

UNITED STATES INTERNATIONAL DEVELOPMENT COOPERATION AGENCY  
AGENCY FOR INTERNATIONAL DEVELOPMENT  
WASHINGTON, D.C. 20523

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PD-AAA-120

ASSISTANT  
ADMINISTRATOR

15W-34144

MAR 15 1984

ACTION MEMORANDUM FOR THE ADMINISTRATOR

THRU : AA/PPC, Richard Derham (Acting) *R. Derham* 84-3  
FROM : AA/LAC, Marshall D. Brown (Acting) *M. D. Brown*  
SUBJECT: El Salvador Private Sector Support Program I  
(519-0267) - Revised Strategy for Disbursement of ESF  
Assistance Obligated under Amendatory Agreement No. 8

Action: Your approval is required to modify four Conditions Precedent to Disbursement of \$25 million in ESF obligated under Amendatory Agreement No. 8 to the subject Program on January 23, 1984, pursuant to an Action Memorandum signed by you January 3, 1984. In addition, your approval is requested to establish a new Covenant under the same Amendatory Agreement.

Discussion: On January 3, 1984 you authorized the obligation of \$25 million in ESF Grant funds under the subject Program. That memorandum (Tab A) states that the Mission in El Salvador should negotiate the following actions as Conditions Precedent to the Disbursement of those funds:

--The Government of El Salvador (GOES) will present evidence that:

- i) Up to 30 percent of the dollar value of cotton export transactions have been transferred to the parallel market;
- ii) At least the equivalent of \$13.0 million for agrarian reform compensation has been expended in CY1983;
- iii) The export/production ratio required of non-traditional producers for entry into the parallel market has been reduced from 25 percent to 10 percent;
- iv) The Central Reserve Bank (BCR) has completed its study of the impact of transfers of import and export transactions to the parallel market.

In coming to an agreement with the Mission on the foregoing Conditions, Mission representatives indicated and the Bureau

recognized that while the Mission would make all efforts to ensure that the Conditions were accepted by the GOES, their sensitive nature made the chances of successful negotiation less than absolutely certain.

After extended negotiations with the GOES, the Mission believes that substantial progress has been made. Achieving that progress has taken time however, and has caused the Mission to alter slightly its strategy with respect to the disbursement of the \$25 million. As a result of its negotiations with the GOES, the Mission has advised in a number of communications (Tabs B, C, and D) that the Conditions Precedent to Disbursement approved by you earlier this year need to be modified.

The situation regarding each of the Conditions is as follows:

i) Transfer of 30 percent of cotton crop transactions to the parallel market. In accord with its strategy for achieving full unification of the official and parallel market rates by the end of 1984, the Mission has sought to negotiate the transfer of cotton transactions (the second largest foreign exchange earner) to the parallel market. For the 1983 cotton crop that has just been harvested for export in 1984, the BCR has permitted the liquidation in the parallel market of \$10 million, which constitutes 36 percent of the estimated \$27 million in cotton exports for the year. Any further transfers to the parallel market for the 1983/1984 crop year would not affect the size of the crop. While this means that the Condition Precedent as stated has been met, the Mission has indicated that the total value of cotton exports for 1983/1984 is still open to question and subject to change. This means that the parallel market transfer as a percentage of total exports could change and conceivably throw the GOES out of compliance with the Condition Precedent as it is now stated. Rather than risk the chance of this happening, the Mission has asked that the Condition be modified to simply require the transfer of \$10 million to the parallel market rather than a percentage figure.

As part of its negotiating package on the subject of cotton crop transactions, the Mission also discussed crop year 1984/1985 which should begin in April or May. As a result of those discussions, the GOES has agreed to sell \$15 million of that crop in the parallel market and to announce this decision

before planting time in order to have a favorable impact on the size of the crop. Further, the GOES has agreed to allow the national cotton cooperative (of which all growers are members) to liquidate 50 percent of the excess of the 1984/1985 exportable crop (above the level of the 1983/1984 export crop) at the parallel market rate. With these steps, it is projected that export sales liquidated through the parallel market in 1985 will amount to 50 percent of the 1984/1985 crop. In view of this development, the Mission has requested that a Covenant covering the 1984/1985 crop be approved in this action.

ii) Expenditures for agrarian reform compensation. The GOES was not able to fully comply with this Condition by the end of CY 1983. While all bureaucratic steps to effect the disbursement, including issuance of an "order to pay" were taken in 1983, the Ministry of Finance did not have enough cash to effect the deposit at the end of the year. The GOES has now agreed to deposit the colon equivalent of \$13.64 million in the agrarian reform compensation fund prior to the disbursement of the \$25 million. Given the date certain wording of the current Condition, the Mission has requested that it be amended to allow compliance by the GOES in 1984.

iii) Decrease in the export/production ratio from 25 percent to 10 percent. This ratio refers to the proportion that the value of a firm's exports outside of the CACM bears to the total value of its production. A 10 percent ratio would mean that the firm must export outside of the CACM at least 10 percent of the total value of its production in order to be allowed to dispose of its export proceeds at the parallel market rate. The Central Bank has agreed to reduce the minimum ratio from 25 to 15 percent, but is reluctant to go to 10 percent, because this would impose what it views as an unreasonable administrative burden on it; i.e., it would have to review the export and production records of a large number of small firms that export relatively small amounts. The BCR has agreed to evaluate the administrative impact of reducing the requirement from 25 to 10 percent with a view towards a further reduction if this proves feasible. The Mission feels that further reduction of the percentage will help encourage the entrance of more small businesses into the non-traditional export market, and it intends to keep pressing on this subject as part of its overall strategy for exchange market unification. In the interim, however, it has asked for an amendment of the Condition Precedent that would put the GOES in compliance and allow quick disbursement of the \$25 million.

iv) Completion of a study of the impact of transfers of import and export transactions to the parallel market. The Mission expects the BCR to complete and deliver its study on the impact on the cost-of-living of transferring transactions to the parallel market. The BCR is also in the process of estimating the impact of the transfer on the balance of payments and on the central government's fiscal accounts. The Mission expects a preliminary report on these two additional aspects by March 31. In order to allow speedy compliance and disbursement, however, the Mission is asking that the relevant Condition Precedent be made specific to the study related to the impact of parallel market transfers on the cost of living.

As part of its on-going dialogue with the GOES regarding the unification of exchange market rates, the Mission has completed a study of its own on the impact of parallel market transfers on the cost of living as a cross check to that of the BCR. An analysis of the economic impact of a one-time overall devaluation (from 2.5 colones to the dollar to 4.0 colones to the dollar) showed some significant negative effects, though these were far less serious than preliminary results obtained from the BCR's econometric analysis suggested. On the other hand, the economic impact of a partial transfer is expected to be favorable, particularly after the first year. The Mission intends to take the results of its and the BCR's work into account as it progresses with its negotiations during the rest of the year.

The Mission has proposed that the BCR establish a time-phased program for the transfer of all imports and exports to the parallel market by the end of 1984. The Mission expects that the BCR will respond in the near future and come up with a counter proposal lengthening the time period suggested by the Mission for unification together with an action plan for implementing the program. The Bureau will discuss the results of this interchange with the Mission upon submission of their request for the next tranche of FY 1984 ESF.

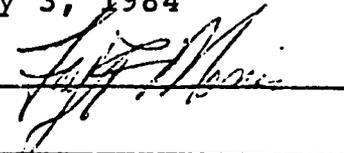
Recommendation:

1. That you approve modifications, as set forth below, to the four Conditions Precedent to Disbursement of the \$25 million approved in the Action Memorandum of January 3, 1984

APPROVE

DISAPPROVE

DATE



3-16-84

2. That you approve a new Condition Precedent to Disbursement of the \$25 million as follows:

The GOES will present in form and substance satisfactory to A.I.D. evidence that the sum of \$10 million of the dollar export value of the 1983/1984 cotton crop has been transferred to the parallel market.

APPROVE *[Signature]*

DISAPPROVE \_\_\_\_\_

DATE 3-16-84

3. That you approve a new Covenant to the Grant Agreement as follows:

With respect to the 1984/85 cotton crop, the Central Reserve Bank covenants to allow cotton exporters to sell in the parallel market \$15 million of the total export proceeds of that crop plus fifty percent of any increase in the exportable amount achieved in 1984/1985 over the level attained by the 1983/1984 crop; and to publicize this decision in advance of the planting season.

APPROVE *[Signature]*

DISAPPROVE \_\_\_\_\_

DATE 3-16-84

4. That you approve a new Condition Precedent to Disbursement of the \$25 million as follows:

The GOES will present in form and substance satisfactory to A.I.D. evidence that the GOES has deposited at least \$13.0 million into the agrarian reform compensation fund to meet compensation costs accrued in CY 1983.

APPROVE *[Signature]*

DISAPPROVE \_\_\_\_\_

DATE 4-11-84

5. That you approve a new Condition Precedent to Disbursement of the \$25 million as follows:

The GOES will present in form and substance satisfactory to A.I.D. evidence that the export/production ratio required of non-traditional products for entry into the parallel market has been reduced from 25 to 15 percent.

APPROVE

*L. J. Morris*

DISAPPROVE

DATE

3-16-84

6. That you approve a new Condition Precedent to Disbursement of the \$25 million as follows:

The GOES will present in form and substance satisfactory to A.I.D. evidence that the BCR has completed its study of the impact on the cost-of-living of lower and middle income groups of transfers of import and export transactions to the parallel market.

APPROVE

*L. J. Morris*

DISAPPROVE

DATE

3-16-84

ATTACHMENTS

- TAB A - Action Memorandum for the Administrator signed 01/03/84
- TAB B - San Salvador 00675
- TAB C - San Salvador 01367
- TAB D - San Salvador 02081

Clearances:

PPC/PDPR:EH *Wander* Date 3/15/84

GC:HFry *Wander* Date 3/16/84

LAC/DR:LKlassen:aep:(0084B):03/12/84:ext. 29152