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STRICTLY CONFIDENTIAL

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

GRAND-DUCHY OF LUXEMBOURG

LOAN APPLICATION

RECOMMENDATIONS OF THE PRESIDENT

TO THE EXECUTIVE DIRECTORS

Washington, D. C. August 28, 1947

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I. RECOMMENDATIONS

The President submits the following recommendations on the application of the Grand-Duchy of Luxembourg for a loan of $12,000,000.

The President recommends that the Bank grant to the Grand-Duchy of Luxembourg a loan of $12,000,000 for a term of 25 years with interest at the rate of 3¼% per annum and a commission (under Section 4 (a) of Article IV of the Articles of Agreement of the Bank) of 1% per annum on the principal amount of the loan outstanding, such interest and commission to be payable from the respective dates on which the proceeds of the loan shall be withdrawn by the Grand-Duchy of Luxembourg. There shall also be a commitment charge at the rate of 1½% per annum on any part of the loan not so withdrawn from the effective date of the loan agreement to the respective dates of withdrawal. The loan is to be amortized in accordance with the amortization schedule annexed to and is to be subject to the other terms and conditions set forth in the form of loan agreement presented herewith. The amortization of the loan is to begin in July 1949 at the rate of $50,000 semi-annually until July 1951; thereafter, it will be based on a constant annuity covering both principal and interest in the semi-annual amount of approximately

$388,000 until final maturity in 1972.

The proceeds of the loan are to be applied to the financing of the purchase of railway rolling stock required by the Luxembourg Railway Company and reversing strip mill equipment needed by the Luxembourg steel industry. The detailed terms and conditions on which it is proposed that the Bank grant the loan are set out in the above-mentioned form of loan agreement.

II. COMPLIANCE WITH THE ARTICLES OF AGREEMENT

A. Compliance with Article I of the Articles of Agreement.

The proposed loan is within the purposes of the Bank as set forth in Article I of its Articles of Agreement. The proceeds of the loan will be used to finance the purchase and importation into Luxembourg of equipment for the Luxembourg steel industry and of rolling stock for the Luxembourg railways. The equipment to be purchased will replace or rehabilitate equipment lost or destroyed in, or depreciated during the war or will modernize existing productive facilities to conform to Luxembourg's peacetime requirements. In addition, the loan will indirectly assist Luxembourg in financing the reconstruction of real property and other extraordinary expenditures as part of the general rehabilitation of its economy. The loan will thus come within the purpose specified in paragraph (i) of Article I of aiding in the reconstruction and development of the territories of a member by assisting in the restoration of the economy of such member which was disrupted by war and in the reconversion of its productive facilities to peacetime needs.

B. Compliance with Article III, Section 4, of the Articles of Agreement.

The proposed loan conforms to the applicable provisions of Section 4 of Article III of the Articles of Agreement of the Bank.

1. The Borrower is a member of the Bank in accordance with paragraph (i) of that Section.

2. On the basis of inquiries made by the Bank and other available information, I am satisfied that in the prevailing market conditions the Grand-Duchy of Luxembourg could not otherwise obtain the proposed loan on reasonable conditions.

3. There is presented herewith a report of the Committee provided for in paragraph (iii) of such Section recommending the project for which the loan is to be made.

4. In my opinion the rates of interest and other charges in connection with the loan are reasonable and the schedule for repayment of principal is appropriate to the project.

5. As is hereinafter set forth, I am satisfied that in making the proposed loan, the Bank would be acting prudently in the interests both of the Grand-Duchy of Luxembourg and of the members of the Bank as a whole, and I believe that there are reasonable prospects that the Grand-Duchy of Luxembourg will be in a position to meet its obligations under the loan. It should be noted, in this connection, that so long as the present monetary arrangements between Belgium and Luxembourg continue, the ability of Luxembourg to maintain the service of the loan will depend on the economic situation of the Economic Union as a whole and on the willingness and ability of the Institut belgo-luxembourgeois du Change or its successors to make foreign exchange available for this purpose. For this reason, the Bank has requested Institut belgo-luxembourgeois du Change, Banque Nationale de Belgique, and the Belgian Government to give satisfactory assurances on this point.

6. Although the loan is desired by Luxembourg to assist in the accomplishment of a general program of reconstruction expenditures, the

precise purposes of the loan are specific projects of reconstruction within the meaning of Subsection (vii) of that Section.

C. Compliance with Article III, Section 5 (b), of the Articles of Agreement.

The form of loan agreement contains provisions to insure that the proceeds of the loan shall be used for productive purposes and only for the purposes for which the loan is recommended.

III. JUSTIFICATION FOR THE LOAN

A. The Need for a Loan.

The damage suffered in Luxembourg as a result of the war had made it necessary for the Government to undertake extraordinary budgetary expenditures for the reconstruction of the national wealth and for the well-being of its people.

1. Expenditures for workers' and farmers' dwellings and rebuilding of roads, bridges, and sewage systems which form the largest part of reconstruction expenditures will improve the country's productivity in the long run but will not have a substantial immediate effect on production. While some of the other extraordinary expenditures such as subsidies, indemnification of war damage to persons and personal property, and deblocking of frozen accounts, cannot be classified as productive, they are necessary concomitants of postwar reconstruction in all countries the economies of which have been disrupted by the war.

European countries faced with the problem of reconstruction have found it necessary and possible to cover emergency expenditures by using domestic savings, expanding internal credit or by the sale of imported goods financed by foreign credits. Luxembourg has temporarily exhausted the possibility of using domestic savings, and in other respects its monetary relationship with Belgium has made it impossible for the Government to handle the financing of reconstruction in the manner common to other countries with a similar problem.

The result of entering into the Economic Union with Belgium was, in effect, that the monetary policy for the Union is formulated by Belgium, with the National Bank of Belgium acting as the central bank for both countries in the Economic Union. This arrangement limited the Luxembourg Government's control of credit and currency in its territory. Before the war, when Luxembourg's expenditures were relatively small and the country was prosperous, the Government had no difficulty in raising funds domestically, and the problem of credit expansion to finance the State's expenditures did not arise. The enormous increase in expenditures after the war raised the question of how a country without sufficient domestic savings and without the ability to expand credit through central bank operations could meet substantial commitments which were almost entirely of a domestic character. Inasmuch as Belgium's postwar expenditures have put a strain on its own resources, Belgium has not found it consistent with its monetary and fiscal policies to assits its partner in the Economic Union to the full extent requested. Consequently, the Luxembourg Government, having exhausted its restricted means of raising money domestically and being unable to borrow abroad to cover its extraordinary budgetary deficit, is taking over certain external assets reserved for modernization of its steel industry. This transaction is dependent upon payment to the industry by the Government of the equivalent in equipment of the amount taken over. Accordingly, Luxembourg is asking for a loan from the Bank, a portion of which is to pay for equipment required by the steel industry. Another portion of the loan will provide means to purchase railway rolling stock which the Government has undertaken to furnish to the Railway Company.

2. The extraordinary expenditures which the State originally planned to make were out of proportion to the reduced real income of the country and could not be carried out in five years, the period originally contemplated, without imposing drastic reductions in consumption. Since the Government did not see its way clear to curtail consumption, it has undertaken instead to spread reconstruction over a longer period and reduce the size of some of the least productive expenditures. Despite the extension of the period of reconstruction and the paring of estimates, however, it will not be possible for the Government to overcome its financial difficulties in the period of transition without assistance from outside the Economic Union. It can be anticipated that, given assistance in 1947, the expected increased production will provide the Government with sufficient receipts from taxation and internal borrowing by the end of 1948 to meet its expenditures in that year.

3. In the last analysis, the ability of the Luxembourg Government to finance expenditures for reconstruction will depend upon increasing its national income. The increase of Luxembourg's national income will depend, in turn, in large part upon increased output and/or output of higher priced products of the steel industry, the major contributor to the country's income. The proceeds of an external loan would be used to purchase equipment for manufacturing high-quality products (which will increase earnings of the steel industry) and provide rolling stock for the railways upon which all industry depends for the movement of its raw materials and finished products. Thus, the need for a loan to raise Luxembourg's national income to a point where reconstruction charges can be met from domestic sources is amply demonstrated.

Having concluded that Luxembourg needs a loan and that such a loan is not available from sources within the Union, there remains the evaluation of the prospects and conditions of recovery.

The prospects of recovery may be summed up as follows:

(a) The main industry of the country, though under-maintained, has not been destroyed by war action and is contributing to the national income to an increasing extent.

(b) Despite the fact that iron and steel production is still below prewar levels, the country, by drawing on accumulated stocks in 1946, achieved an impressive export surplus, mainly composed of steel products, which augmented the foreign exchange resources of the Economic Union. Current demand for steel products is high, and the long-term demand particularly for sheets and plates also is promising, making the outlook for the continued activity of Luxembourg's steel industry encouraging.

(c) Luxembourg is politically stable. The major parties are united in the general objectives of reconstruction. Moreover, the country possesses a relatively large working force, composed of skilled and industrious workers.

The conditions of recovery may be summarized as follows:

(a) At present, the factor which limits output of steel is the shortage of coal in Europe. The country's national income, depending so heavily on the volume of steel production, will be limited unless current attempts to increase the tonnage of coal mined (including the coal in the Ruhr) are successful and allocations of coke to Luxembourg are augmented so as to permit the industry to reach and maintain a high level of production.

(b) The Luxembourg Government must put its financial house in order by spreading that part of the reconstruction expenditure which is at the expense of the Government over a longer period of years than originally contemplated thus limiting the amount of reconstruction expenditures to be financed by borrowing to an amount that is reasonable in relationship to the national income.

B. <u>Prospects of Repayment</u>.

Luxembourg is rich in resources, has demonstrated political and financial stability and has no record of default on any Government obligations, except for interruption of service during the German occupation.

Before the war, Luxembourg had a relatively small debt amounting in 1938 to only L.frs.725 million. By the end of 1946 the debt had reached L.frs.2,336 million ($53.3 million), or L.frs.4,658 million ($106.2 million), if L.frs.2,322 million ($52.9 million), covering blocked accounts and bonds to be issued to the Postal Check Office and Luxembourg banks for commitments already entered into, are included.

Luxembourg's capacity to repay a loan of $12 million from the Bank will depend on its ability to (1) <u>raise the internal means to service its foreign and domestic debt</u> and (2) <u>acquire the foreign exchange required to service its foreign debt</u>.

1. In 1947 the service of the outstanding foreign and domestic debt of Luxembourg included in the budget amounts to L.frs.150 million ($3.4 million). The issue of bonds to cover existing commitments to the Postal Check Office and the banks and the expected consolidation of the existing short- and medium-term debt, likely to occur in 1948, will increase the service to some L.frs.250 million ($5.7 million), which will equal 19% of the 1947 estimated ordinary receipts of L.frs.1,300 million ($29.6 million). The Government originally planned to finance a large part of the extraordinary expenditures through domestic borrowing which the

Government has stated would eventually increase the total debt to some L.frs. 10 billion ($228 million) and require an annual appropriation of about L.frs. 500 million ($11.4 million) for service of the debt. Such an appropriation would represent as much as 38% of the present annual ordinary budgetary receipts. Since Luxembourg is not free to expand its monetary circulation, a burden of this size might impair the ability of Luxembourg to meet its debt obligations. For these reasons the Bank has requested and the Luxembourg Government has agreed that the loan agreement shall contain a provision prohibiting the incurring, without the Bank's consent, of internal or external debt if thereby the annual service on all outstanding debt would exceed 25% of ordinary budgetary revenues for the preceding fiscal year (Article VII, Section 3, of the draft loan agreement). Moreover, the Luxembourg Government has agreed to deliver to the Bank a letter in the form submitted herewith setting forth the Government's policy with regard to the scheduling of reconstruction expenditures.

The above estimates of debt service requirements make no provision for repayment of principal of approximately B.frs.555 million ($12.6 million) of floating debt to Belgium. Accordingly, the Bank has requested the Belgian Government to give assurances to the Bank that Belgium's claims in regard to this debt will not be pressed in such a way as to disturb the Luxembourg financial position to an extent which would prevent or seriously impede the fulfillment of Luxembourg's obligations to the Bank. It is not proposed to sign the loan agreement until assurances on this point satisfactory to the Bank have been obtained.

2. The service of the outstanding debt in currencies other than Belgian francs (including the $12 million requested from the Bank but excluding $1,295,000 owed to Belgium the terms of settlement of which have

not been determined) will amount to about L.frs.60 million ($1.368 million) in 1948 or about 15% of Luxembourg's prewar average annual surplus of exports over imports, a proportion which cannot be considered excessive.

At the present time allocations of foreign exchange are made by the Institut belgo-luxembourgeois du Change. The draft loan agreement (Article XI, Section 3) accordingly provides that the agreement will not come into effect until assurances satisfactory to the Bank have been received from the Institut and Belgian authorities to the effect that foreign exchange required to meet the service of the loan from the Bank will be allocated to the Luxembourg Government against payment in Belgian francs. The Alternate-Director for Belgium has informed the Bank that such assurances will be forthcoming from the Institut, the Banque Nationale de Belgique and the Belgian Government.

The Belgian Government's ability to carry out the assurances mentioned above, and, therefore, the Luxembourg Government's ability to obtain the foreign exchange required to maintain the service of the loan, will depend upon the economic situation of the Economic Union as a whole. Moreover, the foreign exchange benefits of the loan will affect the Economic Union as a whole. It should, therefore, be noted that the Bank has not made a study of the balance of payments of the Economic Union, and that the draft loan agreement contains no provisions forbidding the creation of pledges and other charges to secure Belgian external debt or requiring Belgium to consult with the Bank with regard to the incurrence of external debt. However, in view of the Belgian debt record and the fact that the annual service requirement of the loan is a relatively insignificant item in the international payments of the Economic Union, I am of the opinion that the Bank runs no substantial risk in relying on the assurances to be given by Belgium in regard to the availability of foreign exchange.

C. Conclusion.

The Luxembourg application presents a number of problems that differ from those considered by the Executive Directors in connection with other applications. First, the fundamental need is for internal financing. Second, the Luxembourg recovery is further advanced than that of neighboring countries. Third, Luxembourg has adopted no reconstruction program of the kind formulated in other western European countries embodying the imposition of controls on consumption credit and imports.

Nethertheless I am satisfied that the Bank should make the proposed loan and that assistance given to Luxembourg in her endeavor to achieve a healthy economy will benefit the Economic Union and the economy of neighboring countries.

International Bank of Reconstruction
and Development

by (signed) John J. McCloy
President