Report No. PID9756

Project Name	EAST TIMOR-Second Small Enterprises Project @
Region	East Asia and Pacific Region
Sector	Small Scale Enterprise
Project ID	TPPE72654
Borrower(s)	RECIPIENT: EAST TIMOR Implementing Agency Address GOVERNMENT OF EAST TIMOR AND CAIXA GERAL DE DEPÆSITOS GOVERNMENT OF EAST TIMOR, SEP II Project Implementation Unit Address: Division of Industry, Mineral Resources & Tourism; Department of Economic Affairs; Dili, East Timor Contact Person: Candido da ConceiÓã Manager Tel: 670-390-312-210 x5920 Fax: 670-390-322-008 Email: daconceicao@un.org CAIXA GERAL DE DEPÆSITOS Address: Departamento de Timor; Dili, East Timor Contact Person: João Manuel Tubal GonÓalves, Director Tel: 670-390-323-676 Fax: 670-390-323-678 Email:bnu.timor@arafura.net.au
Environment Category	B
Date PID Prepared	September 28, 2001
Projected Appraisal Date	January 29 - March 8, 2001
Projected Board Date	September 28, 2001

1. Country and Sector Background

Issues:(i) Economic situation: Improving East Timor's economic performance is the key sector issue and has been identified as critical to East Timor's reconstruction and development over the medium- to long-term. East Timor's economy was growing solidly in the three years to 1996 at a rate of about 10% per annum. Following the Asian financial crisis, GDP growth slowed in 1997 to 4% and then contracted slightly in 1998 by 2%. Post-referendum violence in 1999 is estimated to have reduced East Timor's 1999 GDP by between 38% and 45%. Supported by reconstruction efforts and the commencement of renewed private sector activity, the IMF forecast a return to economic growth of 15% year-over-year in calendar years 2000 and 2001. UNTAET has since estimated economic growth for the 2000-2001 financial year to have reached 50% with forecast growth for financial year 2002-2003 of 5-15%. In the immediate aftermath of the post-referendum violence, inflation was high and variable. Inflation has

since abated and, in fact, UNTAET has estimated that in the 11 months to May 2001 there was price deflation of 5.5%. The current account deficit was expected to reach approximately 55% of GDP in early 2001. Negotiations with Australia regarding arrangements for the Timor Gap oil and gas resources have been partially concluded resulting in an agreement for a 90/10 split of revenue proceeds in East Timor's favor. Although East Timor is already in receipt of minor revenues from the Elang Kakatua concession, the vastly greater projected revenues from the Bayu Undan and Greater Sunrise concessions are not expected to commence until 2004-2005. Only limited long-term private sector investment is materializing. The majority of investment to date is seeking to meet the one-off demands of the large international staff presence. Wage and other market distortions are emerging due to this demand shock. Savings are at a reasonable level. A formal credit system is not yet functioning beyond nascent microfinance programs and SEP I's line of credit which is being intermediated by Caixa Geral de Depósitos (CGD) of Portugal. However, the ADB's microfinance project is now underway and the ANZ Bank from Australia has also established operations in Dili.(ii) Unemployment: UN estimates, reported in July 2000 by the IMF, suggested underemployment and unemployment could be as high as 80%. Since then, however, the evidence indicates that the informal and agricultural sectors seem to be keeping the vast majority of people gainfully occupied. Several employment generation projects, including by USAID's Office of Transitional Initiatives, UNTAET, JICA, and the Community Empowerment Project (CEP), temporarily mitigated the early unemployment problem to some degree. Notwithstanding the estimated high underemployment and unemployment IMF figures, it should be noted that approximately 85% of the population is occupied to some extent with agriculture. Thus it is likely that the true level of unemployment and underemployment is relatively low. SEP I is estimated to have so far directly generated over 1100 new jobs with many more jobs indirectly generated. The UNDP and ILO are planning to conduct in July/August 2001 a small study on the informal sector and this should provide a clearer picture of job take-up rates within the economy. SEP I evaluation programs are focusing on obtaining an accurate measure of recent employment generation induced by the project. A cautionary note on employment is that many of the newly created positions in Dili have been generated by the one-time-only demand shock of the multilateral donor effort in East Timor. The impending down-sizing of the international operations in Dili will have a strong negative impact on employment levels. The plan to graduate over time the withdrawal of UN and other international personnel will help soften this negative shock.(iii) Infrastructure and services conditions: Despite a large scale rehabilitation effort, many essential services remain unavailable and infrastructure remains debilitated. This has a strong limiting effect on restoration of private sector activity and the development of other areas. All of telecommunications, airlines, transport and shipping remain weakened compared to pre-1999 capacity. Although a policy on telecommunications has recently been adopted, it is unlikely that a national telecommunications system will be in place within the next 18 to 24 months. This has multiple implications for development of the private sector, especially for enterprises outside of Dili. Banking and public utility services, and especially electricity outside of Dili, remain extremely limited and basic. Air services to/from Dili are slowly improving. The operations of the air and sea ports and customs are operating relatively efficiently. The road rehabilitation program, given

physical and financial constraints, is also proceeding at an effective rate but commerce is plagued by regular road flooding and wash-outs. (iv) Preparing for an industrial/service economy: The agriculture sector relatively rapidly resumed seasonal production following the 1999 destruction which had interrupted cropping cycles. This quick response lessened the humanitarian impact of the crisis and has since ameliorated the worst of the unemployment situation. The agriculture sector is now targeted for large improvements in yield and productivity. The proportion of workers employed in the agriculture sector is estimated at approximately 85%; this level will likely fall as workers make the transition to the industrial/service sector of the economy. In concert with this, there is the need for: prevention of over-urbanization; increases in labor and capital productivity; better access to capital; improved education; and higher capital/labor ratios in production.(v) Enabling frameworks: In order to enhance the development of the private sector, several priority frameworks must be improved. This includes the rule of law, the preservation of peace and security, and sound administration. The successful implementation of these frameworks will determine the ability of the private sector to flourish via reduced investor risk, minimized distortions and corruption, and inflows of Foreign Direct Investment (FDI). Pursuant to the forthcoming 30 August 2001 national elections, the Constituent Assembly will form and will be tasked to prepare and adopt a National Constitution and then transform into the National Parliament on 15 December 2001. East Timor will then be better placed to enter into a range of formal international agreements. During the interregnum, however, the domestic legislative agenda will be delayed. The achievement of full independence, and thus national sovereignty, will also confer a number of advantages on East Timor in areas such as foreign trade and national maritime boundaries. (vi) Business environment: Numerous issues related to the business environment require additional attention by government. Microfinance facilities are not yet readily available. General banking facilities and access to services and capital remain limited. Other business services such as legal and accounting remain largely unavailable and, in any case, are inhibited by the lack of agreed professional standards and conventions. There is no collateral law. There is no form of regulated security against which borrowers can apply for credit and no certainty regarding foreclosure procedures on collateralized assets which may be repossessed by banks in response to loan default. Also, there is no insurance law and no regulation on credit information-sharing. Draft company, foreign investment and labor laws have been prepared but have not progressed through the administration for many months. Conditions surrounding land law remain highly uncertain and do not yet provide serious investors with prerequisite guarantees. Potential and existing foreign and domestic investors view political risk as high. The Bank's forthcoming Country Economic Memorandum will make recommendations against some of these issues.(vii) Recurrent budget implications: SEP II has been designed with the aim of limiting the potential of the project on the future government's limited budgetary resources. As in SEP I, repaid loan funds at the end of the project's life will revert to East Timor's consolidated revenue. Assuming an overall rate of repayment of 80%, East Timor will receive $3.2 million in repaid loan funds at the end of SEP II's life. Along with repaid loan funds under SEP I and the increased capacity of the East Timorese involved with the SME lending program, East Timor will be well resourced to establish an organic SME lending capacity. Other parts

of the project are essentially service delivery and explicitly seek future private sector replication of BDS thus building in sustainability of off-budget service delivery. The market rehabilitation component includes an allotment of funds to pay for maintenance and training for market management groups to ensure self-reliance in the upkeep of the rehabilitated markets. Steps to ameliorate the risk of general contingent recurrent budget implications were discussed widely with UNTAET.(viii) Future negative demand shock: Noting the scheduled timing of elections and independence, a large portion of the international staff presence will begin to withdraw during the first year of the life of SEP II. It is hoped the withdrawal will occur as steadily as possible. But this withdrawal will cause a large negative demand shock across the economy, with the effects being most profound in Dili where international spending is concentrated.(ix) "Timorization": It is becoming increasingly important to ensure that East Timorese civil servants benefit from capacity building and skills transferal, especially as the transition to self-rule approaches. In support of this, it has been agreed that the SEP II Project Implementation Unit (PIU) will be headed by an East Timorese government official, and staffed by East Timorese professionals. The notable exception is that an international advisor will be recruited to assist on a part-time basis with procurement, project and financial management. Strategy:UNTAET bears the responsibility of governing East Timor during the transition to self-rule (currently scheduled for 15 December 2001) and has focused first, on humanitarian relief and establishing security, and thereafter on creating a new regulatory framework and a social safety net. UNTAET has issued regulations regarding, inter alia, legal tender, foreign exchange, bank licensing and supervision, business registration, a services tax, import duty and excise tax, income and wages tax, and judicial and administrative arrangements.Based on agreements at the 1999 donors' meeting in Tokyo, the ADB was given responsibility for infrastructure needs and microfinance, and IDA was given responsibility for the private and social sectors, sub-district institution building, and agriculture. Donors also funded numerous employment generation projects designed to have a quick positive impact on casual employment rates as well as to help restore essential infrastructure expeditiously.Creating economically sustainable business activity and jobs is a cornerstone of East Timor's development strategy, especially for the medium- and long-term. Accordingly, UNTAET has set about instituting appropriate enabling frameworks to support the business environment. UNTAET, in conjunction with the East Timorese leadership, effected a prudent 2000-2001 budget and a lean civil service. A similarly prudent 2001-2002 budget has been cast with revenue and expenditure projections out to 2004-2005. A study of the foreign investment regulatory environment has been carried out by the Foreign Investment Advisory Service (FIAS.) SEP I funded an extensive study on land and property administration in East Timor. Appropriate strengthening of land issues is seen as an essential means to increasing investment confidence.UNTAET is also working at institutional strengthening and increased power-sharing with East Timorese decision-makers in the lead up to the 30 August 2001 elections. It is recognized that a well-instituted, small administration, bolstered by a growing economy, will give the incoming independent government its best chance of success. In support of this strategy, the TSS calls for support to accelerate the recovery of the private sector, especially in sectors and industries that generate the maximum number of new jobs on a competitive basis. Additional assistance

to the private sector in rural and sub-district areas is to be given priority, as is proposed in SEP II. Further investment in service industries in Dili is to be limited. This approach supersedes SEP I which focused more on non-agricultural private sector enterprises which were facing greater start-up barriers such as the loss of physical capital and ruined infrastructure as well as the extant absence of credit facilities.Large (and important) parts of the strategic donor response are yet to be fully implemented. The business enabling environment remains only slightly more advanced than at the time of the late 1999 JAM. While the SEP I-funded land study brought down lucid and workable recommendations, implementation will be a long term process. The current policy on foreign investment (with the exception of land investments by non-resident Indonesian citizens) is to approve all reasonable foreign ventures (via a supervisory committee system.) Meanwhile, no formalized and binding foreign investment procedures exist and many attractive features that reputable foreign investors look for remain absent. Limited microfinance operations have commenced but otherwise the credit system remains in disrepair. Along with restricted access to production inputs, and disrupted demand, these are the major constraints to restoring sustainable private sector activity.

2. Objectives

The main objectives of the Second Small Enterprises Project are to generate employment, accelerate economic growth, and improve SME competitiveness through providing an SME line of credit, capacity building focused on Private Sector Development (PSD), and rehabilitation of market infrastructure.The project has three components: the first provides funds for Caixa Geral de Depósitos to make loans to SMEs for business investment. The second component is capacity building on private sector development: for SMEs -- business development services, including training to improve business management; for policy makers-- technical assistance to develop the analytical skills of operational level PSD policy makers, and to design and implement business legal and regulatory environment. The third component finances community-based rehabilitation of market infrastructure.

3. Rationale for Bank's Involvement

Following the post-referendum violence, East Timor has no independently operating credit or banking system. And until adequate institutions, laws, and business and sector frameworks are in place, independent banking operations will either be slow to commence operations or will not commence at all. This means the supply of credit to East Timor is severely limited without outside assistance. Further, in the lead-up to the referendum, the credit culture was affected by a politically motivated program encouraging East Timorese to default on Indonesian loans. IDA support to a banking operation such as that offered by CGD provides greater security to lenders and encourages their activities.Additional value-adding support is offered in the form of TA for development of the business regulatory environment and advances in this area are intended to complement the lending environment in which SEP II operates. Likewise, other components such as the market rehabilitation component, delivery of Business Development Services and capacity building for desk-level PSD officials, will add specific value by both drawing on the Bank's particular expertise and experience in delivery similar interventions elsewhere and in that they are all designed to be mutually complementary and reinforcing.

4. Description

Project Component 1 - SME Line of Credit - US$ 4.44 millionSME Line of CreditTo meet continued outstanding demand for SME loans, and noting that no other independent SME lending facility is yet available, a further $4.44 million line of credit will be offered on commercial terms under SEP II. The SEP II line of credit will draw extensively upon lessons learned during SEP I. Accordingly, the line of credit will be similar in style and function to that in SEP I but will incorporate adjustments to the delivery method, targeting, interest rate and management processes.The Grant will finance $4.00 million of the $4.44 million SME line of credit. The Grant contribution of $4.00 million represents 90% of the total credit line. The remaining 10 percent of the credit line, $0.44 million, would be contributed by Caixa Geral de Depósitos (CGD), the financial intermediary and project entity for the SME line of credit component. CGD was formerly known as Caixa Geral de Depósitos or CGD. This represents CGD's contribution to a 10 percent risk-sharing arrangement as part of the line of credit.The SEP II line of credit will provide increased focus on the agriculture sector and agri-business opportunities, and in support of this $2.00 million of the total loan funds will be earmarked for agri-business endeavors. Apart from this earmarked amount, the line of credit will not seek to target particular agri-business activities (e.g. equipment for canning or bottling operations, fish and meat processing, roasting and packaging operations for coffee targeted to the export market, livestock trading, corn oil production, copra processing). In addition to the agri-business sector, viable loan applications from other productive industries such as small-scale carpentry shops, mechanical centers or manufacturing facilities also will be supported. The SEP II line of credit will discourage financing of smaller service sector businesses (i.e. kiosks, taxis, restaurants), especially those deemed more susceptible to the future negative demand shock expected with the coming reduction in the size of the international staff presence in East Timor. A notable exception to this would be businesses servicing the prospective tourism sector. Consideration may be given to extension of credit to smaller financial institutions, such as microfinance organizations wanting to develop their own lending programs for the lower range of SME lending (say $500 - $1000 loans), especially with the aim of horizontal expansion of operations into outlying districts and sub-districts.Following a comprehensive appraisal of the financial institutions in East Timor, it has been agreed to reappoint CGD, a Portuguese state-owned commercial bank, as the project entity for SEP II. (The appraisal of the candidate financial institutions has been separately documented.) In brief, CGD was determined to be the most appropriate financial intermediary for the following reasons. First, CGD has built up valuable experience during SEP I in delivering SME lending in East Timor, especially in the outlying districts. CGD management has agreed to establish a permanent staff presence at the district capitals of Dili, Baucau, Maliana, Oecussi. The staff will hold regularly scheduled office hours in the SEP Business Development Centers, make disbursements, and track and enforce repayments. The CGD district staff also will service the remaining districts, as well as the sub-district levels. This is expected to have a strong positive effect on district loan management and repayment rates. The second reason to reappoint CGD is that ANZ, the other full service bank in East Timor, decided that it was not prepared to administer the line of credit at this time. Third, the resident microfinance institutions, whose operations remain strictly microcredit-related, were

fully appraised and deemed to be unsuited at this time to deliver a $4.44 million SME line of credit. Following from the success of their lending under SEP I, CGD has committed in SEP II to assume 10 percent of the risk of the line of credit. For example, for every $100 lent under the project, $90 would be from SEP funds and $10 from CGD. Repayments, too, would be allocated according to the same 90:10 ratio. Under SEP I, CGD had none of its own capital at risk. This was an unavoidable arrangement in SEP I in the aftermath of the devastation following the 1999 popular consultation. However, noting the improved economic and business climate, the steady progress toward transition, improved information, and the high level of repayment to date under SEP I (>84 percent to date), it is assessed as reasonable and, moreover, advantageous for a portion of lending risk now to be assumed by CGD. Risk-sharing by CGD will help improve the loan analysis process, enhance loan management and performance, and help shore up the credit culture. CGD's assumption of a small portion of the risk also will transmit a strong signaling effect to the market that the level of risk involved in lending to SMEs, including those outside of Dili, has fallen by at least the same amount as the level of lending risk to be assumed by CGD in SEP II.Like SEP I, the SEP II line of credit will operate on a revolving basis. Once loan monies are repaid they become eligible again for re-lending. Following the close of the project and the final repayment cycle, the repaid loan funds revert to the future government. One option is for the repaid project funds (estimated at 80 percent of the original value of the line of credit - $3.2 million) to be injected into the paid-up capital of the Microfinance Development Bank planned to be established by the ADB, rather than allocating it to consolidated government revenue. The funds would then be demarcated as a separate lending window for SMEs, thus helping to ensure the sustainable impact of the SEP II SME lending intervention. Another means of enhancing sustainability is the training and experience in SME lending being accrued by CGD facilitators as well as by CGD as an organization. In addition, the capacity-building component of the project (see below) will skill East Timorese in making loan applications of a standard acceptable to SME lenders (as distinct from microfinance providers).With a view toward sustainability of SME lending in East Timor, the interest rate will be increased to 14 percent per annum from the previous rate of 10 percent, reflecting a move away from the subsidized rate and toward a more market rate. As the only commercial entity lending its own funds in East Timor, CGD expects a return of approximately 18 percent on fully secured US dollar loans. (It should be noted that SEP loans are not fully secured.) Given the high risk environment, it is calculated that another commercial bank on-lending its own capital would seek a significant interest spread on top of LIBOR that would put interest rates over 20 percent. The rate of 10 percent per annum under SEP I, therefore, includes a substantial subsidy. As in SEP I, the SEP II maximum loan term will remain at 36 months with an initial grace period of up to three months, in which case interest is capitalized. The repayment period should be as short as feasible and no loan repayment should be due after December 31, 2004. The terms and conditions of loans and services provided by CGD will remain the same. SEP II loans will normally be available in the range of $1,000 to $50,000.IDA, in coordination with Government, will conduct a review of the line of credit once $2.00 million of the $4.44 million is approved for lending by CGD. This is in addition to regular supervision missions by the Bank and other monitoring and audit procedures by the PIU. Further, should the loan performance rate fall beneath 80 percent then a review of

the portfolio and procedures is triggered. This will be conducted by IDA in coordination with Government.Project Component 2 - PSD Capacity-building - US$ 2.28 millionPSD Capacity-buildingThe Grant will provide a total of $2.24 million to finance the following activities:A. Business Development Services: 1. Consultant services for the operation and maintenance of the Business Development Center (BDC) network. 2. Consultant services to deliver Business Skills Training via the BDCs and other facilities. 3. Goods to furnish and equip the four Business Development Centers.B. Civil Servant Training: 1. Consultant services to deliver training on PSD issues to government staff members.C. Business/Regulatory Environment 1. Consultant services to provide technical assistance on the development of the business/regulatory framework.A. Business Development Services - $1.88 millionConsistent with the recommendations of the JAM and the TSS, and noting persistent and reasoned demand from the East Timorese leadership, business and wider community, and other agencies and donors working in East Timor, SEP II will finance a large commitment to the building of private sector capacity. The main objective of BDS financed under the project is to generate employment and increase productivity and economic growth.A principal underpinning of the Business Development Services (BDS) component is the line of credit. Specific BDS will be targeted to both existing and potential SEP I and SEP II borrowers. For approved borrowers, wide-ranging support will be offered to manage and develop the businesses, thus ensuring a higher level of loan performance. Potential borrowers will be assisted in developing a sound and well-presented project proposal before submission of a formal loan application to the implementing bank.BDS is also acutely required for much broader purposes: to build the capacity of the broader private sector community, especially in the 12 districts outside of Dili; to provide services to private microfinance providers and borrowers under other credit projects (including the credit unions to be rehabilitated under the ADB project); and, to provide training to business associations and market management groups. SEP II will provide for the contracting of the services of a consulting firm to deliver the training component under SEP II. A central tenet of the SEP II training component, as in SEP I, is to make a strong investment in train-the-trainer programs which will run over the life of the project. SEP II will finance the delivery of BDS via a variety of platforms. SEP I allocated financing for the rehabilitation of buildings obtained from government under a two-year "public use" lease to become Business Development Centers (BDCs). While the rehabilitation work of the BDC sites is funded under SEP I, a consulting firm will be contracted under SEP II to provide management and coordination of the BDCs and the coordination office. The four BDC sites -- Dili, Baucau, Oecussi and Bobonaro -- were chosen on the basis of a variety of factors including need, location and potential utility, and will be tasked (with the exception of Oecussi) to deliver services to the subordinate districts without dedicated BDCs. In support of the operations of the BDC network, a small separate office to be known as the BDC coordination office will be attached to the Dili BDC. The main task of the BDCs is to facilitate the delivery of BDS. Another principal function of the BDCs, through training to interested parties and demonstration effects, is to encourage the private sector replication of their services and facilities. The imposition of (in most cases, nominal) fees for services will be an important part of BDS delivery. The main purpose of fees will be to secure user commitment, rather than cost recovery, and to help pave the

way for later private sector commercialization of BDS. The fee structure will be concluded by the BDC consulting firm, and subject to review and approval by government and IDA.B. Civil Service Training on PSD - $0.15 millionA small (15-30 person) group of the East Timorese civil service will be given training in PSD theory and practice. The intent of the training is to build awareness of PSD issues within the public sector and to help prepare the civil service -- during and beyond the transition to independent government -- to deal with the various PSD policy issues they are likely to confront. The chosen staff will be drawn in large part from the Department of Economic Affairs. This approach is intended to help ensure that future PSD policy-making is well informed. The training, to be spread over the life of the project, will seek to demonstrate the coincidence between the coursework and the practical daily requirements of the recipient's work. The training will be delivered in East Timor, in generally brief (3-5 day) workshops for each phase. SEP II will fund the services of a consulting firm to provide the comprehensive training program to this target group over the life of the project.C. Business Regulatory Environment - $0.25 millionA central impediment to the successful development of East Timor's private sector in the medium- to long-term is the lack of a functioning business enabling environment. As East Timor takes on more and more of the precepts of an independent country, it will need additional resources devoted to the emplacement of a modern, international best-practice, and highly suitable private sector enabling framework. Given this, SEP II is including this component to provide sharply targeted assistance to the development of the business enabling environment. Thus, the work of this component is supportive of, and integrated with, the other aspects of this project, especially the lending program and the skilling of the public sector PSD staff. This component also is intended to follow on from the regulatory work done on the land and property administration in East Timor -- so important to PSD -- under SEP I.To implement this component, a consulting firm will be contracted to deliver ongoing technical assistance to the Department of Economic Affairs on a part-time basis. And, in an effort to build capacity beyond the public sector, the firm will be requested to sub-contract East Timorese lawyers as part of the team delivering the technical assistance. The goal is to abet local domestic capacity to consider and advance appropriate legislation and regulation, both from a technical legal point of view and especially from the point of view of practical policy implications. The range of areas to be supported will be wide, should not be overly prescribed at the outset of SEP II's project life, and will be somewhat subject to the discretion of the incumbent relevant minister for economic affairs.Project Component 3 - Market Rehabilitation - US$ 1.00 millionMarket RehabilitationThe Grant will provide a total of $1.00 million to fund sub-grants to the 13 districts of East Timor for market rehabilitation. In addition to supporting the creation of sustainable jobs through the SEP II lending program, the enhancement of the regulatory environment and BDS delivery, the appraisal work found strong demand and need for improved marketplace facilities, both at the district and sub-district level. Although some rehabilitative work on marketplaces has already occurred, the vast majority of active produce and goods markets remain in a state of either partial or total destruction or in a dilapidated condition due to lapsed maintenance. As a consequence, farmers and traders have often resorted to selling their goods on crowded sidewalks of larger district capitals, or at makeshift shelters surrounding the inoperative marketplaces. Such marketplace

infrastructure is an important economic and social focal-point for the population, benefiting a wide segment of the society. Marketplace rehabilitation work will have multiple benefits: employment generation at the district and sub-district levels; enhancement of valuable construction skills; and facilitation of improved trading conditions.As mentioned above, a small amount of market rehabilitation work has already occurred in the districts although several large projects have been implemented in Dili and Comoro. In order to determine what market rehabilitation work had been carried out or planned, as part of its pre-appraisal work IDA sent a survey to each district office and to the principal agencies involved with market rehabilitation. (The collated results of this survey are included in Annex 11). In short, the survey found relatively even demand for further market rehabilitation work across all districts. Taking into account the survey's findings, this component will allocate funds of $1 million roughly according to the relative populations of the 13 districts as follows: Dili - $167,000; Baucau - $120,000; Ermera - $111,000; Bobonaro - $84,000; Viqueque - $80,000; Lautem - $68,000; Oecussi - $66,000; Ainaro - $59,000; Liquica - $55,000; Kovalima - $54,000; Manufahi - $48,000; Manatuto - $45,000; and Aileu - $43,000. The BDS component will complement this market rehabilitation work in that it will provide capacity building training to market management groups to help them develop market management and maintenance plans.Following the survey and other appraisal work, and to help ensure the best allocation of resources, it has been determined to devolve responsibility for the implementation of this component to the district administrations working under guidance from the PIU. UNTAET/ETTA district offices are to seek (especially from the sub-districts) expressions of interest from various community-based market management groups. In many cases, rehabilitation work may only require a few thousand dollars. In other cases, larger marketplaces may require greater amounts of work. It will be up to the district administrations, in consultation with local communities, to prioritize the need for each proposed rehabilitation project. The community will assume responsibility, under district administration supervision, to manage and implement the rehabilitation work and to sub-contract services as necessary. Based on guidelines provided by the PIU for operating these sub-grants, each district office shall seek proposals from community-based market management groups for the rehabilitation of their markets.Project Component 4 - PIU Technical Assistance - US$0.31 million PIU Technical AssistanceUnder this component, the Grant will provide $0.26 million to finance the following activities:A. Consultant services to provide technical assistance to the Project Implementation Unit.B. Incremental operating costs for the Project Implementation Unit.C. Consultant services to provide for audits of the project.D. PIU training, including travel costs.E. Miscellaneous items for the PIU office.A PIU will be established within the Department of Economic Affairs; Division of Industry, Mineral Resources and Tourism to oversee SEP II implementation. The PIU will manage contracts for consultant services; submit related payment requests to CGD; oversee allocations for market rehabilitation; and produce monthly and other required reports on the project. An East Timorese government official has been appointed to the project as manager. The Grant will provide funding for technical assistance, including the following consultants: Finance Specialist, Business Development Specialist, Procurement Specialist. These three consultants, East Timorese nationals, will be aided by an international consultant to provide project management consulting, financial and

procurement services and maximum skills transfer. The PIU will be located in the Fomento Building. A further $10,000 has been set aside to fund environmental reviews, as necessary, of proposed projects to be financed under the SME line of credit and the market rehabilitation component. Government will contribute staff, equipment and infrastructure estimated to cost $0.05 million.

5. Financing
Total (US$m)
Total Project Cost $8.03 million (including $7.50 million from the Grant)

6. Implementation
The two main institutions involved are CGD and the government of East Timor.CGD. CGD is the project entity for implementation of the SME line of credit. CGD will:follow standard commercial bank practices, and rules as defined in the Project Manual to screen, evaluate and make decisions on loan proposals.provide loans from $1000 to $50,000 at 14% interest, with a grace period of up to 3 months (with capitalization of interest). A maximum repayment period of 36 months, including the grace period, is permitted. All loan repayments should be completed by December 31, 2004. CGD will provide current accounts at no cost to borrowers and pay foreign suppliers directly without charging money transfer fees. contribute CGD capital at the rate of 10% of the total loan amount. Thus, for every $100 that is lent under the project, $10 will be CGD capital, and $90 will be from the Grant funds. The repayments of principal will be restored to CGD at the same rate of 10%.hold regular office hours in the Dili headquarters of CGD, and in the Business Development Centers in Baucau, Maliana, and Oecussi. The district space will be provided to CGD in order to carry out transactions under the project; remuneration from CGD will not be sought.provide staff, transportation and security to service the district and sub-district populations beyond the four aforementioned districts in order to receive loan applications; disburse loan funds and collect repayments; and make regular visits to borrower projects. (District facilities, aerial transportation and security will require assistance from and coordination with the government.)use loan repayments to provide additional loans until the scheduled end of the project, December 31, 2003. However, in the event that the level of loan performance falls beneath 80% CGD shall cease the extension of any new loans, government and IDA will carry out a review of the loan portfolio and determine and agree on an appropriate course of remedial action.improve the Management Information System (MIS) under the project. The new MIS will track and allow for calculations of loan performance and collection ratios (including portfolio at risk by age, arrears rate, repayment rate, current recovery rate), and efficiency ratios.In addition, CGD will:provide monthly reports and statements of the operations under the loan program to the PIU and to IDA as well as succinct tables, quarterly reports and annual reports as required.allow an independent auditor to review the project accounts each year. CGD will be audited by an international audit firm that is acceptable to IDA; the audit by this firm, provided that it also provides more detailed audits of the loans under the project, would be acceptable. The audits need to be available within six months after the end of the fiscal year. CGD also will allow IDA staff to review progress during supervision missions.Compensation for CGD administration of the SME Line of Credit will be: CGD operating costs are to be covered with the 1.5% loan approval fee and the repayment of the interest fee of

14%. The fee levels were calculated assuming an 80% collection rate and an average loan repayment period of 2 years to cover monthly costs.To remunerate CGD for the 10% capital contribution to the loan amount as noted above, 10% of the principal component of each repayment will go to CGD, reflecting the same percentage of the capital contribution of CGD.From December 31, 2003 to December 31, 2004, all repayment proceeds will be held in a non-interest bearing account with CGD in the name of the government. By January 31, 2005, CGD will provide the government a financial statement with full disclosure of incomes and expenditures under the loan program.The implications of these provisions are discussed in Section E.2, Financial Analysis. (See Annex 4 for forecast cash flow, not including CGD's income from the government's non-interest bearing account.)Because the supervision of IDA normally ends when the Project Grant is fully disbursed, while the loan program will continue implementation beyond this completion date, the above safeguard provisions and dates have been agreed with the government and CGD and recorded in minutes of negotiations. This will supplement the Implementation Program included in the Project Agreement. If the project completion date is changed, then CGD and the Government will agree on the disposition/use of the funds.PIU. A PIU will be established within the Department of Economic Affairs; Division of Industry, Mineral Resources and Tourism. The PIU will be responsible for the overall monitoring and coordination of the project on behalf of government; managing procurement contracts; overseeing allocations for market rehabilitation; and, producing monthly and other required progress reports on the project to IDA. An East Timorese government official has been allocated to the project as PIU manager. The PIU will have other full-time East Timorese staff: Finance Specialist, responsible for project bookkeeping and financial management, and PIU tasks under the SME Line of Credit component; Business Specialist, responsible for PIU tasks under PSD Capacity-building component and Market Rehabilitation component; and Procurement Specialist, responsible for procurement processing and contract management. Also, a PIU international consultant will be contracted on a part-time basis over the life of the project to provide management, financial and procurement consulting services and maximum skills transfer. Other East Timorese staff will be appointed as consultants to the project as necessary. The PIU will be located within the Fomento government building.

7. Sustainability

The project aims to generate a sustainable impact via all of its lending, capacity-building and market rehabilitation components. At the micro-level, the line of credit is designed to provide credit to viable private businesses which will continue to operate well beyond the immediate life of the project. At the macro-level, the lending is designed to help kick-start the overall private sector, and to foster private sector replication of SME lending. The project's other components such as private sector capacity building are all designed to produce sustainable long-term benefits, even though the project itself is only scheduled to run for two years. A central tenet throughout the delivery of the BDS component is the aim of promoting private sector replication of the BDS. The support to the business regulatory environment is designed to produce a long-term enabling framework with long run benefits. The market rehabilitation component's employment generation will be more short term in nature but the benefits of improved market facilities will provide sustained benefits in terms of improving access to markets and attracting

more traders. Sustainability is also addressed individually in each component description.

8. Lessons learned from past operations in the country/sector
Although SEP I is still at a relatively early stage of implementation, the experience gained during SEP I is of considerable benefit in designing and implementing SEP II. The limiting effect of weaknesses of physical infrastructure on banking operations is apparent. The continuing lack of uncertainty regarding land and property title reduces the viability and bankability of many business projects. By extension, the lack of a securities law allowing lenders to take mortgages also restricts credit provision. The limited capacity of human resources in East Timor hampers implementation.SEP I has so far revealed considerable difficulties in disbursement. This is largely due to procedural and training impediments. In some cases, there has been an overly long delay between approval of a loan and disbursement. Disbursement delays were also experienced in the Albanian microcredit project which ran from 1995 to 1999 during a difficult domestic period, causing implementation difficulties. The Albanian project was also hampered by weak counterpart capacity.There is a raft of information available on previous lessons learned in pursuing the establishment of centers similar to the BDCs to be funded and established under SEP I. These lessons learned have been carefully incorporated into the design of the BDS portion of SEP II. In particular, there will be considerable emphasis on delivering appropriate training not just in small business skills and office management, but also promoting private sector replication of the services in order to ensure sustainability.IDA also has considerable experience in the delivery of credit programs, including to the agriculture sector. Key lessons learned in the past include avoiding a supply-push element to the lending program, and incorporating market-based elements into the lending process from the time of inception. SME lending experience has repeatedly shown the need to avoid targeting of credit except in the broadest sense, as in the case of SEP II where half of the line of credit is earmarked for agri-businesses. Interest rate policy is also important and, in general, lessons learned suggest that arbitrarily set interest rates produce a distortionary effect causing harm to the financial sector. However, in the case of East Timor where the initial task is simply to restore an initial supply of credit, and there is no private sector provider of such SME credit, the rate of interest to be applied to SEP II loans will not produce long-term distortive effects.

9. Program of Targeted Intervention (PTI) Y

10. Environment Aspects (including any public consultation)
Issues : It is possible to draw heavily on the experience of SEP I in forecasting the likely environmental issues in SEP II. The most likely adverse environmental impact will be caused by the granting of SEP II loan funds to potentially environmentally adverse businesses, for example, a metal-works. On a case-by-case basis an independent environmental consultant will be contracted to review the proposed investment. To date, there has not been such a case during the course of implementation of SEP I. In the normal course of events, the implementing agency, if processing a loan for a project likely to cause environmental damage, would notify the PIU which would then engage the environmental consultant. Both the PIU and CGD need to exercise good sense in

determining if any disbursement of SEP II funds might have an adverse environmental impact and, erring on the side of caution, should refer any doubts to IDA. It is also remotely possible that the construction of the BDCs might cause environmental damage in which case the PIU would also organize an independent environmental review.Impact on human health and safety is an issue of relevance to SEP II. The PIU should review closely any application for SEP II funds from a business which might pose visible or excessive risk to its employees or associates.

11. Contact Point:

Task Team Leader
Desiree Green
The World Bank
1818 H Street, NW
Washington D.C. 20433
Telephone: (202) 473-2038
Fax: (202) 614-0636

12. For information on other project related documents contact:

The InfoShop
The World Bank
1818 H Street, NW
Washington, D.C. 20433
Telephone: (202) 458-5454
Fax: (202) 522-1500
Web: http:// www.worldbank.org/infoshop

Note: This is information on an evolving project. Certain components may not be necessarily included in the final project.

This PID was processed by the InfoShop during the week ending October 12, 2001.