CABEI

EDIFICIO CRUZ AZUL

Telephones: 25361-8
5a. Ave. 8-30, Zona 1
Guatemala City, Guatemala

Cable: ROCAP/Guatemala City

ROCAP

DEPARTMENT OF STATE
AGENCY FOR INTERNATIONAL DEVELOPMENT
ROCAP

c/o American Embassy
Guatemala City, Guatemala

(1)

47p.

October 5, 1973

AID/W response in State 210319 of 24 Oct '73
Also State 022149 of Feb 1, 1974

Mr. John R. Breen, Director
Office of Development and Resources
Bureau of Latin America
Agency for International Development
Washington, D.C. 20523

Re: AID Loan 596-L-010
Export Development and Tourism
- CABEI -

Dear Mr. Breen:

We received STATE 197282 on 4 October 1973. Among other things, this cable gave us the schedule for the Assistant Administrator's loan status reviews. For ROCAP this was particularly timely because we have today just completed a report evaluating subject loan and making certain specific recommendations for modifying the loan in such a way that we can more effectively carry out the economic purposes for which the funds were made available, and at the same time materially improve the management of the loan.

For the past several months Mr. Tragen and myself, as well as other members of the ROCAP staff, have been working with CABEI at all levels to assist them in improving their procedures and in upgrading their performance under this particular loan. From September 24 to 26 we had a series of meetings in Tegucigalpa with the top staff of the Bank. Our ROCAP staff was represented by myself; Chuck Flinner, the Area Controller; Warren Wolff, our Capital Development Officer; Ed Costello, the Program Economist; and John Kahle, our Legal Counsel. The Bank was represented by the Executive Vice President and four of their department heads. During the first day of meetings, CABEI explained to us what their problems were in connection with this loan. On the second day we explained to them the problems we had with their performance in managing the loan. And on the third day we got together and agreed on a series of actions which, in our collective judgment, would serve to dramatically improve loan performance.

The management of the Bank was acting "ad referendum" in that they must obtain final approval from the Board of Directors before some of the modifications can be put into force. In our case it is necessary that we obtain the approval of AID/Washington.

At this present time CABEI Board of Directors is scheduled to meet on October 22, and we have every reason to believe that the Board will fully authorize the Bank to proceed in accordance with the results of our joint evaluation.

You will find attached to this letter a comprehensive evaluation report and certain recommendations. Among the supporting documentation you will find a draft action memo for the Assistant Administrator, a draft amendment to the loan authorization, and a draft delegation of authority.

We shall be prepared to present our recommendations at the Assistant Administrator's loan status review on the morning of October 11.

I hope that the necessary modifications will be authorized by AID/W so that we can move ahead on this loan with all due speed.

Sincerely,

Robert R Parker

Robert R. Parker
Acting Director

Attachments:
a/s

October 5, 1973

EVALUATION REPORT

CABEI Loan 596-L-010: $30 Million

Export Industries and Tourism

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EVALUATION REPORT

CABEI-AID Loan 596-L-010
$30 Million Export Industries and Tourism

PREFACE

This report and the recommendations contained therein are the work product of several months of joint effort by the staff of the Central American Bank for Economic Integration (CABEI) and the A.I.D. Regional Office for Central American Programs (ROCAP).

These efforts were directed at devising ways and means of more effectively meeting the economic objectives of AID Loan 596-L-010 (Export Development and Tourism) and at improving the management of the loan, with particular attention to speeding up disbursements.

The document was prepared after a series of joint meetings in Tegucigalpa Honduras on September 24, 25 and 26, 1973 chaired for CABEI by its Executive Vice President and for ROCAP by its Deputy Director. These meetings were attended by the senior operating officials of CABEI responsible for loan implementation and their ROCAP counterparts- the Capital Development Officer, Area Controller, Program Economist and Legal Counsel. During the week of October 1-5, 1973, Senior CABEI officers, including the Deputy Chief of the Operations Department, worked with ROCAP officers in Guatemala City on the final drafting of the report.

A. History of the Loan

Date Authorized:	June 19, 1970	
Date Signed:	September 9, 1970	
Terminal Dates:	Commitments:	March 31, 1974
	Disbursements:	June 30, 1974

AID Loan Funds disbursed to August 31, 1973: $5.4 Million

1. Description

On September 9, 1970 ROCAP signed a $30 million loan with CABEI for financing a major private-sector effort to promote, develop expand and effectively operate non-traditional export industries and tourism. The export aspect was to focus on diversified agribusiness activities, and the tourism aspect on moderate-sized hotel projects in areas mainly outside the principal cities of each C.A. country, where many of the most promising tourist attractions are situated.

The overall program amounts to $100 million: The $30 million AID loan, a $30 million contribution from CABEI (cash plus other loans and lines of credit), and a $40 million investment from private entrepreneurs.

Under the AID Loan Agreement, no distinction is made between tourism and export uses. Up to $5 million is available for relending for these purposes to private and public development banks in each CACM country.

The Loan Agreement also provides that up to $2.5 million may be used for financing equity investments and up to $500,000 may be used to finance feasibility studies. Up to $7.5 million is available for financing local costs.

2. Purposes of the Loan

These are threefold·

a. to stimulate increases in non-traditional exports and tourism development by providing CABEI with the loanable funds it needs for financing industries having high foreign exchange potential;

b. to insure the continued growth of a responsive regional development bank; and

c. to strengthen the Central American integration movement.

3. Performance to Date

a. Total Program (as of 8/31/73)
(In Millions $US)

	Total Budget	Committed to Date	Disbursed to Date	
Dollar Costs	$ 22.5	$ 10.0	$ 2.6	
Local Currency Costs	7.5	7.3	2.8	
AID Loan	$ 30.0	$ 17.3	$ 5.4	
CABEI Contribution	30.0	22.4	7.1	
Total AID & CABEI	$ 60.0	$ 39.7	$ 12.5	
Private Sector Contribution	40.0	26.0	?	?
Total Program	$100.0	$ 65.7*	$ 12.5	

*Represents 79 sub-loans: 50 export, 16 tourism and 13 to other lending institutions

b. Uses of AID Loan

Export Industries	$ 14.5	$ 7.6	$ 2.7
Tourism Industries	7.5	5.1	1.4
National Fomentos & Financieras (other banks	5.0 1/	4.6	1.3
Equity Investments in Export/Tourism Industries	2.5 1/	--	--
Feasibility Studies & Tech. Assistance	0.5 1/	--	--
Total AID Loan	$ 30.0	$ 17.3 2/	$ 5.4

1/ Loan Authorization and Loan Agreement restrict the amounts in these categories to the figures shown above.

2/ $8.4 million represents authorized-unsigned sub-loans, and $8.9 million represents authorized-signed sub-loans. In addition to the $17.3 million, $2.4 million are pending authorization (full applications submitted to CABEI), and $14.2 million in partially completed loan applications are under review. Thus, CABEI has loan applications in various stages of processing that utilize almost $34 million, in theory more than fully committing the AID loan.

B. The Problem

Slow disbursements. As of August 31, 1973, only $5.4 million has been disbursed. The estimated figure projected as of June 30, 1974 (terminal disbursement date under the loan) is $10.8 million under the existing terms of the Loan Agreement. See disbursement projections, Schedule 3.

C. Analysis of the Problem

CABEI has not been able to maintain the level of loan disbursements contemplated at the time the loan was signed because of the following:

1. Complexity of Export Industry

CABEI has had notable success in promoting such projects: preliminary loan applications total $25 million, and the Bank is actively discussing with entrepreneurs an additional 42 projects aggregating a further $27 million. CABEI is conducting the most aggressive project promotion in the region, which will pay off in the long run.

On the other hand, many of the Bank's proposals will not develop into bankable loan applications within a reasonable time for financing under AID Loan 010. In many cases, before an application can be brought to the approval or disbursement stage, considerable inputs of the technical assistance are required. This relates to the export process - production, processing, marketing, management (know-how), finance, etc. CABEI is providing large amounts of such assistance which is very time-consuming. CABEI is finding that financing export diversification is a complex business and it is necessary to realign its loan procedures in order to handle more expeditiously the individual problems attendant to processing loan applications for projects of this type.

2. Limitation on Local Cost and Working Capital Financing

See Sections E.2 and E.3.

3. Competition with AID Bilateral Loans

AID bilateral loans to private financieras in the C.A. countries have directly competed with Loan 010 funds. Such loans were made available for a great variety of private industrial projects including, of course, export and tourism development. For example, the AID loans to FIASA and COFISA.

4. Competition by Governments and Commercial Banks

The Government of El Salvador's own export program has all but eliminated CABEI activity in this field in El Salvador. The GOES offers extremely liberal terms including 6% interest to the Borrower. One interesting result of Loan 010 (the first major export program in the region) is that it has stimulated ? more liberal terms for term financing from U.S. commercial banks. Recently, however, this trend has been neutralized by high interest rates in the U.S. evidence?

5. CABEI Management and Current Reforms

CABEI did not organize properly to give prompt and efficient service to the private sector. This has been a major problem and has caused complaints from the Bank's clients together with the withdrawal of some applications which CABEI had helped put together in the first place. 1/

Further, CABEI was without an Executive Vice President for 14 months and as a consequence, the Loan did not receive adequate senior management supervision during this period.

Early in 1973, however, CABEI set in motion long overdue changes in its organization, policies and procedures as described below:

1/ To permit flexibility in implementing the AID loan, particularly in financing its tourism loan applications, AID's customary commodity eligibility criteria were broadened in November 1971 to permit flexibility in the financing of commodities essential to the success of a private tourism project. Commodities previously ineligible for AID financing have not been declared eligible for financing under Loan 010. Reference: Implementation Letters No. 12 and 14.

Under a special Board Resolution in June 1973, CABEI declared FY 1974 the "Year of Loan Signings and Disbursements". A work Committee was established to improve performance under Loan 010. This was stated as the Bank's number one priority.

The Financial Administration Office (responsible for effecting loan disbursements) was eliminated, and is now physically part of and under the management of the Operations Department. The latter has major responsibility in dealing with the private sector and in processing loan applications, and has now been upgraded to handle disbursement responsibilities as well. Previously, there was not only a lack of coordination between these two departments, but they were physically located in two different buildings. This is a major improvement in the internal structure of the Bank. The physical move was completed in August 1973. The Bank's disbursement Instructivos (Manual Orders) are now being revised and updated reflecting CABEI's concern with more rapid disbursement.

The Legal Department has added three new lawyers to its staff in order to greatly speed up the processing of sub-loan agreements and the legal approval of conditions precedent. The CABEI sub-loan agreement form has been streamlined and simplified. A condensed standard format is now in use and greatly reduces the time needed to negotiate an agreement and satisfy conditions precedent, which have been reduced to a minimum.

A permanent Chief of the Promotion and Economic Research Department has been named. For an untoward period this Department functioned under an Acting Chief without full authority. This hamstrung its operations considerably. Its FY 1974 budget provides for the hiring of seven new employees, ranging from economists, financial analysts, and engineers, etc. Recruiting is now taking place.

CABEI maintains a Representative in each country.

These offices have been substantially upgraded in responsibility and personnel so they can play more active managerial role in moving the Bank's loans. For example, the Country Representative now can determine project eligibility which previously had been done solely by Tegucigalpa. This change will speed up the decision process and improve customer relations. The Representatives will report directly to the Executive Vice President of the Bank. Previously they reported to the Operations Department. Procedures are now being worked out so that the Representatives will have additional responsibility in speeding up disbursement requests.

Interest rates on tourism loans remain at 9%. In July CABEI's Board approved a reduction in the interest rate on its direct export loans from 9% to 7%. The Bank's management also recommended a 7% interest rate to the end user (private company) on its loans to other banks (financieras and fomentos) in the region. Presently CABEI charges other banks 5% on such loans which are in turn loaned to the end user at 9%. The Board did not approve the 7% rate, however, CABEI management now plans to resubmit its recommendation to the Board with additional justification in an attempt to obtain a uniform rate of 7% to the end user on export loans.

CABEI has liberalized project review requirements under its loans to other banks. The prior approval limit will be raised to $250,000 from the present $100,000, depending on the institution involved. COFISA in Costa Rica will be the first bank to enjoy the benefits of the liberalized policy. This change will improve CABEI's relationships with the financieras and, as a result, should speed up the drawdown of AID funds.

As stated earlier, CABEI has a large number of projects which it has promoted and hopes to develop into bankable projects at an early date. It will substitute such fast-moving projects for those which, although already approved under Loan 010, are not moving for various reasons. CABEI's current commitments in private industrial lending total $118.1 million, representing 215 approved loans. 79 of the approved loans for $39.7 million are being financed by CABEI and AID under the export/tourism program. (010 ?)

D. Recommendations

CABEI is of the opinion that the 010 Loan Agreement, as presently written, contains several constraints which have seriously impeded loan performance. ROCAP agrees with this analysis. What is important to both is that the objectives and regional impact of the $100 million program will be realized within a reasonable time. Therefore it is recommended that:

The present limitation (imposed by Implementation Letter only) on financing tourism projects industries ($7.5 million) be eliminated. See Section E,1.

The availability of local cost financing be increased from $7.5 million to $15 million. See Section E,2.

The financing of working capital, in dollars and in local currencies, be permitted. See Section E,3.

The present ceiling on funds available for lending to other financial institutions ($5 million) be eliminated. See Section E,4.

The financing of hotels in capital cities be permitted. See Section E,5.

E. Specific Justification in Support of Recommendations

1. Removal Ceiling on AID Funds for Tourism

Issue

Implementation Letter No. 1 of October 16, 1970 stated that no more than $5.0 million of Loan 010 could be used for direct CABEI sub-loans for tourism. In January 1973 this ceiling was raised to $7.5 million. On the basis of a joint ROCAP/CABEI review, it is now proposed to remove the limit on the use of funds for tourism.

Justification

The original limit of $5 million for tourism projects was based on CABEI's 1969-70 estimates of the tourist projects which could be financed outside the capital cities without additional infrastructure expenditure. Further, the record indicates that the $5 million figure was set to insure that tourism projects would get their fair share of the funds, at least $1.0 for each country. In the loan paper tourism is referred to as an important new activity to be encouraged. At the time it was thought that $5.0 million would be sufficient to meet the projected requirements. However, tourism has boomed in Central America much faster than projected. As of August 31, 1973, approved sub-loans for tourism projects under Loan 010 were $5.1 million with disbursements of $1.4 million and the need for tourism funds is projected to increase by at least $10.0.

Further, on February 29, 1973 ROCAP signed a $15 million loan with CABEI (013) for tourism infrastructure in outlying areas. As this infrastructure opens new tourist areas, the need for tourism financing will increase.

As will be demonstrated below, the purposes of the Loan, i.e. to diversify export earnings by promoting non-traditional exports, can be achieved without making a distinction between "export industries" and "tourism".

From the point of the balance of payments, both commodity exports and tourism expenditures by foreigners

Same argument was relevant in 1970 at CAP stage!

appear as credits in the current account, i.e. both "earn" foreign exchange. In the first case, exchange is received by selling a tangible object abroad (i.e. shoes); while in the second, exchange is received when tourists sell dollars to buy Quetzales (i.e. to pay for goods and services purchased in-country). In this sense hotels and tourist facilities are "export industries". Also, since tourism previously had not been a large item in the balance of payments, tourism clearly can be considered a "non-traditional export".1/

Further, from the broader prospective of economic development, tourism may be a better "deal" for the region since in the short run it typically has a greater comparative advantage in tourism than in the export of goods. A region tends to have a comparative advantage in those activities which use large amounts of the region's relatively abundant factor. To the extent tourism depends on large amounts of services (which in turn rely upon labor), there is a presumption that the region would have a comparative advantage in tourism. This, of course, assumes that there is something to see and a way to get there. (In C.A. this is not a problem. Its major attractions include ideal year-round climate; plenty of sun and sea; the outstanding Mayan ruins of Tikal and Copán distinctive folklore, customs, and artifacts; and an adequate transportation network.) In summary, tourist facilities can provide the inputs needed to develop "non-traditional" exports.

Aside from these presumptions, tourism can provide other benefits. As pointed out in the recent DAP, the tourism industry is characterized by relatively high income and employment multipliers. A study by the Bank of Mexico estimated that, in the short run, the GNP increases by $3 for every dollar of tourist expenditures. This estimate abstracts from the long-term effect of tourism revenues on private investment. Moreover, the amount of capital needed to generate a given amount of employment is lower in tourism than it is in almost

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1/ The CABEI hotel study shows that in 1971 receipts on the travel account represent an amount equivalent to 5% of regional exports of goods and services.

all major Mexican industries. Among the 14 major industries in Mexico, only agriculture and textiles require less capital per job created. With respect to labor intensity, the study indicated that for every million Mexican pesos invested in tourism, 45.6 jobs were created: 20 in direct tourism services, 18 in agriculture, 2.3 in textiles, 1.5 in foodstuff and 3.8 in other economic sectors.

The tourism industry is credited with having given a substantial boost to the development of the Mexican economy. Foreign visitors are estimated to have spent $1.4 billion in Mexico in 1971, a figure which represents 110% of the country's commodity exports, 70% of public investment or 37% of private investment. While it is not expected that Central America can duplicate the Mexican experience, the Mexican results show what benefits can be obtained from a well-planned and financed tourism development program with respect to foreign exchange earnings, income growth and employment generation.

Returning to the Central American context, although capital city hotels are only one ingredient in the overall tourism picture, the shortage of hotel facilities appears to be a serious bottleneck, especially since this bottleneck exists in Guatemala City and San Jose -- the hubs of regional tourism development.

In order to both provide adequate funds for tourism development and to speed disbursement under the loan, the deletion of any distinction between export development and tourism is clearly managerially and economically desirable.

2. Increase Availability of Local Currency Financing

Issue

Section 1.01 (The Loan) of the Loan Agreement states that "the amount of Loan funds used to finance Local Currency costs shall not exceed the equivalent of $7.5 million." The joint ROCAP/CABEI review of the program determined to recommend that this language be amended to permit the financing of up to $15 million in local currency costs.

disbursements ?

Analysis

From January 1970 - the date local currency costs ? were initially estimated - to June 1973, CABEI's Ordinary Fund loan approvals increased by $53.8 million, or by 84% as shown below:

Not just Loan 016

Date	No.	Loans	Amount
January 1970	143		$ 64.2 million
June 1973	215		$118 million
increase	72		$ 53.8 million

This increase in activity was not contemplated by CABEI at the time it projected its local currency needs for the AID Loan. Today CABEI finds itself without sufficient local currency resources to adequately service its export and tourism loan applications. (liquidity ?)

This does not mean that CABEI has not taken steps to increase its capital or obtain additional loans and lines of credit from other sources to finance such activity. To the contrary, it has obtained 15 lines of credit totalling $32 million during the past three years alone. In addition the capital of the Ordinary Fund has increased by 10% from $12.4 million to $14 million. Reserves and retained earnings have increased proportionately. This more than satisfied the AID Loan covenant which requires that CABEI "will provide financing in an amount at least equal to the AID loan and will seek sources of credit for this program from other lenders".

How many times is this counted as a "contribution"?

CABEI has fully committed its 6 U.S. commercial bank lines of credit which totalled about $30 million. These were used to a great extent under the AID program. About $5 million alone went to financing "fixed" working capital. CABEI's private industrial loans from the IDB have been committed for some time, and are not available for financing export/tourism projects.

see bottom of p 7.

CABEI's loan repayments (rollovers) totalled $8.9 million as of June 30, 1973, and have already been assigned to 6 large loan commitments for almost an identical amount, $9.1 million. Of the latter, $1.3 million finances an industrial park in Managua and relates to export activities under the AID program.

CABEI has available about $12.4 million from six lines of credit extended by European and Japanese banks. However, these are restricted to the financing of equipment from these countries, and are of no value to CABEI for financing local currency costs.

The Loan Paper indicates that the percentage of local costs contemplated under the program was estimated to be around 55% of total projects costs, including the sub-borrower's contribution. This ratio is still valid today for export industries. However, there has been a shift in the AID Loan from export to tourism financing because of the demand by Borrowers, (See Section E, 1). Tourism financing is now expected to increase from $5 million, as initially estimated, to around $8 million. This places further stress on CABEI's limited local currency resources as tourism projects require about 70 to 80% local cost financing.

Given the importance of local currency financing to export diversification and tourism development; CABEI's willingness to feature the importance of and finance the working capital needs of its clients in those two areas; the rise in loan approvals of the Ordinary Fund; and to be responsive to CABEI's needs today, the relevant sections of the Loan Authorization and Loan Agreement should be amended to increase the availability of local currency financing from $7.5 million to $15 million. Within this amount $5 million will be available for financing working capital.

CABEI will match this local currency allocation by a like amount (50%) from its own $30 million contribution to 7 the program, thereby maintaining the AID-CABEI 1:1 ratio which is consistent not only with the overall contribution, but also with the local currency allocation as well.

A simplified breakdown of dollar and local projects costs for the entire $100 million program (See Section A-3) is shown below:

	$	L.C.	Total
CABEI	$15	$ 15	$ 30
AID	15	15	30
Total CABEI Loan			$ 60
Private Borrower	$15	$ 25 1/	$ 40
	$45	$ 55	$100
	%	%	%

1/ higher if tourism project

3. Authorize Financing of Working Capital

Issue

Section 1.02 of the Loan Agreement states "Loan funds may be used to finance working capital, but only through the development banks and only for Dollar Costs". Section 5.02 contains a similar constraint.

CABEI now wishes to revise the Loan Agreement to permit loan funds to be used to finance (1) the net increment of working capital required to increase production for existing export industries, and (2) the requirements for the permanent investment of funds in circulating capital or gross working capital in new enterprises. ROCAP supports this request.

Discussion

The term "Working Capital" as used in Sections 1.02 and 5.02 of the Loan Agreement is not defined elsewhere in the loan agreement or in the loan authorization. There is a distinct difference in working capital required to meet current operating costs and revenue expenditures, and gross working capital needed for capital expenditures intended to benefit future periods.

One of the major needs of borrowers under CABEI's Export Development and Tourism Program is the financing of permanent investment of funds in circulating capital or gross working capital. This is especially true in those instances where new enterprises are starting up or existing enterprises are expanding to meet new export markets. In these new or expanding enterprises the circulating capital or gross working capital is needed for the start up cost or expanded inventories to be obtained and worked on to produce the product to be sold and for expenditures that have the effect of increasing the capacity, efficiency, span of life or economy of operation of existing fixed assets.

The amount of needed funds varies from time to time but some permanent investment of funds in circulating capital is necessary in any business. It is generally impossible to finance all of a firm's needs for this circulating capital by short-term loans from commercial banks.

CABEI has a financing policy which provides for their total loan to new enterprises to include in addition to the financing of fixed assets the financing of the necessary amount of permanent investment in gross working capital required for the normal development of the company's operation.

In the loans for production increases to existing enterprises they will also finance the net increment of gross working capital required for the new projected increase in volume of production.

CAFBI loans for this type of circulating capital or gross working capital are usually for periods of three to five years and fully collateralized by mortgages, guarantees, etc. It is CABEI's rule of thumb that about 10% of each loan to a new or expanding export project should finance this type of "fixed" asset.

Seasonal working capital needs or financing for short-term operations are not financed by CABEI, but rather are obtained by the borrowers from other credit institutions on short-term loans.

CABEI is financing all gross working capital needs from its U.S. commercial bank lines of credit. CABEI's Ordinary Fund (finances private sector activity) maintains a reasonable substantial cash liquidity, generated from repayments, but these funds are still not sufficient to meet the Bank's needs for financing all its industrial commitments, as stated above, and to serve as a minimum level of liquidity.

The high interest rates now charged by the U.S. commercial banks poses a serious problem to CABEI. As of September 28, 1973, CABEI was paying 11% (1% over prime) to one bank and 12-3/16% (1.25% over the Euro-dollar offering) to another bank. CABEI passes on these same rates to its clients.

Its administrative expenses (about 1.8%) are absorbed. CABEI is reluctant to change administrative expenses, not to mention a profit spread, to its clients because these clients simply cannot afford the additional expense without undue risk to newly developed industries. CABEI's minimum working capital interest rate is 10%.

As of August 31, 1973 CABEI had applications to borrowers which include gross working capital as described above amounting to $5,088,000 of which they have disbursed $1,847,000. The balance of $3,241,000 is projected to be disbursed rather rapidly with a cumulative amount of $4,830,000 disbursed by June 30, 1976. (not just 010)

ROCAP believes that gross working capital or circulating capital is proper for long-term financing and equally important to the financial success of new or expanding industries as the financing of other fixed assets. CABEI should be permitted to use Loan 596-L-010 funds to meet these requirements.

On the basis of the above ROCAP supports the request of CABEI that Loan 596-L-010 be revised to permit CABEI to use funds for financing circulating capital or gross working capital under the financing policies currently established by CABEI. The maximum estimated amount of the loan which it is estimated may be used for these purposes in local currency is the equivalent of $5.0.

4. Removal of Ceiling on AID Loan Funds for Financing Through Other Banking Institutions [redacted])

Issue

Section 1.02 (The Project) of the Loan Agreement states that up to $5 million of Loan funds may be used by CABEI for loans to private and public development banks for further re-lending to non-traditional export and tourism industries Section II-C of the Capital Assistance Paper states that this facility will be used by such institutions to finance those smaller projects which CABEI is not set up to handle, and which can be better serviced locally. The joint ROCAP/CABEI review of the program concluded that it was desirable that this limitation be removed to permit CABEI more flexibility in the use of the Loan, and to encourage a wider participation by other financial institutions in the region.

Analysis

At the time Loan 010 was developed, participation by national development banks was deemed an important feature, even though only $5 million was set aside for this activity. Such participation was written into the Loan for three reasons:

- It would enable CABEI to offer a broad program for the financing of export diversification and tourism industries, regardless of the size of a project. CABEI, by reason of its own size and organization, must focus on developing large projects - the average size of CABEI's direct loans under 010: $500,000. Involvement of local development banks would assure effective service for smaller projects.

- Bringing the local financial institutions into the loan program with CABEI was significant in that it afforded CABEI its first opportunity to exercise on a practical basis a truly regional private sector program. CABEI, a public institution, established its first direct ties with the private banks in each country under the Loan, and the relationship, while rough-edged at times, nonetheless exists and is expanding. Sound industrial development of the region is dependent on more amicable and closer working relationships between the public and private sectors than has existed in the past; Loan 010 will go a long way to improve this effort toward cooperation.

- CABEI's role as coordinator and conduit of resources in this phase of Loan 010 might well carry over to other private sector programs in the future, reinforcing CABEI's coordinated influence over regional industrial development.

The $5 million for relending to local institutions was based on information and estimates received from C. A. USAIDs at the time of developing the loan in 1969-1970. It was a start-up figure. CABEI was told from the beginning that the figure could be increased if export/tourism business generated by local banks warranted it. As of August 31, 1973, $4.6 million of the $5 million availability has been committed. CABEI now wishes to approve two new loans to C. A. financieras in October 1973 totalling $1 million, creating an immediate need to increase the ceiling by $600,000.

There are several reasons why the local banks have not made even greater use of CABEI funding to date:

- A scarcity of well-developed, eligible and really bankable export/tourism projects;

- Delays and inflexibility on CABEI's part in servicing the local banks effectively.

- A need for improved public relations on both sides - CABEI and the banks - to break down the public/private "barrier" and to iron out differences rationally; and

- The need for substantial increases in local cost and working capital financing.

[illegible] c/o ?

At this moment, the local banks may not have large numbers of eligible projects ready, but there seems no doubt that the availability of increased amounts of local currency and working capital financing plus more aggressive and effective CABEI policies and procedures in servicing the needs of local financial institutions will give those institutions the incentives they need to follow through in areas of activity where previously they were clearly constrained.

The $5 million ceiling on relending to local banks no longer is valid. In order to be responsive to the needs of CABEI and local banks, and to speed up Loan disbursements, the relevant sections of the Loan Authorization and the Loan Agreement should be amended to remove that ceiling.

5. Authorize the Use of AID Funds for Financing Hotels in Capital Cities

Issue

At the present time CABEI is limited to the financing hotels mainly outside in Central American capital cities. This restriction is contained in Section 102 of the Loan Agreement, and reads as follows: "Tourist development projects will be mainly outside the principal cities of each Member Country".

Analysis

For some time CABEI had followed a policy of not financing hotels in capital cities. This was an internal bank policy which applied to all sources of funds. Recently, the Bank completed a study which clearly demonstrated the need for additional hotels in capital cities. The Bank Management presented to the Board of Directors a proposal to change the policy limiting CABEI involvement in the financing of such hotels. This modification was approved by the Board and CABEI now desires to participate in such financing with Loan 010 resources as well as its own. CABEI now has a list of hotel projects totaling $10.0 million. (capital cities?)

That there exists a gap between the supply of and demand for hotel rooms in the capital cities of the region is not really an issue.[a] However, the shortage is uneven and varies from country to country. At the present time there are shortages in Guatemala City, San Jose, and Managua and surpluses in Tegucigalpa and San Salvador. By 1977, after taking into consideration current and planned construction, there will be shortages of hotel rooms in all five capitals.[b] Further, there is strong reason to feel that

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[a] In what follows, "hotel rooms" refer to class A & B facilities.

[b] The CABEI study estimates the following deficits by 1977:

San Jose	1,072	Tegucigalpa	260
Managua	636	San Salvador	62
Guatemala City	467		

these shortages are under-estimated. The estimates for visitors in 1977 were determined by projecting the 1969-1972 growth rates. However, in view of the restructuring in world currencies which has taken place in 1972 and 1973 there has been a dramatic increase in the cost of tourism in non-dollar areas (i.e. Europe). This shift can be expected to produce a rather fundamental change in pre-devaluation tourist patterns. Not only are more Europeans now attracted to dollar areas (which includes the U.S., Mexico and Central America), but also, more North Americans can be expected to visit Central America which is "cheap" compared to their previous haunts on the European Continent. The fact that PanAm is now scheduling its Jumbo Jets into the area, and that two of the major stops in the area (San Jose and Guatemala) are experiencing critical shortages of accommodations bear witness to this shift of tourist patterns. Consequently, the hotel room deficits prepared by CABEI should be considered low.

Another factor to be considered is the rational for both the CABEI & ROCAP restriction on involvement in capital-city hotel projects. The available record indicates two considerations were given the most weight:

a. The desire to have an impact in the rural areas coupled with the desire not to exacerbate crowded urban conditions.

b. Capital city hotels were profitable ventures for which there were private sector sources of financing.

attribution problem.

Rural area impact is a desirable goal and is one of ROCAP's priority concerns. However, how this goal can be accomplished by not building hotels in the capital cities is difficult to explain. Because of existing transportation networks, both land and air, the capital cities are the places where visitors first come. If a visitor cannot find a room in the capital city (e.g. Guatemala City) he cannot be expected to visit the rural tourist attractions (e.g. Tikal). Stated differently, the capital cities are both tourist attractions in themselves and also critical in-transit areas to rural tourist attractions.

That hotel construction will exacerbate already crowded urban conditions is a valid consideration. However, like it or not, the urban areas already contain high proportions of unemployed. If hotel construction and resulting service jobs (maids, doormen, waiters, etc.) can absorb a part of this unemployment, so much the better. CABEI is realizing that the above factors auger for a change in their prior policies.

With respect to the second consideration, the thesis that there are private sector sources of financing for capital city hotels deserves serious examination.

Some general considerations will be discussed and followed by a discussion of alternate sources. Traditional economic wisdom tells us that if demand exceed supply the price of the item in question will rise and evoke an increase in output. On this basis, one could conclude that when the price of hotel rooms reaches a high enough level, somebody will build a hotel. The question then becomes, are we willing to wait for the laws of supply and demand to solve the problem? In view of the following two considerations, one could conclude that leaving the matter to market forces will not provide the optimum outcome in the short run.

Interest rates are now at historical levels. If entrepreneurs think they will go higher, construction will be postponed until the higher price can be offset by higher room rentals. If entrepreneur thinks rates are about to fall they will tend to hold off until cheaper money is available. In either case, no hotels will be built.

Construction has a long lead time. A "go" decision today probably won't produce hotel rooms until two years have elapsed. If hotel rooms were an instantaneous commodity supply and demand would produce the optimum outcome. Since this is not the case and since tourism has such high employment multiplier effects (see DAP), one could argue that actions to accelerate hotel construction are called for.

Notwithstanding the above, one cannot overlook the fact that in Central America generally there is excess bank liquidity. A legitimate question then becomes why can't the commercial banking or already existing credit institutions (i.e. financieras) provide the funds for hotel construction? To answer this question CABEI contacted potential sources of financing to determine the availability of funds for hotel construction. The result of these requests are [redacted] summarized below:

El Salvador: The Central Bank's Fondo de Desarrollo is the principal source for hotel financing anywhere in the country. Funds are available at 6% for 15 years including a 3 year grace period and the Bank can participate up to 90% in the value of construction and equipment. Land and working capital are excluded. However, at this time there is a surplus of rooms in El Salvador.

Guatemala: No funds in the Central Bank are available for this purpose and nor discount operations. The Banco Industrial can make funds available on a short term basis (one year) with 180 day renewals. The rate on July 3, 1973 was 9% plus 1% every 6 months for renewals. Note: This rate was presumably tied to prime and is now estimated to be near 11%. CORFINA, the local financiera is permitted by its by-laws to participate in such activity, but has no funds available for such purposes.

Nicaragua: Three potential sources of financing are available. CNI, the Central Bank and INFONAC. CNI is in serious financial trouble and cannot be regarded as a source of funds. The Central Bank says it does not have funds for hotel construction, but was holding one request for a one million cordobas hotel loan. INFONAC replied that they felt there was a $500,000 demand for funds, but did not indicate if they had funds to meet this need. In any event, at least in the short term, the business prospects for new hotels in Managua are highly uncertain.

<u>Honduras</u>: CABEI checked with six potential sources of funds and determined that none had sources earmarked for the tourist sector nor specifically for hotel construction. There are commercial lines of credit available for projects, including tourism, but the interest rate and repayment period are not such as to meet the needs of the tourist sector.

Although the above shows considerable variation both in need for hotels and availability of financing, one conclusion is clear: In those areas having the greatest shortages (Costa Rica and Guatemala) there is no financing available. However, the CABEI survey did not address some of the contradictions which become apparent when one looks into the whole question of hotel financing. In Costa Rica, for example, there is a private sector financiera (COFISA) which has a <u>$5 million AID loan</u> under which private sector activities, including hotel construction, can be financed. This loan is almost completely disbursed ($4.7 million on 6/30/73) and the prospects for another loan are not encouraging. However, why a hotel could have been financed under this loan and yet such a project proscribed under the CABEI loan is a question that remains unanswered.

Nonsense!

Before leaving the subject of alternate sources of financing, two points merit further discussion: Private Sector <u>participation</u> in CABEI financed projects and possible foreign investment participation.

The above tends to place hotel construction into an either/or proposition. In reality, CABEI is limited to 60% participation. Consequently, CABEI involvement necessarily means that 40% of the project must come from the private sector. What CABEI desires is to complement private sector resources, not replace them. Next, if the prospects for hotels are so good why can't U.S. chains be prompted to provide them (i.e. Hilton, Holiday Inn, etc.)? The reply to this is that, in fact, such chains limit their participation to "management contracts" and rarely, if ever, get involved in the construction or long term financing aspects. Foreign investment offers little realistic hope in solving the short run problem.

Therefore, because of the present need for additional hotels in the capital cities and future requirements and, the lack of alternative sources of financing to meet this need, the request by CABEI that financing of hotels in the capital cities be authorized under the loan is justified.

Such language will provide CABEI with considerable flexibility and permit each case to be judged on its own merits. It would also authorize the use of money for feasibility studies of proposed projects.

<u>Insert - Page 24</u>

<u>COSTA RICA:</u> No funds are available for hotels in general and particularly in the capital. CABEI is the only source for such funds and the Central Bank is in the process of formalizing a line of credit with CABEI for this purpose and is seeking a waiver from CABEI's policy.

F. Exploraciones y Explotaciones Mineras Izabal S.A. (EXMIBAL)

A special section of the evaluation report addresses this particular project because of its importance. It is not a problem area

(financio ?)

In April 1973 CABEI authorized a $6 million loan to Exmibal representing its participation in a $90 million consortium that has been formed to finance the first step of a nickel mining and processing project in Guatemala.

Exmibal is a Guatemalan corporation in which the International Nickel Company of Canada holds an 80% interest and the Hanna Mining Company of the U.S. a 20% interest.

?

ROCAP has determined that there is no AID legal or policy constraint in participating in the financing of such a project. CABEI has been informed that the $6 million CABEI participation was eligible for financing under ~~the AID Loan~~. The financing is timely in that $3 million is expected to be disbursed by June 30, 1974.

AID pays 10%, so LA pays nothing

The AID financing relates to the U.S. Export-Import Bank participation in the consortium. The Export-Import Bank is extending direct loan to Exmibal for 45% of its participation; and will guarantee a loan for an additional 45% from U.S. commercial banks. Exmibal is required to make a cash payment for the remaining 10%. The CABEI loan to Exmibal will be used to finance this payment. It will cover the dollar costs of U.S. equipment, materials and services. At this time CABEI estimates that this payment will use $3.0 million of the $6.0 million CABEI participation. The remaining $3.0 million will be used for the dollar and local currency costs of the Project.

Exmibal agreements with the Government of Guatemala include provision for the GOG to acquire, gradually during the first 10 years of production, 30% of Exmibal's initial share capital. Further, in order to encourage the growth of local capital markets, shares of the company will be sold to Central American investors.

The project will have a significant impact on the Guatemalan economy. First, as a non-traditional export it will contribute to both the diversification of the country's production structure while strengthening Guatemala's balance of payments position. Exmibal's entire production will be exported, with gross receipts from exports estimated to average US$30 million annually.

Second, the project will provide employment in a completely new industry. During the construction stage, some 1,200 persons will be employed. When operations begin over 700 permanent jobs will be created. A program for the education and training of Guatemalan employees, both in Canada and Guatemala, has been developed by Exmibal.

Third, ancillary industries, new commercial enterprises, and better services for the local community will help to improve living conditions for a population expected to grow considerably as a result of the Company's activities in the project area; which is located in a sparsly populated zone near Lake Izabal in western Guatemala.

SCHEDULE 1

CENTRAL AMERICAN BANK FOR ECONOMIC INTEGRATION

Loans approved by CABEI for Export Development & Tourism
as of August 31, 1973
(stated in Dollars)

Purpose	Total No.	Total Amount	Funded from Loan 596-L-010	Funded by CABEI	Private Sector Participation
Export Development	50	26,957,516	7,619,460	19,338,056	112,752,085
Tourism	16	6,393,167	5,120,490	1,272,677	10,130,903
Intermediate Financial Institutions	13	6,475,516	4,632,735	1,842,781	4,317,011
TOTAL	79	39,826,199	17,372,685	22,453,514	127,199,999

SCHEDULE 2

CENTRAL AMERICAN BANK FOR ECONOMIC INTEGRATION

Loans Approved by CABEI

Funded from Loan 596-L-010
As of August 31, 1973

(Stated in dollars)

Purpose	Amounts Approved			Amounts Disbursed		
	Total	US$	Loc. Currency	Total	US$	Loc. Currency
Export Development	7,619,460	5,199,753	2,419,707	2,725,260	1,400,947	1,324,273
Tourism	5,120,490	1,488,262	3,632,228	1,379,261	173,492	1,205,769
Intermediate Financial Institutions	4,632,735	3,326,421	1,306,314	1,308,793	998,576	310,217
TOTAL	17,372,685	10,014,436	7,358,249	5,413,274	2,573,015	2,840,259

SCHEDULE 3

CENTRAL AMERICAN BANK FOR ECONOMIC INTEGRATION

PROJECTED SCHEDULE OF DISBURSEMENTS

(In Thousands of Dollars)

completion

	Total Amount	Disbursed 3/31/73	Estimated Cumulative Disbursements As of 12/31/73	6/30/74	12/31/74	6/30/75	12/31/75	6/30/76	12/31/76	6/30/77
I Loans Approved to Date	18,373 1/	5,413	7,145	10,260	14,472	[illegible]	[illegible]	18,272	[illegible]	[illegible]
Dollars	9,365	2,573	3,470	5,058	7,330	8,335	[illegible]	9,265	[illegible]	[illegible]
Local Currency	9,008	2,840	3,675	5,202	7,142	7,945	[illegible]	9,008	[illegible]	[illegible]
II Completed Application on Hand	2,383			320	467	872	2,103	2,383	2,383	[illegible]
Dollars	1,586			232	262	419	1,316	1,586	[illegible]	[illegible]
Local Currency	797			88	205	454	787	797	797	797
III Proposed Applications on Hand	13,477			248	738	2,157	4,939	7,634	10,634	13,477
Dollars	6,900			150	298	736	1,415	2,442	4,312	[illegible]
Local Currency	6,577			98	440	1,421	3,524	5,186	6,322	6,577
Sub-Total Loans Present Criteria	34,233	5,413	7,145	10,828	15,677	19,697	24,898	28,890	31,790	[illegible]
Dollars	17,851	2,573	3,470	5,440	7,890	9,837	11,601	13,399	[illegible]	[illegible]
Local Currency	16,382	2,340	3,675	5,388	7,737	9,860	13,297	14,991	16,127	[illegible]
IV Working Capital Loans	5,038		2,293	2,627	2,912	3,465	4,292	4,830	[illegible]	[illegible]
Dollars	531		314	408	467	[illegible]	467	518	[illegible]	[illegible]
Local Currency	4,507		1,979	2,219	3,445	[illegible]	2,825	4,312	4,507	[illegible]
V Hotels in Capital Cities	10,825			50	721	[illegible]	3,479	6,344	8,865	[illegible]
Dollars	4,473			50	275	[illegible]	[illegible]	1,652	[illegible]	[illegible]
Local Currency	6,352				446	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
VI [illegible]	6,000			3,000	3,500	[illegible]	5,000	[illegible]	[illegible]	[illegible]
Dollars	5,000			2,500	3,000	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Local Currency	1,000			500	500	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Total - Projected Loans Revised Criteria	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Dollars	[illegible]	2,573	3,754	8,398	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Local Currency	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

1/ [illegible] $1 million approved in October for [illegible] development [illegible].

SCHEDULE 4

CENTRAL AMERICAN BANK FOR ECONOMIC INTEGRATION

ADJUSTED PROJECTED DISBURSEMENTS

LOAN 596-L-010

(In Thousands of Dollars)

		CABEI Applications	Disbursements As Of 6/30/74	6/30/75	6/30/76
I	Loans Approved to Date	18,373	10,000	12,500	15,000
II	Completed Applications	2,383	-0-	1,000	6,000
III	Proposed Applications	13,477			
IV	Working Capital	5,088	2,500	3,500	4,000
V	Hotels in Capital Cities	10,825	-0-	1,000	5,000
VI	EXMIBAL	6,000	2,500	4,000	5,000
	Total	56,146	15,000	22,000	35,000 (30,000)
	Dollars	27,905			(15,000)
	Local Currency	28,214			(15,000)

COMMENTS ON FINANCIAL SCHEDULES

Schedule 1 - This schedule shows the total loans that CABEI had approved for the Export Development and Tourism Program as of August 31, 1973. Of the total amount of $39,826,199 the bank had financed $17,372,685 from ROCAP Loan 596-L-010. The balance of $22,453,514 is to be financed with other funds made available to CABEI.

Schedule 2 - This schedule shows the status of the loans approved by CABEI from ROCAP Loan 596-L-010 as of August 31, 1973. Of the total $17,372,865 loans approved $7,619,460 have been to private borrowers for Export Development Industries, $5,120,490 for Tourism, and $4,632,735 to the CACM country development banks for their approval of sub-loans for export development and tourism.

Of the $17,372,685 approved $10,014,436 is for dollar financing and $7,358,249 for local currency financing.

As of August 31, 1973 $5,413,274 has been disbursed.

Schedule 3 - This schedule is CABEI's projection of total applications for possible financing from ROCAP Loan 596-L-010 and their projection of disbursements.

I Loans Approved to Date - Represents loan applications which the Board of Governors of CABEI have approved for financing. Of these loan applications $18,373,000 is to be financed from Loan 596-L-010. (This includes $1 million loan applications to CACM country development banks which was approved in October).

[redacted].

II Completed Applications on Hand are those applications which are being reviewed by the CABEI staff, projects are well defined and borrower has paid application fee. Board of Governors have not yet approved for financing. A percentage of these may fall out before loans are finally signed.

III Proposed Applications on Hand amounting to $13,477,000 are applications received but not yet reviewed. Some of these will not develop into feasible projects and some may not be eligible for AID financing.

The Sub-Total of Categories I, II and III amounting to $34,233,000 represents all of the approved applications and applications on hand that CABEI has as of August 31, 1973 that are currently eligible for Loan 010 financing. As indicated under Categories II and III above, many of these will never get to the loan agreement stage. Even if all $34,233,000 was approved and signed CABEI's projection of disbursement is that only $19,697,000 would be disbursed by June 30, 1975 and $28,390,000 by June 30, 1976.

IV Working Capital Loans amounting to $5,088,000 represents additional amount of financing which CABEI could do with Loan 596-L-010 funds if the loan agreement is revised to permit the financing of "circulating capital" or "gross working capital". It is estimated that $2,627,000 of the $5,088,000 could be disbursed by June 30, 1974 and $4,830,000 by June 30, 1976.

V Hotels in Capital Cities applications in the amount of $10,825,000 could possibly be financed by Loan 596-L-010 funds if the restriction of financing these hotels is removed. If this type of financing is approved $6,344,000 is estimated to be disbursed by June 30, 1976.

VI - EXMIBAL. If negotiations can be finalized it is estimated that up to $6 million of 596-L-010 funds could be loaned to EXMIBAL primarily for the purchase of equipment in the United States. It is estimated that $3 million of this could be disbursed by June 30, 1974 and the total $6 million by June 30, 1976.

Total - Projected Loans. If the restrictions on Category IV and V type loans are removed and EXMIBAL loan is worked out the possible amount of financing which CABEI could fund from Loan 596-L-010 would increase from $34,233,000 to $56,146,000 and CABEI estimates that as much as $16,505,000 of the loan could be disbursed by June 30, 1974.

Schedule 4 - This schedule is prepared to show in more realistic terms what disbursements can be expected to be applied against Loan 596-L-010 on June 30, 1974, June 30, 1975 and June 30, 1976 if the restrictions for financing gross working capital and hotels in capital cities are removed and the EXMIBAL loan is signed.

Category I. Since $10 million of these approved loans are already signed it is estimated that of the $18,373,000 applications approved $15 million will be disbursed by June 30, 1976.

Category II and III. Since none of the applications have reached the stage that they have been approved they have been considered together in this projection. A large fall out of these applications will take place before final disbursements are made. Disbursements will also be slow since they have not yet reached the stage of approval. $6 million of the $15.8 million applications on hand (or additional applications which may be received) are expected to be disbursed by June 30, 1976.

Category IV. Gross working capital disbursements can be expected to move fairly quickly since this permanent investment in plant operation is required early in expansion of industry or new export enterprises. $4 million of the $5 million should be disbursed by 6/30/76.

Category V. Major disbursements for hotel construction do not occur until late in the construction period. However, considering that some of these funds will be used for feasibility studies and some hotel applications are ready for approval by CABEI if financing is authorized, it is estimated that by June 30, 1976 $5 million could be disbursed under this category.

Category VI. EXMIBAL disbursements for equipment should move quickly; however, it is not yet known if the entire $6 million will be used for equipment purchases. Only $5 million is projected to be disbursed by June 30, 1976.

The total of these projected disbursements is $35 million as of June 30, 1976, compared to the loan of $30 million.

Since there are so many variables and conditions to be considered it appears realistic to factor into the estimate at this time the $5 million additional disbursements.

The estimate of applications and disbursements indicates that dollar and local currency portions of the sub-loans average out about equally. It is therefore projected that the $30 million loan disbursement will be $15 million in dollars and $15 million in local currency.

DRAFT by ROCAP

ACTION MEMORANDUM FOR THE DEPUTY U.S. COORDINATOR

FROM : LA/DR/John R. Breen

SUBJECT: A.I.D. Loan 596-L-010: $30 Million
CABEI: Export Industries and Tourism

PROBLEM: The final disbursement date for subject loan is June 30, 1974 and as of August 31, 1974 only $5.4 million had been disbursed. A joint CABEI/ROCAP review was recently conducted and pinpointed several reasons for the poor disbursement record. These include:

1. Limit on subloans to ICI's, 2. Limitation on local currency financing, 3. Restrictions on working capital subloans by CABEI, 4. Restrictions on hotel financing in the capital cities, 5. Certain administrative and procedural problems within CABEI.

To remove the first four bottlenecks to disbursements will require changes in the loan agreement. These in turn will require an amended Loan Authorization. For its part CABEI has been undertaking since March 1973 some important structural changes within the bank that will streamline its loan review and disbursement procedures, essential for improving service to the private sector.

BACKGROUND AND DISCUSSION:

A. On September 9, 1970, ROCAP signed a $30 million loan with CABEI for financing a major private-sector effort to develop, expand and effectively operate non-traditional export industries and tourism. The export aspect was to focus on diversified agribusiness activities, and the tourism aspect on moderate-sized hotel projects in areas outside the principal cities of each C.A. country, where many of the most promising tourist attractions are located.

Under the A.I.D. loan, $7.5 million is available for tourist and $5 million is available for relending to private and public development banks in each CACM country for financing smaller export and tourism projects which CABEI is not set up to handle, and which can better be administered locally.

B. CABEI has not been able to maintain the level of loan disbursements initially contemplated at the time the loan was signed. As of August 31, 1973, $5.4 million have been disbursed, and the estimated figure as of June 30, 1974 is $10.8 million of the total $30 million. This is attributable to the following:

1. Limitations on Subloans to ICI's

$5 million was set aside for relending to other financial institutions in the region. $4.6 million is committed to date. Two new loans ($500,000 each) will be approved in October, topping present limitation by $600,000. Additional approvals are foreseen in the future. CABEI and ROCAP believe the ICI's have a very important role in the program and will facilitate the drawdown of AID funds. A limitation serves no useful purpose. Also, if additional local currency and working capital financing are made available, as recommended, CABEI loan activity through the ICI's will increase at even a faster rate.

2. Limitation on Local Currency Financing

Increasing the availability of local currency financing from $7.5 million to $15 million would be a major step to improving AID disbursements. CABEI does not have sufficient local currency resources to service its expanding private industry loan demand, which increased by 84% during the past three and a half years, far exceeding projections for this period. With shift in the program to tourism and working capital financing, both high in local costs, the AID Loan must be modified to be more responsive to project needs -- i.e. local currency financing. CABEI will match AID financing on a 1:1 basis.

3. Restrictions on Working Capital Subloans

Working capital is currently available only in dollars and to the ICI's. CABEI's experience shows that financing fixed working capital requirements is just as important to a project as equipment or construction and should be included together in a single financial package. Without sizeable amounts of working capital financing for new and expanding export industries, CABEI experience shows that they will not be able to survive.

4. Restrictions on Hotel Financing in Capital Cities

There is now a shortage of hotel accommodations in Guatemala and Costa Rica - the two hubs of C.A. tourism. These are transient points for rural tourist attractions and the shortage of rooms effectively limits the growth of regional tourism. There are no alternative financial sources for hotel construction. CABEI must compliment private sector efforts by providing the long-term financing needed for hotel construction.

5. Internal CABEI Problems

The Bank initially was not properly organized to give prompt and efficient service to the private sector for a program of this magnitude. However, beginning in March 1973, CABEI set in motion a reorganization program to improve the coordination between departments and to streamline loan approval and disbursement procedures so that the private sector could be more effectively served than in the past. Actions taken to date include:

(i) The centralization of the loan disbursement section within the Operations Department. The latter has primary responsibility in dealing with the private sector, processing loan applications, and now in expanding loan disbursements.

(ii) Three lawyers have been added to the Legal Department. A standard loan agreement format was adopted. A permanent head of the Promotion and Research Department has been named and his staff has been increased by seven.

(iii) The CABEI Board has personally taken a serious interest in moving disbursements and has assigned a committee to review each project in an effort to eliminate delays and expedite disbursements.

(iv) The responsibilities of country representatives have been increased thus allowing them to play a more active role in management decisions and in improving service to the private sector.

(v) The prior review limitation per project on loans to ICI's have been liberalized.

<u>CONCLUSIONS</u>: Disbursements under Loan 010 have been slower than anticipated for two general reasons:

1. Restrictions in the Loan Agreement which effectively limit CABEI's ability to move the funds, and which are no longer meaningful or responsive to the program, and

2. Internal CABEI problems which has caused an excessively long loan approval process.

Appropriate changes in the loan agreement will address the first set of problems, while internal adjustments well under way by CABEI will address the second.

<u>RECOMMENDATIONS</u>: That you sign the attached amendment to the authorization of Loan 010. This will permit the changes needed to accelerate disbursements under the Loan.

DRAFT by ROCAP

DEPARTMENT OF STATE
AGENCY FOR INTERNATIONAL DEVELOPMENT
Washington, D. C. 20523

United States Coordinator
Alliance for Progress

A.I.D. Loan No. 596-L-010

AMENDED LOAN AUTHORIZATION (First Amendment)

Provided from: Alliance for Progress Loan Funds
CABEI: Export Industries and Tourism

Pursuant to the authority vested in the Administrator of the Agency for International Development ("A.I.D.") by the Foreign Assistance Act of 1961, as amended, and the delegations of authority issued thereunder, I hereby authorize the establishment of a loan pursuant to Part I, Chapter 2, Title VI, Alliance for Progress, to the Central American Bank for Economic Integration ("Borrower") of not to exceed thirty million United States dollars ($30,000,000) to provide financing for development of non-traditional export industries in the Central American Common Market ("CACM"), for related export services and for tourism development of which up to $500,000 may be used for feasibility studies and technical assistance and up to $2,500,000 may be used for equity investment ("Project"), this loan to be subject to the following terms and conditions:

1. Interest and Terms of Repayment:

Borrower shall repay the loan to A.I.D. in United States dollars within forty (40) years from the date of the first disbursement under the loan, including a grace period of not to exceed ten (10) years. Borrower shall pay to A.I.D. in United States dollars interest on the disbursed balance of the loan of two (2) percent per annum during the grace period and three (3) percent per annum thereafter.

2. Other Terms and Conditions:

a. Except for marine insurance, goods and services financed under the loan shall have their source and origin in the United States or any independent country of the Western Hemisphere south of the United States except Cuba. Marine insurance financed under the loan shall have its source and origin in the United States or any independent country of the Western Hemisphere south of the United States except Cuba; provided, however, that such insurance may be financed under the loan only if it is obtained on a competitive basis and any claims thereunder are payable in convertible currencies.

b. United States dollars utilized under the loan to finance local currency costs shall be made available pursuant to procedures satisfactory to A.I.D.

c. Prior to the opening of the first Letter of Commitment under the loan, Borrower shall have submitted, in form and substance satisfactory to A.I.D., evidence of:

(i) a plan for the periodic audit of all sub-loans to the private sector; and

(ii) the standards and procedures it will use for making sub-loans.

d. Local currency costs financed under the loan shall not exceed the equivalent of $15,000,000, up to $5,000,000 of which may be used to finance fixed working capital costs.

e. Proceeds of the loan shall be used only for sub-projects which have been objectively and comprehensively appraised by Borrower and found to be economically justified and technically sound and feasible.

f. A.I.D. funds may be used in consortium with any other noncommercial source of funding only with the prior approval of A.I.D.

g. Borrower shall covenant that, within six months of the date of signing of the loan agreement, unless A.I.D. otherwise agrees in writing, in cooperation with SIECA, the Central American Monetary Stabilization Fund and the CACM member country Central Banks, it shall have devised a system for financing CACM exporters' commercial paper, and have taken steps to initiate its implementation.

h. The Borrower in carrying out these exports/ tourism objectives will provide financing in an amount at least equal to the A.I.D. loans and will seek sources of credit for this program from other lenders.

i. The loan shall be subject to such other terms and conditions as A.I.D. may deem advisable.

Deputy U.S. Coordinator
Alliance for Progress

Date

DEPARTMENT OF STATE
AGENCY FOR INTERNATIONAL DEVELOPMENT
Washington, D. C. 20523

United States Coordinator
Alliance for Progress

DELEGATION OF AUTHORITY

Pursuant to the authority delegated to me by the U. S. Coordinator for the Alliance for Progress, I hereby delegate to the Director of the A.I.D. Regional Office for Central American Programs authority to negotiate and execute an amendment to Loan Agreement No. 596-L-010 (CABEI: Export Industries and Tourism), dated September 9, 1970 to effect changes authorized by the Amended Loan Authorization dated October __, 1973.

Deputy U.S. Coordinator
Alliance for Progress

Date

PD-AAI-582-E1

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A.I.D. COMM BR

DATE SENT 2-15-74

FROM - ROCAP/Guatemala

SUBJECT - A.I.D. Loan 596-L-010: CABEI Export Industries and Tourism

REFERENCE -

(a) Evaluation Report - Loan 596-L-010 ROCAP Acting Director-Breen Letter October 5, 1973

734B

(b) CAPTO A-160 - December 10, 1973

8(1)

(c) STATE 022149 - Feb. 2, 1974 Cable

I. INTRODUCTION

Reference (c) was a disappointment. In our judgment, it is reflective of a fundamental difference in the philosophy of ROCAP in its relationship with the Central American Bank for Economic Integration (CABEI) and what the "AID/W Project Committee" apparently believes that relationship should be.

The posture of ROCAP towards CABEI has been to act compassionately, to work cooperatively, and to strengthen the bonds of a maturing partnership. CABEI is no nursling institution. It is twelve years old; has a staff of several hundred persons; a portfolio of several hundred million dollars; has had a far reaching effect on Central American development; and has demonstrated its mettle by surviving a war between two of its members and its maturity by the

DRAFTED BY	OFFICE	PHONE NO.	DATE	APPROVED BY:
DD: RRParker CONT: CFlinner	DD	13	2/14/74	DIR: ITragen

AID AND OTHER CLEARANCES

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AID-5-39 (11-65) (Do not type below this line) many programs it has so successfully administered.

ROCAP does not manage the day to day work of CABEI, nor would such a role be consistent with a mature relationship. We have considered that it was our job to cut the umbilical cord of dependence on ROCAP and AID. We believe that we have succeeded. At the same time we believe we have preserved the rapport and mutual respect which has evolved from twelve years of working together towards common objectives, not the least of which was to help create a viable development bank.

II. PARAGRAPH BY PARAGRAPH ANALYSIS OF STATE 022149 (REF. C)

Paragraph 1. A - STATE 022149

> "DECENTRALIZATION OF 010 FUNDS -- we agree with Mission's recommendation to raise current $5.0 million ceiling for funds channelled through "regional" ICIs to proposed $8.0 million with understanding that CABEI will consult with ROCAP prior to commitment of any funds over initial $5.0 million level. This should provide Mission with opportunity to evaluate institutions involved, particularly those in receipt of direct A.I.D. loans, as well as prevent adverse effects to those loans."

ROCAP Comment:

While we are aware of the "favorable" decision of the Committee on this item, there are a couple of items which should be noted for the record.

1. The original $5 million for intermediate credit institutions was, and this is clear in the history of the loan, actually an "earmarking" of that amount so as to assure that the ICIs got their fair share and should not have been made a limitation in the first place; and

2. ROCAP considers that it is CABEI's responsibility to "evaluate institutions involved" and not ROCAP's and that this sort of responsibility and accountability for decision is the very heart of the mature relationship about which we

commented earlier. With respect to institutions having other A.I.D. loans, we have no objection to consultation with CABEI in such cases and it would be no problem to provide for such consultation in an appropriate Implementation Letter; however, requiring an approval to commit funds in excess of $5 million does not really seem to be a method well calculated to achieve the result desired.

Paragraph 1, B - STATE 022149

"TOURISM -- we agree with Mission recommendation that, based on applications under consideration by CABEI, ceiling on tourism sub-projects be raised from current $7.5 million to proposed $10 million."

eliminate ceiling ?

ROCAP Comment:

ROCAP had the authority to take this action by Implementation Letter, hence AID/W agreement was not really an impediment. However, we are concerned with the implicit rationalization of the Committee for so agreeing, i.e. the "applications under consideration by CABEI". Our view is that the loan was for two purposes, exports and tourism, and that demand should govern use. While one indicator of demand is the number of applications which CABEI has under consideration, this alone does not tell the whole story. When ceilings are raised, this tends to generate applications from those who might otherwise not have applied because they understood that no funds were available. Our problem here is not with the Committee result, but with its apparent need to rationalize its decisions.

Paragraph 1, C - STATE 022149

"WORKING CAPITAL FINANCING -- discussions with CABEI staff in Wash ? resolved differing interpretations of term working capital (W/C). For purposes of determining loan eligibility, following items are included within this definition: costs of technical services, raw materials, semi-processed goods, finished goods and spare parts. W/C items not eligible for A.I.D. Loan financing include: salaries, services (power, light, sewage, etc.), accounts receivable and cash. Based on ROCAP analysis and discussions with CABEI staff, we agree that W/C financing including L/C element) is desirable use of loan funds and in consonance with basic objectives of the loan. We have used following data supplied by ROCAP, however, to arrive at a limitation of use of W/C: (1) CABEI's general rule of thumb is to provide "about 10 percent of each loan to new or expanding export project" to finance W/C (P. 15 of Ref. (a); (2) approximately 40 percent of total investment in projects cited P. 8 Ref. (b) was applied towards W/C costs; (3) schedule 4 of Ref. (a) indicates maximum W/C requirement of $5 million, which presumably would decrease since we are proposing somewhat more restrictive definition of W/C and since CABEI's figures seemingly based on total applications in hand ($56 million); and (4) sub-borrowers must provide at least 40 percent contribution to total sub-project costs (Section 1.02, Loan Agreement), some portion of which will presumably be used for W/C.

"Based on above data we propose, therefore, to remove existing limitation included in Loan Agreement on use of working capital ("only through ICIs and only for dollar costs") and replace it with the following: CABEI may use up to a total of $4 million of the loan to finance eligible working capital expenditures (both dollar and LC) as defined in implementation letters. The A.I.D. loan-funded working capital component shall not exceed 25 percent of any individual sub-loan (15 percent of total investment). CABEI shall finance any additional working capital needs from other than A.I.D. loan funds.

"In arriving at above limitations Project Committee has taken into account both CABEI's request for additional flexibility to commit and disburse the A.I.D. Loan in timely fashion and the spirit of Section 5.02 (A) of Loan Agreement."

ROCAP Comment:

The above commentary raises two questions. First, why restrict the definition of working capital (W/C)? The definition of W/C, an accounting term, is "capital in current use in the operation of a business". It does not include "costs of technical services" but it most certainly, and quite necessarily, does include cash and accounts receivable (A/R). Another necessary characteristic of W/C is its liquidity. It doesn't stay in inventory, A/R or cash form. It flows from one form to the other as required by the normal course of business activity. If the "AID/W Project Committee" recognizes that "W/C financing (including L/C element) is desirable use of loan funds and in consonance with basic objectives of the loan", how can the vital elements of cash and A/R be excluded? To what purpose would they be excluded? Even the paragraph C reference to Section 5.02 (a) substantiates the validity of cash as a W/C element because "the financing of exporters' commercial paper", clearly, is a cash requirement. ROCAP is unable to understand the purpose of restricting W/C financing to inventories only.

Second, what is gained by establishing an arbitrary, inflexible W/C percentage on a sub-loan by sub-loan basis, especially when the Project Committee agrees that this use of loan funds is "desirable" and "in consonance with basic objectives of the loan"? The purpose of this loan is to promote and establish viable businesses in the export and tourism fields. Why substitute an arbitrary, inflexible formula for the valued, proven judgment of the lender, CABEI? Isn't CABEI in a much better position to determine the required financing mix of each unique sub-loan? In some cases, a relatively large percentage of AID funds should be utilized for W/C to increase the potential for success. The AID loan is to CABEI and CABEI should be allowed the flexibility required to make the most successful sub-loans possible. If a sub-borrower fails, what

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Therefore commingle and watch CABEI as a whole!

difference does it make if the sub-loan included 15% or 50% of AID funds? What difference does it make if 10% or 90% was for W/C? What is important to the purpose of the loan and to the prospects for eventual repayment to AID, is how well CABEI uses all its resources in all its activities. CABEI is a mature organization that is successfully meeting its responsibilities. AID should not dilute that responsibility by substituting arbitrary, inflexible rules for CABEI's judgment on a sub-loan by sub-loan basis.

Paragraph 1, D - STATE 022149

> "LOCAL CURRENCY FINANCING -- while we have been apprised of shortage of LC to complement CABEI's existing forex resources and are aware of possible effects of such constraints on commitment of remaining loan funds, we nonetheless believe that proposed change in dollar financing of LC costs may not now be required in light of CABEI's recent activities in private U.S. capital market. At least $14 million and up to $24 million of additional funds, which could be used for such financing, may shortly become available for CABEI's relending; presumably some portion of this will be made available for relending to industrial projects. Furthermore, during recent visit of CABEI's senior management, mention made of likelihood of at least one additional bond offering later this year. This information contrasts with figures cited in source and application of funds statement (Ref. b), whereby CABEI projects availability of only $8.6 million in new funds for this program from additional calls of capital, new lines of credit and sale of bonds over the next two years in addition to normal reflows, income on loans and investments, approved calls of capital, etc. Given these new sources of funding we seriously question the necessity for raising the existing ceiling on LC financing."

ROCAP Comment:

While ROCAP "can live" with the constraints indicated in paragraphs 1A, 1B and 1C, we do not believe that it is in the United States interest to do so. The October 1973 evaluation of this loan was undertaken at the initiative of ROCAP because of concerns expressed about the slow rate of disbursement of the loan.

The joint CABEI/ROCAP analysis revealed problems which ROCAP and CABEI set out to solve compassionately, cooperatively and in a manner calculated to strengthen rather than weaken the bonds of our maturing partnership.

The one fact which came through clearly in this joint effort was the absolute need (emphasis added) for additional local currency. The adjustments proposed in paragraphs 1A, 1B and 1C each are calculated to use more not less local currency since this is the ingredient needed to accomplish our short-term objectives, which are:

1. Sound well-conceived projects; and

2. Expeditious disbursement.

Now, (in 1974) CABEI has raised a substantial amount of cash on the world bond market. For more than four years, ROCAP has been urging CABEI to establish itself in the international money market because it was our considered judgment that CABEI was credit-worthy and needed to augment the concessional loans it previously had obtained, particularly from AID, since the probabilities of AID being able to finance additional infrastructure seemed increasingly remote.

The successful sale of bonds apparently led the Committee to the conclusion that "we seriously question the necessity of raising the existing ceiling on LC financing".

In fairness to the Committee, at the time they reached this conclusion they had not asked for information on the use of the bond proceeds nor had ROCAP officers yet had the opportunity to obtain confirmation directly from the President of CABEI as to the uses to which CABEI intended to dedicate its funds.

1974?

In a meeting on February 5, President Ortez informed the Director and Deputy of ROCAP that almost the entire proceeds of the bond issues were to be used to finance infrastructure activities which (a) the Bank was already committed to finance and (b) which were of a type that ROCAP had previously informed CABEI that A.I.D. could no longer finance. Specific examples cited were the Honduras-Nicaragua electrical connection and short falls in financing for highways now being tendered which are going to cost much more because of inflation generally, and the Nicaraguan earthquake and petroleum cost situation, specifically. This was reported to AID/W in a lengthy cable on February 8.

Paragraph 2 - STATE 022149

> "Before AID/W proceeds with amending subject loan agreement authorization to reflect above mentioned changes, Mission is invited to comment. In addition, please advise Mission plans for extending TCD and TDD. FYI -- discussions with CABEI staff revealed that only $18 million of loan funds firmly committed vs. $26 million reported Mission's November monthly loan status report. Both $6 million Eximbal sub-loan and additional $2 million of other sub-loans apparently at least partially contingent upon proposed changes in the loan documents -- End FYI."

ROCAP Comment:

1. This airgram is the acceptance by ROCAP of the invitation of the A.I.D./W Committee to comment on STATE 022149.

2. ROCAP intends to extend both the TCD and TDD on a timely basis. CABEI had made such request in early fall 1973. ROCAP wished to have benefit of full evaluation of progress of loan and also to be assured that CABEI and ROCAP jointly were doing everything possible to expedite disbursements prior to granting extensions. We hope that the Committee is aware the period from October 5, 1973 until now is "lost-time" insofar as full realization of the October disbursement projections.

Paragraph 3 - STATE 022149

> "AID/W also interested in receiving ROCAP's assessment of following aspects of CABEI's activities under this program: (1) does there appear to be any likelihood CABEI will make equity investments with either A.I.D. loan funds or its own funds in export/tourism industries participating in this program? (2) is it likely that any of $500,000 mentioned in CAP for feasibility studies or technical assistance will be used? (3) CAP mentioned CABEI would devise and implement system for financing exporters's commercial paper. Has there been any progress on this recommended action?"

ROCAP Comment:

1. At present, there is little likelihood of equity investments by CABEI. However, such investments possibly may occur in connection with putting together suitable private sector investment plans for the private development related directly to public tourism infrastructure sub-projects under A.I.D. Loan 596-L-013. By the time disbursement takes place on these activities, hopefully, Loan 010 will be fully disbursed.

2. With respect to both feasibility study and technical assistance money, the probabilities are that only small amounts, if any, will be used.

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3. Section 5.02 of subject loan contained a covenant which was designed to encourage CABEI to devise and implement a system for financing exporters commercial paper. There was one problem with this covenant, the assumption was that there was no system for such financing or that the system which existed was inadequate. On April 19, 1972, CABEI submitted a letter to ROCAP which purported to satisfy the covenant, however, the document proposed the establishment of a special fund with an A.I.D. concessionary loan. The then ROCAP Director (Mr. Sause) and the ADO (Parker) agreed that (a) the banking system was adequate to do the job; and (b) there was no economic justification for such a fund. For one year thereafter, ROCAP officers made inquiries among exporters and were not able to document a single case where the inability to obtain financing for export commercial paper caused a product not to be exported or an otherwise firm sale to fail to take place.

On July 17, 1973, ROCAP determined in writing that the enforcement of the covenant by ROCAP under circumstances where ROCAP knew that the assumption on which the covenant was based was incorrect would be tantamount to subreption and, hence, not in the interest of A.I.D. or the loan.

delete from loan agreement?

As a matter of information, the following is a partial quote from that finding:

> "If there is a lesson to be learned in this case, the lesson is that it is unwise to put covenants in a loan unless we are sure what it is that we expect to accomplish by such covenants. It is also at least questionable whether it is good practice to put into a loan a covenant relating to a much broader subject matter than the loan itself."

It should be noted that the availability of this type of financing bears no relationship to the need for local currency under the loan.

III. SUMMARY REQUEST

A. ROCAP requests that AID/W take the following actions:

1. Amend the Loan Authorization to permit:

   a) A ceiling of $8 million for ICIs;

   b) Authorize loan funds to be used for working capital as defined in this airgram;

   c) Authorize the use of up to $15 million of loan funds for local currency expenditures.

2. Delegate authority to the Director, ROCAP, to negotiate and sign a loan agreement amendment in accordance with the revised authorization amendment.

3. Complete these actions sufficiently before March 5, 1974 so that ROCAP can discuss the situation at the quarterly CABEI/ROCAP review.

B. IN THE ALTERNATIVE, and on the explicit understanding that the actions requested - in effect - substitute the judgment of the "A.I.D./W Project Committee" for that of ROCAP, then ROCAP requests that AID/W take the following minimum actions:

1. Amend the Loan Authorization as indicated in STATE 022149;

2. Also amend the Loan Authorization to increase local currency to $15 million; and

3. Furnish ROCAP with the necessary delegation sufficiently before March 5, 1974 for the reasons stated above (See III, A, 2 & 3, supra).

C. IN ANY EVENT, this matter needs to be settled now. It is the most critical operational problem in the ROCAP loan program.

MELOY