objectives in Yugoslavia. Beyond 1988, other adjustment operations are possible, over the next five years, to support the Government's program. One is a financial sector adjustment loan aimed at further improving financial discipline and intermediation. Two other possibilities would most likely support fiscal reform and improvements in wage and employment policy. In addition, a SECAL focusing on restructuring of enterprises might be appropriate.

2. We have been discussing since 1985 many of the proposals now included in the Government Program, particularly in the areas of price and trade liberalization, financial discipline, foreign exchange allocation and investment policy. Progress has been slow, but it has accelerated in the past year, especially since October 1987 when the Government invited a joint Bank-Fund technical team to review its draft Program before it was approved in November. We now believe that based on this Program, and subsequent modifications to it, it will be possible to reach agreement on a structural adjustment program which would justify Bank support. Our discussions with the Government on SAL II have centered on the key areas set out in summary form in Table 2 (p. 19) of the Initiating Memorandum.

3. I joined a preparation mission in Belgrade from May 22 to 27, 1988. Mr. Thalwitz held further discussions in Yugoslavia during the period June 3rd to 8th. During both missions we verified a seriousness in the Government's reform effort which had been lacking in the past. Among the evidence of this, I wish to mention the policy measures already adopted, the work of the Committee for Economic Reform, and the strength of the program supported by the recently approved IMF Standby. Key actions taken by the Government in May include: indexation of a broad range of deposit and lending rates, resulting in positive real effective interest rates; legislation placing a limit on the growth in unit wages; legislation placing a limit on public sector expenditures; substantial price decontrol; expansion of the unrestricted import list to cover 35% of imports from convertible currency areas (up from 18% in 1987); a real devaluation of the dinar by 20%; and establishment of a new system of foreign exchange allocation which allows supply and demand to determine the price of foreign exchange and removes certain administrative controls on foreign exchange allocation.

4. The Committee for Economic Reform has been very active in strengthening the reform beyond these areas by proposing several important new laws and constitutional amendments which are scheduled to be adopted by mid-November. The general thrust of the Committee's recommendations is to move beyond the Government Program's initial proposals in the areas of enterprise management and increasing competition and improving the mobility of factors of production throughout Yugoslavia. Thus, fiscal reforms aim at, among other things, making taxes more uniform across republics and autonomous provinces (RAPs). The firm rather than the basic organization of associated labor (BOAL) will become the fundamental economic decision-making unit in Yugoslavia and the firms will seek to maximize income net of wages (i.e.

profits) rather than, as before, total income including wages. In banking, the National Bank of Yugoslavia (NBY) will function more as a traditional central bank by shedding its commercial banking functions and ceasing to issue preferential credit to priority sectors. In addition, measures are proposed to reduce the heavy influence that companies and enterprises have on the commercial banks. The mobility of capital is expected to increase as the sources of financing for investment by enterprises are broadened to include selling shares and bonds and foreign borrowing. Also, any firm establishing a joint venture or subsidiary will be able to retain control over those units, rather than as now, being forced to give up control if the workers so decide. Firms will be able to participate in the management of the joint ventures and subsidiaries they establish even if these are located in a different Republic. This change should encourage greater mobility of capital and management across Republican boundaries and the creation of small and medium industries (SMIs).

5. The new IMF Standby agreement was approved in principle on June 1, 1988. The program it supports is a tough one which aims both at stabilization and liberalization of the economy. We have worked very closely with the IMF and have helped shape the price, trade and foreign exchange liberalization measures contained in the Standby so they will be consistent with their extension under the proposed SAL II. The measures noted in para. 3 above were prior actions for the Standby agreement. Thus, given the strength of the Standby and the extent to which it overlaps with the proposed SAL II, many of the actions we proposed have already been or shortly will be undertaken. It is this front-loaded element of the proposed SAL II which indicates clearly the Government's commitment to the reforms. We still must obtain schedules for the timing of additional actions, however. These will be set out, along with the general thrust of the Government's program in the Letter of Development Policy to be obtained during the appraisal mission.

Recent Economic Developments

6. During the 1960s and 1970s Yugoslavia's economy grew rapidly, with GSP growth of about 6% per year. This performance, however, was characterized by large investments with insufficient attention to quality or cost. Moreover, the economy's ability to adjust to external shocks was reduced by an excessively accommodating credit policy and by rigidities and distortions, including low mobility of capital and labor, negative real interest rates, an increasingly overvalued exchange rate and highly protected domestic industries. In addition, wage growth exceeded labor productivity in the mid and late 1970s. Yugoslavia initially absorbed the second oil price shock through additional borrowing and managed thereby to cushion its effects in the short run. This resulted in a rapidly increasing foreign debt. External debt doubled between 1978-81, reaching $20 billion. With the increases in world interest rates and the recession in OECD countries, the servicing of the debt became a substantially heavier burden. Debt problems in other countries also created a reluctance by international creditors to provide additional funds. A balance of payments crisis resulted in 1982.

7. Between 1982 and 1985 GSP grew by less than 1% per year. It rose 3.4% in 1986 but fell by 0.5% in 1987. Despite this slowdown, social sector employment increased on average by 2.4% per year at the cost of declines in

labor productivity. Imports were severely cut through restrictive foreign exchange allocations. Fixed investment dropped from 30% of GDP in 1980 to around 23% in 1987. Since 1984 inflationary pressures have accelerated. The retail price index increased by 55% in 1984, 72% in 1985, 90% in 1986 and 118% in 1987 and was accelerating rapidly by November 1987. This reflected the Government's inability to implement a sufficiently restrictive monetary and incomes policy and to induce increases in the productivity of labor and investment. Demand management and incomes policies were particularly relaxed from the second half of 1985 to the end of 1986. Periodic upward revisions of the monetary targets accommodated greater than expected increases in prices. Despite administrative measures introduced in the second half of 1986 to curb the rise in real wages, in the fourth quarter of 1986 real wages were 12% above those of a year earlier.

8. The performance of the economy in 1987 was disappointing. The rise in real personal incomes and government expenditures in early 1987 resulted in further acceleration of the rate of inflation. Workers' remittances and tourism receipts were lower than expected and this, combined with a large bulge in amortization payments falling due, led to a sharp $1 billion decline in reserves in the first half of the year and a postponement in amortization payments due to commercial banks. However, a strong expansion of exports to convertible currency areas (estimated at 9% in volume terms), combined with a sharp compression of convertible currency imports (which declined 11% in volume terms), produced a large (about $1 billion) current account surplus for the year as a whole.

The Government's Medium Term Program

9. In November 1987, the Government published a new program entitled, "Programme of Measures and Activities for Reducing Inflation and Stabilization of the Economy" (the Programme) which focuses on five macroeconomic areas; (i) monetary policy and stabilization; (ii) foreign exchange allocation and price and trade liberalization; (iii) financial discipline; (iv) employment and wages; and (v) fiscal and administrative systems. The first three of these are areas explicitly addressed in the Standby and SAL II. The two other areas are equally important but neither the Government nor the Bank are sufficiently prepared with respect to specific policy instruments that could achieve the desired objectives. For this reason, specific policy measures in these areas are not included in SAL II. The primary objective of the Programme, and, therefore, of the Standby, SAL II and other possible adjustment operations, is to bring about a more competitive, market oriented economy with greater external trade, and mobility of goods, services, capital and labor throughout Yugoslavia.

10. The publication of this Programme was followed in January by the creation of a Committee on Reform of the Economy. This Committee has acted as a main implementing body for the Programme but is deemed to be temporary. Recently, however, the Government also created a new Federal Ministry of the Economy which may carry much of the responsibility for implementation of the Programme after the Committee disbands.

11. The Government's Programme is essentially one of structural adjustment although it begins, as is appropriate, by focusing on the need to stabilize the economy. This is to be achieved primarily through monetary policy, that is, through a concerted policy of limiting the rates of creation

of money and credit and raising real interest rates so as to limit increments in aggregate demand. Beyond that, nominal wage increases are to be restricted both to hold down inflation and to enable larger accumulation by the enterprises in order to increase investment. Improvements in the efficiency of use of existing capital stock are primarily to be achieved by liberalizing the economy in order to increase competition. Price, trade and foreign exchange allocation liberalization, all supported by the proposed SAL II, should improve incentives where appropriate, thus raising productivity and providing signals for improving the allocation of investment. The Programme also stresses improving financial discipline through a more careful application of the Rehabilitation and Bankruptcy Law and recognizes the importance of general application of the uniform project analysis methodology for project selection introduced under SAL I.

12. The Programme, which was partly a response to Yugoslavia's international creditworthiness crisis, has already instituted changes in macroeconomic projections. Notable among these is the much closer and more realistic relationship between the balance of payments and the national accounts projections. In addition, the Programme recognizes the need for fiscal reform, with a reduction of taxes on production, and the need to encourage smaller scale private enterprise by removing restrictions and enabling appropriate incentives to be carried through to potential investors. The Programme has continued to evolve with the important additional measures proposed by the Committee for Economic Reform (para. 4 above).

13. Yugoslavia is aware that its international creditworthiness depends critically on the strength of its adjustment efforts. The country is one of the seventeen highly indebted middle income countries, not so much because of the interest burden of its debt but because of the high amortization payments required over the next few years. It is, therefore, dependent on successful reschedulings. The official financing package associated with the IMF Standby aims at restructuring commercial bank medium- and long-term debt and adding $300 million of new money. In addition, the authorities have requested from the Paris Club a continuation of rescheduling in 1988 with a broadening of the coverage to include previously rescheduled debt. It is estimated that rescheduling of principal will amount to $580 million. New money from official creditors for 1988 is likely to amount, to $300 million. However, the need for new money from official creditors is estimated by Yugoslav authorities at $500 million. The additional $200 million is still being sought. A bridge loan from the BIS and the U.S. amounting to some $250 million for the period following approval by the Executive Board of the IMF is in the process of being finalized. Under the present proposal some $85 million of the Standby would be provided upon effectiveness of the Standby.

The Rationale of the Proposed Loan

14. The overall rationale is to support the growing momentum for reform in Yugoslavia in a setting of an acute shortage of foreign exchange. We feel the proposed reforms are well conceived and appropriate. In addition, the seriousness of the Government's commitment to reform is demonstrated by the actions already taken to carry out the Programme, even before all the

financing details are worked out. The recent Standby Agreement and the seriousness with which SAL II discussions have proceeded in recent months also suggest that now is an appropriate time to support the reform effort and specifically what we feel is a well-conceived, heavily front-loaded Structural Adjustment program.

15. The macro scenario on which the proposed SAL II loan is based envisages Bank commitments of about $600 million per year in FY88-92 with $250-300 of this amount in each year being in adjustment lending. Thereafter it is projected that commitments from IBRD would drop to about $350 million per year as Yugoslavia regains international creditworthiness and is able to borrow more from commercial sources. Under this scenario the Bank's share of disbursed and outstanding debt for Yugoslavia is projected to rise from 14% in 1986 to 16% in 1993 and then to level off. Beyond 1995 it should begin to decline as commercial credits pick up. The Bank's share of debt service, which was 10.7% in 1986 would rise to a high of 14% in 1992 and then begin to decline thereafter. International reserves, which were severely depleted in 1987, will be built up to just under three months imports by the early 1990s.

Core Conditionality

16. The core conditionality can be listed under the following seven categories:

Macroeconomic Framework

(i) Implementation of stabilization program as agreed with IMF. Joint review with IMF and Bank of macroeconomic developments using agreed indicators of progress in adjustment. Presentation of an acceptable set of macroeconomic projections for 1988-95 together with supporting policies, and agreement to annual, rolling revisions (i.e. 1989-96, etc.) of these and establishment of procedures, institutions, etc., to make better use of the projections for policy purposes. The projections together with supporting policies, should be submitted for review and discussion annually two months before submission for approval to the Federal Executive Council. Thus we would expect their submission about November 1st of each year which would form the basis for identifying and agreeing upon macroeconomic objectives and policy instruments.

Foreign Exchange Allocation

(ii) Ensure operation of interbank meetings so that they serve as a true market for foreign exchange. Develop supervision mechanism to ensure that interbank meetings reflect the demand for foreign exchange via market price mechanism and that other administrative interventions in the market are eliminated.

Trade Liberalization

(iii) Establish a schedule for reducing the size of the quota (K), license (D) and conditionally free (LBO) trade restriction categories by approximately the percentages in Table 1, per six or twelve month

period using import values and an import to industrial classification scheme (to permit analysis of the impact on production). Government to provide economic rationale for retaining non-tariff restrictions on items remaining in these categories and develop a program for substitution of tariff/subsidy regime for such non-tariff barrier restrictions. Latter should support the goal of reducing protection.

Table 1: MINIMUM TRADE LIBERALIZATION TARGETS
(% of Convertible Currency Imports)

May	Jan. 1988	June 1989	Jan. 1989	June 1990	Jan. 1990	1991
D	2.2	2.2	2.2	2.2	2.2	
K	21.5	20.0	17.5	15.0	15.0	
LBO	41.3	27.8	15.3	12.8	0.0	
LB*	35.0	50.0*	65.0*	70.0*	82.8*	TBD

* - Minimum targets. TBD - To be decided.

Price Reform

(iv) Establish schedule along the lines of Table 2 for dismantling price control regime including shifting prices into the "freely formed" category and possibly reducing/shifting public personnel and resources from price control to monitoring price decontrol and analyzing price distortions. Examine and agree on methods of determining levels of remaining administered prices and on their levels. Initiate study to eliminate barriers to unified competitive Yugoslavia-wide market.

Table 2: MINIMUM PRICE DECONTROL PROGRAM
(% of Industrial Producer Price Index)

	----------no later than----------			
	May '88	Jan '89	June '89	Jan '90
FREELY FORMED	39.0+	49.9+		
3 DAY POST-NOTIFICATION	7.0+	7.0+		
(sub-total)	(46.0+)*	(56.0+)*	(65.0+)*	(75.0+)*
30 PRIOR NOTICE	14.0+	14.0+	10.0+	5.0+
(sub-total)	(60.0+)	(70.0+)	(75.0+)	(80.0+)
OTHER FORMS OF CONTROL	40.0-	30.0-	25.0-	20.0-

* - Minimum targets.

Interest Rate and Financial Discipline

(v) Sustained implementation of positive real deposit and lending rates. Review banks' profit/loss and balance sheets to verify that new, higher real interest rates are actually paid by enterprises. Reduction in scope of preferential interest rates. Monitor the application of the bankruptcy law by reviewing rehabilitation programs and the laws restricting income payments. Seek agreement on improvement of accounting and auditing capabilities through technical assistance to SDK and the banks.

Investment Allocation and Economic Decision-Making

(vi) Seek agreement to establish an appropriate mechanism for coordinating economic policies and to establish guidelines for its staffing and operation. Develop a monitoring mechanism for nationwide application of the uniform methodology for investment selection. Receive and review joint development plans in major sectors--at least for power and transport--and establish how these plans are to be implemented under different macroeconomic scenarios. Annual consultation on investment program in key sectors.

(vii) The Social Costs of Adjustment

The Bank will review existing arrangements for alleviating the social costs of adjustment, mainly temporary unemployment, with a view to defining a coherent approach including the purposes for which such relief should be provided and the appropriate means by which resources can be mobilized to finance this relief. The Bank will seek to assist the authorities in designing a transparent and well-targetted saftey net for those temporarily unemployed. We will also discuss with the Government ways to make more tolerable other social costs, e.g., those resulting from the phasing out of subsidies. The Bank will continue to encourage and support measures to promote mobility of resources among firms and RAPs, and especially the development of small, labor intensive firms in the private sector.

Processing Schedule

17. Subject to Operations Committee approval, the appraisal mission for the loan is scheduled for June 20, 1988, with Board presentation in November, 1988.

June 8, 1988

The World Bank
OPERATIONS COMMITTEE

CONFIDENTIAL

Minutes of the Operations Committee to Consider
MALI - Policy Framework Paper

Held on June 8, 1988 in Conference Room E-1243

A. Present

Committee		Others	
Messrs.	M. Qureshi (Chairman)	Messrs.	T. Ahlers (AF5CO)
	D. Goldberg (VPLEG)		F. Bauer (AF5CO)
	S. Husain (LACVP)		V. Dubey (EAS)
	E. Jaycox (AFRVP)		M. Gillette (AF5DR)
	B. Kavalsky (VPFPR)		L. Hinkle (AF5CO)
	C. Michalopoulos (EMNVP)		J. Holsen (CEC)
	H. Vergin (SVPOP)		D. Mahar (EAS)
	O. Yenal (ASIVP)		G. Spota (LEGAF)
			S. O'Brien (AFRVP)
			C. Robless (OPNMS)
			W. Schwermer (COD)
			O. Rahkonen (SEC)
		Ms.	E. Makonnen (PPR)
			M. de Zamaroczy (IMF)
			S. Nsouli (IMF)

B. Issues

1. The meeting was called to discuss the Mali Policy Framework Paper. The discussion centered on Mali's commitment to policy reform in light of recent changes in the country's economic team.

C. Discussion

2. The Region briefed the Committee on the recent cabinet reshuffle in Mali. It was reported that through this reshuffling the former Minister of Finance had moved to the Ministry of Transport. His replacement is someone not well known to Bank staff. However, the Region said that it had received assurances from the Government that the change in finance ministers would not result in changes in Mali's economic policies. The Region also reported that important reforms had been taken recently as part of the Public Enterprise Sector Adjustment Project (scheduled for Board presentation on June 24, 1988), including the liquidation of Air Mali and SOMIEX. The Committee was further informed that a plan had been worked out to streamline the Development Bank of Mali and that 300 employees had already been retrenched.

3. The IMF representative at the meeting confirmed the Region's assessment of Government commitment to policy reform. However, he said that it might be necessary for the Fund to send a further mission to Mali before making a final decision on the Government's request for a stand-by and SAF.

4. The Chairman ended the meeting by remarking that the Mali PFP appeared to be fully consistent with the Public Enterprise Sector Adjustment Project discussed by the OC in February 1988.

June 14, 1988

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THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE : June 3, 1988

TO : Operations Committee

FROM : Vinod Dubey, Director, EAS

SUBJECT: INDIA: Country Strategy Paper - Agenda

1. The Operations Committee will meet on Wednesday, June 8, 1988 at 3:00 p.m. in Room E-1243 to discuss the India CSP distributed on May 13, 1988. The Committee may wish to consider the issues identified below as an agenda for the meeting.

Background

2. During the three decades following Independence, the Indian economic development strategy was dominated by concerns about equity and national self-reliance. The State played an important role in regulating the economy as well as in direct production. Macroeconomic management was conservative and characterized by modest budget deficits, minimal nonconcessional external borrowing and inward-looking trade policies. Though this overall policy framework helped India to maintain macroeconomic stability and forestalled a widening of internal economic disparities, it did so at the cost of relatively slow growth and a loss of opportunities to improve its share in international export markets.

3. Over the past decade or so, Indian economic policy has gradually changed. Fiscal and monetary policies have become more expansionary and a greater concern for improving productivity and efficiency has been evident. The role of the State has begun to move away from the past emphasis on direct involvement to more of a guiding role through incentives, infrastructure development and the provision of improved public services. Recent Indian economic policies have also placed more emphasis on export promotion and a series of measures have been taken over the past few years to improve the relative profitability of production for export although less progress has been achieved in liberalizing imports. Finally, the Government has played a more active role in poverty alleviation through, inter alia, the development of targeted employment schemes and the expansion of basic social services, particularly in the rural areas.

4. The results of India's recent policies have generally been positive: GDP growth has accelerated from an average of 3.5 percent per year in 1960/61-1973/74 to an estimated underlying rate of 5 percent p.a. in the 1980s, the incidence of poverty has fallen, and the volume of manufactured exports has increased appreciably. Moreover, this progress has been achieved in the context of modest current account deficits and high external reserves. On the other hand, the fiscal deficit/GDP and debt service ratios have both risen and domestic industry remains highly protected and inefficient. The number of Indians living in poverty also remains very high: a recent study cited

in the CSP estimated that the absolute number of poor people has remained constant over the past decade.

5. The main thrust of Region's strategy for India is to support--through lending, economic and sector work, and policy dialogue--measures aimed at sustaining annual economic growth in the 5-6 percent range while simultaneously attacking poverty through more direct means. This would appear to be an appropriate response to India's current developmental needs. However, some questions could be raised concerning: (i) export projections; (ii) policy reform and conditionality; (iii) Bank exposure; (iv) cost-sharing proposals; (v) use of IDA reflows; and (vi) human resource development.

Export Projections

6. The CSP emphasizes (para. 59 and elsewhere) the critical role of exports in the overall strategy aimed at maintaining high rates of economic growth. Indeed, the Region estimates that the growth of exports must be sustained at around 7 percent per year in order to maintain a financeable current account deficit consistent with a 6 percent growth scenario. The CSP estimates (Table B1) that India's exports will grow at an average of 9.1 percent annually during 1990-95.

7. The Region may wish to explain to the Committee how the export projections were made. In particular, what are the underlying assumptions regarding the evolution of the economic policy framework? What types of products are expected to lead this projected export growth?

Policy Reform

8. The need for additional policy reforms--both macroeconomic and sectoral--is highlighted throughout the CSP. Indeed, it is clearly implied that the key objective of sustaining high growth rates over the balance of this century would be in jeopardy if such reforms were not undertaken. Yet, the CSP is somewhat ambivalent about the ability of the Bank to influence the content and pace of economic reform in India. On the one hand, the CSP refers to the "active state of our policy dialogue with the Government" (para. 82), linking the lending program for industry to "progress of policy reform" in domestic regulation and trade policy (para. 98), and increased use of non-project lending to serve as a vehicle "for supporting changes in Government policies and programs" (para. 122). On the other hand, the CSP rules out policy conditionality in lending operations on political sensitivity grounds, and states that we must be "realistic . . . about the extent to which our ideas about economic policy and the phasing and timing of its implementation and those of the Government of India coincide" (para. 127).

9. Given the above, the Region may wish to brief the Committee on the nature of the Bank's current policy dialogue with the Indian Government. To what extent do our ideas on economic policy actually coincide with those of the Government? What are the major areas of disagreement? Have we been able to influence policies in the past? Do

we expect our influence to grow in the future? If so, why? In what manner will our lending be linked to progress on policy reform? What performance criteria will be used to measure this progress?

Bank Exposure

10. The CSP points out (paras. 83-84) that the Bank's exposure in India will increase considerably in the coming years. Indeed, India is projected to exceed both the "share of debt service" and "share of exports" guidelines by 1990. The "portfolio share" guideline is expected to be exceeded shortly thereafter. The CSP attributes this increasing Bank exposure to the decision to substitute Bank lending for IDA, especially since FY85. The CSP proposes to constrain Bank lending somewhat over the next five years in order to limit Bank exposure, although it is emphasized that nothing short of a major reduction in lending would prevent India's share in the Bank's portfolio from rising above 10 percent by FY92.

11. The Region may wish to provide the Committee with more detail on the implications of the rapidly-rising Bank exposure in India. In particular, does the Region feel that economic management in India is of such good quality that exceeding Bank exposure guidelines should not be a matter of concern? To what extent does the Region view the large fiscal deficit as a sign of increasing country risk? What would be the Region's fall-back position if the fiscal deficit were to worsen substantially?

Cost Sharing

12. The CSP proposes (paras. 90-91) three different cost-sharing ratios depending on the sector or type of project. These ratios would be: 30 percent (or foreign exchange costs whichever is higher) for large infrastructure, industry, and oil and gas projects; 70 percent for projects aimed at human resource development and poverty alleviation; and 50 percent (or foreign exchange costs whichever is higher) for all other projects. It is estimated that 50 percent of project costs would be financed on average.

13. The Region may wish to explain to the Committee how the CSP proposals on cost sharing differ from, and improve upon, current practices. On average, would the proposed ratios result in an overall increase in cost sharing in India? Would the relatively high cost-sharing ratio proposed for the social sectors be accompanied by efforts to improve cost recovery in these sectors?

IDA Reflows

14. The CSP refers (para. 95) to the projected decline in IDA net transfers from US$ 794 million in FY88 to US$ 270 million in FY98. The Region considers this decline to be "unwarranted" given India's poverty problem and generally good economic performance. The CSP then notes that IDA reflows from India will total almost US$ 500 million over FY88-92 and requests that serious consideration be given to earmarking these reflows for the India program.

15. While the utilization of IDA reflows is a matter of general IDA allocation policy, the Region may be asked the rationale for earmarking the reflows from India to that country.

Human Resource Development

16. The CSP proposes (paras. 108-110) an increase in activity in support of population and human resources as part of its poverty alleviation focus. Sixteen projects, comprising 15 percent of the total lending program, are proposed for FY88-92. This may be compared with the 12 projects, comprising 9 percent of the lending program, financed by the Bank in FY83-87. Of the 16 social sector projects proposed for FY88-92, eight are for urban and water, three are for education, and five are for population, health and nutrition. The CSP also proposes a greater focus on poverty and human resource development concerns in its ESW program.

17. The Region may wish to provide the Committee with more detail on its decision to emphasize vocational training and higher technical education in the proposed lending program when problems at the primary level appear to be so severe. Given the inclusion of four population projects in the proposed lending program, the Region may also wish to comment on the effectiveness of our ongoing population projects and on what we expect to achieve through the proposed follow-up projects. In light of the critical health problems faced by India, why has the Region chosen not to include a free-standing health project in the proposed lending program?

cc: D. Lee, A. Shakow, J. Holsen, D.C. Rao, Burmester/Thahane, R. Liebenthal, A. Steer, T. Baudon, B. Alisbah, O. Yenal, D. Ritchie, D. Greene.

For Information Only:

D. Hopper, D. Bock, D. Goldberg, R. Frank, J. Parmar, G. Pfeffermann, J. Baneth, F. Aguirre-Sacasa, M. Haug, C. Robless.

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DMahar:pl

Population

Human Resources

P. 30

Home

Giving up the [illegible] part of the lending program —

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE : June 3, 1988

TO : Operations Committee

FROM : Vinod Dubey, Director, EAS

EXTENSION: 78061

SUBJECT : MALI: Draft First-Year PFP; Agenda

1. The Operations Committee will meet on Wednesday, June 8, 1988 at 4:00 p.m. in Room E-1243 to discuss the draft Policy Framework Paper for Mali distributed on May 19, 1988. A draft First-year PFP for Mali was previously approved by Bank and Fund management in 1986, but it was never negotiated owing to a lack of commitment on the part of Government to economic policy reform. Negotiations for a proposed Bank-financed Public Enterprise Reform Project, approved by the Loan Committee in the same year, also could not be completed due to the failure of Government to agree to a reform package. A reformulated version of this project was approved by the Operations Committee in February 1988, and negotiations were successfully completed in March.

Background

2. Mali, with a 1986 per capita income estimated at US $170, is one of the poorest countries in the world. Other available social indicators--such as life expectancy, infant mortality rates, and school enrollment ratios--are equally worrisome. Mali's recent economic performance has been erratic, in part due to climatic factors. Although real GDP grew by 10 percent and 4 percent in 1986 and 1987, respectively, per capita income has fallen by an average of 1.6 percent annually over this decade. Mali's future development prospects are subject to formidable constraints, both natural and man-made. Among these are the country's landlocked geographical position, weak resource base, fluctuating weather conditions, rapid population growth, inadequate human resource development, and a distorted economy characterized by extensive government intervention.

3. The Malian government carried out an economic adjustment program during 1982-86, supported by three stand-by arrangements with the Fund. Substantial progress was achieved in the policy reform area including the liberalization of cereal markets, marked reductions in the scope of price controls, upward adjustments in public service tariffs to bring them more into line with costs, and the abolition of import and export monopolies. Commitment to further reform faltered considerably in late 1986 and 1987. As a consequence, Mali was unable to continue drawing on the third Fund stand-by, and plans for a SAF and Bank-financed public enterprise reform project were shelved. The Malian delegation presented a draft of their own PFP to Bank and Fund staff at last year's annual

meetings. Though this signalled a willingness on the part of the Government to resume the policy reform process, elements of this document referring to the public enterprise sector were still considered to be inadequate. These outstanding issues have since been resolved in the context of the revised PE reform project.

Issues

4. The Committee may wish to consider the issues identified below as an agenda for the meeting.

5. Government commitment. Given the stop-and-go nature of Malian economic policy in recent years, one might question the seriousness of the Government's commitment to reform. This issue was discussed fairly extensively last February during the Operations Committee's review of the Public Enterprise Sector Adjustment Project. At that time, the PE project was characterized by the Region as a test of the Malian Government's commitment to policy reform. The Region may therefore wish to update the Committee on the results of negotiations, and on subsequent steps taken by the Government to satisfy conditions for Board presentation and credit effectiveness.

6. Administrative capacity. The draft PFP (page 4) refers to the "limited managerial and administrative capacity to implement reforms" existing in Mali. Yet the Government is proposing to carry out a comprehensive economic adjustment program during 1988-92 comprised of, inter alia, steps to increase food security and agricultural diversification, improve production incentives, reform the public enterprise sector and banking system, and rationalize public resource management. The Region may wish to comment on what appears to be a gap between the Government's intent regarding policy reforms and its ability to implement these reforms. What are the Bank and other donors doing to strengthen the administrative capacity of the Malian Government? Is administrative weakness on the part of the Government likely to rule out "front loading" in possible future adjustment operations? If so, which reforms should be tackled first?

7. External financing requirements. The draft PFP indicates (Table 3) the existence of relatively large financing gaps over the 1988-90 period, particularly during the first year when it is expected to amount to more than US$ 82 million. Given these gaps, the Region may wish to brief the Committee on the status of donor co-financing for Mali's adjustment program. What role is the Bank playing in helping to mobilize international support for the program? What would be the consequences for Mali's adjustment program if there were a significant shortfall in the availability of external financing?

8. Longer-term development prospects. As noted above, Mali would appear to face formidable constraints to sustained economic growth and development, even if the Government manages to successfully complete a structural adjustment program. The draft

PFP refers to the importance of agricultural diversification and the attainment of food security, and the development of manufacturing. However, the reader is given little feel for what Mali's comparative advantage might be and what the economy might look like in the "post adjustment" era. Accordingly, the Region might wish to brief the Committee on the content of the Bank's overall country strategy for Mali. What types of new investments will be required over the coming years? What in the Region's opinion would be the appropriate mix of investments between the productive sectors and the social sectors? What is the status of the Bank's dialogue with the Government on the population issue?

cc: D. Lee, A. Shakow, J. Holsen, D.C. Rao, Burmester/Thahane, R. Liebenthal, A. Steer, T. Baudon, M. Gillette, L. Hinkle, F. Laporte, T. Ahlers, S. O'Brien.

For Information Only:

D. Hopper, D. Bock, D. Goldberg, R. Frank, J. Parmar, G. Pfeffermann, J. Baneth, M. Haug, C. Robless, R. Agarwala

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June 6, 1988

The World Bank
OPERATIONS COMMITTEE

CONFIDENTIAL

Minutes of the Operations Committee to Consider
the 1988 Country Risk Management and Portfolio Review

Held on June 7, 1988, in Room E-1243

A. Present

Committee		Others	
Messrs.	M.A. Qureshi (Chairman)	Messrs.	K. Siraj (COD)
	S. O'Brien (AFRVP)		R. Harris (COD)
	A. Karaosmanoglu (ASIVP)		S. Burmester (SEC)
	K. Dervis (EMNVP)		R. Liebenthal ((PPR)
	J. Holsen (VPDEC)		T. Hutcheson (PPR)
	D. Goldberg (VPLEG)		F. Colaco (PPR)
	D.J. Wood (VPFPR)		D. Bock (DFS)
	H. Vergin (SVPOP)		V. Dubey (EAS)
			E. Grilli (EAS)
			G. Pohl (EAS)
			D.C. Rao (FRS)
			A. Steer (FRS)
			R. McPheeters (FRS)
			F. Kilby (FRS)
			S. Mitra (FRS)
			D. Hanna (FRS)
		(Ms.)	M. de Nevers (FRS)

B. Issues

1. The Operations Committee met on June 7, 1988 to consider the draft 1988 Country Risk Management and Portfolio Review, prepared by the Risk Management and Financial Policy Department. The discussion concentrated on six issues (1) the economic outlook; (2) the risk ratings; (3) exposure management; (4) burden sharing; (5) the role of adjustment lending; and (6) guarantees and other credit enhancements.

C. Discussion

2. The Global Outlook. The Chairman commented that while even the minimum financing requirements of developing countries continue to exceed resources available, he felt that there was--contrary to the tone of the report--no deterioration in the economic outlook compared to a year ago. The world economy had adjusted quite well to the stockmarket crash and growth in major countries was higher than expected. He invited other speakers to comment. One speaker said that in his view there had been considerable improvement in the economic outlook; the US economy was growing reasonably fast, Japan had accelerated growth and in Europe there was no decline and commodity prices had improved. There were no indications of sharp reductions of growth in the OECD area over the next few years. Moreover, several countries in East Asia experience very rapid growth. In Latin America, some countries have made substantial improvements, particularly Mexico and Chile, and the situation in Argentina was also improving. Another speaker said that he was less optimistic, as the US still had to make adjustments in its fiscal and external imbalances, and fiscal imbalances had increased in several developing countries, but are now financed internally. Only diversified exporters were doing relatively well.

3. FRS staff commented that clearly the current performance of the OECD economies is more robust than was commonly anticipated six months ago. This is entirely consistent with the report. The points made in the report are (a) workout strategies are generally based upon assumptions--especially for capital flows--which tend to be towards the top end of the range of what is likely; and (b) there remains a real possibility of an economic slowdown in 1989/90. These suggest the need for additional attention to downside risks in IBRD country strategy formulation. Another speaker said that the short-term outlook was very important since financial flows are not likely to be very large. But the short-term outlook was surprisingly good: the US and Japan are growing much faster than projected six months ago. Moreover, US dollar prices of exports have increased substantially over the past 6 months in a lagged adjustment to the depreciation of the dollar. This will help to reduce debt service ratios for many highly indebted borrowers. The greater realism in this year's WDR was welcome but should not be taken as a deterioration of the short-term outlook. The Chairman concluded that these points should be reflected in the report. The improved trade balances were an important positive element in the economic outlook.

Risk Ratings

4. The Chairman stressed that it was an important responsibility of the Country Departments to undertake risk assessment and mentioned that he had instructed the Country Departments to improve and deepen their analysis in this regard. The countries in the box of Table 4.3 in the report deserve considerable attention but the risk/exposure classification needed to be improved. For example, there were no large risks for the Bank in Egypt but, on the other hand, Indonesia which was not in the box, deserves continued close scrutiny.

5. The discussion then turned to the proposed down-grading in India's creditworthiness ranking. The Region argued that India should not be downgraded. Certainly the fiscal gap had increased but growth and exports had improved, and the projected current account deficit remains moderate. The Chairman pointed out that a substantial part of the increase in debt-service during 1987-89 was due to repurchases of IMF resources, and could be seen as part of reserve management. He inquired what had changed in India's prospects over the past year to justify a change in the category. FRS responded that India had traditionally been a IIc country before being upgraded to IIb two years ago. It was always difficult to determine exactly when to change a country's ranking, but there were two reasons for lowering the rating now. First, the fiscal deficit and rising debt service ratio were cause for concern. Second, the profile of IBRD flows of sharply rising net disbursements, followed by a declining IBRD contribution was itself a cause for increased risk of arrears. The Chairman concluded that we need to have significant changes in perceptions of a country's creditworthiness in order to change the ranking. In his view, this was not the case for India. Another speaker said that he felt that Mexico should have been upgraded given the recent progress in Mexico's adjustment program.

Exposure Management

6. The Chairman said there was no question that the exposure guidelines have an important role and should trigger tough questions once they are exceeded. However, it is not clear what represents "excessive" exposure. We need to undertake further work to improve the guidelines in two respects: (a) to recognize that risks can be compounded (adding or alleviating overall risk) and (b) to reflect that we have now more instruments at our disposal. The principal safeguard for the Bank is not adherence to the exposure guidelines but, rather, the ability to involve ourselves in the solution of adjustment problems through policy dialogue, our catalytic role, etc. We then become part of the solution rather than part of the problem.

7. Mr. Wood pointed out that the substantial number of countries currently exceeding the guidelines is not in itself a reason to change the guidelines. In his view, the system worked reasonably well; for the most part, the right questions were being asked and most of the countries exceeding guidelines do so appropriately. He agreed that the earlier "exposure" indicators (IBRD's share in total debt and debt service) were imperfect and had prompted the introduction of another indicator (IBRD's debt service relative to export earnings) two years ago. Another speaker said that this does not yet deal with the problem of compounded risks. Exposure risks increase with the level of total debt. Exposure guidelines should be revised to reflect this important interrelation. FRS noted that risk and exposure were related but distinct. This report had noted that special attention needs to be given to those countries which have high risk and risk exposure. The Chairman pointed out that even though Brazil did not exceed the "exposure" guidelines because the Bank's share in its large extend debt

was small, our exposure risk in Brazil was significant but was not identified by the present indicators.

8. A representative of the Legal Department said that while the guidelines can be exceeded since they are only triggers for more intensive scrutiny, it was difficult to accept that a large number of countries would continue to exceed the guidelines. If we have guidelines, we should use them, and if they are inadequate we should change them. The Chairman concluded the discussion by saying that the presentation of exposure in the report should be less mechanistic and that further work is needed to improve the exposure guidelines.

Burden Sharing

9. The Chairman introduced this topic by saying that we have always to emphasize burden sharing, but it would be wrong always not to lend, if other lenders do not agree to a desirable pattern of burden sharing. The Bank could, in some situations, make good adjustment programs less underfunded through increased use of its own resources, but this should, of course, remain the exception. It is therefore not possible to use quantitative guidelines in this area. FRS responded that burden-sharing was indeed a slippery concept and what is important is an acceptable overall financing package. The issue at present is not that burden sharing concerns are not being discussed, but that clear and monitorable guidance is not being given and acted upon. Another speaker pointed out that in most adjustment programs, the Bank's share in net financing could temporarily rise to very high levels, particularly if external imbalances were being reduced significantly. The Chairman concluded that these considerations need to be spelled out more clearly in the discussion of burden-sharing.

Role of Adjustment Lending

10. The Chairman felt that the role of adjustment lending was not appropriately portrayed in the report. One of the principal objectives of adjustment lending was the support of programs designed to restore creditworthiness. Another speaker added that the benefits of adjustment lending were completely lost in the report. [FRS pointed out that these were described in the first paragraph of the section]. In many cases, adjustment lending had led to an improvement, and not a deterioration, in the relationship with borrowers because borrowers appreciated the advice and help extended in the context of adjustment operations. He also felt that the arguments in favor of lengthening disbursement periods of adjustment loans to better manage country risks were very weak. FPR responded that the main objective of the proposal was to smooth disbursements profiles. Another FPR speaker noted that concerns over the riskiness of adjustment lending are being expressed by Board members and by the Bank's underwriters. The report has tried to document these risks and suggest a couple of implications. While one might not agree with the multiyear adjustment lending, there remains a clear need for medium-term strategies agreed in advance with governments. Another speaker remarked that this is a question of the overall lending program rather than adjustment operations. A speaker from PPR added that quick-disbursing adjustment operations actually

strengthen creditworthiness. The representative of the Legal Department said that the use of positive lists might strengthen the perception that adjustment lending finances development expenditures. Another speaker noted that the charts in the report (figure 4.2) certainly raised some important issues for country risk management.

11. The Chairman concluded that whenever we are undertaking adjustment operations or when we are facing high country risks, management of disbursements and net flows should be one of the important elements of our strategy. There are many ways to achieve this. We have now an adequate range of instruments, including SALs, SECALs, projects with sector components, etc. to do so.

Credit Enhancement Instruments

12. The Chairman said that it would not be possible to limit B-loans only to countries in particular risk categories as the Bank would then have to make its risk classification public. [FPR pointed out that this need not be the case; the same argument could be made for other operational implications of the risk ratings]. To avoid severe constraints from "entanglement" with other creditors, the Bank needs to be very selective in the use of credit enhancement instruments, such as B-loans and guarantees. The Board had asked for an analysis of the issues involved in extending guarantees. A paper being prepared in DFS in response to this request would be the appropriate vehicle to tackle this issue. He requested Mr. Bock to provide FRS with specific suggestions for revising this part of the paper.

June 10, 1988

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in
Change Guidelines

1. Process.

Does it call for any changes in the treaty

- Country Risk - responsibility - India.

~~Risk of Guidelines~~

- Role of Public Enterprises.

Guidelines - Mechanism for deciding.
P.C.

Areas: -

Investment | Models for adjustment lending Package

adjustment lending | Recovery has been slower than we had expected - Sector Investment lending.

Budget | Investment base

Major new | Multiply it 3-4 times over

Clearly thought out.

① IDA - size.

(2)

(3) IDA reflows - Para 4)

Working Group.

1. Has no commentary on Operations.

2. Operations in 1987 were less effective than before.

3. Comments on Commodities which does not help

4. The Bank must have done some good

Bank has had a major impact on Chuquicamata, Chile.

(5.) A report on Operations should begin with a report by Sector departments

(6) Should not go to the Board

(7) Uses Avis but there are factual mistakes

(8) What is "Development Effectiveness"

(9) Pick some selected development issues + then review the impact

of Bank programs.

~~(2) Paragraph~~

(10) Have a proper division of labor between ARIS, OED & the Development Effectiveness Report. What should this report add?

(11) The report takes the approach of solution by regulation. If guidelines are provided, then the solution will be found -

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(12) Creditworthiness ~~The should not be a~~ a source of repayment to the other

(13) Conceptual basis of exposure criteria

(14) Not candid about the issues - Interfering in what on earth the Mgmt is doing - Paper does not take up the real issues -

(15) Paper does not see the issues of burden sharing & adjustment lending - Safety is the main with the underlying to support adj - & former lending

(3)

16) Three choices if you find that others are not doing their share

(a) You can "muddle along"

You walk away

You adopt the debt strategy opportunistically to use credit enhancement to establish an credit.

17) Restrict the B loans to certain group of countries

18) Explore in between Exposure guidelines & Risk

19) Restructure

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: June 7, 1988

TO: Mr. Moeen A. Qureshi

FROM: David R. Bock

EXTENSION: 72942

SUBJECT: 1988 Country Risk Management Portfolio Review

1. You asked my comments on the 1988 review of the IBRD portfolio, specifically on the section dealing with credit enhancement instruments and related risk management issues.

2. The discussion in the paper generally reflects current thinking about the use of the Bank's credit enhancement instruments in the heavily indebted middle income countries, and in substantial part takes the same positions as the recent operational strategy paper. That is, it argues strongly against payment sharing arrangements such as B-loans in the restructuring countries, recommending that guarantees on late maturities be the only instrument available in these cases. The paper also argues for continued severe constraints on "entanglements" with commercial banks, and raises again the now familiar objections of Finance to credit enhancement on near term payments (by which they presumably mean interest payments).

3. As you know, we feel this is an inadequate and potentially wrong view of credit enhancement for the reasons set out in the attached paper on the Costa Rica transaction. More generally, however, I feel that the creditworthiness review fails to deal adequately with the relative costs and benefits of the alternatives facing the Bank. The review seems to reflect the conviction that the present strategy of concerted support by official and private crditors will work and is the only viable option available to the Bank. For example, late maturities guarantees in essence bring forward future exposure on a present value basis today. Guarantees of principal, however, are inherently more likely to be called if the country is experiencing debt servicing problems. Thus, an exclusive preference for this instrument must reflect the conviction that either (a) countries will have succeeded in adjusting and/or restoring their access to commercial funds by the time guarantees are callable, or (b) if not, then they will still be willing and able to service IBRD loans and guaranteed loans on a preferential basis. On the other hand, if one doubts the viability of the present strategy, then greater weight might be given to using credit enhancement as a way of reducing debt burdens even though it would entail a higher IBRD share of total debt.

4. This is an example of the failure of the paper to adequately grapple with the risk management issues inherent in use of credit enhancement instruments. Similarly, the paper does not close the loop between adjustment lending in the form of balance of payments support and the cost and benefits of using credit enhancement instruments in lieu of direct lending by the Bank. As you know, we have been exploring the use

of guarantees to secure agreed debt reductions as part of a structural adjustment program. The economic viability of debt reducing scenarios and the potential long run risk to the Bank may well be less under this approach than under the present concerted lending strategy. Also, in the event that concerted lending fails to materialize from other creditors, what are the risks to the Bank of continuing to supply balance of payments support rather than facilitating new money agreements through guarantees, etc., or facilitating debt reduction?

5. I do not have a complete set of answers to these questions but I think they should be addressed in any serious attempt to lay down guidelines for use of credit enhancement instruments. The creditworthiness review does not deal with the broader issues and I strongly recommend that any specific conclusions in this area be held in abeyance until we complete the board paper on operational aspects of guarantees in which we will be addressing the larger issue of under what circumstances the Bank should deploy its cofinancing and guarantee powers. In that context, we will consider not only the restructuring countries but also other circumstances such as re-entry to the market following debt restructuring (e.g., Turkey) and the Bank's credit enhancement role in forestalling restructuring (e.g., Colombia).

6. There is a specific recommendation in para. 4.29 to restrict the B-loan syndication program in its present form to risk categories I, IIa and IIb. I don't disagree with the thrust of this recommendation but this is operationally unworkable since we cannot disclose our categories to the market. Again, I recommend that we hold decisions on this issue until we can treat it comprehensively in the Operational Aspects of Guarantees paper.

7. Finally, on the subject of negative pledge waiver, we need to distinguish (in a way that the Creditworthiness Review does not) the difference between the Mexico bond transaction and other forms of waivers. Again, this is an old argument between ourselves and Finance. The Mexico bond transaction is really a prepayment of principal with the interest payments in no way senior to IBRD claims. The debt ratios for Mexico and other countries using the same technique need to be adjusted to reflect the fact that a portion of the principal has in effect been prepaid. We would also probably look differently on waivers for the type of proposal put together by Chemical Bank for Colombia in which an interest escrow account effectively subordinates IBRD loans.

8. We have a number of other comments relating to exposure guidelines (which desperately need to be reviewed) and the effects of exchange rate movements on IBRD exposure (where I find the discussion in the Review simplistic, misleading and counterproductive). We will communicate these other comments separately.

Attachment

cc: Messrs. Dubey
Vergin
Grilli

DBock/mjw

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: May 3, 1988

CONFIDENTIAL

TO: Mr. Moeen A. Qureshi

FROM: David R. Bock

EXTENSION: 72942

SUBJECT: **Costa Rica Debt Reduction Scheme**

1. I have seen Mr. Stern's memo to Mr. Conable on the Costa Rica scheme dated April 29. While Mr. Stern agrees that we should proceed with such a scheme, he strongly prefers that it be done with a late maturities guarantee of principal rather than as presently structured (i.e. the modified BofA approach). I remain convinced that the differences between the two approaches are more apparent than real except that the Finance scheme involves more risk for the Bank. Both approaches involve de facto guarantees of interest, etc. Regrettably, I feel it necessary to continue to press for an acceptance of the essential equivalence of the two approaches even though Finance themselves have tried to minimize the differences and are generally supportive of the Bank's involvement in a debt reduction effort in Costa Rica. The reason is that I believe the Finance proposal would be much more difficult in the end to sell to our shareholders and the banks, notwithstanding its adaptation of the already accepted technique of guaranteeing late maturities.

2. The differences in the two schemes can be brought out quite simply. The one sentence version of the modified BofA proposal is as follows: if banks write off the full principal amount and cut the interest rate to 4%, the IBRD will guarantee that they receive at least one year's interest, on a rolling basis. The Finance proposal (as we understand it) is: if banks write of 60% of principal, cut the interest rate to 4% and self-finance an interest support fund equal to two years' interest (part of which will be used to further reduce interest payments), the IBRD will guarantee repayment of the remaining 40% of existing principal.

3. The Finance proposal is, in my view, more complicated and, if anything, increases the potential for politically-driven criticism of appearing to bail out the banks by extending IBRD guarantees to the existing debt stock (i.e., principal balances rather than the interest flow). Its other two alleged advantages are that it achieves greater present value benefit for the borrower (for the same cost to banks) and that it avoids a de facto guarantee of interest. The first is open to debate but is in any event not really necessary and may not be acceptable to the banks. The second is simply incorrect. Indeed, the Finance scheme represents a potentially greater degree of interest protection for banks.

4. To see why, consider what the borrower must do to avoid a call on the IBRD guarantee. Under the modified BofA scheme, the borrower must pay full interest for about 5 years. Interest defaults thereafter will not create a deficiency in the trust funds, hence no payments by IBRD. Under

the Finance scheme, unless the borrower pays all interest for the life of the loan and 40% of principal, IBRD will be called to make payments, since the normal application of proceeds provisions will not permit the borrower to pay principal ahead, or independently, of interest.[1] The equivalence of the two schemes in terms of "entanglement" is even closer when one takes into account the fact that the forgiveness feature will probably operate only if the borrower is current on interest in year 20. Also, both approaches would likely include optional cross default clauses to other IBRD loans as protection for the Bank against the borrower allowing interest arrears to build up to the point where IBRD payments would become unavoidable.

5. Guarantees of late maturities do not avoid the entanglement issue and are probably more likely to be called than interest guarantees if a borrower has debt servicing problems at the time they may be called. Their advantage lies in the fact that potential IBRD payment is pushed to the future thereby: (a) allowing time to remedy events that could lead to a call; and (b) permitting us to count them on a less than 1 to 1 basis against capital at the time of commitment. The modified BofA proposal also has these features, but has more tightly controlled risk exposure for the Bank.

6. Our concern with the Finance proposal is not that it gives the banks too little protection but that it gives them too much and creates a "lumpy" debt service burden for the borrower. Also, it is more complex, forces the banks to accept the concept of self-financing their own interest and runs at least as great a risk of appearing to "bail out" banks by guaranteeing principal that BofA has already said it is willing to write off. Because it is more generous financially to the banks, they may well accept it in lieu of the modified BofA scheme but only for that reason.

7. Mr. Stern's note is correct in saying that initial reactions of shareholders might be less favorable to the modified BofA approach, but given the detailed scrutiny that the transaction will undergo, my own judgment is that the substantive features of the proposal will be the deciding factor, notwithstanding the fact that some shareholders have an aversion to interest guarantees (for reasons I don't completely understand). Their substantive concern is risk to the Bank in getting involved with existing debt; here I think the modified BofA proposal is superior since it limits IBRD financial exposure to the early years when we have more leverage/control over borrower action.

8. In short, I remain unpersuaded that the Finance proposal is superior to the modified BofA proposal other than in perhaps giving more debt relief up-front (which I regard as unnecessary) and in its *prima facie* avoidance of guarantees of interest (aversion to which I think can and

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1/ This is true notwithstanding the fact that payment by IBRD could only be applied to principal.

should be overcome). I believe that we have adequately addressed the risk management concerns initially raised by Finance in the modifications negotiated with BofA -- perhaps to a greater extent than Finance intended -- and that we should proceed on that basis.

9. Mr. Stern raises another issue, namely the possible effects on negotiations with major debtors. We are preparing a separate note on that subject.

cc: Messrs. Wood, Rao, Steer
Husain, Steckhan, Morais, Flannery
Ms. Haug

DB/gm

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: June 3, 1988

TO: Moeen A. Qureshi, SVPOP

FROM: Enzo Grilli, EG Chief Economist, EAS

EXT: 78061

SUBJ: 1988 Country Risk Management and Portfolio Review

1. The main contentions of this report are that, with respect to a year ago, a) the world economic outlook has deteriorated and the downside global risks have thus increased, b) more countries are in a higher risk category with a consequent deterioration of the Bank portfolio. Looking at the future, the report contends that current lending projections to 1995 do not indicate any significant change in the overall portfolio score. The overall situation, therefore, does not improve in time. On the risk management front, the report focuses on three subjects: a) bank exposure management; b) management of net flows in the presence of fast disbursing loans; and c) problems related to credit enhancement. Bank exposure is examined solely on the basis of existing "guidelines" (share of debt service and share of exports). High risk and high exposure countries are identified on this basis. For these countries the report argues that: a) improved policies are by themselves insufficient ground for high case lending. In addition, it would be necessary to prove that Bank lending "will not be used to finance unsustainable public deficits", nor "to fund inefficient expenditures"; b) downside risks be carefully evaluated and a contingent retrenchement strategy for the Bank be formulated; and c) that the question of Burden-sharing be carefully explored.

2. Downside global risks have not increased with respect to a year ago. Quite to the contrary. The world economy has adjusted quite well to stock market crash, the realignment of exchange parities and to the fears of an inflation outburst. The expected negative wealth effect of the stock market crash has not materialized. Fiscal policies have become more expansionary in Japan and global demand has been sustained by relatively relaxed monetary policies. In fact both the IMF World Economic Outlook of April 1988 and the June 1988 OECD projections indicate that over the next 2-3 years real GDP growth in industrial countries will be relatively high(at about 3 percent per annum) and LDC export earnings growth will be well in excess of 10 percent per annum (volumes at 6 percent per annum and dollar prices at above 5 percent per annum). In effect, earnings growth could be much higher, given the lagged adjustment of export prices to the dollar depreciation. According to IECAP data, G-7 imports from LDCs are up by 26 percent in dollar terms over the past 6 months. The 8.8 percent growth in LDC export earnings over the period 1988-90 that results from the aggregation of country economist projections (Table 1.1) is, therefore, quite conservative and not optimistic as the report characterizes it. An improvement of trade balances, with respect to current expectations, would reduce the financing needs of many highly indebted LDCs and thus reduce their reliance on concerted lending, whose prospects do not in themseleves appear so terrible as to prevent an average net flow of $10 billion a year in 1988-90, particularly when these

financing requirements are equivalent to only one third of possible interest capitalization in HICs.

3. On risk rating the report, applying existing methodology, arrives at the following conclusions: two countries are upgraded (Portugal and Chile) and eight are downgraded (Fiji, India, Cameroon, Argentina, Yugoslavia, Romania, Panama, and Syria). The former account for 2.4 percent of the Bank portfolio, while the latter make up for 15.3 percent of it. India's downgrading (to Category IIc) is by far the most important, since this country accounts for 5.4 percent of total Bank outstanding loans, and is at the same time the most striking, since India has been (together with China) a star growth performer in recent years. Other countries in Category IIc have projected debt indicators that are far worse than those of India, while those in Category IIb are similar to India or worse (e.g. Jordan). Furthermore, the increase in India's total debt service ratio to 24-25 percent during 1986-89 is almost entirely due to large repurchases of IMF resources (equivalent to 5 percent of exports) which will sharply decline in 1990, with projected total debt service ratio falling to 19 percent in 1990 and 17 percent in 1995. The deterioration of the budget deficit situation (but not of the current account deficit which has remained stable) noted in recent years has apparently come to an end and the GOI is now acting on this front. The budget deficit situation in other countries placed in Category IIb is not better than India's: Malaysia's deficit is 11 percent of GDP, Jordan's is 13 percent of GDP (as against the 9.6 percent of India). Obviously all these deficits are far too high in absolute, but the issue here is that of the"downgrading" of India, whose situation in relative terms is not worse than that of countries left in Category IIb.

4. The portfolio review shown in the paper suffers from the fact that the numeraire of all analytical indicators is still the dollar. A discussion of lending and export trends in SDRs would give a better idea of what has happened and avoid statements such as those contained in para 3.6 (on the subject of repayments). Overall, the short term implications for the Bank's portfolio drawn in the report (para 3.16) are heavily dependent on the downgrading of India. Without such downgrading, the 1988 deterioration in the quality of the Bank portfolio due to changes within country categories that the report notices, would have been limited to a slight increase of the share of Bank loans held by countries in the Category IIIb (due to the downgrading of Argentina and Yugoslavia from Category IIIa to IIIb). Similarly the portfolio risk scores (Table 3.6) would show almost no increase between 1987 and 1988 if India's macroeconomic performance had not been judged so severely.

5. The discussion of the lending projections contained in the report fails to take into account that our high-low planning ranges for HICs and other high risk middle-income countries were set to allow for prudent lending responses to different adjustment and workout scenarios. As such, the country ranges were never meant to be additive. The most likely expectation is that countries will fall at various intermediate points of the ranges, and not all on one end or the other at the same time. As shown in the report, therefore, the analyses of the lending programs and their implications for disbursement, debt service and net flows in the high and low scenarios can be misleading.

6. Bank exposure management is dealt in the report almost exclusively in terms of "exposure" indicators. Country risk comes in only in the form of country categorizations. We have in a separate memorandum (on "Creditworthiness Reviews") argued for a change in exposure indicators and for a direct and explicit incorporation of risk factors in the analysis. The lack of progress on this front that is shown by the report is highlighted by Table 4.3, where there is no differentiation between countries included in Categories I and II and where "exposure growth' is what differentiates (in a negative sense) countries such as India and China from the rest. For these countries exposure considerations should not be of concern. Quite to the contrary, one could argue that more Bank loans to India and China would reduce the overall riskiness of our portfolio (and help us keep other customers in line).

7. The issues of what needs to be done for high-exposure/high-risk countries (as identified by the Report in Table 4.3) are dealt rather summarily in para 4.8. Bank lending hardly goes to finance "unsustainable public deficits "or to fund" inefficient expenditures". Again, to say that downside risks need to be carefully assessed is uncontroversial, but hardly a step forward. Burden sharing does pose difficult questions for the Bank. The risks of underfunded adjustment programs in middle-income countries are there. Country strategy documents must address them (and indeed many of them do). There is, however, no substitute in these cases to careful analysis and to realism in decision making. These are case by case decisions par excellence.

8. On management of net flows, the report takes the view that the definition of a "core" plus a "fallback" lending program is appropriate from the standpoint of risk management and that longer disbursement periods may also be useful. No issue can be taken with the first recommendation (we established a "low case" in our lending allocation review). Yet, the case for slower disbursement lending remains somewhat unconvincing. It is not clear what additional leverage comes to the Bank from undisbursed loan balances as opposed to changes in new commitments. One could in fact argue that keeping risky countries on a short leash in terms of both maturities and disbursements would enhance our leverage. On the issues related to credit enchancement, David Bock will provide you with comments on Monday.

cc: Messrs. Vergin, Dubey, Robless, Bock, Baudon

EGrilli/cpf

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: June 6, 1988

TO: Mr. D. C. Rao, Director, Risk Management and Financial Policy

FROM: Mr. John Holsen, Director, Country Economics

EXTENSION: 61755

SUBJECT: 1988 Country Risk Management and Portfolio Review

This year's Country Risk Management and Portfolio Review is very well done and FRS staff are to be commended for a fine and insightful piece of analysis. We agree fundamentally with its assessment of a significantly more somber picture than that of only one year ago. If anything, our assessment of risks in a number of countries, e.g. Mexico, may be a little more pessimistic than FRS's. The paper points up how fundamentally dependent the Bank is on the external environment, whether with regard to the effect of OECD growth on the creditworthiness of our borrowers, the availability of other financing of adjustment programs, or debt relief. This memorandum discusses a number of the policy issues raised by the paper that will require further work.

The issue of relief of non-preferential debt is not addressed directly by the report, but it is implicit in the analysis of assumed levels of financing from private sources (para. 1.10 - 1.11). This issue needs to be addressed directly -- both as a developmental issue and as a way of increasing creditworthiness and reducing the Bank's risk. There is a serious danger that the Bank is lending into situations where the total financing package is not enough to allow a sustained and orderly adjustment process. This greatly increases the risk of default -- even on preferential debt. The debt relief issue also arises in deciding when and whether to guarantee new commercial loans. Likewise, in discussions with other lenders over burden sharing, we have to consider the tradeoffs between debt relief and new lending. Finally, the Bank's stance on debt relief for a particular country would no doubt have an effect on Bank relations with that country.

The analysis of the fundamental inconsistency between the amounts of new money assumed to be forthcoming in the current country projections and the amounts that are likely to be available points to a need for much greater realism in adjustment and other Bank lending. Realism must also extend, however, to the speed of the country supply response to the reform package and to the external environment. Either more net resources, including relief of non-preferential debt, will have to become available or considerably more retrenchment than is being assumed will be necessary. This inevitably increases the risk that country policy efforts will falter, but these can be reduced if alternatives are faced at the outset and if Bank lending is conditioned more heavily on actions prior to loan signing, on evidence of substantial improvements in creditworthiness, and on the country's determination to follow through. We should seek to avoid governments' believing they were betrayed by the financial markets and misled by the

Bank. This might affect both their ability and willingness to service Bank debt.

The deterioration in creditworthiness is well known. More sobering is the report's judgement about the continuing erosion in the Bank's preferred creditor status. In this regard, we second the report's recommendation of the need for very careful analysis of the use of B loans, guarantees, etc. We should, of course, be exploring all sorts of alternatives to our present risk trajectory. It would be helpful, however, to have a clear policy which sets out the benefits of attempting to leverage additional resources from commercial lenders versus the financial risks inherent in the instruments used and the qualitative loss of uniqueness that could result from "entanglement" in commercial lending repayments. Unless the resulting financial package is clearly adequate to permit, under realistic assumptions, sustained and orderly growth, we may be adding to our risks without really helping the borrower work out a lasting solution to its debt management problems. Although sometimes advisable, maintaining zero net disbursements is an inadequate and risky policy stance toward many problematical borrowers.

Closely related to the Bank's status as a preferred creditor is the issue of our lending profile. The report clearly indicates the danger of a rapid build-up of fast disbursing loans that will almost inevitably result in significantly negative net transfers in the medium term. In the context of a failed and politicized adjustment program, relations with the Bank could deteriorate to the point of undermining the country's willingness to service Bank debt at just the time negative net transfers were reducing the cost of default.

The report suggests two ways of dealing with this risk: (1) maintain a "fallback" or "core" lending program which would keep open Bank - country dialogue even if further adjustment lending became impossible and (2) scaling back on fast disbursement lending. We believe that a strategy of maintaining a core lending program, "safe" from the vicissitudes of macroeconomics, has merit. It will, however, require considerable work to determine what ought to constitute this core. In some cases, for example, including lending for poverty and the environment, which often appeal to constituencies in the borrowing country different from those that support "adjustment," could lower the risk of the total portfolio. In other cases the core would have to consist of other kinds of investment lending. We must recognize, however, that macroeconomic maladjustments can constrain operations even in "core" activities. Moreover the budgetary implications of "maintaining a strong pipeline" as recommended cannot be overlooked.

We believe that the commitments undertaken to achieve structural and sector adjustment are inherently long term and therefore structural and sector adjustment loans should usually be undertaken in an explicit multi-year framework. It does not follow from this, however, that slower disbursing adjustment loans are the solution. It seems difficult to define specific and operationally meaningful conditions for tranches that would only be released well into the future; consequently, a series of one-year loans supporting 100% front loaded policy actions and maintenance of previous commitments may be

more effective than a single loan disbursed in annual tranches over three or four years. (If tranch release conditions are taken seriously, such slower disbursing adjustment loans would not give the borrower significantly greater assurance of continued Bank support.) More fundamental is the extent of the need for quick disbursing assistance to support higher levels of imports and investment. If the need is really there, it seem counterproductive to delay disbursements; inadequate financing only increases the risk that an adjustment program will break down. Only in certain cases, e.g. hybrid loans, might it be appropriate to extend the disbursement period of the adjustment loan. The solution seem to be greater selectivity in the use of fast disbursing loans. They should be undertaken only if the preconditions are met.

We believe that the Regions need more specific guidance on exposure policy and burden sharing. Thus, increasing relative exposure is more acceptable in the context of an overall improvement in creditworthiness that came about either through country performance or debt reduction by non-preferential creditors.

It might be appropriate to mention the role in reducing the +volatility of countries' debt service obligations to the Bank of alternative lending instruments being investigated by FRSFP. The report points out that recent exchange rate movements have significantly reduced the Bank's net transfers, but it could usefully alert senior management of the connection with our choice of lending instruments. If debt service to the Bank were more closely related to our borrowers' cash flow availabilities, they would presumably be more willing to service our debt, in preference to that of others, if necessary.

cc and cleared with :

	A. Shakow,	Director, Strategic Planning and Review+
	J. Baneth,	Director, International Economics
	F. Colaco,	VPPRE
cc:	M. Qureshi,	SVPOP
	D. Hopper,	SVPPR
	S. Fischer,	VPDEC
	V. Rajagopalan,	VPPRE (o/r)
	V. Dubey,	EAS
	M. Haug	EXC
	R. Liebenthal,	SPRPA
	M. Carter,	SPRIE
	F. Sagasti	SPRSP

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THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE : June 2, 1988

TO : Mr. Moeen A. Qureshi

FROM : Vinod Dubey V. Dubey

SUBJECT: Creditworthiness Reviews

1. The upcoming 1988 Creditworthiness Review, prepared by FRS, provides a timely opportunity to review the Bank's risk management processes and procedures. This short memo and the attached annex concludes that, in our view, the Bank's risk management could be improved in three different directions, either separately, or in conjunction:

(a) the Bank's system of creditworthiness indicators need to be revised to reflect risks more accurately; in our view, the present system of indicators has not been sufficiently changed to reflect the new role of the Bank and the different types of risks it now faces;

(b) the various element of the Bank's risk management processes (e.g. lending allocation review, creditworthiness review, country strategy review, review of adjustment operations, etc.) are, at present, not very well integrated; it would thus be desirable to review whether closer integration of the Bank's risk management processes would be indicated; this might, however, have organizational implications;

(c) the country departments have clearly the best knowledge of conditions and prospects in their countries and play an important role in the Bank's risk management; to enhance the role of country departments, ways must be found to reduce the inevitable country bias of CD staff.

Creditworthiness indicators.

2. The revision of the creditworthiness indicators would clearly be the most limited change, but could, nevertheless, lead to substantial improvements in the Bank's risk management procedures. The present indicator system does not identify high risk countries very accurately: too many creditworthy countries exceed one of the exposure guidelines. At the same time, not enough attention is paid to the very high risk cases. A basic deficiency of the indicator system is that it does not reflect that risks are compounded, e.g. having a 20% share in debt service of a highly indebted country poses far more risk than a 20% share in the case of a country with low total debt and debt service levels. The same applies to the Bank's portfolio concentration limits.

3. While these indicators are only meant to be triggers for a more intensive scrutiny of creditworthiness, it is, nevertheless, important

that they direct attention to the real risks as accurately as possible, otherwise the indicator system does not fulfill its function. The attached annex argues in some further detail that the "exposure" guidelines (i.e. the Bank's share of debt service) and the portfolio concentration limit should be differentiated to reflect the risks attached to different levels of indebtedness. The resulting indicator system could be simpler, and possibly more accurate than the present system. The annex also argues that creditworthiness reviews tend to put too much emphasis on avoiding rescheduling. This objective has now become less urgent as the Bank can now assist a member in liquidity difficulties with quick-disbursing adjustment lending.

Integration of risk management processes.

4. One legacy of the reorganization is that the Bank's various risk management processes are not very well integrated. Strongly interrelated processes, such as the creditworthiness review, the lending allocation review, the country strategy review, the review of high-conditionality operations, etc. have each been handed to a different unit in three of the Bank's four complexes. There are substantial costs to this arrangement, as it involves a considerable amount of duplication. Moreover, it could very well be argued that country risk management is primarily part of the lending function, and should thus be consolidated under the SVPOP. This would, most importantly, facilitate the integration of passive risk management approaches (portfolio constraints, lending allocations) with active risk management tools (types and extent of conditionality, lending and disbursement profiles, etc.). Given the serious debt management difficulties among a large number of the Bank's borrowers, the question is not whether to lend, or even how much, but rather: how much, in what form and under what conditionality. Another important question is what to do in case of sudden worsening of the country creditworthiness situation. Better integration could, of course, have organizational ramifications and would have to be approached very carefully.

A more active role of the Country Departments.

5. While CD staff tend to have the best knowledge of their countries' situation, prospects, adjustment needs and likely success, etc., they are less well placed to view risks from a comparative point of view. Furthermore, CD staff are likely to have a positive bias towards the countries they are working for. This is quite natural and desirable, but carries with it the danger that they will underestimate risks in their countries. This is further exacerbated if CD managers see their role primarily, as in the past, in maximizing the lending program for their countries. It is thus important that strong signals be given to Country Departments to discuss risks openly and to prepare for alternative situations, particularly in internal documents, such as CSPs. To do so, the methodology of risk analysis at the country level needs to be considerably refined. Several improvements have already happened in part through the tightened and more consistent review process in the Operations Committee. However, more needs to be done to adapt managers and staff more quickly to the new environment of excessive debt and high risks and to develop more up-to-date assessment

instruments. One organizational possibility would be more frequent and systematic rotation between line and staff ("control") functions. This would help to make the Bank's approaches internally more consistent. Beyond this, it would be desirable to make good risk assessment a criterion for rewards and promotions. This would be a significant departure from the past Bank culture where people were mostly rewarded for "positive" actions, but not always for the realism of their judgments. Finally, better instruments for macro analysis and risk assessments have to be developed at the country level. Here there is an obvious role that PPR can play in helping to design and develop the next generation of country models.

GPohl:pl

Some Thoughts on Creditworthiness Reviews

1. Creditworthiness is becoming of increasing concern for the Bank because:

- the debt exposure of developing countries has dramatically increased over the past ten years, with the aggregate debt service ratio increasing from 8.5% of exports in 1975 to 21.3% in 1986;

- at that level of indebtedness, debt service difficulties are becoming very likely--only three countries with debt service ratios above 20% in 1982 avoided rescheduling during 1982-87;

- in the aggregate, debt will thus have to increase more slowly than exports, if the creditworthiness of a large number of countries is to improve; while net disbursements can remain positive, net transfers are likely to become negative in a large number of highly indebted countries, increasing the incentives for debt repudiation;1

- finally, Bank bond holders, underwriters and credit rating agencies look increasingly and critically at the quality of the Bank's portfolio; the Bank's triple-A rating and low borrowing costs can only be maintained if the Bank's portfolio does not deteriorate significantly.

2. In recognition of the increased importance of creditworthiness issues, the creditworthiness review function was strengthened in 1982 and transferred to the Country Program Review Division. At the same time, the Regions were asked to participate in the review process. With the 1987 Reorganization, creditworthiness reviews became the principal function of the Country Risk unit in FRS, while the primary responsibility for CSP and adjustment operation reviews has been assigned to EAS and SPR.

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1 However, different groups of countries have fared very differently: Asian countries have generally been able to maintain rapid export growth in the 1980's, dramatically increasing their share in total developing countries' exports, while real export growth stagnated in Latin America and declined in Africa. Preliminary indicators show the same trend in 1987: US$ imports of G-7 countries from Asian NIC's have increased by 32% in 1987, but only 10.6% for highly indebted middle income countries. However, total debt outstanding increased by only 3% for the latter group, thus leading to the first improvement in the debt/export ratio since the onset of the debt crisis.

3. Four different types of issues arise with respect to the creditworthiness review process:

(a) the proper concept of creditworthiness at the Bank, given its special role as a "lender of last resort";

(b) the appropriateness of the creditworthiness indicators being used;

(c) the roles of various participants in the review process and appropriate checks and balances; and

(d) the role of the Country Departments in managing country risks.

Creditworthiness

4. Creditworthiness of a country refers to its ability and willingness to service debt obligations according to contractually agreed schedules and conditions. The doctrine of sovereign immunity reduces the ability of lenders to enforce contractual claims in sovereign lending for commercial and multilateral financial institutions alike. Nevertheless, the Bank's creditworthiness assessments are by nature very different from those of commercial banks, since it was created to lend to countries that were not considered sufficiently creditworthy by commercial banks and international financial markets. At the same time, and in contrast to other lenders, the Bank refuses to participate in any rescheduling of debt obligations owed to it. Thus, the Bank's concept of creditworthiness is at the same time looser and tighter than that of commercial banks. Probably the most important difference is its longer perspective, combined with the cooperative character of the institution.

5. Country creditworthiness analysis of commercial banks is generally more short-term oriented and based on less information and analysis. In fact, all except the largest commercial banks rely primarily on external risk information and analysis services. The Bank (and IMF), in contrast, have considerable knowledge and analytical capability to assess the policies and development prospects of borrowers through economic and sector work, policy dialogue, in adjustment operations, etc. The special status of the Bank implies also more leverage, which commercial banks have tried to emulate through cross-default clauses that were introduced to increase the costs of "selective" default for the debtors. However, with the prospect of only modestly positive net disbursements and negative net transfers in many countries, the Bank's ability to avoid loan losses is now less assured.

6. A second element in the Bank's risk management continues to be a strict policy against participation in debt rescheduling. In practice this means that the Bank prefers to provide financial relief through new loan commitments rather than revision of existing loan agreements. Commercial banks, by contrast, prefer rescheduling because they want to make sure that every creditor shares the risk, while maintaining the appearance of their voluntary involvement in debt relief vis-a-vis both

debtors and their own regulatory authorities (which would not be upheld e.g. in the case of interest capitalization).

7. Whether or not a country will remain creditworthy depends on three main factors: the level and terms of debt, the quality of domestic economic policies (especially those affecting foreign trade and the balance of payments), and the degree to which various external shocks are likely to affect the economy and, in particular, the level of export earnings. Of these, the quality of economic policy-making is the most important variable. While reasonable assessments of past and present policies can be made, it is very difficult to project these into the future, since abrupt government changes of one kind or another can quickly and drastically alter the economic policy environment. Country creditworthiness assessments thus always involve, at least implicitly, political risk assessments.

8. The political risk element (and uncertainty in general) also limits the usefulness of rational analyses such as projections of the balance of payments, debt service payments etc. Serious debt service difficulties and loan losses are often the result of major political upheavals that remain by their very nature unpredictable. The country that currently accounts for the largest amount of "nonaccrual" at the Bank was not even in the highest risk category until 1986. Portfolio rules, such as the maximum exposure to any single borrower, thus remain essential.

Creditworthiness Indicators

9. The Bank's creditworthiness assessment is carried out in two somewhat disjointed processes: (a) the lending allocation review into which the country strategy reviews and the country performance ranking feed, and (b) the creditworthiness review undertaken by Finance, with substantial inputs from the Regions. However, with today's high levels of indebtedness and high Bank exposure, country economic management performance (a major determinant in the lending allocation review) and creditworthiness are intricately related. Indeed, the latter is largely a function of the former.

10. According to a recent note for the Executive Directors, the Bank's assessment of country creditworthiness is "based on a detailed analysis of the country's development situation and policies and its medium- and long-term prospects, particularly as reflected in the balance of payments and external debt", summarized in a risk rating (Categories I to IIIc), and is "supplemented by the use of country exposure indicators" whose role is to "signal the need for a particularly careful review by the Bank management of actual and projected Bank exposure in the country".

11. The risk rating system groups countries into three major categories: minimal risk of debt service difficulties (I), some risk (II), and high risk (III), which are, in turn, broken down into a total of seven sub-categories. Before the debt crisis intensified around 1983, the risk rating was based on both quantitative and qualitative

assessments of debt service difficulties, and any country that had a (MLT) debt service ratio of over 20% was automatically given a ranking in Category III. Furthermore, any country approaching the 20% threshold was given a IIc ranking, and the analysis usually focussed on the "high risk" countries in categories IIc to IIIc. With the onset of the debt crisis in 1983, the ranking of a large number of countries was downgraded (27 out of 88), increasing the share of Category III countries from 39% to 63% of the Bank's loan portfolio. The overwhelming majority of Category III countries actually underwent rescheduling of private and/or bilateral official debt during 1982-87. Moreover, one-third of Category II countries have now a debt-service ratio in excess of 20%, as risk classifications are now predominantly judgmental. This is probably entirely appropriate but, nevertheless, the criteria are today less stringent than they used to be.

12. The supplementary exposure indicators fall into two categories: (a) portfolio concentration; and (b) the Bank's share in the borrower's debt and debt service. A number of portfolio concentration ratios has been used in the past, but today only one remains: the share of any one borrower in the loan portfolio is to be limited to 10%, but this guideline is to be used flexibly and can be exceeded temporarily. In 1982, suggestions were made to make the single-country concentration ratio more stringent (6-8%), with higher risk borrowers to be limited closer to 6%, but this was not implemented because it would overly constrain lending to the few very large countries (China, India, Brazil, Indonesia, Mexico). A more stringent limit was observed for the portfolio share of the largest four borrowers (33%), but this was relaxed in 1985. Moreover, suggestions have been made to relax the single-country ratio further to 15%, perhaps combined with a higher reserve ratio target (presently 8-10%).

13. The Bank's share in the borrower's debt and debt service is the second category of exposure indicators, introduced to safeguard the preferred creditor status of the Bank. Until 1982, there was a single limit of 25% of a country's public and publicly guaranteed debt and debt service. In 1982, this limit was reduced to 20%, and a more stringent limit of 15% was to be observed, if debt or debt service to all preferred creditors exceeded 33%.

14. While these exposure indicators were to be used primarily to identify countries in which risks had to be watched more carefully, they are frequently taken as actual constraints. The latter group of indicators, usually--and incorrectly--referred to as "exposure" guidelines, contain rather dysfunctional incentives if applied literally. In particular, since non-guaranteed debt is not included, despite the quasi-sovereign nature of most private sector debt in developing countries, the present "exposure" guidelines implicitly view countries with low levels of private debt as potentially larger risks than more heavily-indebted countries. While low private debt levels and data unavailability justified limiting the denominator to public debt during the 1970s, this does not apply today. Moreover, the guidelines do not distinguish between countries with different levels of total debt and implied differences in exposure risk. (An increase in commercial bank debt could actually bring a country from above to below these

"exposure" guidelines. Similarly, a Paris Club rescheduling could lead to an increase in the Bank's "exposure" above the guidelines.)

15. Partly in response to this concern (discussed in the 1986 Creditworthiness Review -- para. 4.9), an additional exposure guideline was introduced in 1986: a limit on debt service to the Bank to 5% of exports (gnfs). The numerical value of the limit could be rationalized as a combination of the pre-1982 exposure limit of 25%, multiplied by a recommended maximum total debt service ratio of 20% (0.25x0.2 = 0.05). If the other debt service exposure guidelines had been abandoned in favor of this new rule, the Bank's share in a country with a low total debt service ratio of 10% could be as high as 50%, whereas in a country with a 50% debt service ratio, the Bank's share of total debt service (and, approximately, debt outstanding) would be limited to 10%. This looks like a rather reasonable risk management rule. However, the other debt/debt service guidelines were retained, preserving their dysfunctional incentives. The 1987 Creditworthiness Review, in particular, appears to give too much weight to "exposure" concerns, thus defined, at the expense of more fundamental factors determining creditworthiness, such as policy adjustments and work-out prospects, that operate mainly through the denominator, i.e. exports.

16. There is another reason to de-emphasize concern about the Bank maintaining its preferred creditor status (i.e. avoiding being drawn into rescheduling agreements). In the old days of almost exclusive (slow-disbursing) project lending, the Bank could do relatively little to help a member country in debt difficulties; the most effective way would have been to participate in reschedulings. Today, with quick-disbursing adjustment loans accounting for a substantial share of lending, the situation is rather different: the Bank can provide quick and effective debt "relief", provided a country is ready to address the underlying problems. Since the Bank's "new money" is likely to add more than a participation in a London or Paris Club rescheduling, other lenders should now be willing (and are indeed willing) to recognize the Bank's special status (that in some sense has existed only since 1980). The concern with the need to preserve the special status through a low share in public and preferred debt is therefore less urgent. The large number of Category II countries now exceeding these limits also argues for a revision. These indicators direct too much attention to the wrong issues and cases.

17. It would thus be desirable to replace the current set of "exposure" guidelines with a set of indicators that reflects risks to the Bank more accurately, taking into account that risk factors are mutually reinforcing, that the nature of Bank operations has changed, and that its role as lender of last resort has been enhanced. A limit on projected Bank debt service relative to exports would operate very much like an IMF quota and would have attractive in-built features, such as rewarding countries with good economic performance and increasing debt service capability. One could, however, argue that the 5% limit, adopted in 1986, is set too low, and that a limit closer to 10% would be more appropriate, subject to concurrent portfolio concentration limits. The 5% rule is now the most frequently violated exposure indicator, with

Colombia, a country that has avoided rescheduling, leading the list with a ratio of 9.5%.

18. There would still remain the question of risk associated with excessive borrowing from other sources. One possible refinement of the limit on debt service to the Bank (relative to exports) would be to reduce the limit by, say, half a percentage point for each percentage increase in the projected total debt service ratio above 20%, i.e. if a country were to increase its debt service ratio to 30%, the Bank's limit would be reduced by 5 percentage points, e.g. from 10% to 5% of exports. One might argue that some countries could prudently increase their debt service ratios well above the 20% norm, but these are likely to be countries that would not need to rely extensively on Bank lending (e.g. major natural resource exporters).

19. In practice, sharp increases in debt service ratios can occur relatively suddenly and unexpectedly as a result of largely unforeseen changes in the economic environment, such as sudden major changes in relative prices, sudden increases in real interest rates etc. The Bank's role in this regard has increasingly become that of a lender of last resort, catalyzing--in conjunction with the IMF--the required support from other lenders through the "certificate of improved housekeeping" that an adjustment operation entails. The Bank will thus find itself often in a situation where it will be lending to countries that might already exceed these exposure indicators very considerably. This does not affect the suitability of the proposed exposure indicator. Indeed, if it were taken literally, it would simply imply that other creditors would first have to agree to a rescheduling that would bring down the debt service ratio towards 20% before the Bank could put in more of its own money. But that would, of course, be too mechanistic.

20. Similarly, a relaxation of the portfolio concentration limit from 10% to 15% is probably indicated, particularly in view of the limited IDA resources available to China and India. This makes all the more sense in the present climate of excessive indebtedness and considerably increased risk of prolonged arrears and loan losses. The Bank needs not only the income from large and still highly creditworthy borrowers such as China and India, it might also need their political support in keeping potential defaulters "in line". What is better than the self-interest in keeping loan service charges low? As a refinement it might be desirable to differentiate the portfolio concentration limit by the creditworthiness of different borrowers. As for the exposure indicator, the higher concentration limit of 15% would be applicable only for countries with a projected debt service ratio of up to 20%. Beyond that limit, the concentration ratio would be also be reduced by half a percentage point for each percentage point increase in the projected debt service ratio. The present concentration limit of 10% would then apply to countries with a debt service ratio of 30%, and the limit would be further reduced to 5% for a country with a debt service ratio of 40% (e.g. Mexico).

21. Summary. In terms of the more narrow issue of appropriate creditworthiness indicators the argument is that:

- creditworthiness is primarily determined by the quality of a country's economic management;

- major deteriorations in creditworthiness are likely to be the result of unforeseen political upheavals that no amount of analysis and projection can predict;

- portfolio limits are thus essential in a world of uncertainty, but major changes in the criteria and limits traditionally used by the Bank are indicated as a result of the changed environment and the changed role of the Bank; the present indicator system directs too much attention to the wrong cases;

- a relaxation of the 10% portfolio concentration limit will be needed sooner or later; while action could be taken later, it might be desirable to do so now, rather than only once it becomes inevitable; the concentration limit could be varied with risk, as measured by a projected total debt service ratio above 20%;

- the so-called "exposure" indicators, designed to safeguard the Bank's preferred creditor status, have outlived their usefulness and should be replaced with a single indicator linking projected Bank debt service to exports; the limit should probably be set at 10% rather than at 5%, and should be reduced if the projected debt service ratio exceeds 20%;

The Creditworthiness Review Process

22. In the new environment of generally excessive indebtedness of developing countries, country creditworthiness is becoming an issue of almost overriding importance. Indeed, the Bank's future as a viable financial institution is at stake. Many of the excessively indebted countries will have to take strong adjustment measures, if they are to repay their contractual loan obligations that they entered into voluntarily and as responsible partners. Unfortunately, the chances that all heavily-indebted countries will actually undertake these adjustment measures and meet their payment obligations, even after extensive rescheduling of principal, are not very good. The "debt crisis" is likely to last well into the late 1990's and could become a permanent preoccupation for the Bank.

23. Country creditworthiness judgments and lending decisions will thus become increasingly interlinked. This will affect not only decisions about the level and composition of lending, but also decisions on appropriate vehicles and conditions of our lending, and will extend to what is now called Bank "assistance" in general, i.e. including economic analysis and advice given or managed by the Bank. In short, creditworthiness will have to become a principal concern of "operations"

and require mostly the skills of seasoned country economists, rather than merely financial engineering.

24. The country teams thus have to be essential participants in the country creditworthiness review process. They have the best country knowledge and their work will be largely geared to help improve their countries' creditworthiness so that these can become acceptable risks again. However, working for one client invariably carries the danger of getting too close. Therefore, appropriate checks are needed to reduce bias, and to ensure consistency across countries in creditworthiness judgments, realism of work-out scenarios, lending conditionality, etc. From being a peripheral activity of FPA in the 1970s, and PAB in the early 1980s, risk management has to become a central preoccupation of operations in the 1990s.

25. In one respect, the shift of creditworthiness analysis from PAB to FRS was an improvement: FRS now has only one major focus: risk analysis. It also has been able to get some very seasoned ex-country economists to do the work. But in other respects, the split has not been so successful, since strongly interrelated processes have been handed to different units: the country strategy review to EAS, the creditworthiness review to FRS, the lending allocation review to the Director, Operations Staff, the review of high conditionality operations to EAS, and preparation for Policy Committee reviews of any of these to SPR, with EAS, FRS and SPR participating in each of these activities. Furthermore, each of these three units requires exactly the same kind of staff: seasoned country economists with macro- and institutional economics skills. The debt management unit is the fourth unit dealing with debt work-outs, albeit with a more narrow focus on financial engineering. But again, relations with different types of creditors are split between EAS and DFS.

26. There are thus substantial costs to the present arrangement, as there is duplication of effort, insufficient coordination and, most importantly, insufficient integration of these review processes that are all major elements of the Bank's risk management. While it is quite obvious that the country departments need a check with respect to each of these processes, it is by no means clear why these checks have been distributed over so many different units in three out of the four new complexes of the Bank.

27. Country risk management is clearly part of the lending function, rather than the funding function, and a good case can therefore be made to include this function in Operations, rather than in Finance. The argument of locating the country risk management function in Finance rests largely on the observation that our creditors are increasingly interested in the quality of our portfolio, and that the fund raisers therefore need to know more about the Bank's risk management. But the fund raisers (FOD) do not participate in the risk management review process. Rather, FRS is an entirely separate unit, staffed largely with ex-country economists, that could just as well (and perhaps more appropriately) report to the SVPOP. If this argument is therefore really serious, FOD should participate in the creditworthiness review

process and, on a selective basis, in some of the other review processes and major lending decision to get a feel for what is going on.

28. The only other argument that can me made to justify the location of the creditworthiness review function outside Operations is that an independent check is required on the Operations Committee and the SVPOP, that participation of Finance and PPR in the OC is not sufficient, and that the initiative for a substantial part of operational (lending) risk management should be located outside Operations. The logic of this argument is not fully clear. Since the Bank is resource-constrained, somebody needs to make an allocation decision, and it is not clear why Operations would prefer a more risky mix of lending than Finance. Moreover, since the Bank is becoming increasingly a lender of last resort, active as well as passive risk management tools need to be applied in a coordinated way, and conditionality, creditworthiness, and lending allocations have thus become closely interrelated approaches that need to be brought together at the level of the Operations Committee.

29. As an alternative to the present arrangements, it might thus be desirable to consolidate the country risk management function in one central unit in Operations that has the principal responsibility for the various risk management and consistency processes outlined above, i.e. country strategy, creditworthiness, lending allocations, as well as conditionality.

The Role of Country Departments in Risk Management

30. As a complement to an appropriate system of check and balances, more could be done to make managers and staff in line functions more sensitive and responsive to risk management issues. However, it can be argued that the reorganization into Country Departments has actually worked into the opposite direction. Each Department now sees its interests--even more than in the past--as assisting its country or set of countries. Not infrequently, this is equated with striving to maximize the lending program and to minimize conditionality in order to achieve the first objective with the least resistance.

31. It is therefore important that strong signals be given at the highest levels of management that risks are to be discussed openly, particularly in internal documents such as Country Strategy Papers, but increasingly also in Board documents, such as CEM's and adjustment operations. In this context, it is important that downside risks be quantified through "low case" scenarios in economic projections attached to CSP's, country creditworthiness reviews, adjustment operations, etc. In some cases, e.g. primary commodity exporters, it is relatively straightforward to quantify and model downside risks arising, e.g., from volatile commodity prices. More frequently, however, the risks will be associated with backsliding in policy reforms, and are thus very difficult to quantify both in terms of likely magnitudes and probability of occurrence.

32. In the past, Bank management has not always been very supportive of staff who have pointed to large risks and thus created controversy. To stop a poor project required considerable courage, as such "troublemaking" was often regarded as a negative staff attribute that did not help carrier advancement. But if it is already risky to try and stop poor projects, one cannot expect country department staff to be very forthcoming with their views about country risks, as long as their managers see their objectives primarily as "delivering" lending programs. Indeed, risk assessments in private conversation at the working level are often very different from statements made by country department staff and managers, e.g. in Operations Committee meetings. One should thus not underestimate the difficulty of changing a managerial culture that has prevailed for nearly two decades.

33. One element to adapt managers and staff more quickly to the new environment of excessive debt and high risks would be more systematic rotation between line and staff functions, and between the different complexes. This should contribute to make the Bank's approaches and actions internally more consistent. Another element would be clear signals to managers that they will be held accountable for poor risk assessments. This has yet to be translated into reward and promotion decisions.

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May 27, 1988

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

88060008 1. MAR

DATE: June 2, 1988

TO: Operations Committee Members

FROM: D. C. Rao (FRS)

EXTENSION: 75456

SUBJECT: Country Risk Management Review

A meeting of the Operations Committee to discuss the Country Risk Management and Portfolio Review will be held on Tuesday, June 7, at 3:00 p.m. in Room E-1243. The following are suggested as topics for discussion:

1. Financing Assumptions in Work-Out Strategies. The threat of an imminent recession has receded, but the report notes (Chapter 1) that financing requirements continue to exceed what is generally thought likely to be available. How might the risks of an "underfunded" work-out program be better managed in country strategy formulation?

2. The Issue of Burden Sharing. The Bank's share of net finance implied in most country work-out projections is fairly modest, due to assumptions of relatively plentiful financing available from other creditors. To what extent are these assumptions optimistic? Is there a need for guidelines for the implementation and monitoring of burden-sharing ~~consensus~~? concerns

3. Safeguards against Excessive Exposure in High Risk Countries In view of the risks associated with "high case" lending programs in high risk countries, what safeguards are required to protect against "excessive" exposure? The report suggests (Chapter 4) that the exposure guidelines have an important role to play in triggering "tough questions" on the quality of the adjustment program, the downside risks, and burden sharing. Does the Committee agree? Are there other possible safeguards?

4. Adjustment Lending Issues. In view of the risks (and benefits) associated with adjustment lending (Chapter 4), is there a danger of becoming too dependent upon quick disbursing lending to sustain significant net disbursement levels? What scope is there for slower (multi-year) adjustment lending as suggested in the report?

5. Protecting the Bank's Preferred Creditor Status. In the present environment in which the Bank's special "cooperative" relationship with some members is under stress, protecting the Bank's preferred creditor status must be a key element of country risk management. The report suggests that one area in which the Bank's distinctiveness may be undermined is through excessive near-term "entanglement" between the Bank and commercial creditors in high risk countries. The report suggests inter alia that Bank participation in "B" loans should be restricted to countries in risk categories I, IIa and IIb. Does the Committee agree?

cc: Messrs. D. Lee, V. Dubey, A. Shakow, J. Holsen, S. Burmester/ T. Thahane, R. Liebenthal, T. Baudon, D. Hopper, D. Bock, D. Goldberg, J. Baneth, C. Robless.

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

CONFIDENTIAL

DATE: May 26, 1988

TO: Operations Committee Members

FROM: D. C. Rao, Director, FRS

EXTENSION: 75456

SUBJECT: Country Risk Management and Portfolio Review

Attached is this year's country risk review, for discussion by the Operations Committee on June 6. Volume I contains the Main Report, while Volume II contains risk assessment notes for 34 countries (accounting for 92% of the FY88-92 lending program). An executive summary will be distributed separately. This note touches upon some of the broad conclusions.

The report assigns risk ratings to individual countries, assesses the overall riskiness of the Bank's portfolio and discusses options for the Bank's risk management strategy. The assessment of country risk obviously has implications for our financial policies and projections. These are not explicitly addressed in this report. Rather, the report will be used as an input into our ongoing work on financial policy and particularly in the forthcoming annual review of Bank income.

It is clear that the Bank is now operating in an environment in which the probability of serious prolonged arrears has increased significantly. There are two related reasons for this. First, recent progress in debt workouts have been disappointing and the outlook for improved creditworthiness in general is not good. Second, there are indications that the Bank's "preferred-creditor status" has begun to erode.

Yes, Not quite

The Outlook for Creditworthiness

The continuing uncertainty concerning the outlook for OECD growth makes it difficult to assess fully the realism of the country forecasts that form the basis of the risk assessments. Although the near-term outlook may have improved recently, there is still a consensus that a downward correction in OECD growth is a necessary element in the elimination of its structural balances. Thus, weak OECD growth must be viewed as a significant source of risk in the economic environment for our borrowers. The downside risks are heightened by the clear inconsistency between the aggregation of commercial financing assumed in the individual country "workouts" and the commonly held assessment of likely flows of commercial new money. If, as is probable, there are major shortfalls in commercial financing that cannot be offset by higher official flows, the burden of macroeconomic adjustment is that much greater on the borrower countries. The record in this regard has so far been rather mixed. In view of these concerns, the report suggests that the management of risk in the coming year will require:

Not concerned in US

Different issue

- o a more detailed analysis of options facing the borrower and the Bank in the absence of adequate financing from other creditors;

- o more specific guidance on burden-sharing parameters in the short term;

- o closer scrutiny of the high-risk and/or high-exposure countries with regard to the feasibility and probability of success of adjustment and financing packages.

Protecting the Bank's Preferred-Creditor Status

Ensuring that the Bank stays "at the front of the queue" with regard to receiving debt-service payments from our borrowers will be a key aspect of country risk management in the coming years. The dollar depreciation since 1985 has been very unhelpful in this regard. It has raised annual debt-service obligations to the Bank by over $3 billion and reduced the Bank's annual net disbursements by almost $2 billion (to about $4 billion in FY88-89). Net disbursements to the Highly Indebted Countries as a whole (under the Lending Allocation Review "base" lending case) are likely to be only about $2 billion per year over the next five years, down from the $3 billion annual net disbursements that had been commonly anticipated. These sharp unanticipated increases in debt-service obligations to the Bank and corresponding reductions in our contribution to overall financing requirements will clearly not enhance borrowers' attitudes towards the Bank.

The report suggests two broad areas in which protection of the Bank's preferred-creditor status must be a major criterion in policy and program formulation. The first is the management of exposure and net flows. While some country situations may require sharp increases in lending, attention needs to be given to the subsequent profile of net disbursements. Adjustment lending, while obviously designed to help restore creditworthiness, entails significant risks for the Bank in this regard. In particular, adjustment lending tends not only to result in "bulges" in the profile of net flows, but also makes the Bank's net disbursements subject to dramatic declines in the event of policy slippage. For the FY88-92 period, quick-disbursing loans account for 145% of our total net disbursements to the Highly Indebted Countries, and 119% in the group of countries rated IIIb (i.e., with a particularly high risk of arrears). In view of this high degree of "dependence" on adjustment lending, the report suggests that increased attention needs to be given to managing the associated risks.

- o First, it is essential that a strong project pipeline be maintained for the high-risk countries and that a "fallback" country strategy be established. The introduction of the "low case" in the Lending Allocation Review is an important step in this direction.

- Second, from a risk management standpoint, a strong case can be made for slower disbursing adjustment lending. Multi-year adjustment lending (over, say, a four-year period) would not only lead to a smoother profile of net disbursements; it would also be attractive in countries where policy backsliding has been the norm rather than the exception or where there is a significant chance that governments may change and new administrations may feel no "ownership" of or support for, the adjustment program.

A second area in which care must be taken in protecting the Bank's preferred status is in avoiding excessive "entanglement" with commercial lenders. The Bank is increasingly being requested to expand its role in providing comfort to commercial banks in both new money and debt-reduction packages--and good scope exists for an expansion of the guarantee program. However, guarantees callable in the near term--say, over the next 3-4 years--are very risky, due to the inherent fragility of the country workout strategies. The report suggests that inadequate attention has so far been paid to exploring alternative scenarios under which guarantees might be called, and corresponding response options for the Bank. The potential costs to the Bank in participating in near-term guarantees or in payment-sharing arrangements stem from linking the Bank's country relationship with that of the commercial creditors to the detriment of the country dialogue, the lending program and timely debt service to the Bank. More generally, the concern is that the Bank's preferred-creditor status in the minds of the borrower, other creditors, and the Bank's bondholders might be futher eroded.

We would be pleased to discuss any aspects of the report in advance of the June 6th O.C. meeting. Comments and questions should be addressed to myself or to Andrew Steer (X72601).

Attachment

Distribution

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

cc: Finance:
Messrs. Stern, Roth, Eccles, Kavalsky

SVPOP/DFS:
Messrs. Dubey, Vergin, Bock

Country Directors:
Messrs. Alisbah, Asanuma, Bottelier, Burki, Cheetham, Choksi, Dervis, Gillette, Isenman, Kaji, Koch-Weser, Kopp, Lari, Loh, Madavo, Sandstrom, Serageldin, Steckhan, Stoutjesdijk

PPR:
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