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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

REPUBLIC OF CHINA

FOR A

THIRD RAILWAY PROJECT

May 14, 1969
1. I submit the following report and recommendation on a proposed loan in an amount in various currencies equivalent to $31.2 million to the Republic of China, for relending to the Taiwan Railway Administration (TRA) for a Third Railway Project.

PART I - HISTORICAL

2. In April 1965 the Bank lent $20 million to the Republic of China for the TRA to help finance its capital improvements during the years 1965-68. Traffic rose much faster than expected, leading to a revision of the investment program and a second $17.5 million loan in January 1968 for imported rolling stock, motive power and other equipment.

3. The TRA has recently drawn up a new Capital Investment Plan for the period 1969-72 amounting to $125 million equivalent with a foreign exchange component of $74 million equivalent. This proposed loan would finance the foreign exchange cost of high priority investments to be made in 1969-70.

4. The proposed loan would support the Government's efforts to improve and expand the country's infrastructure, especially in transportation, to the level required for further economic progress. Public investment in infrastructure has increased appreciably in recent years but has not kept pace with the rapid development of the directly productive sectors of the economy. Accordingly greater emphasis is now being placed on investment in transportation, electric power, water supply, telecommunications and education.

5. Negotiations for the loan were held in Washington from March 28 to April 4, 1969. Representing the Central and Provincial Governments were Mr. Martin Wong, Economic Minister and Mr. T.W. Hu, Economic Attache in the Embassy. The TRA was represented by Mr. S.H. Chen, General Manager; Mr. C.F. Chen, Chief of Operations; and Mr. Tuan, Chief Engineer.

6. The Bank has made eight loans to the Republic of China and the proposed loan would bring the total to $178 million net of cancellations. IDA has made four development credits, totalling $13.1 million net of cancellations, which are fully disbursed. The following is a summary statement of Bank loans and IDA credits as of March 31, 1969:
<table>
<thead>
<tr>
<th>No.</th>
<th>Year</th>
<th>Borrower</th>
<th>Purpose</th>
<th>Bank</th>
<th>IDA</th>
<th>Undisbursed</th>
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<tbody>
<tr>
<td>6</td>
<td>1961</td>
<td>China</td>
<td>Harbor dredging</td>
<td>2.2</td>
<td></td>
<td></td>
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<tr>
<td>7</td>
<td>1961</td>
<td>China</td>
<td>Ground water</td>
<td>2.0</td>
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<tr>
<td>9</td>
<td>1961</td>
<td>China</td>
<td>Water supply</td>
<td>4.0</td>
<td></td>
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<tr>
<td>17</td>
<td>1961</td>
<td>China</td>
<td>China Development Corporation</td>
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<td></td>
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<td>356</td>
<td>1963</td>
<td>China</td>
<td>Deep-sea fishing</td>
<td>7.6</td>
<td></td>
<td></td>
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<td>397</td>
<td>1964</td>
<td>CDC</td>
<td>Industrial Development</td>
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<td>0.3</td>
<td></td>
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<tr>
<td>409</td>
<td>1965</td>
<td>China</td>
<td>Railways</td>
<td>17.8</td>
<td>1.6</td>
<td></td>
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<tr>
<td>498</td>
<td>1967</td>
<td>China</td>
<td>Deep-sea fishing</td>
<td>6.9</td>
<td>5.6</td>
<td></td>
</tr>
<tr>
<td>506</td>
<td>1967</td>
<td>DGT</td>
<td>Communications</td>
<td>17.0</td>
<td>16.6</td>
<td></td>
</tr>
<tr>
<td>508</td>
<td>1967</td>
<td>CDC</td>
<td>Industrial Development</td>
<td>15.0</td>
<td>10.7</td>
<td></td>
</tr>
<tr>
<td>524</td>
<td>1968</td>
<td>China</td>
<td>Railways</td>
<td>17.5</td>
<td>16.9</td>
<td></td>
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<tr>
<td>574</td>
<td>1968</td>
<td>Taipower</td>
<td>Electric Power</td>
<td>50.0</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Total net of cancellations
of which has been repaid to the Bank and others

Total now outstanding

Amount sold
of which has been repaid

Total now held by Bank and IDA

Total undisbursed

1/ Not yet effective

7. All the projects financed by IDA and the First Deep-sea Fishing project have been satisfactorily completed. The implementation of the projects financed by previous Bank loans is progressing satisfactorily. Disbursements under the Second Deep-sea Fishing loan (498 CHA) are related to the construction of fishing vessels which is on schedule. Disbursements of the Telecommunications loan (506 CHA) are about a year behind schedule because a major contract had to be retendered.

8. An appraisal mission for a thermal power project is scheduled to visit Taiwan shortly and a loan is expected to be presented to the Executive Directors in January 1970.

9. China has recently joined IFC, but so far no IFC investments have been made in the country.
PART II - DESCRIPTION OF THE PROPOSED LOAN

10. Borrower: Republic of China

Beneficiary: Taiwan Railway Administration (TRA)

Amount: The equivalent in various currencies of $31.2 million

Purpose: To help finance the purchase of locomotives, rolling stock, track equipment, signalling equipment and miscellaneous items.

Amortization: In fifteen and one-half years including a three and one-half year grace period, through semi-annual installments beginning December 15, 1972 and ending December 15, 1984.

Interest Rate: 6½ percent per annum

Commitment Charge: 3/4 of 1 percent per annum

Relending Terms: The same as the terms of the Bank loan to the Republic of China

PART III - THE PROJECT

11. An appraisal report entitled "Appraisal of Third Railway Project, China" (PTR-10a) dated May 9, 1969 is attached.

12. Inland transport requirements are mostly concentrated within a corridor stretching the length of the western plain, and containing most of the country's large cities. The TRA's main railway line passes through this 400 km corridor, serving more than 80 percent of the population. Road transport of passengers and freight along the route is still largely confined to short distance and local traffic. Coastal shipping on the western coast of Taiwan is almost non-existent, and the narrow gauge railways operated by the sugar, mining and timber industries serve mostly as feeders for the TRA lines. The narrow valley on the east side of the island relies to an even greater extent on the narrow gauge East Railway Line. This railway is paralleled by an unpaved road which can be used throughout its length only in the dry season.

13. In compliance with the terms of earlier Bank loans a Committee for Coordination of Transport has been established, consisting of heads of transport agencies. Several short-term problems have been studied and the Committee is now concentrating on the preparation of long-term development programs. Current studies under way or to be started shortly cover the feasibility of railway electrification, proposals for
new port and airport facilities, the proposed north-south expressway connecting Keelung and Kaohsiung and urban transport problems. Regardless of the outcome of the above studies, the items to be financed by this loan would be required by the railways and are justified.

14. The loan would help finance the first two years of the TRA's Capital Investment Plan for 1969-72, making a total investment in the years 1969 and 1970 of $86 million, including foreign costs of $54 million. The proposed loan would cover the cost of imported locomotives, passenger and freight cars, track and signalling equipment, and minor miscellaneous items; and additionally would provide for the foreign exchange cost of consulting services.

15. Consultants to be financed out of the proceeds of the proposed loan would carry out a feasibility study of the electrification of TRA's main line and help in the establishment of a railway planning unit. The planning unit will assist TRA's management to plan investments, examine transport competition, review operational efficiency, traffic costs and tariff policy. In particular the consultants would help to introduce modern traffic costing techniques and would instruct TRA's staff in devising a rate and fare structure based on traffic costs. To ensure proper staffing of the planning unit to be established the proposed loan will also cover the foreign exchange costs of training abroad of suitable TRA staff. The allocation for the feasibility study, the assistance in planning, and for training amounts to $300,000.

16. The goods to be financed would be procured through international competitive bidding. Local suppliers will probably compete for some contracts, especially for freight cars and will be allowed a preference of 15 percent or the existing level of customs duties and taxes, whichever is lower. Disbursements from the loan against contracts won by local suppliers would be for the foreign cost component of the contract.

17. Arrangements for purchasing 18 locomotives to be included in the loan have already been made, as Executive Directors have been advised. This was done last March when at the Bank's suggestion TRA combined this purchase with the purchase of 26 locomotives under the previous Bank loan to TRA (524 CHA), both being on the basis of full international competition. In this way TRA was able to standardize on a single type and achieve substantial cost savings.

18. The railroad is generally well managed, its personnel are efficient, and the organization is qualified to carry out the project. The TRA is financially sound and earns a satisfactory rate of return. Under the loan the railroad would be required to earn a 6.5 percent rate of return for fiscal years 1969 and 1970, and not less than 7 percent thereafter. Cash requirements during the four-year period of the Capital Investment Plan are about $175 million. Internal cash generation of approximately $105 million leaves $70 million to be borrowed. The proposed and expected future Bank loans, together with modest short-term borrowing from local sources, would cover the gap.
Debt will constitute a reasonable portion of TRA's capitalization during the Plan period and earnings are expected to cover debt servicing requirements by a satisfactory margin.

19. The project will provide high priority items urgently needed by the railroad and will give economic rates of return varying from 9 to 35 percent on investments.

20. The proposed loan would be for a term of fifteen and one-half years, a period which is somewhat shorter than is customary for a project of this kind and which reflects China's favorable foreign exchange position and prospects. The Government will relend the proceeds of the proposed loan on the same financial terms and conditions to TRA, and cash flow projections indicate that the proposed repayment schedule will not be burdensome for the railway.

PART IV - LEGAL INSTRUMENTS AND AUTHORITY

21. The draft Loan Agreement between the Republic of China and the Bank, the draft Project Agreement between the Bank, the Province of Taiwan and the Taiwan Railway Administration, the Report of the Committee provided for in Article III, Section 4(iii) of the Articles of Agreement and the text of a draft Resolution approving the proposed loan are being distributed to the Executive Directors separately.

22. The draft loan documents are substantially in the form usually used for railway projects and follow closely the documents used for the previous two loans. In addition, provisions are made in the draft loan documents:

(i) amending rate covenants in the previous Loan and Project Agreements (Loan Nos. 409 CHA and 524 CHA) to conform with the new rate covenants (Sections 7.01(c) and 7.02(b) of the draft Loan Agreement and Sections 3.01(a) and 3.02(a) of the draft Project Agreement);

(ii) for cross defaults under the previous two Loan Agreements and the new Loan Agreement (Section 6.02(b), 7.01(a), (b) and 7.02(a));

(iii) restricting TRA's contribution to the Province during the period of January 1, 1970 to December 31, 1972 to $1.25 million in any year (Section 2.10 of the draft Project Agreement);

(iv) requiring TRA to consult the Bank on implementation of the electrification of its railway system (Section 2.11 of the draft Project Agreement); and

(v) for preference to the local suppliers (paragraph 5 of Schedule 4 of the draft Loan Agreement).
23. An economic report, "Current Economic Position and Prospects of the Republic of China" (AS-142a), dated September 11, 1968, in two volumes was circulated to the Executive Directors on September 17, 1968. The economic growth of the Republic of China accelerated further in 1968; GNP in real terms increased by 10.3 percent as compared with 9.9 percent in 1967 and 9.4 percent in 1966. As a result of this and a notable decline in population growth, per capita GNP in real terms increased by almost 8 percent to US$273 equivalent. Prospects for further rapid growth are favorable. Wholesale prices on the average rose by 2 percent in 1968 and consumer prices by more than 6 percent. Being alerted by this evidence of some inflationary pressure from a considerable credit expansion, the Central Bank tightened credit.

24. Manufacturing and construction continued to grow faster than other sectors; manufacturing production increased by 20 percent in 1968, with more output from new and technically advanced industries. Power supply has improved as a result of a substantial increase in hydropower made possible by abundant rainfalls during the year. However, a drought could adversely affect the supply of hydroelectricity. Accelerated economic growth and the trade boom have led to rapidly increasing demand for transportation services. In 1968, overland passenger and freight traffic each rose by more than 10 percent, total import and export shipments by almost 30 percent, and the volume of cargo loaded and unloaded at the harbors by 17 percent.

25. Merchandise exports accelerated from a 20 percent increase in 1967 to a 26 percent increase in 1968 while the growth in merchandise imports slowed down from 22 percent in 1967 to 13 percent in 1968. The deficit on goods and services amounting to $130 million in 1968 is relatively small compared with the total export earnings from goods and services of over $1 billion. Possible reduction of receipts from Vietnam in case of a peace settlement is estimated at only 2-3 percent of total exports of goods and services.

26. Being fully aware of the bottlenecks existing in infrastructure services the Chinese Government in its Fifth Four-Year Development Plan (1969-72) emphasized investment in transportation, power, the expansion of urban facilities, and the development of technical and scientific education to train more technical personnel and skilled labor which are in short supply. Intensification of industrialization, particularly in increasing investment in more capital-intensive and technologically sophisticated industries, along with export promotion, is also emphasized. To finance the necessary investments in economic and social infrastructure, Government savings should increase through tax reform measures. A Tax Reform Commission has been established under the Executive Yuan and new tax legislation is being drafted. The Tax Reform is to be designed to increase total Government revenue from 18.5 percent of GNP in 1968 to 21.6 percent in 1972. Government savings will rise from a negligible amount in 1968 to 2.6 percent of GNP in 1972. Total domestic savings as percentage of GNP is expected to be stepped up from 21 percent in 1968 to 25 percent in 1972.
27. Gross official foreign exchange reserves amounting to $330 million at the end of 1968 were equivalent to more than five months' imports. Annual debt service in 1968 was less than 6 percent of exports of goods and services. It is estimated that further foreign capital requirements after taking account of relatively less favorable terms on which it can probably be obtained will raise the debt service ratio to 10 percent by the mid 1970's. Given the past record of progress and the favorable prospects for the future, the Republic of China is credit-worthy for the proposed Bank loan.

PART VI - COMPLIANCE WITH ARTICLES OF AGREEMENT

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

PART VII - RECOMMENDATION

29. I recommend that the Executive Directors approve the proposed loan.

Attachment

Robert S. McNamara
President
by J. Burke Knapp

May 14, 1969