

MEMORANDUM AND RECOMMENDATION OF THE PRESIDENT
OF THE INTERNATIONAL DEVELOPMENT ASSOCIATION
TO THE EXECUTIVE DIRECTORS
ON A PROPOSED CREDIT TO THE REPUBLIC [REDACTED]
FOR A MUNICIPAL SECTOR DEVELOPMENT PROJECT

1. I submit for your approval the following memorandum on a proposed development credit to the Republic [REDACTED] for SDR 30.1 million, the equivalent of US\$42 million, on standard International Development Association (IDA) terms with a maturity of 40 years. The credit would help finance a Municipal Sector Development Project to improve municipal management and resource allocation for municipal investment projects, particularly in disadvantaged regions and to the benefit of poor urban populations. Part of the proceeds of the credit, in an expected amount of approximately US\$20 million, would be on-lent to Fondo Nacional de Desarrollo Regional (FNDR) on the same terms and conditions as the IDA credit to [REDACTED]. The Inter-American Development Bank (IDB), the Corporación Andina de Fomento (CAF), the Fondo Financiero para el Desarrollo de la Cuenca del Plata (FONPLATA) and the Japanese Government would also support FNDR's lending activities, through additional financing.

PART I. COUNTRY POLICIES AND BANK GROUP ASSISTANCE STRATEGY

The Goal: Reducing Poverty

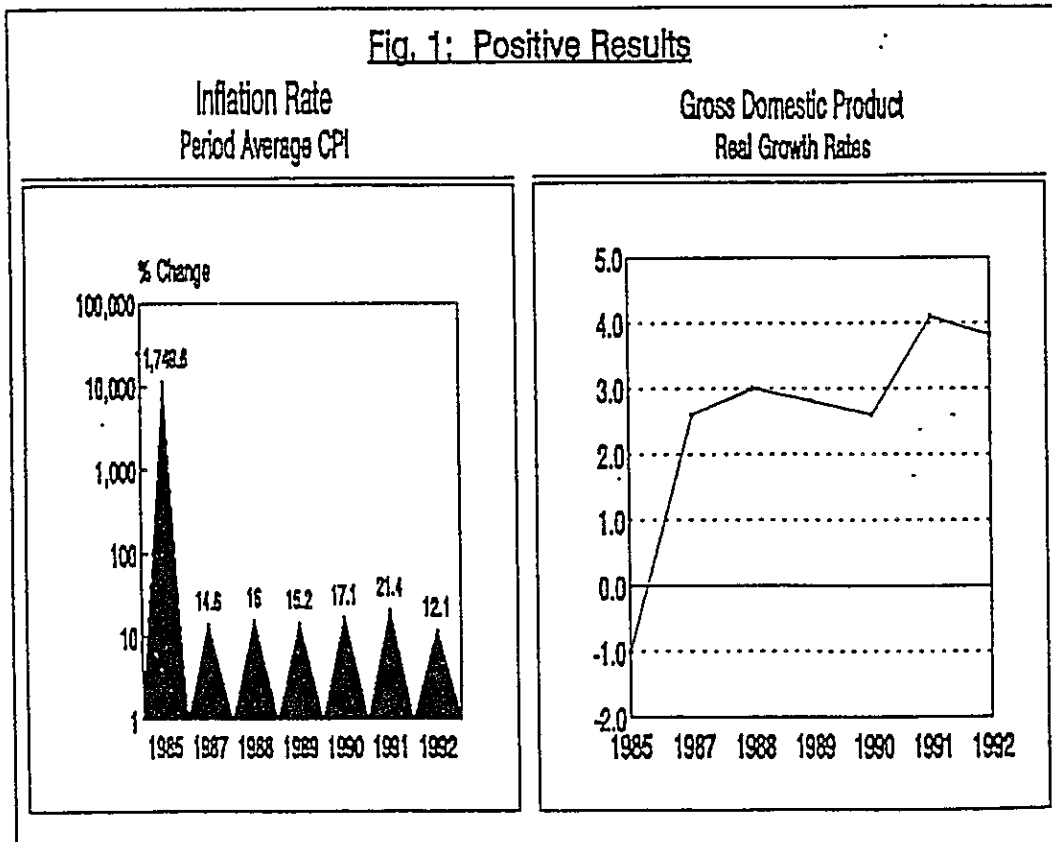
2. By any reasonable standard, most [REDACTED] are poor. They are poor in terms of income: per capita GDP is less than US\$680 and not equitably distributed. They are poor as well in terms of basic necessities: half or more of the population lacks access to clean water, adequate sanitation and basic health care; the coverage and especially the quality of public education are low and deteriorating. The consequences are an infant mortality rate (92 per 1,000 live births) nearly double the regional average and a population more than half of which is functionally illiterate. Standards of living for most [REDACTED] will rise only through a significant acceleration in, and equitable distribution of, economic growth and a significant improvement in levels and quality of social services. The strategy outlined below is a practical means of achieving and sustaining these two fundamental goals of development as quickly as possible. Its cornerstones are a series of second-generation reforms that will restructure and redirect the role of the state and a reform of the country's education system that will give all [REDACTED] access to good quality basic education.

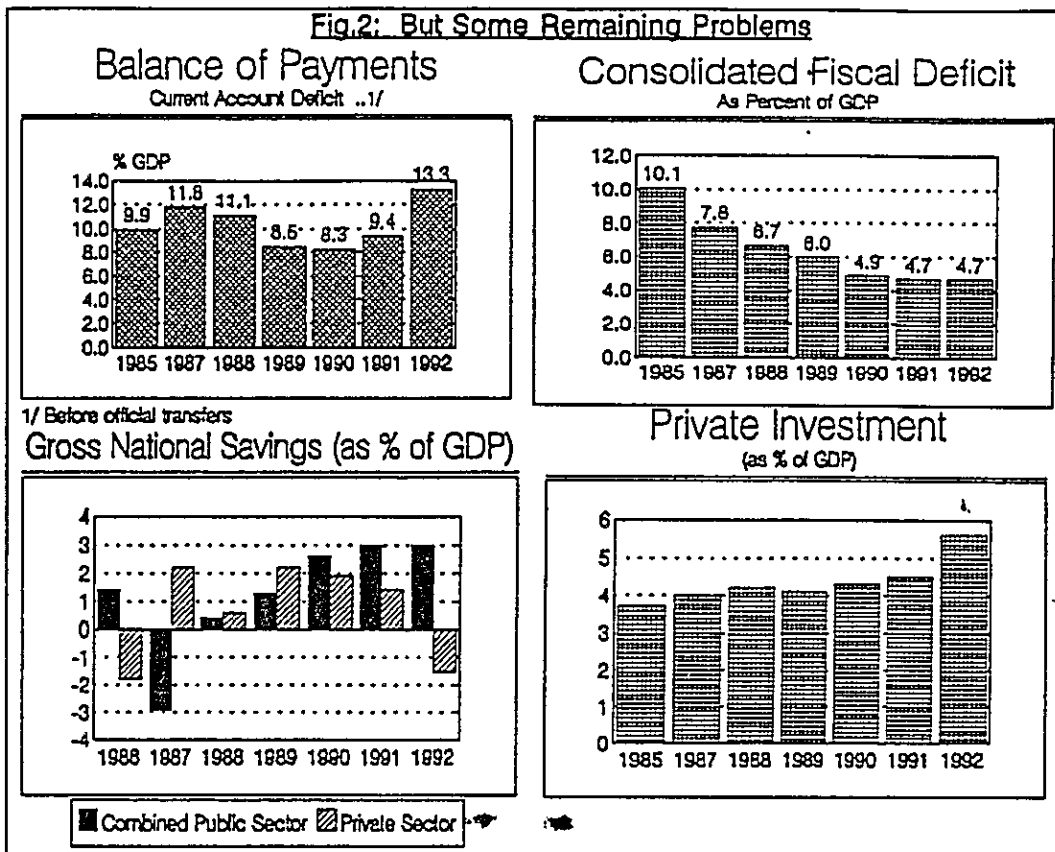
3. The current Government, which took office in August 1993, is carrying out an imaginative and radical reform program, which, if successful, will transform the country. It intends to foster private and social investment by withdrawing the state from productive activities as well as strengthening its capacity to make policy, regulate, enforce laws, and execute social programs. An overarching theme is the incorporation of the country's poor indigenous majority, which has in large part been excluded from the opportunities afforded by past economic growth and stability, into the economic mainstream. These reforms offer the best hope of shortening the country's development path by accelerating economic growth, and by freeing up resources to fund expanded programs in education, basic health, potable water and sanitation.

A. Recent Economic and Social Performance

4. [redacted] launched and sustained profound political and economic reform in the last eleven years. During this period, democratic institutions succeeded in replacing an unpredictable political environment, and economic reform brought stability and modest growth. [redacted] nevertheless remains a country of untapped potential, yet to take full advantage of its endowment in land, mineral, hydrocarbon and human resources.

5. One of the [redacted] in free market-based reform, [redacted] has gained solid economic ground during the past eight years. Inflation fell from stratospheric levels in 1985 to about 10% in 1993, and growth accelerated gradually to close to 4% annually in the last two years (see Figure 1). Despite these positive signs, the economic system remains fragile (see Figure 2). Declining terms of trade and rising import volume weakened the balance of payments position during the last six years, and the current account deficit widened from 8.5% to an estimated 13.2% of GDP between 1989 and 1993. The most serious problems were drops in tin and natural gas prices, mitigated only slightly by robust growth in nontraditional exports





(gold, zinc, soya, timber and manufactured goods) and partly offset by illegal coca exports. The deficit of the nonfinancial public sector increased from 4.7% of GDP during 1992 to a projected 6.6% of GDP in 1993, a level more than double the original 1993 IMF target. Public sector savings remain quite low (3% of GDP in 1993), especially given that the main productive and infrastructure sectors are still dominated by the state. The benefits of tax reform have been constrained by slow improvements in tax administration, and [redacted], the state-owned enterprise which controls the hydrocarbons sector, still accounts for about half of total government revenues.

6. Although there are encouraging signs of increased private sector confidence, such as the rapid increase in bank deposits, the private investment rate remains low (about 6% of GDP in 1992), even relative to historical levels. There are several reasons for this cautious response on the part of the private sector. Perhaps most importantly, state enterprises continue to play a monopolistic role in the two most important productive sectors, mining and hydrocarbons. The "rules of the game" in these sectors are less attractive than those prevailing in many other countries with similar resource endowments. In addition, the last Government's attitude toward an increased role for private investors was ambivalent, as demonstrated by the failure of the negotiations for private lithium development and by persistent delays in the negotiations of joint venture for state-owned mining properties.

7. Systemic problems also affect [REDACTED]'s attractiveness to investors. An archaic and poorly functioning legal/judicial system creates an unpredictable environment and adds to perceived risk. Weak and sometimes corrupt public institutions at national and municipal levels increase the cost of doing business through cumbersome regulations and procedures. For those of wealth or political clout, these barriers are easily surmounted; for the average [REDACTED], they lower the returns to entrepreneurship, risk-taking, and hard work. The result has been growth that benefited mainly the rich. Legal and institutional reforms are needed to level the playing field not only between the public and private sectors, but also between large-scale and small-scale entrepreneurs within the private sector. Such reforms are essential for a private-sector-led strategy that both raises growth and improves equity.

8. Difficulties in reaching agreement, both within the Government coalition and in the larger society, delayed the progress of economic reform during the past four years. In the last 18 months, however, a pragmatic consensus among the major political parties has emerged concerning the need to reduce and rationalize the role of the state and to move the social agenda forward. The consensus and the commitment of the current Government to bring about radical restructuring of the economy provide a unique opportunity to attack the remaining barriers to investment and growth.

B. The External Environment

9. The external environment confronting [REDACTED] is difficult in several respects. First, the country has experienced a painful decline in the terms of trade (almost 50% decline between 1980 and 1990) as prices for its main export commodities (gas, tin, other minerals) have plummeted. Export diversification (nontraditional minerals such as gold, wood and wood products, leather, flowers, and soya) have mitigated the ill effects somewhat, but dependence on a few basic commodities still constitutes a major source of economic fragility. Second, the circumstances of neighboring countries have affected [REDACTED]'s ability to sell its single most important export, natural gas. Repeated problems in receiving payment for gas from [REDACTED] have impeded fiscal management. Moreover, the discovery of important additional gas reserves in that country as well as the recent deregulation of the market may affect sales to Argentina in the next few years. At the same time, [REDACTED]'s internal problems and uncertainty in its energy policy have prevented the start of construction on a natural gas pipeline to [REDACTED], which would benefit both countries. A third factor is the pace at which economic reform is proceeding in other [REDACTED] countries. With reforms underway or completed in [REDACTED], [REDACTED], and [REDACTED], not to mention Eastern Europe and the Soviet Union, [REDACTED] will need to move quickly to stay competitive with other destinations for foreign investment.

10. Of course, improvements in the economic management of neighboring countries also hold out good prospects for expanding intraregional markets and exports. Neighboring countries currently account for about 28% of [REDACTED]'s non-gas exports. [REDACTED] has actively sought trade integration arrangements to further the development of regional trade. It is currently a member of the [REDACTED] Group ([REDACTED], [REDACTED], [REDACTED], [REDACTED] and [REDACTED]) and is seeking bilateral agreements with neighboring countries which would include drastic import tariff reductions to facilitate trade (agreements have already been signed with [REDACTED], [REDACTED] and [REDACTED]). It is also negotiating a bilateral trade agreement with [REDACTED] in order to take advantage of the recently

signed NAFTA treaty. These steps toward integration are important elements in the country's medium and long-term export prospects.

11. The recently-concluded Uruguay Round GATT agreement will not have major consequences for [REDACTED] but those effects that are expected to emerge are generally positive. [REDACTED] was active in discussions on textiles and is expected to improve access, especially to U.S. markets. Agriculture producers may also benefit through expanded markets for soybeans and timber.

12. Although its international price has declined dramatically in recent years, tin remains an important component of [REDACTED]'s exports. One factor influencing the price of tin is the U.S. policy regarding sales of its tin stockpiles. Although we have not carried out a detailed study, rough estimates indicate that cessation of such sales could have a sizable effect on the international price of tin in the very short run. However, medium term effects are expected to be negligible as other suppliers take up the shortfall that would be created by U.S. withdrawal.

13. Perhaps the most serious external factor that will affect [REDACTED]'s development prospects in the near term is its access to concessional aid. [REDACTED] is now highly dependent on both bilateral and multilateral concessional aid. Roughly 55% of the pledges recently tabled at the Consultative Group Meeting on [REDACTED] were on concessional terms. Of the concessional pledges, the U.S. and IDA accounted for about 45%. Thus, the U.S.'s commitment to [REDACTED]'s development program, closely linked to the objective of coca eradication and alternative development, and IDA's future are key factors that will shape [REDACTED]'s external support in the years to come.

C. [REDACTED]'s Economic and Social Agenda

14. There are four critical areas of reform necessary to transform [REDACTED]'s economy and accelerate development. First, the country needs to unbind the productive and export potential of its most important natural resources--hydrocarbons, minerals and land--by withdrawing the state from productive and certain infrastructure sectors, providing a legal and institutional framework which supports private investment, and improve key economic infrastructure. Second, the country needs to strengthen essential public institutions which define and enforce policy by implementing civil service and legal/judicial reforms. Third, it must take action to address a major cause of the country's deep-seated poverty by providing broad access to and improving the quality of basic education. Popular participation will be an essential instrument in achieving this goal. And, fourth, it must establish a policy context that promotes sustainable economic growth through rational management of natural resources.

15. **The Capitalization Program.** In an attempt to address the problems discussed above, the Government has proposed an imaginative approach to the task of withdrawing the state from its dominance in the hydrocarbons, mining, telecommunications, power, and transport sectors, which together currently account for more than 70% of public investment. The centerpiece of the Government's platform is a program of privatization of six major public enterprises through a process called *capitalization*. This program involves transferring management control and up to 50% of the ownership of key state-owned enterprises to strategic investors. Unlike traditional

privatization, the state will receive no funds from these transactions. Investors will not buy existing assets, but rather will make an investment in the company. In keeping with the Government's objective of increasing popular participation, the state's present ownership of the existing assets will be transferred entirely to the [REDACTED] people, most likely through a pension fund mechanism. The establishment of an appropriate legal and regulatory environment for each sector is an integral part of the capitalization process.

16. The main targets for the Government's Capitalization program are hydrocarbons, mining, power and telecommunications. [REDACTED], the Government-owned mining company, is not formally included in the capitalization program for legal reasons, but it is undergoing a parallel process of structural reform designed to provide for majority private participation in and management of its properties. In the transportation sector, the Government-owned airline and railway will also be a part of the Capitalization Program.

17. **Strengthening and Focusing Public Institutions.** Because government institutions are weak and politicized, as well as involved in so many aspects of the economy, [REDACTED] has difficulty in designing policy, choosing and implementing investment projects, executing social programs and regulating public utilities. To address this problem, restructuring public institutions to create a smaller and more focused government is the second critical objective of the new administration. One aspect of this program is the divestiture of public enterprises described above. In addition, a restructuring of the executive branch of government has already taken place in which the Government has reduced both the number of ministers--from 17 to 10--and the number of second and third-level management positions. Moreover, it has resisted political pressures and has staffed most senior government posts with well-qualified individuals. The Government is also moving forward with the civil service reform program, which has been in preparation for the past two years. The program includes the use of transparent selection processes in which there is extensive international donor participation and establishes an adequate compensation scale and secure financing for public employees. Weaknesses in the legal and judicial sector also constrain growth and equity. The Government is currently considering a judicial reform program, which establishes new selection procedures for Supreme Court justices and guarantees a minimum budget for the sector, and proposes to establish a new judicial commission responsible for sector administration.

18. **Popular Participation, Decentralization and Education Reform.** The central objective of the new Government is to broaden the benefits of economic growth by increasing the economic and political participation of [REDACTED]'s poor. It is attempting to do so through the distribution of shares in public enterprises, by creating a government which is responsive to people's needs, by ensuring that legal and regulatory mechanisms work for everyone, and by seeking ways to decentralize decision-making and management of social programs to the local level. An important element of the popular participation program is education reform. Low coverage and poor quality of education are major causes of [REDACTED]'s deep-seated structural poverty. About 20% of the adult population is illiterate and at least 55% is functionally illiterate, including many who finished primary and even secondary school. On average, the population has completed four years of school; only 44% have completed primary school. These problems reflect an inefficient and centralized administration, poorly paid and badly trained teachers, dilapidated infrastructure and the scarcity of teaching materials. The Government has recently initiated an education reform program which is directed at restructuring the sector and

which will have significant long-term effects on poverty reduction. Its objectives include increasing participation at the community level in educational decisions, delegating administration to local entities, restructuring and limiting the role of the Secretary of Education, rationalizing expenditures on tertiary education, introducing tuition fees, training and appropriate incentives for teachers, and rehabilitation of infrastructure.

19. **Environmental Management.** [REDACTED]'s prospects for sustainable growth are inextricably linked to a rational management of the environment. Currently, [REDACTED] faces three environmental challenges: (a) managing a relatively rich natural resource base for development in the [REDACTED]; (b) managing agriculture, grazing lands and the associated biotic resources in the altiplano and valleys; and (c) managing scarce water resources. The [REDACTED] region is developing rapidly, with some damage to soil and forests. In the altiplano and valleys, peasant agriculture plays a dominant role. Natural causes and mismanagement of the soil by overgrazing, over-cropping and inappropriate use of technology are accelerating erosion and reducing fertility. Finally, there is intense competition for water for agriculture, mining and human consumption particularly in the arid and semi-arid regions of the altiplano and valleys. Adding to this, mining operations are discharging processing effluents and other pollutants into rivers and streams, contaminating irrigation and drinking water.

20. The establishment of the Ministry of Sustainable Development and the Environment indicates the importance the new Government places on rational resource management. Building upon the framework environmental law, biodiversity and forest management laws have been drafted and will be presented to Congress within the coming year. Among [REDACTED]'s natural resources, however, land is perhaps the most important in terms of generating employment and income for the rural poor. The rational management of land depends upon the establishment of clear property rights. In early 1993, partly in response to several public scandals concerning land distribution, the former Government declared a moratorium on distribution of state-owned land pending institutional restructuring of its tenure regime and established a ministerial commission to oversee the process. Although there are few issues as potentially divisive, a consensus on the need for land tenure and land administration reform has clearly emerged in the past year, and the current administration has established legislative and institutional reform in this area as a high priority.

D. The Bank Group's Assistance Strategy

21. The strategy outlined below focuses the Bank Group's resources on the Government's most critical reforms. The window during which difficult political decisions can be taken will be a narrow one, in the first two years of the administration, hence the Bank Group's program is heavily front-loaded. The strategy set out below was presented to the new Government shortly after taking office and has also been discussed in a programming/project implementation review mission.

22. **Macroeconomic Management and Medium Term Prospects.** In the near term the principal challenge for macroeconomic management is to reduce the fiscal deficit to a level which can be financed by external assistance without resort to domestic credit. The new Government inherited a difficult fiscal situation which had developed during the first half of

1993; recognizing that macroeconomic stability is the foundation for private sector led growth, it has sharply cut expenditures in the latter months of 1993 and is committed to reducing the fiscal deficit in 1994 through both revenue enhancements and expenditure controls.

23. If the new Government is successful in getting the fiscal program back on track and is able to implement the major reforms in the first year or two of its administration, we would expect sustained economic growth of about 4% annually for the next three years, increasing to an annual average of 5% during 1997-2000. If construction of the gas pipeline to ██████ begins within the next two years, even higher rates are possible towards the end of the decade. This projected level of growth assumes that annual investment averages about 18% of GDP over the period. The growth in investment is predicated on the proposed reforms stimulating private investment, mainly in hydrocarbons, mining, communications and agriculture. Total private investment is projected to increase from about 6% of GDP in 1992 to about 10% by the year 2000. The level of public investment would gradually decline from 9% of GDP, but its efficiency would be improved, and it would be reallocated towards essential economic and social infrastructure. The Government's own projections for future growth are considerably higher than the Bank Group's, driven mainly by much higher assumed levels of private sector investment. In large part these higher investment levels stem from the Government's assumptions about dramatic increases in private capital inflows to be generated by its Capitalization Program. Since the Capitalization concept is as yet untried and untested, we continue to base our own projections on more conservative private investment growth assumptions.

24. IDA Lending. Since 1986 when it resumed lending after a four-year hiatus, IDA's main goals have been to encourage economic reform and reactivation, improve infrastructure and provide basic social services. The proposed four-year lending program will focus on the remaining stubborn structural constraints to growth, and will increase resources available for poverty and human resource development. These priorities reflect the Government's agenda described above, aimed at reducing the role of the state in productive and infrastructure sectors while increasing social sector spending. The proposed 4-year lending program amounts to US\$320 million spread among 14 projects. The projects fall in the following major categories. A tabular summary of objectives and instruments (Table 1) follows this discussion.

25. Rationalizing the role of the State (50% of the lending program). In order to build a solid foundation for reducing poverty, half of the proposed lending program will assist the Government in restructuring the role of the state. The first group of projects (25% of the lending program) will provide financial and technical assistance support for the Government's Capitalization Program. A policy-based credit will set the stage by supporting the capitalization process and the technical, legislative and regulatory work needed to recast the role of the state in the hydrocarbons and major infrastructure sectors. Its financing would be used to offset the fiscal costs associated with the adjustment process. This policy operation will be followed by two operations in the hydrocarbons and power sectors, to support the restructuring process and to help mobilize private sector participation. The second group of projects (25% of the lending program) will strengthen essential public institutions through judiciary, civil service and social security reform to improve the state's ability to set, regulate and enforce policy. Institutional strengthening is also a major theme in the Municipal Sector Development Project which will

strengthen institutional capability of small municipalities, finance economic and social infrastructure in these municipalities and institute a civil service reform at the municipal level.

26. Poverty and Human Resource Development (40%). Our poverty strategy for FY94-97 builds on a FY93 lending program that included two important investment projects in the social sector: the Integrated Child Development Project and the Second Social Investment Fund Project. The former will attempt to provide basic nutrition and simple preschool education to some 50% of children under 6 through low-cost, home-based day care centers in urban and peri-urban low-income neighborhoods. The latter will provide continued support to [REDACTED]'s successful Social Investment Fund. During FY94-97, a rural water supply and sanitation project will reduce the incidence of child mortality and enteric diseases by relying on low-cost technology and heavy community involvement in installation and maintenance. The lending program also includes a rural investment project directed at increasing rural incomes through productive investments at the community level, and a proposed second health project. Finally, a sector loan would support the Government's education reform to broaden access to and improve the quality of basic education, followed by a project specifically targeted at primary education.

27. Natural Resource Management (10%). The FY94-97 lending program includes a project to define standards and enforcement mechanisms for industry and mining and to correct environmental problems in both sectors to decrease river and aquifer pollution. This project will build on the two projects approved in FY93 directed at strengthening the Government's ability to manage the country's natural resources, to support sustainable growth, and to promote biodiversity. A project to support implementation of the Agrarian Reform Law and reform of the land tenure system will help rationalize land ownership and use, with important implications for production, equity and especially environment management of land use.

28. Vehicles for IDA Assistance. The proposed lending program would rely on adjustment lending to a lesser extent than in the past; only one policy-based credit is programmed, conditioned on adequate fiscal policy and macroeconomic management. Instead, sector and project credits would permit deeper entry into and longer-term involvement in key reform areas. The proposed lending program would also rely on some relatively small operations, mainly to support technical assistance, with ambitious reform objectives (land administration, civil service, and regulatory/judicial reform). Given the importance and the controversial nature of these operations, IDA will need to keep them at the center of the policy dialogue.

29. Economic and Sector Work. The proposed economic and sector work program is directed at supporting policy dialogue, advancing aid coordination and contributing to the development of lending operations. This year a report on the *State of the Economy and Reform Programs* was produced for distribution at the Consultative Group (CG) held in December 1993. A "briefing book," summarizing recent economic and sector work, was prepared for key officials in the new Government, summed up alternative courses of action and their consequences. The FY94 CEM will focus primarily on the fiscal implications of the planned economic and social reforms to help the Government in carrying out a reform program consistent with good macroeconomic management. The next full CEM is planned for FY96, although we will prepare relatively brief Updating Economic Memoranda in the alternate years to serve as documentation for the CG.

Table 1: OBJECTIVES AND INSTRUMENTS OF COUNTRY ASSISTANCE STRATEGY, FY94-97

Objectives	Current Situation	Instruments
A. Unbind the country's productive and export potential	The country's most important natural resources—hydrocarbons, minerals and land—remain largely under the state's control. Increased private investment in these areas requires withdrawal of the State from productive and certain infrastructure sectors, provision of a legal and institutional framework favorable for private investment and improving key economic infrastructure.	Capitalization adjustment operation; Regulatory and judiciary reform; Hydrocarbon deregulation; Power sector reform; FY94 CEM will assess fiscal implications of various reforms and propose sequencing.
B. Strengthen essential public institutions	Government institutions are weak and politicized. They need to be strengthened to carry out policy formulation, regulatory and judiciary functions as well as to provide essential public services.	Civil service reform; Regulatory and judiciary reform; Municipal development project; Social security reform; Education reform.
C. Broaden the benefits of economic growth	The country's poor—the majority of its population—have little say in public decisions that affect their lives. To increase the economic and political participation of Bolivia's poor, decision-making and management of social programs will be decentralized to local levels and shared in public enterprises widely distributed.	Education reform; Municipal development project; Rural water and sanitation; Rural development project; Health; Primary education; Capitalization adjustment operation
D. Promote sustainability of natural resources	The establishment of the Ministry of Sustainable Development and the Environment indicates the Government's commitment to rational and sustainable resource management. Reform of the existing agrarian law and of the land tenure system is critical for sustainable and equitable management of natural resources.	Land administration; Environment project for industry and mining sectors.

30. Sector work concentrates on human resources, poverty, resource management and economic infrastructure, mainly transport. The most important analytical work in human resources will be an updating poverty assessment directed at determining income distribution, diagnosing poverty and recommending additional areas of action for alleviating poverty. These works will be followed up by a comprehensive reassessment of the health sector, including health benefits under the social security system. In the area of resource management, an assessment of environmental priorities and strategy is planned for FY95 to determine progress and define priorities for action. In the infrastructure sector, work will be done to identify the potential for and the means to promote private sector involvement in infrastructure development. Our ESW program will be based on a participatory approach in which we agree annually on priorities with the Government, execute the work jointly whenever possible, and involve the Government at early stages of review.

31. Project Implementation. The proposed lending program is built on [REDACTED]'s implementation record over the past seven years. In general, project execution has been better than for many other Latin American borrowers, but disbursement rates have slipped recently (Table 2). Project implementation has been constrained by three factors: the weakness of counterpart institutions, as evident in low staff skill levels and high turnover rates; scarcity of counterpart resources (from overall fiscal constraints and from diversion of resources to other objectives); and lack of government ownership of IDA projects and programs. For too many projects the IDA is the primary source of leadership and continuity in execution.

32. In the past, these problems have been addressed in project design through inclusion of financing for local consultants, topping off of Government salaries, establishment of project units with separate salary scales and even creation of new institutions whose administrative costs are funded internationally. This approach has enabled implementation of projects or programs which otherwise could not have been executed, but it has tended to reduce government ownership. The proposed lending program will phase out at least part of the budget support which has characterized lending to [REDACTED] in recent years to bring issues of institutional development to the center of the policy dialogue. Specifically, in new projects, we propose to: (a) phase out "topping off" of salaries as a practice, (b) phase out financing of line personnel and local consultants taking on line roles (with the possible exception of the civil service project), and (c) minimize financing of administrative budgets. This change in policy may carry the cost of slowing project preparation and implementation in the short run, but is deemed necessary to achieve the longer term goals of efficiency and government ownership of projects. We also propose to continue the current policy which requires [REDACTED] to pay at least 20% of project costs.

33. One of the biggest challenges in the program, and one of the key objectives of the new administration, is to deliver social programs to remote sparsely populated rural areas. Reaching the poorest people in isolated rural communities will be a central issue in the design of most human resource projects. One approach is to increase the technical and financial capability of local communities and municipalities, although the problems are so severe that this cannot help but be a long-term process. In this regard, there are interesting models in both Colombia and Mexico, but population density in Bolivia is much lower and local institutions far weaker than

in either of those countries. Part of the proposed sector work will focus on the question of what service delivery mechanisms are most appropriate to the [redacted] environment. In addition, the Municipal Sector Development project being presented and the proposed rural development project will have as their major focus the strengthening of local capability.

Table 2: Selected Indicators of Portfolio Performance and Management

	FY92	FY93
<i>Portfolio Performance</i>		
No. of Projects under Implementation	20	21
Ave. Implementation Period (years) ^{a/}	2.9	3.2
Average Ratings	1.84	1.95
% Project Rated "3" or "4"	10	9.5
Disbursement Ratio (%) ^{b/}	<u>25</u>	<u>17</u>
<i>Portfolio Management</i>		
Supervision Resources (total staff-weeks)	306	349
Average Supervision (staff weeks/project)	<u>15.3</u>	<u>16.6</u>
Date of Last CPPR: November 1993		

a/ Average age of projects in the Bank Group's country portfolio.

b/ Ratio of disbursements during the year to undisbursed balance of the Bank Group's portfolio at the beginning of the year.

34. **Bank Group Supervision.** Projects with high policy and technical assistance content, a broad-ranging lending program, local support in the form of many small contracts and a scarcity of critical project management skills have complicated supervision of the portfolio, and, together with the institutional weaknesses described above, have resulted in supervision coefficients higher than [redacted] averages. The nature of the proposed lending program is likely to require similar levels of supervision. Although there is little room to reduce total supervision resources, we will use these resources more effectively by shifting more supervision responsibility to the Resident Mission and by relying on local staff and more junior consultants for on-the-ground follow-up of project problems.

35. **Impact of Lending Program on Illegal Coca Activities.** The illegal production of coca for processing into cocaine poses a troublesome problem for [redacted]. With income retained by [redacted] factors of production estimated at about 2% of GDP in 1991, the coca economy has served as a source of income for around 50,000 families in the Chaparre region, and has provided an economic cushion for the unemployment caused by adjustments in the mining sector and in public sector downsizing. At the same time, the growth of criminal sources of income threatens to undermine the country's fragile public institutions, and drug use, while still

relatively rare, is increasing, particularly among [REDACTED]'s street children. The proposed lending program is designed to provide alternatives to coca production. First, it is directed at achieving fast and equitable economic growth that will generate alternative economic activities for coca producers. Second, it includes projects directed at reducing rural poverty, and, therefore, incentives to migrate into coca-producing regions. The proposed rural development project, for example, will focus on areas, such as [REDACTED], characterized by heavy outmigration to the [REDACTED]. Finally, the lending program will provide support directed specifically at the support of public institutions, in particular the judiciary, which are specially at risk.

36. IFC, FIAS and MIGA Activities. IFC has to date had only a modest participation in [REDACTED], focusing mainly on operations in the mining and financial sectors. It is currently seeking opportunities to participate in the capitalization program, and, if successful, could substantially expand its program in the country. IFC's role should in the future be more important as opportunities for the private sector improve. Representatives from FIAS have visited [REDACTED] on several occasions to assist the Government in its strategy to diversify exports. While [REDACTED] is a member, it has not yet undertaken any operations with MIGA.

37. Donor Coordination. Joining forces with other donors is a central part of the Bank Group's strategy. The Bank Group will continue to work closely with the IMF. Under the continuing ESAF agreement, the Bank Group, IMF and the Government have jointly prepared annual Policy Framework Papers. Upon expiration of the fourth year of the current ESAF agreement it is expected that there will be a successor IMF program with [REDACTED]. The Consultative Group for [REDACTED] met for the eighth time in December 1993, and has evolved into a mechanism as much for identifying and reaching a consensus on [REDACTED]'s development priorities as for mobilizing aid. One sign of success is the dominant role taken by the Government in the last three years in shaping the agenda and preparing supporting documents. Cofinancing has become the most useful mechanism of coordination; we currently have cofinancing arrangements on most ongoing and proposed new projects. While cofinancing arrangements substantially increase the time and work involved in project preparation, the payoff in terms of avoiding duplication of effort and working at cross purposes is high. In order to share the administrative costs of supervision, three arrangements were negotiated recently with bilateral donors (USAID, Holland and Switzerland) to finance some of the supervision costs of jointly-financed projects. We will seek additional, similar arrangements in the future, in particular for supervision of social projects. We also coordinate closely with the Interamerican Development Bank (IDB). For example, IDB is providing parallel financing for the Municipal Sector Development Project. In response to the new administration's accelerated reform program the IDB has increased its programmed assistance to US\$240 million in 1994 to support capitalization, education reform, social security reform and capital market development.

38. Program Size and Bank Group Exposure. A lending program of US\$320 million in 14 credits is proposed for FY94-97. The actual size of the program is likely to be somewhat higher, given that [REDACTED] will continue to benefit from IDA reflows. As indicated, the program

will be front-loaded to provide maximum support during the first half of the new administration. Total debt service to the World Bank Group amounted to 5.6% of exports in 1992, but is expected to drop to about 2% of exports by the end of the decade.

39. Risks and the fall-back position. The proposed lending program is ambitious and designed to provide maximum support to the new Government in its pursuit of its high-growth policy path, and there is some risk that we will not be able to achieve all of its objectives. The major domestic risks include strong union opposition to reforms in [REDACTED], [REDACTED] and the education sector, and the weakness of public institutions which are to carry out reforms. Both could delay implementation. Externally, [REDACTED] may face unanticipated shortfalls in official capital inflows and further unfavorable developments in its trade. The first five months of the new administration give grounds for optimism and some caution. The administration has made good appointments and is putting the fiscal program back on track. Work is well underway on legislation and decisions to support key reform areas (capitalization, education reform, and laws for hydrocarbons, telecommunications, and power sectors). However, the pace of actions has not met expectations as the reorganization of the executive branch added to the usual costs of transition between administrations.

40. The Bank Group has maintained an unusually close collaborative working relationship with the [REDACTED] Government during the last nine years, and has played an important role in helping the new Government identify issues and priorities. Our continued active commitment to and promotion of this high-growth strategy will increase its chances of implementation. We believe the effort is warranted because of the Bank Group's special relationship with [REDACTED], the opportunity presented by the new Government, and because even partial success could substantially accelerate development and expand economic opportunities for [REDACTED]'s poorest people. A low-case lending scenario would arise were the Government to fail to maintain an acceptable macroeconomic program. Under such circumstances we would not go forward with the proposed adjustment operation and the lending program would be reduced accordingly.

E. Agenda for Board Discussion

41. The proposed assistance strategy is designed to meet the challenge of accelerated and more equitable growth and concentrates on four areas of interventions. First, the policy-based lending and accompanying TA projects will help the Government privatize the major public enterprises and create an economic and legal environment conducive to private investments. Second, public sector institutions will be strengthened to carry out policy formulation, regulatory and judiciary functions as well as to provide essential public services. Third, poverty alleviation in both the medium and long-run will be pursued through the education reform program and investments in rural development and water supply. And finally, sustainable and equitable management of natural resources will be supported by land administration reform and additional assistance on environmental policies for industry and mining.

42. [REDACTED]'s new Government has proposed a comprehensive and far-reaching reform program aimed at a major transformation of the [REDACTED] economy. The success and sustainability of this ambitious program depends critically on how rapidly the Government is able to put it in place. Our strategy for [REDACTED] recognizes the narrow window of opportunity the Government has to launch its programs during the early part of its administration by significantly front loading the next three-year cycle of Bank Group lending. As currently programmed, more than half of our three-year lending allocation for [REDACTED] will be delivered in FY95. This element of our strategy is considered essential in order for the Bank Group to provide support to the Government when it is most needed.

