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Report No. P-5612-POL

MEMORANDUM AND RECOMMENDATION
OF THE
PRESIDENT OF THE
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
TO THE
EXECUTIVE DIRECTORS
ON A
PROPOSED LOAN
IN THE AMOUNT EQUIVALENT TO US\$60 MILLION
TO THE
POLISH DEVELOPMENT BANK
WITH THE GUARANTEE OF
THE REPUBLIC OF POLAND
FOR A
PRIVATE ENTERPRISE DEVELOPMENT PROJECT

APRIL 16, 1992

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CURRENCY EQUIVALENTS

Currency Unit - Zloty (Zl)

AVERAGE EXCHANGE RATES
(Zlotys per US\$)

	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1990</u>	<u>1991</u>	<u>1992</u>
US\$1.00 - Zl	265	430	4,000	9,500	10,957	(March) 13,500

WEIGHTS AND MEASURES

Metric System

POLAND - FISCAL YEAR

January 1 - December 31

ABBREVIATIONS

EC	-	European Community
FY	-	Fiscal Year
GDP	-	Gross Domestic Product
IFC	-	International Finance Corporation
NGO	-	Non-Government Organization
P&RP	-	Privatization and Restructuring Project
PDB	-	Polish Development Bank
PHARE	-	Poland-Hungary Assistance for Economic Reconstruction
PSU	-	Project Support Unit of the Cooperation Fund
SME	-	Small and Medium Size Enterprise
USAID	-	United States' Agency for International Development

POLAND

PRIVATE ENTERPRISE DEVELOPMENT PROJECT

LOAN AND PROJECT SUMMARY

Borrower: Polish Development Bank (PDB)

Guarantor: Republic of Poland

Beneficiaries: Emerging private enterprises, PDB, Office of the Undersecretary for Business Promotion at the Ministry of Industry and Trade, Project Support Unit (PSU) of the Cooperation Fund at the Ministry of European Integration and Foreign Aid Coordination, and non-government organizations (NGOs).

Amount: US\$60.0 million equivalent.

Terms: Seventeen year maturity with a five year grace period, at the Bank's standard variable interest rate.

Relending Terms: The funds for the investment financing component (US\$58.0 million) will be on-lent by PDB to participating banks, and by them to enterprises at variable or fixed interest rates in any currency included in the Bank currency pool at the option of the enterprise. Given current trade patterns in Poland, the bulk of on-lending is expected to be in US\$ or in DM. Interest rates to be charged by PDB to participating banks will be set with reference to market indices, and will provide for covering PDB's costs of funds, the foreign exchange risk and the interest rate risk associated with the Bank's currency pool and interest rate policies, as well as PDB's administration and intermediation costs, and a reasonable profit margin. PDB's margin will be reviewed with the Bank regularly, at least semi-annually. Participating banks will on-lend to enterprises according to prevailing market interest rates; sub-loans will be for up to seven years maturity with up to three years grace.

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The funds for the institutional support component (US\$2 million) will be on-lent by PDB to the Guarantor under terms and conditions (maturity, interest rate and other charges) similar to those of the Bank loan. The Guarantor will provide these funds on a non-reimbursable basis (under a cost sharing scheme) to finance eligible activities.

Financing Plan:

	<u>Local</u>	<u>Foreign</u>	<u>Total</u>
	-----US\$ million-----		
IBRD	-	60.0	60.0
Enterprises	45.0	10.0	55.0
Other Commercial Sources	10.0	42.0	52.0
Local institutions	2.0	-	2.0
Other donors a/	<u>5.1</u>	<u>13.1</u>	<u>18.2</u>
Total Financing	<u>62.1</u>	<u>125.1</u>	<u>187.2</u>

a/ Including EC-PHARE program, USAID, UK Know-How Fund.

Economic Rate of Return:

Not applicable

Staff Appraisal Report:

Report No. 9812-POL

**MEMORANDUM AND RECOMMENDATION OF THE PRESIDENT
OF THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
TO THE EXECUTIVE DIRECTORS
ON A PROPOSED LOAN
TO THE POLISH DEVELOPMENT BANK
WITH THE GUARANTEE OF THE REPUBLIC OF POLAND
FOR A PRIVATE ENTERPRISE DEVELOPMENT PROJECT**

1. I submit for your approval the following memorandum and recommendation on a proposed loan to the Polish Development Bank (PDB) with the guarantee of the Republic of Poland for the equivalent of US\$60 million to help finance a private enterprise development project. The loan would be at the Bank's standard variable interest rate, with a maturity of seventeen years, including five years of grace.

2. **Background:** The far-reaching Economic Transformation Program (ETP) launched in January 1990 was designed to achieve macroeconomic stabilization; structural reform of the productive base to restore growth; and progressive restoration of creditworthiness. Judging by a macroeconomic yardstick, the results have been mixed. Inflation has subsided from levels of over 240 percent in 1989 and 600 percent in 1990. Average inflation amounted to less than 80 percent in 1991, and is now running at an annual rate of about 40 percent; however, major structural problems remain and the economy has not performed well. In 1991, GDP declined an estimated 8-10 percent; unemployment, which amounted to less than 2 percent of the total work force in early 1990, topped 11 percent by end 1991.

3. The overall production and price statistics, however, mask sharply different trends among sectors of the economy, and cannot portray accurately important underlying changes in the standards of living of the Polish population. Price statistics, for instance, cannot capture the shortage of products and queuing, or the inferior product quality that was the trademark of the output of industries not concerned with the competitiveness of their products. These features are now largely gone from Poland: stores are full of merchandise; lines have disappeared. These improvements are not reflected in real income statistics, but can reasonably be quoted as evidence of some success in the implementation of the ETP.

4. Even when using production statistics as a benchmark for success of policies, important qualifications are necessary. Arguably, the disappointing overall supply response results largely from the inability of the state-owned enterprise (SOE) sector to adapt to the new economic realities. On the other hand, a fundamental objective of the ETP's move towards a market economy is private sector growth. On this account, a noticeable degree of success has been attained: private sector growth was strong in 1990 and 1991 (some 7 and 3 percent, respectively). The contribution of the private sector to total GDP rose from the 28 percent level in 1989 to more than 34 percent of GDP in 1990, and to about 40 percent in 1991. Approximately 1.3 million private sector enterprises have been established, suggesting a rate of growth of approximately 55 percent during 1990 and 1991. Private production (including cooperatives) now accounts for a quarter of total industrial production, over 50 percent of construction, and three quarters of trade.

5. Growth of the private sector has occurred in response to the changed market signals, and also as a result of determined Government action. This has consisted of the adoption of comprehensive policy and regulatory measures to create a substantially improved business environment for the creation and growth of new private enterprises. A cornerstone of these measures was the policy and regulatory changes introduced in January 1989 by the "Law on Economic Activity", which abolished severe restrictions on licensing, registration, number of employees and economic activities applied to private sector initiatives. Subsequent legislation has reinforced the foundations for the creation of a strong private sector, by modernizing the commercial code, establishing the basis for a clear regulatory framework in a number of economic sectors, and by laying the grounds for a modern tax system.

6. There remain, however, substantial constraints to continued private sector growth. Renewed macroeconomic instability would arguably pose the greatest danger to economic transformation. The unsettled state of financial markets, with the resulting limited access to term financing and to credit in general for start-up businesses, also represents a substantial hindrance to new investments. Too many resources still flow to some of the more inefficient SOEs. The success of the privatization program has been largely confined to the smaller scale enterprises, as progress with large and medium-scale units has been slow. Furthermore, insufficient technical expertise and lack of business skills must be overcome, a process that requires time and a concentrated effort.

7. Rationale for Bank Involvement: The proposed project is designed to address some of these problems. The Bank assistance strategy for Poland is geared to back the Government's economic program and the transformation to a private sector-based market economy in a number of mutually reinforcing areas. Private sector growth is sought through; (a) the maintenance of a stable macroeconomic framework, which was one of the main objectives of the program supported by the Structural Adjustment Loan (SAL); (b) SOE privatization and reform, supported by the Privatization and Restructuring Project; and (c) restructuring and enhancement of financial markets (the Financial Institutions Development Loan). In addition, in parallel with the support provided to the privatization of state-owned enterprises, the Bank has also sought to address the complementary process of the creation and growth of new, private enterprises. A Bank review of the constraints to the development of private SMEs conducted in 1990 provided the basis for the development of the Government's initiatives to support private enterprise. The proposed project builds on this effort and is designed to address identified constraints in the access to finance, the provision of financial services and the availability of institutional support needed for rapid growth of this sector.

8. Besides providing scarce term financing for private sector investment, the proposed project would directly contribute to a better development of financial markets. The Bank will lend directly to the Polish Development Bank, instead of to the Government or the Central Bank (National Bank of Poland) as in previous Bank loans. While PDB has been recently established, it has quickly built up a strong management team, a skilled staff complement and sound policies. Within the Polish banking system, PDB has developed as the main apex institution for the provision of term credit. A direct loan to PDB will help to refocus the role of NBP as a central bank, and will further strengthen the ongoing relationship with the Bank, initiated

under the Privatization and Restructuring Project, for which PDB is the apex institution.

9. The project also complements efforts by IFC to support the development of the private sector, including the establishment of the Polish Business Advisory Service. Additionally, the Bank is cooperating with other multilateral agencies which are developing parallel support programs, with a view of maximizing efficiency in the use of resources and thus limiting Bank financing to essential priorities.

10. Project Objectives: The principal objective of the proposed project is to support the creation of new private businesses. To meet this objective, the project provides financing for efficient investment in private enterprises, particularly in SMEs, and for a program aimed at overcoming deficiencies of business practices and building support services for private enterprise development.

11. Project Description and Implementation : The proposed project includes two related components:

(i) An investment financing component (US\$58 million), which will provide sub-loans (channeled through PDB to eligible commercial banks) to finance efficient investments in private enterprises. Specifically, this component will finance the procurement of machinery and equipment, spare parts and permanent working capital; the construction and rehabilitation of plants, buildings or storage facilities for start-up and expansion projects; and technical assistance required to address production, marketing and financial management needs of private enterprises; and

(ii) An institutional support component (US\$2 million), which will provide financing for technical assistance to the two key agencies responsible for stimulating private sector development (the Office of the Undersecretary for Business Promotion and the Project Support Unit), and through these agencies (on a non-reimbursable and cost-sharing basis) to local private sector support institutions (such as chambers of commerce, small business support centers and business training institutions) to finance eligible promotion activities. Cofinancing for these programs from the EC is in place and additional cofinancing from other bilateral and multilateral grant funds is contemplated.

12. For the investment finance component PDB, in its role as an apex institution, will on-lend proceeds of the proposed Loan to the participating banks, and they in turn will on-lend to the final borrowers. PDB will also be responsible for the evaluation of potential participating banks according to agreed criteria for participation, which include the banks' capacity to adequately judge the soundness of the sub-projects they propose to finance; and the monitoring of the use of projects funds. For the institutional support component, funds will be on-lent by PDB to the Guarantor, who under agreed arrangements will pass-on funds to eligible institutions.

13. Environmental Aspects: The Government is very conscious of the severity of the environmental problems in Poland, and with the support of the Bank-assisted Environmental Management Project (Report P-5256-POL), is

building-up the capability and means to elaborate, enforce and monitor suitable environmental protection policies and legislation. For the preparation of sub-projects under the proposed project, PDB and the participating banks will ensure in their on-lending agreements that all beneficiary enterprises will build facilities and operate their plants, financed under the project, in accordance with environmental and safety standards acceptable to the Bank. The project has been reviewed and placed in environmental screening category B.

14. Actions Agreed: Agreements reached at negotiations relate to: (i) policies and procedures to be adopted by PDB to manage the foreign exchange and interest rate risks associated with the Bank currency pool; (ii) periodic review of PDB's on-lending rates; (iii) the arrangements for EC grant funds for an amount of ECU 6 million to cofinance the institutional support component; (iv) the eligibility criteria for the local organizations (non-government, non-profit organizations with adequate management capacity); activities to be funded under the institutional support component; and the arrangements under the institutional support component with the view to ensure full coordination among the institutions involved in its implementation; (v) the participating conditions for banks, which include compliance with banking regulations, satisfactory financial performance and adequate lending policies and procedures; (vi) the legal agreements required to formalize the obligations of the entities involved in the implementation of the proposed project, and regulate the flow of funds from PDB to the beneficiaries; (vii) the maximum size of sub-loans to finance sub-projects (US\$2 million equivalent), the maximum amount of loan financing per enterprise (US\$4 million equivalent), and financial covenants for eligible enterprises and sub-projects; (viii) free limits for sub-loans; and (ix) procurement procedures, disbursement arrangements, auditing and reporting requirements. The conclusion of a Subsidiary Loan Agreement between the Guarantor and PDB will be a condition of loan effectiveness.

15. Benefits: The proposed project will assist Poland's economic transformation program by stimulating the creation and growth of new, privately-owned enterprises, and by helping to foster an environment in which they can flourish. The growth of this segment of the economy is expected to contribute to: addressing a fundamental imbalance in the ownership and size structure of the enterprise sector; strengthening the culture of entrepreneurship and improved enterprise management; enhancing competition and related improvements in productivity; and, critically, generating the much needed supply response and growth, including of exports. Additionally, the project would support activities which would help absorb labor shed by the restructuring of state enterprises; and promote regional economic development with direct and indirect employment generation.

16. Risks: The main risk is related to the uncertainty of macroeconomic developments and sustainability of current policies, which may weaken the investment climate and slow down the implementation of the proposed project by reducing the demand for investment funds. Maintaining economic stability is, however, a major priority for the Government. The budget recently presented to parliament incorporates a deficit target that could be financed from identified domestic and financial sources consistent with a moderate inflation scenario. The proposed budget provides a good foundation for the ongoing negotiations with the IMF on a new Stand-by Arrangement, which are expected to be completed soon. In addition, the Government is discussing

the contents of a program of enhanced structural reform, aimed at stimulating the supply response. Measures in this area include accelerating privatization, confronting the crisis in the financial and state-owned enterprise sectors, and improving the cost effectiveness of the social safety net. Agreement on this program of action may lead to substantial Bank support in the months ahead. Additional risks are related to the limited experience of institutions supporting private enterprises and the limited managerial and marketing experience of entrepreneurs. The technical assistance to be provided under the institutional support component, which complements technical assistance provided under other Bank operations, is designed to minimize these risks.

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

Lewis T. Preston
President

Attachments
Washington, D. C.
April 16, 1992

POLAND
PRIVATE ENTERPRISE DEVELOPMENT PROJECT
Estimated Project Costs and Financing Plan

Project Cost:

	Local	Foreign	Total
	— (US\$ million) —		
Investment Component	55.0	110.0	165.0
Institutional Support Component	7.1	15.1	22.2
Total Project Cost	62.1	125.1	187.2

Financing Plan:

	Local	Foreign	Total
	— (US\$ million) —		
IBRD	-	60.0	60.0
Enterprises/entrepreneurs	45.0	10.0	55.0
Other Commercial Sources	10.0	42.0	52.0
Local Institutions	2.0	-	2.0
Other Donors g/	5.1	13.1	18.2
Total Financing	62.1	125.1	187.2

g/ Including EC-PHARE program, USAID, UK Know-How Fund.

POLAND

PRIVATE ENTERPRISE DEVELOPMENT PROJECT

Procurement Method and Disbursements

Proposed Procurement Methods^{a/}
(US\$ million)

	International Shopping and Direct Purchase	Other ^{b/}	Total
Civil Works	-	15.0 (5.0)	15.0 (5.0)
Goods	100.0 (30.0)	49.2 (20.0)	149.2 (50.0)
Consultant Services	-	18.0 (5.0)	18.0 (5.0)
Other ^{c/}	-	5.0	5.0
Total	100.00 (30.0)	87.2 (30.0)	187.2 (60.0)

^{a/} Figures in parentheses are for financing under the proposed Bank loan.

^{b/} Includes goods and services to be procured according to commercial practices of the private sector.

^{c/} Includes taxes, duties and other local components.

Proposed Disbursement Categories

Component	Amount (US\$ million)	% Financing
<u>Investment Financing</u>		
Goods	43.0	100% of foreign expenditures; 100% of local expenditures (ex-factory cost); or 80% ^{a/} of local expenditures for other items procured locally
Civil Works	5.0	40% ^{a/} of expenditures
Consultants' services and training	3.0	100% of expenditures
Capitalized interest	4.0	Amounts capitalized financed with Bank resources
<u>Institutional Support</u>		
Goods	0.5	100% of foreign expenditures; 100% of local expenditures (ex-factory costs); or 80% ^{a/} of local expenditures for other items procured locally
Consultants' services and training	1.5	100% of expenditures
<u>Unallocated</u>	<u>3.0</u>	
TOTAL	60.0	

^{a/} Estimates of foreign exchange component therein.

Estimated Disbursements
(US\$ million)

IBRD FY	1992	1993	1994	1995	1996	1997	1998
Annual	0.5	3.3	14.9	17.3	12.9	7.4	3.7
Cumulative	0.5	3.8	18.7	36.0	48.9	56.3	60.0

POLAND

PRIVATE ENTERPRISE DEVELOPMENT PROJECT

Timetable of Key Project Processing Events

- (a) Time Taken to Prepare: 10 months
- (b) Prepared by: Participating institutions with Bank assistance
- (c) First Bank Mission: April 1991
- (d) Appraisal Mission
Departure: June 28, 1991
- (e) Negotiations: December 9, 1991
- (f) Planned Date of
Effectiveness: June 1992
- (g) List of Relevant
PCRs and PPARs: None

POLAND
PRIVATE ENTERPRISE DEVELOPMENT PROJECT
THE STATUS OF BANK GROUP OPERATIONS

A. STATEMENT OF BANK LOANS a/
(As of March 31, 1992)

Loan No.	Fiscal Year	Borrower	Project	US\$ Million	
				Loan	Undisbursed
<u>One Loan (SAL) Fully Disbursed:</u>					
3247	1991	Republic of Poland	Structural Adjustment Loan	300.0	
Total Fully Disbursed SAL, SECAL and Program Loans				300.0	
<u>Loans Under Disbursement:</u>					
3166	1990	National Bank of Poland	Ind. Export Devt.	260.0	229.1
3167	1990	National Bank of Poland	Agroindustry Export Devt.	100.0	80.0
3190	1990	Republic of Poland	Environment Management	18.0	16.4
3193	1990	Republic of Poland	Transport	4.8	3.6
3194	1990	Polish State Railways	Transport	145.0	118.5
3215	1990	Polish Oil and Gas Co.	Energy Resources Devt.	250.0	202.9
3319	1991	Polish Post, Telephone and Telegraph	Telecommunications	120.0	116.4
3338	1991	Republic of Poland	Employment Promotion Services	100.0	98.0
3341	1991 b/	Republic of Poland	Financial Institutions Devt.	200.0	200.0
3342	1991	Republic of Poland	Privatization and Restruct.	280.0	277.9
3343	1991	Republic of Poland	Agricultural Devt.	100.0	100.0
3377	1991 g/d/	Republic of Poland	Heat Supply Restructuring	75.0	75.0
3378	1991 g/d/	DHE-Gdansk	Heat Supply Restructuring	40.0	40.0
3379	1991 d/	DHE-Gdynia	Heat Supply Restructuring	25.0	25.0
3380	1991 g/d/	Voivodship DHE	Heat Supply Restructuring	55.0	55.0
3381	1991 d/	Municipal HE-Krakow	Heat Supply Restructuring	25.0	25.0
3382	1991 d/	Capital Region HE	Heat Supply Restructuring	100.0	100.0
3383	1991 d/	Wielkopolski Bank Kredytowy	Heat Supply Restructuring	20.0	20.0
Total				2,217.8	
Of which: Repaid				-	
Total now held by the Bank				2,217.8	
Total Amount Sold				0.0	
Of which Repaid:				0.0	
Total undisbursed					1,762.8

a/ The status of these projects is described in a separate report on all Bank/IDA financed projects in execution, which is updated twice yearly and circulated to the Executive Directors on April 30 and October 31.

b/ SAL, SECAL or Program Loan.

c/ Not yet effective.

d/ DHE - District Heating Enterprise. Seven loans made for one project.

POLAND

PRIVATE ENTERPRISE DEVELOPMENT PROJECT

THE STATUS OF BANK GROUP OPERATIONS

B. STATEMENT OF IFC INVESTMENTS

(As of March 31, 1992)

Fiscal Year	Obligor	Type of Business	Gross Commitments		
			US\$ Million		
			Loan	Equity	Total
1989	Hortex	Agriculture & Livestock	17.09	-	17.09
1990	Export Development Bank	Sales & Export Finance Leasing	26.96	-	26.96
1990	Decmet	Sales & Export Finance Leasing	0.12	-	0.12
1990	Eurocamion	Sales & Export Finance Leasing	0.06	-	0.06
1990	Grassi	Sales & Export Finance Leasing	0.10	-	0.10
1990	Ital-Pol Co.	Sales & Export Finance Leasing	0.30	-	0.30
1990	Mariusz Malkiewi	Sales & Export Finance Leasing	0.06	-	0.06
1990	Rotter	Sales & Export Finance Leasing	0.09	-	0.09
1990	Saar Papier	Sales & Export Finance Leasing	0.21	-	0.21
1990	Sawena	Sales & Export Finance Leasing	0.82	-	0.82
1990	Tedeuzs Manczak	Sales & Export Finance Leasing	0.14	-	0.14
1990	Rybka Ironwork	Sales & Export Finance Leasing	0.39	-	0.39
1990	Tworczoosc	Sales & Export Finance Leasing	0.61	-	0.61
1990	Waldeman Machele	Sales & Export Finance Leasing	0.38	-	0.38
1991	Bristol Hotel	Hotel Development	10.26	-	10.26
1991	International Bank of Poland	Commercial Banks		3.20	3.20
1992	Chemagev	Real Estate & Business Service	<u>10.38</u>	<u>1.06</u>	<u>11.64</u>
		Total Gross Commitments	68.18	4.26	72.44
		Less: Cancellations, Terminations, Exchange Adjustments, Repayments, Write-offs and Sales	<u>7.92</u>	<u>0.00</u>	<u>7.92</u>
		Total Commitments Held by IFC	<u>60.26</u>	<u>4.26</u>	<u>64.52</u>
		Total Undisbursed	42.58	1.92	44.51
		Total Outstanding	17.68	2.34	20.01