REPORT AND RECOMMENDATIONS
of the
PRESIDENT
to the
EXECUTIVE DIRECTORS
on the
PROPOSED LOAN
to the
CORPORACION DE FOMENTO DE LA PRODUCCION
and the
COMPANIA MANUFACTURERA DE PAPELES Y CARTONES
AS CO-BORROWERS
FOR THE CONSTRUCTION OF A NEWSPRINT AND A CHEMICAL PULP PLANT

September 2, 1953
1. I submit herewith a report and recommendations on a proposed loan of $20,000,000 to the Corporacion de Fomento de la Produccion and the Compania Manufacturera de Papeles y Cartones for a pulp and paper project in Chile.

**PART I - HISTORY OF NEGOTIATIONS**

2. Cia. Manufacturera de Papeles y Cartones approached the Bank early in 1950 with a project for the construction of a chemical pulp mill and a newsprint plant in Chile. In October and December 1951, representatives of the company visited Washington and presented a preliminary project to the Bank for its consideration. After studying this project, the Bank indicated that it was prepared to negotiate a loan to finance its foreign exchange costs provided investigations in the field showed it to be economically and technically sound.

3. In February 1952 Bank representatives visited Chile to examine further the technical, financial, and economic aspects of the project and in June-July of that year loan negotiations were conducted. However these negotiations were interrupted when the conditions under which the then government would guarantee the loan became the subject of active political debate in Chile. Agreement on these conditions was recently reached between the new Chilean Government and the company, and on August 31, 1953, formal negotiations were resumed.

**PART II - DESCRIPTION OF THE PROPOSED LOAN**

The Borrowers

4. The loan would be made to the Corporacion de Fomento de la Produccion and to the Compania Manufacturera de Papeles y Cartones, S.A., as co-borrowers. Fomento is a government corporation, established in 1939 for the purpose of carrying out the government's development policies. Compania Manufacturera de Papeles y Cartones, S.A. is a private joint-stock corporation established in 1920 and is the only pulp and paper manufacturer in Chile.

5. The agreement mentioned in paragraph 3 above forms the basis for the Government's guarantee of the loan and sets forth the conditions under which Fomento would become a co-borrower. It provides, inter alia,
that Fomento will have a non-voting member on the company's Board of Directors, will be entitled to buy from the company up to 5,000 tons of chemical pulp annually at cost plus 10%, and will have a 10% participation in dividends paid in excess of 84 million pesos per annum. The agreement expires when the Bank loan is repaid.

Guarantor

6. The loan would be guaranteed by the Republic of Chile, a member of the Bank.

Amount

7. The loan would be for an amount in various currencies equivalent to US $20.0 million.

Purpose

8. The proceeds of the loan would be used by Compania Manufacturera de Papeles y Cartones to finance the foreign exchange costs of constructing a paper and pulp project and would cover interest and other loan charges during the period of construction.

9. The project would consist of two plants, one located at Concepcion and the other in the Central Valley at Laja. The plant at Concepcion is designed to make 44,000 tons of newsprint, and 6,600 tons of boxboard per year from ground wood, chemical pulp and scrap paper. The plant at Laja is designed to make about 50,000 tons of chemical pulp and to manufacture 10,000 tons of kraft paper annually. Both the boxboard and the kraft paper machines are presently owned by the company and will be transferred to their respective sites from the company's plant at Puerto Alto. They will also be modernized with part of the proceeds of the loan to insure greater efficiency of operation.

Terms

10. The loan would bear interest at the rate of 5% including the statutory commission of 1%.

11. The commitment charge would be 3/4 of 1% per annum and would accrue from the Effective Date of the loan or from 90 days after signature of the Loan Agreement, whichever is the earlier.

12. The loan would be for a term of 17 years with a 4 year period of grace conforming to the expected period of construction. It would be amortized by semi-annual payments beginning May 15, 1958, and ending November 15, 1970 as set out in Schedule 1 of the proposed Loan Agreement.

Legal Instruments and Legal Authority

13. Drafts of the following legal instruments, which would be executed to give effect to the proposed loan, are attached:
(i) A Loan Agreement between Fomento and the company as co-borrowers and the Bank.


(iii) A translation of the form of mortgage and industrial pledge to be executed by the company in favor of the Bank.


Special Provisions of the Loan and Guarantee Agreements

15. The following are the principal differences between the draft Loan and Guarantee Agreements relating to the proposed Chilean paper and pulp loan and the usual forms of agreements:

A. Loan Agreement

(i) The loan would be made to Fomento and the company as joint borrowers. The company is the principal party in interest, and obligations such as that to carry out the project are limited to it. Fomento must be a party because of the requirements of the Chilean guarantee legislation.

(ii) The notes to be issued under the Loan Agreement will be secured by a mortgage and industrial pledge executed pursuant to Chilean law, covering the properties of the company which will be included in the project, together with certain additional properties such as timber plantations. An original mortgage covering property now owned by the company will be executed as a condition of the effective date. Supplemental mortgages will be executed as property included in the project is acquired. (Article V).

(iii) Until the Bank has received a satisfactory mortgage covering all the property which is to be subjected to the lien of the mortgage, the company is prohibited from selling, mortgaging or otherwise disposing of any of its property other than in the normal course of its business (Section 6.05).

(iv) Because of the requirements of Chilean mortgage law, the Bank will receive notes rather than bonds to evidence the amount of the loan disbursed (Article IV and Schedule 5-A).

(v) Limitations are imposed upon the amount of interest-bearing debt which the company may incur (Section 6.04), upon the amount of cash dividends which it may pay and upon the amount of its own shares which it may acquire for cash (Section 6.12).

(vi) The company is required to maintain insurance satisfactory to the Bank covering the property to be mortgaged to the Bank (Section 6.09(b)).
(vii) If completion of the project may be delayed because the company does not have sufficient funds available, Fomento is required to supply the funds promptly and upon reasonable terms (Section 6.10).

(viii) In order to enable the Bank to exercise its rights under the mortgage promptly, the notes and mortgage have been excluded from operation of the arbitration clauses (Schedule 3).

B. Guarantee Agreement

(i) Since the loan would be made primarily to a private company, the Guarantee Agreement guarantees only payment of principal, interest and other charges and not performance of all obligations of the borrowers (Section 2.01).

(ii) To protect the company against a default solely on the part of the guarantor (e.g., a violation of the negative pledge) the Bank has no right under the Loan Agreement to premature the loan for a default by the guarantor under the Guarantee Agreement. In case of such a default by the guarantor, however, the Bank has the right to premature the loan against the guarantor. The guarantor then succeeds to the rights of the Bank under the mortgage, but not under the Loan Agreement, and may exercise its rights under the mortgage only in case of an event of default by the company under the mortgage (Loan Agreement, Schedule 3; Guarantee Agreement, Section 5.01).

PART III - APPRAISAL OF THE PROPOSED LOAN

16. The following documents are attached hereto:

(i) "Technical Report on Chemical Pulp and Newsprint Mills in Chile" (T.O.-33), which discusses the technical and financial aspects of the proposed project.

(ii) "Chile's Economic Position and Prospects" (W.H.-9A), which sets out the economic background against which the proposed loan is to be considered.

(iii) The report of the Committee provided for in Article III, Section 4(iii), of the Articles of Agreement of the Bank.

Justification of the Project

17. Chile embarked about thirty years ago on a program of afforestation in areas unsuited for agricultural development. Most of the young forests are now at the stage of requiring thinning in order to obtain timber of maximum value. Without facilities to convert these thinnings into pulp, they would for the most part be burnt or otherwise wasted. The present project is an important step, therefore, in the development of one of Chile's most important natural resources.
18. Chile possesses all the requirements necessary for production of newsprint and pulp at low cost. In addition to having ample reserves of wood it has the advantages of cheap power and labor and produces domestically all the necessary chemicals.

19. Consumption of paper and paper products in Chile is at present low. However it has been increasing steadily in recent years and it is expected that this increase will continue. During the early years of plant operation the newsprint and Kraft pulp mills are expected to have an excess capacity of 25% over domestic requirements. The production not needed for domestic consumption could in all probability be exported to the neighboring countries of Argentina, Uruguay, Peru and Bolivia, which are importing Kraft paper, pulp and newsprint in amounts substantially above the expected excess production in Chile. Operation of the mills at 45% of capacity, which is well below the level required to supply domestic needs, would still provide the funds to cover debt service.

20. From the balance of payments point of view, the contribution of the project would be of great value. In 1950, Chile's imports of newsprint and chemical pulp were valued at US $5.4 million, practically all in U.S. dollars. Assuming pre-Korean prices, the cost of importing newsprint and pulp requirements for 1960 would be about US $8.3 million. In that year, the project would not only fully satisfy the domestic market for these products, but would permit exports amounting to about US $2.7 million. The net contribution of the project to Chile's foreign exchange position after allowing the equivalent of US $2.3 million for debt service would, therefore, be the equivalent of approximately US $8.7 million annually.

Economic Situation

21. The outstanding developments in the Chilean economy in the last two years have been the increase in copper prices following the Korean War and the accelerated rate of inflation. The net proceeds to Chile from copper exports account for 70% of total dollar earnings and 50% of total foreign exchange. Consequently the rate of new investment and the importation of capital goods necessary for the economy's development are closely linked to copper. In the last two years copper proceeds rose from $105 million to $222 million and total imports increased 52%, with at least one-half of this increase going into additional purchases of capital goods. Reserves of gold and foreign exchange also increased from $75 million at the end of 1949 to $98 million by January 1953.

22. The decline now being felt in copper prices will check this recent spurt and the economy may be expected to level off with imports remaining at the 1950 level. This downward adjustment may seem oppressive to any whose expectations have been overstimulated by recent developments, but judged from the perspective of 1946-50, the Chilean economy has been pushed to a new plateau. With appropriate monetary and fiscal policies it could remain there and consolidate the gains of the recent period; in fact, however, inflation remains a major threat.

23. Inflation, which has driven prices up 25-30% annually since 1950, can be largely attributed to a succession of government deficits and an expansion of commercial bank credit which combined to increase the money supply at an annual rate of 27% in these two years. To cope with this
problem, the new Chilean government, which took office in November 1952, has launched a stabilization program designed (1) to balance the government budget, thereby checking the major source of inflation, (2) to eliminate the preferential exchange rate subsidies, converting all imports (and eventually all exports) at 110 to the dollar, (3) to impose quantitative and qualitative controls on commercial bank credit as an additional brake on inflation. The stabilization program is well conceived technically but it can be carried to a successful conclusion only if the government remains resolute in the face of powerful inflationary forces.

24. External debt payments will average $25 million during 1954-58, which is expected to represent 9% of total exchange availabilities but 13% of net dollar proceeds. After 1958 the average debt schedule will be reduced about $10 million and will absorb about 7% of estimated dollar availabilities. The scheduled service on the proposed pulp and paper project begins in 1958, and does not burden the debt service in the peak years 1956-57. Moreover, substantial exchange savings and some exchange earnings will be realized by the new plant which will make it self-liquidating in the balance of payments.

Prospect of Fulfillment of Obligations

25. The Compania Manufacturera de Papeles y Cartones, S.A. is a well managed joint stock company whose shares are distributed among over 7,000 stockholders. It has a long record of consistently profitable operations and is amply qualified to undertake the proposed project.

26. The local currency cost of the project would be about 690 million pesos, which at the conversion rate of 110 pesos per US $1, would amount to US $6.3 million, representing about 23% of the estimated cost of the project. The company expects to be able to finance the local currency cost from its own resources and from small bank loans of a short term. If, however, a shortage of local funds should at any time threaten to hinder the progress of the project, Fomento would be responsible for making available the additional monies required.

27. Amortization payments are not scheduled to begin until 4 years after the signing of the loan, by which time the project is expected to be completed. Once the new plants are in operation, the company's earnings should be more than adequate to cover service payments on the loan. In fact it is calculated that the company could service the loan even if these plants operated at only 45% of capacity.

PART IV - COMPLIANCE WITH ARTICLES OF AGREEMENT

28. I am satisfied that the proposed loan will comply with the requirements of the Articles of Agreement of the Bank.
PART V - RECOMMENDATIONS

29. I recommend that the Bank make a loan of $20.0 million to the Corporacion de Fomento de la Produccion and the Compania Manufacturera de Papeles y Cartones, S.A. for a term of 17 years at such rates and on such other terms as are specified in the attached draft Loan and Guarantee Agreements.

Eugene R. Black

September 4, 1953