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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

REPORT AND RECOMMENDATIONS

OF THE

PRESIDENT

TO THE

EXECUTIVE DIRECTORS

ON A

PROPOSED LOAN

TO

IRAN

FOR A ROAD PROJECT

May 19, 1959

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

REPORT AND RECOMMENDATIONS OF THE PRESIDENT
TO THE EXECUTIVE DIRECTORS ON A
PROPOSED LOAN TO IRAN
FOR A ROAD PROJECT

1. I submit the following report and recommendations on a proposed loan to Iran in an amount in various currencies equivalent to \$72 million. The loan would be used to assist in financing the road program included in Iran's Second Seven-Year Development Plan.

PART I - HISTORICAL

2. The Government of Iran requested the Bank in the spring of 1957 to participate in financing the construction, reconstruction and improvement of some of Iran's principal roads, a project of the highest priority in the economic development of the country. The Bank exchanged technical views on the project with the Government in the summer of 1957 and the spring of 1958. In the summer of 1958, the Bank assisted the Government in preparing the project, including the working out of arrangements between the Plan Organization (P.O.) and the Ministry of Roads (the Ministry) for the execution of the project, and made a detailed appraisal of the project. Subsequently the Bank informed the Government that it would be prepared to consider a loan up to \$60 million (the then estimated foreign exchange cost) for the road project as soon as an understanding could be reached on the Government's financial and development policies. The Bank also agreed to help the Government in obtaining private bank participations to supplement the amount of the Bank's loan by covering part of the local currency costs. Four private American commercial banks agreed to participate in the early maturities (up to May 1964) in an aggregate amount of \$12 million, increasing the amount of the proposed loan to \$72 million. The estimated foreign exchange cost has increased to \$69.6 million and \$9.6 million of the commercial banks' participations would be applied towards it, leaving \$2.4 million to cover part of the local currency expenditures.

3. An understanding has been reached with the Government on its financial and development policies as set forth in the attached letter of March 16, 1959 from the Prime Minister (No.1) and negotiations were commenced in Washington on April 22, 1959. They were concluded on May 6, 1959. The Government of Iran was represented in the negotiations by Messrs. Khodadat Farmanfarmanian, Hossein Daftarian, Cyrus Samii, Cyrus Ghani, and Emile Hens of the P.O. and Mr. Mojtaba Soltani of the Roads Department of the Ministry.

4. This loan if made would be the Bank's second loan to Iran. The status of the previous loan is as follows:

Amount (fully disbursed; none repaid)	\$ 75,000,000
Portion sold	\$ 5,000,000
Net amount held by Bank	\$ 70,000,000

As indicated by the attached chart (No. 2), the proposed loan would increase the commitments in Iran to \$147 million inclusive of the commercial banks' participations, and to \$130 million exclusive of such participations. The maximum net investment, including participations, under both the previous and proposed loans would not exceed \$100 million at any time and would be reduced to \$66 million by the end of 1962 when the Bank's previous loan to Iran is scheduled to be repaid.

PART II - DESCRIPTION OF THE PROPOSED LOAN

5. The main characteristics of the proposed loan would be as follows:

Borrower:	Iran
Amount:	The equivalent in various currencies of \$72 million, including \$12 million of commercial bank participations
Amortization:	By 31 semi-annual repayments beginning May 1, 1961 and ending May 1, 1976
Interest rate:	6% per annum, including the 1% commission
Commitment charge:	3/4 of 1% per annum

6. The loan would be used to finance the foreign exchange cost of the project, currently estimated at \$69.6 million, and local currency costs amounting to \$2.4 million. Most of the loan (\$50.7 million) would be used to finance the foreign exchange cost of payments made by the Borrower to contractors for construction and reconstruction work. Because of the difficulty in maintaining and presenting accounts with respect to the foreign exchange component of such payments, and because of the desire to relate the Bank's disbursements to the progress of construction, it has been agreed that the Bank will reimburse the Borrower for 35% of the payments made to contractors from time to time over the entire construction period. This percentage represents the currently estimated foreign exchange component of such payments and may be varied if there is any substantial change in either the estimated total or foreign exchange costs of such payments.

7. On the basis of present estimates, \$2.4 million would be used to reimburse the Borrower for local currency expenditures made to contractors. This is the amount of the loan in excess of the currently estimated foreign exchange cost of the project and represents a portion of the commercial banks' participations.

8. The remainder of the loan will be used to reimburse the Borrower, or make advances on behalf of the Borrower, for foreign exchange purchases of specific imported goods required for the execution of other parts of the project.

9. Work on the project started over a year ago and it is proposed that the loan cover payments made from April 21, 1958, the date to which disbursements were made under the Bank's previous loan to Iran.

10. The Government intends to devote a substantial portion of its future, as well as current, oil revenues to economic development. Since, as in the earlier Bank loan to Iran, the proposed loan would be in the nature of a borrowing against future oil revenues for the purpose of maintaining the pace of development projects now under construction, the Government has agreed to make arrangements for the repayment of the proposed loan out of its future oil income.

11. It is reasonable to expect that the project would be completed by June 1962. However, as the final settlement of accounts of the road contracts is likely to take up to ten months after completion of construction, it has been agreed that the closing date of the proposed loan would be May 31, 1963.

12. The amortization schedule of the proposed loan provides for repayments of \$8.5 million before the Closing Date, representing maturities falling due under the commercial banks' participations. This maturity schedule was a condition to obtaining such participations. The average term of the commercial banks' participations is 3.5 years from the date of signature of the loan.

PART III - APPRAISAL OF THE PROPOSED LOAN

Description of the Project

13. The project is described in the attached "Appraisal of a Roads Project in Iran" (No. 3). The project includes (a) the construction and reconstruction of approximately 2,470 km. of the principal main roads in western and southern Iran, including the trans-Iranian highway from the Persian Gulf to the Caspian Sea; (b) the improvement of a 440 km. road link that would connect Shiraz with Iran's major Gulf ports, Khorramshahr and Bandar Shapur; and (c) the design and engineering of Iran's next main road program and a series of feeder roads in the important agricultural areas.

14. The Plan Organization is responsible for the construction and reconstruction of the main roads included in the project and for the engineering of Iran's next main road and feeder road programs. The Ministry is responsible for the improvement of the road link out of Shiraz and for adequately maintaining the roads included in the project.

Justification of the Project

15. Inadequate communication facilities have long been a major handicap to the economic development of Iran, an area as large as Germany, France, Italy and Spain combined. Iran's road system of about 25,000 km. carries the bulk of the country's freight and passenger traffic, and ranges from

caravan trails to a small number of paved all-weather roads. Few of Iran's roads have been built to standards adequate for motor vehicle traffic and most of Iran's roads are in an advanced state of disrepair, causing damage and delays in transporting cargo and increasing the cost of operating trucks which are the principal users of the roads. This has particularly affected the development of agriculture which today employs about 80% of Iran's population. The absence of adequate connections to the consuming centers has reduced the incentive for increasing production and, moreover, resulted in the waste of produce, increased prices to consumers and financial losses to cultivators. Bad roads also have been an obstacle to the execution of Government-sponsored development projects and to the growth of private industry. The roads in the project will provide adequate connections between the Gulf ports and the more heavily populated centers of the country and will traverse the areas that account for two-thirds of Iran's agricultural production. When completed and properly maintained, they will contribute substantially to Iran's economic development.

Method of Procurement

16. Contracts for the execution of the project have been and will continue to be let on the basis of international competition.

Economic Situation

17. The general trends reported in the "Economic Situation and Prospects of Iran" (R58-80), distributed to the Executive Directors on July 24, 1958, have continued during the past Iranian year ending March 20, 1959. Iran's oil income rose to \$247 million and was the principal element in sustaining the growing prosperity of Iran. The relatively high level of agricultural output was maintained, the pace of governmental development activity continued to accelerate and private investment in industry and residential building have also increased. The rising rate of investment, and the growing purchasing power of the population, have resulted in an increase in imports from \$375 million in 1957/58 to more than \$450 million in 1958/59. Iran's foreign exchange reserves fell during the year from \$276 to \$228 million, equivalent to about 6 months' imports at the current rate.

18. Inflationary pressures have continued despite the rise in imports which include a wide range of consumer goods. Money supply increased about 20% and the cost of living index by 10% during the past year. This was largely due to a substantial expansion in bank credits to the private sector, which was stimulated by the Government making credits to finance up to half the cost of expanding and creating private industry. Government funds for this purpose were obtained from the profits derived from the reevaluation of Iran's currency in May 1957 and have now been fully committed.

19. One of the principal developments in Iran's economic and financial position during the year was the 9% reduction in February 1959 in the Persian Gulf price of oil. The Government is discussing with the consortium of companies producing and marketing Iranian oil the possibility of offsetting the price reduction by increasing exports over and above the normal rate of

increase (8% per annum) expected from the expanding oil market. No understanding has as yet been reached and it is, therefore, possible that Iran's oil earnings this year may not be substantially greater than last year. Unless there is a further softening of prices, however, it is expected that Iran's oil income would again increase about 8% annually beginning in 1960/61.

20. Tax revenues during the past year were approximately 20% more than in the preceding year but were still below the Government's operating expenses which increased substantially in recent years. Operating expenses for the current year have been budgeted at last year's levels with the exception of small increases for health and education. The Government estimates that its tax revenues during the current year will be at least 10% more than in the past year. Nevertheless, the Government's ordinary budget forecasts a deficit of Rls. 1.5 billion (\$20 million) despite diversion of a substantial share of Iran's oil revenues to the financing of current operations. The Government hopes that oil revenues will be sufficiently large this year to allocate approximately \$100 million to the ordinary budget. However, with the intent of balancing future budgets without borrowing from Bank Melli and without further diversion of oil revenues from development, the Government has begun the preparation of a financial plan which will program all of Iran's financial operations, including development, and establish policy with respect thereto. The Government has also adopted procedures for a more effective control over the incurring and guaranteeing of new external indebtedness.

21. The Government has decided to allocate at least \$130 million of this year's oil revenues to the P.O. and to allocate at least 55% in the remaining years of the Plan (ending September 1962). The P.O. expects to receive \$530 million of oil revenues from now until the end of the Plan. It has recently reviewed its activities and considers that a minimum balanced program, consisting nearly entirely of projects already under construction, will cost about \$730 million during the same period. The Government is, therefore, seeking credits, including the proposed loan and possible further borrowings from DLF, to cover the \$200 million shortfall in the current P.O. minimum program.

22. The Bank intends to review Iran's economic and financial position and prospects in July-August 1959. At that time, the Bank will also consult with the Government concerning Iran's financial and development policies.

Prospects of Fulfillment of Obligations

23. The Borrower should be able to meet its obligations under the Loan Agreement. The project is sound and the cost estimates appear reasonable. The P.O. and the Ministry have worked out arrangements, satisfactory to the Bank, for the implementation of the project. Competent engineering consultants and other experts have been, and are being, retained to engineer and supervise the project. The local currency requirements will be met out of the P.O.'s own resources, and possible further borrowing from the Development Loan Fund.

24. The Ministry, with the help of the U.S. Bureau of Public Roads, is improving and strengthening its maintenance organization. It is also assigning members of its technical staff to the consultants with a view to building up an experienced road construction department. One of the principal causes of deterioration of Iran's roads is overloaded trucks and the Government has initiated a number of measures designed to control the weight of vehicles.

25. Annual service on Iran's existing external indebtedness of \$455 million and on the proposed loan would amount to 14% of current foreign exchange earnings in 1961/62 and 1962/63, to 7% through 1965/66 and to 3% thereafter. Iran's oil revenues are expected to increase at approximately 8% annually and the overall foreign exchange earnings are likely to grow at a rate of at least 5% per year. The proposed loan, therefore, should be within Iran's capacity to service.

PART IV - LEGAL INSTRUMENTS AND LEGAL AUTHORITY

26. Attached is a draft of the Loan Agreement between the Bank and Iran (No. 4) providing for the proposed loan. The draft Loan Agreement generally follows the form of the Bank's loan agreements for road projects except as indicated below. Also attached is the report of the Committee provided for in Article III Section 4 (iii) of the Articles of Agreement of the Bank (No. 5).

27. The standard withdrawal provisions in the Loan Regulations have been modified to provide for three types of disbursements:

- (a) Amounts calculated to represent the foreign exchange component of payments to contractors as explained in paragraph 6 supra (Section 2.03 (a) (i)).
- (b) Amounts for (i) reimbursement of foreign exchange expenditures made to purchase specific goods; and (ii) advances for such expenditures (Section 2.03 (a) (ii) and (iii)).
- (c) Amounts representing payments of \$2.4 million equivalent made to contractors in excess of amounts paid under (a) above, and which represent a part of the commercial banks' participations as explained in paragraph 7 supra (Section 2.03 (b)).

Amounts disbursed under (a) and (c) above will be in U.S. dollars or in freely convertible currencies as the Bank may reasonably determine in consultation with the Borrower (Section 2.03 (c)).

28. A debt consultation clause has been included (Section 5.07).

29. The Loan Agreement provides that arrangements will be made whereby oil revenues will be set aside during each debt service period in an amount sufficient to cover the service on the loan for that period - see paragraph 10 supra (Section 5.08 (a)). The revenues are paid in pounds sterling and

the arrangements would include provision that the Borrower would take all necessary action to assure that the sums thus set aside would be converted into such currencies other than pounds sterling as might be required for service of the loan. The Borrower would agree that it would not, without the consent of the Bank, alter these arrangements or take any other action which would interfere with their effective implementation (Section 5.08 (b)). In view of these provisions, the customary negative pledge clause has been omitted. The making of these arrangements is a condition for the effectiveness of the Loan Agreement (Section 7.01). These arrangements will be in addition to and without prejudice to the similar arrangements made under the Loan Agreement of January 22, 1957 with Iran (Section 5.08 (a)).

30. The Iranian Government has negative pledge obligations under agreements with the Export-Import Bank covering credits (including ICA credits) aggregating \$95 million. In connection with these credits, the Government of Iran has informed the Export-Import Bank that it is willing to make set-aside arrangements for the servicing of the Export-Import Bank credits similar to those to be made for the servicing of the proposed IBRD loan, and negotiations to this end are in progress.

31. Notwithstanding the set-aside arrangements, repayment of the loan and interest and other charges thereon will be a general obligation of Iran (Section 2.09).

32. Before the Loan Agreement becomes effective, authorization or ratification by the Iranian Parliament of the proposed transaction with the Bank will be required.

PART V - COMPLIANCE WITH ARTICLES OF AGREEMENT

33. I am satisfied that the proposed loan complies with the requirements of the Articles of Agreement of the Bank.

PART VI - RECOMMENDATIONS

34. I recommend that the Bank at this time make a loan to Iran in an amount in various currencies equivalent to \$72 million for a total term of 17 years with interest (including commission) at 6% per annum and on such terms and conditions as are specified in the form of the attached draft Loan Agreement and that the Executive Directors adopt a resolution to that effect in the form attached (No. 6).

Attachments
Washington, D.C.

J. Burke Knapp, Vice President
for
Eugene R. Black, President

May 19, 1959