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Report No.: 20253

PERFORMANCE AUDIT REPORT

POLAND

ENTERPRISE AND FINANCIAL SECTOR ADJUSTMENT LOAN
(Loan 3599-POL)

March 27, 2000

Operations Evaluation Department

Currency Equivalent
(as of September 30, 1999)

Currency Unit = Zloty (Z)
US$1.00 = 4.1141 Zlotys
Z1 = US$0.2431

Average Exchange Rate
Zlotys per US$1.00

1993	1994	1995	1996	1997	1998
1.8145	2.2727	2.4244	2.6965	3.2808	3.4937

Abbreviations and Acronyms

BGZ	The State Agricultural Bank
EBRP	Enterprise and Bank Rehabilitation Program
ECA	Europe and Central Asia Region
EFSAL	Enterprise and Financial Sector Adjustment Loan
DDR	Debt and Debt Service Reduction
FIDL	Financial Institutions Development Loan
G24	The Group of 24 Developed Nations
IF	Intervention Fund
MOF	Ministry of Finance
PAR	Performance Audit Report
PKO BP	The State Savings Bank
SOCB	State-owned Commercial Banks
SOE	State-owned Enterprise
SMEs	Small and Medium-Scale Enterprises

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The World Bank
Washington, D.C. 20433
U.S.A.

Office of the Director-General
Operations Evaluation

March 27, 2000

MEMORANDUM TO THE EXECUTIVE DIRECTORS AND THE PRESIDENT

SUBJECT: Performance Audit Review on Poland Enterprise and Financial Sector Adjustment Loan (Loan 3599-POL)

Attached is the Performance Audit Report (PAR) on the Poland Enterprise and Financial Sector Adjustment Loan for US$450 million, approved in 1993. The project closed on June 30, 1996, one year later than scheduled. Following a period of significant improvement in Poland's economy and public finances, the Borrower no longer required additional financing from the EFSAL. Therefore, at the Government's request, the planned third tranche of US$125 million was cancelled.

Designed by the Government, the EFSAL addressed the systemic insolvency in the state-owned enterprises and the banks which had extended them credit. The EFSAL adopted an innovative approach for dealing with the structure of enterprise ownership and governance, which was adopted for use in three other transition economies.

Specific objectives were to: (i) improve enterprise responsiveness and adaptation to market signals by facilitating the exit of nonviable enterprises and reorganizing state enterprises; and (ii) enforce financial discipline on enterprise debtors through mandatory out-of-court conciliation agreements, faster bank privatization and strengthened bank supervision.

The EFSAL was highly successful, contributing significantly to the rapid recovery and transformation of the Polish economy. Nine state-owned commercial banks were privatized (though most after the EFSAL had closed), enterprise privatization goals were met, and the bank-led conciliation process for indebted enterprises proved effective. Bank workout capacity and supervisory oversight of their activities were substantially strengthened. As a result, Poland's financial sector now resembles that of a modern market economy.

While there were some shortcomings, such as the weak design and execution of the Intervention Fund, the PAR accords greater weight to the highly innovative nature of the EFSAL, and its overall contributions to Poland's economic progress. Therefore, *outcome* is rated highly satisfactory. *Sustainability* is considered likely, in view of generally positive trends in macroeconomic and financial sector management. *Institutional development impact* is rated substantial, taking into account the strengthening of bank workout capacity and government banking oversight. *Bank performance* is rated satisfactory, based on the participatory approach to design of the project and effectiveness in aid coordination. These ratings all agree with those of the earlier Evaluative Summary. *Borrower performance* is rated highly satisfactory (compared to satisfactory in the Evaluative Summary), based on the Government's innovative project design and the major improvements in financial sector regulation.

Key lessons include: (i) It pays to listen to the client, who in this case proposed a superior project design; (ii) The EFSAL was successful because it dealt simultaneously with the bad debt stock and the associated flow problems of enterprises; and (iii) Careful sequencing ensured that, before bank recapitalization occurred, the prerequisites for sustaining responsible bank behavior were put in place.

Contents

This report was prepared by Luis Landau, Elliot Hurwitz and John Johnson (Task Manager). Betty Casely-Hayford provided administrative support.

Preface

This is a Performance Audit Report (PAR) for the Polish Enterprise and Financial Sector Adjustment Loan (EFSAL), in the amount of US$450 million equivalent which was approved on May 4, 1993, and made effective on January 6, 1994. The loan was intended to provide an innovative vehicle for the resolution of the systemic insolvency of large, state-owned enterprises which owed large sums to state-owned banks. It was also designed to provide incentives for these banks to strengthen their portfolios, and help them build capacity in their workout units, prior to privatization. The EFSAL was one of two Bank loans in the financial sector—the other being the Financial Institutions Development Loan—which supported Poland's policy reforms under the Government's 1993 Enterprise and Bank Restructuring and Privatization Program.

The loan's first tranche of US$125 million was disbursed on June 6, 1994, followed by a DDSR set-aside of US$100 million, disbursed on November 14, 1994,[1] and a second tranche of US$100 million released on March 20, 1996. A planned third tranche was not utilized,[2] and the balance of US$125 million was cancelled. The project closed on June 30, 1996, one year later than anticipated.

This PAR is based on the Implementation Completion Report dated June 16, 1997, as well as interviews with project staff, project records, and material collected in conjunction with the Poland Country Assistance Review (June 1, 1997). In addition, an OED mission visited Poland in April 1998, and discussed the project with Government officials and representatives of civil society and other donors.

The draft PAR was reviewed by the Government of Poland, whose comments of March 25, 2000 (attached as Annex D) are fully reflected in the final text.

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[1] The Bank committed US$400 million from tranches of various operations to support a successful London Club arrangement reached in March 1994 to restructure Poland's large debt to foreign private banks.

[2] The third tranche was cancelled because, with the overall improvement in the economy and Poland's public finances, the country did not require the additional financing from the EFSAL.

Ratings and Responsibilities

Performance Ratings

	Evaluation Summary	PAR
Outcome	Highly Satisfactory	Highly Satisfactory
Sustainability	Likely	Likely
Institutional Development Impact	Substantial	Substantial
Bank Performance	Satisfactory	Satisfactory
Borrower Performance	Satisfactory	Highly Satisfactory

Key Project Responsibilities

	TM	Division Chief	Director
Appraisal	Olivier Godron	Michel Noel	Kemal Dervis
Completion	Hormoz Aghdaey	Michel Noel	Jean-Michel Severino
ICR prepared by	Michael Borish		

1. BACKGROUND

1.1 By 1993-94, despite structural flaws, Poland's economy had begun to emerge from the macroeconomic instability that followed the end of its planned economy and the collapse of the CMEA trade regime (Annex C). Earlier Bank lending and technical advice had helped with initial steps in the transition and stabilization.[1] In addition, other donors provided assistance: the European Union/PHARE; the European Bank for Reconstruction and Development; United States Agency for International Development, which provided a US$1 billion stabilization fund; and the International Monetary Fund, which established a US$1.6 billion Extended Fund Facility. However, Poland still lacked many preconditions for private sector expansion, including a legal and institutional framework that could facilitate the exit of loss-making firms.

1.2 *Enterprise Sector*—By early 1994, the private sector was expanding rapidly after the stabilization of prices and external trade. However, most private sector growth was driven by the creation of new enterprises—not by the privatization and restructuring of large state-owned enterprises (SOEs). Privatized and restructured state enterprises—burdened by old operational procedures, lack of marketing experience, heavy debt, and outdated technology—lacked the dynamism to compete in new markets, and many faced a deepening crisis. Large loss-makers employed around 500,000-700,000 workers, often geographically concentrated ("company towns"). At the time of EFSAL effectiveness in January 1994, progress in reforming SOEs was disappointing. The pace of ownership and governance reforms was slow, and restructuring often proceeded in a haphazard manner. The Government anticipated enterprise requests for "rescue," and wisely preferred that these be addressed in a transparent manner.

1.3 *Banking Sector*—The portfolio of the state-owned banks consisted largely of loans to SOEs, and as their situation worsened, so did the banks' balance sheets. The magnitude of the crisis and its systemic nature would have taxed the normal "exit mechanisms" of even countries with a fully-developed market economy. However, such mechanisms in Poland were very limited. It was also clear to the Government that the potential risks of inaction, or misguided action, were large: higher unemployment, severe pressure for Government spending and subsidies, a threat to macroeconomic stability, and the fate of the entire reform process.

2. EFSAL OBJECTIVES AND DESIGN

2.1 Against this backdrop, it was clear to the Polish Government that decisive action was required to create a program that would:

- Provide a clear and limited vehicle to ensure that the resolution of socially sensitive cases would be adequately funded in a transparent, but limited, manner
- Provide a vehicle to resolve the systemic insolvency of the SOEs and the banking system, which would minimize economic costs and by-pass the banking system

[1] A Structural Adjustment Loan of US$300 million, approved in 1990, had bolstered the credibility of the country's reforms. Bank investment lending and technical advice were also helpful in building institutions for a market economy.

- Provide incentives for banks to strengthen their portfolios, improve their management and prepare for privatization.

2.2 The blueprint for this program was adopted by the Polish Government in 1993 in conjunction with the Enterprise and Bank Rehabilitation Program (EBRP), after consultation with the Bank and other partners.[2] Following the development of EBRP, the Bank and the Government developed a financial sector strategy intended to stimulate sustained private sector growth and speed Poland's economic transformation. This was to be achieved by removing major policy constraints, and by strengthening the institutions required for financial intermediation in a market-based system.

2.3 The Financial Institutions Development Loan (FIDL) introduced in 1992 and the Enterprise and Financial Sector Adjustment Loan (EFSAL), approved in January 1994. As summarized in Table 1, these projects focused on:

- Financial system modernization (FIDL and EFSAL)
- Institutional strengthening and privatization of banks (FIDL and EFSAL)
- Enterprise restructuring and privatization (EFSAL)

Table 1: Main Provisions of FIDL and EFSAL

	FIDL *January 1992-December 1998*	***EFSAL*** *January 1994-June 1996*
Objectives and Components	Institutional development of banks, including twinning with foreign partners	Strengthen bank workout capability
	Establishment of a deposit insurance scheme	Recapitalization of 7 state-owned commercial banks
	Privatization of 6 of 9 state-owned commercial banks	Privatization of 2 of 9 state-owned commercial banks, and significant progress toward privatizing remaining 7
	Elimination of subsidized lending and directed credit	Stimulate GOP action to meet enterprise privatization targets
	Adoption of revised Banking and Collateral Laws	Bank-managed restructuring of enterprises
	Adoption of revised prudential requirements	Creation of Intervention Fund
		Strengthened bank supervision

2.4 Specifically, the EFSAL was the Bank's principal financial vehicle supporting the policy reforms introduced by the EBRP. Designed by the Government, the EFSAL addressed a root cause of the SOE crisis: the ineffective structure of enterprise ownership and governance.

2.5 During this period, the Bank, the International Monetary Fund, and other major donors organized a debt and debt-service reduction package covering Poland's massive debt to private foreign banks, which had been in default. A successful London Club arrangement was reached in March 1994, which the Bank

[2] The Bank's proposal had been to create a "hospital" for bad loans, a separate agency empowered to absorb the bad loans, which, however, had the drawback of not building workout capacity in the banks .

supported with US$400 million (US$170 million from the Debt and Debt Service Reduction loan and US$230 million from funds set aside from three previously approved adjustment loans—of which US$100 million came from the EFSAL). The deal provided Poland with substantial debt relief and helped restore its creditworthiness and immediate access to international financial markets.

2.6 The EFSAL fostered a microeconomic response to the new environment created by the price and trade liberalization policies of the early 1990s. It was made possible by passage in February 1993 of legislation—the Law on Financial Restructuring of Enterprises and Banks—to facilitate enterprise restructuring. This innovative law encouraged banks to play a leading role in enterprise restructuring through out-of-court conciliation agreements. The project's primary objectives were to: (i) improve the enterprise sector's responsiveness and adaptation to market signals, facilitating the exit of nonviable enterprises; and (ii) raise the level and quality of financial intermediation through improved credit allocation and enhanced bank capacity to impart and enforce financial discipline on enterprise debtors.

Enterprise Reform

2.7 The enterprise reform objective, in turn, was advanced by three main components:

(i) reducing the debt overhang of the SOEs, while cleaning up the portfolios of the State-owned commercial banks (SOCBs).[3]

(ii) accelerating privatization of sound and potentially viable enterprises; and

(iii) financing the creation of an Intervention Fund (IF) to act as a "shock absorber" for actions affecting key enterprises, mitigating the consequences of reorganization and downsizing.

Strengthening Financial Intermediation

2.8 The EBRP legal framework linked bank recapitalization to improvements in operating systems. It revamped the enabling environment for commercial banks, through privatizing, strengthening prudential regulations, and enhancing supervision of their activities. The Bank also collaborated with the U.S. Treasury in setting up a Bank Privatization Fund, an offshoot of the G24 Stabilization Fund supporting the *zloty* against speculation. Once the *zloty* had been stabilized, about US$500 million from the Stabilization Fund was redirected into bank recapitalization under EFSAL.

2.9 Banks privatized or in the process of privatization[4] were eligible for recapitalization after they had:

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[3] It should be noted that the EFSAL dealt exclusively with the state-owned commercial banks, representing less than 25 percent of total banking sector assets. The Government took the position that the two other largest banks—BGZ, the agricultural bank, and PKO BP, the savings and mortgage bank—should not be dealt with separately, because their problems were qualitatively different from those of the SOCBs.

[4] The EFSAL called for privatization of at least two of the nine state-owned commercial banks (SOCBs) by second tranche disbursement, and "significant progress toward privatization of the remaining banks" by third disbursement of the tranche.

- commissioned independent financial audits and portfolio reviews;
- assigned their troubled assets to a separate organizational unit; and,
- submitted to the MOF a strategic plan to deal with the troubled assets.

2.10 Finally, banks assumed leadership in restructuring enterprises through mandatory out-of-court conciliation agreements, mainly with larger enterprises, since SMEs were less likely to have large-scale bank obligations.[5]

3. IMPLEMENTATION

Achievements

3.1 The preparation, design, and implementation of the EFSAL were innovative and highly successful, contributing to the rapid recovery and transformation of the Polish economy. The EFSAL dealt simultaneously with the SOE debt overhang and the portfolio problems of the banking system, whereas in earlier Bank financial sector loans, reform of the enterprise sector commenced only after bank recapitalization. In doing so, the EFSAL markedly reduced the expected frequency of financial crises.

3.2 Among the transition economies, Poland was a pioneer in linking recapitalization in this way to improvements in bank operating systems. The decentralized approach for working out bad loans was also pathbreaking, and was adapted for use in three other transition countries. Banks played a central role in enterprise restructuring, while enterprises gained new opportunities for successful reorganization. The conciliation process had mainly positive outcomes, building capacity in bank workout units, forcing otherwise passive creditors to take action against bad debtors, weeding out unviable firms.[6] On average, conciliation took six to seven months, with agreement on restructuring plans adding another four months. Stronger firms qualified, while weaker ones were forced into bankruptcy or liquidation.[7]

3.3 The structure of Poland's banking sector now resembles that of a modern market economy. An independent central bank is responsible for monetary policy, and a professional bank supervision department has been developed. By disbursement of the EFSAL second tranche, two commercial banks had been privatized (the other seven were privatized later), capital adequacy ratios of participating banks exceeded international standards, problem loans were fully provisioned, workouts had been actively pursued, and most banks enjoyed progressive and market-oriented management. Foreign banks have since entered the market, in many cases by acquiring Polish banks, fostering competition and modernization. Interest rate spreads are now significantly smaller, the scope and quality of financial services have markedly improved, and lending to enterprises has increased substantially, nearly doubling from 1994 to July 1999.[8] The EFSAL also helped banks improve key business skills.

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[5] Enterprises included in the EFSAL were mainly large industrial firms in sectors other than mining, steel, shipbuilding, defense, and energy.

[6] See Cheryl Gray and Arnold Holle, "Bank-Led Restructuring in Poland," World Bank, Sept. 1996, and Simon Commander, "Enterprise Restructuring and Unemployment in Models of Transition," World Bank, April 1998.

[7] See also Fernando Montes-Negret and Luca Papi, "The Polish Experience with bank and Enterprise Restructuring," World Bank, January 1997.

[8] Calculated in US dollars. Data from Resident Mission, Warsaw.

3.4 As of late 1999, the financial sector was sound, with the possible exceptions of BGZ, the state agricultural bank, and PKO BP, the state saving bank. Approximately 65 percent of the equity (and a somewhat smaller proportion of the assets) in the financial sector is in private hands. Meanwhile, newly-created pension funds, a consequence of pension system reform, serve more than 8 million people and have helped deepen capital markets.

3.5 The EFSAL required at least 3,200 privatizations to be completed before third tranche disbursement. Although, this tranche never actually disbursed, this target was fully met by September 1996, with 2,714 direct privatizations, 512 companies placed into the Mass Privatization Program, and 180 "capital transactions," for a total of 3,406 enterprises privatized in accordance with the Privatization Law.

Macroeconomic and Poverty Impact

3.6 The EFSAL contributed significantly to Poland's economic recovery. As shown in Annexes A and C, Poland's macroeconomic performance during and after implementation of the EFSAL improved significantly. From 1993 to 1998, real GDP expanded by nearly 34 percent, or 6.1 percent per year. Unemployment, after peaking in 1993 at 16.4 percent, declined to 9.5 percent in June 1998. By the end of 1998, the fiscal deficit was under 3 percent of GDP.[9] Poverty data are not available for Poland, but there is evidence that income inequality increased less than in any transition country except Slovakia.[10] Poland also compares favorably with other ECA and upper-middle income countries in life expectancy, infant mortality, and literacy.

Shortcomings

3.7 Shortcomings were noted in the operation of the Intervention Fund, the pace of bank privatization, and the design of conditionality among bank operations.

The Intervention Fund (IF)

3.8 The Intervention Fund [11] was intended as a "shock absorber", an instrument for reducing the impact of restructuring or liquidating enterprises, whenever this would have been "exceptionally difficult from an economic or social standpoint". The IF was meant to be a "limited measure... with strong negative incentives for enterprises and banks to apply for public money" (see Box 1). However, not all IF operations have remained within the short-term, time-bound framework originally intended, in part because the legal provisions included no "sunset" clause. Had the IF included a condition that enterprises receiving budgetary support were required to be *privatized (*as opposed to commercialized), and had a sunset provision been included, this component would not have clashed with the intent of the overall reform program. A second issue concerns the use to which IF resources were put. Although the loan agreement called for an audit of the IF as a condition for the third tranche release, the Borrower cancelled the EFSAL before disbursement. Consequently, no audit was performed. Nor did the Bank avail itself of

[9] Data through 1998 from OECD, and estimates for 1999 from Resident Mission, Warsaw.

[10] The Gini coefficient increased by only 2 in Poland over this period compared with an increase of 3 in Slovenia, 11 in Estonia, and 23 in Russia. Grzegorz W. Kolodko, "Incomes Policy, Equity Issues, and Poverty Reduction in Transition Economies," *Finance and Development*, September 1999. A second study found that the Gini ratio in Poland (1993-95) was 28, compared to an average of 33 for all transition countries (other Central Europe, 24; Bulgaria and Romania, 32; Baltics, 34; "Slavic Republics and Moldova," 40; Central Asia, 39). Branko Milanovic, "Income, Inequality, and Poverty During the Transition from Planned to Market Economy," World Bank, February 1998.

[11] US$ 125 million from the first tranche of the EFSAL was used to support the IF. Not including the DDSR set aside, spending on the IF comprised 56% of total EFSAL disbursements.

the option of performing an audit or review as part of its general authority. The IF remains in operation as of October 1999.

3.9 Supervision of the Intervention Fund was also inadequate. The original intent—in conjunction with the third tranche—to perform an external audit as part of a comprehensive review of the IF, was never fulfilled. After the third tranche was cancelled, Bank staff declined the option of conducting an audit under its general audit authority. Moreover, the Bank should have acted sooner and more forcefully when signs arose that the Intervention Fund was operating in ways not fully compatible with the privatization and restructuring goals of the EFSAL.

Box 1: Criteria for Intervention Fund Eligibility

- Budgetary support to a given enterprise was to be provided only once.
- Restructuring or liquidation plans were to provide for divestiture of all non-productive assets, with wage and/or layoff provisions vetted by unions.
- The eligible borrowing enterprise had have been commercialized.
- SOE ownership rights to land and buildings had to have been clarified.
- Evidence had to be provided that state budgetary resources had not been used to pay off other creditor claims.

Delays in Bank Privatization

3.10 Bank privatization proceeded more slowly than expected. It was connected with the complicated process of the transformation of the Polish economy, which included problems with bad loans. A lack of precision in the EFSAL legal documents deprived the Bank of a clear mandate to monitor the pace of privatization[12]. Also, finding strategic investors proved difficult. By the EFSAL's second tranche, two of nine state-owned banks had been privatized, as agreed. The remaining state-owned banks were privatized in 1999. The privatization of the banks accelerated the development of the capital market and influenced changes in other sectors of the Polish economy.

Terms Among Related Bank Lending Operations

3.11 The EFSAL was prepared and approved during 1992-93, when Poland's ability to finance its then large current account deficit was in doubt. Later Poland was able to generate strong capital account surpluses, thanks to a surge in net export earnings and inflows of foreign direct investment (see Annex C). The Government also viewed the loan as a strong external vote of confidence for its reform program.

3.12 Nonetheless, given the numerous sources of finance available at the time, Poland's need for a loan of this size (US$450 million), which came soon after receiving US$200 million from the FIDL, remains an open issue. Also, as shown in Table 2, there was substantial overlap in the conditionality of the two loans. Indeed, only one year after EFSAL approval, the Polish authorities were registering concern about the size of the Bank's commitment fees, expressing a preference for smaller, simpler Bank projects in the future focussed on social sector initiatives for which private funding was unlikely to be available.

[12] See Poland *Country Assistance Review*, v. II, p. 24.

Table 2: Overlapping Conditionality in Lending to Poland

Conditionality	***EFSAL $US450m***	***FIDP $US200m***
Macroeconomic Stabilization	✓	✓
Enterprise Reform/Restructuring/ Privatization	✓	
Government Funding of Enterprises	✓	
Bank Reform/Recapitalization/Privatization	✓	✓
Strengthen Bank Supervision	✓	✓
Improve legal/regulatory framework for banking	✓	✓
Bank Development and Strengthening	✓	✓
Deposit Insurance Reform		✓
Banking Sector Policy Reform		✓

4. OUTCOME AND SUSTAINABILITY

Outcome

4.1 Outcome is judged to be *highly satisfactory*. Despite its shortcomings, the EFSAL convincingly achieved its main objectives, laying the foundation for a robust financial sector.

Sustainability

4.2 Sustainability is judged as *likely*. The privatization of commercial banks is unlikely to be reversed; the banking and enterprise sectors have improved management and governance; and Poland is experiencing rising levels of financial intermediation. Poland's progress toward entering the European Union offers further evidence that the reforms achieved by the EFSAL are likely to be sustained.

5. BANK AND BORROWER PERFORMANCE

Bank Performance

5.1 On balance, Bank performance was *satisfactory*. While the specification of the terms of conditionality could have been clearer, and the efficacy of supervision improved, the project was developed in a participatory manner; the Bank contributed materially to strengthen the project design; and the Bank was effective in coordinating activity with other donors. The Resident Mission played a key role in the launch of the reform program. Throughout, the Bank's work was made more difficult by several factors. The Polish experiment was new, and Bank staff had to respond quickly to unprecedented challenges in a continually changing environment. Abrupt changes in the Governmental line-up and policies disrupted the policy dialogue and, at times, program implementation.

Borrower Performance

5.2 Borrower performance was *highly satisfactory* in project design and in most aspects of implementation, particularly in the passage of necessary legislation, the establishment of effective policy and regulatory bodies, and the maintenance of a supportive macroeconomic framework. Enterprise privatization, although hesitant at certain points, was in line with EFSAL targets. And privatization of the nine SOCBs was achieved, albeit not within the expected time frame. Only with respect to administration of the Intervention Fund could it be said that Borrower performance fell short of satisfactory.

Institutional Development

5.3 The project's institutional development impact was *substantial*. The bank supervision capacity of Poland's Central Bank was strengthened, as were the workout capabilities of the commercial banks. Poland's banking sector now resembles that of a modern economy, with bank management generally regarded as progressive and market-oriented.

6. LESSONS LEARNED

6.1 **It pays to listen to the client.** The design of the EFSAL was conducted in a participatory fashion. The Bank's initial concept for the project was entirely different from the eventual design. The core concept—linking bank recapitalization to enterprise restructuring/liquidation—was proposed by a small group of innovative Polish Government officials. Bank staff listened carefully, and ultimately agreed to these changes.

6.2 **The EFSAL was comprehensive in addressing the insolvency problems of SOCB loans,** dealing with the bad debt stock problem and the associated flow problem. It made assistance to the commercial banks contingent on the completion of concrete actions with respect to enterprises, including privatization or liquidation. Polish banks were not only recapitalized, but were helped in improving their credit assessment and risk control systems. The lesson is that improving banking skills and incentives helps ensure the success of bank recapitalization.

6.3 **A key to EFSAL success was careful sequencing.** Success required that bank recapitalization be started after other prerequisites for sustaining responsible bank behavior were in place, including an effective bank supervision function; measures to sanction abusive practices by banks; the ground-work for bank privatization and strong Borrower commitment to macroeconomic stabilization management.

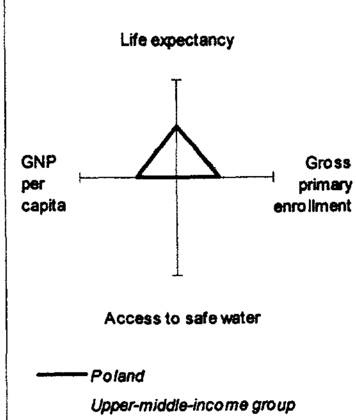
6.4 **Conditionality needs to be spelled out precisely in the legal convenants.** The EFSAL's intended conditionality was weakened by the lack of precision in the legal documents. The Loan covenants failed to spell out adequately the Bank's mandate to monitor the agreed pace of privatization and to supervise adequately the operations of the Intervention Fund. Lack of timely involvement by Bank lawyers in the project design played a role.

Poland at a glance

9/22/99

POVERTY and SOCIAL	Poland	Europe & Central Asia	Upper-middle-income
1998			
Population, mid-year (millions)	38.7	473	588
GNP per capita (Atlas method, US$)	3,900	2,190	4,860
GNP (Atlas method, US$ billions)	150.9	1,039	2,862
Average annual growth, 1992-98			
Population (%)	0.1	0.1	1.4
Labor force (%)	0.8	0.6	2.0
Most recent estimate (latest year available, 1992-98)			
Poverty (% of population below national poverty line)	24	..	..
Urban population (% of total population)	65	68	77
Life expectancy at birth (years)	73	69	70
Infant mortality (per 1,000 live births)	10	23	27
Child malnutrition (% of children under 5)	..	..	..
Access to safe water (% of population)	..	..	79
Illiteracy (% of population age 15+)	0	4	11
Gross primary enrollment (% of school-age population)	96	100	108
Male	97	101	..
Female	96	99	..

Development diamond*

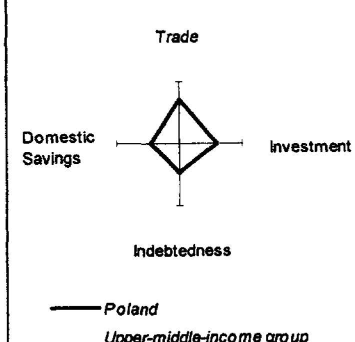


KEY ECONOMIC RATIOS and LONG-TERM TRENDS

	1977	1987	1997	1998
GDP (US$ billions)	..	..	147.9	157.5
Gross domestic investment/GDP	..	..	24.7	27.0
Exports of goods and services/GDP	..	..	25.7	20.7
Gross domestic savings/GDP	..	..	20.4	18.7
Gross national savings/GDP	..	..	20.4	22.6
Current account balance/GDP	..	..	-2.9	-4.4
Interest payments/GDP	..	..	0.9	1.1
Total debt/GDP	..	..	27.0	30.5
Total debt service/exports	..	..	7.9	..
Present value of debt/GDP	..	..	24.2	..
Present value of debt/exports	..	..	110.7	..

	1977-87	1988-98	1997	1998	1999-03
(average annual growth)					
GDP	..	3.6	6.8	4.8	5.2
GNP per capita	..	3.5	6.7	5.3	5.0
Exports of goods and services	..	13.5	12.2	9.2	8.4

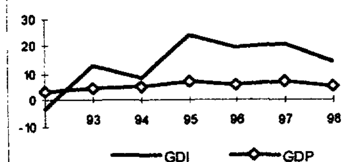
Economic ratios*



STRUCTURE of the ECONOMY

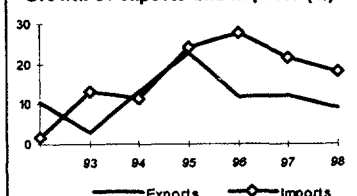
	1977	1987	1997	1998
(% of GDP)				
Agriculture	..	..	5.6	..
Industry	..	..	37.5	..
Manufacturing	..	..	22.5	..
Services	..	..	56.9	..
Private consumption	..	..	63.5	..
General government consumption	..	..	16.1	..
Imports of goods and services	..	..	30.0	..

Growth of investment and GDP (%)



	1977-87	1988-98	1997	1998
(average annual growth)				
Agriculture	..	-1.0	0.6	..
Industry	..	4.4	10.8	..
Manufacturing	..	..	..	..
Services	..	..	..	..
Private consumption	..	4.2	6.9	4.2
General government consumption	..	2.6	3.5	..
Gross domestic investment	..	8.9	20.8	14.1
Imports of goods and services	..	18.8	21.4	17.9
Gross national product	..	3.7	6.8	5.4

Growth of exports and imports (%)



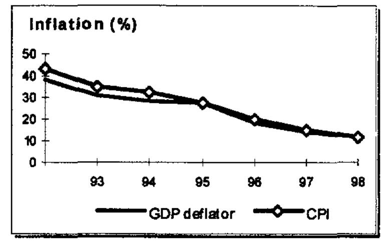
Note: 1998 data are preliminary estimates.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

Poland

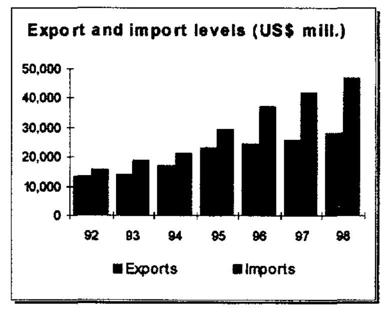
PRICES and GOVERNMENT FINANCE

	1977	1987	1997	1998
Domestic prices				
(% change)				
Consumer prices	..	..	14.9	11.8
Implicit GDP deflator	..	..	14.0	12.0
Government finance				
(% of GDP, includes current grants)				
Current revenue	..	..	24.1	23.0
Current budget balance	..	..	-1.0	-0.7
Overall surplus/deficit	..	..	-2.7	-2.4



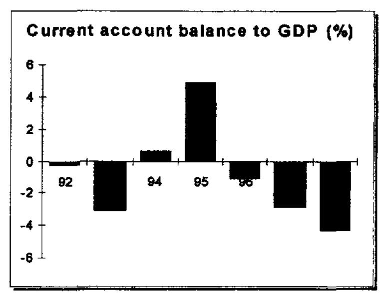
TRADE

	1977	1987	1997	1998
(US$ millions)				
Total exports (fob)	..	..	25,751	28,229
n.a.	..	..	..	..
n.a.	..	..	..	..
Manufactures	..	..	20,040	22,905
Total imports (cif)	..	..	42,308	47,054
Food	..	..	2,894	2,968
Fuel and energy	..	..	3,710	2,964
Capital goods	..	..	6,485	7,356
Export price index (1995=100)	..	..	122	130
Import price index (1995=100)	..	..	126	129
Terms of trade (1995=100)	..	..	97	101



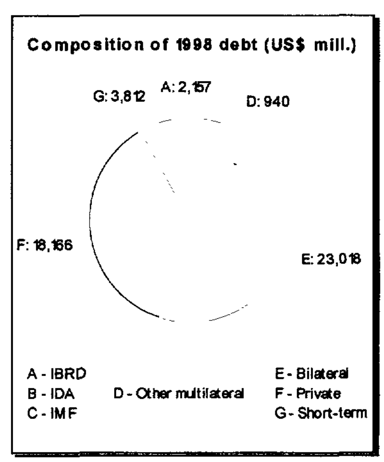
BALANCE of PAYMENTS

	1977	1987	1997	1998
(US$ millions)				
Exports of goods and services	..	..	30,953	33,799
Imports of goods and services	..	..	41,968	48,028
Resource balance	..	..	-11,015	-14,229
Net income	..	..	-458	-567
Net current transfers	..	..	1,150	1,942
Current account balance*	..	..	-4,312	-6,858
Financing items (net)	..	..	7,902	12,566
Changes in net reserves	..	..	-3,590	-5,708
Memo:				
Reserves including gold (US$ millions)	..	..	20,670	27,382
Conversion rate (DEC, local/US$)	..	..	3.2	3.5



EXTERNAL DEBT and RESOURCE FLOWS

	1977	1987	1997	1998
(US$ millions)				
Total debt outstanding and disbursed	..	42,603	39,889	48,093
IBRD	..	0	2,078	2,157
IDA	..	0	0	0
Total debt service	..	2,060	2,562	..
IBRD	..	0	297	321
IDA	..	0	0	0
Composition of net resource flows				
Official grants	..	0	431	..
Official creditors	..	-232	-140	..
Private creditors	..	-246	934	..
Foreign direct investment	..	12	4,908	..
Portfolio equity	..	0	945	..
World Bank program				
Commitments	..	0	0	20
Disbursements	..	0	239	153
Principal repayments	..	0	155	174
Net flows	..	0	84	-21
Interest payments	..	0	142	147
Net transfers	..	0	-58	-168



Development Economics 9/22/99

* Includes unclassified transactions of $6.011 billion in 1997 and $5.996 billion in 1998.

Basic Data Sheet

Poland - Enterprise and Financial Sector Adjustment Loan (Loan 3599-POL)

Key Project Data *(amounts in US$ million)*

	Appraisal estimate	*Actual or current estimate*	*Actual as % of appraisal estimate*
Total project costs	450	325	78.2
Loan amount	450		

Cumulative Estimated and Actual Disbursements *(US$ millions)*

	FY93	*FY94*	*FY95*	*FY96*
Appraisal estimate	0	325.00	450.00	450.00
Actual	0	75.66	224.96	324.39
Actual as % of estimate	-	23.30	50.00	72.10
Date of final disbursement				March 20, 1996

Project Dates

	Original	*Actual*
Identification (Concept Review)		January 20, 1991
Preparation		June 26, 1992
Decision Meeting		September 23, 1992
Appraisal		October 28, 1992
Negotiations		January 19, 1993
Letter of Development Policy		April 8, 1993
Board Presentation		May 4, 1993
Signing		October 11, 1993
Effectiveness	June 1993	January 4, 1994
First Tranche Release	June 30, 1993	June 6, 1994
DDSR Set-Aside	1994	November, 1994
Second Tranche Release	December 31, 1993	
Third Tranche Release	June 30, 1994	NA
Loan Closing	June 30, 1995	June 30, 1996

Annex B
Page 2 of 2

Staff Inputs *(Staff Weeks)*

Stage of Project Cycle	*Planned*		*Revised*		*Actual*	
	Weeks	*US$*	*Weeks*	*US$*	*Weeks*	*US$*
Preparation to appraisal					88.8	253,700
Appraisal					22.5	65,100
Negotiations through Board Approval					48.9	155,200
Supervision					223.9	697,200
Completion	9.0	46.5				
Total	267.6	826.6				

Mission Data

Stage of Project Cycle	*Month/Year*	*No. of Persons*	*Days in Field*	*Specialization*[1]	*Performance Rating*[2]		*Type of Problems*[3]
					Implementation Status	Development. objectives	
Identification	3/91	6	96	E,F			
Identification	12/91	4	40	E,F			
Pre-Appraisal	6/92	9	180	E,F			
Appraisal	10/92	7	70	E,F			
Supervision	6/93	4	44	E,F	1	1	M/T
Supervision	2/94	3	36	E,F	1	1	M/T
Supervision	2/95	3	27	E,F	1	1	M/T
Completion	1/97	1	15	F			

1. Specialization
E = Economist
F = Financial Analyst

2. Performance Rating
1 = Minor problems

3. Types of Problem
M = Managerial
T = Technical

ANNEX C

Key Macroeconomic Variables, 1990-98

DESCRIPTION	*Unit*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1994-98* Average
Real GDP growth (%,)		..	-5.5	3.1	4.3	5.1	7.00	6.0	6.8	4.8	6.1
Price Change (CPI, %)		585.8	70.3	43.0	35.3	32.2	27.80	20.1	13.2	8.6	20.0
Current Account Balance	$ Millions		-1359.0	-269.0	-2868.0	677.0	5310.0	-1371.0	-4312.0	-6858.0	-1310.8
Net direct investment inflows	$ Millions		117.0	284.0	580.0	542.0	1134.0	2741.0	3041.0	4966.0	2484.8
Net portfolio investment inflows	$ Millions		0.0	0.0	0.0	-624.0	1171.0	241.0	2098.0	1330.0	843.2
Exchange rate (ZL/USD, average)		0.9	1.06	1.4	1.8	2.3	2.4	2.7	3.3	3.5	2.8
Unemployment rate (end of period, %)		6.1	11.8	13.6	16.4	16	14.9	13.6	10.3	10.4	13.0

Source: OECD

Comments of the Polish Government on the Audit

REPUBLIC OF POLAND
MINISTRY OF FINANCE
Foreign Assistance Funds Department

12 Świętokrzyska Str.
00-916 Warszawa, Poland
TEL No: (48-22) 694-37-37; 694-39-64, FAX: (48-22) 694-38-18; 826-03-00; 826-66-70

Date:	27th, March, 2000	Number of pages: 3
To:	**Mr Ruben Lamdany** **Manager, Country Evaluations and Regional Relations, Operations Evaluation Department** **The World Bank, Washington D.C, USA**	
Fax No:	202/522-3124	
From:	Beata Nehrebecka IFO Division Head, Foreign Assistance Funds Dept.	
Fax No:	48-22/ 826-03-00	
Copy:		
Fax No:		

Message:

Re: Enterprise and Financial Sector Adjustment Loan (Loan No 3599-0 POL) Draft Performance Audit Report

Dear Mr Lamdamy,

Enclosed please find the letter signed by Mr Krzysztof J. Ners – Under-secretary in the MOF concerning the above mentioned draft of the PAR.

Yours sincerely,

Beata Nehrebecka
IFI Division Head
Foreign Assistance Funds Department

Warsaw, 2000.03. 25

MINISTRY OF FINANCE
UNDERSECRETARY OF STATE
KRZYSZTOF J. NERS
OF/MIF/PW/ 827/00

Mr. Ruben Lamdany
Manager
Country Evaluations and
Regional Relations
Operations Evaluation Department
The World Bank

Re: Poland: Enterprise and Financial Sector Adjustment Loan (Loan 3599- POL)
Draft Performance Audit Report

Dear Mr. Lamdany,

Referring to your letter dated February 17, 2000 I have several comments on the above mentioned report:

1. I propose to change text of the article 3.10 in your document as follows: „***Bank privatisation proceeded more slowly than expected. It was connected with the complicated process of the transformation of the Polish economy, for example with bad loan problems. A lack of precision in the EFSAL legal documents deprived the Bank of a clear mandate to monitor the pace of privatisation. Also, finding strategic investors proved difficult. By the EFSAL's second tranche, two of nine state-owned banks were privatised, as agreed. The remaining state-owned banks were privatised until 1999. The privatisation of banks accelerated the development of capital market and influenced changes in other sectors of the Polish economy".***
2. In my opinion in Annex A of the report, there should be also included data for 1999.
3. Please correct on the front page of the document: incorrect exchange rate on 30.09.1999 - **is 5.7091, should be 4.1141** and exchange rates in the table as follows:

	1993	**1994**	**1995**	**1996**	**1997**	**1998**
is	**2.9317**	**3.5579**	**3.6687**	**4.1349**	**4.7467**	**4.9337**
should be	**1.8145**	2.2727	2.4244	**2.6965**	**3.2808**	3.4937

4. The Page 5: The economic growth in years 1994 - 1998 in the relation to 1993 (1993 = 100) is 34% and in the document there is marked average growth 6,1% and it's limited to years 1995-1998 without 1994.
5. Annex A page 1:

- GDP (US$ billions) in 1997 is 147,9 - **should be 143,1**
- GDP (US$ billions) in 1998 is 157,5 - **should be 157,3**
- Gross domestic investment/GDP in 1997 is 24,7 - **should be 23,6**
- Gross domestic investment/GDP in 1998 is 27,0 - **should be 25,3**
- export of goods and services/GDP in 1998 is 20,7 - **should be 28,4**
- Gross domestic savings/GDP in 1998 is 18,7 - **should be 21,1**

6. Annex C

	1991	1992	1993	1994	1996	1997	1998
GDP % is	**-5,5**	**3,1**	**4,3**	**5,1**			
GDP % should be	**-7,0**	**2,6**	**3,8**	**5,2**			
Current Account Balance is	**-1.359,0**	**-269,0**					
Current Account Balance should be	**-2.596,0**	**- 1.515,0**					
CPI average is					**20,1**	**13,2**	**8,6**
CPI average should be					**19,9**	**14,9**	**11,8**

Sincerely Yours