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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

REPORT AND RECOMMENDATION

OF THE

PRESIDENT

TO THE

EXECUTIVE DIRECTORS

ON A

PROPOSED LOAN

TO

THE YUGOSLAV INVESTMENT BANK

FOR

INDUSTRIAL PROJECTS

June 30, 1967

REPORT AND RECOMMENDATION OF THE PRESIDENT
TO THE EXECUTIVE DIRECTORS ON A
PROPOSED LOAN TO THE YUGOSLAV INVESTMENT BANK
FOR INDUSTRIAL PROJECTS

1. I submit the following report and recommendation on a proposed loan in an amount in various currencies equivalent to \$10.5 million to Jugoslovenska Investiciona Banka (Yugoslav Investment Bank).

PART I - HISTORICAL

2. The Bank has made nine loans to Yugoslavia for a total amount of \$270.7 million. After three loans aggregating \$60.7 million had been made between 1949 and 1953, lending was resumed in 1961 following the permanent settlement of the Yugoslav prewar external debt in French francs in 1958 and the temporary settlement of the debt in sterling, Swiss francs and US dollars in 1959. An offer for the permanent settlement of the US dollar debt was made by the Yugoslav Government in March 1967. Negotiations for the permanent settlement of the sterling debt are now being held and will be followed by negotiations on the Swiss franc debt.

3. The proposed loan would be the fourth for industry in Yugoslavia. A loan of \$2.7 million (20 YU) was made in 1949 for the purchase of timber processing equipment. Of the two following loans (51 and 73 YU), which totalled \$58.0 million equivalent and were made in 1951 and 1953 to assist projects in various sectors of the Yugoslav economy, the major portion of \$48.5 million assisted 38 projects in industry and mining. All projects assisted under these loans were successfully completed and the enterprises are reported to be in normal operation.

4. A request for assisting the modernization of Yugoslav industrial enterprises carried out in connection with the economic reform of July 1965 was submitted to the Bank in February 1966. To enhance our understanding of the role of industry within the Yugoslav economy and of the nature of the Yugoslav enterprise system, the economic mission to Yugoslavia in March/April 1966 reviewed as part of its assignment the industrial sector. Its findings are contained in the report distributed last September (EA-162a of September 8, 1966). The projects to be included in the loan now proposed were submitted to the Bank in December 1966 and appraised by a mission in February/March 1967. Negotiations were held in Washington between June 13 and 19. Principal members of the Yugoslav delegation were Mr. M. Bojanic, General Manager of the Yugoslav Investment Bank, and Mr. G. Popovic, Economic Counsellor of the Yugoslav Embassy in Washington.

5. Yugoslavia has received no IDA credits and is not a member of IFC. The following is a summary statement of Bank loans to Yugoslavia as of May 31, 1967:

<u>Year</u>	<u>Loan Nos.</u>	<u>Borrower</u>	<u>Purpose</u>	<u>Amount (US \$ Million)</u>	
				<u>Amount</u>	<u>Undisbursed Balance</u>
1949	20 YU	Federal Government	Industry	2.7	-
1951	51 YU	Federal Government	Industry, Power Agriculture & Transport	28.0	-
1953	73 YU	Federal Government	Industry, Power Agriculture & Transport	30.0	-
1961	277 YU	Yugoslav Invest- ment Bank	Power	30.0	0.5
1962	318 YU	Yugoslav Invest- ment Bank	Power	30.0	0.9
1963	344 YU	Yugoslav Invest- ment Bank	Roads	35.0	-
1963	361 YU	Yugoslav Invest- ment Bank	Railways	35.0	1.9
1964	395 YU	Yugoslav Invest- ment Bank	Railways	70.0	56.2
1967	485 YU	Yugoslav Invest- ment Bank	Roads	<u>10.0</u>	10.0
Total				270.7	
of which has been repaid				<u>29.3</u>	
Total now outstanding				<u>241.4</u>	
Amount sold				3.5	
of which has been repaid				<u>1.4</u>	
Total now held by Bank				<u>2.1</u>	
Total undisbursed					<u>69.5</u>

6. Execution of most of the projects has been satisfactory. The closing dates of the two power loans (277 and 318 YU) have been postponed by about one year for reasons which were outside the control of the Yugoslav authorities. The projects are now practically completed. The 1964 railway project (395 YU) is more than one year behind schedule mainly due to slow awarding of contracts resulting largely from the 1965 currency reform and to modification of designs. A revised timetable for the project has been prepared and work is now proceeding satisfactorily on almost every section of the project.

7. The Bank is presently appraising a project for constructing a railway line from Belgrade to the Adriatic port of Bar. Discussions are being held between the Yugoslav Investment Bank, a Yugoslav enterprise and foreign companies on an aluminum project involving possible Bank financing.

PART II. - DESCRIPTION OF THE PROPOSED LOAN

8. Borrower: Yugoslav Investment Bank
- Guarantor: Socialist Federal Republic of Yugoslavia
- Beneficiaries:
1. Foundry of Malleable and Grey Iron Castings (KIKINDA), in Kikinda, Serbia;
 2. Plywood and Veneer Factory Lignosper (LIGNOSPER), in Bosanski Novi, Bosnia-Herzegovina;
 3. Naum Naumovski-Borce Organic Chemical Industry (OHIS), in Skopje, Macedonia;
 4. Enterprise Tito (PRETIS), in Vogosca, Bosnia-Herzegovina;
 5. Iron and Steel Works (SISAK), in Sisak, Croatia;
 6. Sladkogorska Cardboard and Paper Mill (SLADKI), in Sladki Vrh, Slovenia; and
 7. Automobile and Motor Factory (TAM), in Maribor, Slovenia.
- Amount: Various currencies equivalent to \$10.5 million.
- Purpose: To assist in financing the foreign exchange cost of imported equipment required for the modernization of the Beneficiary Enterprises.
- Amortization: Term of 14 years, including 2½ years grace, with semi-annual payment dates of February 15 and August 15, beginning February 15, 1970 and ending August 15, 1981.

Interest Rate: 6% per annum

Commitment Charge: 3/8 of 1% per annum

Relending Terms: The proceeds of the loan would be relent by the Borrower to the Beneficiary Enterprises in amounts and upon terms and conditions approved by the Bank (see paragraph 16).

PART III - THE PROJECT

9. A report entitled "Appraisal of Yugoslav Industrial Projects" (LA-2a) is attached (No. 1).

10. Yugoslav industry experienced a remarkable growth since the early 1950's. Industrial production rose by almost 12.5% annually since 1952 and accounted for over one-third of total output in 1965-66. Industrial exports, including mining products, now account for about 80% of merchandise exports. During the 1950's priority was given to the development of capital goods industries which still contribute almost half of total industrial output. In recent years, the expansion of consumer goods industries has received greater emphasis.

11. Weaknesses in the structure of the economy emerged in the early 1960's. To correct them, various measures have been taken during the past few years. Of these, particularly important was the economic reform of July 1965, which aimed at making enterprises more efficient and more competitive domestically and abroad by giving market forces increasingly the predominant role in determining production, pricing and investment decisions. The ability of industry to adjust to the measures introduced under the reform and to become competitive by international standards will be decisive for Yugoslavia's success in integrating her economy more closely with the world markets and liberalizing imports and the foreign exchange regime. Modernization of enterprises will be a key factor in this process and is expected to account for most of the investments in manufacturing industry during the next few years, estimated at approximately \$350 million annually with a foreign exchange component of about one-third.

12. The Yugoslav enterprise system is unique. The Yugoslav constitution provides that the means of production are socially owned and that the control of an enterprise is vested in its employees acting through elected management organs. Since the early 1950's there has been a trend towards decentralization of economic decision-making, and the autonomy of enterprises has been further strengthened to a considerable extent by the reform measures of recent years. As in other countries, enterprises

are subject to such general government regulations as price controls, minimum wages, safety standards, and foreign exchange control and they are responsive to a lesser or greater degree to general policies of the government. It is not possible to tell to what extent individual enterprises at the present stage of development of the Yugoslav economic system are influenced on broad policy matters by governmental authorities at various levels. In their daily operations and their investments, however, enterprises seem to be able to make their decisions on the basis of business considerations. The mission to Yugoslavia in February/March concluded that judging from the seven enterprises appraised the system of self-management does not constitute any inherent impediment to efficiency and appears to work satisfactorily in practice.

13. The capital required to establish a new industrial enterprise is as a rule provided in the form of credits. In the past most of the capital was provided by public authorities, including municipalities, but the banks are becoming a major source of capital for both new and existing enterprises. New legislation is expected to be introduced shortly which would permit enterprises to invest in other enterprises on a quasi-equity basis, sharing in both management and profits. Once operating, an enterprise builds up own funds through retaining earnings. By reducing taxes and other levies, the 1965 reform has significantly increased the funds left at the disposal of enterprises.

14. With the encouragement of the Government, Yugoslav enterprises are actively seeking to increase cooperation with private foreign firms. A law is expected to be enacted in the near future which would allow foreign firms to share in the management and profits of enterprises as an incentive to investing in Yugoslavia and providing technical know-how.

15. The proposed loan would assist in financing the foreign exchange requirements for the modernization of seven existing enterprises in various fields of Yugoslav industry: iron and steel, trucks and buses, bearings, synthetic fibers, paper and wood. The principal objective of the projects is to rationalize production, reduce costs and improve product quality. The projects were selected by the Yugoslav Investment Bank as being of high economic priority in various sectors of industry. Their total cost is estimated at \$37 million equivalent, including requirements for working capital. The direct foreign exchange component is estimated to be about \$14 million, of which \$10.5 million would come from the proposed Bank loan and most of the rest from a loan of £1 million (\$2.8 million) to one enterprise (OHIS) from U.K. sources. The local cost equivalent to \$23 million will be provided by the enterprises themselves and through loans from Yugoslav banks.

16. The proposed loan, which would be guaranteed by the Yugoslav Federal Government, would be made to the Yugoslav Investment Bank, an investment institution established in 1956. The Investment Bank has served as a

conduit for the six Bank loans to Yugoslavia since 1961, totalling \$210 million equivalent. A description of the organization of the Investment Bank and of its activities is given in Appendix 1 of the appraisal report. The loan proceeds would be relent by the Investment Bank to the Beneficiary Enterprises in amounts and upon terms and conditions approved by the Bank. It was agreed during negotiations that the repayment and grace periods of the subsidiary loans would be the same as those of the Bank loan to the Investment Bank. The amounts to be made available to the individual enterprises would be as follows:

<u>Enterprise</u>	<u>Product</u>	<u>Proposed IBRD Loan Amount (US\$ million)</u>
SLADKI	Paper and Board	2.00
TAM	Trucks and Buses	2.00
PRETIS	Bearings	1.87
OHIS	Acrylic Fibers	1.50
KIKINDA	Iron Castings	1.10
SISAK	Steel Tubes	0.92
LIGNOSPER	Plywood and Veneer	<u>0.36</u>
		9.75

In addition, an amount of \$0.25 million would be provided for interest during construction in the case of three enterprises. There would furthermore be a provision for contingencies of \$0.5 million. Any savings from funds allocated for a particular project would be allocated to contingencies and would be available, with the agreement of the Bank, for those projects in which there was an overrun in foreign exchange costs.

17. The projects have been investigated in the field and have been found well designed and ready for execution. The managements of the enterprises are capable and should be able to carry out the projects effectively. All enterprises have performed well in the past and their financial position is sound. Several of them have arrangements for cooperation with Western firms relating to technical matters, supply of components, and marketing.

18. Due to the nature of the modernization projects, the loan proceeds would be used to finance a relatively large number of mostly comparatively small items which represent to some extent specialized equipment. The goods would be grouped to make the contracts suitable for inviting bids on an international basis. For contracts over approximately \$100,000 equivalent, procurement would be on the basis of inviting bids from a list of qualified prospective suppliers from different countries, reviewed and approved by the Bank. Bidding documents and contract awards would be subject to the Bank's approval. Contracts amounting to \$100,000 or less would be awarded in accordance with the usual procedures of the

Beneficiary Enterprises which provide that whenever practicable, not less than three suppliers should be requested to submit quotations. It is estimated that more than half of the loan would be used to finance contracts above \$100,000.

PART IV - LEGAL INSTRUMENTS AND AUTHORITY

19. The draft Loan Agreement between the Bank and the Yugoslav Investment Bank, the draft Guarantee Agreement between the Socialist Federal Republic of Yugoslavia and the Bank and the Report of the Committee provided for in Article III, Section 4 (iii) of the Articles of Agreement are being distributed to the Executive Directors separately. These draft agreements contain provisions generally used for projects of this type. Attention is drawn to the following provisions of the draft Loan Agreement:

- (a) The Yugoslav Investment Bank would undertake to provide any additional funds that may be required for the projects (Section 6.01(b));
- (b) The Bank would have the right to cancel portions of the Loan corresponding to amounts of the subsidiary loans cancelled by the Yugoslav Investment Bank (Section 6.07); and
- (c) In case of prepayment of a subsidiary loan by any of the Beneficiary Enterprises, the Yugoslav Investment Bank would have to prepay a corresponding amount of the Loan (Section 6.08).

PART V - THE ECONOMY

20. An economic memorandum dated May 23, 1967 is attached (No. 2). It updates the economic report on "Current Economic Position and Prospects of Yugoslavia" (EA-162a) dated September 8, 1966 which was circulated to the Executive Directors on September 21, 1966. The memorandum reviews the developments of the Yugoslav economy after the introduction of the economic reform of July 1965 and the measures associated with it. It concludes that despite the difficulties encountered in carrying out the economic reform, the performance of the Yugoslav economy has been good, that prospects for continued growth are favorable and that Yugoslavia is creditworthy for further Bank lending.

PART VI - COMPLIANCE WITH THE ARTICLES OF AGREEMENT

21. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Bank.

PART VII - RECOMMENDATION

22. I recommend that the Executive Directors adopt the following resolution:

RESOLUTION NO. _____

Approval of Loan to Yugoslav Investment Bank in an amount equivalent to U.S. \$10,500,000 to be guaranteed by Socialist Federal Republic of Yugoslavia.

RESOLVED:

THAT the Bank shall grant a loan to Yugoslav Investment Bank to be guaranteed by Socialist Federal Republic of Yugoslavia, in an amount in various currencies equivalent to ten million five hundred thousand United States dollars (U.S. \$10,500,000), to mature on and prior to August 15, 1981, to bear interest at the rate of six per cent (6%) per annum, and to be upon such other terms and conditions as shall be substantially in accordance with the terms and conditions set forth in the form of Loan Agreement (Industrial Projects) between the Bank and Yugoslav Investment Bank, and the form of Guarantee Agreement (Industrial Projects) between Socialist Federal Republic of Yugoslavia and the Bank, which have been presented to this meeting.

George D. Woods
President

Attachments

Washington, D.C.
June 30, 1967