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Report No. P-6338 LV

MEMORANDUM AND RECOMMENDATION
OF THE
PRESIDENT OF THE
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
TO THE
EXECUTIVE DIRECTORS
ON A
PROPOSED CURRENCY POOL LOAN
IN AN AGGREGATE LOAN AMOUNT OF US$20 MILLION EQUIVALENT,
A PROPOSED SINGLE CURRENCY LOAN
WITH A TRANCHE OF US DOLLARS
IN AN AGGREGATE AMOUNT OF US$10 MILLION EQUIVALENT,
AND A TRANCHE OF DEUTSCHE MARK
IN AN AGGREGATE AMOUNT OF DM8.5 MILLION EQUIVALENT
TO THE
REPUBLIC OF LATVIA
FOR AN
ENTERPRISE AND FINANCIAL SECTOR RESTRUCTURING PROJECT

August 16, 1994

Privatization and Enterprise Development Division
Country Department IV
Europe and Central Asia Region

Report No: P- 6338 LV
Type: MOP

Currency Equivalents
(as of July 20, 1994)

Currency Unit	=	Latvian lati (introduced May 1993)
Ls 1	=	US$1.79
US$1	=	0.56 Ls

Average Exchange Rates
per US$1

		Rate
1993	May 1993	.67
1994	April 1994	.56
1994	June 1994	.56

Fiscal Year

January 1 - December 31

Weights and Measures
Metric System

Abbreviations and Acronyms

CAS	-	Country Assistance Strategy
EBRD	-	European Bank for Reconstruction and Development
EC PHARE	-	European Commission Assistance Program for Eastern Europe
FSUB	-	Former Soviet Union and Baltics
GDP	-	Gross Domestic Product
ICB	-	International Competitive Bidding
IMF	-	International Monetary Fund
LCB	-	Local Competitive Bidding
LPA	-	Latvian Privatization Agency
Ls	-	Latvian currency unit (Latvian Lati)
MOF	-	Ministry of Finance
PCR	-	Project Completion Report
PFI	-	Participating Financial Institution
PMU	-	Project Management Unit
PPAR	-	Project Performance Audit Report
SCL	-	Single Currency Loan
SCF	-	Swedish Capital Fund
TA	-	Technical Assistance
TU	-	Technical Unit

Enterprise and Financial Sector Restructuring Loan

Loan and Project Summary

Borrower: Republic of Latvia

Guarantor: Ministry of Finance

Beneficiaries: The Government of Latvia, Bank of Latvia, Latvian Privatization Agency, private enterprises, and participating commercial banks

Amount: Two loans, in the following amount, aggregating about US$35 million equivalent:
(a) US$20 million equivalent
(b) US$10 million and DM8.5 million equivalent (about US$5.0 million)

Terms: Two loans each repayable over 17 years, including 5 years' grace:
(a) a US$20 million equivalent currency pool loan at the Bank's standard variable rate;
(b) a single currency loan of two tranches: a US dollar tranche in an amount of US$10 million equivalent at the Bank's standard US$ LIBOR-based rate; and a deutsche mark tranche in an amount of DM8.5 million equivalent at the Bank's standard DM LIBOR-based rate.

Onlending Terms: From the Government to the financial intermediaries in Latvian lati, US dollars and deutsche mark; from the financial intermediaries to individual borrowers in the same currencies and maturities at freely-determined interest margins. Depending on the subproject requirements, the maturity for subloans granted to finance fixed capital formation would vary from 1 to 12 years, with a maximum grace period of 3 years. Associated permanent working capital subloans would be for a maximum of 2 years, with a 6-month grace period.

Financing Plan:

	Local	Foreign	Total
	US$ million		
IBRD	0.00	35.00	35.00
Other Bilateral Donors	0.00	11.68	11.68
EC PHARE	0.00	3.63	3.63
Gov't of Sweden	0.00	10.60	10.60
Gov't of Latvia	46.50	0.00	46.50
Participating Banks	6.00	0.00	6.00
Beneficiaries	0.20	0.00	0.20
TOTAL	52.70	60.91	113.61

Poverty Category: Not applicable

Staff Appraisal Report: Report No. 12977 LV

Map: IBRD No. 24630R

MEMORANDUM AND RECOMMENDATION OF THE PRESIDENT OF THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT TO THE EXECUTIVE DIRECTORS ON PROPOSED LOANS FOR AN ENTERPRISE AND FINANCIAL SECTOR RESTRUCTURING PROJECT

1. I submit for your approval the following memorandum and recommendation on two proposed loans to the Republic of Latvia for the equivalent of US$35 million to help finance an Enterprise and Financial Sector Restructuring project. The first is a single currency loan with a US dollar tranche of US$10 million equivalent and a deutsche mark tranche of DM8.5 million equivalent. This loan will be repayable in seventeen years including 5 years of grace at the Bank's standard LIBOR-based interest rate for US dollar and deutsche mark SCLs, respectively. The second is a US$20 million currency pool loan at the Bank's standard variable rate repayable over seventeen years including five years of grace.

2. **Sector Background.** In the *enterprise sector* structural reforms encompassing privatization of rural land and small businesses have been progressing well; but, privatization of medium and large scale enterprises has been at a virtual standstill since 1991. The current government, however, is committed to quickening the pace of privatization. Progress has been made in preparing the legal and institutional infrastructure to begin the mass privatization of medium and large-scale enterprises. An amended Privatization Law was enacted, for instance, in March 1994 and a State Property Fund and Privatization Agency have been established. A first phase of privatization transactions is now being prepared with the assistance of the Bank and a number of bilateral and multilateral donors.

3. In the *financial sector* the reform process--particularly the restructuring of the banking sector--had been proceeding slowly until early 1993. However, considerable progress has now been made in addressing the future of the 49 branches of the Bank of Latvia that were formerly branches of the Soviet specialized banks. Some branches have been sold to existing banks, some have been privatized individually, and the remaining 19 have been amalgamated into a new state commercial bank--the Universal Bank of Latvia (Unibank)--which the Government intends to privatize. The Government has also decided to rehabilitate and privatize the Savings Bank, which has a large branch network and still commands the confidence of the public at large. World Bank preparatory missions have been working with the Latvian authorities since February 1993 on a strategy for addressing the structural issues in the banking system.

4. **Lessons Learned from Previous Bank Operations.** Previous bank involvement in project implementation in Latvia has been limited to the Rehabilitation Project (Ln 35250 LV) and the Agricultural Development Project (Ln 3695 LV). In addition to this involvement, the experience of a number of bank missions to Latvia has underlined the inadequacies in management and institutional capacity to support adjustment and restructuring. Experience in Eastern Europe also points to the necessity of supporting enabling institutions as the economy opens to entrepreneurial activity. Another pertinent lesson from this region is that bank and enterprise reform should proceed, to the extent possible, in tandem. The Latvian banking system has begun to act as a channel for credit lines, most recently through facilities provided by the G-24 and IMF. Experience with the former facility suggests that, on the one hand, there is a significant demand for longer-term funding. On the other, the reported misuse of funds in some specific cases suggests that it is important to design and implement a robust mechanism for the channeling of credit.

5. **Rationale for Bank Involvement.** The Bank has a firm commitment to assisting Latvia undertake the difficult transition from a centrally planned to a market economy. However, structural reforms in the enterprise and financial sectors have, until relatively recently, proceeded slowly in Latvia. Given the central importance of the two sectors to the economy, it is vital to reinvigorate the reform process in these areas if the overall reform program is not to stall.

6. The proposed project is designed to provide an impetus to the reforms in the enterprise and financial sectors and bring closer the point at which income and employment generated by new industrial activity begins to exceed income and employment falls in the declining industries. The project is consistent with current bank policy in that it helps to catalyze trans-sectoral support for private sector development, privatization and subsequent restructuring. As Latvia is a new member, an interim Country Assistance Strategy (CAS) was discussed when the first Bank-supported Rehabilitation Loan (Ln 35250 LV) was presented in October 1992. A comprehensive CAS, to be presented to the Board alongside this project, provides a full discussion of the Bank's assistance strategy for Latvia of which this project is an integral component.

7. **Project Objectives.** The project's main objective is to support--and help accelerate--the Government's reforms in the enterprise and financial sectors, focussing in particular on enterprise privatization and bank restructuring. An important aspect of this is the design and implementation of a coordinated strategy of reform for both sectors and the development of skills for addressing problems on the interface between the sectors (i.e., work-out capacities for dealing with bad debtors). These reforms will pave the way for improved intermediation through the banking sector, specifically to newly-privatized and other emerging private sector enterprises. To further support intermediation through the banking system, the project will assist in the development of the payments system. The credit component of the loan will act as a catalyst to the development of intermediation at the medium- and long-term end of the maturity spectrum and will encourage new investment in the emerging private sector. A key objective in this context will be the establishment of a strong mechanism--a Technical Unit--for channeling credit lines to the private sector.

8. **Project Description.** The project comprises the following three components: (1) *a Credit Line*--in tandem with a Capital Fund for bank capitalization that is expected to be provided by the Government of Sweden--to finance investment and related permanent working capital needs in newly privatized and other private sector enterprises; (2) *an Institutional Development Component*, in support of the Latvian Privatization Agency (LPA), the Project Management Unit (PMU) and the Technical Unit (TU); and (3) *a Financial Infrastructure Investment* Component, for the purchase of computer hardware and software for payments system development.

(1) *Credit Line Component (US$29.58 million*[1]): This component will be financed out of the single currency loan--US$10 million and DM8.5 million (about US$5.0 million equivalent)--and US$14.58 million equivalent from the currency pool loan. The purpose of the credit component is to provide resources for investment finance (and associated permanent working capital) for newly-privatized enterprises and other private sector enterprises. US$10 million of the credit line will be earmarked for newly privatized enterprises. If this element is not

1. This amount includes US$980,000 of unallocated funds under the currency pool loan that are expected to be deployed in the credit line.

disbursed within eighteen months, it will be made available for other private sector borrowers. This component will be supported by the Swedish Government in the form of a Capital Fund (of US$10 million) that will be used for bank capitalization. A small number of private commercial banks will be eligible for injections of capital (US$2 million) from this Fund. These will also be recipients of funds from the credit line. Unibank and the Savings Bank are also expected to be direct recipients of a capital injection from the Capital Fund (US$5 million and US$3 million, respectively). The Government has already replaced non-performing loans in Unibank's balance sheet with government bonds as part of an overall recapitalization program for the bank. Over time, as Unibank develops acceptable investment projects, subloans under the credit line will replace the bonds (which will then be extinguished). The Savings Bank--which has also been recapitalized by an injection of government bonds--will not, however, be a participating bank for the channeling of the credit line.

(2) *Institutional Development Component (US$3.42 million)*: This component is financed entirely from the currency pool loan. A subcomponent for the LPA (US$3 million) will help to fill critical gaps in the overall program of TA being provided to support the *enterprise privatization* process by a range of bilateral and multilateral donors. Grant funding will be sought to finance this component also, where possible. Where additional grant funding is obtained there will be a reallocation of this loan component's proceeds to the credit line component. The technical assistance being included under this component (US$ 2.5 million) will support the auction track of the Mass Privatization Program. Channeled through the Latvian Privatization Agency, loan funds will be used to assist in the preparation of selected enterprises for privatization, specifically through the provision of basic pre-privatization financial and organizational restructuring. To this end, about 10 advisory teams will be formed, comprising local experts and foreign specialists with extensive privatization experience in Central and Eastern Europe. Each team will analyze the economic and financial situation of the enterprise, recommend "soft" restructuring measures to be taken prior to auction, develop a strategic business plan, and prepare a short prospectus for auction participants. The loan will also finance the equipment necessary for a bidding center to facilitate the auction process. US$0.5 million will also be used to finance computer hardware and software for strengthening the LPA and for establishing the auction mechanism. A subcomponent of US$0.42 million will also be provided to strengthen the PMU and the TU. With regard to *bank restructuring*, the Bank has taken the lead during the loan preparation phase in providing assistance, with the help of a PHRD grant, for rehabilitating Unibank. During the loan implementation phase, the Bank has secured resources from a range of donors in support of the further institutional development and privatization of Unibank and the Savings Bank.

(3) *Financial Infrastructure Investment Component (US$2.0 million)*: This component is financed entirely from the currency pool loan. The Government has decided to undertake a modernization of the domestic payments and clearing system. In the first phase of development, which will be supported under the loan, the existing payments and clearing mechanism will be upgraded to Western

standards. This component will finance the acquisition of computer hardware and software equipment to assist the Bank of Latvia in the upgrading of the payments system. The component will be cofinanced by EC PHARE and bilateral donors. If, subsequently, grant sources are identified to finance equipment needs, the proceeds of this component will be reallocated to the credit line component.

9. **Project Implementation.** The proposed project would be supported by the establishment of a strengthened Project Management Unit in the Ministry of Finance and a new Technical Unit that will be an independent state entity. The project cost is estimated at US$114 million equivalent, with a foreign exchange component of US$61 million equivalent (54%). The Bank's standard variable interest rate would be charged on the disbursed portion of the currency pool loan. For the single currency loan -- in US dollars and deutsche mark -- the Bank's standard LIBOR-based interest rate for the relevant currency will be charged. Of the total financing requirement of US$114 million, the Bank will finance US$35 million (31%). A breakdown of costs and the financing plan are shown in Schedule A. Amounts and methods of procurement and of disbursements, and the disbursement schedule are shown in Schedule B. A timetable of key project processing events and the status of Bank Group operations in the Republic of Latvia are given in Schedules C and D, respectively. A map is also attached. The Staff Appraisal Report, No. 12977 LV dated August 5, 1994, is being distributed separately.

10. **Agreements reached at Negotiations.** Agreements were reached at Negotiations on: (1) the overall structuring of the loan; (2) the organization, staffing, functions and financing of the PMU and TU; (3) the guidelines for the Credit Line Regulations Manual and the Operating Procedures for the TU; (4) the framework for the Special Performance and Monitoring Program for participating banks, and; (5) environmental review procedures and the content and scope of environmental technical assistance. In addition, agreements were reached on two "set asides." First, a set aside of US$10 million equivalent of loan funds for newly-privatized enterprises that become eligible for subloans. This set aside would be in effect for the first eighteen months following loan effectiveness. Second, a set aside of US$2 million for the Swedish Capital Fund (SCF) for eligible participating financial institutions (PFIs). This would be in effect for the first nine months following loan effectiveness. The funds from the set aside will be disbursed to specific PFIs eligible for participation in the SCF established under an Agreement, acceptable to the Bank, between the Borrower and the Government of Sweden. The following conditions of effectiveness were established: (i) the Subsidiary Loan Agreements between at least two participating banks and the Bond Redemption Agreement for Unibank, satisfactory to the Bank, must have been executed by the relevant parties; (ii) a Financial Agency Agreement, satisfactory to the Bank, must have been signed and a Separate Project Account must be opened at the Bank of Latvia on behalf of the Republic; (iii) the TU must have been staffed in a manner satisfactory to the Bank; (iv) an environmental screening procedure for subproject financing, satisfactory to the Bank, must be established (including an Environmental Assessment Manual); (v) a model of the Subloan Agreement, satisfactory to the Bank, must be submitted to the Bank; (vi) a privatization program for Unibank, satisfactory to the Bank, must be prepared; and (vii) the Credit Line Regulations Manual and the Operating Procedures of the TU must have been agreed with the Bank.

11. **Environmental Aspects.** This project is classified as a category "B" project involving intermediary lending. An environmental review mechanism will be built into the subproject approval process. Technical assistance will be provided to strengthen the capacities of the Ministry of Environment to monitor subprojects. Technical assistance will also be provided to help the Government develop legislation that will address the issue of liability for past pollution in regard to enterprises that are being privatized.

12. **Project Benefits.** The project will assist the marshalling and efficient allocation of resources in Latvia by enabling improved intermediation. The heavy emphasis in the project on the restructuring of the banking system, coupled with the strengthening of the financial infrastructure (through the upgrading of the payments system) will place the financial system in a better position to support an enhanced level of activity in the real sector. The project will also encourage new investment in the emerging enterprise sector through the provision of medium- and long-term credit. By acting as a catalyst to the privatization process it will improve the supply response in the economy and quicken the transition to a market based economic system. Undergirding all of the loan components is a major effort to support the development of institutions--and the associated skill transfers--that will be vital to the success of transition. The choice of single currency loan terms for a portion of the credit line will enable the onlending of that currency which is best suited to the needs of the subborrowers without requiring the government or the commercial banks to take the foreign exchange risk.

13. **Risks.** The project is being developed against the backdrop of a fragile coalition government. This increases the risk that project objectives could be undermined by a sudden change in government. Another risk is the development of unacceptably high budgetary costs associated with enterprise and financial restructuring that might act as a drag on the reform process. With regards to the channeling of the credit component, any resurgence of inflation would curtail the trend towards lower nominal interest rates. This could undermine the credit line by reducing the demand for credit by the private sector. Similarly, there is some possibility that the highly profitable trade transactions (involving trading in Russian commodities and metals which is stimulated by Russian prices below international levels), which have been financed at very high rates of interest, will not run down quickly. This type of financing is dominating bank lending and distorting the interest rate structure at present. A specific risk to the bank restructuring effort is that a further deterioration in the economy will lead to a significant future build-up of non-performing loans that would undermine the stability of the banking system. The LIBOR basis of the single currency loan component may create interest risk for those subborrowers whose revenues do not have the same interest rate sensitivity: credit appraisals should take into account the capability of subborrowers to manage this risk.

14. **Recommendation.** I am satisfied that the proposed loan would comply with the Articles of Agreement of Bank and recommend that the Executive Directors approve the proposed loan.

Lewis T. Preston
President

Attachments: Schedules A - D

Washington, D.C.
August 16, 1994

Schedule A

ENTERPRISE/FINANCIAL SECTOR RESTRUCTURING PROJECT

(US$ million)

Estimated Costs and Financing Plan
(US$ 113.6 million)

	Local	Foreign	Total
Estimated Project Cost			
Credit Line	6.20	29.58	35.78
Institutional Development	45.70	23.03	68.73
Financial Infrastructure Investment	0.80	8.30	9.10
Total Cost	**52.70**	**60.91**	**113.61**
Financing Plan			
IBRD		35.00	
Other Bilateral Donors		11.68	
EC PHARE		3.63	
Gov't of Sweden		10.60	
Gov't of Latvia	46.50		
Participating Banks	6.00		
Beneficiaries	0.20		
Total	**52.70**	**60.91**	**113.61**

ENTERPRISE/FINANCIAL SECTOR RESTRUCTURING PROJECT

(US$ million)

Summary of Proposed Procurement Arrangements
(US$113.6 million equivalent)[1]

	ICB	LCB	OTH	N.B.F.	TOTAL
Credit Line	2.0 (1.0)	5.0 (4.0)	30.8 (24.6)[3]	8.0	45.8 (29.6)
Institutional Development			3.4 (3.4)[4]	17.2	20.6 (3.4)
Financial Infrastructure Investment			2.0 (2.0)[5]	0.2	2.2 (2.0)
Other[2]				45.0	45.0
TOTAL	**2.0** **(1.0)**	**5.0** **(4.0)**	**36.2** **(30.0)**	**70.4**	**113.6** **(35.0)**

[1] Figures in parentheses are the respective amounts financed by the Bank loan.

[2] This category represents the approximate budgetary cost for the Government of Latvia of paying interest (for three years) on the government bonds that have been placed on the balance sheets of Unibank and the Savings Bank in replacement of non-performing loans.

[3] Other is expected to include goods, works and services procured under commercial practices (US$16.6 million) and through International Shopping (US$8 million).

[4] For technical assistance, services will be procured according to the Bank's Guidelines on the Use of Consultants (1981). Procurement of recurrent costs required for the operation of the TU will follow a program previously agreed with the Bank. Office equipment would be procured through local shopping.

[5] This is expected to be procured through International Shopping. However, because of the amount and cost of the equipment, there might eventually be a need to procure some of it through ICB.

LATVIA ENTERPRISE AND FINANCIAL SECTOR RESTRUCTURING

IBRD Disbursements

Category	Amount (US$000)	Percent of Expenditures to be financed
Credit Line		
Goods and services under approved subloans	28.6	100% of foreign expenditure (C.I.F.), and local expenditures (ex-factory costs, and consultants' services); 80% of expenditures for other items procured locally.
Unallocated Funds	1.0	
Institutional Development		
Consulting Services	2.5	100% of expenditures
Incremental Recurring Costs of Operating the TU	0.4	100% of expenditures
Equipment and Materials	0.5	100% of foreign expenditures (C.I.F.), and local expenditures (ex-factory costs); 80% of expenditures for other items procured locally.
Financial Infrastructure Investment		
Computer Hardware & Software	2.0	100% of foreign expenditures (C.I.F.), and local expenditures (ex-factory costs); 80% of expenditures for other items procured locally.
TOTAL	35.0	

Estimated IBRD Disbursements

(US$ Millions)

	FY95	FY96	FY97	FY98
Annual	8	12	10	5
Cumulative	8	20	30	35

Schedule C

ENTERPRISE/FINANCIAL SECTOR RESTRUCTURING PROJECT

Timetable of Key Project Processing Events

(a)	Time taken to prepare the project:	12 months, Beg-March 1993 - End- March 1994
(b)	Prepared by:	Foreign consultants and Government with Bank Assistance
(c)	First Bank mission:	March 1993
(d)	Appraisal mission departure:	February 1994
(e)	Negotiations:	June 1994
(f)	Board Presentation:	September 1994
(g)	Planned date of effectiveness:	October 1994
(h)	List of relevant PCRs and PPARs:	N.A.

The project was prepared by Alexander E. Fleming, Principal Financial Economist, Privatization and Enterprise Development Division, Country Department IV, Europe and Central Asia Region.

Schedule D

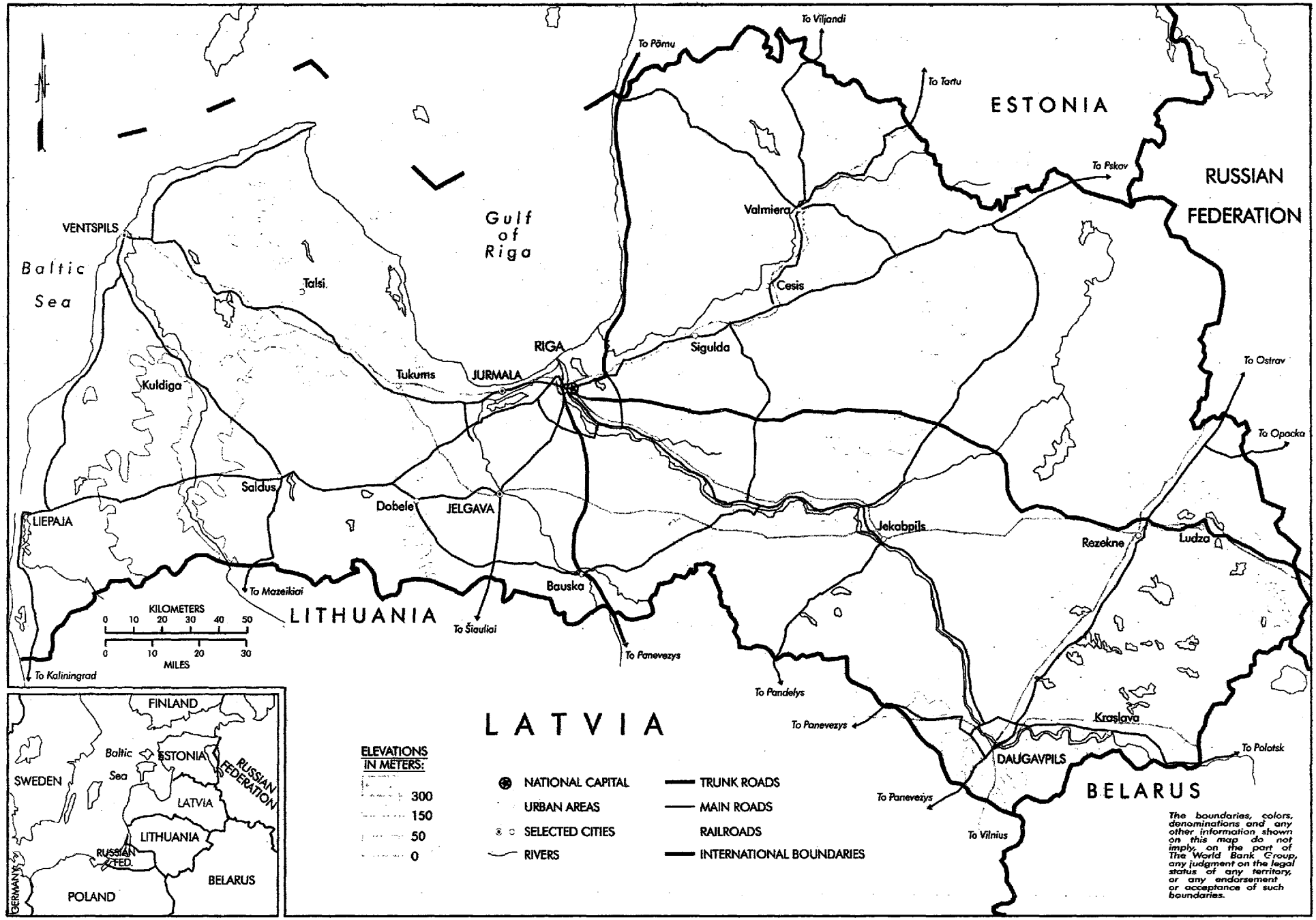
LATVIA
ENTERPRISE/FINANCIAL SECTOR RESTRUCTURING

A. Statement of Bank Loans
(As of July 20, 1994)

Loan No.	Fiscal Year	Borrower	Project	US$ Million (less cancellations) Loan	Undisbursed
35250 LV	1993	Rep. of Latvia	Rehabilitation	45.0	12.0
3695 LV	1994	Rep. of Latvia	Agriculture	25.0	23.0
		Total			
		Of Which: Repaid		00.0	
		Total held by Bank		70.0	
		Total amount sold		00.0	
		of Which: Repaid		00.0	
		Total undisbursed		35.0	

B. Statement of IFC Investments
(As of July 20, 1994)

Expected Board Date	Fiscal Year	Borrower	Project	Amount (US$ million)
September 1994	1995	Lattelekom	Infrastructure	16.4



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