Rev.

GLOBAL MULTISECTORAL CREDIT PROGRAM

(BO-0034)

EXECUTIVE SUMMARY

BORROWER AND GUARANTOR: The Republic of Bolivia

EXECUTING AGENCY: Gerencia de Desarrollo of the Central Bank of Bolivia (BCB) and the Second Tier Financing Entity (Entidad de Segundo piso) - ESP

AMOUNT AND SOURCE: Bank Financing will be provided from the Fund for Special Operations (FSO) as follows:

	TOTAL
IDB: (US$million)	70
Counterpart:	17.5
Total:	87.5

TERMS AND FINANCIAL CONDITIONS:

Amortization period (years):	40
Grace period (years):	10
Disbursement period (years):	4
Interest rate (per year):	1-2%1/
Inspection fee:	1%
Commitment fee:	0.5%

1/ interest rate 1% during grace period, 2% thereafter.

OBJECTIVES: Since 1985, Bolivia has adopted a far reaching program to arrest hyperinflation and remove major structural weaknesses in the economy. The Government has taken vigorous action to move away from a legacy of heavy state intervention in the economy, towards policies to foster private sector-led growth. Bolivia has a sound economic and legal framework that also gives support to an appropriate environment for private sector development. To that end, since 1990, the Government has designed and, with the IDB, The World Bank and IMF support, has agreed to a range of policy measures aimed at further opening key areas of

diminishing the size and increasing the efficiency of the public sector, and improving conditions for the private sector to invest in productive activities. These actions have since led to increased growth of private sector initiatives.

As a complement to existing reforms, the proposed Global Multisectoral Credit Program II would continue to: (i) provide through a competitive market pricing mechanism, the medium- to long-term multisectoral financing to the private sector initiated in 1991; and (ii) support institutional and operational reforms to improve the financial intermediation process.

DESCRIPTION: The purpose of the new Multisectoral Credit Program II is to provide medium- and long-term financing for economically and financially viable investment projects in the private sector by means of a competitive market pricing mechanism (the credit auction). The Program will ultimately be administered by a new second-tier development bank, once this bank is formally created. Credit resources may also be utilized to finance pre-feasibility and feasibility studies to support sub-loan requests, as well as environmental impact studies, in accordance with the environmental monitoring system currently in place.

ENVIRONMENTAL CLASSIFICATION: The Environmental Management Committee, at its meeting of July 27, 1993, classified this as a Category III operation.

IMPACT ON POVERTY: The program is designed to finance private investment in various productive sectors. Therefore the operation does not conform to any of the criteria for meeting the poverty reduction objective, as established in the Eighth Replenishment.

BENEFITS: The Program would assure the continued supply of long-term funds to the private sector for investment purposes. The creation of a new second-tier bank to administer the funds would lessen the susceptibility of development credit to changes in macroeconomic policy.

RISKS: The legislation necessary for the creation of the second-tier bank may be delayed in Congress, in which case the Program will continue to be carried out under the auspices of the Central Bank of Bolivia.

THE BANK'S COUNTRY AND SECTOR STRATEGY: The proposed Program is consistent with the lending strategy and the priorities agreed upon with the Bolivian authorities during the July, 1990

Programming Mission and was included at that time in the 1990-1993 pipeline. Subsequently, the Country Programming and the Programming Mission papers (CPP and PMP) of January and November 1993, respectively, have continued to recommend ongoing support of financial sector reforms and of credit for private sector development as comprehensive instruments of support by the Bank aimed at consolidating the macroeconomic adjustment program and structural reforms initiated by the Government in 1985.

SPECIAL CONTRACTUAL CONDITIONS:

Prior to first disbursement, the Borrower shall: (a) enter into an agreement with the Central Bank of Bolivia for the transfer of the resources of the Financing, and the responsibilities for the Program execution to the Second tier Financing Entity, upon its creation; (b) demonstrate that the mechanism for the allocation of resources and program's credit regulations are in effect; (c) enter into a participatory agreement with at least an eligible ICI. In addition, prior to first disbursement of the institutional strengthening component, the Borrower shall: (a) demonstrate that the Second Tier Financing Entity has been created; and (b) provide the Financing Entity with the definitive terms of reference for the consultants required for the execution of such component. (¶ 3.1, 3.11, 3.20)

Other special contractual conditions include: (a) the advance of funds up to the equivalent of 20% of the SF Financing (¶ 3.13); (b) a restrictive mechanism for the environmental evaluation and control of the sub-loans (¶ 2.19, 3.25, 3.29, 3.31, 3.33); (c) the borrower's commitment to provide the Bank with annual reports on: (i) the use of funds from repayment of sub-loans that exceed total payments made for the Borrower's foreign debt service; (ii) the proposals to reduce such overage. (¶ 1.49); (d) Borrower's commitment to provide the Bank with the Program's and Executing Agency's Financial Statements (¶ 3.22).

The Loan Contract sets forth, in addition to the foregoing conditions, special contractual conditions related to the FFAL Mechanism, including the Borrower's commitment to: (a) enter into an agreement with the Central Bank to implement the administrative measures necessary to use the FFAL mechanism for repayment of the Financing; (b) provide the Bank with a detailed report on the inflows and outflows of funds under the FFAL mechanism; (c) provide the Bank with a Supreme Decree modifying the current functioning of the FFAL mechanism, and an action plan to improve specific areas in which deficiencies have

been detected; and (d) demonstrate that the new FFAL mechanism and the above-referenced action plan have been implemented. (¶ 2.7, 2.8).

I. FRAME OF REFERENCE

A. Macroeconomic framework

1.1 Since the mid-1980's Bolivia has undergone major macro-economic and sectoral reform. The following paragraphs summarize the key structural adjustment programs undertaken both by previous governments and the current administration. Subsequent sections present the significant financial reforms and improvements to the banking system which provide the sectoral context for the proposed Multisectoral Credit Program.

1. Developments since 1985

1.2 The drying up of external financing at the beginning of the 1980s soon led to the deterioration of Bolivia's economy, which culminated in hyperinflation midway through the decade. To counteract this process, the new economic policy (NEP) was launched in 1985, with the dual objective of (i) stabilizing the economy and (ii) modifying the ground rules under which it operated, by replacing the import-substitution model that involved high levels of State intervention with one based on an open market economy.

1.3 The NEP was implemented through Supreme Decree 21,060. The measures taken, in a context of an increase in prices that reached an annual rate of 23,500 percent in September 1985, focused on three areas: (i) control of severe fiscal imbalances; (ii) unification of the foreign exchange market and elimination of restrictions on the purchase of foreign exchange; and (iii) deregulation of the goods and factors markets.

1.4 **Fiscal policy:** Unlike the three other stabilization programs essayed in the region at around the same period, the ultimately unsuccessful Austral, Cruzado, and Inti plans launched in Argentina, Brazil, and Peru, respectively, the NEP sought sustainable fiscal management. On the income side this initially resulted in a significant rise in the prices of public services, primarily fuel — the price of which rose to international levels.

1.5 At the same time, a far-reaching reform of the Bolivian tax system was introduced in 1986, eliminating over 400 taxes and replacing them with a simplified system. The results of the new regime were very favorable, with real increases in tax receipts on the order of 270 percent between 1987 and 1992. Despite this progress, the tax burden did not rise above 10 percent of GDP in 1993 and the treasury continued to rely more heavily on nontax income.

1.6 The reduction in expenditures focused on staff cutbacks in both the central government and State-owned companies and a drop in public investment between 1985 and 1987. COMIBOL cut 23,000 of its 30,000 staff while YPFB went from 12,000 employees to 6,000.

1.7 **Exchange rate policy:** The various governments have maintained full convertibility and exchange unification since the implementation of the program in 1985. Rates are adjusted through a system of daily foreign exchange auctions, known by the name "bolsin", held by the Central Bank.

1.8 **Deregulation of goods and factors markets:** Unlike the three stabilization plans mentioned, the NEP did not resort to unorthodox methods of controlling the prices of goods and factors. The deregulation of goods included international trade with reduced levels of protection and a narrowed range between tariff categories and the elimination of quantitative restrictions. In the area of factors, restrictions on the hiring and termination of workers were lifted, while deregulation in the financial market covered not only interest rates but also the possibility of operations using local or foreign assets.

2. Results of the Adjustment Program

1.9 **Reduced inflation:** The NEP made it possible for Bolivia to put a stop to hyperinflation and give it one of the lowest inflation rates in the Americas. In 1992, inflation fell to 12.1 percent, and an additional drop, to 8.5 percent, took place in 1993; it is expected that the annual target of 7.5 percent will be reached in 1994. The results were less favorable in terms of level of activity: while GDP has grown since 1987, GDP per capita has slowed by 1.5 percent over the 10 years since implementation of the NEP.

1.10 **Private investment:** Trends in private investment, which has not been very dynamic since the implementation of the NEP, explain these mixed results. Changes in the ground rules, which include the need to operate in a context of trade liberalization as well as the cost and availability of long-term credit, are behind the discouraging performance of this variable. Private investment contrasts here with public investment, since the process of consolidating stability has allowed public investment to resume the levels of the early 1980s. Finally, the domestic contribution to the savings ratio has deteriorated in the last few years and has needed to be supplemented with external resources.

1.11 **Public finances:** A fiscal policy of austerity implemented in the last quarter of 1992 continued in 1993 to deal with the imbalances in the public accounts that year. It included net layoffs of 9,250 employees. As a result, it has been possible to reduce the overall nonfinancial public sector deficit from 6.8 percent of GDP in the first half of 1993 to 3.4 percent of GDP during the same period in 1994, a level slightly above the 1994 target agreed upon with the IMF.

1.12 **External debt:** Bolivia has undertaken a complex negotiation process to restructure its debts with neighboring countries, in the context of the Paris Club and with commercial banks. These

measures have made it possible to reduce the external public debt from the US$4.289 billion owed in late 1987 to US$3.788 billion in late 1993 and to improve the cost and maturity profiles of the external debt.

3. <u>The agenda of the new Government</u>

1.13 As a result of the political timetable, the possibility of executing economic policy during 1993 was severely constrained during the first three quarters of the year. Following national elections on June 6, 1993, the new government took office in August 1993, and since that time, economic policy has been conducted on two levels – one concerned with the short term, under which it was necessary to bring the gap in public finances under control immediately, and one addressing the medium term, involving the new government's program of structural transformations, whose most noteworthy initiatives are the capitalization of State-owned companies, broad-based participation (through a decentralization scheme), social security system reform, and educational reform.

1.14 **Program with the IMF:** In mid-November 1993, the country concluded an agreement with the IMF on monthly performance targets from that month to March 1994, and quarterly targets for the remainder of 1994, as well as structural fiscal and monetary management measures, including mechanisms to control spending and legislation to grant autonomy to the Central Bank. The fulfillment of the monthly goals made it possible to finalize the phase of the enhanced structural adjustment facility (ESAF) still pending, with a new three-year program now under preparation.

1.15 **Capitalization program:** In the economic arena, structural reform will be implemented by incorporating private capital into State-owned companies. The framework law on capitalization was passed in 1993 and the statutory regulations are scheduled to be adopted before the end of 1994. The group of enterprises in the hands of the regional development corporations (CRDs) will be transferred to the private sector under a traditional privatization scheme.

1.16 **Broad-based participation:** The decentralization policy will be effected through legislation (*Ley de Participación Popular*), whereby the physical infrastructure for education, health care, sports, secondary roads, and irrigation are being transferred to the municipalities, together with the resources necessary to maintain it. The CRDs, for their part, are responsible for regional planning, the strengthening of municipal management, and joint intermunicipal and central government outlays for physical infrastructure for the purpose of taking advantage of regional externalities, with royalties as the main resource.

B. Overview of the financial system

1. Public debt: term structure, primary and secondary markets

1.17 As of early 1994 the Bolivian public and Government guaranteed debt totalled US$3.8 billion equivalent. Of this US$2,030 million was owed to multilaterals, US$1,664 million to bilaterals, and the remaining US$133 million constituted restructured debt to commercial banks.

1.18 In May 1993, the Bolivian commercial debt restructuring was signed, with 43 percent of the US$180 million in debt repurchased by the Central Bank of Bolivia (BCB) for 16 percent of its face value; 18 percent exchanged for 30-year bonds and the remainder entered into a complex program involving NGOs. Since the amount of Bolivian bonds in circulation is so small no market valuation numbers exist.

1.19 The Central Bank has been issuing short-term CDs, known as "CEDES", which make up most of the activity on the Bolsa. The total amount outstanding as of March 31, 1994 is US$29.9 million, of which US$5.2 million equivalent is in local currency and the rest is roughly evenly divided between CDs denominated in foreign currency (US dollars) and CDs in local currency indexed to the dollar. Most of these instruments have maturities of 90 days. The CDs are commonly held by banks for liquidity management and investment purposes. They yield rates below bank deposit rates reflecting both the perceived higher quality of sovereign risk and the small amount of instruments available as compared with the need banks have to invest their excess funds in a saleable instrument.

1.20 Recent reforms have included measures taken to consolidate obligations between the BCB and Treasury Department (TGN). As part of these reforms the Government intends to shift the outstanding public sector debt from Central Bank to Treasury Department instruments, and has begun this process by issuing 91-day LTs ("Letras del Tesoro"). At present, there are a total of US$43.6 million outstanding. Thus total outstanding domestic obligations of the public to the private sector, as of March 1994, was US$73.5 million, i.e. the sum of the Central Bank CDs mentioned in the preceding paragraph and the two forms of LTs discussed here.

2. Private commercial banks

1.21 The private financial system is dominated by fifteen national and four (4) foreign banks which, as of June 30, 1993, held 90.2 percent of all deposits, with "mutuales" next with 7.5 percent of deposits (of which a large part is actually re-channeled into the banking system). Two banks hold a leadership position with approximately 15 percent each of system deposits. They are followed by another six (6) banks, each holding at least 5 percent of system deposits; some of them also house powerful corporate banking departments taking proportionately more of their funding from multilateral and other offshore sources.

1.22 In terms of loan volume, banks held 88.9 percent of system loans, with 5.58 percent in "mutuales", 1.74 percent in cooperatives, and the remainder in other institutions of which FINDESA, a regional development corporation of the Department of Santa Cruz, represented the largest proportion. While four foreign banks are operating in Bolivia, their participation is minimal with assets at June 30, 1993 equal to only 1.58 percent of system totals.

3. Recent developments

1.23 The banking system, as measured by its liabilities, has grown from US$1.30 billion at 12/31/90 to US$2.3 billion at 12/31/92 and US$3.0 billion at 12/31/93. During this same period the average maturity of fixed term deposits also increased substantially, from approximately 100 to 150 days, suggesting a greater confidence in the banking system. Much of this rapid growth is largely as a result of the public returning foreign currency funds to the system previously held outside the system or abroad. Foreign currency liabilities to the public grew from US$644 million in December 1990 to US$1,478 million at June 30, 1993. Local currency liabilities (including deposits indexed to the dollar) grew during the same period from the dollar equivalent of US$154 million to US$368 million. Overall the growth in liabilities was US$1,034 million, of which those in local currency represented only 21 percent due to continuing distrust in local currency as a savings instrument.

1.24 Capital and profitability: Bolivian private banks have increased capital from US$97 million at 12/31/90 to US$165 million at 12/31/92 and US$225 million at 12/31/93. But liability growth has been even greater taking leverage from 11.8 times to 13.5 at 12/31/93. If contingencies were taken into account the ratio is 17.3. This will likely be squeezed down in coming months as mandatorily convertible debt previously issued converts to equity and banks raise new capital to conform with the requirements of the new law and its regulations. Return on equity has varied substantially between private Bolivian banks. For the system as a whole it declined during the latter half of 1993 from 12 percent to 2 percent reflecting the deteriorating condition of a few banks.

1.25 Interest rates: The average rate on fixed short-term dollar deposits fell from approximately 11.5 percent in December 1991 to 9.9 percent in February 1994 and around 8.5 percent in September 1994. While declining, this is high by recent international standards for dollar deposit rates of comparable terms (less than one year). This reflects Bolivian depositor wariness; strong loan demand; and the 13 percent IVA tax. Additionally, lending spreads reflect the 10 percent reserve requirement levied on deposits up to and including 365 days. No reserves are required on deposits of more than one year. Prior to May 1st, 1994 the Central Bank paid a nominal interest rate on these reserves, after which it ceased paying interest. Thus banks have to take into account this loss of interest in computing their spreads.

4. The state banks

1.26 In 1991 three state-owned banks: BAB, BAMIN and FONEM held 14 percent of all banking assets, 25 percent of all bank locations, and employed 19 percent of all bank staff. Due in part to the reforms undertaken with support from the Financial/Investment Sector Reform Program (F/ISRP, Loan 628/OC-BO) and the parallel IDA Structural Adjustment Credit (SAC), today only final liquidation of these banks remains with total clean-up pending. Central Government agencies are now lending only through intermediaries (qualified by the SBEF) with the exception of one "fondo" which lends only to municipalities.

1.27 The remaining direct lending provided by Government entities is through FINDESA, partially owned by the Santa Cruz Regional Development Corporation (CORDECRUZ), and the very minimal portfolios of the provincially owned Unidades Crediticias y Financieras (UCFs).

5. The cooperative savings and loan system

1.28 With a few important exceptions, the cooperative system (including mutuales) remains weak with a number of institutions effectively decapitalized. The SBEF is now responsible for oversight of the "mutuales" and those cooperatives which qualify for access to Government funds for on-lending. It has attempted to take steps towards strengthening or closing weak institutions through enforcement of capital requirements.

C. Oversight of the financial system

1.29 As part of the economic reforms carried out since 1985, a number of important measures have been undertaken to improve the competitiveness and prudential oversight of the financial sector. These initiatives which improve the sectoral environment for the proposed lending program, are summarized in the following paragraphs.

1. The new Banking and Financial Entities Law

1.30 In April 1993 a new banking law was published (Ley de Bancos y Entidades Financieras -- Ley No. 1488, 14 de abril de 1993). Old regulations have been revised and new ones promulgated to establish the regulatory framework to apply the law. The law includes increased capital requirements for each bank in proportion to its level of assets weighted according to their respective risk. These requirements are based on the standards established in the Basle (Bank of International Settlements) accords.

1.31 The new banking law provides for financial service firms to be covered by the prudential regulations and supervision specified in the new law. Such firms include leasing, factoring, and warehousing firms. Also "non-bank banks" such as credit unions and

mutual savings banks for mortgage finance, as well as development finance agencies, private investment funds, financial NGOs etc. are brought under the oversight established by the Law.

2. Strengthening the Superintendency of Banks

1.32 The new banking law has empowered the Superintendency of Banks and Financial Entities (SBEF) to become a strong institution capable of examining and enforcing compliance with laws and regulations. The agency's staff is well qualified and generally respected by the financial entities it examines. It routinely publishes timely and comprehensive information on the financial sector.

1.33 The scope of the SBEF has been increased to include all institutions which either take deposits from the public or borrow funds from the Government for on-lending. The SBEF now provides oversight for mutual savings and loan banks, which had previously been inadequately supervised by CACEN and those financial cooperatives and NGOs which wish to access Government lending programs. One area where strengthening appears to be needed is in the qualification and supervision of NGOs where progress has been slow.

3. Proposed new Central Bank Law

1.34 A draft Central Bank Law (Proyecto de Ley del Banco Central) was introduced to the Legislature in March 1994. Its main provisions include focusing the objectives of the BCB much more narrowly on core central bank functions, namely on implementation of monetary policies to assure the stability of the purchasing power of the domestic currency. The Central Bank will only represent the Government of Bolivia to international financial organizations which have a strictly monetary character, such as the IMF.

1.35 In keeping with this more narrow focus, the proposed law provides for the elimination of the administration of development credit lines as one of the BCB's responsibilities. Thus the Central Bank will cease to be the executing agency for development credit operations such as those granted by the IDB, IDA, USAID, etc. Once the new law takes effect, the Gerencia de Desarrollo will be formally abolished, to be replaced by an independent second-tier Financing entity, as noted in paras. 3.5-3.9.

4. Reinforcement of the Central Bank oversight function

1.36 The Central Bank is charged with averting banking crises, and efforts have been made to strengthen the Gerencia del Sistema Financiero (GSF) within the Central Bank so that it can effectively handle such crises and the disposition of decapitalized banks.

1.37 The GSF is also charged with managing the credit risk inherent in the Central Bank's development lending activities. GSF's credit evaluation and risk management capabilities remain weak.

Historically, the Gerencia de Desarrollo of the BCB has made long-term loans to banks without differentiation according to borrower strength. Heavy reliance has been placed on the Superintendency's qualification which permits banks to be open to the public but does not necessarily provide assurance that a particular bank will remain sound.

D. Improvements in the term credit market

1.38 As noted above, Bolivia has undergone fundamental reforms to its macro-economic and financial sector structure. Prior to 1990 the Central Bank provided administered lines of credit at wholesale rates substantially below both the Government's and the banks' cost of mobilizing resources in the domestic market. The retail banks (ICIs) in turn were limited in the spreads they could charge to their customers.

1. Effects of administered lines of credit prior to 1990

1.39 Such below market pricing had two important effects. Because the demand for funds exceeded the supply at these rates, the Central Bank was able to exercise great discretion in allocating credit across the recipient banks. This was accompanied by substantial paperwork requirements and led to delays in the disbursement of funds. In turn this raised the processing ("transaction") costs to the retail intermediaries and final subborrowers according to an evaluation carried out by the World Bank in 1991. 1/ Because the retail banks were limited in the spreads they could charge, they had an incentive to concentrate the funds among their least cost and least risk clients, thereby limiting the access of the smaller (higher cost) clients who may not have had such a well established track record.

1.40 The second effect was related to the relative cost to the banking system of the Central Bank development credit lines as compared to their alternative sources of funding. There was little incentive for banks to mobilize additional resources from the domestic markets, because the Central Bank resources were so much cheaper. As a result by the late 1980s the banking system relied on the Central Bank as a funding source for between 40 and 50 percent of its outstanding loans.

2. Introduction of the credit auction

1.41 In September 1990 the Development Credit Department (GD) of the Central Bank introduced a method for allocating credit which was consistent with the reforms taking place elsewhere in the economy. In the absence of a free market for long term credit in Bolivia an auction mechanism was established, and it has been reinforced with

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1/ T. Glaessner and J.L. Guasch "Studies of Auctioning Credit III: The Case of Bolivia". World Bank, June 1991

technical cooperation support from loan 629/OC-BO. The auction had four major objectives: The first was to liberalize the rates of interest charged on the lines of credit so as to be comparable to the Government's and the retail bank's own cost of funds. Despite the many administrative controls on the use of the funds, banks had found means to invest these development funds in Government securities, thereby enjoying a risk-free return at the Government's expense. Limiting opportunities for arbitrage was thus an important motivation for making the rates more comparable.

1.42 A second objective of the new method was to improve the efficiency of allocation of credit across alternative investment projects. Rather than relying exclusively on Central Bank officials to make the decision, market forces were to be relied upon more heavily. Projects would compete for funds on the basis of price (interest rate). A third objective in introducing the auction was to reduce the transactions costs of administering the development credit program. Documentation requirements were simplified and processing of disbursement requests was shortened from several months to a few days. The fourth objective was to increase the transparency of the process for assigning the credit. Rather than a myriad of sector and geographic specific eligibility requirements, which were confusing and often ultimately arbitrary, a multisectoral approach was adopted in which all projects could be funded which met basic financial and environmental selection criteria. As credit risk was entirely borne by the ICIs and price distortions were being reduced as part of the general economic liberalization in the country, this approach strengthened the private incentive to fund socially useful projects.

3. <u>Experience with the auction</u>

1.43 The auction while not without problems has been a marked improvement over the previous method of administered allocation of development credit at sub-market rates. Because the funding costs are comparable, banks now rely much less heavily on the Central Bank for resouces, and as of September 1993 these resources represented approximately 15 percent of all outstanding commercial bank loans (down from the 40-50 percent observed in the late 1980s). The elapsed time between a well prepared and successful bid for credit and the receipt of funds has been reduced to a few days and disbursement is processed virtually automatically.

1.44 **Reduction in spreads:** Another area of improvement both relative to other forms of credit in Bolivia as well as similar credits in other countries is the spreads being charged by the ICIs. While both subborrowers and Bolivian Government authorities continue to express concern that first story bank spreads are too high and there is insufficient incentive for these banks to become more efficient, the data suggest the opposite. Recent interviews with several ICIs revealed that their average spreads on development credit have been falling and were projected to continue to fall

from around 5 percent in 1992 to 3 to 4 percent in 1994. These spreads are approximately half of their levels before the auction was started in 1990 and are low, compared to Bolivia's intermediation margins of 8 percent in general and to margins elsewhere in Latin America which average in the 10 percent range.

1.45 **Multiple credit lines:** When the auction started it administered many existing lines of directed credit each with its own sectoral and other limitations on use. This was inconsistent with the idea of allocating funds according the a simple bidding procedure. This impediment was largely overcome by an agreement between the Central Bank and the IDB, its largest funding source, to modify existing loan agreements to convert all lines to multisectoral use. *(See para. 1.61.)*

1.46 **Fluctuations in demand:** The World Bank evaluation mentioned previously pointed out other shortcomings, notably that in the auctions observed up to mid 1991, the date of the report, demand fell short of supply and most bids came in at rates marginally above the floor rate, thus suggesting that the retail banks might be holding back deliberately. While this may have been the case in 1990-91, demand picked up substantially in 1992 when a restricted amount of 15-year housing finance from bilateral Japanese sources was auctioned in the same pool as shorter term development credit for productive activities. It is also important to note that when credit is priced at essentially market levels, fluctuations in observed demand are inevitably going to be greater than if the resources are priced below market. In the latter instance desired demand will exceed supply and observed utilization of the resources will more nearly conform to projected levels.

1.47 **Frequency of auctions:** Interviews during the latter half of 1993 with commercial banks which had participated in the auction revealed several problems. The major problem was the infrequency with which the auctions were held culminating in their suspension in March of 1993. This was very disruptive to the banking community and to the underlying final borrowers who need regular and predictable access to development credit for orderly investment planning.

1.48 The suspension took place due to the particular role of development credit in Bolivia which represents such a large proportion of total credit in the system that the relending of net subloan recoveries, although required as a standard contractual requirement, had been subordinated to macroeconomic concerns about macroeconomic stability during the latter three quarters of 1993. The decision to cease relending of sub-loan recoveries, combined with the unavailability of fresh resources from the IDB starting in March of 1993, led to the suspension of the credit auction until funding sources were reestablished in early 1994.

1.49 **Agreement on recoveries:** As a result of this experience, an agreement was reached between the Bank and the BCB regarding the use of reflows. A detailed analysis of all external agency lines of credit to the BCB determined that the total reflows in excess of the amount necessary for debt service was about US$72 million as of September 1993. The IDB portion of these un-lent reflows totalled approximately US$40 million. Based on discussions between the Bank, the IMF and the Government authorities, it was agreed that the BCB would re-lend US$20.8 million of the accumulated reflows of IDB resources in 1994. *(Letter from the President of the Central Bank to the IDB Representative of Feb. 2, 1994.)* This proposal is consistent with the IMF program and it assures the de-linking of development credit from short-term fiscal and monetary policy of the Central Government. The letter from the Government authorities further commits the BCB to re-lending the remaining balance (plus net new reflows) during 1995 and 1996. The Borrower is committed to provide the Bank with annual reports on: (i) the use of funds from repayment of sub-loans which exceed total payments made for the Borrower's foreign debt service; and (ii) the proposals to reduce such overage.

1.50 **Floor interest rates:** A second problem with the development credit auction was the means by which the floor interest rate, above which banks bid for funds, was determined. Related to this was the method for computing the half-yearly adjustments to the floating rate paid on outstanding loans. Under the previous auction regulations both rates were determined as an average of rates paid in the most recent prior auction. As no new auctions had been held since March 1993, the floating rates paid on the loans existing as of the third quarter of 1993 were adjusted according to these rates. Coincidentally short-term rates in Bolivia had declined by late 1993. Thus the auction-related rates bore little relationship to the market in general, and were widely perceived as being "much too high." This deficiency has been corrected *(see para. 3.18)*.

1.51 **Participation of new intermediaries:** To date the ICIs participating in the auction have been the traditional commercial banks which meet the eligibility criteria. However, under the Banking Law passed in April 1993, other non-traditional intermediaries can become eligible as well. Banco Solidario S.A.(BancoSol), founded in 1992, is a bank specialized in providing credits to low income individuals and microenterprise. It grew out of a successful effort to convert the Non Governmental Organization, PRODEM, into a commercial bank fully qualified by the Superintendency of Banks. Specializing in mobilizing small short-term savings accounts and using the solidarity-group approach to granting loans, its deposit base has grown to US$10 million, an increase of 66 percent between December 1992 and June 1993. On the lending side BancoSol makes around one quarter of the number of all loans in the Banking system, while maintaining better than average portfolio quality and solvency indicators.

1.52 Now that BancoSol is branching out to lending longer term for productive purposes to its microentrepreneurial clientele, it has applied to the Central Bank for eligibility to participate in the credit auction. The application is under active review and when approved will provide a means for development credit to be channelled directly to small and micro business through this market oriented mechanism.

4. Lessons learned

1.53 The experience with the credit auction between 1990 and its suspension in March 1993 suggest that critical requirements for a successful auction are: (a) a predictable timetable; (b) assurance of a reasonable level of funds available at each auction; (c) establishment of a consistent and reasonable method of periodically repricing loans; (d) assurance that all bidders have access to the same information in a process which is transparent; (e) establishment of conditions that are attractive to the best banks as well as the weaker banks (which will naturally want to access the auctioned funds); (f) adequate restrictions over access to funds by weaker banks, particularly for long terms; and (g) management by officials oriented towards assuring that both banks' needs and development objectives are met.

1.54 In preparation for the proposed Multisectoral Credit II operation and in response to these points, several improvements to the auction mechanism have been made which are described more fully in para. 3.18.

5. Other sources of term credit

1.55 Some first-tier banks also obtain term funding directly from certain other multilateral or bilateral agencies, including the IFC and CAF, at terms which tend to be below the banks' alternative cost of either domestic funds or offshore private market or the auction. CAF, for example, offers long-term credit directly to ICIs at LIBOR plus 3.5 - 5 percent. The mechanisms vary considerably and any one agency may offer varying programs intended to achieve different purposes. Furthermore, credit is available from the Government-owned export financing agencies of many countries which trade with Bolivia. While such resources also are generally offered at rates below market, they are normally restricted to use in purchasing goods from the particular country.

1.56 Complete harmonization of these programs is not likely to happen as the objectives, procurement requirements, and special conditions of different international lenders vary. However, improvements in the auction arrangements and the development of the new second-tier bank should help to make it a more attractive vehicle for credit allocation.

E. Recent capital market developments

1.57 The economic and social reforms initiated in the early 1990s by the Bolivian Government with the strong support of the IDB, IDA and IMF centered largely on two principal areas: in the financial sector, on increasing the efficiency of financial intermediation through increasing competition and broadening the scope of borrowers through non-bank financial institutions, removing remaining controls on interest rates, and eliminating inefficient banks, public or private; improving the soundness of the financial system through more effective supervision and regulation; and removing various impediments to capital market development.

1.58 Driving this process is the growing comfort on the part of investors with the Bolivian economy and Government, as evidenced by lengthening terms for bank deposits and a willingness by the general public to buy negotiable CDs and commercial paper out to, in a few cases, two (2) years. Further encouraging the process has been the steepening of the rate differential between short-term rates which have fallen and long-term rates which have stayed high, giving investors an incentive to commit funds for longer terms.

1.59 The local capital market, while still in the early stages of development, is showing signs of progress. Banks are placing small amounts of CDs (known as DPF negociables) through the Securities Exchange as well as buying and selling each others' as a form of liquidity management. They have also underwritten twelve debt issues by corporations for a total of some US$16 million for terms reaching two (2) years in a recent issue. With credit support from the USAID and CAF, several banks have also issued their own longer term bonds in addition to the debentures described above. The next step will be the issuance of equity sold to the general public with the banks as likely candidates.

F. Bank strategy and lending program in Bolivia

1.60 Since its inception through December 31, 1993, the Bank has approved 106 loans to Bolivia reaching over US$2 billion; as of that same date, there were 26 loans in execution totaling approximately one billion dollars, of which US$564.6 million (54 percent) had been disbursed.

1.61 Until 1990, six global credit operations were approved by the Bank in an amount of US$258.2 million and were directed principally to the agricultural, industrial, tourism and mining sectors, to be channeled by the Development Credit Department of the Central Bank through eligible ICIs. In March of 1991, the IDB approved the reformulation of Loans 830/SF-BO (Global Agricultural Credit Program) and 564/OC-BO (Global Industrial and Tourism Credit Program) to broaden their objectives, thereby making available the first multisectoral credit to the recently-adopted credit auction mechanism. Then, in September of that year, the first Global Multisectoral Credit Program (629/OC-BO) was approved for US$80

million, of which US$60 million has now been disbursed (75 percent) and US$64 million (80 percent) committed. Of all global credit approved to date, Loan 629/OC-BO is currently the only IDB multisectoral credit operation still in execution.

1.62 In terms of the Bank's lending strategy as contained in the latest CPP for Bolivia, the Bank will continue as the main source of external financing and institutional strengthening for the country during the present decade. The overall objective of the Bank's medium-term strategy is the removal of bottlenecks to Bolivia's sustained economic and social development. Specific emphasis is placed on two objectives: improvements in social conditions, and increased production for exports and domestic consumption. Within these objectives, the Bank's strategy emphasizes investment assistance to facilitate private sector activity as well as in social infrastructure and services.

1.63 Based on the Bank's experience, and considering the Government's ambitious reform and investment agenda, a conditioning element of the Bank strategy in Bolivia is the public sector's institutional capacity to deliver its proposed agenda. Therefore, improvements in public administration are a critical component of the Bank's strategy. Moreover, a strategy to minimize the risk of exposure, without undermining the Bank's role in Bolivia's economic development as the main source of external financing, includes assigning high priority to loans with a positive and rapid impact on the country's export capacity to ensure the expected decrease in debt-service-to-the-Bank to exports.

1.64 The proposed Global Multisectoral Credit Program II would continue to provide ongoing credit resources for private investment as endorsed by the above strategy, while the inclusion of an institutional strengthening component for the proposed CFB would also assure adequate institutional capacity as executing agency of the Program, in accordance with that strategy.

1.65 The proposed Program would also continue to be carried out within the policy reform framework included in the Financial and Investment Sector Reform Loan (628/OC-BO) which complements the IDA Structural Adjustment Credit (SAC), and which is also tied through cross-conditionality to 629/OC-BO. Since the approval of the various loans in September of 1991, First and Second Tranches have been released. The date for loan expiration has been extended to December 2, 1995. Specific actions taken to date as conditionality requirements of the Financial Sector Reform include: (a) the closing of three state banks/financial institutions (BAB, BAMIN and FONEM) and the privatization of a fourth, BANEST; (b) the implementation of eligibility criteria for access of banks and non-bank ICIs to development credit and supervision of these intermediaries consistent with sound regulatory practices; (c) enactment and implementation of prudential regulations of the financial system, including (among other provisions) an 8 percent capital-risk asset limit, explicit provisions for handling bank

crises, establishment of the authority and autonomy of the SBEF, and codification of certain prudential regulations; (d) implementation of an action plan to improve supervision and regulation, including: (i) establishment of an adjustment period for the strengthening of the capital base of commercial banks according to prudential regulations; (ii) a requirement that a recipient of commercial loans above a given amount have audited financial statements; and (iii) modification of the classification system for bank loans and investments, including the assessment of loan collateral, in order to reduce discretion; (e) agreement on terms of reference for studies or actions to be taken, evidence of initiation of studies and implementation of actions for the improvement of the legal framework for and supervision of insurance, pension system and securities market; and (f) issuance of a Supreme Decree modifying the statutes of the Fondo de Desarrollo Campesino (FDC) to serve the rural poor by channeling grant funds to small agricultural producers for construction of infrastructure, and to provide social services and institutional strengthening, consistent with the Government's financial sector policies.

1.66 Similarly, specific actions taken to date as conditionality requirements of the Multisectoral Credit include maintenance of a credit auction mechanism which fully reflects market conditions, continued application of eligibility criteria and norms of supervision and regulation of non-bank ICIs, and maintenance of credit regulations and an environmental monitoring system acceptable to the Bank.

II. THE PROGRAM

A. Objectives

2.1 The purpose of the new Global Multisectoral Credit Program II is to provide medium- and long-term financing for economically and financially viable investment projects in the private sector by means of a competitive market pricing mechanism (the credit auction). Credit resources may also be utilized to finance prefeasibility and feasibility studies to support sub-loan requests, as well as environmental impact studies, in accordance with the environmental monitoring system currently in place.

2.2 The proposed Program would be consistent with ongoing support of institutional and operational reforms and policy changes aimed at improving the efficiency of the financial intermediation process, and would assist in the process of financial deepening and efficiency of the financial system in Bolivia, as initiated through the loans mentioned earlier. Moreover, the proposed Multisectoral Credit would continue to provide for ongoing supervision of financial sector reforms, further fine-tuning of the credit auction mechanism as needed, an adequate flow of resources to the private sector for investment based on anticipated demand, assistance to the process of financial deepening and development of saving instruments and institutions more suitable to medium and small savers; and opening-up access to term financing to a larger number of borrowers.

B. Program description

2.3 Program resources would be channeled through the Central Bank of Bolivia to the Gerencia de Desarrollo on an interim basis until the new second-tier bank is legally constituted. Once the new bank, known as the Second Tier Financing Entity (ESP) is created, it would become the Executing Agency. Both under the existing GD and proposed ESP arrangements, the funds would then be allocated to private-sector productive activities using a two-stage process: first, through the auction mechanism administered by the GD (subsequently the ESP) to qualified ICIs, and second, through the ICI to the final beneficiary.

C. Cost and financing

2.4 The total cost of the Multisectoral Credit Program is estimated at up to the equivalent of US$87.5 million, of which US$70 million would consist of IDB financing, representing 80 percent of the cost of the program. In accordance with the following table, a total of US$86.2 million would be made available for loans to the private sector, including local counterpart, and US$600,000 would be provided for institutional strengthening of the ESP (see Annex I):

Components of Program Financing (In US$ Millions)

	IDB	Local	Total	%
Multisectoral Credit	68.8	17.4	86.2	98.5
Institutional Strengthening Component	0.5	0.1	0.6	0.5
Inspection & Supervision	0.7	---	0.7	1.0
Total	70.0	17.5	87.5	100.0
Share (%)	56	20	100	

2.5 The proposed Bank financing would be provided from both FSO and OC/"Dollar Window" resources with loans in the amounts of US$70 million and $30 million respectively. FSO financing is consistent with Bank policy and Eighth Replenishment requirements pertaining to the financing of loans in Group D2 countries. The FSO credit would be disbursed over a period of four years and repaid over 40 years from date of loan signature including a 10 year grace period. The rate of interest would be equal to 1 percent p.a. during the grace period and 2 percent thereafter. A one time inspection and supervision fee equal to 1 percent of the loan (US$700,000) would be charged to the resources of the loan in quarterly installments starting with the first disbursement. A commitment fee of 0.5 percent p.a. of the undisbursed balance of the loan would begin to accrue 12 months after approval of the operation by the Bank's Board of Executive Directors.

2.6 **The FFAL Mechanism:** A "two step" procedure has been used in Bolivia when financing programs for productive sectors with the Fund for Special Operations (FSO). The Government of Bolivia receives the resources from the Bank at the FSO rate and then on-lends them to the executing agency at a rate of interest equivalent to the current Ordinary Capital (OC) rate. The revenues to the central government derived from the difference between the FSO and OC rates have been deposited in special trust fund, called the Fondo Fiduciario de Aportes Locales (FFAL). These funds have been lent to government agencies to enable them to meet their counterpart responsibilities on a timely basis. They may also be used to repay the Republic of Bolivia's obligations to the Bank. As part of the analysis for the present operation, a number of deficiencies were detected in the use of the funds for local counterpart, particularly in the area of prompt repayment of the loans made by FFAL. The accounts have been audited and measures are being developed to rectify the problems encountered.

2.7 In order to avoid delay of the proposed multisectoral credit II operation pending resolution of the outstanding FFAL issues, it is

recommended that a separate accounting be established within the FFAL for the receipt and disposition of the revenues derived from interest-rate differential in this multisectoral credit operation. It is also recommended that these revenues be earmarked solely for the repayment of the outstanding debt of the Bolivian government to the IDB. This will avoid the accounting difficulties encountered with the use of the funds for local counterpart. Finally it should be noted that repayment of external debt is a particularly appropriate use of the differential for this global multisectoral credit operation given that the subloans are self liquidating and that the exchange risk is born entirely by the subborrowers.

2.8 It is understood that parallel to the initial execution of the present operation, the Country Office and Bolivian authorities will prepare a solution to the more general FFAL issues and that this solution will serve as the framework for managing the the interest rate differential on future FSO operations in Bolivia. The proposal for this solution will be presented to the Bank within nine (9) months of contract signiture and will be implemented within eighteen (18) months of signature.

D. Size of the Program

2.9 Two independent estimates of demand prepared in late 1993 suggest that the productive sectors could exceed US$150 million at market interest rates in 1994 alone. The first estimate ranging from US$148 to more than 200 million is based on statistical projections of past levels of long-term "development" credit, its relation to total credit use and variations in interest rates. The second estimate is based on a survey done by the Bank Association (ASOBAN) of its major member intermediary credit institutions (ICIs) which revealed a demand for 1994 on the order of US$ 160 million. Both of the estimates are limited to demand for credit for productive activities and do not include demand for mortgage housing finance. To date demand has fallen short of these estimates as noted in the following paragraphs.

1. Alternative sources of supply

2.10 In order to estimate the demand for the resources of the new program, the alternative sources of supply have to be taken into account. These consist essentially of remaining disbursements and net recoveries from existing IDB loans, the operations of the Corporación Andina de Fomento (CAF), and other international lenders, notably IDA and USAID. Aside from the IDB, the most important source of fresh resources for long term credit in Bolivia is the CAF which approved a loan for US$60 million in 1993. The Bolivian authorities signed the loan agreement in April 1994 and funds were first offered to eligible intermediaries in May of this year. The terms of the CAF loan are complementary to the proposed IDB line as discussed more fully in the next chapter. *(See para.*

3.12.) It is expected that approximately half of the CAF resources will be committed this year and half in 1995.

2.11 In addition to the approximately US$30 million in CAF resources other sources of funding for 1994 include the proposal for use of US$20.8 in net recoveries on past IDB loans *(para. 1.49)*, the disbursement of the remaining US$27.5 million from 629/OC-BO, and an undetermined portion of the approximately US$28 million in recoveries from prior IDA and USAID loans. In 1995 the second half of the CAF loan (US$30 million) and a maximum of US$24 million in IDB net recoveries would be available.

2. Factors affecting utilization of development credit

2.12 As noted in Chapter I, the credit auction was initiated in September of 1990 and suspended in March 1993 due to lack of fresh funds and a decision by the authorities to discontinue the relending of loan recoveries in early 1993. This sudden break in the flow of long-term resources had a serious impact on the ICIs and subborrowers, leading to considerable skepticism about the reliability of this source of credit. The Central Bank resumed granting credit in January 1994, and in order to counter this skepticism, announced its intention to conduct an auction twice each month, and has honored this commitment to date.

2.13 One factor which has affected demand is the changes introduced into the credit auction methodology, and the eligibility requirements for ICIs to participate in the auction. *(See para. 3.18.)* Based on experience with some banks which had difficulty in meeting their repayment obligations, the BCB/GD has tightened up the standards both for participation and for total indebtedness to the Central Bank. While undoubtedly improving the quality of the BCB's development credit portfolio, this has had the effect of initially reducing effective demand, as each of the ICIs has had to be requalified to participate according to the new criteria.

2.14 Another factor was the CAF loan. Although approved by the CAF Board of Directors in 1993, the loan contract had not been signed by the Bolivian authorities when the credit auction was resumed. Believing that there was an opportunity to obtain funding on more favorable terms, the Chamber of Eastern-Lowland Agribusiness (Cámara Agropecuaria del Oriente - CAO) attempted to influence Government authorities to specify that the CAF resources would be channelled exclusively to this sector and at preferential rates. Pending resolution of this issue, the members of the CAO and other interested borrowers limited their utilization of the auction. Discussions between CAO and Government officials took place over several months and were finally resolved in early May when the CAF reiterated its insistence that its operation was to be truly multisectoral and that the funds were to be allocated according to the same auction procedures as used for all other development credit resources.

3. Recent experience and projected future utilization

2.15 Since the terms and conditions of the CAF loan have been resolved, demand for all resources has increased . The auctions held on May 11 and May 26 resulted in the placement of US$15.2 and 9.1 million, respectively. In more recent auctions placements have ranged from $300,000 to $2.3 million. Based on the pattern of credit placements in 1994 to date, it appears that total placements for the year should fall in the range of US$55-65 million, and the funds available from alternative sources will be sufficient to satisfy this demand. Assuming that some of the investment activity on which the 1994 projections were based will be carried out in 1995 and that investments related to the capitalization program increase substantially next year, total demand for program resources should fall in the $60 - 100 million range. At the present time it is only possible to project comparable levels of demand for the remaining years of the program disbursement period. If housing becomes eligible for financing as result of the analysis for the Housing Sector Support Program (BO-0008) currently in preparation *(see para. 3.20)*, demand would be increased substantially over these levels.

2.16 As noted previously, alternative funding in 1995 should total around US$55 million ($30 million CAF and $25 million of net reflows and other sources). In 1996 the CAF operation would be fully disbursed and reflows and other sources would decline. Based on these rough estimates, demand for the Global Multisectoral II program resources in 1995 would range from $5 to 45 million and for 1996 could range from $40 to 80 million. This would be sufficient to fully absorb the US$87.5 million of program resources well within the four year disbursement period.

E. Environmental considerations

2.17 An important objective of the operation is to guarantee the environmental quality of the various investment projects that would be financed under the program. In this regard and on the basis of an analysis of experience gained in the control of environmental quality during execution of loan 629/OC-BO and environmental institutional development in Bolivia, specific recommendations are being made to improve the environmental control procedures for purposes of applying them to the proposed program. These recommendations are aimed at making environmental quality control more effective and expeditious and at strengthening the environmental control mechanisms that are beginning to be developed under the Environment Law and with the organization of the new Ministry of Sustainable Development and Environment. A period of transition is anticipated until the country's institutional structures have been fully established. For this reason, specific areas of environmental control required under 629/OC-BO will be maintained at the outset, but existing environmental management instruments will be used as much as possible and financial institutions such as the Central Bank and the ICIs will be released

from environmental monitoring responsibilities. In addition, training and information dissemination activities will be emphasized and an environmental evaluation element will have to be built in from the beginning as an integral part of the project documents that subborrowers submit to the ICIs to receive financing.

III. PROGRAM EXECUTION

A. The Borrower and Executing Agency

3.1 The Borrower of the proposed Global Multisectoral Credit Program II a would be the Republic of Bolivia, which would transfer the resources to the Executing Agency. Initially this would be the Development Credit Department (GD) of the Central Bank of Bolivia (BCB). Currently the draft Central Bank Law is pending passage before Congress, which would provide for the dissolution of the GD. The Government has also introduced complementary legislation to create a new second-tier bank which is to be called the Entidad de Segundo Piso (ESP). It is envisioned that upon the passage of both laws, the Executing Agency of the Program would automatically become the ESP. However, the change in Executing Agency would not alter the Government guarantee in any way, inasmuch as the Republic of Bolivia would remain as the Borrower.

3.2 As evidence of the Government's commitment to the above, the Bank obtained a letter from the Central Bank of Bolivia which reiterates the Government's intent to create the ESP and to present the respective legislation before Congress. An information copy of this letter appears as Annex II. The ESP legislation was introduced when Congress resumes its ordinary sessions in August.

1. Description of the Interim Executing Agency

3.3 Since 1982, the GD has been responsible for the management of investment credit lines funded by the IDB, IDA, USAID, CAF, and bilateral sources. These credit lines have generally been of a medium- and long-term nature. The BCB determines which banks are eligible to on-lend Central Bank credit, based on data and recommendations provided by the Superintendency of Banks. As discussed below in more detail, eligibility criteria are continuously monitored and tightened as needed, to ensure that all banks on lending development credit operate efficiently, and to minimize the danger of misdirecting credit to distressed borrowers.

3.4 As noted in Chapter I, the introduction of the auction mechanism for allocating term credit increased the efficiency and reduced the cost of administering these functions. As part of this new approach, the GD was restructured to reflect its new objectives and functions. This included a staff reduction of about 33 percent to approximately 70 positions. This streamlining of the organization and staffing implied a rationalization of the use of human resources available to the GD in keeping with the new objectives described above. In addition, through IDB technical assistance, the financial institutions involved in development credit (the GD, ICIs and selected sub-borrowers) were strengthened to: (i) carry out their respective functions related to the management of development credit; (ii) assist them in streamlining

documentation requirements and approval procedures; and (iii) prepare them to take on new functions related to assessing and monitoring environmental impact on future multisectoral lines of credit. To date the objectives of this assistance have been satisfactorily met.

2. Description of the Second Tier Financing Entity (ESP)

3.5 The Government is firmly committed to the creation of a new second-tier bank and to that end has pending before Congress the legislation mentioned earlier. With IDB assistance provided since October of 1993, a task force of consultants has completed the necessary studies on the design, functions, staffing and management information needs of the ESP. Legally, the legislation proposes that the ESP be structured with mixed public/private ownership (sociedad anónima de economía mixta) and an initial capitalization of US$60 million. Its purpose will be to intermediate funds exclusively to domestic private financial institutions. In that regard, the pending legislation includes the necessary supreme decree and regulations for implementation.

3.6 The ESP is to be self sufficient in its operation, covering all operating and financing costs from revenues. Its management will be held accountable for transparency in all technical and financial matters. Particular attention will be paid to impartiality in the definition and aplication of policies on the eligibility of ICIs, the allocation of resources, and the accounting for all transactions.

3.7 With regard to capitalization, the proposed level of US$60 million conforms to the Basle Committee guidelines, as incorporated in the new Ley de Bancos y Entidades Financieras promulgated in April of 1993, which requires that capital be at least 8 percent of risk-weighted assets (Art. 47). The proposed capitalization would allow for lending of up to US$750 million assuming a maximum 100 percent risk weight, which is way above the projected portfolio of US$190 million in existing BCB/GD loans to be taken over by the ESP, plus approximately US$120 million in new loans to be made during 1995/96. Therefore, the capitalization levels may be considered adequate for the probable levels of activity of the CFB during the execution period of the proposed operation. Nonetheless, it will be particularly important to monitor the capital adequacy of the CFB as part of the normal Bank supervision of this operation.

3.8 In terms of institutional structure, the ESP will consist of five levels below the General Assembly of Shareholders. The highest decision-making authorities, the President and the Board of Directors, will be responsible for high-level institutional planning and control of policy and for all strategical decisions. The Executive level will be responsible for implementing the decisions of the President and the Board and for the planning, organizational, direction and control of all operational

activities. It will include three departments and managers for Loan Placement (Colocaciones), Finance and Operations. The Operational level will be responsible for specific operational activities dealing with qualification of ICIs, portfolio administration, financial administration, accounting, budgeting, systems and general administration. It will supervise the performance of six units to carry out these functions. The Advisory level will provide high level advice in internal auditing and legal matters. The final level, Administrative, will include all support staff. On a selective and discretionary basis, GD staff may be tapped for employment by the ESP.

3.9 On the timetable for ESP implementation, the originally scheduled completion date of April 1st for the technical preparations for the ESP has been delayed, as has been the anticipated date for the passage of the legislation. As a result, the Central Bank made interim provisions for the ESP to become operational on a "shadow" basis, whereby the core staff is being selected and will be using the new ESP operating procedures as they become available. The "shadow" ESP is now de facto managing the development credit portfolio even before the new bank is formally constituted, which is expected to take place in early 1995.

3. Institutional strengthening

3.10 Included in the Program are resources for the institutional strengthening of the ESP in order to assure its adequate capacity as eventual Executing Agency of this Program. An amount of up to US$500,000 of FSO resources has been earmarked to cover the cost of upgrading information systems, providing staff training, providing management advisory services, and for initial promotional and marketing activities of the ESP as it becomes known to the public. 2/

4. Assignment of existing Bank loans

3.11 Once legally constituted, the ESP is scheduled to take over responsibility for administration (re-lending of net recoveries) and debt service of the following Bank loans; 629/OC-BO (including remaining original disbursements), 213/IC-BO, 830/SF-BO and 564/OC-BO. Subloans made with these resources are performing well, and it is expected that the CFB will be able to profitably manage this portfolio. Other Bank global credit operations administered by the Central Bank (479/OC-BO, 118/IC-BO, and 712/SF-BO) have had a poor record of recovery due to the nature of the subborrowers targeted (e.g. small miners) and to the terms of the subloans (negative real rates of interest in some cases). As a result, many subloans will have to be largely written off. In order not to burden the CFB

2/ See Annex I for a detailed presentation of the institutional strengthening component.

with responsibility for debt service of these loans, they will be assigned to the National Treasury Department (TGN), which will also attempt to recover as much of the outstanding subloan portfolio as possible.

5. Relation to the CAF Program

3.12 As noted in Chapter II *(para. 2.16)*, the recently signed CAF loan agreement with the Central Bank will be channelled to the ICIs and on to the subborrowers according to the same credit allocation criteria and auction mechanism used for all funds administered by the BCB, including the proposed Program. In this respect, the CAF program represents a comparable and compatible funding source. In other respects it complements the proposed Bank program very well as the CAF program does not prohibit the use of its funds for refinancing short-term debt. By utilizing the CAF funds for restructuring their short-term obligations, clients are enabled to assume additional long-term debt to finance new investment projects. Based on the most recent auctions held, there is some indication that Bank and CAF funds are being used in this complementary fashion, particularly in the agricultural sector.

B. Program implementation and execution

1. Advance of funds

3.13 The credit auction mechanism is largely dependent on the ESP's having regular access to the Multisectoral Credit resources and in sufficient quantities so as not to disrupt the flow of medium- and long-term credit to the ICIs. Once the Multisectoral Credit would be declared eligible for first disbursement, the advance of funds for the FSO portion will be 20 percent.

2. Relending of subloan recoveries

3.14 The resources deriving from amortizations of subloans granted with the resources of the Loan, which are accumulated in excess of the amounts needed for the servicing of the Loan, would only be utilized for granting new subloans which would be compatible with the conditions established in the Loan Contract and in the Credit Regulations for the Program, with the exception that after a period of five (5) years from the date of last disbursement of the Loan, the Bank and BCB may approve an alternate use for the recoveries, but which would adhere to the basic objectives of the Program and would not reduce the period of effectiveness of said obligation.

3.15 In order to assure continued compliance with the spirit of the agreement as discussed in para. 1.49, it is recommended that the loan Contract establish that during the disbursement period of the operation, the Executing Agency present an annual plan to the Bank within the first 90 days of each calendar year, indicating how it proposes to reduce the outstanding balance of unlent reflows, consistent with the IMF program in force at that time.

3. The credit allocation system

3.16 As noted in Chapter I, the credit allocation system has been modified to take into account several lessons learned. The modifications were in the areas of qualification of participating ICIs, determination of the floor interest rate, the means by which the rate is periodically readjusted during the life of the subloans, and a better mechanism for taking into account the ICIs' efficiency. In response to the strong criticism of the unpredictability of the old auction, the Central Bank has also committed itself to conducting the auction regularly twice each month.

a. Qualification of participating ICIs

3.17 The criteria for qualifying ICIs to participate in the auction were formalized in December 1993 and issued as the "Reglamento para la Habilitación de Entidades Financieras Bancarias como 'Instituciones Crediticias Intermediarias'" (copy available in the project files). These regulations were prepared to reflect the passage of the new banking law and to assure that weaker banks could not exploit the credit allocation system as had occasionally happened in the past. The main features of the new regulations are as follows:

- the Gerencia de Sistemas Financieros will review each application and will solicit the views of all relevant departments in the BCB before rendering its opinion. The GSF's analysis and recommendation will be reviewed by the President of the Bank before being transmitted to and formally considered by the Board of Directors of the BCB;

- in preparing its opinion, the GSF will take into account the specific criteria. These are noted in full in Article 8 of the Regulations, but key among them are the capital adequacy of the applicant, its being current in all obligations to the BCB, its own portfolio not being more that 10 percent in arrears, that the GD has verified the correct use of all development credit, full compliance with counterpart funding requirements 3/ and any other aspects which pertain. (This last stipulation empowers the BCB to deny or remove commercial banks from ICI status if they do not comply with one or more of the credit allocation regulations discussed in the next section.); and

- a particularly noteworthy clause of the "Reglamento de Habilitación" is the limitation on total indebtedness of the applicant bank with the Central Bank. This indebtedness includes development credit, as well as all other facilities

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3/ Prior to the suspension of the auction in early 1993, a few of the weaker banks had been found to have diverted development credit funds to cover their shortfall in general liquidity.

such as the Reciprocal Agreement on Payments and Credits (C.P.P.R.) between ALADI member states. Heretofore this limit had been set at five times the commercial bank's net worth. The new regulations have reduced this limit to <u>three</u> times net worth. (One bank has already been affected by this more stringent requirement and is taking measures to raise its capital accordingly.).

b. <u>The revised credit auction procedures</u>

3.18 The lessons learned about the auction procedures were made operational in the revised credit regulations which were prepared prior to the resumption of the auction on February 3, 1994. The revised procedures are currently being applied by the Gerencia de Desarrollo and it is understood that they will be substantially adopted by the ESP, when it is legally constituted. The regulations include the tightened ICI eligibility requirements mentioned in the previous paragraph and the decision to hold auctions twice monthly. Key aspects of the regulations are as follows 4/:

- **project verification:** Funds are allocated to specific projects for which the ICI in conjunction with the subborrower has carried out a cost-benefit and environmental impact analysis and has developed a financing plan. A system of two sealed envelopes is used to prevent recurrence of the past abuse of the auction in which funds were diverted in order to meet general liquidity needs of the offending ICIs;

- **base rate:** The rate below which bids from a given ICI will not be accepted is the higher of either (i) the cost of funds or (ii) the savings mobilization rate. The cost of funds is defined by the rate paid by the BCB to the international agency plus 1.5 percent (0.5 for administration costs and 1.0 percent to cover the currency basket risk to the BCB). The savings mobilization rate is defined as the interest rate paid by each ICI on its 180 day time deposits;

- **adjudication rate:** Each bid is accompanied by a rate of interest offered by the ICI for that particular bid. If this rate is accepted, it becomes the adjudication rate. If demand for funds exceeds the supply in a given auction, bids are rank-ordered from highest to lowest according to an adjudication procedure which takes into account the rate offered and the retail rates the ICI has charged on past development credit loans. Funds would be allocated to each bid in descending order until exhausted;

4/ The complete credit allocation regulations are available in the project files for consultation.

- **disbursements:** Once the winning bids are awarded, funds are disbursed within three days of the ICIs presenting required supporting documentation, including the environmental impact assessment for the project and the proposed measures if needed to alleviate negative impact; and

- **readjustment rate:** At the time the bid is awarded, the margin between the adjudication rate and the cost of funds is determined. This margin remains fixed during the life of the subloan. Periodically (usually every six months) the rate is readjusted by adding the fixed margin to the current cost of funds for the GD.

c. Further adjustments in the rules for ICI qualification and credit allocation

3.19 The credit regulations are under constant examination in order to determine areas for further improvement. However, it is also important to maintain continuity in the auction procedures and introduce changes only as needed after due deliberation. A collaborative review by the three major source of external funding for development credit in Bolivia, namely the IDB, World Bank/IDA, and CAF, has identified the following areas for attention: mechanisms for setting the floor rates and means of adjudicating competing bids. The floor interest rate based on the domestic savings rate will need to be adjusted to take into account the cessation on May 1st, 1994 by the Central Bank of its remuneration to commercial banks for their required reserves. Another area for review is the basis on which the first story intermediaries are selected to participate in the program, and once selected, the amount and term of financing they are eligible to receive. These and related issues will be reviewed by the borrower and the Bank as part of the review and approval of the credit regulations prior to first disbursement.

4. Relation to the Housing Sector Support Program (BO-0008)

3.20 Loan 629/OC-BO does not permit lending for housing. Consideration has been given to including housing in this credit; however, at least two issues need to be resolved before formally proposing the inclusion of housing in the Multisectoral Credit Program II: (i) the difficulties and delays in executing foreclosure; and (ii) the extent and nature of the demand for housing finance. The analysis that both issues merit would delay preparation of this operation. These points are being addressed in the preparation of the Housing Sector Support Program (BO-0008) and the associated Project Preparation Facility (BO-0026). Once solutions are found and if a decision is made to include housing in the proposed Program, the credit regulations would be modified accordingly.

5. Auditing and control

3.21 During the execution periods of the loan and for a period of up to two (2) years following the date of the last disbursement, the Government would present to the Bank financial statements for the loan. In addition, financial statements of the BCB/ESP would be provided to the Bank throughout the life of the loan contract. These statements should be submitted annually within 120 days of the close of the fiscal year and should be certified by a firm of independent public accountants designated by the BCB/ESP and acceptable by the Bank.

6. Inspection and supervision

3.22 The BCB and subsequently the Second Tier Financing Entity would be responsible for the supervision of the Program. The Bank would carry out its inspection and supervision of the Program through its Country Office in Bolivia.

3.23 The Bank would determine the inspection requirements, it would deem appropriate in order to assure the satisfactory execution of the Program. To that end, the Borrower and Executing Agency would cooperate to the extent necessary to assure that proper and adequate inspection and supervision of the Program take place. Of the total amount of the Bank loans, an amount of US$700,000 would be earmarked as income to the Bank's account for general inspection and supervision.

7. Ex-post evaluation

3.24 There is no formal ex-post evaluation requirement for this operation; however, it should be noted that the evaluation of the loan currently in execution, 629/OC-BO, will be carried out during the administration of the proposed operation, and that it will include analysis of many of the issues surrounding the new operation. Also regular evaluations of compliance with environmental and other subloan conditions will be carried out as part of this new operation, paying particular attention to the measures taken to mitigate any negative impacts. These reports will constitute an important feedback mechanism both for the ICIs and the CFB, as they reexamine their lending and subloan administration procedures.

C. Environmental monitoring

3.25 Experience to date with the environmental quality control mechanisms and the measures currently underway to enhance them were discussed at length in the Environmental Summary which was considered and approved by the Environmental Committee in its meeting of April 19, 1994 (Minutes 13/94). The Summary describes the institutional and procedural changes being put into place, as a result of the creation of the new Ministry of Sustainable Development and Environment (MDSMA) with the support of the Bank's

Environmental Support Program (BO-0028) in preparation. Following is a brief synopsis of the major conclusions and recommendations from the Environmental Summary, as they pertain to specific actions required during the implementation of the proposed Multisectoral Credit II Operation. *(A copy of the complete Summary is available in the project files.)*

3.26 Aplication of the environmental monitoring procedures of program 629/OC-BO is to continue subject to the adjustments made to such procedures in September 1993, which are reflected in the aide-mémoire signed with the government (September 24, 1993). These adjustments transfer responsibility for environmental control, including review and approval of environmental briefs and assessments, to the Environmental Quality Control Subsecretariat of the Ministry of Sustainable Development and the Environment (MDSMA). Moreover, specific responsibilities are defined for the borrowers and intermediary credit institutions (ICIs), especially in terms of shared responsibility, under sworn statement, for the environmental information they provide with their applications. The environmental analysis is included from the beginning as part of the overall feasibility analysis of the projects.

3.27 Taking into account that a national environmental system is in the process of being established and that this system will be strengthened and guided in the context of an IDB loan (BO-0028), an agreement will have to be worked out with the government, through the MDSMA and the program executing agency, to adjust the procedures within the first six months after signature of the contract. To that end, the program executing agency and the MDSMA will prepare and submit to the Bank a plan of action reflecting the institutional changes being made, including those resulting from the implementation of the current Environment Law, with a focus on the specific needs of the multisectoral loan. The plan should take into account, *inter alia*: (i) the specific responsibilities and functions of the environmental units involved with regulations under the Environment Law and other pertinent sectoral measures; (ii) the environmental assessment activities mentioned in paragraph 3.28; (iii) possible sources of financing for these activities; and (iv) mechanisms for distributing environmental guidelines and procedures to the ICIs and the borrowers, an activity that the government has undertaken to finance with counterpart funds. This plan of action should also consider the advisability of paying the MDSMA and the environmental units for providing specific services to the multisectoral credit program. The amount and payment arrangements would be determined by the MDSMA, in coordination with the executing agency and the ICIs, and will be described in the plan of action to be submitted.

3.28 The contractual clause of program 629/OC-BO which requires the executing agency to submit regular environmental assessments for the program to the Bank through the Environmental Control Secretariat must be maintained. The mechanism that provides for penalties for noncompliance with the requirement to take

environmental protection measures or for irregularities in the processing of environmental briefs and environmental impact assessments (EIAs) will be similar to those in force under program 629/OC-BO. Nevertheless, the plan to be submitted will define this mechanism in detail and the necessary changes and adjustments may be made, according to the previously-mentioned plan of action on the implementation of institutional changes to be made.

3.29 Given the importance the program is expected to have in allocating resources to the agricultural sector in eastern Bolivia, the government, through the MDSMA, must submit to the Bank, together with the plan of action mentioned above, a report on the location and functions of the forestry services to be created, which it is understood would replace the Forestry Development Center and its soil conservation unit. The arrangements to be pursued to make these forestry services financially self-sustaining will have to be specified as well as their physical and human-resources capacity to guarantee that they can fulfill their function, under the law, of controlling and allocating felling permits.

IV. VIABILITY AND RISKS

4.1 The proposed Program centers on the passage of two laws critical to progress in Bolivia's financial sector reforms. The new Central Bank Law, among its various proposals, would provide for the dissolution of the Development Credit Department (GD) within the Central Bank, thus ending the BCB's involvement in development credit activities. The Law for the Creation of the Second Tier Financing Entity (ESP) would provide for the creation of the country's new second-tier bank, which would ultimately assume most development credit activities formally carried out by the GD, thus definitively separating credit policy and practices from monetary, as traditionally carried out by the Central Bank. The draft laws have been officially presented to and reviewed by the IDB, and the Bank endorses the legal and institutional structure proposed for the ESP. The passage of both laws is now pending before Congress.

A. Viability of the proposed Program

4.2 In light of the above, the present document recommends initiating the Program using the GD as Executing Agency, in order to provide continuity and support to the processes now taking place in Bolivia with the pending passage of the laws and with the initiation of ESP activities through its shadow program. As Executing Agency since 1982 of various global loans approved by the donor community, and as beneficiary of comprehensive advisory services and institutional strengthening, the GD has amply demonstrated its capacity to adequately carry out development credit programs in keeping with Bank requirements. The eventual transition of Executing Agencies incorporates adequate measures to assure that GD experience and capacity are ultimately transferred to the ESP and is complemented by the proposed institutional strengthening component. Therefore, the execution mechanism envisaged for the Program combines years of GD experience and capacity with the new and specialized capabilities with which the ESP would be endowed with the passage of the Law.

B. Issues and risks

4.3 Although the Government of Bolivia is fully committed to the passage of both the Central Bank law and the new second-tier bank law, there is a possibility that Congressional approval of the latter will be delayed. If the Central Bank Law is passed, the Gerencia de Desarrollo will be formally abolished; however, as noted in the letter of commitment to create the ESP from the Central Bank President *(Annex II)* there are provisions in place which will allow the Central Bank to continue administering the functions of the second-tier bank on an interim basis. There is a related risk that prior to the formal establishment of the CFB Central Bank may try to exercise undue control over the allocation of sub-loan recoveries for monetary policy purposes. This risk is

addressed by the provisions on relending of subloan recoveries specified in the loan contract .

4.4 Finally, the proposed Program would continue to improve the allocative efficiency of the Bolivian financial system in order to ensure that scarce investment resources be channelled to the most productive uses. These benefits would result from improvements to the credit allocation mechanism and from the implementation of a second-tier bank independent of the Central Bank able to pursue alternative funding sources and offer new financial products, while at the same time continuing to provide medium- to long-term financing to the Bolivian private sector to encourage an acceleration of growth.

C. Impact on low-income groups

4.5 The program is designed to finance private investment in various productive sectors. Therefore the operation does not conform to any of the criteria for meeting the poverty reduction objective, as established in the Eighth Replenishment.

D. Impact of the Program on women

4.6 The opening of access through the credit auction to new ICIs which traditionally serve low-income groups would be likely to include among its prospective final beneficiaries, significant numbers of women as individual borrowers and heads of households.

INSTITUTIONAL STRENGTHENING COMPONENT FOR THE SECOND-TIER FINANCING ENTITY

The institutional strengthening needs of the second-tier Financing Entity (ESP) bank and an estimate of budgets by area are presented below.

1. Information systems

Because of the activities that have been taking place in this field, it will be necessary to upgrade and provide technical support for the applications software (updates, consultations, periodic reviews, systems audits, communications, software and database tuning) for a minimum of 12 months.

Back-up equipment is needed for the hardware as well as new development work. A Novell communication system is needed in addition to the network software to connect the ESP with the Central Bank of Bolivia (BCB) and the intermediary credit institutions (ICIs).

2. Training

Training in finance is essential in this type of institution, a need compounded by the difficulty of finding qualified financial analysts in Bolivia who are able to develop the needed relationships with the ICIs, especially since there are plans to broaden the range of institutions to which these resources are expected to be transferred.

In this operation, training support is offered basically at two levels:

a. Formal training courses abroad for financial analysts, like those conducted by Citibank or the Morgan Group. It is estimated that at least three people will be trained for a period of three months each.

b. On-the-job courses or lectures at the ESP, which could also benefit executives and professionals of the BCB, the SBEF, and the financial system in general. These courses will basically offer practical training in working with charts of accounts, the analysis and evaluation of ICIs, use of manuals, management courses, treatment of nonbank financial institutions, new financial instruments, etc.

3. Advisory services to management

The ESP's senior management will receive a virtual "turnkey" project, for which ongoing follow-up advisory services will be required in order to guide them smoothly from the stage of general conceptualization to day-to-day administration, including operational systems and procedures.

These follow-up advisory services are expected to last four months.

4. **Marketing**

At the start of the second-tier bank's operations, the image of the current Development Credit Department of the Central Bank, along with its style and operating mode, will still be present. The new financial services offered by the second-tier bank will require opening new markets, identifying beneficiaries more specifically, and promoting new financial instruments. Moreover, the method of work being proposed implies a change from the passive role of receiving bids from the ICIs for the auctions.

On the basis of the above, an overall marketing strategy will need to be devised that gives priority to at least the following areas:

a. Create an image for the ESP and promote it among clients and end borrowers, in order to support efforts to increase the size of the market.

b. Design a strategy whereby the ESP will reach out to prospective end users of its services, under the concept of market pull, so that such parties are aware of the possibilities and opportunities and will put pressure on eligible ICIs to obtain this type of resource.

c. Estimate, project, and monitor on the financial system's actual capacity to absorb resources. If the availability of the ESP's resources exceeds such capacity, determine the causes and possible corrective measures to be taken.

d. Conduct a study on incorporating new types of ICIs and new financial products as participants and additional focuses of the ESP's financial activities.

BUDGET

	US$	SUBTOTAL	TOTAL
1. **Information systems**		**65,000**	
♦ "Upgrade"	12,000		
♦ Novell LAN for up to 25 users with network card and cable	10,000		
♦ Back-up hardware	43,000		
2. **Training**		**169,000**	
♦ Courses abroad (average of three months) 3 people x US$15,000 Per diem 90 days x 3 x US$204 3 fares = US$3,000	105,000		
♦ Local training courses	64,000		
1 course — chart of accounts (1 week)	2,500		
5 courses — use of manuals (1 week each)	12,500		
* 2 courses — ICI analysis & evaluation (2 weeks each) (US$400/day + per diem + fares + organization + classrooms and materials)	22,000		
1 course — treatment of nonbank financial institutions (1 week)	2,500		
* 1 management course (1 week)	11,000		
* 1 course on new financial instruments (2 weeks) (US$800 day + per diem + fares + organization + classrooms and materials)	13,500		
* To be conducted with assistance from foreign instructors			
3. **Management advisory services**		**75,000**	
♦ Follow-up advisory services:			
. Conceptual and managerial	35,000		
. Procedures	20,000		
. Systems	20,000		
			Cont.../

	US$	SUBTOTAL	TOTAL
... Cont.			
4. Marketing		**114,000**	
♦ Hiring of corporate image/PR firm	25,000		
♦ Marketing consultants (1 person/month, outside)	8,000		
♦ Marketing consultants (3 person/months, local)	12,000		
♦ Studies			
. Financial system's capacity to absorb resources	5,000		
. Incorporation of new types of ICIs (2 types)	10,000		
. Development of new financial products (2 products)	30,000		
♦ Strategy design: (1 person/month, outside)	12,000		
(3 person/months, local)	12,000		
5. Contingencies		**52,000**	
6. Administrative costs		**25,000**	
TOTAL:			**US$ 500,000**

Original: Spanish

CENTRAL BANK OF BOLIVIA

La Paz, May 31, 1994

PRES. No. 162/94

Mr. Carlos A. Galvis
Deputy Representative
Inter-American Development Bank
La Paz, Bolivia

Ref.: Request from the Inter-American Development Bank's Middle Management Committee (CAM) (FBO/CA-2146/94 of May 24, 1994)

Dear Sir:

In response to the above-referenced request, we are enclosing copies of the drafts of the law establishing the second-tier bank as well as the drafts of incorporation papers for a semi-public corporation, the supreme decree, and bylaws.

As you know, the various alternatives for creating the above-mentioned financial entity, and particularly the related legal considerations, have been under examination since October 1993. In January 1994, consultants specializing in the following areas joined the work team: banking, systems, organization and methods, and finance. Some of the studies have already been completed and are being implemented in the Development Credit Department, while others are still being reviewed.

With regard to the Government of Bolivia's commitment to create a second-tier bank, the various IDB missions that have visited Bolivia in recent months were informed by the undersigned and by executive branch authorities of our government's decision to establish the second-tier bank [Banco de Segundo Piso] (BSP).

The National Congress will be able to consider the law establishing the BSP beginning this coming August during its regular session.

Once the Bolivian Central Bank Law has been adopted, if the law establishing the second-tier bank has still not been passed, the Republic, through the Ministry of Finance and Economic Development, will be responsible for carrying out the functions related to loans to the private sector. In this regard, the Central Bank of Bolivia would attend

to such loans, by order and for account of the Ministry of Finance and Economic Development. The latter could delegate this function on a temporary basis to other government institutions, including the Central Bank.

Sincerely,

[Signature]
Fernando Candia Castillo
President

Enclosures

APENDICE

PROPOSED RESOLUTION

BOLIVIA. LOAN /SF-BO TO THE REPUBLIC OF BOLIVIA
GLOBAL MULTISECTORAL CREDIT PROGRAM II

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 of the Bank, to enter into such contract or contracts as may be necessary with the Republic of Bolivia, as borrower, for the purpose of granting it a financing to cooperate in the execution of a global multisectoral credit program. Such financing shall be for the amount of US$70,000,000 or its equivalent in other currencies, except that of Bolivia, which are part of the Fund for Special Operations of the Bank. The financing shall be subject to the "Special Contractual Conditions" and the "Terms and Financial Conditions" of the Executive Summary of the Loan Proposal.