INVESTMENT SECTOR LOAN

(HA-0046)

EXECUTIVE SUMMARY

BORROWER AND GUARANTOR:	Fast-disbursing component: Technical assistance:	Republic of Haiti Banque de la Republique d'Haïti
EXECUTING AGENCIES:	Ministry of Economy and Finance (MEF) Ministry of Planning and External Cooperation (MPEC) The Prime Minister as Tutelle of the Public Enterprise Modernization Commission Banque de la Republique d'Haïti (BRH)	
AMOUNT AND SOURCE:	IDB (FSO): Technical assistance (FSO): Local counterpart funding: Total:	US$50,000,000 US$ 2,495,000 US$ 250,000 US$52,745,000
FINANCIAL TERMS AND CONDITIONS:	Amortization period: Disbursement period: - fast disbursing resources: - technical assistance component: Interest rate: Inspection and supervision: Credit Fee:	40 years 24 months 36 months 1% for first 10 years; 2% thereafter 1% .5% of undisbursed balance
OBJECTIVES:	The objective of the ISL program is to stimulate private sector initiative and economic growth by lowering risk and transaction costs in the markets that allocate basic economic resources. The program will consist of fast-disbursing resources in support of the Government of Haiti's (GOH) fiscal/monetary program, back by an Enhanced Structural Adjustment Facility (ESAF) of the International Monetary Fund (IMF), as well as a reform program with technical assistance directed at controlling future fiscal costs related to the state-owned electricity company and financial sector and building the basic institutions and legal framework required for an efficient and stable open economy.	
DESCRIPTION:	The ISL reform program will consist of four principal components, under a macroeconomic framework conducive to the objectives of the program: (1) legal and	

regulatory reform of the financial sector, 2) secured transactions reform, (3) stabilization of state banks, and (4) private sector participation in the management/ownership of the electricity sector. Specific actions to be carried out in each sector are presented in the Policy Matrix in Annex I.

(i) **Legal and regulatory reform of the financial sector**: The primary objective of the financial sector reform initiative will be to establish a modern legal, regulatory and institutional framework, first addressing the most threatening weaknesses of the financial system. This reform will consist of a modernization of the legal, prudential and regulatory framework, which will entail the implementation of a calendar of legal and regulatory reforms supported by a technical assistance component to support the implementation of the new framework. The precise sequence and timing of the reforms is designed to address the most immediate sources of risk to the financial sector while building the basis for a transparent and efficient regulatory regime.

(ii) **Secured transactions reform**: The policy matrix of the ISL will include the legislation of a reformed legal and institutional framework for secured transactions. Technical support to the executing agency, the Presidential Commission for Economic Growth and Modernization, for implementation of the reform program is provided through ATN/MT-5078, approved in December 1995. This component of the program addresses one the most fundamental constraints to the extension of credit services to historically marginalized sectors of the market and will alleviate the currently dangerous competition in the banking sector for the few clients that can meet current requirements for collateral. The positive impact on the micro and small business sector, both urban and rural, is expected to be significant.

(iii) **State banks**: The objective of this tranche is to bring the Banque National de Credit (BNC) into conformity with all prudential norms and regulatory measures required to establish the soundness of the bank. The BRH (the Central Bank) will supervise a full diagnostic assessment of the BNC followed by a program of corrective actions as described above. The BRH will contract the services of a firm with appropriate international experience in performing such assessments, as described in the draft terms of reference elaborated for this purpose in collaboration with the BRH. The technical assistance

program with the BRH will include financing for the diagnostic, as well as for the subsequent corrective measures.

(iv) **Electricity sector:** The objective of this component is to improve productive and allocative efficiency of electricity sector via private sector participation in the management/ownership of Electricite d'Haïti (EdH, the currently state-owned electricity company), with appropriate legal and regulatory framework.

In October, 1996, Parliament passed the Public Enterprise Modernization Law, authorizing the Public Enterprise Modernization Commission (CMEP), with the assistance of a Technical Secretariat, to conduct the transactions required to facilitate private sector participation in the currently state-owned enterprises in the form of a mixed-company, management contract or concession.

The reform of EdH will be financed by ATN/MT-5334 and includes 1) the contracting of a consultant to assist the GOH in formalizing the GOH policy for the sector reform and in preparing the terms of reference and selecting an international firm to prepare the bidding documents and legal framework, 2) contracting of the international firm and execution of terms of reference, 3) legislation of any required legal and regulatory reforms, 4) execution of the bid and selection of the private owner/operator.

Since July 1995, Electricité de France (EdF) and Hydro-Quebec (HQ) have provided technical assistance to EdH, financed by the Caisse Francaise de Developpement (CFD) and the Canadian International Development Agency (CIDA). This technical assistance team has been responsible for the implementation of generation rehabilitation works and has also provided assistance in all other areas of operation and management of EdH. Its work has been crucial in restoring the thermal capacity, repairing the distribution and transmission networks, and improving commercialization, billing, accounting and financial management. It is of crucial importance that the work continue during preparation of the sector reorganization plan. The CFD and CIDA are willing to continue funding this technical assistance as a preparatory effort within the reform program proposed in the ISL and financed with the MIF operation.

DISBURSEMENT:

The first tranche of the fast-disbursing component of the ISL will be 20% of the total, or US$10 million, and will be eligible for disbursement upon legal effectiveness of the loan contract between the Bank and the Republique d'Haiti and compliance with conditions prior to first disbursement. The balance of the fast-disbursing resources will be allocated to three, sector-specific, non-sequential "floating" tranches, which will be disbursed as conditions specific to each tranche are met; all disbursements will be subject to the condition of maintenance of a sound macroeconomic framework consistent with program objectives and compliance with the policy objectives and programs described in the Policy Letter. Evidence of compliance with audit conditions on prior disbursements will also be required at the time of each tranche disbursement. The amounts assigned to each tranche are as followed: 1) financial sector tranche for US$15 million, 2) state banks tranche for US$10 million, and 3) electricity sector tranche for US$15 million.

The floating tranches for the financial sector and state banks will consist of a part A and B, with the tranche amount divided between them: US$5 and US$10 million for parts A and B, respectively, of the financial sector tranche, and US$5 million for both parts A and B of the state banks tranche. These tranches will be disbursed in two parts, as the conditions defined in parts A and B are fulfilled, always under the condition of compliance with the macroeconomic program conditions. The electricity sector tranche will be disbursed in one part when the conditions for that tranche, as well as the macroeconomic conditions, have been fulfilled. Compliance with all conditions proposed for the floating tranches should be achieved within 18 months of the effective date of the contract. A final disbursement period of 24 months following contract effectiveness is proposed for the disbursement period.

TECHNICAL ASSISTANCE PROGRAM

The program will include financing under separate contract for a technical assistance program to the BRH for the implementation of the financial sector and state bank reform programs, according to the Plan of Operations in Annex III.

ENVIRONMENTAL CLASSIFICATION:

The Environmental Management Committee, at its meeting of June 11, 1996, classified this as a Category III operation.

BENEFITS: Successful completion of the program should produce two principal benefits for the country. First, the fast disbursing resources will contribute to an economic stabilization plan that is expected to control inflation and facilitate private sector confidence. This benefit has far reaching and immediate positive effects for all sectors. In the medium term, successful completion of the reform program will reduce the potential fiscal costs associated with the state-owned enterprises and financial sector, thereby facilitating a more rational allocation of budget resources. Secondly, the reform program itself will also result in reduced transactions costs for the productive sectors and begin to establish a business environment conducive to long term economic growth.

POVERTY ALLEVIATION: Given that Haiti is a D country, the program meets the Eighth Replenishment criteria for poverty alleviation

RISKS: There are three categories of risks that will come to bear on the implementation of the proposed ISL program: risks related to the macroeconomic program, the sectoral reforms, and to the implementation capacity of the executing agencies. These risks are compounded by the fact that many of the critical steps in the proposed reforms are scheduled late in the program calendar.

(i) **The macroeconomic program**: the fiscal/monetary program is based on assumptions regarding fiscal revenue performance, public expenditure management, and the absorption of external financial resources that will require immediate and profound transformation of state institutions. In broader scope, the macroeconomic program is based on ambitious projections regarding GDP growth, increases in exports, and a decreasing external account deficit; the veracity of all projections are subject to the lack of reliable empirical data. Failure to maintain the required balances in the internal and external accounts will have a profoundly negative effect on the proposed programs, and on private investment and economic growth in general.

Moreover, the macroeconomic program, based as it is on tight fiscal and monetary policy, entails certain risks for private investment and economic growth. The benefits of tight monetary policy and internal and external price stability may also be outweighed by a deterioration in relative prices effecting the

productive sectors; the effect could be particularly devastating in the export sectors. The ISL program includes a series of studies to monitor this relationship between the fiscal/monetary program and economic performance of strategic sectors.

(ii) Risks related to sector reforms: The proposed sectoral reforms face the common risk of opposition from powerful and entrenched interests. These risks are compounded in those cases where the proposed reform will require parliamentary legislation.

The conceptualization process of the GOH's reform program has been limited to high level policy discussions with the Executive branch and members of the Board and staff of the Central Bank. While this has expedited general policy discussions, the consensus of other stakeholders in the reform process is uncertain.

The Public Enterprise Modernization Law, ratified in October 1996, mandated the CMEP to define and carry out the proposed reform of the EdH and the electricity sector. However, the CMEP must be constituted, accept the responsibilities of executing agency for the ISL program, and establish a Technical Secretariat with adequate capacity to execute the activities defined under ATN/MT-5334. The lack of a clear counterpart during the development of the Program delayed the technical work required to advance the sectoral reform, and the new mandate assigned to the CMEP effectively preempts the policy directives discussed with the GOH during the orientation and analysis missions. Nevertheless, the CMEP is expected to be officially constituted before the end of 1996, and to begin the reform initiative immediately.

The most serious risk to the electricity sector reform stems from the law itself, which requires any concession contract negotiated by the CMEP to be ratified by Parliament. This condition introduces a significant element of risk into any transaction related to the public enterprises, and this will come to bear on the interest and behavior of potential bidders, as well as the negotiation process with the Republic.

(iii) Implementation capacity: The lack of implementation capacity and inter-institutional coordination in the GOH constitutes a fundamental constraint to the execution of the reform program.

The severity of this condition constitutes the fundamental justification for the ISL, as well as the institutional focus of the reform program. This approach is consistent with one of the principle lessons derived from past sectoral loans, that institutional strengthening should precede substantial policy reform. At the same time, fast-disbursing operations have generally not been successful in supporting the long term efforts required to strengthen institutional capacity. For this reason, the parallel technical cooperation component of the ISL is critical to the success of the program.

THE BANK'S COUNTRY AND SECTOR STRATEGY:

The Bank' strategy for development and poverty reduction in Haiti is based on initiatives that facilitate sustainable private sector-led economic growth. This strategy entails a commitment to investment in human capital, institutional strengthening and the development of an economic environment and legal and institutional framework conducive to private sector investment and economic growth.

The proposed ISL program is based on the investigations and policy dialogue carried out during the elaboration of the GOH's Policy Framework Paper and parallel development of the Enhanced Structural Adjustment Facility of the IMF and Emergency Recovery Credit II of the World Bank. The fast-disbursing financing component of the operation is critical to maintaining macroeconomic stability while the GOH initiates the reforms required to address the structural deficiencies causing the imbalances. Within this context, the ISL is designed and scaled to complement the objectives of the fiscal program with a focus on sectoral reforms that support the productive capacity of the Haitian economy.

SPECIAL CONTRACTUAL CONDITIONS:

Disbursement of fast-disbursing resources will be subject to the conditions presented in the Policy Matrix in Annex I, with no exceptions to Bank policy. In addition, legal effectiveness of the parallel technical assistance loan contract will be a condition prior to disbursement of the fast-disbursing resources. The Loan Contract will also contain Bank's standard clauses.

EXCEPTIONS TO BANK POLICY

Procurement policies for the technical assistance component will include two exceptions to standard Bank policy. The diagnostic assessment of the BNC will be awarded to a consortium consisting of Gardiner, Kamya International, Inc., KPMG/Mérové-

Pierre, and Hanney and Associates in a sole-source contract, given the technical and institutional advantage of the consortium.

In order to avoid unnecessary delays in the execution of the Technical Assistance program, resources of the program can used to finance the purchase of goods and services for the period that begins up to twelve months prior to Board approval. The amount of resources used to finance expenses during this period is limited to US$250,000.

I. FRAME OF REFERENCE

A. Background

1.1 The current Government of Haiti (GOH) assumed office in February 1996 and inherited an economy in steep decline from the embargo period as well as the fiscal deficit of the previous government. The new GOH began immediately to formulate its own economic plan in the context of discussions with the International Monetary Fund (IMF), World Bank, IDB, European Union (EU) and various bi-lateral donors concerning, respectively, the Enhanced Structural Adjustment Facility (ESAF), the Emergency Recovery Credit II (ERCII) and the proposed Investment Sector Loan (ISL), the EU budget support program and the respective bi-lateral programs.

B. Economic framework

1.2 The Haitian economy experienced 3.5% per year real growth during the last half of the 1970's, led mostly by private investment in the export assembly sector and by foreign aid expenditure. Internal inflation was minimal and the Gourde maintained its almost 60 year old parity with the US dollar.

1.3 By the early 1980's, the general trend of the economy began to reflect the adverse effect of deeply rooted internal imbalances, exacerbated by a sequence of economic shocks and political instability. The fiscal deficit widened due to poor public sector expenditure management and the increasing burden of unprofitable public sector enterprises. Increasing Central Bank financing of the deficit and accumulation of internal and external arrears was mirrored in the loss of international reserves and gradual depreciation of the Gourde.

1.4 Economic programs supported by the IMF and the World Bank during the last half of the 1980's failed due to political instability. Real GDP declined by approximately 5% over the period and inflation rose to 24% by 1990. Tax collections declined in relation to GDP and total public sector expenditures increased. The current account of the balance of payments continued to deteriorate and the Gourde depreciated almost 40% to 7.5:US$1 by September 1990.

1.5 The economic program of the Aristide government, including a negotiated Stand-by agreement with the IMF, was derailed by the military coup of September 1991. The subsequent embargo caused a severe contraction in agricultural production and the assembly industry; tourism, already in decline since the early 1980's, all but disappeared. Public investment ceased in the absence of foreign assistance. Exports declined from US$200 million in fiscal year (FY) 1990/91 1/ to less than US$60 million by FY 1993/94.

1/ The GOH fiscal year runs from October to September.

Imports also declined but were maintained by humanitarian assistance and external arrears, resulting in an external current account deficit of 6.9% of GDP in FY 1993/94. The overall deficit, approximately 4-4.5% of GDP, was financed by Central Bank credit and the accumulation of arrears, causing a depreciation of the Gourde to 21.5:US$1 by August of 1994.

1.6 The restoration of the Aristide government in October 1994 was supported by an immediate package of emergency assistance from the international community. External arrears of US$82 million to multi-lateral agencies were eliminated with bi-lateral support. However, subsequent structural reform initiatives, supported by the IMF, World Bank, IDB and other agencies, failed due to GOH ambivalence regarding key components of the reform program. Discussions regarding the ESAF agreement and the Structural Adjustment Credit/HA-0048 (SAC), to be co-financed with the World Bank, ceased completely by October 1995.

1.7 Meanwhile, the inflow of foreign assistance during 1995 arrested the deterioration of key global economic indicators. Net Central Bank financing of the central government was negative and net international reserves rose to 3.5 months of imports. The 12-month rate of consumer price increases fell from 40% in 1994 to 30% in 1995. The value of the Gourde appreciated and oscillated in the range of GD14-16:US$1. However, although data available to the IMF shows moderate (4.5%) real GDP growth in 1995, this was sustained by an extraordinary inflow of foreign assistance (US$425 million, equivalent to around 18% of GDP) that financed explosive growth in public expenditure, consumption and imports. According to official figures, aggregate consumption in real terms was 126% of GDP compared to 91% of GDP in 1994. The dollar value of imports more than doubled from 1991 levels, with food, petroleum and manufactures comprising over 60% of the total. The external current account deficit (excluding grants) for 1995 was around US$440 million (19% of GDP), compared to 8% in 1991. Gross domestic investment remained low (around 10% of GDP), financed primarily by the public sector with foreign-aid resources; private investment (estimated at 2.5% of GDP) remained at about one-third of pre-embargo levels.

1.8 The most recent estimates for FY1996 indicate external financing of an external current account deficit equal to 14.7% of GDP. GDP growth is estimated at 2% in real terms with annual inflation of 21% and a 11% decrease in the nominal value of the Gourde.

C. <u>Fiscal performance and the balance of payments</u>

1.9 The fragility of the macroeconomic environment, rooted in the fiscal deficit, continues to be the principal debilitating force across all sectors of the Haitian economy and constitutes a disincentive to business expansion and domestic savings as well as the repatriation of private capital for investment. It is important to emphasize that macroeconomic imbalances have an

immediate and broad-reaching effect on Haiti's economy given the degree of liberalization in the foreign exchange and trade regimes and the weak regulation of the banking sector. 2/ The monetary expansion that results from fiscal imbalances imposes direct pressure on the exchange rate via the demand for imports and dollars for savings. In order to maintain the stability of the exchange rate, the monetary authorities have typically resorted to sales of international reserves and high legal reserve requirements, negatively effecting the banking system already weakened by an abrupt rise in interest rates and an increasingly precarious foreign exchange position. Furthermore, the magnitude of the imbalances constitutes a formidable disincentive to repatriation and investment of domestic capital. Thus strict control of the fiscal deficit is a fundamental requirement of Haiti's increasingly open economy.

1.10 Fiscal support in the form of foreign donations and loans to the GOH during 1995 and 1996 have financed an unsustainable fiscal and external current account deficit. Discretionary spending and historically poor public expenditure management deteriorated drastically in the last quarter of FY95 and through the first half of FY96 when the overall government deficit reached 6.7% of GDP. The GOH succeeded in limiting expenses in the second half of the fiscal year to the amount of received revenues, bringing the overall government deficit to 3.2% of GDP by the end of the fiscal year. However, whereas foreign financed budgetary support facilitated a modest reduction of domestic credit to the non-financial public sector during FY94-5, domestic financing of the FY96 deficit was equal to 2.8% of GDP.

1.11 Historically, the GOH has not serviced its domestic debt to the Central Bank, and this is reflected in the poor financial performance of the institution as well as in the unremunerated reserve requirements which suppress deposit rates, crowd out private sector investment, and threaten the financial performance of the banking system. The Banque de la Republique d'Haïti (BRH, or Central Bank), with no open market monetary instruments, has taken recourse to high legal reserve requirements (between 48 and 51.5%) and sales of international reserves in order to protect the value of the Gourde. The net international reserves of the Central Bank declined from US$178 million (3.5 months of imports) in 1995 to US$118 million (2.1 months of imports) in 1996.

2/ The industry literature is unequivocal about the importance of establishing a stable macroeconomic environment prior to liberalization of the financial sector, trade and foreign exchange regimes. See, for example, *The Reform of Development Banks in IDB Financial Sector Loans (RE-203/95), Evaluation Office/IDB*, or, Killick, Tony, *The Adaptive Economy: Adjustment Policies in Small Low-income Countries*, The World Bank, 1993.

1.12 In addition to the immediate actions required to control current fiscal expenditures, the GOH will need to take measures to avoid the potential future fiscal costs that will escalate if key reforms are not implemented soon. Most important in this regard are the state-owned infrastructure enterprises, particularly the electricity company, which impose fiscal costs on the GOH as well as an economic cost in the form of inadequate service to the productive sectors. Public pensions will also continue to encumber the fiscal deficit and deny an important source of funds to the capital market. The two state banks could impose significant fiscal costs if their financial performance continues to deteriorate to the point of requiring external support. And as long as the monetary authorities are forced to take recourse to measures that squeeze the liquidity of the financial system, the GOH faces a similar threat from the rest of the financial sector, which in its current state is lacking in the most basic elements of a legal and regulatory framework.

1.13 Finally, the lack of strategic allocation of current and capital expenditures in general forestalls investment in the social sectors and constitutes a pernicious impediment to long term economic growth.

D. Performance of the real sectors

1.14 Although the post-embargo consumption patterns represent to some degree a corrective response of pent up demand from the embargo period, the poor performance of the primary and secondary sectors 3/ provides disturbing evidence of serious barriers to future economic growth. The tertiary sector, roughly 41% of GDP, expanded at a rate of 4% during 1995 based mainly on transportation and international telecommunications. The primary sector virtually stagnated, declining as a share of GDP from 35% in 1994 to 30% in 1995, with export crop production at less than 10% of 1991 levels and total agricultural production decreasing by more than 7% over 1994. The secondary sector, around 24% of GDP, grew modestly driven by construction and aid-financed infrastructure investment.

1.15 The export assembly industry has been slow to respond due to the reluctance of foreign clients and of local operators to invest private capital in the current environment. In May 1996, the assembly sector was comprised of approximately 94 firms providing 19,400 jobs. Although this represents an improvement from January 1995 (49 firms with 3,900 employees), it is still far from the 117 firms and 65,000 jobs prior to the embargo. Moreover, the bulk of the sector's activity is concentrated in 15 of the firms that

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3/ The primary sector in Haiti consists mainly of agriculture and mining, the secondary sector of manufacturing, assembly and construction, and the tertiary sector of government, transport, communications, financial and other services.

provide around 50% of the employment; 31 firms have less than 50 employees and only about 54 have any significant production.

1.16 In summary, the fundamental performance of the Haitian economy during 1995 and 1996 provides some evidence of both interest and investment capacity of the private sector. However, there are strong indications that macroeconomic instability and structural impediments still pose a significant barrier to growth, even recuperation, of production capacity, employment, exports and fiscal revenues.

E. The GOH macroeconomic program

1.17 The core of the GOH macroeconomic stabilization program has been defined during recent negotiations with the IMF regarding the Policy Framework Paper (PFP) and the ESAF agreement. Implementation of the program, approved by the Executive Board of the IMF on October 18, 1996, is a basic condition for arresting the deterioration of fiscal performance and the balance of payments position, as well as for restoring private sector confidence in general.

1.18 The ESAF-based macroeconomic program is comprised mainly of fiscal and monetary policies related to the mobilization of fiscal revenues, public expenditure control, stabilization of internal (inflation) and external (exchange rate) prices, a build up of international reserves and external financing of the balance of payments deficit.

1.19 The table of IMF projections below demonstrates the assumptions required to support the ESAF-backed economic program through 1998. In order to demonstrate the role and significance of both the proposed fast-disbursing ISL resources and the reform initiatives to the macro program, it is important to highlight the sensitivity of the variables and ultimate importance of such resources, depicted under "net public sector capital flows" in the capital account of the balance of payments.

Table I: KEY ECONOMIC INDICATORS				
(in US$ millions)	**FY95**	**FY96**	**FY97**	FY98
GDP (annual change)	4.5%	2%	4.5%	4.5%
Fiscal deficit as % of GDP	(4.8%)	(5.0%)	(3.2%)	(2.0%)
External Current Account, excluding grants	(444.5)	(381.5)	(422.7)	(380.7)
% of GDP	(19%)	(14.7%)	(14.9%)	(12.2%)
External Grants	376.8	165.6	267.2	150.1
% of GDP	16.1%	6.4%	9.5%	4.8%
Current Account Balance	(67.7)	(215.9)	(155.5)	(230.6)
% of GDP	(2.9%)	(8.3%)	(5.5%)	(7.4%)
Capital Account Balance	266.5	155.9	195.5	255.7
% of GDP	11.4%	7.6%	6.9%	8.2%
of which, net public sector capital flows	112.3	79.6	123.8	148
% of GDP	4.8%	3.1%	4.4%	4.7%
Overall BOP (deficit -)	198.8	(60)	40	25
% of GDP	8.5%	(2.3%)	1.4%	.8%
Gross official reserves	178.1	118.1	158.1	183.1
in months of imports	3.5	2.1	2.7	2.9

Source: International Monetary Fund tables

1.20 The projections for fiscal years 1997-1999 assume a slight decline in the overall government deficit from FY1996 levels, financed by external resources which would allow for negative domestic financing in every year. Net international reserves should be equal to 2.9 months of imports by 1998. However, these projections rely on large, though declining (13.3 - 7.8% of GDP), inflows of foreign assistance together with the growth of internal resources that will require a profound level of institutional reform in the fiscal sector. Projected revenue increases are based on the projected 4.5% real annual GDP growth, and will depend on the success of recently implemented projects in tax structure reform, rationalization of tax exemptions, and modernization of both the tax and customs authorities. Projected expenditure levels will be achieved by a reform of an overly rigid budgeting process, wholesale reform of all aspects of public expenditure management (proposed for FY97), and realization of significant efficiency gains in public administration during a period when political developments will result in budget pressures. Similarly, substantial reforms in the financial and infrastructure sectors are required to build confidence and provide the basic resources

required to sustain the required response from the supply side of the economy, particularly from the export sector.

1.21 The same projections indicate a manageable level of GOH external debt servicing obligations. Although the external debt balance is projected to increase from 33% to 40% of GDP by 1999, the anticipated concessional terms of this financing are expected to result in a ratio of debt service to export receipts + private transfers of 11.6% (1999), which would be 11.8% of public sector receipts. Again, this favorable scenario depends upon the projected levels of economic growth, fiscal receipts and export earnings as well as a significant stream of grants and concessional financing.

F. The Bank's strategy

1.22 The Bank' strategy for development and poverty reduction in Haiti is based on initiatives that facilitate sustainable private sector-led economic growth. This strategy entails a commitment to investment in human capital, institutional strengthening and the development of an economic environment and legal and institutional framework conducive to private sector investment and economic growth.

1.23 The proposed ISL program is based on the investigations and policy dialogue carried out during the elaboration of the GOH's PFP and parallel development of the ESAF of the IMF and ERC II of the World Bank. The fast-disbursing financing component of the operation is critical to maintaining macroeconomic stability while the GOH initiates the reforms required to address the structural deficiencies causing the imbalances. Within this context, the ISL is designed and scaled to complement the objectives of the fiscal program with a focus on sectoral reforms that support the productive capacity of the Haitian economy. The ISL will also build upon and support the reforms carried out through the numerous technical cooperations approved by the Bank and other external agencies in 1995 and 1996.

II. THE SECTOR PROGRAM

A. Objectives

2.1 The objective of the ISL program is to stimulate private sector initiative and economic growth by lowering risk and transaction costs in the markets that allocate basic economic resources. The program will consist of fast-disbursing resources in support of the ESAF-backed, GOH fiscal/monetary program as well as a reform program with technical assistance directed at controlling future fiscal costs related to the state-owned electricity company and financial sector and building the basic institutions and legal framework required for an efficient and stable open economy.

2.2 Accordingly, the ISL reform program will consist of four principal components, under a macroeconomic framework conducive to the objectives of the program: 1) legal and regulatory reform of the financial sector, 2) secured transactions reform, (3) stabilization of state banks, and (4) private sector participation in the management and/or ownership of the electricity sector.

2.3 Bank experience with ISLs 4/ provides three basic parameters for the design and scale of the ISL in the Haitian environment. First, priority will be given to macroeconomic stabilization. Haiti's trade and investment regime is already fundamentally open, and thus macroeconomic instability has an immediate impact on capital movement, trade, investment and consumption patterns. Moreover, macroeconomic instability, driven by the GOH deficit, continues to be the most immediate destabilizing force in the Haitian economy and constitutes a significant threat to the proposed reform program.

2.4 Second, the reform program will focus on those aspects of Haiti's institutional and legal framework that currently constitute the most immediate and formidable constraints to economic growth. The program must facilitate reform initiatives in areas critical to economic growth in the real sectors, both to ensure the financial viability of the loan as well as the sustainability of the reform program.

2.5 Finally, the reform program gives priority to building basic management and operational capacity in Haiti's public sector institutions. Capacity building in the areas of policy making, management and technical research are necessary in order to facilitate a coherent process of legal and regulatory modernization in subsequent stages of the reform.

4/ See Annex II of the Sector Lending Profile I (distributed to the Programming Committee for information on April 23, 1996) for a summary of Bank experience with sector lending operations.

B. Economic framework

2.6 Successful execution of the fiscal/monetary program, as structured in the IMF ESAF agreement, is critical to the success of the GOH's broader economic program as well as the proposed ISL program. Thus the Bank will accept the quantitative targets proposed in the IMF Letter of Intent as a framework for quarterly monitoring of the fiscal/monetary program. The Bank will monitor closely those aspects of the program directly related to the ISL reforms in the financial and electricity sectors.

2.7 At the same time, the Bank will collaborate with the GOH in monitoring the performance of the real economy in light of the impact of the fiscal/monetary program on the productive sectors. In particular, the Bank and the GOH will monitor (1) the effect of external fund transfers on the exchange rate, (2) the impact of the fiscal deficit on private investment, and (3) the relationship between the fiscal deficit and the external current account deficit. The Bank will monitor these effects through a quarterly review of data to be defined with the GOH. In addition, the technical assistance program will include financing for a series of studies to investigate these issues throughout the execution of the program.

C. Legal and regulatory reform of the financial sector

2.8 The primary objective of the financial sector reform initiative will be to establish a modern legal, regulatory and institutional framework, first addressing the most threatening weaknesses of the financial system.

2.9 The economic efficiency of the Haitian banking system in intermediating capital has been limited historically by a composition of factors external to the industry itself, notably the GOH fiscal and monetary policy, an inadequate legal and judiciary system and constraints to real sector firms. Weaknesses in the legal and regulatory structure of the banking industry have exposed the sector to external shocks as well as risks arising from unregulated competition. As described above, the macroeconomic instability has resulted in the predicable pressures on the banking system. This has come at a time when two of the four foreign banks have or are exiting Haiti and local investors have created four new banks since 1991, resulting in aggressive competition for a small number of clients, depositors and bank employees in a period of significant economic contraction. In response to liquidity constraints on local currency deposits, financial institutions have increased off-balance sheet transactions and dollar deposit accounts, which are not subject to legal reserve requirements. However, with a limited number of clients willing or capable to assume foreign exchange risk, the banks have increasingly matched dollar liabilities with local currency assets, priced at historically high interest rates to cover the banks' currency risk exposure. The combination of these factors has created elements of

risk at a scale previously unknown to the sector and provoked behavior that compromises the integrity of the banking system. These recent developments require immediate correction of longstanding weaknesses in the legal and regulatory structure of the sector.

2.10 This component will entail the implementation of a calendar of legal and regulatory reforms supported by a technical assistance component to support the implementation of the new framework. The precise sequence and timing of the reforms is designed to address the most immediate sources of risk to the financial sector while building the basis for a transparent and efficient regulatory regime. The proposed calendar of reforms and the technical assistance program will build on the current IMF program of support to the Central Bank.

2.11 **The legal framework.** The reform of the legal framework of the financial sector will be carried out with a view to establishing an institutional framework appropriate for a market-oriented, open economy. The legal reform will involve a modernization of the general banking law, BRH organic law and complementary aspects of the commercial and civil codes to ensure the autonomy and authority of the BRH as the regulator and supervisor of the sector as well as the appropriate legal framework for enforcement of prudential norms. Priority will be given to establishing the regulatory regime for all financial institutions, clear and sound rules for market entry and exit and the authority of the regulator to govern all aspects of market entry and exit. The Policy Letter presents the guidelines that will be govern this reform.

2.12 The legal reform will also establish an adequate framework for Haiti's emerging capital market. Currently, Haiti has virtually no money or capital markets. The legal framework does not adequately support the private issue of bonds. There are no treasury issues and the Central Bank does not engage in open market operations. The national pension fund Office National d'Assurance Vieillesse (ONA) and the civil service and military pension funds (Pension Civile and Pension Militaire) are in need of reform. Regulation of the private pension funds and the insurance industry are not adequately supported by the Haitian legal code, and neither sector is supervised.

2.13 **The normative framework for prudential regulation.** Current prudential norms and financial reporting requirements are deficient, particularly in areas of increasing risk: portfolio classification, related party (risk concentration) and insider lending, and capital adequacy. In addition, the lack of uniform accounting procedures and consolidated financial reporting on bank groups impedes application and supervision of prudential norms. However, the BRH issued the first of its program of prudential norms, the norm regulating foreign exchange positions, with an effective date of October 1, 1996.

2.14 Given the complexity and time required to complete the comprehensive legal reforms, the first phase of the ISL operation will focus on establishing critical prudential norms within the existing legal framework and providing technical assistance to the Division de la Supervision Bancaire et Institutiones Financieres (DSBIF). 5/ The second disbursement of the financial sector tranche will be conditioned on the legal effectiveness of the foundational elements of the normative framework and in drafting of changes to the legal framework, and the final tranche disbursement will follow legal effectiveness of the reformed legal framework and full implementation and compliance with the normative framework.

2.15 **Implementation of the reform**. The Central Bank will be the primary executing agency for the proposed reform of the legal and regulatory framework. The work will be carried out in collaboration with the Ministry of Economy and Finance (MEF), who will be responsible for sponsoring the presentation of legislation to the Council of Ministers and to Parliament.

2.16 The elaboration of the new laws and prudential norms, as well as the institutional reforms required to implement the new regimes, will be carried out within the existing program of technical assistance initiated by the IMF, supplemented with financing from the Bank. The Bank financed technical assistance program will provide the BRH with resources to procure relevant international experience during the process of drafting the laws and norms, consultation with the banking sector, and modernization of the Supervision Department. The BRH will consult with the Bank during the process to ensure that the new regime is satisfactory to the Bank.

2.17 The technical assistance program, summarized in the Plan of Operations in Annex III, will also include a complementary component designed to modernize and strengthen those aspects of the Central Bank directly related to its essential role in managing monetary policy and the payments system. This component of the program is critical to the overall program objective of establishing an adequate institutional framework for determination and management of monetary policy, public sector expenditure management, and efficient management of the increasingly complex financial sector and payments system. A priority for this program will be to support the development of open-market instruments that provide the Central Bank with a mechanism for remuneration and eventual reduction of the legal reserve requirement.

5/ This approach is consistent with the diagnosis and reform program supported by the Department of Monetary and Exchange Affairs of the IMF.

D. Secured transactions reform

2.18 The Haitian legal code does not provide an adequate framework for the creation of security interests (collateral) in credit contracts. The perfection of security interests is impeded by lack of a unified registry of liens in the case of chattel mortgages, an antiquated system of mortgage perfection that is controlled by notaries, cumbersome access to public registries that are inefficient and unreliable, and the lack of a cadastral system for the identification of real estate. Finally, the enforcement of security interests suffers from a particularly weak judicial process and general ignorance of the law. As a result, very few clients can produce the collateral required by banks and thus bank lending has been limited historically to people related to or well known to the banks.

2.19 The policy matrix of the ISL will include the legislation of a reformed legal and institutional framework for secured transactions. Technical support for implementation of the reform program is provided through ATN/MT-5078, approved in December 1995. This component of the program addresses one the most fundamental constraints to the extension of credit services to historically marginalized sectors of the market and will alleviate the currently dangerous competition in the banking sector for the few clients that can meet current requirements for collateral. The positive impact on the micro and small business sector, both urban and rural, is expected to be significant.

E. Stabilization of the state banks

2.20 Haiti's two state-owned commercial banks, the Banque National de Credit (BNC) and the Banque Populaire Haitienne (BPH), comprise approximately 25% of the banking system, the former being the second largest commercial bank and the latter the smallest. General assessments by the International International Finance Corporation (IFC) during 1995 indicated that the BPH has a negative net value of approximately US$1.5 million but is currently profitable due to reasonably sound management. Following the assessments, the GOH, in the PFP, identified both banks among the list of state-owned enterprises to be privatized over the next two years.

2.21 Subsequent analysis of the BNC indicates, however, that the performance of the institution has deteriorated significantly since the period of the IFC assessment. Information presented by the BNC to the BRH over the period September 1994 to March 31, 1996, provides indication of financial distress, lack of management and control systems, and transactions that require careful examination to determine the current condition of the BNC as well as the potential risk it poses to the financial system. In addition, official correspondence between the BRH and the BNC over the past years is characterized by a lack of BNC compliance with Central

Bank communiques and instructions as well as a lack of enforcement of the same.

2.22 The more recent assessments of the BNC demonstrate the possibility of mounting fiscal liabilities as the performance of the BCN deteriorates and, therefore, the need to determine the actual financial performance of the BNC followed by immediate corrective action to bring the BNC into conformity with prudential norms and regulatory measures required to establish the soundness of the bank. These actions are also a necessary preliminary step towards inviting private sector participation in the ownership and management of the BNC. However, privatization of either the BNC or the BPH will be considered only after the implementation of the proposed legal and regulatory reforms in the financial sector.

2.23 The BRH will supervise a full diagnostic assessment of the BNC followed by a program of corrective actions as described above. The BRH will contract the services of a firm with appropriate international experience in performing such assessments, as described in the draft terms of reference elaborated for this purpose in collaboration with the BRH. The technical assistance program with the BRH will include financing for the diagnostic, as well as for the subsequent corrective measures.

2.24 Any capitalization or privatization scheme involving the state banks will be postponed until the introduction of the new legal and regulatory framework of the financial system, the diagnostic study of the two banks and completion of subsequent corrective actions required to bring the BPH and BNC into conformity with the legal and prudential framework and measures necessary to establish the soundness of the banks. In addition, during the duration of the program, neither the BRH nor the FDI will increase the net amount of their loans to BNC and BPH beyond levels prevailing as of September 1996, and the Government of Haiti will not provide either of the state banks with any form of additional capitalization.

2.25 **Fonds de Developpement Industriel**. The Fonds de Developpement Industriel (FDI) is a second-tier financing facility housed in the BRH that provides loan guarantees and rediscounts loans originated by commercial banks. FDI loans at negative real interest rates, well below the marginal cost of capital in the financial market, without adequate qualification of the financial institutions, including institutions not regulated by the DSBIF. The pricing policies of the FDI, as well as other guarantee mechanisms recently financed by bi-lateral agencies are highly subsidized and directed and the eligibility criteria are inadequate. The impact on the banking sector is minimal, however, as long as these programs do not grow beyond their currently modest scale. The Policy Letter reflects the GOH's commitment to restructuring the FDI in the context of the financial sector reform and to developing prudential guidelines for the classification of loans with such third-party guarantees.

F. Reform of the electricity sector

2.26 The lack of infrastructure and basic services - specifically roads, maritime, customs, electricity, communications, and water and sanitation constitute the most significant constraints to private sector firms, especially in the real sectors. All of these services are controlled by the GOH and have suffered from mismanagement and the lack of public investment. In addition, elimination of the current fiscal loss incurred by Electricité d' Haiti (EdH) is a critical component of the macroeconomic program. Any substantial improvement in this area will require industry restructuring with a significant element of private participation in the management or ownership of these currently public utilities.

2.27 In October, 1996, Parliament passed the Public Enterprise Modernization Law, authorizing the Public Enterprise Modernization Commission (CMEP), with the assistance of a Technical Secretariat, to conduct the transactions required to facilitate private sector participation in the currently state-owned enterprises in the form of a mixed-company, management contract or concession. Nevertheless, it is possible that the desired form of private sector participation and industry structure in any given sector will require additional changes to existing legal framework, and these changes may require parliamentary legislation. Moreover, the Modernization law requires that all concession contracts be submitted for the approval of Parliament, introducing a significant level of uncertainty in the reform process, particularly for the private sector bidders, that the law was originally intended to eliminate.

2.28 The electricity sector component of ISL program will focus on facilitating private sector participation in the ownership and/or management of the currently state-owned enterprise EdH. EdH is an autonomous institution of the GOH under the direct supervision of the Ministry of Public Works, Transportation and Communications, with a national monopoly on the generation, transmission, distribution and commercialization of electric power. The performance of EdH has shown an accelerating downward trend at least for two decades, due to numerous technical and managerial problems, themselves rooted in the institutional and incentive structure of EdH and distorted by its dependence on the state. The situation is unsustainable fiscally and imposes devastating production costs on the productive sectors.

2.29 The reform of EdH will be financed by ATN/MT-5334 and includes 1) the contracting of a consultant to assist the GOH in formalizing the GOH policy for the sector reform and in preparing the terms of reference and selecting an international firm to prepare the bidding documents and legal framework, 2) contracting of the international firm and execution of terms of reference, 3) legislation of any required legal and regulatory reforms, 4) execution of the bid and selection of the private owner/operator.

2.30 Since July 1995, Electricité de France (EdF) and Hydro-Quebec (HQ) have provided technical assistance to EdH, financed by the Caisse Francaise de Developpement (CFD) and the Canadian International Development Agency (CIDA). This technical assistance team has been responsible for the implementation of generation rehabilitation works and has also provided assistance in all other areas of operation and management of EdH. Its work has been crucial in restoring the thermal capacity, repairing the distribution and transmission networks, and improving commercialization, billing, accounting and financial management. Although the lack of autonomy of the EdF and HQ hampered progress during the first phase, the contract for phase II of the operation will set more appropriate guidelines concerning the autonomy of the technical assistant providers. It is of crucial importance that the work continue during preparation of the sector reorganization plan. The CFD is willing to continue funding this technical assistance as a preparatory effort within the reform program proposed in the ISL and financed with the MIF operation.

G. Environmental protection measures

2.31 The proposed electricity sector reform is expected to establish a legal, normative and institutional framework for the regulation of the electrical sector, including issues related to environmental impact. Therefore, the overall impact of the reform is expected to be positive. However, the reform must be structured to ensure adequate regulation and enforcement of measures designed to address both existing environmental liabilities as well as those that will emerge with the expected expansion of the privatized company.

2.32 The authority and technical secretariat to be established through the global framework law will be responsible for definition and implementation of all of the proposed sectoral reforms. This authority will be responsible for ensuring that environmental measures are incorporated into the reformed industry structure.

2.33 In order to provide the Government with adequate resources to implement a sound environmental policy within the sectoral reforms, the MIF operation that will finance the electricity sectoral reform will include an environmental assessment in order to determine the impact of the reform and define the policy and regulatory framework as well as enforcement mechanisms for environmental issues.

2.34 Environmental policies will be implemented through two principal mechanisms:

1. Legal and regulatory framework

2.35 The legal and regulatory framework that will be designed for the electricity sector will determine the responsibility of the regulatory agency for supervising those aspects of the law that define the Government's policy on conservation of natural resources

affected by the sector. For example, tariff prices should reflect the economic cost of natural resource extraction.

2. Contracting with the private sector

2.36 The contract that governs the participation of the private sector in the management and/or ownership of the electricity sector enterprises must define the responsibilities of the private operator/owner with respect to the environmental aspects of the legal framework.

H. Status of actions taken to initiate reforms

2.37 The GOH has taken the measures listed below, and identified in the matrix in Annex I, to initiate the implementation of reforms anticipated in the ISL program. In addition, the GOH confirmed their commitment to the precise sequence of the proposed reforms during the Negotiation mission.

1. Economic framework

2.38 On October 18, 1996, the Executive Board of the IMF approved the ESAF agreement with Haiti, formalizing the GOH's commitment to a macroeconomic program consistent with the basic objectives of the ISL. The GOH presented the IDB with a signed copy of the Policy Letter of the ISL on November 18, 1996.

2. Legal and regulatory framework of the financial sector

2.39 The BRH initiated an ambitious program of modernization of the prudential norms and DSBIF at the same time that the Bank initiated discussions with the GOH regarding the ISL. As agreed during the Analysis mission, the BRH has emitted the first of the planned sequence of prudential norms. On October 7, 1996, the BRH sent a letter to the Professional Bankers Association (PBA) informing them of the reforms anticipated in the World Bank and IMF programs, with copies of the relevant documents. The BRH will also inform the PBA regarding the ISL program when the program has been finalized. Finally, the Plan of Operations of the parallel Technical Cooperation agreement defines a technical assistance program which, supplementing the existing UNDP/IMF program, provides the BRH with the resources required for implementation of the ISL reforms.

3. Secured transactions reform (sub-component of the financial sector tranche)

2.40 A draft of the Law governing chattel mortgage on movable property and the corresponding public registry is currently under final revision and, according to information provided by the GOH to the negotiation mission, will be ready for final consideration of the Council of Ministers and presentation to Parliament when they return to normal session in January 1997. The rapid process of designing the draft legislation is due to the broad participation

and consensus of representatives from all relevant State institutions as well as the private sector.

4. State banks

2.41 On July 25, 1996, the BRH advised the BNC of its intentions to conduct a supervision mission of the BNC. During the Analysis phase of the ISL, terms of reference for mission where drafted and discussed with both the BRH and the BNC. BRH has solicited proposals from international firms to provide assistance with the assessment, to be paid with resources of the parallel Technical Cooperation agreement with the Bank.

5. Electricity sector reform

2.42 The Haitian Parliament passed the Public Enterprise Modernization Law on October 10, 1996 establishing the CMEP with the authority to implement reforms of the public enterprises with the objective of incorporating the participation of the private sector through management contract, leasing or concession agreements, or equity ownership. The CMEP, through its Technical Secretariat, will be the executing agency for the MIF operation ATN/MT-5334, which provides the resources required for the planned reform of the electricity sector. In addition, the GOH signed an agreement with the Caisse Francaise and CIDA in October 1996, extending the existing technical assistance contract with EdF and HQ in order to make critical improvements during the process of negotiations with future private sector owners or concessionaires.

2.43 These actions were taken by the GOH in the attempt to initiate a complex reform process in a political environment subject to the dynamics of an incipient democracy. The Bank Project Team and management have worked with the GOH to design a sequence of the reform process that is politically manageable and precise enough to allow the Bank to accompany the GOH through a reform process that can be monitored in terms of tangible results and adapted to the changing Haitian environment. During the Negotiation mission, the GOH formalized their commitment to the spirit of the reform process reflected in the Policy Letter as well as the implementation sequence presented in the Policy Matrix. Most importantly, the GOH has demonstrated their capacity to develop consensus and mobilize sufficient resources to initiate the reform process that will be completed with the assistance of the Bank through the ISL program.

III. PROGRAM EXECUTION

A. Program execution

3.1 The borrower for the fast-disbursing component of the ISL (the Project) will be the Republique d'Haïti.

3.2 The Ministry of Economy and Finance (MEF) will be responsible for execution of the Project and use of the fast-disbursing resources. The Program will be executed by four different agencies. The Ministry of Planning and External Cooperation (MPEC) will be responsible for overall program coordination, including the collection of evidence of condition compliance and reports due to the Bank. The Prime Minister, in his capacity as the presiding member of the Council for the Modernization of Public Enterprises (CMPE), will be responsible for the execution of the electricity sector component, with the understanding that the CMPE will be the executing agency of this component when it is formally constituted. The BRH will be the executing agency for the legal and regulatory reform of the financial sector and the state bank component. And the MPEC will supervise the execution of the secured transaction reform component through the implementation of the ATN/MT-5078 Program.

B. Program financing

3.3 The total amount of the program will be US$52,745,000, consisting of US$50 million of fast-disbursing resources to be disbursed according to the normal conditions of the Fund for Special Operations (FSO), US$2.495 million for a Technical Cooperation Loan to be disbursed from the FSO, and US$250,000 in local counterpart funding for the Technical Cooperation Loan. In addition, MIF resources of US$1,157,000 will be used to finance the Energy Sector Reform program (ATN/MT-5078).

3.4 The proposed amount of US$50 million of fast-disbursing resources represents a critical component of the projected US$264 million required during fiscal years 1997 and 1998 for externally financed budget support (or, alternatively, the US$271.8 million projected in net public sector capital in-flows on the capital account of the balance of payments). The ISL fast-disbursing component is especially important given that the flow of funds may be impeded by the limited ability the GOH to meet disbursement requirements of other sources of financing.

C. Terms and conditions

3.5 The terms and conditions of the proposed FSO financing are summarized below:

Terms and Conditions	Detail
Amount	Total: US$52,745,000 - fast-disbursing funds: US$50,000,000 - technical cooperation: US$ 2,495,000 - counterpart funding: US$ 250,000
Grace period	10 years
Amortization period	40 years
Disbursement period	24 months for fast-disbursing funds; 36 months for technical cooperation financing
Interest rate	1% per annum for the first 10 years; 2% per annum until final repayment of the loan
Inspection and Supervision	1%
Credit fee	0.5% per annum of the undisbursed balance

D. <u>Disbursement Schedule for fast-disbursing financing</u>

3.6 The first tranche of the fast-disbursing component of the ISL will be 20% of the total, or US$10 million, and will be eligible for disbursement upon legal effectiveness of the loan contract between the Bank and the Republique d'Haiti and compliance with conditions prior to first disbursement. The balance of the fast-disbursing resources will be allocated to three, sector-specific, non-sequential "floating" tranches, which will be disbursed as conditions specific to each tranche are met; all disbursements will be subject to the condition of maintenance of a sound macroeconomic framework consistent with program objectives and compliance with the policy objectives and programs described in the Policy Letter. Evidence of compliance with audit conditions on prior disbursements will also be required at the time of each tranche disbursement. The amounts assigned to each tranche are as followed: 1) financial sector tranche for US$15 million, 2) state banks tranche for US$10 million, and 3) electricity sector tranche for US$15 million.

3.7 The floating tranches for the financial sector and state banks will consist of a part A and B, with the tranche amount divided between them: US$5 and US$10 million for parts A and B, respectively, of the financial sector tranche, and US$5 million for both parts A and B of the state banks tranche. These tranches will be disbursed in two parts, as the conditions defined in parts A and B are fulfilled, always under the condition of compliance with the macroeconomic program conditions. The electricity sector tranche will be disbursed in one part when the conditions for that tranche, as well as the macroeconomic conditions, have been fulfilled. See the disbursement table below for a summary. Compliance with all conditions proposed for the floating tranches should be achieved within 18 months of the effective date of the contract. A final

disbursement period of 24 months following contract effectiveness is proposed for the disbursement period.

Disbursement Table

<table>
<tr><th>Floating Tranches
(US$ millions)</th><th>First
Disbursement</th><th>Part A</th><th>Part B</th></tr>
<tr><td>Financial Sector</td><td rowspan="3">10.0</td><td>5.0</td><td>10.0</td></tr>
<tr><td>State Banks</td><td>5.0</td><td>5.0</td></tr>
<tr><td>Electricity Sector</td><td colspan="2">15.0</td></tr>
</table>

E. <u>First Tranche: conditions prior to first disbursement</u>

3.8 The proposed conditions prior to first disbursement, presented in the Policy Matrix in Annex I, represent the minimum actions required to establish an environment conducive to the reform as well as the GOH commitment to the reform program. These conditions, as well as the criteria for their fulfillment, were finalized during the negotiation mission. Justification of each of the conditions is provided below.

1. <u>Conditions related to Program administration</u>

3.9 These conditions are necessary to ensure that the GOH has established an appropriate mechanisms for program coordination and that the GOH has the technical assistance resources it will require to carry out the reforms. The GOH will present, to the satisfaction of the Bank:

(a) evidence that the contract for the parallel Technical Assistance Loan is legally effective;

(b) evidence that the MPEC has appointed the person responsible for Program coordination activities.

2. <u>Conditions related to the macroeconomic program</u>

3.10 The objective of this component is the maintenance of a macroeconomic environment based on sound fiscal and monetary policies conducive to private sector led growth in the productive sectors. GOH will present, to the satisfaction of the Bank:

(a) evidence of the establishment of a sound macroeconomic framework consistent with objectives of the ISL Program; and,

(b) evidence of implementation of programs and policies described in the Policy Letter.

3. <u>Conditions related to the financial sector tranche</u>

3.11 The objective of this component is the establishment of a legal and regulatory framework conducive to a safe, sound and competitive financial system. In addition, the secured transactions component is intended to establish a legal and institutional framework conducive to efficient creation, perfection and execution of secured transactions

3.12 These conditions have been constructed to initiate a reform process that is both transparent and supported with the technical assistance the BRH requires. The conditions represent benchmark actions of the reform process currently supported by the existing IMF/United Nations Development Program (UNDP) program of support to the BRH. Conditions related to the Secured Transactions Reform Program reinforce the terms of the separate contract governing that agreement, executed by the Presidential Commission for Economic Growth and Modernization under the supervision of the MPEC. The GOH will present, to the satisfaction of the Bank:

(a) evidence of legal effectiveness (including an attesting legal opinion) of the prudential norm regarding foreign exchange position;

(b) evidence of official notification of the Professional Bankers Association by the BRH regarding the financial sector reform program defined in the ESAF and ISL programs;

(c) evidence of an action plan and financing for technical assistance plan for implementation of the reform program;

(d) evidence that the law establishing a legal framework for the chattel mortgage (gage sans déposession) on moveable property and the corresponding lien registry system has been formally presented to Parliament.

4. <u>Conditions related to the state bank tranche</u>

3.13 The objective of this tranche is to bring BNC into conformity with all prudential norms and regulatory measures required to establish the soundness of the bank. The GOH will present, to the satisfaction of the Bank:

(a) evidence of official notification from the BRH to the BNC regarding the implementation of an inspection mission;

(b) evidence of effective contract with experts with relevant international experience, acceptable to the Bank, to assist the BRH in the BNC diagnostic assessment;

(c) evidence that neither the BRH nor the FDI have increased their respective balances of credit outstanding to the BNC or the BPH as of September 1996; and,

(d) evidence that neither BNC nor BPH have been capitalized by the public sector beyond levels outstanding as of September 1996.

5. Conditions related to the electricity sector tranche

3.14 The objective of this component is to improve productive and allocative efficiency of electricity sector via private sector participation (PSP) in the management/ownership of EdH, with appropriate legal and regulatory framework. As a means to this end, the program supports the GOH's effort to establish a global policy and institutional framework for the anticipated reforms involving PSP in management/ownership of currently state-owned enterprises.

3.15 The first three conditions correspond to the GOH's decision to establish a global legal and institutional framework for the reform of state-owned enterprises. The conditions are necessary to ensure that the CMEP, recently mandated by the Public Enterprise Modernization Law, is established, agrees to assume the responsibilities of executing agency, and is operationally capable of implementing the proposed reforms. The condition related to the shortlist of consultants ensures a timely decision by the CMEP to initiate the process according to commonly accepted international standards. The last condition is necessary to ensure adequate short term management of the enterprise. The GOH will present, to the satisfaction of the Bank:

(a) evidence of an effective legal and regulatory framework for private sector participation (PSP) in the electrical sector in the form of management contracts, leasing or concession agreements, or equity ownership;

(b) evidence that the CMEP (1) has accepted the contractual obligations and responsibilities of the executing agency of the electricity sector component, and (2) has ratified its commitment to carry out the activities described in articles (c) and (d) of paragraph 3.15 and articles (a) through (d) of paragraph 3.21;

(c) evidence that the Technical Secretariat of the CMEP is functioning and staffed with qualified personnel, and has the legal authority to act as executing agency of ATN/MT-5334;

(d) evidence of official invitation sent to short list of consultants selected to present proposals for preparation of bidding documents and legal framework for electricity sector reform; and,

(e) evidence of signed letter of agreement between GOH and Caisse Francaise/CIDA with terms and conditions of extended, reinforced technical assistance contract for EdH.

F. Floating tranche conditions

1. Economic framework

3.16 Conditions related to the macroeconomic framework will apply at all times to all of the individual floating tranches. Both Part A and Part B consist of the same two conditions. The GOH will present, to the satisfaction of the Bank:

(a) evidence of maintenance of a sound macroeconomic framework consistent with objectives of the ISL program; and,

(b) evidence of implementation of programs and policies described in the Policy Letter.

2. Financial sector floating tranche

3.17 Part A of the financial sector floating tranche consists of the following conditions. The GOH will present, to the satisfaction of the Bank:

(a) evidence of banking sector compliance with existing prudential norms, regulatory and reporting requirements;

(b) evidence of legal enactment (with attesting legal opinion) of (i) uniform chart of accounts and accounting policies and procedures for commercial banks, and (ii) norms requiring consolidated financial reporting requirements for banks and their associated companies, with previous third-party technical review and approval by the IDB;

(c) evidence of legal enactment (with attesting legal opinion) of the prudential norms governing (i) portfolio classification and provisioning, (ii) risk concentration in related parties and insider lending, and (iii) capital adequacy, with previous third-party technical review and approval by the IDB. These norms will include the calendar for compliance with the norm, penalties for non-compliance, and the treatment of transactions with parties related to the banks;

(d) drafts of general banking law and BRH organic law, together with third-party technical opinion, for IDB commentary;

(e) evidence of legal effectiveness of the law (accompanied by a copy of the Moniteur in which it is published) establishing the legal framework for chattel mortgage (gage sans deposession) on movable property and inventory, and for the corresponding lien registry system, following IDB review of third-party technical opinion and approval of the text of the law;

3.18 Part B of the financial sector floating tranche consists of the following conditions. The GOH will present, to the satisfaction of the Bank:

(f) evidence of continuing compliance with the conditions stipulated in Part A;

(g) evidence of legal effectiveness of the General Banking Law and the Organic Law of the BRH (accompanied by a copy of the Moniteur in which they are published);

(h) evidence of legal effectiveness of the law (accompanied by a copy of the Moniteur in which it is published) establishing the legal framework for chattel mortgage (gage sans deposession) on accounts receivable, and for the corresponding lien registry system, following IDB review of third-party technical opinion and approval of the text of the law;

3. <u>State banks floating tranche</u>

3.19 Part A of the state banks floating tranche consists of the following conditions. The GOH will present, to the satisfaction of the Bank:

(a) evidence of legally effective BRH directive (with attesting legal opinion) defining plan of corrective actions (with quantitative indicators and monitoring method) for BNC conformity with prudential norms, regulatory and reporting requirements and measures required to establish soundness of the bank. The Bank will review the content of the directive prior to its emission;

(b) evidence of BNC conformity with BRH directive;

(c) evidence that neither the BRH nor the FDI have increased their respective balances of credit outstanding to the BNC or the BPH as of September 1996;

(d) evidence that neither BNC nor BPH have been capitalized by the public sector beyond levels outstanding as of September 1996.

3.20 Part B of the state banks floating tranche consists of the following conditions. The GOH will present, to the satisfaction of the Bank:

(e) evidence of continuing compliance with conditions of Part A, stipulated in articles (a), (c) and (d) of paragraph 3.19;

(f) evidence of BNC conformity with BRH directive, including the quantitative targets and indicators established by the Bank and the BRH at the time of disbursement of Part A.

4. <u>Electricity sector floating tranche</u>

3.21 The GOH will present, to the satisfaction of the Bank:

(a) evidence of legal effectiveness (with attesting legal opinion) of a legal and regulatory framework that ensures (i) legal effectiveness of the contract described in article (b) of this paragraph, (ii) adequate regulation of the electricity sector, and (iii) competition;

(b) evidence of legal effectiveness (with attesting legal opinion) of a contract that defines the terms of a private sector agent's participation in the management and/or ownership of EdH in the form of a management contract, leasing or concession arrangement, or equity participation, in accordance with the principles defined in the Policy Letter.

G. Administration

1. Disbursement procedures and conditions

3.22 Disbursement of fast-disbursing resources will follow the Bank's policies for sector loans, which allow for retroactive financing of authorized expenditures made within six months prior to the date on which the loan contract becomes effective, with total retroactive financing limited to 50% of the total loan.

3.23 Fast disbursing resources will be used to finance the Free on Board (FOB) cost of authorized imports, or the Cost, Insurance and Freight (CIF) cost if freight is included. Disbursement under each tranche will be made against the presentation of import documents by the MEF, which will be responsible for coordinating and compiling the necessary documentation and for preparing and submitting disbursement requests. The MEF will keep the import documentation on file for examination by authorized Bank personnel and the auditors.

2. Records and auditing

3.24 For each disbursement, the executing agency will provide documentation listing the goods imported during each period, the country of origin, and the date and value of the transaction. The borrower will open an account in the Central Bank for accounting and control of loan transactions. The Bank will establish inspection procedures to ensure satisfactory program execution.

3. Inspection and supervision

3.25 The Bank shall establish such inspection procedures as it deems necessary to ensure satisfactory execution of the program. The borrower shall cooperate fully in providing all assistance and information required for this purpose.

3.26 The borrower and the Bank shall hold quarterly meetings to review the progress achieved in implementation of the proposed reforms and the supporting technical assistance programs, fulfillment of conditions prior to the disbursement of the tranches, and the

consistency between the economic framework and the objectives of the ISL program. Prior to these quarterly meetings, the Bank will present the borrower with a list of specific information to be provided by the borrower in report form prior to the meeting.

4. Ex-post evaluation

3.27 The ex-post evaluation will be conducted within twelve months after final disbursement of the loan. The Bank will provide detailed terms of reference for the evaluation, anticipating the participation of Bank staff in the evaluation missions. The evaluation will entail an assessment of compliance with loan execution conditions, fulfillment of the policy conditions and, as far as possible, the impact of the reforms.

H. Environmental classification

3.28 The Environmental Committee designated HA-0046 as a Category III operation in the meeting of June 11, 1996.

I. Technical Assistance Program

1. Program execution

3.29 The BRH will be the borrower of the Technical Assistance Loan and will assume all the responsibilities of the executing agency of the Technical Assistance Program as defined in the Plan of Operations in annex III.

2. Cost and Financing

3.30 Total cost of the proposed program is the equivalent of US$2,745,000 consisting of the equivalent of US$2,495,000 financed by the Bank, and the equivalent of US$250,000 in counterpart funds. Counterpart funds will used to provide equipment, on-site training and general administration expenses.

3.31 The program execution period will extend to 24 months beyond the effective date of the contract, and the final disbursement will be made no more than 36 months beyond the same date.

3. Procurement

3.32 Procurement of goods and services with program resources will be conducted according to the normal procedures of the Bank. The procurement of goods and services in amounts greater than the equivalent of US$250,000 will be conducted by an international bidding process. For acquisitions of less that US$250,000, procurement will be conducted according to national procedures.

3.33 The diagnostic assessment of the BNC will be awarded to a consortium consisting of Gardiner, Kamya International, Inc., KPMG/Mérové-Pierre, and Hanney and Associates in a sole-source

contract. The firm of KPMG/Mérové-Pierre is the only Haitian firm with affiliation to internationally recognized accounting and auditing firms. The firm has extensive and unrivaled experience in auditing the institutions of the Haitian banking sector. Moreover, the firm supervised the separation of the BNC from the Central Bank in 1979. Peter Hanney of Hanney Associates has provided support to both the Central Bank and the IDB during the conceptualization of the proposed program and his participation is required to ensure continuity during program execution. The firm Gardiner has been selected by KPMG/Mérové-Pierre and Hanney Associates to provide the additional expertise required in the assessment.

4. Advance of Funds

3.34 An advance of funds equivalent to 10% of the amount of financing provided by the Bank will be made to facilitate efficient disbursement of program resources.

5. Reimbursement of expenses with program resources

3.35 In order to avoid unnecessary delays in the execution of the reform program, resources of the program can used to finance the purchase of goods and services for the period that begins up to twelve months prior to Board approval. The amount of resources used to finance expenses during this period is limited to US$250,000.

6. Evaluation and monitoring

3.36 Completion of the program will be evaluated on the basis of successful completion of the reform program as well as a general assessment of the BRH's capacity to perform the essential functions of a central bank.

3.37 Progress and constraints will be monitored by the quarterly reports of the long-term advisors and the semi-annual reports of the BRH. The Bank will hire, with program resources, a consultant to assist with the mid-term evaluation. In addition, performance of the BRH in the execution of the economic program will provide significant benchmarks for the general assessment in the final evaluation.

IV. VIABILITY AND RISKS

A. **Benefits**

4.1 Successful completion of the program should produce two principal benefits for the country. First, the fast disbursing resources will contribute to an economic stabilization plan that is expected to control inflation and facilitate private sector confidence. This benefit has far reaching and immediate positive effects for all sectors. In the medium term, successful completion of the reform program will also reduce the potential fiscal costs associated with the state-owned enterprises and financial sector, thereby facilitating a more rational allocation of budget resources. Secondly, the reform program itself will also result in reduced transactions costs for the productive sectors and begin to establish a business environment conducive to long term economic growth.

B. **Risks**

4.2 Sustainable progress towards medium term development objectives in Haiti will require political and social stability, an unprecedented level of efficiency in public sector management, confidence and leadership from the private sector, and the development of Haiti's human capital. The GOH will have to maintain its commitment to an open economy and efficient use of foreign assistance resources, and the international community will have to support the process over a significant period of time. The dynamics of an emerging democracy, compounded by the pressure of a growing and increasingly urban population present additional challenges to the process.

4.3 There are three categories of risks that will come to bear on the implementation of the proposed ISL program: risks related to the macroeconomic program, the sectoral reforms, and to the implementation capacity of the executing agencies. These risks are compounded by the fact that many of the critical steps in the proposed reforms are scheduled late in the program calendar.

1. Risks related to the macroeconomic program

4.4 As indicated in the Framework chapter, the fiscal/monetary program is based on assumptions regarding fiscal revenue performance, public expenditure management, and the absorption of external financial resources that will require immediate and profound transformation of state institutions. In broader scope, the macroeconomic program is based on ambitious projections regarding GDP growth, increases in exports, and a decreasing external account deficit; the veracity of all projections are subject to the lack of reliable empirical data. Failure to maintain the required balances in the internal and external accounts will have a profoundly negative effect on the proposed programs, and on private investment and economic growth in general.

4.5 The GOH will have to make careful use of currently available external resources, investing in priority areas that will stimulate the growth of domestic savings capacity to compensate for the gradual decline of foreign assistance. External assistance is projected at high though declining levels, from about 13% of GDP in FY1997 to 8% in FY1999, two-thirds of which is expected from the Bank, the World Bank (IDA) and the European Union. The external debt, though expected to be in concessional terms, will require careful management in order to avoid an unmanageable debt service load in the future.

4.6 Moreover, the macroeconomic program, based as it is on tight fiscal and monetary policy, entails certain risks for private investment and economic growth. The high legal reserve requirements, maintained to compensate for past fiscal deficits, will continue to crowd out private sector investment and weaken the banking system unless the GOH begins to service its debt to the Central Bank and the Central Bank develops alternative monetary policy instruments. The benefits of tight monetary policy and internal and external price stability may also be outweighed by a deterioration in relative prices effecting the productive sectors; the effect could be particularly devastating in the export sectors. In particular, a real appreciation of the exchange rate could have a negative effect on relative prices, creating market signals that could cause changes in the patterns of production which may not be sustainable in the economic environment caused by the projected medium-term decline in the flow of external resources. This could generate negative results that would counteract the expected positive effects from the disciplined fiscal and monetary policies included in the macroeconomic program. The ISL program includes a series of studies to monitor this relationship between the fiscal/monetary program and economic performance of strategic sectors.

4.7 The considerable external current account deficits projected for the near future (between 10 to 15 percent of GDP per annum) signal the need to monitor the effects of projected policies and reforms in terms of economic growth, especially in the export sectors. The composition of imports and exports should be assessed in this context. Again, foreign financing may introduce macroeconomic distortions that could facilitate and unsustainable current account deficit. This calls attention to the relationship between the fiscal deficit (its level and its composition) and current account deficit, since most of foreign funds are channeled through the GOH. Evidence in recent history suggests that the economy in Haiti is very sensitive to the emergence and persistence of "twin deficits", and that the cost of reversing negative trends associated with them may be higher than Haiti can afford.

2. <u>Risks related to sector reforms</u>

4.8 The proposed sectoral reforms face the common risk of opposition from powerful and entrenched interests. These risks are compounded

in those cases where the proposed reform will require parliamentary legislation.

4.9 The conceptualization process of the GOH's reform program has been limited to high level policy discussions with the Executive branch and members of the Board and staff of the Central Bank. While this has expedited general policy discussions, the consensus of other stockholders in the reform process is uncertain.

4.10 The proposed financial sector reforms related to the Central Bank are consistent with the existing IMF program, and have been elaborated in coordination with management staff of the BRH. However, the reform is in its initial stages and will require a significant level of cooperation from the commercial banks.

4.11 The proposed audit and subsequent reform of the state banks will require the cooperation of the banks themselves as well as decisive action on the part of the Executive.

4.12 The Public Enterprise Modernization Law, ratified in October 1996, mandated the CMEP to define and carry out the proposed reform of the EdH and the electricity sector. However, the CMEP must be constituted, accept the responsibilities of executing agency for the ISL program, and establish a Technical Secretariat with adequate capacity to execute the activities defined under ATN/MT-5334. The lack of a clear counterpart during the development of the Program delayed the technical work required to advance the sectoral reform, and the new mandate assigned to the CMEP effectively preempts the policy directives discussed with the GOH during the orientation and analysis missions. Nevertheless, the CMEP is expected to be officially constituted before the end of 1996, and to begin the reform initiative immediately.

4.13 The most serious risk to the electricity sector reform stems from the law itself, which requires any concession contract negotiated by the CMEP to be ratified by Parliament. This condition introduces a significant element of risk into any transaction related to the public enterprises, and this will come to bear on the interest and behavior of potential bidders, as well as the negotiation process with the Republic.

3. Implementation capacity

4.14 The lack of implementation capacity and inter-institutional coordination in the GOH constitutes a fundamental constraint to the execution of the reform program. The severity of this condition constitutes the fundamental justification for the ISL, as well as the institutional focus of the reform program. This approach is consistent with one of the principle lessons derived from past sectoral loans, that institutional strengthening should precede substantial policy reform. At the same time, fast-disbursing operations have generally not been successful in supporting the long term efforts required to strengthen institutional capacity.

For this reason, the parallel TC component of the ISL is critical to the success of the program.

ECONOMIC POLICY

PROPOSED POLICY MATRIX FOR INVESTMENT SECTOR LOAN (HA-0046)

OLICY AREA	OBJECTIVE	ACTIONS REQUIRED PRIOR TO FIRST DISBURSEMENT	FLOATING TRANCHE CONDITIONS	
			PART A	PART
onomic Program	maintenance of a macroeconomic environment based on sound fiscal and monetary policies conducive to private sector led growth in the productive sectors	The GOH will present, to the satisfaction of the Bank: * evidence of establishment of a sound macroeconomic framework consistent with objectives of the ISL Program; * evidence of implementation of programs and policies described in the Policy Letter.	• evidence of establishment of a sound macroeconomic framework consistent with objectives of the ISL Program; • evidence of implementation of programs and policies described in the Policy Letter.	• evidence of establishme sound macro framework c with object the ISL Pro • evidence of implementat programs an policies de in the Poli Letter.

ursement schedule and conditionality matrix:

ranche of the loan will be eligible for disbursement upon legal effectiveness of the loan contract between the Bank and the Republique
ith conditions prior to first disbursement.

of the loan amount will be allocated to three separate "floating" tranches, which will be disbursed separately as the conditions specific to
addition, all disbursements will be subject to the condition of maintenance of a sound macroeconomic framework consistent with program ob
ith the policy objectives and programs described in the Policy Letter. Evidence of compliance with audit conditions on prior disbursements
the time of each tranche disbursement.

tranches for the Financial Sector and State Banks will consist of a part A and B, with the tranche amount divided between them to be disb
efined in parts A and B are fulfilled, always under the condition of compliance with the macroeconomic program conditions. The floating tra
Sector will be disbursed in its entirety when the conditions defined for the floating tranche have been met.

t tranche conditions marked with * have been identified as actions required to initiate the proposed reform sequence, and have been fulfille
mission.

PROPOSED POLICY MATRIX FOR INVESTMENT SECTOR LOAN (HA-0046): FINANCIAL SECTOR TRANCHE

OLICY AREA	OBJECTIVE	ACTIONS REQUIRED PRIOR TO FIRST DISBURSEMENT	FLOATING TRANCHE CONDITIONS	
			PART A	PART
ization of legal egulatory framework e financial system	establishment of a legal and regulatory framework conducive to a safe, sound and competitive financial system	The GOH will present, to the satisfaction of the Bank: * evidence of legal effectiveness (including an attesting legal opinion) of the prudential norm regarding foreign exchange position; * evidence of official notification of the Professional Bankers Association by the BRH regarding the financial sector reform program defined in the ESAF and ISL programs; * evidence of an action plan and financing for technical assistance plan for implementation of reform program.	• evidence of banking sector compliance with existing prudential norms, regulatory and reporting requirements; • evidence of legal enactment (with attesting legal opinion) of (i) uniform chart of accounts and accounting policies and procedures for commercial banks, and (ii) norms requiring consolidated financial reporting requirements for banks and their associated companies, with previous third-party technical review and approval by the IDB; • evidence of legal enactment (with attesting legal opinion) of the prudential norms governing (i) portfolio classification and provisioning, (ii) risk concentration in related parties and insider lending, and (iii) capital adequacy, with previous third-party technical review and approval by the IDB. These norms will include the calendar for compliance with the norm, penalties for non-compliance, and the treatment of transactions with parties related to the banks; • drafts of general banking law and BRH organic law, together with third-party technical opinion, for IDB commentary.	• evidence of continuing with the co stipulated • evidence of effectivenes General Ban and the Orga of the BRH (accompanie copy of the in which th published).

PROPOSED POLICY MATRIX FOR INVESTMENT SECTOR LOAN (HA-0046): FINANCIAL SECTOR TRANCHE

OLICY AREA	OBJECTIVE	ACTIONS REQUIRED PRIOR TO FIRST DISBURSEMENT	FLOATING TRANCHE CONDITIONS	
			PART A	PART
ization of the and institutional ork for secured ctions	establishment of a legal and institutional framework conducive to efficient creation, perfection and execution of secured transactions	• evidence that the law establishing a legal framework for the chattel mortgage (gage sans déposession) on moveable property and the corresponding lien registry system has been formally presented to Parliament.	• evidence of legal effectiveness of the law (accompanied by a copy of the Moniteur in which it is published) establishing the legal framework for chattel mortgage (gage sans deposession) on movable property and inventory, and for the corresponding lien registry system, following IDB review of third-party technical opinion and approval of the text of the law.	• evidence of effectivenes law (accompa copy of the in which it published) establishin legal frame chattel mor (gage sans deposession accounts re and for the correspondi registry sys following I of third-pa technical o approval of of the law.

PROPOSED POLICY MATRIX FOR INVESTMENT SECTOR LOAN (HA-0046): STATE BANK TRANCHE

OLICY AREA	OBJECTIVE	ACTIONS REQUIRED PRIOR TO FIRST DISBURSEMENT	FLOATING TRANCHE CONDITIONS	
			PART A	PART
Banks: BNC and BPH	bring BNC and BPH into conformity with all prudential norms and regulatory measures required to establish the soundness of the state banks	The GOH will present, to the satisfaction of the Bank: * evidence of official notification from the BRH to the BNC regarding the implementation of an inspection mission; • evidence of effective contract with experts with relevant international experience, acceptable to the Bank, to assist the BRH in the BNC diagnostic assessment; • evidence that neither the BRH nor the FDI have increased their respective balances of credit outstanding to the BNC or the BPH as of September 1996; • evidence that neither BNC nor BPH have been capitalized by the public sector beyond levels outstanding as of September 1996.	• evidence of legally effective BRH directive (with attesting legal opinion) defining plan of corrective actions (with quantitative indicators and monitoring method) for BNC conformity with prudential norms, regulatory and reporting requirements and measures required to establish soundness of the bank. The Bank will review the content of the directive prior to its emission; • evidence of BNC conformity with BRH directive; • evidence that neither the BRH nor the FDI have increased their respective balances of credit outstanding to the BNC or the BPH as of September 1996; • evidence that neither BNC nor BPH have been capitalized by the public sector beyond levels outstanding as of September 1996.	• evidence of continuing c with conditi Part A; • evidence of conformity w directive, i the quantita targets and indicators established Bank and the the time of ment of Part

PROPOSED POLICY MATRIX FOR INVESTMENT SECTOR LOAN (HA-0046): ELECTRICITY SECTOR TRANCHE

POLICY AREA	OBJECTIVE	ACTIONS REQUIRED PRIOR TO FIRST DISBURSEMENT	FLOATING TRANCHE CON
ical sector reform	improve productive and allocative efficiency of electricity sector via private sector participation in the management/ownership of EdH, with appropriate legal and regulatory framework	The GOH will present, to the satisfaction of the Bank: • evidence of an effective legal and regulatory framework for private sector participation (PSP) in the electrical sector in the form of management contracts, leasing or concession agreements, or equity ownership; • evidence that the CMEP (1) has accepted the contractual obligations and responsibilities of the executing agency of the electricity sector component, and (2) has ratified its commitment to carry out the activities of the electricity sector component (specified in the contract); • evidence that the Technical Secretariat of the CMEP is functioning and staffed with qualified personnel, and has the legal authority to act as executing agency of ATN/MT-5334; • evidence of official invitation sent to short list of consultants selected to present proposals for preparation of bidding documents and legal framework for electricity sector reform; and, • evidence of signed letter of agreement between GOH and Caisse Francaise/CIDA with terms and conditions of extended, reinforced technical assistance contract for EdH.	• evidence of legal eff (with attesting legal of a legal and regula framework that ensure legal effectiveness o contract described in (b) of this paragraph adequate regulation o electricity sector, a competition; • evidence of legal eff (with attesting legal of a contract that de terms of a private se agent's participation management and/or own EdH in the form of a contract, leasing or arrangement, or equit participation, in acc with the principles d the Policy Letter.

POLICY LETTER

MINISTRY OF ECONOMY AND FINANCE

Mr. Enrique Iglesias
President
Inter-American Development Bank
1300 New York Avenue, NW
Washington, D.C. 20577

Dear Mr. Iglesias:

1. The Government of Haïti is requesting an Investment Sector Loan (ISL) in support of its program of economic reform and structural adjustment. The proposed ISL program will consist of policy and institutional reforms aimed at removing the most immediate impediments to private sector-led economic growth as well as balance of payments financing in support of the Government's short term macroeconomic stabilization program.

2. The Government of President Aristide initiated an Emergency Economic Recovery Program shortly after returning to power in September 1994, supported by an immediate package of emergency assistance from the international community, that arrested the deterioration of key global economic indicators during 1995. Gross Domestic Product increased by 4.5% in real terms, net Central Bank financing of the central government was negative and international reserves were increased to an amount equal to 3.5 months of imports while the external current account deficit was financed with external resources. The 12-month rate of consumer price increases fell from 40% in 1994 to 30% in 1995, and the exchange rate appreciated and oscillated in the range of GD14-16:US$1. At the same time, the Government initiated several structural reforms in the trade and financial sectors.

3. Despite the stabilization efforts of 1995, however, fiscal performance deteriorated significantly in the last quarter of FY95 and continued to decline through the first half of FY96 due to weak public expenditure management. The GOH succeeded in limiting expenses in the second half of the fiscal year to the amount of received revenues, bringing the overall government deficit to 3.2% of GDP by the end of the fiscal year. Whereas foreign financed

budgetary support facilitated a modest reduction of domestic credit to the non-financial public sector during FY94-5, domestic financing of the FY96 deficit was equal to 2.8% of GDP. The Banque de la Republique d'Haïti (BRH, or Central Bank), with no open market monetary instruments, has taken recourse to high legal reserve requirements (between 48 and 51.5%) and sales of international reserves in order to protect the value of the Gourde. Thus the fiscal imbalances have contributed to the fragility of the macroeconomic environment, which continues to be the principal debilitating force across all sectors of the Haitian economy and constitutes a disincentive to business expansion and domestic savings as well as the repatriation of private capital for investment.

4. Expansion of economic activity has slowed since 1995. The primary and secondary sectors have performed poorly since the end of the embargo, an indication of serious barriers to future economic growth. Total agricultural production decreased by more than 7% during 1995. The export assembly industry has been slow to respond due to the reluctance of foreign clients and of local operators to invest private capital in the current environment. The tight monetary policy of the Central Bank has resulted in a contraction of credit to the private sector while lending interest rates have increased dramatically and deposit rates remain negative in real terms.

5. In response, the GOH has defined a three-year macroeconomic stabilization program, based on an Enhanced Structural Adjustment Facility Agreement (ESAF) with the International Monetary Fund (IMF). At the same time, the GOH is implementing a medium term strategy of reforms that address the structural deficiencies causing the imbalances, seeking to stimulate private sector initiative and economic growth by lowering risk and transaction costs in the markets that allocate basic economic resources and by building the basic institutions and legal framework required for an efficient and stable open economy.

6. Within this framework, the ISL reform program will consist of four principal components, under a macroeconomic framework conducive to the objectives of the program: (1) legal and regulatory reform of the financial sector, (2) secured transactions reform, (3) stabilization of state banks, and (4) private sector participation in the management and/or ownership of the electricity sector.

THE MACROECONOMIC FRAMEWORK

7. The principal objectives of the Government's macroeconomic program are to stimulate economic growth in order to achieve pre-embargo levels, maintain inflation at low levels, and strengthen the balance of payments to withstand the anticipated future decline in external support. The major components of the program are directed at balancing the fiscal accounts, financing the balance of payments deficit with external resources in the short term and maintaining

internal and external price stability in order to encourage rational and efficient private sector investment.

8. The Government will seek to maintain price stability through prudent fiscal and monetary policy. At the same time, the macroeconomic program includes measures to mitigate the crowding out effect that has resulted from the accumulation of domestic financing of fiscal deficits. The Central Government will respect its debt servicing agreements with the Central Bank, as defined in the ESAF agreement. In turn, the Central Bank will develop open market instruments in order to remunerate and eventually reduce legal reserve requirements. The Government is committed to maintaining its floating and free exchange rate regime.

9. At the same time, the Government will monitor the performance of the real economy in light of the impact of the fiscal/monetary program on the productive sectors. In particular, it will be necessary to monitor the effects of the anticipated high level of external financing on the real exchange rate. Such high levels of foreign transfer payments can cause a real appreciation of the exchange rate, creating signals that can provoke unsustainable patterns in the aggregate supply. The technical assistance program will include financing for a series of studies to investigate these issues throughout the execution of the program.

FINANCIAL SECTOR REFORM

10. The primary objective of the Government's financial sector reform initiative will be to establish a modern legal, regulatory and institutional framework, first addressing the most threatening weaknesses of the financial system. The Government will implement a calendar of legal and regulatory reforms supported by a technical assistance component to support the implementation of the new framework, according to the guidelines presented in the attachment.

The legal framework

11. The reform of the legal framework of the financial sector will be carried out with a view to establishing an institutional framework appropriate for a market-oriented, open economy. The legal reform will involve a modernization of the general banking law and the BRH organic law to ensure the autonomy and authority of the BRH as the regulator and supervisor of the sector as well as the appropriate legal framework for enforcement of prudential norms. The legal reform will also establish an adequate framework for Haiti's emerging capital market. Priority will be given to establishing the regulatory regime for all financial institutions, clear and sound rules and the authority of the regulator to govern all aspects of market entry and exit.

The normative framework for prudential regulation

12. In coordination with the legal reform, the Government will implement a regime of prudential norms and financial reporting requirements. The reforms will be carried out in a sequence that addresses the areas of risk that pose the most immediate threat to the financial system.

13. Given the complexity and time required to complete the comprehensive legal reforms, the first phase of the reform will focus on establishing critical prudential norms within the existing legal framework and providing technical assistance to the BRH facilitate rapid employment of the regime. The elaboration of the new laws and prudential norms, as well as the institutional reforms required to implement the new regimes, will be carried out within a program of technical assistance to be financed by the Bank and administered in collaboration with the existing IMF program of support to the BRH.

14. The technical assistance program will also include a complementary component designed to modernize and strengthen those aspects of the Central Bank directly related to its essential role in managing monetary policy and the payments system. This component of the program is critical to the overall program objective of establishing an adequate institutional framework for determination and management of monetary policy, public sector expenditure management, and efficient management of the increasingly complex financial sector and payments system. A priority for this program will be to support the development of open-market instruments that provide the Central Bank with a mechanism for remuneration and eventual reduction of the legal reserve requirement.

Secured transactions reform

15. The Haitian legal code does not provide an adequate framework for the creation of security interests (collateral) in credit contracts. The perfection of security interests is impeded by lack of a unified registry of liens in the case of chattel mortgages, an antiquated system of mortgage perfection that is controlled by notaries, cumbersome access to public registries that are inefficient and unreliable, and the lack of a cadastral system for the identification of real estate. Finally, the enforcement of security interests suffers from a particularly weak judicial process and general ignorance of the law. As a result, bank lending has been limited historically to the few clients that can produce the collateral legally required by banks.

16. The GOH will carry out a reform of the legal and institutional framework for secured transactions. The new legal framework will be established either through the promulgation of a new law or systematic revision of the existing legal code. The institutional reform will establish the public registries with an appropriate degree of autonomy in an institutional framework conducive to its

mandate. Technical support for implementation of the reform program is provided through operation ATN/MT-5078, approved in December 1995. This component of the program addresses one the most fundamental constraints to the extension of credit services to historically marginalized sectors of the market and will alleviate the currently dangerous competition in the banking sector for the few clients that can meet current requirements for collateral. The positive impact on the micro and small business sector, both urban and rural, is expected to be significant.

THE STATE BANKS

17. Haiti's two state-owned commercial banks, the Banque National de Credit (BNC) and the Banque Populaire Haitienne (BPH), comprise approximately 25% of the banking system, the former being the second largest commercial bank and the latter the smallest. General assessments during 1995 indicated that the BPH has a negative net value of approximately US$1.5 million but is currently profitable. Analysis of the performance of the BNC over the subsequent period, however, confirms the need to determine the actual financial performance of the BNC followed by immediate corrective action to bring the BNC into conformity with prudential norms and regulatory measures required to establish the soundness of the bank. The BRH will supervise a full diagnostic assessment of the BNC followed by a program of corrective action, with the assistance of a firm with appropriate experience in performing such assessments.

18. The Government has identified both banks among the list of state-owned enterprises to be privatized. The proposed diagnostic and corrective actions are a necessary preliminary step towards inviting private sector participation in the ownership and management of the state banks. However, capitalization or privatization of either the BNC or the BPH will be considered only after the implementation of the proposed legal and regulatory reforms in the financial sector, the diagnostic studies and the completion of subsequent corrective actions required to bring the BPH and BNC into conformity with the legal and prudential framework and measures necessary to establish the soundness of the banks. Furthermore, throughout the program, the BNC and BPH will not increase their debt exposure to any entity of the Haitian State.

Fonds de Developpement Industriel

19. The Fonds de Developpement Industriel (FDI) is a second-tier financing facility housed in the BRH that provides loan guarantees and rediscounts loans originated by commercial banks. The Government is committed to restructuring the FDI in the context of the financial sector reform in order to establish a second-tier entity with market interest rates, adequate qualification of participating financial institutions, professional management and an institutional structure that requires the FDI to maintain the real value of its equity capital.

INFRASTRUCTURE

20. The lack of infrastructure and basic services - specifically roads, maritime, customs, electricity, communications, and water and sanitation constitute the most significant constraints to private sector firms, especially in the real sectors. All of these services are controlled by the GOH and have suffered from mismanagement and the lack of public investment. The Government will carry out reforms in these sectors by restructuring the respective industries in order to facilitate private participation through management contracts, leases, concessions and equity ownership.

21. The Government has passed the Public Enterprise Modernization Law establishing basic principles and a political authority responsible for enactment of the sectoral reforms. The law provides for the establishment of the Public Enterprise Modernization Council and a Technical Secretariat with the mandate to execute the sectoral reforms.

Electricity sector

22. The Government recognizes that the deteriorating performance of Electricité d'Haïti (EdH) is due to numerous technical and managerial problems, themselves rooted in the institutional and incentive structure of EdH and distorted by its dependence on the state. The situation is unsustainable fiscally and imposes devastating production costs on the productive sectors.

23. The Government intends to address these deficiencies by reorganizing the sector and creating a legal and regulatory framework conducive to private sector participation. The specific objectives of the reform are to improve the quality and economic efficiency of electrical service, create a sector that functions according to commercial practices without excessive political interference, liberate the Haitian State from the financial liability imposed by the sector in its current form, ensure private investment and management of an expansion of the sector, and, ensure the protection of consumers and the environment.

24. The Public Enterprise Modernization Law has established the general guidelines for reform of the sector. This framework allows for private sector participation in the form of management contracts, concessions (including leasing arrangements) and capitalization (equity ownership). Each of these options will have to be supported by a distinct market and regulatory structure.

25. A concession or leasing arrangement would allow for an integrated sector and the benefits of economies of scale in Haiti's extremely small sector. In this type of arrangement, the regulatory regime is typically defined in the contract with the concessionaire, particularly those aspects related to tariffs. This allows the

State, as owner, to encourage economic efficiency by means such as marginal cost pricing. Furthermore, this model does not require an initial modification or indefinite determination of the ownership structure of the industry, allowing for future modifications to the structure of the sector as the market grows and develops. The integrated company can be later vertically and horizontally separated to introduce competition in the market for generation without having to impose on the structure of a privately owned firm.

26. The capitalization model assigns the right to a private company to operate the system, or one of its parts, indefinitely, by means of a permanent operating license. Since the ownership structure of the industry is determined in the initial stage of the reform, it is necessary to conduct the first transactions with a view towards establishing the proper industry structure. This implies the establishment, from the beginning, of a vertically and horizontally separated industry. This requires a very complete and complex regulatory and legal framework at the outset, which would have to be established before the private sector is called to participate in the ownership, management and operation of the Electricity sector.

27. Finally the management contract leaves the responsibility of the general direction of the sector in Government hands. The Government hires at its own expense the services of an operator, to carry out the day-to-day management of the sector, with or without performance incentives. In any case, the Government retains responsibility for the sector. This would not liberate EDH from its current dependence on the State and therefore would not address the fundamental cause of the sector's deterioration.

28. In the Government's opinion, all factors mentioned in the above three paragraphs, have to be considered in the reform of the electricity sector. As a consequence, the process of reform must by carried out by phases, as follows:

In the first phase, the Government, with the help of expert consultants, will study the organization options established by the modernization law, their financial, economic and private participation consequences, and the market structure best adapted to each option. At the end of this phase the Government will choose the option best suited to the Haitian context.

In the second phase, once the option has been chosen, the Government will hire consultants to carry out the corresponding study and prepare the legal and regulatory framework adequate for the chosen option.

In a third phase, the Government will elaborate the necessary changes or additions to the legal framework and present them to Parliament, and produce the necessary statutes required for their implementation.

In the fourth phase, the government will hire consultants to carry out the preliminary studies necessary for a plan of reorganization of the sector, according to the chosen option and its corresponding legal framework, and to produce the bidding documents to invite the private sector to participate in the reorganized sector.

In the fifth phase, once the necessary laws have been approved by parliament, the Government will establish the institutions, fully staffed, responsible for execution of the legal and regulatory framework of the sector.

In the sixth phase, the Government will, if needed, restructure EDH to prepare it for the process of private participation within the chosen option.

In the final phase, the Government will initiate the marketing process, issue the proposal calls, select the most desirable firm, and negotiate and sign the contract.

29. In order to ensure adequate management of EdH during the period required to transfer operations to the private sector, the Government, in cooperation with the Caisse Francaise de Developpement (CFD) and the Canadian International Development Agency (CIDA), has contracted the services of Electricité de France (EdF) and Hydro-Quebec (HQ) to provide technical assistance to EdH. The Government will ensure that such an arrangement continues during the transition period, providing an appropriate level of autonomy to the private sector technical assistance provider.

Infrastructure sectors

30. At the same time, the Government will implement similar reforms in the port, telecommunications and airport sectors.

ENVIRONMENTAL PROTECTION

31. The proposed sectoral reforms are expected to establish a legal, normative and institutional framework for industry regulation, including issues related to environmental impact. Therefore, the overall impact of the reforms is expected to be positive. During the design of each of the sectoral reforms, the Government will ensure that the respective industries and contracts with the private sector are structured to ensure adequate regulation and enforcement of measures designed to address both existing environmental liabilities as well as those that will emerge with the expected expansion of the privatized company.

32. The authority and technical secretariat to be established through the global framework law will be responsible for definition and implementation of all of the proposed sectoral reforms. This authority will be responsible for ensuring that environmental measures are incorporated into the reformed industry structure.

33. Environmental policies will be implemented through two principal mechanisms:

a. **Legal and regulatory framework**

The legal and regulatory framework of the respective sectors will determine the responsibility of the regulatory agency for supervising those aspects of the law that define the Government's policy on conservation of natural resources affected by the sector.

b. **Contracting with the private sector**

The contract that governs the participation of the private sector in the management and/or ownership of the respective enterprises will define the responsibilities of the private operator/owner with respect to the environmental aspects of the legal framework.

ATTACHMENT

GUIDELINES FOR THE MODERNIZATION OF THE LEGAL AND REGULATORY FRAMEWORK OF THE FINANCIAL SECTOR

Modernization of the regulatory framework will entail the drafting of a legal framework in coordination with a normative structure for the regulation of financial institutions. The following observations regarding the relative strengths and weakness of the current legal and normative framework are presented as general guidelines for the anticipated reform. The assessment is grouped by aspects of prudential regulation that are inter-related in practice and typically established through a combination of legal and regulatory measures. The comments are not exhaustive but are intended to emphasize different aspects of and approaches to the regulation and supervision of financial institutions and provide an indication of the general orientation and depth of the reform initiative.

1. **Industry structure**

Regulations governing market entry and exit establish basic parameters for the behavior of individual financial institutions. Minimum capital requirements, eligibility criteria related to professional experience of owners and managers, and requirements for a sound business plan should be defined in order to ensure an adequate level of professionalism and economic liability of owners or managers. The Haitian framework will have to be improved substantially to provide incentive to the owners of financial institutions to safeguard the interests of the public in their pursuit of return on capital.

a. **Minimum capital requirements**

The current minimum capital requirement of GDS 5 million is extremely low even compared to similar countries in the region. The possibility of abuse or neglect is further compounded by the lack of prudential norms limiting concentration of assets in transactions with parties related to the banks.

b. **Bankruptcy**

Haitian law also does not appear to support a special bankruptcy procedure for financial institutions, allowing the Central Bank, as the regulator, to intervene swiftly to protect the interests of depositors.

c. **Supervision of foreign banks**

The presence of foreign banks in Haiti has contributed historically to the professional standards of the industry, however the recent

exodus of 2 of the 4 foreign banks has changed the composition of the sector substantially. Supervision of subsidiaries of foreign banks is no different from domestic banks as long as they are a legal entity according to the Haitian law. This neutrality should be maintained to provide a favorable and equitable environment for foreign banks.

2. **Transparency and information**

Access to information is a basic condition for an efficient supervision regime as well as for an efficient market that sends clear signals. Current reporting standards and requirements need to improved substantially for both objectives.

a. **Reporting requirements**

The reporting requirements of the Central Bank should set standards for any publication of financial performance data. Rationalization of reports currently sent to different departments of the BRH will help to reduce current inconsistencies in bank reporting. The reporting requirements should be defined to provide the Central Bank with all data required for off-site inspections and regulatory purposes. The system should be improved to ensure accurate assessment of compliance with prudential norms. The reporting requirements of the Central Bank should also serve as the standard for the more limited information that is made available to the public.

b. **Standardization of chart of accounts and accounting procedures**

The standardization of accounting procedures will establish a foundation for standardized reporting. The new regime should be based substantially on International Accounting Standards and International Standards on Auditing.

c. **Auditing standards**

Annual external audits are a critical component of a regulatory regime that relies to any degree on market forces. The accounts of financial institutions should be audited annually by an external auditor according to internationally accepted norms and procedures. In addition, standards for external audits can be adapted to include assessments that the supervisor prefers to delegate to third-parties.

In practice, it appears that many banks comply with standards that exceed current prudential norms. The external auditors of banks claim to follow the GAP/International Standard Guidelines, even though these guidelines are not required. These standards should be formalized.

d. **Identification of major shareholders**

For supervisory purposes it is important to know the identity of major shareholders in financial institutions. The holding structure of financial institutions in Haiti is not clear due to the lack of updating of public registries.

e. **Credit to management and shareholders**

The prudential framework should set clear parameters for the right of parties directly related to financial institutions such as managers, employees and shareholders to receive financing from their own institutions. There are different mechanisms to limit these type of credits; however, whatever the normative framework, such practices should be transparent, both to the regulator and to the public. At present no such regulation exists.

f. **Management information systems and internal control mechanisms**

Supervisors increasingly are emphasizing the importance of the quality of management information systems and internal risk management mechanisms within regulated institutions. The increasing complexity of the financial markets make it necessary for supervisors to verify risk management capacity as well as mathematically calculated ratios. The current normative structure does not address this issue.

3. **Supervision and control of risks**

The current framework lacks the specific prudential norms that are typically employed to ensure that bank assets are not exposed to unmanageable risk, and that the existing risk is properly identified and provisioned. These norms necessarily precede norms related to capital adequacy, since such ratios are only meaningful when the risk exposure of the assets is known and integrated into the balance sheet. The current system in Haiti is extremely weak in this area.

a. **Consolidated supervision: supervision of bank groups**

The scope of prudential regulation imposed on a financial institution must extend to associated institutions that pose a risk to the regulated institution. A bank with a significant holding in another bank or financial institution should be subject to supervision of its financial situation on a consolidated basis, including all those institutions in which the bank has such holdings. No regime of this sort exists at this time, although several banks are linked to associated financial institutions.

b. **Portfolio classification and provisioning**

There are currently no norms governing the classification and provisioning of loans and investments according to criteria for origination procedures, guarantees or repayment performance. This represents a fundamental weakness of the current system, since the quality of bank assets is unclear. The future system should also take into account circumstances particular to the Haitian context. For example, although most loans are fully backed by collateral, the weakness of the judicial system raises some doubt regarding the ability of a creditor to realize a secured interest regardless of the fact that the contract is legal. In addition, loan insurance by insurance companies or guarantee schemes should be carefully regulated since neither entities are adequately regulated in Haiti.

c. **Exchange rate risks**

The BRH is currently preparing, in collaboration with the banking sector, prudential regulation on foreign exchange position. This is particularly important in the Haitian context given the rapid growth of dollar liabilities of the banking sector, the lack of reserve requirements on those liabilities, and the floating exchange rate regime which has become more volatile in the current economic environment.

d. **Non credit-related risks**

In addition to foreign exchange risks, Haitian banks are increasingly exposed to interest rate and market risks. The current framework does not address these risks.

e. **Concentration of risk in large exposures to related parties**

The current normative structure establishes no limits on exposure to a single client or group of related parties. As with other types of risk, these should be controlled as a reasonable percentage to first-tier capital of the financial institutions.

f. **Liquidity ratio**

Although there are no current norms regarding liquidity ratios per se, the legal reserve requirements requires banks to maintain liquidity levels far above a level required for prudential purposes. However, it will be important to revisit this issue as the reserve requirement falls in line with expectations of monetary policy.

g. **Capital adequacy**

Within a framework of norms that ensure an adequate measure of risk in the balance sheet of financial institutions, regulation of capital adequacy establishes the shareholders capital as the first

wall of defense against financial failure due to shocks. At this time, no such norm exists in Haiti. When introduced, the norm should define and distinguish between different tiers of capital and establish a minimum risk-weighted asset ratio according to international standards.

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Rosny Smarth	Fred Joseph
Prime Minister	Minister of Finance

Port-au-Prince, November 15, 1996

TECHNICAL ASSISTANCE
PLAN OF OPERATIONS

I. BACKGROUND

1.1 The Banque de la Republique d'Haïti (BRH) was created as the Central Bank in 1979 following sixty years of a currency board system. As a Central Bank, the BRH has suffered from a lack of legal autonomy and an organic structure that does not establish a framework conducive to professional and transparent management of the institution. Moreover, the financial autonomy of the BRH and thus its ability to conduct monetary policy has been undermined through the accumulation of unremunerated Government debt to the BRH.

1.2 During 1995, the BRH initiated a modernization program with the support of the Monetary and Exchange Affairs Department (MAE) of the International Monetary Fund (IMF) and the financial support of the United Nations Development Program (UNDP). The program has focused on strengthening the basic administrative structure and operations of the BRH, strengthening of the banking supervision department, and the introduction of prudential norms. The program also anticipates a reform of the legal structure of the financial sector, including the General Banking Law and the organic law of the BRH, with the purpose of establishing the autonomy of the Central Bank.

1.3 The Haitian Government has also requested financing from the Bank for a program of technical assistance in support of the reforms anticipated in the Investment Sector Loan (HA-0046). The proposed technical assistance program will complement activities currently supported through the IMF/UNDP program.

II. THE PROGRAM

A. Objectives

2.1 The objective of the technical assistance program is to support the Central Bank in the implementation of the reform program of the ISL.

B. Specific Objectives

1. Development of a legal framework for the financial sector

2.2 The BRH will hire experts to assist with the drafting of a new General Banking Law and Organic law of the BRH. Priority will be given to establishing a legal framework that ensures and appropriate level of autonomy and authority for the Central Bank as

the primary monetary authority as well as regulator and supervisor of a competitive and sound financial system.

2. Modernization of the regulatory and supervision framework for the financial sector

2.3 The proposed reform program will entail a profound level of change in both the normative framework and the operations of the Supervision Department of the BRH. In addition to the assistance currently provided by the IMF, the Bank financed program will provide (1) a longterm advisor in banking supervision techniques, (2) short term training specialist in specific supervision techniques, (3) short term experts who will assist in the development of the Central des Risques, (4) a short term systems expert for the development of an integrated information system, and (5) information system equipment.

3. Institutional strengthening of the BRH

2.4 **Modernization of the payments system.** In the first phase, experts will be hired to assist the BRH in improving systems for (1) management of the money in circulation, and (2) management of payment system transactions (compensation, transfers, clearing, etc.). The program also provides resources for subsequent purchase and installation of automated systems.

2.5 **Development of the Monetary and International Affairs Department.** The BRH will hire a longterm expert in Central Bank operations to assist in the organization of the department and implementation of systems and procedures for management of international reserves, external debt (anticipating the eventual installation of SIGADE), exchange operations, and fiscal transactions for the Central Government.

2.6 **Consultant support for follow-up activities.** The program will provide financing for consulting support in the areas that will be defined during the initial stages of the modernization program. In particular, additional expertise will be required during the development of the Monetary and International Affairs Department. In addition, the BRH will carry out several policy related studies that will be finalized during the program. These will include macroeconomic and sectoral studies to monitor the performance of the real sectors and rural financial systems.

4. Diagnostic assessment of the Banque Nationale de Credit

2.7 The BRH will supervise a diagnostic assessment of the BNC followed by a program of corrective actions as described above. The BRH will contract the services of a firm with appropriate international experience in performing such assessments, as described in the draft terms of reference elaborated for this purpose in collaboration with the BRH. The technical assistance program with

the BRH will include financing for the diagnostic, as well as for the subsequent corrective measures.

C. Activities

1. Contracting of long term advisors

2.8 The technical assistance program will be supported by two (2) long term advisors. One of the advisors will provide assistance to the Department of Banking Supervision (DSBIF) in the area of inspection techniques, and the other will provide support to the Monetary and International Affairs Department.

2. Contracting of short term consultants

2.9 Short term consultants will be hired to provide technical support during the development of the legal structure of the BRH and the financial system. In addition, short term consultants will support the BRH modernization program. The Bank will hire, with program resources, a consultant to conduct a mid-term evaluation.

3. Contracting of experts for diagnostic assessment of Banque National de Credit (BNC)

2.10 The BRH will contract experts with appropriate experience to assist the BRH with a diagnostic assessment of the BNC according to draft terms of reference that were attached to the aide memoire of the orientation/analysis mission.

4. Equipment

2.11 The BRH will purchase the equipment required for the computerized information systems and other automation equipment required for the payment systems and banking supervision components.

D. Execution

2.12 The proposed program will be executed by the BRH. The BRH will be ultimately responsible for the completion of the program objectives as well as the expected results defined for activities that involve the implementation of policies and procedures.

2.13 Prior to the contracting of the advisors or consultants, the BRH shall submit for approval by the Bank the final terms of reference and short list of candidates. The terms of reference shall include the tasks to be completed by the advisor or consultants, a work program, reporting requirements, and designate the counterpart within the BRH. All terms of reference should clarify the responsibilities of the advisor or consultant for conducting on-the-job training of BRH employees. The BRH will contract advisors and consultants and make all equipment acquisitions. At the request of the BRH, the Bank will make direct payments to consultants or suppliers.

2.14 Prior to acquisition of computer equipment or software, the BRH will submit to the satisfaction of the Bank a global plan for the computerization of the BRH to ensure adequate integration of BRH computerized information systems.

2.15 Prior to the contracting of short term consultants for the activities in the banking supervision component, the BRH will submit to the satisfaction of the Bank a global plan for the reform of regulation and supervision activities. The global plan will clearly identify the respective roles of all experts contracted by the BRH for this purpose.

E. Program monitoring

1. **Supervision**

2.16 The Technical Cooperation Agreement will stipulate that the Bank will supervise the program through the Haiti Country Office, assigning technical responsibility to RE2/FI2.

2. **Reports**

2.17 The BRH shall submit to the Bank semi-annual program progress reports.

2.18 Each of the long-term advisors and short-term consultants will be required to submit quarterly progress reports to their counterpart with the frequency defined in their terms of reference, with a copy to the Haiti Country Office of the Bank.

2.19 The BRH shall submit annual financial reports, audited by an independent firm approved by the Bank, of the goods and services procured with program resources.

2.20 Within three months of completion of the program, the BRH shall submit a final program evaluation report that provides a detailed account of achievements and failures of program execution. Within the same period, the BRH shall submit a final financial report, audited by an independent firm approved by the Bank, of the goods and services procured with program resources.

3. **Mid-term evaluation**

2.21 The Bank will hire, with program resources, a consultant to assist with the mid-term evaluation of the Program.

F. **Cost and Financing**

2.22 Total cost of the proposed program is the equivalent of US$2,745,000 consisting of the equivalent of US$2,495,000 financed by the Bank, and the equivalent of US$250,000 in counterpart funds.

Counterpart funds will used to provide equipment, on-site training and general administration expenses.

BUDGET				
Item		Bank Financing	Counterpart	Total
1.	Professional service firms	215,000		215,000
2.	Individual consultants (125.5 consulting months)	1,490,000		1,490,000
3.	Training		30,000	30,000
6.1	Equipment	670,000	100,000	770,000
6.2	General administration		120,000	120,000
8.	Mid-term evaluation	20,000		20,000
98	Contingency	100,000		100,000
	Total	2,495,000	250,000	2,745,000

2.23 The program execution period will extend to 24 months beyond the effective date of the contract, and the final disbursement will be made no more than 36 months beyond the same date.

2.24 The Bank financing component will be disbursed in dollars of the United States of America and charged to the Fund for Special Operations. The executing agency will pay a 1% up-front inspection and supervision fee as well as a commission equal to .5% of the committed amount. The loan will be amortized over 40 years, including a 10 year grace period on principal payments. In addition to the commission, the executing agency will pay 1% over the declining balance of the outstanding loan obligation in interest over the first 10 years (the grace period) and 2% over the amortization period from years 11 through 40.

2.25 The Borrower will be the BRH.

G. Procurement

2.26 Procurement of goods and services with program resources will be conducted according to the normal procedures of the Bank. The procurement of goods and services in amounts greater than the equivalent of US$250,000 will be conducted by an international bidding process. For acquisitions of less that US$250,000, procurement will be conducted according to national procedures.

2.27 The diagnostic assessment of the BNC will be awarded to a consortium consisting of Gardiner, Kamya International, Inc., KPMG/Mérové-Pierre, and Hanney and Associates in a sole-source contract. The firm of KPMG/Mérové-Pierre is the only Haitian firm with affiliation to internationally recognized accounting and auditing firms. The firm has extensive and unrivaled experience in auditing the institutions of the Haitian banking sector. Moreover,

the firm supervised the separation of the BNC from the Central Bank in 1979. Peter Hanney of Hanney Associates has provided support to both the Central Bank and the IDB during the conceptualization of the proposed program and his participation is required to ensure continuity during program execution. The firm Gardiner has been selected by KPMG/Mérové-Pierre and Hanney Associates to provide the additional expertise required in the assessment.

H. **Advance of Funds**

2.28 An advance of funds equivalent to 10% of the amount of financing provided by the Bank will be made to facilitate efficient disbursement of program resources.

I. **Reimbursement of expenses with program resources**

2.29 In order to avoid unnecessary delays in the execution of the reform program, resources of the program can used to finance the purchase of goods and services for the period that begins up to twelve months prior to Board approval. The amount of resources used to finance expenses during this period is limited to US$250,000.

III. BENEFITS AND RISKS

A. **Benefits**

3.1 The program will improve the execution capacity of the Central Bank in implementing the reforms anticipated in the ISL operation, thus the program contributes directly to the objectives of the sectoral operation.

B. **Risks**

3.2 The technical assistance program is subject to the risks identified in the Sectoral Loan Document.

IV. EVALUATION

4.1 Completion of the program will be evaluated on the basis of successful completion of the reform program as well as a general assessment of the BRH's capacity to perform the essential functions of a central bank.

4.2 Progress and constraints will be monitored by the quarterly reports of the long-term advisors and the semi-annual reports of the BRH. The Bank will hire, with program resources, a consultant to assist with the mid-term evaluation. In addition, performance of the BRH in the execution of the economic program will provide significant benchmarks for the general assessment in the final evaluation.

PROPOSED RESOLUTION

HAITI. LOAN /SF-HA TO THE REPUBLIQUE D'HAITI
(Investment Sector Loan)

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf the Bank, to enter into such contract or contracts as may be necessary with the République d'Haïti, as Borrower, for the purpose of granting it a financing to cooperate in the execution of an Investment Sector Loan. Such financing will be for the amount of up to US$50,000,000, or its equivalent in other currencies, except that of Haiti, which are part of the resources of the Fund for Special Operations, and will be subject to the "Special Contractual Conditions" and the "Terms and Financial Conditions" of the Executive Summary of the Loan Proposal.

PROPOSED RESOLUTION

HAITI. TECHNICAL COOPERATION LOAN /SF-HA TO THE BANQUE DE LA REPUBLIQUE D'HAITI (Investment Sector Loan)

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf the Bank, to enter into such contract or contracts as may be necessary with the Banque de la République d'Haïti, as Borrower, for the purpose of granting it a financing to cooperate in the execution of an Investment Sector Loan. Such financing will be for the amount of up to US$2,495,000, or its equivalent in other currencies, except that of Haiti, which are part of the resources of the Fund for Special Operations, and will be subject to the "Special Contractual Conditions" and the "Terms and Financial Conditions" of the Executive Summary of the Loan Proposal.