

RESTRICTED

Report No. P-220

FILE COPY

This report was prepared for use within the Bank. In making it available to others, the Bank assumes no responsibility to them for the accuracy or completeness of the information contained herein.

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

REPORT AND RECOMMENDATIONS

OF THE

PRESIDENT

TO THE

EXECUTIVE DIRECTORS

ON A

PROPOSED LOAN

TO

PAKISTAN

FOR THE

INDUS BASIN PROJECT

April 18, 1960

Department of Operations
South Asia and Middle East

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

REPORT AND RECOMMENDATIONS OF THE PRESIDENT
TO THE EXECUTIVE DIRECTORS ON A
PROPOSED LOAN TO PAKISTAN FOR THE INDUS BASIN PROJECT

1. I submit herewith the following report and recommendations on a proposed Loan, in various currencies equivalent to \$90 million, to the Republic of Pakistan. The proceeds of the Loan would be used to finance part of the cost of constructing a system of works which would enable Pakistan to use and develop the share of the waters of the Indus River Basin allocated to it under a treaty which is expected to be concluded shortly between India and Pakistan.

2. If approved, the proposed Loan would be the Bank's thirteenth loan to Pakistan. The previous loans were as follows :

<u>Year</u>	<u>Borrower</u>	<u>Amount</u> (US \$ million equivalent)
1952	Pakistan (Railway Rehabilitation)	\$ 27.20
	Pakistan (Agricultural Machinery)	3.25
1954	Sui Gas Transmission Company, Ltd.	14.00
1955	Karachi Electric Supply Corp. Ltd.	13.78
	Karnaphuli Paper Mills Ltd.	4.20
	The Trustees of the Port of Karachi	14.80
1957	Pakistan (Railway Rehabilitation)	31.00
	PICIC Limited	4.20
1958	Karachi Electric Supply Corp. Ltd.	14.00
1959	Karachi Electric Supply Corp. Ltd.	2.40
	PICIC Limited	10.00
	Pakistan (Railway Improvement)	<u>12.50</u>
	Total (net of cancellations)	\$ 151.33
	of which has been repaid	<u>18.87</u>
	Total now outstanding	\$ 132.46
	Amount sold or agreed to be sold \$ 9.11	
	of which has been repaid <u>6.56</u>	<u>\$ 2.55</u>
	Net amount held by Bank	<u>\$ 129.91</u>

The above total includes \$55.1 million not yet disbursed.

PART I - HISTORICAL

3. The Indus River and its tributaries all rise in the Himalayas. The three Eastern Rivers - the Ravi, the Beas and the Sutlej - flow directly from India into Pakistan. The three Western Rivers - the Jhelum, the Chenab and the Indus itself - flow through the territory of Jammu and Kashmir before entering Pakistan. The sharing of the waters of these rivers has been a source of friction for many years. Until 1947, the dispute was carried on primarily between the Sind and the Punjab Provinces of undivided India. With Partition, the division of the waters ceased to be a provincial matter and became an international problem; it has since remained a cause of strained relations between India and Pakistan. The border between the two countries was drawn right across the Indus river system so that Pakistan became the downstream riparian on all the rivers. In some places the border left in India barrages which controlled canals and irrigation in Pakistan.

4. In 1951 I offered the good offices of the Bank in an attempt to find a solution to the dispute, and suggested that the two countries seek to work out together a comprehensive co-operative plan for the use of the waters which would substantially increase the amount of useful water available to both countries. The offer was accepted by the two Governments early in 1952. In 1954, after two years of study in collaboration with India and Pakistan, the Bank put forward a basis for solution recognizing that, in the existing state of relations, a plan based on co-operative development of the Basin would not be acceptable to either country.

5. The Bank Proposal had three essential features. It allocated the waters of the three Western Rivers (the Indus, Jhelum and Chenab) to Pakistan, and the three Eastern Rivers (the Ravi, Beas and Sutlej) to India. The uses in those parts of Pakistan which had historically been fed from the three Eastern Rivers were to be met thenceforward from supplies to be transferred from the Western Rivers through a system of link canals. India was to make a contribution towards the cost of the replacement works. During the period of construction of these works, India was to limit her withdrawals from the Eastern Rivers to amounts relative to Pakistan's ability to replace. The Bank Proposal was accepted by both countries, although with substantial reservations, as a basis for a settlement of the dispute.

6. Since 1954 the Bank has been engaged in discussions with the two countries and in the preparation of engineering studies to try to devise an Engineering Plan in conformity with the Bank Proposal. The objective of the Plan was to accomplish adequate replacement of the waters diverted from the existing uses in Pakistan and also to provide a substantial element of development for both countries; the Bank also had the problem of discovering means by which such a Plan might be financed. During this period, the use of the rivers has been regulated either by temporary arrangements negotiated with the Bank's good offices, or at times by less formal understandings.

7. Any Plan which would satisfy the criteria mentioned above would have to be of very large magnitude and far beyond the capacity of the two

countries to finance. The Plan which has finally emerged will require total financing, in local currency and foreign exchange, of more than \$1,000 million equivalent. The cost of the works in Pakistan is estimated at \$838 million equivalent.

8. During a visit to the Sub-continent in May 1959, I was able to reach an understanding with the Pakistan Government on a plan of works acceptable to it, and with the Indian Government on the amount of the Indian financial contribution and the length of the transition period during construction of these works. This understanding, however, was subject to the availability from foreign sources of adequate financing. I have since been in contact with various governments with a view to finding out whether they would be prepared to assist in providing the necessary financing. In view of the pressures which already exist, entirely apart from this project, on the Pakistan balance of payments, it was necessary that a very substantial part of the financial contributions be made in a form which would not impose further foreign exchange repayment burdens.

9. I am happy to say that the Governments of Australia, Canada, the Federal Republic of Germany, New Zealand, the United Kingdom and the United States have offered substantial contributions in the form of grants, or loans repayable in rupees. These Governments, together with the Government of Pakistan and the Bank, would sign an international agreement, to be known as "The Indus Basin Development Fund Agreement" (attached hereto, No. 1), embodying the financial arrangements for meeting the cost of the works in Pakistan. There is a provision in the Agreement leaving it open to any other government or institution which wished to do so to become a party to the Agreement at any time.

10. Discussions are continuing between India and Pakistan, with the good offices of the Bank, towards the conclusion of an international water treaty to be known as "The Indus Waters Treaty 1960". All parts of the settlement, including the Fund Agreement and the proposed Loan, are contingent on the signing and ratification of the Treaty. A memorandum will be circulated on the obligations which it is proposed that the Bank should assume under the Treaty.

PART II - FINANCIAL AND ADMINISTRATIVE ARRANGEMENTS

11. The cost of the works to be constructed by Pakistan would be met from a Fund to be established under the Fund Agreement, to which Pakistan, the other participating Governments and the Bank would be parties. The Fund, which would be held in trust and administered by the Bank, would receive contributions from the parties, as well as the payments to be made by India under the Treaty totalling £ 62,500,000 (equivalent to \$ 175,000,000). Subject to such parliamentary or congressional action as may be necessary in each case, the Governments have agreed to contribute the following amounts to the Fund in their own currencies, which for purposes of the Fund would be freely useable or convertible for purchases anywhere:

		<u>US\$ equivalent</u>
Australia	£A 6,965,000 in grants	\$ 15,600,000
Canada	\$Can. 22,100,000 in grants	\$ 22,984,000*
Germany	DM 126,000,000 in grants	\$ 30,000,000
New Zealand	£NZ 1,000,000 in grants	\$ 2,800,000
United Kingdom	£ 20,860,000 in grants	\$ 58,408,000
United States	\$US 177,000,000 in grants	\$ 177,000,000
	\$US 70,000,000 in loans (repayable in rupees)	<u>\$ 70,000,000</u>
Total		<u>\$ 376,792,000</u>

*Calculated at Can.\$ 1 = US\$ 1.04

12. The amount of the proposed Bank loan to be paid into the Fund for the works would be \$80 million, bringing the total foreign exchange resources of the Fund to \$632 million equivalent. The balance of the Loan (\$10 million) would be available to meet interest and commitment charges on the Loan.

13. In addition to its contributions in foreign exchange, the United States has agreed, subject to the necessary congressional action, to contribute to the Fund an amount in rupees equivalent to \$235 million. Pakistan would contribute \$27.6 million equivalent in rupees. The balance of the local currency requirements of the project would be met by the purchase of rupees from the State Bank of Pakistan by the Fund, against foreign exchange; the amount estimated to be required is \$155 million equivalent.

14. The total contributions to the Fund in foreign exchange and local currency, as indicated above, amount to \$894.6 million, which is larger by \$56.6 million than the presently estimated requirements for the works in Pakistan (\$838 million). The difference is accounted for in part by the Special Reserve (\$27.6 million) to be accumulated from the Indian payments to the Fund against the possibility that Pakistan may have to make compensatory payments to India, which Pakistan would be required to do under the Treaty if it requested an extension of the Transition Period (see Fund Agreement, Article IV). The balance of the difference (\$29 million) is a general reserve available to be drawn on, if required, to meet price increases and other contingencies.

15. As Administrator of the Fund, the Bank would receive contributions to the Fund, hold the assets of the Fund in trust, and make disbursements from the Fund so far as possible in accordance with the Bank's normal procedures. In agreeing to act as Administrator the Bank would, in effect, be assuming responsibility for the general supervision of the project, in both its technical and financial aspects, on behalf of the parties to the Fund Agreement. Given the nature of the financial arrangements, I consider that such supervision, which will be essential if this immense project is to be executed successfully within the limits of time and money laid down for it, could most appropriately be carried out by the Bank. To assist it in fulfilling its task as Administrator,

the Bank proposes to engage the services of experienced engineering and accounting consultants, as described in the Technical Report (attached, No. 2). The Bank would be entitled to reimburse itself out of the Fund for these and other expenses incurred solely because of its services as Administrator.

PART III - DESCRIPTION OF THE PROPOSED LOAN

16. Particulars of the proposed Loan are :

Borrower: The Republic of Pakistan

Amount: Various currencies equivalent to \$90 million, of which \$80 million equivalent for the project and \$10 million for interest and commitment charge.

Amortization: 40 semi-annual instalments beginning October 1, 1970 and ending April 1, 1990.

Interest rates: Rates in effect at the time when parts of the Loan are credited to the Loan Account.

Commitment charge: $3/4$ of 1% per annum on amounts in the Loan Account.

Closing Date: September 30, 1973.

17. The Bank Loan would finance part of the cost of the system of works described in the Technical Report. The works comprise two large storage dams on the Indus and Jhelum Rivers, the latter equipped with facilities for the generation of 300,000 Kws of electricity; barrages and link canals to transfer water from the Western to the Eastern Rivers; tubewells and drainage works to contribute additional supplies of water for irrigation and to assist in lowering the water-table in areas threatened by water-logging and salinity.

18. In view of the exceptional nature of the transaction of which the proposed Loan would form a part, and the long construction period of the project, special arrangements would be made for the disbursement of the proposed Loan and for the determination of interest and commitment charge.

19. Disbursement of the Loan would be made by the Bank (a) to the Fund in accordance with periodic calls made by the Bank acting as Administrator of the Fund, and (b) in payment of interest and commitment charge on the Loan during the first 8 years. Under Article III of the Fund Agreement the Administrator would estimate the requirements of the Fund during each six months' period, beginning with the period April 1 - September 30, 1960, and apportion these requirements among the Parties. As soon as the proposed Loan became effective, and thereafter on October 1 and April 1, the amount to be met from the Bank Loan during the six months would be credited to the Loan Account. On the same day (through October 1, 1967) the Bank would also credit the Loan Account with the

estimated interest and commitment charge which would accrue on the Loan during those six months.

20. Commitment charge would accrue from the dates on which amounts were credited to the Loan Account, and interest would run from the time such amounts were transferred to the Fund or paid to the Bank on the due dates for payment of interest and commitment charge. Each part of the Loan would carry its own interest rate, which would be the Bank's current rate at the time such part was credited to the Loan Account.

PART IV - LEGAL INSTRUMENTS AND AUTHORITY

21. It is contemplated that the Treaty, the Fund Agreement and the Loan Agreement would be signed by the respective parties at the same time. The Treaty would come into force upon ratification by India and Pakistan, and the Fund Agreement by its terms would come into force simultaneously, both with effect retroactively from April 1, 1960. One of the conditions of effectiveness of the Loan Agreement would be the coming into force of the Treaty (Section 8.01(b)).

22. Attached is a draft Loan Agreement between the Republic of Pakistan and the Bank (No. 3). I would draw attention to the following features:

- a) Loan Regulations have been incorporated in the Loan Agreement. This has been done in order to avoid setting out numerous minor changes in the Regulations, and in order to have a self-contained document which can be annexed to the Fund Agreement.
- b) A number of provisions which are normally included in Bank loan agreements have been either omitted altogether or substantially modified, as they are covered by corresponding provisions of the Fund Agreement. These concern the use of the proceeds of the Loan (covered by Article V of the Fund Agreement and by Article II of the Loan Agreement), the withdrawal arrangements (Article VI of the Fund Agreement) and particular covenants of the Borrower, including those relating to maintaining records, furnishing information and inspection (Article VII of the Fund Agreement). The Project is described in Annexure D to the Fund Agreement, to which the Loan Agreement makes reference (Section 2.01).
- c) The arrangements for crediting the Loan Account and for the payment of interest and commitment charge, described in paragraphs 19 and 20 above, are set out in Article I. Section 1.02 of that Article provides for separate credits to the Loan Account :
 - (i) to meet the requirements of the Fund as specified by the Administrator, up to a maximum of \$80 million equivalent;
 - (ii) to pay interest and commitment charge on the Loan during the first eight years, up to a maximum of \$10 million equivalent.

23. I would also draw special attention to Article VIII of the Fund Agreement, which defines the rights and responsibilities of the Bank acting as Administrator of the Fund, and to Article IX which provides for the suspension of disbursements from the Fund and the termination of the Fund Agreement in certain eventualities.

PART V - APPRAISAL OF THE PROPOSED LOAN

24. The Engineering Plan which is to be financed - so far as the works in Pakistan are concerned - from the Indus Basin Development Fund, including the proceeds of the proposed Loan, has made it possible for India and Pakistan to approach a final settlement of the vexatious issue of the division of the Indus waters that has so embittered relations between them since they attained Independence. The costs of the Plan are far beyond the capacity of the two countries to meet from their own resources, and they would not have accepted it without financial assistance on the scale to be provided by the contributing countries and the Bank.

25. Apart from easing the general relationships between the two countries, following a settlement of the water dispute, the Engineering Plan would bring important economic benefits to both of them.

26. For India, it would release the whole flow of the Eastern Rivers for new irrigation developments there. India has already constructed, or has under construction, barrages, canals and a reservoir which are capable of using the flow of the Eastern Rivers.

27. For Pakistan, the system of works to be constructed, as well as permitting replacement of the waters of the Eastern Rivers, would provide substantial additional irrigation, develop important sources of hydro-electric power, make an important contribution to soil reclamation and drainage, and afford a measure of protection against floods.

Procurement

28. All goods and services required for the works in Pakistan are to be procured on the basis of international competition, except as the Administrator otherwise agrees (see Fund Agreement 7.01(b)).

Economic Situation

29. A Memorandum on the Economic Situation and Prospects of Pakistan was circulated on April 14, 1960 (R60-44). The Memorandum points out that the financial situation of Pakistan has, in general, been improving. The Government has refrained from borrowing from the banking system, and exchange reserves have been restored to the level at which they stood before the serious drain on the reserves began in 1957. However, import restrictions continue to be severe although the private sector now has access to unlicensed imports of specific items, including raw materials and replacement parts, through the operation of an export bonus scheme under which exporters receive entitlements to imports which they may sell freely. Available statistics on industrial production do not extend beyond June 1959; these, however, indicate a continued growth of industrial production which now contributes 8% of national income. Preliminary crop

estimates for the current year suggest that over-all agricultural production is about the same as in 1958/59, with an increase of food crops and a drop in non-food crops and fibers.

30. The Government has been giving serious attention to improving the country's administration and a number of steps in this direction have already been taken. Development projects which are to be financed domestically or externally are now subject to scrutiny and approval by the Economic Committee of the Cabinet. A longer range development program for the five years beginning July 1960, has been drawn up by the Planning Commission, and its Report (the Second Five Year Plan) will shortly be issued. It is intended, however, that development programming should be flexible and the Second Five Year Plan will in fact be executed through a series of Annual Development Programs, the public sector of which will be embodied in the Budget.

31. Much remains to be done to strengthen Pakistan's basic economic position. Agricultural production has not yet begun to increase, savings are low in relation to national income and no expansion of exports is yet discernible. The Government is aware of the importance of these problems, and the agricultural question in particular has been given high priority. But the underlying difficulties will not be solved easily and, except perhaps in the case of food production, the desired results are not likely to be achieved in any short period.

32. Pakistan's total public external debt amounted to \$264.8 million as of December 31, 1959. Debt service is estimated to average \$33 million annually during the 5 years 1961-65, with a peak of \$48 million in 1962. Service payments on this debt decline to \$19.1 million in 1968 and to \$12.5 million in 1970. Service of \$33 million represents 8.6% of current account exchange earnings in 1958/59 and 7.9% of average current account earnings for the five year period 1960/61 to 1964/65, as estimated by the Planning Commission. In view of Pakistan's present weak balance of payments position, this burden of service on existing debt is heavy and the Government should exercise restraint in incurring any new debt involving transfer payments.

Prospects of Fulfilment of Obligations

33. In view of the fact that priority is to be given to the works needed for replacement and that Pakistan would not begin to enjoy development benefits until towards the end of the period of construction, interest on the proposed Loan would be capitalized for the first eight years and repayment would not begin for 10 years. Service on the proposed Loan would start in April 1968 and would amount to \$3.7 million in that year, to \$4.3 million in 1969 and to \$6.0 million in 1970. Thereafter service of the Loan (from October 1970 to April 1990) would add approximately \$7.8 million a year to the country's annual payments in foreign exchange.

34. This addition to the calls on Pakistan's limited foreign exchange earnings is considerable. But since the proposed Loan would not increase Pakistan's debt service until the service on its existing debt had passed the peak and until Pakistan had obtained benefits from the project, the

proposed Loan should be within Pakistan's capacity to repay.

35. Attention is also called to the attached chart (No. 4) which shows that the actual amount of the Bank's net investment in Pakistan would not be increased beyond the level of about \$125 million at any time by reason of the proposed Loan. In effect disbursements under the proposed Loan after 1963 would be approximately offset by repayments under previous Bank loans in Pakistan.

PART VI - COMPLIANCE WITH ARTICLES OF AGREEMENT

36. I am satisfied that the proposed Loan complies with the Articles of Agreement of the Bank. The Report of the Committee provided for in Article III, Section 4(iii) of the Articles of Agreement is attached (No. 5).

PART VII - RECOMMENDATIONS

37. I recommend that the Executive Directors approve the Bank's acting as Administrator of the Fund substantially on the terms and conditions set forth in the attached draft of Indus Basin Development Fund Agreement and adopt a resolution to that effect in the form attached (No. 6).

38. I further recommend that the Executive Directors approve a loan by the Bank to Pakistan in an amount in various currencies equivalent to \$90,000,000 substantially on the terms and conditions specified in the attached draft Loan Agreement and adopt a resolution to that effect in the form attached (No. 7).

Eugene R. Black

Attachments.

Washington D.C.

April 18, 1960.