PD-AAT-947 46246

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

EL SALVADOR

PROJECT PAPER

AGRARIAN REFORM FINANCING

AID/LAC/P-292

Project Number: 519-0307

AGENCY FOR INTERNATIONAL DEVELOPMENT

PROJECT DATA SHEET

1. TRANSACTION CODE: A (A = Add, C = Change, D = Delete)

Amendment Number: ______

DOCUMENT CODE: 3

2. COUNTRY/ENTITY: EL SALVADOR

3. PROJECT NUMBER: 519-0307

4. BUREAU/OFFICE: LAC

5. PROJECT TITLE (maximum 40 characters): AGRARIAN REFORM FINANCING

6. PROJECT ASSISTANCE COMPLETION DATE (PACD): MM 06 DD 30 YY 91

7. ESTIMATED DATE OF OBLIGATION (Under 'B:' below, enter 1, 2, 3, or 4)

A. Initial FY 86 B. Quarter 3 C. Final FY 90

8. COSTS ($000 OR EQUIVALENT $1 =)

A. FUNDING SOURCE		FIRST FY B. FX	FIRST FY C. L/C	FIRST FY D. Total	LIFE OF PROJECT E. FX	LIFE OF PROJECT F. L/C	LIFE OF PROJECT G. Total
AID Appropriated Total		100	6,400	6,500	3,625	46,375	50,000
(Grant)		(100)	(6,400)	(6,500)	(3,625)	(46,375)	(50,000)
(Loan)		( )	( )	( )	( )	( )	( )
Other U.S.	1.						
	2.						
Host Country			2,300	2,300		17,000	17,000
Other Donor(s)							
TOTALS		100	8,700	8,800	3,625	63,375	67,000

9. SCHEDULE OF AID FUNDING ($000)

A. APPROPRIATION	B. PRIMARY PURPOSE CODE	C. PRIMARY TECH CODE 1. Grant	C. PRIMARY TECH CODE 2. Loan	D. OBLIGATIONS TO DATE 1. Grant	D. OBLIGATIONS TO DATE 2. Loan	E. AMOUNT APPROVED THIS ACTION 1. Grant	E. AMOUNT APPROVED THIS ACTION 2. Loan	F. LIFE OF PROJECT 1. Grant	F. LIFE OF PROJECT 2. Loan
(1) ARDN	230	030				6,500		50,000	
(2)									
(3)									
(4)									
TOTALS						6,500		50,000	

10. SECONDARY TECHNICAL CODES (maximum 6 codes of 3 positions each)

055 | 011 | 031

11. SECONDARY PURPOSE CODE

12. SPECIAL CONCERNS CODES (maximum 7 codes of 4 positions each)

A. Code	BR						
B. Amount	50,000						

13. PROJECT PURPOSE (maximum 480 characters)

To increase the availability and productive use of credit in the agrarian reform sector.

14. SCHEDULED EVALUATIONS

Interim MM 01 YY 88 | MM YY | Final MM 05 YY 91

15. SOURCE/ORIGIN OF GOODS AND SERVICES

[X] 000 [ ] 941 [X] Local [ ] Other (Specify) ______

16. AMENDMENTS/NATURE OF CHANGE PROPOSED (This is page 1 of a ______ page PP Amendment.)

17. APPROVED BY

Signature: B. Schoute

Title: acting Director

Date Signed: MM 07 DD 15 YY 86

18. DATE DOCUMENT RECEIVED IN AID/W, OR FOR AID/W DOCUMENTS, DATE OF DISTRIBUTION

MM 09 DD 09 YY 86

AID 1330-4 (8-79)

ANNEXES

* Bulk Annex

ABANSA		Asociación de Banqueros Salvadoreña (Association of Salvadoran Bankers)
A.I.D.		Agencia Internacional para el Dearrollo (Agency for International Development)
BCR	-	Banco Central de Reserva (Central Reserve Bank)
BFA	-	Banco de Fomento Agropecuario (Agricultural Development Bank)
BH		Banco Hipotecario (Mortgage Bank)
CENREN	-	Centro de Recursos Naturales (Center for Natural Resources)
CENTA	-	Centro Nacional de Tecnología Agropecuaria (National Center for Agricultural Technology)
CU		Unidad Coordinadora (del BCR) (Coordination Unit)
DIECRA	-	Desarrollo Integral de Empresas de la Reforma Agraria (Integrated Development of Agrarian Reform Enterprises)
EOPS		Finalización del Estado del Proyecto (End of Project Status)
FEDECCREDITO		Federación de Cajas de Crédito (Credit Union Federation)
FEDECACES		Federación de Asociaciones Cooperativas de Ahorro y Crédito de El Salvador (Savings and Loans Cooperative Associations Federation of El Salvador)
FESACORA		Federación Salvadoreña de Cooperativas de la Reforma Agraria (National Federation of Agrarian Reform Cooperatives)
FINATA	-	Financiera Nacional de Tierras Agrícolas (National Finance Office for Phase III Agrarian Reform Lands)

GOES	-	Gobierno de El Salvador (Government of El Salvador)
IDB		Banco Interamericano de Desarrollo (Inter-American Development Bank)
INCAFE		Instituto Nacional del Café (National Coffee Institute)
ISTA		Instituto Salvadoreño de Transformación Agraria (Salvadoran Institute for Agrarian Transformation)
MAG	-	Ministerio de Agricultura y Ganadería (Ministry of Agriculture and Livestock)
PACD		Fecha de Terminación de Asistencia al Proyecto (Project Assistance Completion Date)
PERA	-	Planificación y Evaluacionón de la Reforma Agraria (Planning and Evaluation of the Agrarian Reform)
PFI		Instituciones Financieras Participantes (Participating Financial Institutions)
RFTP		Solicitud para Propuesta Técnica (Request for Technical Proposal)
USG		Gobierno de los Estados UnidosCENCAP (Government of the United States)

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AGENCY FOR INTERNATIONAL DEVELOPMENT
UNITED STATES OF AMERICA A. I. D. MISSION
TO EL SALVADOR
C/O AMERICAN EMBASSY.
SAN SALVADOR, EL SALVADOR, C. A.

PROJECT AUTHORIZATION

Name of Country/Entity:	El Salvador The Government of El Salvador (GOES) Central Bank of Reserve (BCR)
Name of Project:	Agrarian Reform Financing Project
Number of Project:	519-0307

1. Pursuant to Section 103 of the Foreign Assistance Act of 1961, as amended, I hereby authorize the Agrarian Reform Financing Project, encompassing a grant to the Government of El Salvador (GOES), involving planned obligations not to exceed Fifty Million United States Dollars in development assistance grant funds over a five year period, subject to the availability of funds in accordance with the A.I.D. OYB/allotment process. The planned Life of Project is 60 months from the date of the signing of the Project Grant Agreement. The implementing entity for project activities is the Central Reserve Bank (BCR), which is the intermediate credit institution channeling project assistance to ultimate beneficiaries.

2. The project consists of the following elements: a rediscount line of credit for production and investment loans to the reform sector; a training program for agricultural loan officers of the BCR and its subsidiaries, the participating financial institutions (PFIs); a series of policy studies and seminars; and a pilot rural savings mobilization program, administrative support and evaluation.

3. The Project Agreement, which may be negotiated and executed by the officer to whom such authority is delegated in accordance with A.I.D. regulations and Delegations of Authority, shall be subject to the following terms and conditions, together with such terms and conditions as A.I.D. may deem appropriate.

A. Source and Origin of Procurement of Commodities and Other Services

Commodities and services financed by A.I.D. under the Project shall have their source and origin in the United States or in member countries of the Central American Common Market. However, in order to permit the utilization of third country (non-Central American) training and technical assistance resources, procurement of these services shall be permitted from A.I.D. Geographic Code 941 up to a total value of One Million United States Dollars.

B. Conditions Precedent to Disbursement

Except as A.I.D. may otherwise agree in writing:

(1) Prior to initial disbursement of Project credit funds, the GOES will, except as the Parties may otherwise agree in writing, furnish to A.I.D. in form and substance satisfactory to A.I.D.:

(a) A statement of the name of the person(s) in the BCR empowered to act for the BCR as the GOES implementing entity with reference to the Project Agreement and of any additional representatives, along with a specimen signature of such person(s);

(b) Evidence that the BCR has established a separate rediscount credit line for channeling project credit funds to the participating financial institutions;

(c) Evidence that the Grant Agreement has been duly ratified;

(d) Evidence that the BCR has informed PFIs of the availability of the new credit line and all terms and conditions for use of the credit line, including interest rates, terms, loan conditions and administrative procedures.

(2) Prior to any disbursement of Project funds for training activities, the GOES will, except as the Parties may otherwise agree in writing, furnish to A.I.D. in form and substance satisfactory to A.I.D.:

(a) A detailed training plan outlining the amounts and the schedule of long-term and short-term training activities during the life of the project.

C. Covenants

(1) The Cooperating Country shall covenant that, unless A.I.D. otherwise agrees in writing:

(a) The GOES through the BCR will verify on an ongoing basis, and report to A.I.D. at least annually, that the amount of funds made available through the Project's rediscount line will be in addition to the amount of funds currently being made available by the BCR to the reform sector. Calendar year 1985 will be used as the base year.

(b) Prior to receiving funds from the Project's rediscount line the Agricultural Development Bank (BFA) will disburse all funds in the Integral Credit Line financed under A.I.D. Project 519-0263 and be in full compliance with all outstanding covenants from Project 519-0263.

(c) A.I.D. will be able to brief and debrief contractors, participants and invitational travelers financed under the Agreement and will be furnished copies of reports produced by such persons.

(d) The BCR will assure the integrity and proper accountability for the rediscount line funds during the life of the Project. In the event of a default by a PFI, the BCR will cover the loss so as to protect the integrity of the credit fund.

D. Waivers

U.S. source/origin requirements are hereby waived in order to permit the procurement of up to One Million Dollars for training and technical assistance services from A.I.D. Geographic Code 941 sources.

Bastiaan B. Schouten
Robin L. Gómez
Director

7/15/86
Date

Drafted by: JCloutier, PRJ:mz
Cleared by: DBoyd, PRJ
KEllis, RDD
JDavison, CONT 7/11/86
BSchouten, DDIR BS

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7/7/86

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I. SUMMARY AND RECOMMENDATIONS

A. Recommendations

The USAID Project Development Committee recommends authorization of a $50 million Development Assistance Grant for the Agrarian Reform Sector Financing Project (519-0307). State 50374 provides authority for review and approval of this project by USAID/El Salvador and State 159054 approves the use of grant funding for the project.

B. Grantee

The Government of El Salvador (GOES) will be the Grantee and will make a contribution to the Central Reserve Bank (BCR) of El Salvador to establish a rediscount line of credit for reformed sector borrowers. The major implementing agency will be the Central Reserve Bank of El Salvador (BCR), which is the intermediate credit institution in the Project.

C. Project Summary

The Project is intended to respond to the immediate needs for additional credit to the reformed sector while working to expand the role of the commercial banking system in lending to the reformed sector. A large demand for production and investment credit in the reform sector is currently not being met and a disproportionate amount of credit to the sector is channelled through the Agricultural Development Bank. By improving the capability of Participating Financial Institutions (PFI) to meet the credit needs of the sector and by creating financial incentives for them to do so, it is expected that the Project will increase the availability and productive use of credit to the reform sector.

The Project contains four elements: a rediscount line of credit for production and investment loans to the reform sector; a training program for agricultural loan officers of the BCR and the PFIs; a series of policy studies and seminars; and a pilot rural savings mobilization program.

The rediscount line of credit will be available on a competitive, non-preferential basis to the PFIs for production or investment loans to the reform sector. The terms of the rediscount line will be structured to allocate additional points of the "spread" (the difference between the rediscount rate and the interest charged the final borrower) to the PFIs to cover the additional costs and risk of medium-term investment loans and small loans to the Phase III beneficiaries. A long-term technical advisor will be assigned to the BCR to assist in the administration and monitoring of the fund and to improve credit administration procedures in the PFIs.

The training component will include short and medium term in-country training as well as participant training in other countries on both a long and short term basis. The training will be focused on strengthening agricultural credit delivery in the banking system. A long-term advisor based in the BCR will work with all participating institutions to develop an integrated, comprehensive agricultural credit training program.

The policy studies and seminars component is intended to clarify major policy issues affecting the agricultural sector, and the reform sector in particular, and bring them to the attention of policy level managers in the GOES. Short term technical assistance will be financed by the Project to conduct the studies and seminars.

A pilot rural savings mobilization program will explore the feasibility of expanding the financial institutions efforts to attract demand and time deposits in rural areas. The pilot program will be implemented in four of BFA's rural branches.

The Project administration will be located in the Credit Agent Program Coordinating Unit in the BCR. This unit will be responsible for coordination and direction of training activities, use of technical assistance, identification and execution of policy studies, organization of seminars, and project monitoring.

The summary financial plan is as follows:

	A.I.D. Grant (US$ 000)	GOES	Total
1. Rediscount Credit Line	46,000	14,000	60,000
2. Administration of Credit	750	2,050	2,800
3. Training	1,640	250	1,890
4. Studies	300	50	350
5. Savings Mobilization Pilot Project	225	215	440
6. Evaluation and Financial Review	200		200
7. A.I.D. Project Administration	385		385
8. Contingency/Inflation	500	435	935
TOTAL PROJECT	50,000	17,000	67,000

D. Conditions and Covenants

Except as A.I.D. may otherwise agree in writing:

(1) Prior to initial disbursement of Project credit funds, the GOES will, except as the Parties may otherwise agree in writing, furnish to A.I.D. in form and substance satisfactory to A.I.D.:

(a) A statement of the name of the person(s) in the BCR empowered to act for the BCR as the GOES implementing entity with reference to the Project Agreement, along with a specimen signature of such person(s);

(b) Evidence that the BCR has established a separate rediscount credit line for channeling project credit funds to the participating financial institutions;

(c) Evidence that the Grant Agreement has been duly ratified;

(d) Evidence that the BCR has informed PFIs of the availability of the new credit line and should provide for A.I.D. approval all terms and conditions for use of the credit line, including interest rates, terms, loan conditions and administrative procedures.

(2) Prior to initial disbursement of Project funds for training activities, the GOES will, except as the Parties may otherwise agree in writing, furnish to A.I.D. in form and substance satisfactory to A.I.D.:

(a) A detailed training plan outlining the amounts and the schedule of long-term and short-term training activities during the life of the project.

Covenants

(1) The Cooperating Country shall covenant that, unless A.I.D. otherwise agrees in writing:

(a) The GOES through the BCR will verify on an ongoing basis, and report to A.I.D. at least annually, that the amount of funds made available through the Project's rediscount line will be in addition to the amount of funds currently being made available by the BCR to the reform sector. Calendar year 1985 will be used as the base year.

(b) Prior to receiving funds from the Project's rediscount line the Agricultural Development Bank (BFA) will disburse all funds in the Integral Credit Line financed under A.I.D. Project 519-0263 and be in full compliance with all outstanding covenants from Project 519-0263.

(c) A.I.D. will be able to brief and debrief contractors, participants and invitational travelers financed under the Agreement and will be furnished copies of reports produced by such persons.

(d) In the event of a default by a PFI, the BCR will cover the loss so as to protect the integrity of the credit fund.

E. The USAID Project Development Committee was composed of the following officers:

Ken Ellis, Rural Development Officer
John Cloutier, Office of Projects
William Naylor, Financial Analyst
Luis Arreaga, Economist
José Isaac Torrico, Project Manager

The following consultants contributed to the design:

Harris Jafri, Institutional Analyst
John Gillies, Design Specialist
David Eling, Financial Analyst
Mike Hanrahan, Economist
David Hansen, Sociologist

The Project Review Committee is composed of the following:

Robin Gómez, Director
Bastiaan Schouten, Deputy Director
Ronald Witherell, Associate Mission Director for Operations
Donald Boyd, Chief, Office of Projects
Roberto León de Vivero, Program Officer
John Davison, Controller
Robert Anderson, Economist

II. PROJECT BACKGROUND AND RATIONALE

A. Macroeconomic Background

After a thirty year period of sustained economic growth with low inflation rates and without major fiscal deficits or balance of payments disturbances, the economy of El Salvador entered a turbulent phase in 1979. Adverse external factors, aggravated by guerrilla activity and its sequel of disruption of the productive apparatus and erosion of private sector confidence, led to a prolonged decline in economic activity, high inflation and large budget and balance of payments deficits. With the adoption of a stabilization program in 1982, the rate of inflation slowed, the budget deficit was curtailed, and there was an incipient recovery of confidence. The economic decline was arrested by 1983 and a modest growth of real GDP, the first in six years, was registered in 1984 and 1985. However, the economic recovery remains fragile, and the improvement in the fiscal and balance of payments performance after 1982 was due, in large measure, to heavy infusions of U.S. aid, mainly in the form of grants.

During 1985, there was a deterioration in the fiscal situation, with increased domestic financing of the budget deficit. There was a steady buildup of demand pressures and increased speculation against the exchange rate, leading to a widening spread between the street exchange rate and the parallel market rate. The Government countered with several exchange liberalization measures in 1985, transferring an increasing proportion of exports and some imports to the parallel market and moving the parallel market rate closer to the street rate. However, these measures failed to stem the tide of speculation. In January 1986, taking advantage of the favorable international environment (rising coffee prices, falling oil prices), the GOES launched a rather comprehensive stabilization program. The program consisted of: unification of the official and the parallel market rates (but at a level substantially below the street rate); some new revenue measures (temporary windfall tax on coffee exports; raising domestic petroleum price above the international price, in order to yield a differential for the Government, some luxury taxes); measures of monetary restraint, including a general increase of some 2% in interest rates and an increase in legal revenue requirements from 20% to 25%; increase in the minimum wage and some public sector wages; and subsidies and price controls. As expected, the initial inflationary impact of the adjustment program has been significant and a marked increase in discontent and labor conflict has followed. The fiscal program remains weak, with a large budget deficit expected for 1986. While the spread between the unified rate and the parallel rate has narrowed, inflationary expectations remain strong. It is doubtful that the price performance in the second semester will be on target without additional measures of fiscal-monetary restraint. In the present scenario, it seems unlikely that a positive real interest rate will prevail for 1986 as a whole. There are no easy or short-run solutions to the problems resulting from the severity of domestic and external resource constraints, as long as the civil conflict continues. It is, therefore, of paramount importance that available resources be used efficiently and, in particular, that agricultural credit be provided effectively.

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B. Agrarian Reform Background

The Basic Law of Agrarian Reform, promulgated by the Government of El Salvador (GOES) on March 5, 1980, began the ambitious process of changing traditional social, economic, and land tenure patterns across the country in an effort to create greater income equity, more job opportunities, and increased and diversified agricultural production. This program has radically changed the structure of Salvadoran agriculture and has been the focal point of economic and political change in the nation for the past six years.

The agrarian reform program was structured to be implemented in three distinct phases, each of which shared certain common features--rights of new owners, government compensation to former owners, and new owner payments to amortize government debts incurred in the land purchase (agrarian debt.) Each phase differed in the type of property and individual affected.

Under Phase I of the agrarian reform the Salvadoran Institute of Agrarian Reform (ISTA) has acquired, by expropriation and voluntary sales, 469 properties incorporating a total of 220,000 hectares (15 percent of total farm land in the country). These properties have been reorganized into 317 cooperatives, or "productive units", consisting of 31,500 members who had previously been associated with the properties as sharecroppers, resident laborers, or renters. The total number of people affected is approximately 188,000, assuming 6 persons per household, which represents about 8.5% of the rural population. Of the total number of cooperatives, 145 had received titles as of March 1986 and about 57 which were located in conflict areas were either abandoned or were marginally operating.

Phase II of the reform program affects properties between 245 and 500 hectares in size. Landowners with properties which could be affected under this phase have until December 1986 to dispose of the excess land or face possible expropriation without prior compensation. Approximately 11,000 hectares of potential Phase II land have been acquired through voluntary sales by ISTA and another 13,000 hectares have been claimed by the Phase III beneficiaries. The timetable of possible implementation for Phase II will depend to a great extent on the ability of an already overtaxed government apparatus to tackle the additional financial, administrative and political burdens of this phase and will require the passage of implementation legislation by the National Assembly. There remain about 389 landholdings that would be affected by Phase II.

Phase III of the agrarian reform, which commenced in March 1981, provided rights for up to seven hectares to tenant farmers and sharecroppers, on the principle that those who work the land should own it. By the June 1984 filing deadline, 79,142 applications had been filed. As of March, 1986 about 62,160 parcels had been claimed by about 51,800 rural farm families, or approximately 310,800 beneficiaries assuming six persons per household.

Unlike the Phase I organization of beneficiaries into cooperatively operated farms, Phase III beneficiaries are given individual titles to their land. The number, small size, and dispersion of the Phase III farmers have effectively limited the ability of the GOES agencies to provide credit and technical assistance services to the beneficiaries.

Not surprisingly, considering the amount and quality of land affected, the reform sector is a major contributor to national production of basic grains and export crops--14% of the coffee, 40% of the cotton, 37% of the sugar cane and 21% of the rice in the 1983/84 crop year. Upon completion of all three phases of the agrarian reform program, it is expected that about 25% of the rural poor population would be beneficiaries and approximately 25% of the farm land would be affected. (For greater detail about the agrarian reform, see "Agrarian Reform in El Salvador: Process and Progress", Dr. Michael Wise, USAID El Salvador, July 1985.)

In May 1986, the Government of El Salvador announced a restructuring of the agrarian debt which greatly lessoned the debt burden on reform beneficiaries. The restructuring included the enactment of the 6% interest rate over a 50 year period with a five year grace period and restructured the restricted accounts.

C. Assistance to the Agrarian Reform Sector

Success of the agrarian reform program is a high priority for both the GOES and the U.S. Government. In the past six years, El Salvador has received substantial foreign assistance from the U.S. to implement the program.

1. Technical Assistance

The Phase I cooperatives have been given priority assistance by several government and non-government agencies. In addition to its responsibility for land acquisition and cooperative establishment, ISTA was also responsible for providing technical and material assistance to the cooperatives in the early years, including a period of co-management of the cooperatives. Other support services include the National Center for Agricultural Technology (CENTA), which provides research and on-farm technical assistance; the Salvadoran Federation of Agrarian Reform Cooperatives (FESACORA), which provides technical and financial assistance; the National Center for Agricultural Training (CENCAP), which provides training to extension agents and cooperative members; and a special agency to plan the cooperative development, DIECRA, prepared several studies on problems faced by the cooperatives, including resource use and debt service. Other on-going Ministry of Agriculture (MAG) programs also provide assistance to the cooperatives and Phase III beneficiaries.

Under the Agrarian Reform Sector Support Project (519-0265), over $ 50.0 million in A.I.D. loan and grant funds are being used to promote agrarian reform, including technical assistance to ISTA, FINATA and MAG for cooperative management and accounting assistance, training of cooperative members, assistance in accelerating the land transfer process, and institutional development for the implementing agencies. The current efforts under the

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Agrarian Reform Sector Support project have been extended through 1987 and focus on improvement of management and accounting services available to Phase I cooperatives, completion of titling, and the promotion of private sector opportunities in the reform sector.

2. Credit

Special attention has also been given to providing credit to the Phase I cooperatives. Immediately after Phase I expropriation in 1980, 118 million colones of short-term "emergency" credits were extended to the cooperatives as start-up funds in a BCR line of credit extended through the BFA. This so-called "Cartera BFA/ISTA" was disbursed with little concern about accounting and control. After partial repayment by the cooperatives, the outstanding balance was consolidated in a bond issue which ISTA used to repay the BFA. One of the components of the recent restructuring of the agrarian debt was to freeze the interest on this emergency credit and delay payment of the principal until such time as the cooperatives were current on their land debt.

Credit lines to the reform sector have been supported by A.I.D. project funds, IDB loans, and GOES resources. The A.I.D. Agrarian Reform Credit project (519-0263), authorized in 1980, has provided about $80 million through the BFA for credit to agrarian reform beneficiaries. Technical assistance was provided to the BFA to improve the bank's performance in credit administration, loan supervision, accounting and availability of financial information, development of farm plans for the cooperatives, loan processing, loan recovery, and other operational areas. The mid-term evaluation concluded that the Project has been a qualified success in contributing to the flow of credit but that institutional development of the BFA has fallen short of expectations. The BFA has a much higher rate of default and refinancing than do the mixed banks, although this is at least partially attributable to the relatively large number of financially weak cooperatives assigned to it.

Despite the preferential treatment and the substantial external resources provided, the amount of credit available to the reform sector has dropped since 1980 in both real and relative terms. In 1980, agricultural credit flows to Phase I cooperatives was 166 million colones, or 17% of the total agricultural credit for that year. Although the nominal amount of credit had risen to 224 million colones by 1984, the reform sector share represented less than 13% of the total. In real terms, adjusted for inflation, this constituted a 16% reduction in available credit to the sector. Virtually all of the credit has been for production loans.

In August 1980, the responsibility for meeting the credit needs of the cooperatives was divided among nine mixed banks, the Mortgage Bank, two national credit institutions, and the Agricultural Development Bank (BFA). In the past several years, a number of the cooperatives in poorer financial condition have been reassigned from the commercial banks to the BFA. The cooperatives which are still assigned to the commercial banks are generally better managed and more creditworthy.

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The most important lenders to the agricultural sector as a whole are the nine commercial banks (also called the bancas mixtas) with 48% of the annual credit flow, the Mortgage Bank (BH) with 23%, and the BFA with 19%. The commercial banks as a group are also the largest lender to the reform sector, providing 56% of the total credit in 1984. However, the largest banks providing credit to the reform sector are BFA (26%) and the Mortgage Bank (13%). Most of the commercial banks have very limited contact with the Phase III beneficiaries: BFA provides 95% of the credit from the formal banking system going to that subgroup. It is also noteworthy that although the BH and the commercial banks use their own funds (from capitalization, savings, and deposits) for most other loans, they rely almost entirely on BCR rediscount lines for agricultural loans. Since most of the BCR rediscount lines are for production credit for specific crops, the availability of medium term and long term investment loans is limited. The commercial banks contribute a majority of the credit available to the reform sector largely as a result of intense government pressure.

The credit agent program, begun in 1985, is currently financed through the BCR with PL480 local currency generations and is therefore not yet a fully integral part of the commercial banks. Because maximum interest rates are established by the Monetary Board, lenders are not able to increase interest rates to compensate for increased costs or higher risk. Not surprisingly, the commercial lenders have reacted rationally to these incentives and have channeled credit almost exclusively to the most creditworthy borrowers and for purposes which entail the lowest amount of risk and lowest transactions costs. This program placed 20 credit agents in the commercial banks and three supervisors in the BCR. Since the program began, the credit agents have identified 365 investment projects in the cooperatives and the BCR loan analysis unit has approved 49 loans, for a total loan portfolio of ¢21.7 million.

D. Performance of the Agrarian Reform Sector

Caught in the vortex of civil unrest, agrarian and other structural reform, the collapse of world markets for the important export crops, and disincentives caused by marketing and pricing policies, the performance of the Salvadoran agricultural sector since 1980 has not been particularly good. Overall agricultural production in both the reform sector and the nation as a whole has dropped. From the five year pre-reform average, national export crop production has decreased 21% led by a 66% decrease in cotton. National basic grain production has increased by about 10% but in the Phase I reform sector, basic grain produced collectively on the cooperatives has fallen over 60%. Phase I export crop production, shored up by earmarked credit and a 40% increase in hectares planted in other diversified crops, has increased 9% over the five crop years from 1980/81 to 1984/85. Despite the assistance provided to the Phase I beneficiaries and the fact that they inherited some of the best lands in the country, the economic performance of the cooperatives compares unfavorably with that of the properties in the pre-reform period. While under

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the former owners the properties returned a substantial profit after debt service, the total annual income of almost 75% of the cooperatives is barely sufficient to meet the service payments on the current bank debt alone. If the debt burden of the Agrarian Debt and the Cartera BFA/ISTA were included, less than 5% of the cooperatives would show a profit. A recent restructuring of the agrarian debt, which lowered the interest rate and lengthened the repayment period, has helped to alleviate this problem.

Although the patterns of production on the cooperatives remain largely unchanged from the pre-reform period, the number of hectares under cultivation on Phase I cooperatives has decreased dramatically for all crops except sugar cane. The yields obtained by the cooperatives are equal to or better than the national average for most crops, but this is to be expected given the quality of the land. The lower levels of production and profitability are caused not only by the global problems of civil war, weak commodity prices, and macroeconomic changes, but also by problems related directly to the agrarian reform structure itself. Among these problems are titling and adjudication, beneficiary rights, debt burden, and management.

Difficulties in defining property, assigning properties to cooperatives, property valuation and owner reimbursement, and administrative adjudication and titling procedures have significantly delayed the titling process. These delays have increased the level of uncertainty in the cooperatives, restricted medium-term planning, and inhibited the evolution toward self-management.

Members of the Phase I cooperatives have certain rights derived from their membership, but they do not have any right to ownership of the cooperative land nor do they have any explicit legal right to the cooperatives' assets or profits. The vagueness surrounding beneficiary rights, the low wages paid, and seasonal unemployment make the beneficiaries appear to be more like seasonal workers than co-owners of the enterprise. The failure of the cooperative system, as currently structured, to give the members a direct stake in the business has resulted in a lack of commitment and motivation on the part of the members, which acts as a disincentive to productivity. The debt burden of the cooperatives includes the Agrarian Debt, the Cartera BFA/ISTA, and bank credit. The implicit assumption of the agrarian reform was that the cooperatives would remain productive and profitable enough under the new ownership to compensate the GOES for restitution payments to the former owners, cover ISTA's operating costs, and pay off production loans. With the benefit of hindsight, it is clear that the complexity of the process, administrative difficulties, management weaknesses in the cooperatives, civil war, and macroeconomic disruptions rendered such an optimistic outcome extremely unlikely and that some degree of subsidy would have been required.

However, on the basis of this assumption virtually all financial assistance to the cooperatives has been in the form of debt--the Agrarian Debt to pay the former owners, initial operating capital (the Cartera BFA/ISTA), and annual production loans. The structural debt of the Agrarian Debt and the Cartera BFA/ISTA is added to each year by production loans, many of which have to be refinanced for a variety of reasons (poor management, weak agricultural markets, etc.) The importance of this overhanging debt is that even given improved management and more favorable agricultural markets, the debt is a continuous drain on the cooperatives' financial resources. In addition, unpaid production debt must be refinanced each year to allow cooperatives to be eligible for new production loans, thus creating a perpetual and expanding need for refinancing credit. The recent restructuring of the agrarian debt and the restricted accounts will help to make more cooperatives economically viable.

Part of the repayment problem results from the poor managerial capabilities and inadequate accounting systems of the Phase I cooperatives. A majority of the cooperatives lack the experienced and qualified managerial personnel required to organize these complex entities and productively utilize the assistence and credit provided. The GOES is currently looking at ways to move from the co-management system with ISTA to self-managed cooperatives with qualified managers and accountants trained and selected in the PAU and PRODEA projects. This continues to be a major emphasis of the Agrarian Reform Sector Support (519-0265) and Technoserve (519-0321) projects.

While it is easy to dwell on the problems faced by the reform sector beneficiaries, it is important also to recognize the strengths of the sector. Some of the cooperatives are well managed and profitable entities and many more have considerable potential with improved management and access to the necessary inputs. The recent restructuring of the agrarian debt will contribute to furthering the reform's economic viability. Also, continuing policy dialogue efforts to address other structural issues discussed above will help to improve the long-run situation of beneficiaries. Titling efforts for Phase I will be nearly completed by the end of 1986 and for Phase III by the end of 1987.

E. Project Rationale

The consolidation of the agrarian reform process requires a coordinated package of activities which will meet the needs of the sector to the degree possible. The expected outcome of this program of support is the existence of a strong reform sector composed of financially viable agricultural entities capable of competing without special assistance. Such an outcome will also strengthen the overall economy by increasing levels of production and improving productivity in the agricultural sector. A.I.D. support for this process is continuing with technical assistance under project 519-0265 (through 1987) and a grant to Technoserve (519-0312) to improve the management and accounting in Phase I cooperatives.

A study on rural financial markets and savings mobilization, completed in March 1986, estimates the unmet credit demand in the reform sector in 1985 at $37 million, of which $29 million was for medium and long term investment credit. The credit demand from Phase III beneficiaries was largely ignored in the study, in large part because of the limited experience and interest of the commercial banks in this type of lending. If credit is available and the transaction costs are reasonable, it is likely that substantial additional credit demand would exist in this sector from borrowers who have been discouraged by lack of access and high transaction costs. A detailed review of the agricultural credit demand from the reform sector is included in the Economic Analysis Annex.

On a short term basis, the Project is justified to provide credit which will complement on-going technical assistance and institution building projects. In agricultural development, the lack of a critical input at the right time can make the difference between some degree of success and complete failure. Beyond the immediate need for infusion of credit, however, agricultural production in both the reform and traditional sectors requires the existence of a stable and efficient credit delivery infrastructure. It is not reasonable to expect that the government development bank (BFA) will ever be able to fill this role for the entire country. The commercial banks represent a viable alternative and have shown interest in expanding their agricultural credit operations for creditworthy clients in the reform sector as well as the traditional sector. An effort to encourage the commercial banks in this direction and improve their capabilities to promote and assess agricultural investment loans can pay dividends well into the future by broadening the credit infrastructure available to the entire agricultural sector.

After six years of specialized and targeted assistance to the reform sector as a whole, it is time to begin to differentiate between those agrarian reform beneficiaries with potential for success and those with limited financial viability. It is unrealistic to assume that all of the cooperatives and Phase III beneficiaries will be successful and unwise to allocate limited technical and financial resources based on such an assumption. Even under ideal circumstances, the success rate for complex agricultural entities like cooperatives is not high, and the situation faced by the agrarian reform cooperatives is far from ideal. The troubled economic situation of the country and the deterioration of the agricultural sector require improved allocation of limited GOES resources into areas with the highest potential for return. Such an allocation of effort has begun with the establishment by MAG of a classification system of cooperatives concerning degrees of self-management to focus efforts of ISTA and other GOES agencies on the most viable entities.

It must be clearly understood that the provision of credit and improvements in the commercial credit delivery system cannot by themselves solve the larger problems of the reform sector. Until the critical issues of agrarian debt, beneficiary rights, management, and the burden of previously refinanced loans are fully dealt with, the reform sector will continue to be problematic.

Nonetheless, it is equally clear that these problems, given the level of political consensus required and the highly controversial nature of the program, will not be solved easily or quickly. These and other policy questions are part of the on-going policy dialogue between A.I.D. and the GOES. In the meantime, continued financial and technical support to the sector designed to reduce the level of subsidization, increase reform sector cooperatives' autonomy, and strengthen credit delivery channels will establish a base for future development if the policy issues are adequately addressed. The interest of the commercial banking sector, existing unmet credit demand by qualified borrowers, complementary A.I.D. projects, and an emphasis on commercial viability of reform sector entities, combine to make this a particularly appropriate and advantageous time to initiate project activities.

The Project contains an incentive (through a spread differential) to promote specifically investment credit. Increased investment credit will permit and promote greater flexibility in approving agriculture projects, leading to increased diversification of agricultural investment and production. New and alternative investment opportunities are expected to be exploited from the greater availability of investment credit.

III. PROJECT DESCRIPTION

A. Project Objectives

The Project goal is to improve the economic well being of agricultural reform sector farm families. This goal, as measured by increases in net family income, will be achieved through increased productivity of land and labor. The Project purpose is to increase the availability and productive use of credit in the agricultural reform sector. Achievement of the purpose will be measured by the indicators of the End of Project Status (EOPS):

* The flow of credit from Participating Financial Institutions (PFIs) to reform sector cooperatives and Phase III beneficiaries will increase by at least the amount made available under the Project.

* The number of Phase III beneficiaries receiving credit and the total amount loaned to these beneficiaries will increase by at least 10% a year.

* The repayment rate for the reform sector cooperatives and phase III beneficiaries will improve by at least 15% over the 1985 levels by 1991.

B. Project Strategy

Over the long-term the reform sector will require more from the financial infrastructure than a BCR rediscount line of credit. The sector's needs will not be met by a continuing reliance on subsidized credit and perpetual refinancing of loans to non-viable cooperatives and Phase III beneficiaries. Rather, it is necessary to develop a long-term relationship between creditworthy reform sector borrowers and financial institutions on a sound commercial basis and to create a financial and policy infrastructure conducive to this relationship. The necessary conditions for such a relationship include the following:

-Lending to the reform sector must be placed on a commercial basis. The cooperatives and Phase III beneficiaries must meet the same loan criteria (as much as legally possible) as other borrowers. This is necessary in order to improve both the repayment performance of the reform sector and to change the commercial bank's perception of the sector as subsidized borrowers rather than commercial borrowers.

-In order to make the credit available to as broad a segment of the reform sector as possible, coordinated action between the banks and technical assistance agencies can assist marginal cooperatives to qualify for loans.

-Clear financial incentives must exist for the commercial banks to expand their lending to the reform sector. At a minimum, the return to the banks must compensate for additional expenses and higher risk involved in lending with limited collateral, medium-term investment credit, and small farmer credit. This return must come either from higher interest rates charged the ultimate borrower or by a larger "spread" between the rediscount rate paid and the interest rate charged. Over the long term, the movement of interest rates to levels determined by market forces rather than regulatory agencies is necessary to provide acceptable real returns. This Project contemplates a generous spread to the PFIs as an incentive to assume the higher perceived risks of lending to the reform sector. However, as this Project's rediscount line continues beyond PACD the spread offered should decrease to the point where it is consistent with those of other agricultural rediscount lines.

-The loan repayment performance of the reform sector cooperatives and Phase III beneficiaries must be better understood, and standard criteria for creditworthiness adopted and improved by the banking institutions to enable a more accurate assessment of default risk. In addition, the procedures and standards for agricultural loans to the reform sector must be evaluated and improved to enable banks to adopt the least cost and most efficient systems.

-The BCR and agricultural credit departments of the commercial banks need more and better trained personnel to more efficiently analyze investment projects and process loan applications.

The Project strategy is to use financial incentives to encourage broader participation by the commercial banks in lending to reform sector beneficiaries and to develop a mutually beneficial commercial relationship while meeting the immediate credit needs of the reform sector. This will be done by placing lending to the reform sector on a commercial basis and strengthening the institutional capability of the commercial banks to analyze and supervise agricultural loans, particularly for investment. A rediscount line of credit will be structured to reward the banks for taking on the additional risk and incurring the additional costs of lending to small Phase III farmers, of lending for medium and long term investment projects, and of lending to borrowers who are legally exempt from standard collateral requirements.

Technical assistance and training will improve the efficiency of the credit delivery system, reduce transaction costs, and help lending institutions find improved mechanisms for providing small farmer credit. At the same time, more rational loan criteria, more technical assistance from the credit agents, and better coordination with the technical assistance available from other A.I.D.-sponsored projects will improve cooperative management, accounting, and therefore overall creditworthiness. A pilot savings mobilization program will look at the feasibility of establishing a full scale effort to expand the supply of loanable funds through encouraging savings in rural areas. Finally, the constraints to effective credit delivery and utilization will be studied and discussed with policy level managers in the government and the banks to improve all aspects of the financial intermediation system. With increased familiarity and experience in agricultural lending, it is expected that the commercial banks will continue to serve the needs of the sector after the

Project ends, increasingly using their own resources as well as Central Bank rediscount lines. This will benefit not only the reform sector, but the entire agricultural sector.

C. Project Elements

The project consists of four elements: a rediscount line of credit in the Central Reserve Bank; a training program for bank officials and credit agents; policy studies and seminars dealing with issues relevant to agricultural financial institutions; and a pilot savings mobilization project.

1. Rediscount Line

The BCR will establish a $60 million ($46.0 from A.I.D.) million rediscount line of credit for on-lending to intermediate credit institutions. The rediscount line will operate as follows:

1. The institutions deemed to have the institutional capacity to draw upon the rediscount line will be the mixed banks, the Mortgage Bank and the BFA. The rediscount line will not be allocated among PFIs by means of quotas or any other system of rationing. Access to the rediscount line will be determined by the BCR on the basis of the efficiency and performance of each institution in presenting eligible paper rather than by any non-market discretionary mechanism. A quota system or other such artificial method of apportioning rediscount line credit is to be specifically avoided. However, prior to its access to the rediscount line, the BFA must be in full compliance with all covenants and conditions from A.I.D. Project 519-0263.

2. The rediscount line will be available for short-term production and medium and long-term investment credit. It will not be restricted by crop or type of activity.

3. The rediscount line will be available for on-lending by the PFIs exclusively to reform sector borrowers (Phase I cooperatives and Phase III beneficiaries). Within this category of borrowers, there will be no further restrictions (such as quotas) for any sub-category of borrowers. As a result of higher transaction costs, a higher interest rate spread will be offered to the PFI's in order to induce a reasonable flow of credit to Phase III farmers.

4. It is the responsibility of the participating PFIs to undertake loan analysis, assess the creditworthiness of the ultimate borrower, complete the necessary documentation, and present it to the BCR. The PFIs must bear any losses arising out of nonpayment of loans financed by the rediscounts.

5. The interest rate charged to the final borrower will be the same as the maximum rate prescribed by the Junta Monetaria for that type of loan (currently 15% for production loans and 17% for investment credit) and will be adjusted fully and promptly in line with changes in the maximum interest rate prescribed by the Junta Monetaria.

6. The maturity structure will be patterned after the existing rediscount lines, with production credits having the same maturity (in general, one year) as the corresponding production credits under existing BCR rediscount mechanisms and the investment credits having the same maturity (5-15 years) as the corresponding investment credits under the existing BCR investment rediscount line for Phase I cooperatives.

7. Principal payment reflows and the amount of the spread to be used for fund capitalization will be credited to the rediscount fund to be relent under the same conditions and for the same purposes unless otherwise agreed to by A.I.D. No part of the funds of the rediscount line may be used for refinancing.

8. The BCR will protect the integrity of the fund by ensuring that any default by a PFI will be covered by the BCR itself.

It is the intent of A.I.D. and the BCR that the rediscount line supplement current levels of credit available to the reform sector in order to meet unsatisfied demand and that it not replace existing lines of credit. The BCR will monitor credit to the reform sector on a bank-by-bank basis to ensure that gross credit flow to the sector from all funding sources through participating banks increases, every calendar year, over the previous calendar year by at least the colon equivalent of the US dollar amount made available under this Project. For the first calendar year of operation of the Project, the base period will be the calendar year 1985. Gross credit flow will be measured in amounts disbursed.

A.I.D. and the BCR recognize that credit flows, credit usage and the measurement of credit can be affected by many factors and must be considered within the framework of monetary policy, particularly the requirements of the monetary program. The BCR will make an annual report to A.I.D. within three months of the end of the calendar year documenting the gross flow of credit to the reform sector and demonstrating to A.I.D.'s satisfaction that the additionality requirement has been met for the preceding year. In the case of non-compliance, the BCR must explain to A.I.D.'s satisfaction why the requirement was not met. In the absence of an explanation satisfactory to A.I.D., participating institutions which do not meet the requirement will be ineligible for further drawing rights on the rediscount line until compliance is achieved.

The BCR rediscount line will be structured to create incentives for the intermediate institutions to provide medium and long term investment credit to cooperatives and to lend money to Phase III beneficiaries for production and investment credit. Therefore, the terms of the rediscount line will vary according to the proposed use and the status of the borrower. Through adjustments in the amount of the spread, the difference between the cost of borrowing to the PFI and the interest rate charged to the ultimate borrower, the BCR will attempt to compensate the PFIs for higher costs and risk and thereby encourage the flow of funds into the financially and economically desirable projects. The standard BCR procedures for determining spread will be followed for the first 4% spread. This includes a standard 2% spread to all institutions and up to an additional 2% for performance in supervising loans. The amount each institution receives of the additional 2% is to be determined annually in conformity with existing BCR guidelines. Beyond the basic BCR spread, additional percentage points will be allocated according to the proposed use and the status of the borrower, as illustrated by the following schedule:

Credit use	Type of Borrower	Basic Spread	Added Points	Total Spread	BCR Rediscount Rate	Interest charged to borrower
Production	Phase I	4%	0	4%	11%	15%
Investment	Phase I	4%	2%	6%	11%	17%
Production	Phase III	4%	3%	7%	8%	15%
Investment	Phase III	4%	5%	9%	8%	17%

In addition to the spread based on credit use and type of borrower, an PFI will be allocated an additional 1% spread if it provides at least 10% of the total loan from its own funds. All remaining points of the spread (less 2% to cover the BCR administrative costs) will be used to capitalize the fund.

The spread schedule will be reviewed annually and may be adjusted at any time by joint BCR-A.I.D. agreement. Changes will be made in the spreads if the actual flows of production and investment credit to reform sector borrowers, as well as the willingness of the PFIs to include their own funds in the loans, indicate a need to adjust the structure. Similarly, in the case of a change in the maximum interest rates prescribed by the Junta Monetaria, the spreads allowed the PFIs will be reviewed.

The PFIs will use the spread to finance all costs of administering these loans and to build a reserve for bad debts. Administration costs will include some of the costs of fielding credit agents, loan analysts, and other personnel working on the agricultural portfolio, office expenses, and any transportation or per diem expenses incurred by the credit agents in their work. These costs are currently reimbursed by the BCR from a trust fund established with PL480 local currency generations. Each PFI will determine its own needs for credit agents based on the characteristics of their cooperative and Phase III clients: the total number served, size and complexity, location, types of enterprises, and potential. It is expected that an additional 18 credit agents will be hired and trained during the first two years of the Project.

Credit agents in the PFIs will assist cooperatives to identify and develop investment opportunities. In some instances, they may work in coordination with the technical assistance services available through the PAU and PRODEA projects in order to target both technical and credit assistance to the same cooperatives for maximum impact. In the PAU/PRODEA projects, a seven member commission comprised of ISTA, ABANSA, BFA, A.I.D., and three campesino organizations selects managers and accountants for the cooperatives.

The BCR will utilize established procedures and documentation for drawing upon the rediscount line and standard loan review procedures will be used for both production and investment credit. In the case of production credit, this means that the new, simplified procedure for avío rediscounts introduced for 1986-1987 will be followed, involving acceptance of eligible paper from PFIs without prior case-by-case review by the BCR loan analysis office but subject to spotchecks and ex post audits. Investment loan applications will be reviewed first by the Coordination Unit and then passed to the Financial Analysis section for review and finally to the Credit Committee for approval. The investment loan review procedure will be streamlined as the PFIs capability in loan analysis is improved.

Upon BCR approval, all loan applications from Phase I cooperatives are currently sent to ISTA for its loan guarantee (aval). This requirement needs to be specifically eliminated for all loans granted under this Project.

The Project will be administered through the Coordination Unit for the Credit Agent Program in the BCR. A long term technical advisor in agricultural credit administration and delivery will be assigned to the Coordination Unit to assist in monitoring loans, improving credit administration procedures in the BCR and the PFIs, and coordinating the training programs, studies, and seminars. The long term advisor, and short term advisors as necessary, will work with each PFI agricultural credit department to improve administration and experiment with innovative methods for promoting and administering small loans (Phase III). The long term advisor will coordinate all short term technical advisors throughout the life of the project.

The total cost of this project element is \$62.8 million, of which US grant funding of \$46 million will be provided for the rediscount line and \$750,000 for corresponding technical assistance. The GOES counterpart contribution consists of the colon equivalent of \$14 million for the rediscount line and contributions from the BCR and PFIs of \$2.05 million for salary payments, transportation, per diem, office space and expenses, and other related costs.

2. Training

The administration of agricultural credit is highly dependent upon the capabilities of bank officials at all levels to promote credit use, process applications efficiently, analyze proposed credit uses adequately, deliver the credit in a timely fashion, and provide follow up supervision and assistance. Since the commercial banks have concentrated almost exclusively on short term production credit to the agricultural sector, their capability in project appraisal and formulation is limited. The initial group of 20 credit agents and 3 supervisors have received only limited training, consisting of a week of orientation to the BCR, PFI procedures, and familiarity with standard loan documentation. Personnel at other levels of the agricultural credit system, including the central administration of the program in the BCR, agricultural loan officers and loan analysts in the PFIs, branch managers, and BCR financial analysts have not received any specialized training in project formulation and appraisal.

Short term and long term training will be provided under the Project to strengthen the capability of all participating institutions to deliver agricultural credit and project appraisal services efficiently and to assure the productive use of t' loan funds. The training program will be open to employees and managers from all participating financial institutions involved in the agricultural credit analysis and delivery system, including credit agents, loan analysts, managers of agricultural credit departments, and BCR loan supervisors. The rationale for this kind of training is that PFI capability, which appears adequate at this time to absorb at least the initial tranche of project funding, needs to be strengthened since further funding will mean more PFI involvement in investment credit and will increase the volume of credit proposals received.

In-country training will consist of short-term courses and on-the-job training in credit administration, formula ion and appraisal of agricultural investment projects, credit promotion and supervision, loan analysis, banking procedures and accounting, and management of agricultural credit programs. Training will be designed and conducted by Salvadoran and foreign experts in credit administration and will utilize the facilities and expertise of the training center at the Banking Association of El Salvador (ABANSA). Currently, ABANSA has no courses specifically dealing with agricultural credit administration, so short term technical assistance will be provided to develop the required courses. The on-going training program in BFA will be responsible for all agricultural training within that institution. A minimum of 15 in-country short courses will be conducted each year, including annual skill development courses for credit agents, loan supervisors, loan analysts, and management level personnel.

Employees of agricultural credit and other departments of participating PFIs will be assigned to work with the technical advisors on policy studies and seminars (Component 3), particularly for studies which have a direct relevance to the employee's institution. This form of on-the-job training will encourage greater interest and understanding of policy and administrative problems and possible solutions.

International training will consist of approximately 150 person months of short course training in U.S. and Latin American training institutes and six long-term scholarships in credit administration and financial analysis. All long-term trainees will attend short courses in management training and if possible will have a short internship with agricultural credit agencies. Study tours will also be arranged for agricultural program managers to visit model credit programs in other Latin American countries and in the U.S.

The Credit Agent Coordination Unit in the BCR will be responsible for coordinating and arranging all training activities in coordination with the ABANSA facilities and BFA training office. The BCR employee assigned to the CU to coordinate the training program will be assisted by short term Salvadoran and foreign training experts to develop a training plan, develop a continuous training and skills development program for credit personnel, locate and contact institutions capable of conducting the needed training, identify candidates for training, and arrange the courses. Project funds will be used to purchase training materials and equipment to be used in ABANSA for the program, including visual aid materials, video teaching materials, a personal computer, library books, and office equipment. This equipment procurement will total $80,000.

The scholarship and training decisions will be made with the assistance of a committee, consisting of representatives of each of the participating banks. Scholarships for out-of-country short courses will be distributed among the personnel of all participating banks, with preference given to the most active banks and to individuals who have shown considerable initiative and promise in the program.

The total cost of this element will be $1,890,000. Of this total, the US contribution will be $1.64 million in grant funds for short term technical assistance and training ($750,000 for short term international training, $360,000 for long term international training, $300,000 for technical assistance, $150,000 for in-country training costs, and $80,000 for equipment). The GOES contribution will be the colon equivalent of $250,000 in in-kind contributions, salary costs for training personnel and facilities.

3. Policy Studies and Seminars

Transformation of some reform sector cooperatives from dependents of the state to autonomous, well-managed agricultural enterprises and the concomitant restoration of the lands to higher levels of productivity are inhibited by many remaining operational and structural problems. Primary among these problems are: the burden of refinanced bank debts; uncertain ownership rights for individual members of Phase I cooperatives; poor cooperative management and the evolution to self-management; and the viability of the cooperative structure itself. In addition, improving the access of Phase III beneficiaries to credit and technical assistance services is still constrained

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in many ways which are not well understood. Moreover, the entire agrarian reform must be seen in the context of the larger agricultural sector problems and economic and trade policies. In order to design policies and programs which will improve the financial viability of the agrarian reform cooperatives, cooperative managers, GOES program managers, and policy makers must clearly understand the situation as it exists now and the implications of alternative policy choices. In the context of commercial credit, any factor which might affect the profitability and viability of clients is of considerable interest, including the efficiency of the credit delivery system itself, analysis of creditworthiness, impact of government policies, and marketing arrangements.

The Project will fund a series of studies on policy and program related matters, to be followed up with special seminars for policy level managers on the implications for program implementation and policy development. The topics studied will include factors which can influence the productive use of credit in the agricultural sector, including agricultural credit policies and problems, credit administration, financial and economic viability of the cooperatives, agricultural price and marketing policies, bank management, and rural savings mobilization.

In addition to individual policy studies, this component will include a detailed monitoring system to track the flow of credit through the system, end use, and efficiency of the credit administration procedures. The Project structure, working as it is through a number of intermediary institutions each of which may apply its own procedures and criteria, offers a unique opportunity to evaluate the relative effectiveness and efficiency of different loan procedures, productive use of funds, management practices, credit agent programs, loan criteria, and lending practices. The monitoring system will analyze the Project from this point of view. The information from this system will be used in the annual review of the spread structure to evaluate whether the spread is sufficient to channel credit into desired activities. The monitoring system will enable the Coordinating Unit to evaluate the effectiveness of these measures in allocating credit as well as the impact of alternative loan procedures and loan criteria on repayment rates and profitability to the PFIs.

Other areas to be studied include the following:

-Impact of refinanced production loans from previous years on the creditworthiness of cooperatives and Phase III beneficiaries.

-Comparative transactions costs among financial institutions.

-Identification of alternative cost effective mechanisms to channel credit to Phase III beneficiaries, including working through the informal market intermediaries or identification of creditworthy borrowers who could be eligible for direct bank loans.

-A cooperative ranking and evaluation system for use by government agencies and credit institutions for determining priority access to assistance and credit programs. A prototype system is currently under development by ABANSA, MAG and ISTA. Improvement of the system, particularly with the input of the project monitoring system, could result in a dynamic tracking system for assessing changes in relative creditworthiness and management capability. It could also serve as a means of evaluating the impact of assistance programs to the reform sector.

-Methods to improve the tracking of financial information needed by BCR and A.I.D. for the monitoring of this Project.

For those studies whose recommendations are accepted, follow up assistance in the form of implementation studies or technical assistance to implement the changes can be made available to the participating institutions.

A minimum of 15 seminars will be conducted over the life of the project. These seminars will include annual reviews of the impact of economic and agricultural policies on the use and effectiveness of agricultural credit (for top level officials of GOES and participating banks), special seminars for mid-level managers of agricultural programs on special topics of management and administration of agricultural credit, reviews of the relative performance of participating banks in utilizing the credit line (for bank officers and the head of the agricultural departments) and special briefing seminars after every policy study.

This project element will be administered through the Coordination Unit of the BCR. A BCR employee will be assigned to coordinate topics for review and arrange seminars. The long term technical advisor will assist in developing a study program and developing terms of reference for the studies. Local and foreign technical advisors will be hired to perform the studies and conduct the seminars. Local sources may include Salvadoran university personnel as well as private companies. All studies and seminars will be coordinated with the Economic Research Branch of the BCR. In addition to the specific studies discussed above, other studies will be identified over the life of the Project in response to perceived problems in administering the Project or to changes in the economic or policy environment. Study topics will be discussed at each of the seminars and suggestions and scopes of work for such studies or seminars will be solicited from the representatives of the participating banks, cooperatives, and selected GOES officials.

The total cost of this project component will be $350,000. Of this total, the US contribution will be $300,000 in grant funds for short term technical assistance. The GOES contribution will be the colon equivalent of $50,000 in in-kind contributions for salary costs and facilities.

4. Pilot Savings Mobilization Program

Rural financial markets in El Salvador are almost exclusively directed toward providing credit to the sector rather than performing a financial intermediation service. The majority of the savings in the country takes place in urban areas, although some substantial portion of the savings comes from agricultural activities. Although the commercial banks have substantial funds from demand and time deposits, they rely heavily on BCR rediscount lines for agricultural lending.

The low level of small farmer savings is caused as much by lack of access to savings mechanisms in the formal financial markets as by low levels of income. Like all people, farmers also have to put aside something in anticipation of future problems and needs. Limited access creates the need to save outside of the financial intermediation system, thus reducing the overall availability of capital in rural areas. This is particularly true for the small farmer who lacks the substantial income, financial sophistication, and close linkages with the urban areas to facilitate savings. Aside from access, other constraints to mobilizing savings in rural areas include the low (or even negative) real interest rates paid by the banks. The question of incentives for use of savings accounts by rural residents is discussed in the Financial Analysis Annex.

Commercial banks account for 99.5% of the savings mobilization in the country. BFA, by contrast, has only a limited savings program in three branches. However, by virtue of its extensive network of 26 branches throughout the country and its dominant role in providing agricultural credit in rural areas, it is in an excellent position to mobilize rural savings. In the past several years, the BFA has had little interest or incentive to expand its savings deposits program because of the availability of substantial amounts of loan funds from international assistance agencies, including A.I.D. and the IDB. In the future, BFA sources of financing will likely be more restricted as foreign assistance levels to the bank are reduced and its own portfolio is decapitalized through delinquency and refinancing.

In order to assess the feasibility of mobilizing rural savings in El Salvador, a pilot project in savings mobilization will be financed. The pilot program will consist of assisting BFA to improve the existing deposits program in three branches and expand it to four new branches.

The BFA branches which currently offer savings deposits are the Central Office, San Salvador and La Libertad. Savings programs will be initiated in branches in Ilobasco, San Juan Opico, Sonsonate and San Miguel. Extensive review of the operations, portfolios, liquidity reserves, accounting practices and personnel training requirements will be undertaken in these branches to assess their operations.

The pilot program will consist of training of BFA employees on the branch and central office level in administration of savings programs, accounting requirements, and other general banking practices to improve skill levels. Key officials of the bank will visit other Latin American countries to observe the structure and performance of successful rural savings programs.

Short term technical assistance will be provided to assist in initiating the pilot program, identifying training needs, and developing or improving procedures. In addition, the advisor will assist in developing promotional campaigns which will be tested in the participating branches and evaluated to determine the effectiveness of different approaches. The mid-term project evaluation will review the pilot project and make recommendations as to what, if any, further role A.I.D. should take in rural savings mobilization.

The BFA will remodel the four branches which will participate in the program to assure that adequate security and infrastructure exists to facilitate the savings program.

The total cost of this component will be the equivalent of $440,000. A.I.D.'s contribution will be $225,000 in grant funds for technical assistance and training. The BFA will contribute the colon equivalent of $215,000 to remodel the branches, pay salaries and operating expenses and other in-kind costs.

D. Financial Plan

A. Summary Financial Plan

The total Project cost is $67 million, of which A.I.D.'s contribution will be $50 million in grant funds and the GOES counterpart contribution will be $17 million.

FINANCIAL PLAN
(US$ 000)

COMPONENT	A.I.D. GRANT	GOES COUNTERPART	TOTAL
Rediscount Line			
Rediscount Fund	46,000	14,000	60,000
Technical assistance in Credit Administration (LT)	750	2,050	2,800
Subtotal	46,750	16,050	62,800
Training			
Int'l. Short Courses	750	100	850
Int'l. Long-Term Training	360	100	460
Technical Assistance	300		300
In-country training	150	50	200
Equipment	80		80
Subtotal	1,640	250	1,890

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FINANCIAL PLAN
(US$ 000)

COMPONENT	A.I.D. GRANT	GOES COUNTERPART	TOTAL
Studies	300	50	350
Savings Mobilization Pilot Program			
Technical assistance	100		100
Training	100		100
Remodeling		100	100
Promotion Costs	25	15	40
Operating Costs		100	100
Subtotal	225	215	440
A.I.D. Project Administration	385		385
Evaluation and Financial Review	200		200
Contingency and Inflation	500	435	935
TOTAL PROJECT COSTS	50,000	17,000	67,000

The following is the projected schedule of disbursements:

Schedule of Disbursements ($000,000)

Source of Funds	FY86	FY87	FY88	FY89	FY90	FY91	TOTAL
Total A.I.D. Grant							
Rediscount Fund	6.0	9.0	9.0	9.0	9.0	4.0	46.0
Other Uses	0.5	0.8	0.8	0.8	0.8	0.3	4.0
GOES Counterpart							
Rediscount Fund	2.0	2.5	2.5	2.5	2.5	2.0	14.0
Other Uses	0.3	0.6	0.6	0.6	0.6	0.3	3.0
Total	8.8	12.9	12.9	12.9	12.9	6.6	67.0

The use of A.I.D. grant funds will be divided between foreign exchange and local currency costs as follows:

Use of Funds	FX Costs	LC Costs	Total
Rediscount Line	-	46,000,000	46,000,000
Other Costs	3,625,000	375,000	4,000,000
Total	3,625,000,	46,375,000	50,000,000

The anticipated obligation schedule is as follows:

($,000,000s)

	FY86	FY87	FY88	FY89	FY90	Total
A.I.D. Grant	6.5 m	12.0	11.0	11.0	9.5	50.0

IV. PROJECT IMPLEMENTATION

A. Administrative Arrangements

1. GOES Arrangements

The Coordination Unit for the Credit Agent Program within the Central Reserve Bank will be responsible for administering and coordinating technical assistance and training activities, except for those affecting the BFA. The responsibilities of the CU include coordination of technical assistance and training activities, project monitoring, studies and seminar coordination. Training activities will be coordinated with ABANSA and with the BFA Training Office. Studies and seminars will be coordinated with the Economic Research Office.

The CU currently has a staff of three professionals. Two additional professionals will be assigned to the unit (or hired) to work on the training program and the studies program. At least one additional secretary will also be hired. This is part of the GOES contribution.

The unit responsible for the implementation of training and the pilot savings mobilization program in BFA will be the Deposits Department.

2. A.I.D. Arrangements

The Rural Development Office will have primary responsibility for the supervision of the project. A contract Agricultural Credit Specialist in RDO will be responsible for the day-to-day monitoring and implementation of the project, under the direction of the RDO. The amount of $385,000 has been provided both to finance 2 person years for this specialist (this position is funded through December 31, 1987 under Project 519-0263) and to purchase equipment needed by the specialist such as a PC, typewriter and other office equipment. Other USAID offices will offer backstopping and other support, as needed.

A.I.D. will conduct project review meetings at least once each quarter to review progress on the project. The project manager and the long-term technical advisor will prepare a project status report prior to each meeting detailing the activity in the rediscount line and progress or problems encountered. The BFA program manager will also prepare and submit a statement on the progress of the savings mobilization pilot program on a quarterly basis.

3. Payment Verification/Implementation Arrangements

The following is the approved payment verification matrix:

Method of Implementation	Method of Financing	Amount (000,000)
Rediscount Line Grant to BCR	Host Country Reimbursement	46.0
Technical Assistance Direct A.I.D. Contract (Umbrella contract)	Direct Pay	1.650
Training Direct A.I.D. Contract	Direct Pay	1.360
Equipment A.I.D. Procurement	Direct L-Com or Direct Pay	.08
Savings Promotor Costs Host Country Institution	Host Country Reimbursement	.025
A.I.D. Project Administration	Direct Pay	.385
Contingency/Inflation		.500
Project Total		$ 50.0

During project design, reviews of the Central Bank's administrative controls and procedures were performed (See Financial Annex).

A.I.D./GOES Administrative Arrangements

a) Local currency costs - Project local currency costs will be disbursed through the Central Bank. Specific disbursement procedures will be included in Implementation Letter Number 1. Local currency disbursement will also be made and will be based on an annual action plan to be submitted by the BCR.

b) Dollar costs - All dollar cost procurement will be done by A.I.D. direct contract. At present, it is expected that one umbrella contract will be used for U.S. technical assistance and U.S. long and short-term training.

c) Policy Determination No. 71 - It will be agreed between the GOES and A.I.D. that the credit and other resources provided from this Project will not be used to finance the production for export of palm oil, citrus, sugar and related products.

d) Gray Amendment - The major rural financial markets study conducted to assess savings potential and credit demand was conducted by a minority owned firm. It is expected that the umbrella contract for technical assistance and training will include many sub-contracts with minority-owned and other Gray Amendment organizations.

B. Implementation Plan

1. Schedule of Project Activities

The implementation schedule below represents the targets for completing key activities in the Project.

Event	Target Date	Responsible Agency
Authorization signed	o/a June 20, 1986	A.I.D.
Project Agreement signed	o/a June 30, 1986	A.I.D./GOES
Initial CPs met	August 15, 1986	BCR/GOES
RFTP issued	August 15, 1986	A.I.D.
* Training Plan Completed	August 15, 1986	BCR/PFIs/A.I.D.
Seminar Held (on project implementation)	September 15, 1986	BCR/PFI/A.I.D.
First Disbursement for Rediscount Fund	September 30, 1986	BCR
Technical Proposals Received	October 15, 1986	A.I.D.
First two BFA branches remodeled	October 15, 1986	BFA
** Savings Promotion Initiated (includes (short-term TA)	October 30, 1986	A.I.D./BFA/BCR
Technical Contract signed	November 30, 1986	A.I.D.
Comparative Transactions Costs Study Initiated	November 30, 1986	A.I.D./BCR
Ten Credit Agents Hired	December 31, 1986	BCR/PFIs
First Annual Review of Additionally Criteria Adherence	January 31. 1987	A.I.D./BCR
Long-Term Advisor in place	January 31, 1987	A.I.D.
Action Plans submitted (subsequent Action Plans to be submitted annually in October)	February 28, 1987	BCR
Policy Studies initiated	June, 1987	A.I.D./BCR
Eight Credit Agents Hired	September 30, 1987	BCR/PFIs
Savings Mobilization Program Assessed	May, 1988	A.I.D./BCR/BFA
Mid-Term evaluation	January, 1989	A.I.D./BCR
Final Evaluation	May, 1991	A.I.D./BCR
PACD	5 years ProAg from date of	

* Training plan will further detail both mix of long-term and short-term training and timing of training activities.

** Specific short-term TA needed prior to the awarding of the umbrella contract will be procured directly by A.I.D. from IQCs and other sources.

2. COMMODITY AND SERVICES PROCUREMENT SUMMARY

Estimated Description (US$)	Approximate Unit Cost	Amount	Cost ($)	Mode
1. Long term Advisor in credit administration	150,000/yr	48 pm	600,000	Contract
2. Short term advisors in credit administration	12,500/pm	10 pm	125,000	Contract
3. Short term advisors in credit administration, local hire	100/day	12 pm	25,000	PSC
4. Long term training advisor, local hire	25,000/yr	24 pm	50,000	Contract
5. Short term advisors in training	12,500/pm	12 pm	150,000	Contract
6. Short term advisors training, local hire	2,000/pm	50 pm	100,000	Contract
7. Short term advisor BFA savings mobilization	12,500	8 pm	100,000	PSC
8. Short term technical assistance for studies and seminars	12,500/pm	20 pm	250,000	Contract
9. Short term technical assistance for studies and seminars, local hire	2,000/pm	25 pm	50,000	Contract
10. Evaluation	12,500	16 pm	200,000	Contract
Total TA needs			1,650,000	

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TRAINING SUMMARY

Description	Estimated Unit Cost (US$)	Amount	Approximate Cost
1. Short-term out of country training	5,000/pm	150 pm	750,000
2. Long-term participant training	30,000/yr	12 yrs	360,000
3. In Country training fees	300/pm	500 pm	150,000
4. Savings mobilization (Misc)			100,000
TOTAL TRAINING BUDGET			1,360,000

EQUIPMENT

ABANSA equipment	misc	misc	80,000

Since some of the training and technical assistance listed above will be contracted (or sub-contracted) from sources outside of the Project's designated A.I.D. Geographic Code of 000 and Central America Common Market member countries, the project authorization will contain a waiver to permit up to $1 million of training and technical assistance from sources in the 941 A.I.D. Geographic Code. It is expected that training facilities in other Latin American countries will be used extensively.

C. Evaluation

Monitoring of the impact of the Project and the performance of the participating institutions is an important component of the Project. The information gathered in this monitoring process will greatly facilitate evaluation of the project.

Two evaluations are planned, a mid-term assessment and an End-of-Project impact evaluation. The mid-term evaluation will be concerned with efficiency of the project structure in channeling credit resources into desired activities and to desired beneficiaries and with the effectiveness of the technical assistance and training in improving operations of the agricultural credit delivery system. It will draw conclusions as to the effectiveness of the spread structure and make recommendations to improve targeting, improve efficiency, and use of technical assistance and training. The mid-term evaluation will also review the progress and potential of the rural savings mobilization program and make recommendations as to what, if any, future role A.I.D. should play in this area. It is essentially a corrective evaluation to improve project implementation.

The final evaluation will further assess the number of cooperatives that have invested in diversified agricultural activities, allowing them to better utilize their resources. The amount of their own money that they are loaning to the reform sector will be an indicator of the success of the program.

D. Conditions, Covenants, and Negotiating Status

1. Negotiating Status

Close contact was maintained with GOES officials during the Project design process. Numerous meetings were held with BCR officials at all levels and contact was made with the agricultural departments of almost all of the PFI's which are likely to participate in the Project. While the general parameters of the Project have been discussed and agreed upon, the specific details of the proposed interest rate differential structure, the conditions of the rediscount line, and the definition and measurement of additionality will need to be further negotiated and modified, as necessary during the life of the project.

2. Covenants

The Cooperating Country shall covenant that, unless A.I.D. otherwise agrees in writing:

(a) The GOES through the BCR will verify on an ongoing basis, and report to A.I.D. at least annually, that the amount of funds made available through the Project's rediscount line will be in addition to the amount of funds currently being made available by the BCR to the reform sector. Calendar year 1985 will be used as the base year.

(b) Prior to receiving funds from the Project's rediscount line the Agricultural Development Bank (BFA) will disburse all funds in the Integral Credit Line financed under A.I.D. Project 519-0263 and be in full compliance with all outstanding covenants from Project 519-0263.

(c) A.I.D. will be able to brief and debrief contractors, participants and invitational travelers financed under the Agreement and will be furnished copies of reports produced by such persons.

(d) The BCR will assure the integrity and proper accountability for the rediscount line funds during the entire life of the Project. In the event of a default by a PFI, the BCR will cover the loss so as to protect the integrity of the credit fund.

3. Conditions Precedent to Disbursement

Prior to initial disbursement of Project credit funds, the GOES will, except as the Parties may otherwise agree in writing, furnish to A.I.D. in form and substance satisfactory to A.I.D.:

(a) A statement of the name of the person(s) in the BCR empowered to act for the BCR as the GOES implementing entity with reference to the Project Agreement, along with a specimen signature of such person(s);

(b) Evidence that the BCR has established a separate rediscount credit line for channeling project credit funds to the participating financial institutions;

(c) Evidence that the Grant Agreement has been duly ratified;

(d) Evidence that the BCR has informed PFIs of the availability of the new credit line and should provide for A.I.D. approval all terms and conditions for use of the credit line, including interest rates, terms, loan conditions and administrative procedures.

Prior to initial disbursement of Project funds for training activities, the GOES will, except as the Parties may otherwise agree in writing, furnish to A.I.D. in form and substance satisfactory to A.I.D.:

(a) A detailed training plan outlining the amounts and the schedule of long-term and short-term training activities during the life of the project.

V. SUMMARY OF ANALYSES

A. Institutional Analysis

1. BCR

The BCR has had long experience (before and after the 1980 structural reforms) in establishing and managing the avío rediscount lines. A review of its implementation of existing avío rediscount lines and the investment rediscount line for the Phase I cooperatives, has led to the conclusion that the BCR indeed does have adequate management capability to implement and monitor the Project. This capability would be further strengthened as a result of the technical assistance and training inputs of the Project.

The simplified avío rediscount procedure introduced in 1986-1987 has greatly speeded up disbursements from the rediscounts. While it is too early to make a definite assertion on this point, available evidence indicates that there has been no significant sacrifice in terms of precision and thoroughness. The PFI's have experience with the requirements and criteria of the BCR and have experience in implementing them. Besides, the stiff BCR sanctions applicable to occasional non-compliance, act as a deterrent against PFI laxity.

The BCR performance with respect to the implementation of the investment rediscount line has also been such as to inspire confidence. In only one year of operations, the Coordinating Unit has proved its effectiveness. Even though the credit agents received minimal training (about a week) in the beginning, they have learned much on the job. Their analysis of the identified investment projects is of good quality and they have been able to give reasonable coverage to 133 cooperatives. In less than a year, the Unit was able to appraise enough investment projects to commit the entire funds of the rediscount line. Moreover, the Unit has appraised many additional projects which have been approved subject to the availability of funds.

Both the Coordinating Unit (responsible for appraising investment projects of Phase I cooperatives) and the Financial Analysis Department (responsible for determining the eligibility of avío rediscount applications as well as for the purely financial analysis of investment projects of cooperatives) are staffed by competent professionals. The technical assistance and training component of the Project has been designed to augment the effectiveness of the Coordinating Unit and the Financial Analysis Department. These factors, as well as the fact that the modalities of the Project have been determined in close consultation with the BCR officials, provides reasonable assurance that the BCR will undertake effective implementation of this Project.

2. The PFIs.

The management capability of the PFIs, particularly the bancas mixtas, will be adequate to implement and monitor this Project. In view of doubts about the BFA's present capability, it would not have access to the rediscount line unless the the covenants included in Project 0263 are complied with (which would greatly improve the institutional effectiveness of the BFA).

a) Bancas Mixtas

In the 1960's and 1970's, the private banks in El Salvador were considered among the most efficient and dynamic in Central America. Even after nationalization, each bank has largely retained its identity and its traditions.

The bancas mixtas have had ample experience in agricultural credit operations dating back to the pre-agrarian reform period. Since 1980, with the assignment of Phase I cooperatives, these banks have accumulated substantial, and on the whole satisfactory, experience in dealing with these cooperatives. They have made available some of their own funds and large amounts of BCR rediscount funds for avío credits to the cooperatives, as well as relatively small amounts for investment credits to the cooperatives and credits to Phase III farmers.

The above factors, together with the banks' familiarity with BCR rediscounting procedures and the technical assistance and training component of this Project designed to strengthen their Agricultural Sections, support the conclusion that the bancas mixtas have the managerial capability to implement and monitor this Project.

b) Banco Hipotecario

While the BH is not as strong institutionally as the more efficient banks among the bancas mixtas, it can be rated as no worse than the weaker banks among the bancas mixtas. The BH has the same familiarity with BCR procedures as the bancas mixtas and has greater experience in dealing with Phase I cooperatives. Hence, for the same reasons as those mentioned in the case of bancas mixtas and given the fact that its agricultural section would be a recipient of technical assistance and training under this Project, it will have the managerial capability to participate in this Project.

c) Banco de Fomento Agropecuario (BFA)

The BFA has been the chosen vehicle of GOES for providing credit to the reform sector and has played a major role, under GOES directives, in financing the agrarian reform cooperatives. It is the single most important provider of credit to the agricultural sector in general and to the reform sector in particular, accounting for 20% and 25% of total credit to these sectors respectively. It has the largest network of branches in the countryside.

In spite of these clear advantages, the BFA has had serious difficulties in its financial performance and institutional capability. As a result, several conditions precedent and covenants were included in the A.I.D. Agrarian Reform Credit Project (Project 0263), in order to improve its performance. The BFA would have access to the funds of this Project only with evidence of continuing compliance with the covenants.

Given the extensive network of branches in the countryside, the BFA is in a good position to experiment with a pilot savings mobilization program. Any success in this effort will reduce the BFA's dependence on external resources and resources provided by GOES and BCR.

d) ABANSA

The Salvadoran Bankers' Association (ABANSA) has two years of experience in conducting a three-year undergraduate course in general banking. The course, which utilizes local lecturers, is conducted in the mornings and in the evenings, in a large building with 8 classrooms, so that additional courses can easily be conducted during the day.

ABANSA is eager to conduct additional intensive training courses related to the Project under the supervision of the BCR, and is capable of doing so.

3. Rediscount mechanism

In the light of experience with the earlier Agrarian Reform Credit Project (Project 0263), the structure of the rediscount mechanism with a market orientation based on incentives rather than discretionary measures, is designed to convince and induce the PFIs to augment the flow of their own resources to the reform sector. Thus, by the end of this Project, it is expected that the supply of credit to a broad segment of the reform sector will reach adequate levels, will not be dependent on the infusion of external resources or BCR rediscounts, and will be self-sustaining and market-oriented.

It may be stressed that, apart from the specific modalities of the rediscount mechanism, the project's success will be affected by:

a. Prompt implementation of the technical assistance and training component of the Project, in order to strengthen the credit delivery capability of the BCR and the PFIs.

b. Expeditious granting by ISTA of its guarantee (aval) needed for bank credit to the cooperatives.

In addition it is expected that an effort to target the PAU-PRODEA programs towards making the Phase I cooperatives more creditworthy for this project will also impact on project success.

B. Social Soundness Analysis

The Social Soundness Analysis contains four sections: (1) a description of the stages of the agrarian reform and the beneficiaries of each stage, (2) the use of credit by beneficiaries in each stage, (3) a statement regarding social constraints to the use of credit, and (4) a review of the project's impact on women. Tables supporting the social soundness analysis are contained within the analysis itself (presented as Annex G) and are not repeated here.

THREE STAGES OF THE AGRARIAN REFORM AND ITS BENEFICIARIES

The Salvadoran agrarian reform, in its three phases, is restructuring rural society and access to productive agricultural resources in rural areas. The reform is divided into three distinct phases, each affecting a different type of production system, distributing benefits in a different manner and presenting different credit needs and constraints. Phase I involves the formation of 300 plus cooperatives on large, formerly privately owned haciendas. There are approximately 32,000 direct beneficiaries, former hacienda workers who are now cooperative members. For the most part, the Phase I farms operate in much the same manner as they did before the reform, except that ownership is communal, vested in the cooperative members and management decision making is often relegated to member committees with advice of hired managers or ISTA cogestores. These farms are usually large, complex agricultural operations producing both export crops and basic grains. They often have several profit centers and require extensive management capability as well as significant investment and production credit requirements.

Phase II of the agrarian reform involves the voluntary sale of land by owners holding in excess of 245 hectares. It is as yet poorly defined, and credit requirements of Phase II beneficiaries will most likely be handled through existing credit sources without the borrowers being specifically identified as agrarian reform beneficiaries. There are no reliable estimates of the number of persons who will benefit from Phase II since implementing legislation defining eligible beneficiaries has not yet been passed by the Legislative Assembly.

Phase III has distributed land to about 52,000 direct beneficiaries. Recipients of Phase III land are almost exclusively small, often part-time, farmers who prior to the reform raised subsistence crops on rented or sharecropped land. Their minimal production credit needs were met from their own resources or informal credit sources, often their landlord. They differ from Phase I beneficiaries in that they are now sole owners of their land and management decisionmaking, including the use of credit, is vested in individual owner-operators as opposed to cooperatives' credit committees. Since Phase III beneficiaries are dispersed and the transactions costs of serving them are high, especially in relation to the size of the loans, there has been an effort to organize them into credit "solidarity groups".

BENEFICIARY CREDIT NEEDS AND CONSTRAINTS

As one might easily imagine, the credit needs and constraints of Phase I and Phase III beneficiaries differ significantly, as do the sources of credit to them. The Phase I cooperatives need significant amounts of both production and investment credit, although the emphasis in recent years has been on production credit. Three reasons for this are: (1) daily wages are the main source of income for cooperative members and production credit includes money for wages, (2) credit committees, inexperienced in management of large scale, capital intensive enterprises, often don't recognize the need for investment credit, and (3) a lack of flexible investment credit lines. Only about 30% of the credit supplied to the Phase I cooperatives is from the agricultural development bank (BFA), the agricultural sector's lender of last resort. The remainder is supplied by the commercial or mortgage banks. The BFA is an important lender to the Phase I reform sector. However, those cooperatives to which the BFA makes loans are usually the less creditworthy and thus frequently excluded from loans under commercial banking standards.

Credit needs of the Phase III beneficiaries differ greatly from those of the Phase I cooperatives. The Phase III beneficiaries are numerous and widely dispersed. This, coupled with the small size of their loan requests, adds to the costs of making loans to them; and, as a result, almost 95% of their loans are extended through the BFA. As noted above, in many cases loans through the BFA are the first experience Phase III beneficiaries have had with formal credit institutions. While some effort is necessary to overcome their natural reluctance to participate in the formal credit market, the changes in their tenure status and production practices necessitate the switch. Phase III beneficiaries, who now have secure title to land for the first time, are investing in longer-term projects for which the informal credit market is often unsuitable. Phase III beneficiaries are investing in drainage and soil conservation measures, as well as planting more permanent crops, all of which require greater investment and production credit than they previously needed.

SOCIAL CONSTRAINTS TO CREDIT USE

Given the background presented above, there are no clear social constraints to using credit provided under this project. On the contrary, the Phase I cooperatives especially depend on this credit, particularly as they develop management skills, replace pre-reform capital goods and cope with reduced world prices for many of their important export crops. Phase III beneficiaries, making the transition from itinerant farmers to landowners, need the credit provided under this program, and as the banking system becomes more adept at servicing the needs of small borrowers, the trend toward more formal credit sources for Phase III beneficiaries will continue.

PARTICIPATION BY WOMEN

Few data exist to document the role of women in the reform or their relationship to the credit system. It is estimated that about 10% of the cooperative membership is women, enjoying the same rights and privileges as men. Recent wage legislation mandates equal pay for men and women in agricultural labor, so the extent to which credit pays daily wages, women benefit. They are a large part of the labor force during the peak harvest season. A number of Phase III beneficiaries are women and no systematic discrimination against women in credit allocation is obvious. Of course, a great many women in both phases indirectly benefit from credit as members of households which depend, in small or large part, on agricultural credit.

C. Financial Analysis

The main issues covered in this summary are as follows. First, do the BCR and PFIs have the financial management capabilities to ensure that credit extended under this rediscount line is properly utilized according to the terms of the Grant Agreement?. Second, is the spread allocated to the PFIs a sufficient incentive for them to increase their lending to Phase I and Phase III clients?. Third, are the projected levels of repayment high enough for the PFIs to cover their costs and increase their provision for bad debts through the spread?

1. Financial Strength of the BCR and PFIs

The Central Reserve Bank has experience in dealing with rediscount lines for the agricultural sector. It has the basic minimum procedures (supported by manuals) necessary to operate a rediscount line effectively. BCR internal reports as to the status of rediscount lines, both for the reform and non-reform sector, are timely and produced with adequate frequency.

The BCR has performed an annual review of all the agricultural departments of the PFIs that have dealt with BCR rediscount lines since the 1981/1982 cropping season. The evaluation is well done and it takes into account the quality of proposals submitted, future projection on financing, supervision and control, and repayment. This annual review forms the justification for the additional, up to 2 points, spread that the PFIs may receive.

In addition, the Coordinating Unit utilized the 20 credit agents assigned to the mixed and the Mortgage Bank to carry out a resource survey on all the cooperatives (155) served by those same banks. The resource survey included information on the formation of the cooperative, membership, management, resource base (soils, topography, water, infrastructure, cropping patterns, equipment, etc.,) and projected activities. Upon completing the detailed resource survey, data was collected from each bank on the loan status of each cooperative as of 15 June, 1985. The data on each loan included all information on outstanding loans by purpose, credit contracted, credit disbursed, balance, estimated interest, balance not due, and balance past due and whether or not the bank's own resources or the Central Bank's resources were used. The Coordinating Unit did a good job toward the establishment of a data base.

The BCR department of financial systems receives a quarterly report on the status of reform sector loans. This quarterly report is based on summing the current balances from every cooperative and seems to be the best base of information provided by the PFIs to the BCR. The semi-annual report from the mixed banks that includes loan balances from the same period contains different totals. A review of these reports is currently being undertaken by the BCR.

BCR Internal Audit utilization of staff and prioritization of functions is one area where short term outside technical assistance is recommended.

Based on the financial review of the BCR there is sufficient basis to be confident with BCR financial management capabilities to ensure the proper utilization of project funds. As long as there is complete access to any information from any bank that accepts a rediscount credit from the BCR there are no difficulties foreseen.

2. Analysis of the Spread Structure

The BCR and the PFIs, based on their current costs, need 2 points to cover their administrative costs. Spreads greater than 2 points can then be utilized for fund capitalization (BCR) or for bad debt contingencies (PFIs) and additional costs and risks perceived with increased reform sector lending. Flexibility is required to adjust the spread based on project experience in achieving credit flow to desired activities and recipients. It is important that strict monitoring of projects and users be established at the beginning so that adjustments to the spread can be made as required.

An analysis of the spread structure shows that for short term production credit the lending institutions should be confident of a 95% repayment rate if they are to cover their administrative costs and repay the BCR in full. The repayment level necessary to cover administrative expenditures for medium and long-term loans depends on the terms of the lending. Given a five year loan with a 2 year grace period, a repayment rate of 90% would be required (exclusive of the bank's commission). Without greater details on perceived risk and current repayment rates it is difficult to project the adequacy of the spread.

3. Repayment and Refinancing

Agricultural sector loan repayment and refinancing is a problem associated with all banks. The magnitude of the problem is not known. Not knowing repayment rates by project makes it extremely difficult to say which reform sector portfolios have been most successful. In order to address this problem, it is recommended that all loans of a recipient of this Project's rediscount line be analyzed and repayment rates calculated. In addition, the tracking of all a recipient's loan activity under this project should be carried out on a quarterly basis. Given the capabilities of the PFIs and the BCR Coordinating Unit this should present no problem.

4. Interest Rates

1986 interest rates to both borrowers and savers are at an all time high even though real interest rates are negative. During 1985 the mixed and mortgage banks increased their national currency deposits from 3,381.3 million colones to 4,340.5 million colones, a 28.4% increase. In addition, the loan portfolios of the same banks increased at a slightly smaller amount. Based on the experience of these banks in 1985 there is every reason to believe that high levels of both saving and lending will be reached in 1986.

5. Project Monitoring

Project monitoring through the BCR coordinating unit of this Project is viewed as a major key to success. Establishing a data base to monitor recipient performance, fund allocation and use, and additionality are priority tasks. Capabilities within the BCR are sufficient to carry out these functions.

D. Economic Analysis Summary

The Agrarian Reform process achieved a redistribution of the ownership of productive resources from the traditional landowners to agricultural laborers. The process was disruptive to the agricultural production process for several reasons: 1) The new landowners did not have the managerial capability to bring all productive resources together efficiently; 2) the traditional business relationships between the former landowners and suppliers of financial capital were not extrapolated to the new owners; and, 3) the traditional channels of distribution of agricultural output for domestic consumption and especially for export were sevearly disturbed. Additionally, downward swings in the prices for some of the traditional export crops produced in the affected lands reduced the incentive to maintain, let alone increase, production. The net result of these elements was an immediate reduction of output, i.e. an increase in the unrealized productive potential of the transferred agricultural land.

The initial reaction of both governmental institutions and the new landowners was to direct their efforts at minimizing production losses and the attendant reduction in welfare. Government efforts, concentrated in making available financial resources and performing some of the marketing functions for inputs and outputs associated with traditional crops for exports and domestic consumption. The new landowners concentrated in maintaining the traditional crops they had helped to produce while they were laborers. The result of these efforts was an erratic production trend which has not resulted in a sustained improvement in the welfare of the reform sector.

The basic problem is that some of the reform related factors which disrupted production have not been fully addressed. On the subject of managerial ability, GOES efforts with U.S. assistance have made substantial progress in introducing sound managerial practices to many of the agrarian reform cooperatives. As a result of this assistance, many of the recipient cooperatives are in financially viable positions. On the subject of disrupted channels of distribution for agricultural outputs, the GOES marketing functions for traditional export and domestic crops seem to be performed with less interruptions and confusion. The GOES does not appear to be interested in performing those functions for new crops which leaves the field open for the establishment of more efficient channels of distribution for a diversified output mix.

The factor which has been addressed the least is that of the traditional relationships between landowner and the suppliers of financial capital. The providers of financial capital to the former landowners were not only affected by the reform when ownership of financial intermediaries was transferred to the public sector, but they had to face the loss of its traditional creditworthy clients and face new ones with little or no credit records, and without the capacity to provide their equity as collateral for any loan request. Logically, banking system operations minimized lending exposure in the reform sector. As a result and as shown in the saving mobilization study, much of the credit provided to the reform sector comes from government sponsored programs, which have concentrated on production credit. There has been little or no credit available for investment.

The lack of access to long term finance has had the negative effect of discouraging the development of new investment projects that take full advantage of the resource endowment in the reform sector. This has been particularly detrimental to the implementation of an agricultural development strategy based on the diversification of production. In this sense, the structure of credit available to the reform sector is one of the principal constraints to increased agricultural production and the development of the sector.

The principal objective of this project is to begin addressing the credit constraint. The strategy of the project is to provide investment credit resources to the reform sector, and to initiate a technical assistance program designed to strengthen credit delivery mechanisms to the reform sector from financial intermediaries. The project has three major components: a) the establishment of a line of credit on a commercial basis to the reform sector; b) the introduction of a technical assistance program for PFIs designed to improve credit delivery to the reform sector by reducing transaction costs and applying technically sound project financial analysis (the assistance is also designed to find improved mechanisms to deliver credit to small farmers); and, c) the introduction of a pilot savings mobilization program designed to test the feasibility of mobilizing rural savings in El Salvador.

In a attempt to analyze the economic feasibility of expanding production in the agricultural sector, including the reform sub-sector, the Mission has performed several analyses of potential investment opportunities. For this project, the design team analyzed investment projects recently submitted by agricultural cooperatives for approval by the banking system. The foregoing analyses are relevant to the implementation of this project, since the projects analyzed are representative of the type of investment potential in the agricultural sector, and in some cases represent projects ready for submission to the banking system. Thus, the projects are indicative of the economic feasibility associated with the establishment of the line of credit and the provision of technical assistance to financial intermediaries. The table on the following page presents a summary of the Mission's analyses. The left column presents a brief description of the projects analyzed, the right column shows the economic rates of return estimated for each of the project's activities. The methodologies involved in each of the estimates follow widely accepted and utilized cost/benefit literature.

The projects presented in the table represent a broad range of investment opportunities. Their rates of return (economic and financial) vary substantially from marginally feasible projects with economic rates of return of as low as 2% to projects which constitute a tremendous potential for the country with rates of return in excess of 30%. At the lower range are those activities associated with traditional agricultural production. With the exception of coffee, the rates of return associated with traditional activities such as milk production underline the need to diversify the productive base, i.e. to implement projects with high rates of return. At the upper range are those projects which bring together the results of assistance to the agricultural sector designed to ideally eliminate, but certainly reduce, constraints to increased production. These are projects which take to fullest advantage the resource endowment in the agricultural sector. In this sense, the credit component of the project becomes an essential element which completes the total assistance package for the agricultural sector.

The Mission expects the project not only to provide financial resources for economically viable investments, but to restructure the financing available to the reform sector. The availability of credit itself should become the catalyst for cooperatives to identify investment projects that generate higher returns than the traditional productive activities in which they are engaged. The technical assistance component should enhance the willingness of participating financial institutions to provide the necessary financing in a more efficient basis.

Table

EL SALVADOR - RATES OF RETURN FOR INVESTMENT IN AGRICULTURE

Project Description	ECONOMIC INTERNAL RATE OF RETURN
The introduction of irrigation, a change in the crop mix, expansion of area cultivated, and marketing technical assistance to a 300 hectares pilot project. The crop mix includes Honeydew melons, Watermelons, Cucumber, Squash and Green Beans for export.	30.8%
Coffee replanting. The project would consist of replanting 360,000 seedlings over a two-year period, as well as, establishing and maintaining for three years a nursery of 180,000 seedlings.	38.0%
Fluid Milk Production. The establishment by purchase and propagation of an improved dairy herd of 50 to 85 cows and two to four bulls. The establishment of 37 manzanas of well-and-pump-irrigated pasture for maintenance of the herd. The project also foresees the purchase of concentrates and the construction of an irrigation system.	2% to 14%
Fruit Production and Processing for Export. This project consists of planting 1500 hectares over a 5 year period with melons, watermelons, cucumbers, zuchini and corn for export. The project also contemplates the construction of a processing plant which would prepare the products for export to Financial IRR third country markets.	17.3 to 30%.

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INITIALS

E.O. 12356: N/A
TAGS:
SUBJECT: AGRARIAN REFORM SECTOR FINANCING PROJECT (519-0307) GUIDANCE FOR PP DEVELOPMENT
REF: SAN SALVADOR 01451

1. PID APPROVAL. THE SUBJECT PID WAS REVIEWED BY THE DAEC ON JANUARY 24, 1986 AND APPROVED. THE MISSION IS REDELEGATED THE AUTHORITY TO APPROVE THE PROJECT PAPER. THE DAEC DETERMINED, HOWEVER, THAT THE PROJECT AS DESCRIBED DOES NOT MEET THE CRITERIA FOR FULL GRANT FUNDING AS ESTABLISHED IN QUOTE THE GUIDELINES ON TERMS OF AID UNQUOTE APPROVED BY THE ADMINISTRATOR AND ISSUED ON MAY 16, 1985. DESPITE ARGUMENTS SET FORTH IN REFTEL, WE CONTINUE TO BELIEVE THAT THE PROJECT SHOULD BE LOAN FUNDED, EXCEPT FOR TECHNICAL ASSISTANCE WHICH MAY BE GRANT FUNDED. IF MISSION WISHES TO PURSUE ARGUMENT ON DEBT SERVICE RATIONALE IT MAY DO SO BY PROPOSING, IN ACTION PLAN, TO MOVE ENTIRE DA PROGRAM TO A GRANT BASIS.

. DEMAND FOR CREDIT. THE PROJECT PAPER MUST DESCRIBE HOW THE LACK OF CREDIT, CITED IN THE PID, IS THE KEY CONSTRAINT TO INCREASED AGRICULTURAL PRODUCTION BY REFORM BENEFICIARIES. ARE CROPPING ALTERNATIVES AND PREVAILING PRICES THE MAJOR DISINCENTIVE TO THE SECURING OF CREDIT FROM TRADITIONAL SOURCES? HOW MUCH OF THE DEMAND IS SATISFIED THROUGH INFORMAL LENDERS? BUREAU REQUESTS THAT RESULTS OF ONGOING CREDIT/MARKET DEMAND STUDY, WHICH EXAMINES THESE AND OTHER ISSUES, BE SHARED WITH AID/W PRIOR TO COMPLETION OF INTENSIVE REVIEW FOR PROJECT PAPER.

3. ECONOMIC ANALYSIS. IN ADDITION TO ADDRESSING CREDIT DEMAND/SUPPLY ISSUES, THE INTENSIVE REVIEW SHOULD ALSO ATTEMPT TO DETERMINE NET ECONOMIC BENEFITS--BOTH PAST AND PROSPECTIVE--ATTRIBUTABLE TO AID-SUPPORTED CREDIT PROGRAMS.

4. INTEREST RATE POLICY. THE QUOTE GUIDELINES ON TERMS OF AID UNQUOTE STIPULATES THAT IN LDCS WHERE PREVAILING INTEREST RATES ARE DISTORTED BY LOW LEGAL CEILINGS AND DO NOT REFLECT OPPORTUNITY COSTS OF CAPITAL, INTEREST RATES FOR PRIVATE BORROWERS SHOULD BE SET IN CONTEXT OF THE MISSION'S EFFORTS TO ENCOURAGE THE LOCAL GOVERNMENT TO PROGRESSIVELY ELIMINATE THE IMPEDIMENTS TO FREE CAPITAL

4. AT A MINIMUM, THE INTEREST TO ULTIMATE PRIVATE BORROWERS MUST BE POSITIVE WHEN ADJUSTED FOR INFLATION. DAEC RECOGNIZED THAT INTEREST RATES IN EL SALVADOR ARE NOW NEGATIVE IN REAL TERMS. THE PID FOR THIS PROJECT WAS APPROVED ON THE UNDERSTANDING THAT THE USAID IS WORKING WITH GOES TO ACHIEVE POSITIVE INTEREST RATES BY THE END OF 1985. THE PP SHOULD DESCRIBE HOW TERMS ON LOANS TO SUBBORROWERS WILL CONFORM TO AID POLICY IN THE CONTEXT OF THIS EFFORT.

5. CENTRAL BANK LOAN REVIEW PROCEDURES. THE BCR REDISCOUNT PROCEDURE SHOULD RELY SUBSTANTIALLY ON THE LOAN APPLICATION ANALYSIS CAPABILITIES OF PARTICIPATING IFIS, WHICH SHOULD BE ANALYZED IN THE PP. IN THE PAST, BCR PROCEDURES FOR REDISCOUNT LOAN ANALYSIS HAVE SIGNIFICANTLY DELAYED FINAL APPROVAL/DISAPPROVAL. THE DISCUSSION IN THE PID OF THESE BCR PROCEDURES DID NOT INDICATE THAT THEY HAD BEEN STREAMLINED. THE DAEC WAS INFORMED BY THE MISSION REPRESENTATIVES THAT THESE

PROCEDURES ARE NOW LESS CUMBERSOME THAN BEFORE AND THUS SHOULD NO LONGER BE A HINDRANCE TO SMOOTH PROCESSING OF LOANS. THE PP SHOULD THOROUGHLY DESCRIBE CURRENT AND/OR PROPOSED BCR PROCEDURES FOR REVIEWING LOANS SENT FOR REDISCOUNT.

6. SAVINGS MOBILIZATION PROGRAM. THE PP SHOULD CLEARLY JUSTIFY THE INVESTMENT OF RESOURCES IN THE PILOT SAVINGS MOBILIZATION PROGRAM. QUESTIONS TO BE CONSIDERED INCLUDE: A) WILL THE INTEREST RATE STRUCTURE UNDER WHICH THIS PILOT ACTIVITY WILL OPERATE BE A DETERRENT TO SAVINGS MOBILIZATION? B) WHAT ARE THE OTHER PROBLEMS IN THE SALVADORAN ENVIRONMENT WHICH MIGHT DETER A SUCCESSFUL SAVINGS MOBILIZATION PROJECT AND HOW WILL THE DESIGN OF THE PILOT PROGRAM COUNTER THESE DISINCENTIVES? C) WHAT IS THE SAVINGS PROGRAM EXPERIENCE OF CREDIT UNIONS IN EL SALVADOR AND HOW WILL THE SAVINGS MOBILIZATION EFFORT UNDER THIS PROJECT DRAW FROM THIS EXPERIENCE?

7. EVOLUTION OF BFA. WHILE IT IS RECOGNIZED THAT THE BFA HAS MADE CONSIDERABLE PROGRESS IN MEETING THE DEMANDS OF ITS CLIENTELE UNDER THE AGRARIAN REFORM CREDIT PROJECT (519-0263), THE DAEC IS CONCERNED THAT, AS EVIDENCED BY THE RECENT PROJECT EVALUATION, THE BANK IS STILL EXPERIENCING HIGH ADMINISTRATIVE COSTS AND OTHER MANAGEMENT PROBLEMS. THE MISSION IS ENCOURAGED TO KEEP PRESSING FOR IMPROVEMENTS IN THESE AREAS. TO THE EXTENT THAT CONDITIONS PLACED ON ASSISTANCE TO BFA UNDER PROJECT #263 HAVE NOT BEEN MET, BFA PARTICIPATION IN THE NEW PROJECT SHOULD BE CONDITIONED ON ITS MEETING OF TARGETS FOR IMPROVED MANAGEMENT AND THE ADMINISTRATION OF ITS PORTFOLIO. THE PROJECT PAPER SHOULD CLEARLY DEFINE THESE
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TARGETS FOR THE EVOLUTION OF THE BFA INTO A VIABLE BANKING OPERATION, AND SHOULD DISCUSS HOW THEY WILL BE MET.

8. PAYMENT VERIFICATION POLICY. MISSION IS REMINDED THAT ALL PROJECT PAPERS MUST INCLUDE, AS PART OF THE FINANCIAL ANAYSIS SECTION, A DETAILED ASSESSMENT OF THE METHODS OF IMPLIMENTATION AND FINANCING OF THE PROPOSED ACTIVITY. PLEASE REFER TO THE APPROPRIATE GUIDANCE, DATED DEC. 30, 1983 WHICH WAS RECENTLY REDISTRIBUTED UNDER A LETTER TO ALL LAC MISSION DIRECTORS FROM AA/LAC, DATED FEB. 3, 1986.

9. GRAY AMENDMENT. GRAY AMENDMENT POLICIES SHOULD BE CAREFULLY CONSIDERED DURING PP PREPARATION. SHULTZ
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E.O. 12356: N/A
TAGS:
SUBJECT: AGRARIAN REFORM SECTOR FINANCING PROJECT
(519-0307)

REF: (A) SAN SALVADOR 03588; (B) STATE 050374; (C) SAN SALVADOR 01451

1. PER REQUEST IN REFTELS (A) AND (C), AA/LAC HAS APPROVED THE USE OF GRANT FUNDING FOR THE SUBJECT PROJECT IN ITS ENTIRETY. THE MISSION MAY THEREFORE PROCEED TO DEVELOP THE PROJECT IN LINE WITH THE GUIDANCE CONTAINED REFTEL (B).

2. GIVEN THE FUNDING MODE, THE MISSION IS ADVISED TO CONSIDER THE NEED FOR SOURCE AND ORIGIN WAIVERS AS PART OF ITS PROCUREMENT PLANNING IN PP DEVELOPMENT. SHULTZ
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ANNEX B

AGRARIAN REFORM SECTOR FINANCING

(519-0307)

LOGICAL FRAMEWORK MATRIX

Narrative Summary	Objectively Verifiable Indicators	Means of Verification	Important Assumptions
Project Goal: To increase the economic well being of farm families in the reform sector.	1) Increased income of reform sector beneficiaries 2) Increased access to essential services 3) Improved living conditions	Statistics of Central Bank of Reserve Statistics of MAG Reports and special studies to be conducted by PERA.	1- GOES policies will be favorable and encourage production (i.e. price incentives for agricultural output, exchange rate policies) 2- Favorable climatic conditions will prevail. 3- The present level of violence in the country will decrease.
Sub-Goal: To increase agricultural reform sector output.	1) Increased overall agricultural production in the reform sector in both volume and value.		
Project Purpose: To increase the availability and productive use of credit in the reform sector.	Project Status (EOPS): 1. Intermediary credit Institutions' annual flow of credit will increase at least by the amount made available annually under the Project. 2. Creditworthy Ag reform coops and other beneficiaries will increase their total ag credit at least by the amount made available through Project. 3. The loan repayment rate for reform sector cooperatives and Phase III beneficiaries improved by at least 15% over the 1985 levels by 1991.	Central Bank of Reserve statistics/ records on banking system loan portfolios; PFI Records Records/reports of ag reform cooperatives.	1- Credit being made available from the Project will be in addition to present credit levels of Reserve Bank and PFIs. 2- Technical assistance in cooperative organization, management, and financial planning will improve overall cooperative management procedures. (0265, Technoserve) 3- Credit will be distributed according to credit evaluation criteria to be established

(519-0307)

LOGICAL FRAMEWORK MATRIX

Narrative Summary	Objectively Verifiable Indicators	Means of Verification	Important Assumptions
Outputs:			
1) Rediscount credit line established and functioning	1) Rediscount loans made to PFI	- Central Bank records and reports - PERA field surveys - PFI records/reports - Ag reform coop records	1- Interest rates will be flexible and approach market rates when possible. 2- Incentives will exist to encourage savings.
2) Training program in place.	2) Training sessions and other activities held.		
3) Policy study and Education Program functioning	3) Demonstrated efforts/interaction i.e. meetings/dialogues; seminars		
4) Pilot savings mobilization program established.	4) Reports produced.		

Inputs:

	AID	* GOES	Means of Verification	Important Assumptions
Rediscount line	$ 46 M	$14.0 M	- AID Controller's records - Central Bank of Reserve reports	1- Central Bank of Reserve disbursements made in a timely manner.
Technical Assistance	1.7 M	2.05 M		
Training	1.3 M	.025 M		2- AID funds made available as scheduled.
Other Costs	1.0 M	.925 M		
	$50.0 M	$ 17.0 M		

* In-kind contribution and BCR rediscount credit line

5C(2) PROJECT CHECKLIST

Listed below are statutory criteria applicable to projects. This section is divided into two parts. Part A. includes criteria applicable to all projects. Part B. applies to projects funded from specific sources only: B.1. applies to all projects funded with Development Assistance Funds, B.2. applies to projects funded with Development Assistance loans, and B.3. applies to projects funded from ESF.

CROSS REFERENCES: IS COUNTRY CHECKLIST UP TO DATE? HAS STANDARD ITEM CHECKLIST BEEN REVIEWED FOR THIS PROJECT?

A. GENERAL CRITERIA FOR PROJECT

1. FY 1982 Appropriation Act Sec. 523; FAA Sec. 634A; Sec. 653(b).

   (a) Describe how authorizing and appropriations committees of Senate and House have been or will be notified concerning the project; — a) CN submitted

   (b) is assistance within (Operational Year Budget) country or international organization allocation reported to Congress (or not more than $1 million over that amount)? — b) Yes

2. FAA Sec. 611(a)(1). Prior to obligation in excess of $100,00, will there be

(a) engineering, financial or other plans necessary to carry out the assistance and (b) a reasonably firm estimate of the cost to the U.S. of the assistance?

a) Yes

b) Yes

3. FAA Sec. 611(a)(2). If further legislative action is required within recipient country, what is basis for reasonable expectation that such action will be completed in time to permit orderly accomplishment of purpose of the assistance?

N/A

4. FAA Sec. 611(b); FY 1982 Appropriation Act Sec. 501. If for water or water-related land resource construction, has project met the standards and criteria as set forth in the Principles and Standards for Planning Water and Related Land Resources, dated October 25, 1973? (See AID Handbook 3 for new guidelines.)

N/A

5. FAA Sec. 611(e). If project is capital assistance (e.g., construction), and all U.S. assistance for it will exceed $1 million, has Mission Director certified and Regional Assistant Administrator taken into consideration the country's capability effectively to maintain and utilize the project?

N/A

6. FAA Sec. 209. Is project susceptible to execution as part of regional or multilateral project? If so, why is project not so executed? Information and conclusion whether assistance will encourage regional development programs.	No
7. FAA Sec. 601(a). Information and conclusions whether project will encourage efforts of the country to: (a) increase the flow of international trade; (b) foster private initiative and competition; and (c) encourage development and use of cooperatives, and credit unions, and savings and loan associations; (d) discourage monopolistic practices; (e) improve technical efficiency of industry, agriculture and commerce; and (f) strengthen free labor unions.	The project is designed to strengthen agricultural cooperatives
8. FAA Sec. 601(b). Information and conclusions on how project will encourage U.S. private trade and investment abroad and encourage private U.S. participation in foreign assistance programs (including use of private trade channels and the services of U.S. private enterprise).	Investment credit from project will involve purchase of U.S. products such as farm machinery; production credit loans will involve purchases of U.S. fertilizers.

9. FAA Sec. 612(b), 636(h); FY 1982 Appropriation Act Sec. 507. Describe steps taken to assure that, to the maximum extent possible, the country is contributing local currencies to meet the cost of contractual and other services, and foreign currencies owned by the U.S. are utilized in lieu of dollars.	Government contribution to be defined in bilateral agreement.
10. FAA Sec. 612(d). Does the U.S. own excess foreign currency of the country and, if so, what arrangements have been made for its release?	No
11. FAA Sec. 601(e). Will the project utilize competitive selection procedures for the awarding of contracts, except where applicable procurement rules allow otherwise?	Yes
12. FY 1982 Appropriation Act Sec. 521. If assistance is for the production of any commodity for export, is the commodity likely to be in surplus on world markets at the time the resulting productive capacity becomes operative, and is such assistance likely to cause substantial injury to U.S. producers of the same, similar or competing commodity?	N/A
13. FAA 118(c) and (d). Does the project comply with the environmental procedures set forth in AID Regulation 16? Does	Yes

the project or program take into consideration the problem of the destruction of tropical forests? — N/A

14. FAA 121(d). If a Sahel project, has a determination been made that the host government has an adequate system for accounting for and controlling receipt and expenditure of project funds (dollars or local currency generated therefrom)? — N/A

B. FUNDING CRITERIA FOR PROJECT

1. Development Assistance Project Criteria

a. FAA Sec. 102(b), 111, 113, 281(a). Extent to which activity will (a) effectively involve the poor in development, by extending access to economy at local level, increasing labor-intensive production and the use of appropriate technology, spreading investment out from cities to small towns and rural areas, and insuring wide participation of the poor in the benefits of development on a sustained basis, using the appropriate U.S. institutions; (b) help develop cooperatives, especially by technical assistance, to assist rural and urban poor to help themselves toward better life, and

a) High impact

b) High impact

otherwise encourage democratic private and local governmental institutions; (c) support the self-help efforts of developing countries; (d) promote the participation of women in the national economies of developing countries and the improvement of women's status; and (e) utilize and encourage regional cooperation by developing countries?	c) High impact d) Some impact e) N/A
b. <u>FAA Sec. 103, 103A, 104, 105, 106</u>. Does the project fit the criteria for the type of funds (functional account) being used?	Yes
c. <u>FAA Sec. 107</u>. Is emphasis on use of appropriate technology (relatively smaller, cost-saving, labor-using technologies that are generally most appropriate for the small farms, small businesses, and small incomes of the poor)?	Yes
d. <u>FAA Sec. 110(a)</u>. Will the recipient country provide at least 25% of the costs of the program, project, or activitiy with respect to which the assistance is to be furnished (or is the latter cost-sharing requirement being waived for a "relatively least developed" country)?	Yes

e. FAA Sec. 110(b). Will grant capital assistance be disbursed for project over more than 3 years? If so, has justification satisfactory to Congress been made, and efforts for other financing, or is the recipient country "relatively least developed"? (M.O. 1232.1 defined a capital project as "the construction, expansion, equipping or alteration of a physical facility or facilities financed by AID dollar assistance of not less than $100,000, including related advisory, managerial and training services, and not undertaken as part of a project of a predominantly technical assistance character.	N/A
f. FAA Sec. 122(b). Does the activity give reasonable promise of contributing to the development of economic resources, or to the increase of productive capacities and self-sustaining economic growth?	Yes
g. FAA Sec. 281(b). Describe extent to which program recognizes the particular needs, desires, and capacities of the people of the country; utilizes the country's intellectual resources to encourage	The project supports an essential agrarian reform program; will strengthen capability of Host Country to administer agricultural credit and to promote savings.

institutional development; and supports civil education and training in skills required for effective participation in governmental processes esential to self-government.

2. Development Assistance Project Criteria (Loans Only)

a. FAA Sec. 122(b). Information and conclusion on capacity of the country to repay the loan, at a reasonable rate of interest. — N/A

b. FAA Sec. 620(d). If assistance is for any productive enterprise which will compete with U.S. enterprises, is there an agreement by the recipient country to prevent export to the U.S. of more than 20% of the enterprise's annual production during the life of the loan? — N/A

c. ISDCA of 1981, Sec. 724 (c) and (d). If for Nicaragua, does the loan agreement require that the funds be used to the maximum extent possible for the private sector? Does the project provide for monitoring under FAA Sec. 624(g)? — N/A

3. Economic Support Fund Project Criteria

a. FAA Sec. 531(a). Will this assistance promote economic or political — N/A stability? To the extent possible, does it reflect the policy directions of FAA Section 102?

b. FAA Sec. 531(c). Will assistance under this chapter be used for military, or paramilitary activities? N/A

c. FAA Sec. 534. Will ESF funds be used to finance the construction of the operation or maintenance of, or the supplying of fuel for, a nuclear facility? If so, has the President certified that such use of funds is indispensable to nonproliferation objectives? N/A

d. FAA Sec. 609. If commodities are to be granted so that sale proceeds will accrue to the recipient country, have Special Account (counterpart) arrangements been made? N/A

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ANNEX D

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Subject: Acquiring AID support

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MINISTERIO DE PLANIFICACION Y COORDINACION DEL DESARROLLO ECONOMICO Y SOCIAL

SETEFE-536/86

San Salvador, 27 de mayo de 1986

ASUNTO: Ref. Proyecto de Crédito para el Sector Reformado.

Señor
Robin Gómez
Director
Agencia para el Desarrollo Internacional -AID-
Presente.

Estimado Señor Gómez:

Tomando en consideración los esfuerzos que esa Agencia ha venido desarrollando en la consolidación del proceso de la Reforma Agraria, hemos considerado conveniente iniciar los trámites a fin de obtener una donación de esa Agencia por EUA$50,000.000.00, para atender las necesidades del crédito del Sector Reformado en sus Fases I y III, el Gobierno de El Salvador, por su parte, aportaría EUA$17.0 millones durante la vigencia del Proyecto, la cual se estima de 1986 a 1989.

Los fondos obtenidos se canalizarían a través de una línea de redescuento del Banco Central de Reserva de El Salvador (BCR), para ser redescontados por las instituciones intermediarias de crédito que presentasen documentos de redescuento elegibles al BCR para crédito de producción e inversión del mencionado sector. Asi mismo, parte de los fondos se utilizarían para establecer un amplio programa de entrenamiento para los oficiales del crédito del BCR e instituciones intermediarias de crédito participantes en el proyecto, estudios de políticas y seminarios sobre temas relacionados con la Reforma Agraria, Política Monetaria y Crediticia y un programa de movilización de ahorros rurales.

Como es de su conocimiento, el BCR tiene una larga experiencia en el manejo de líneas de redescuento tanto para el sector reformado como para el no reformado, de modo que tiene la capacidad de manejar en forma eficiente un proyecto de esta naturaleza. Por otro lado, existe al presente la Unidad de Coordinación de Agentes de Crédito en el BCR, que ha acumulado experiencia en el crédito de inversión para las cooperativas del sector reformado a través de la banco comercial mixta y el Banco Hipotecario.

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Esta Unidad sería responsable de la administración y coordinación de las actividades del Proyecto. Las otras instituciones participantes serían la banca comercial mixta, Banco Hipotecario y Banco de Fomento Agropecuario que, al presente, apoyan financieramente a más del 96% de las cooperativas del sector reformado y beneficiarios de la Fase III de la Reforma Agraria.

El Programa de entrenamiento y las actividades de estudio de políticas y seminarios tratarían también de incluir a Universidades Locales, además de las instituciones intermediarias de crédito. La movilización de ahorros rurales se planificaría mayormente a través del BFA.

El total de fondos requeridos para la implementación de este proyecto alcanzaría EUA$ 67.0 millones que tentativamente se distribuirían entre los diferentes componentes de acuerdo al siguiente detalle:

	Donación AID Miles EUA$	GOES Miles EUA$	TOTAL Miles EUA$
1. Línea de Redescuento	46,750	16,050	62,800
2. Entrenamiento	1,640	250	1,890
3. Estudios	300	50	350
4. Movilización de Ahorros	225	215	440
5. Evaluación	200		200
6. Imprevistos	885	435	1,320
TOTAL PROYECTO	50,000	17,000	67,000

Mucho agradeceríamos sus gestiones en procura de agilizar la culminación de los pasos que permitan concretar, en el menor tiempo posible, el convenio de donación mencionado.

Atentamente,

FIDEL CHAVEZ MENA
MINISTRO

INSTITUTIONAL ANALYSIS

The agricultural credit proposed to be funded through this Project would be provided to the ultimate beneficiaries (Phase I reform sector cooperatives and Phase III Decree 207 beneficiaries) through the intermediation of the Banco Central de Reserva (BCR) and the Participating Financial Institutions (PFIs), namely, the nationalized commercial banks (bancas mixtas), Banco Hipotecario (BH) and Banco de Fomento Agropecuario (BFA).

The institutional analysis in this Annex consists of:

A. Description of Monetary Authorities and Monetary Policy Instruments

B. Description of the organization and functions of the BCR and the PFIs.

C. Description of the existing rediscount mechanism.

D. Description of the recommended rediscount mechanism.

E. Comparison of the existing rediscount mechanism with the recommended mechanism.

F. Assessment of the management capability to implement and monitor the Project:

   1. In the BCR

   2. In the PFIs

G. Description of the credit delivery system to be applied between the BCR and the PFIs and between the PFIs and the final borrower.

A. Monetary Authorities and Monetary Policy Instruments

The Salvadoran monetary and financial system is regulated by the 1982 "Ley del Regimen Monetario." Under this law there are three entities that have jurisdiction over the country's banking system: the Monetary Board; the Superintendency of the Financial System; and the Central Reserve Bank. The Monetary Board (composed of cabinet ministers holding economic portfolios and the President of BCR) is the policy-making element and holds the ultimate power in the system as it is responsible for the Government's monetary, foreign exchange, and financial policies. The Superintendency of the Financial System performs audit and inspection functions in order to enforce legal provisions (including Monetary Board decisions) applicable to the financial system. The Central Reserve Bank is assigned the role of carrying out monetary policy under the direction of the Monetary Board. There are three basic instruments of Salvadoran monetary policy: a) legal reserve requirements; b) rediscounts; c) interest rate ceilings.

The legal reserve requirements on demand and time deposits serve to limit monetary expansion. After remaining unchanged at 20% for many years, they were raised to 25% in January 1986 as part of the stabilization program.

Rediscounts are used to alleviate seasonal or temporary problems of illiquidity within the financial system in order to facilitate a smooth flow of credit. They are also used selectively to direct credit to priority and productive activities. In recent years, rediscounts have also served to refinance loans that have proved hard to collect because of factors beyond the borrowers' control and related largely to the armed conflict and adverse economic environment prevailing in El Salvador. Hence, rediscounts influence the money supply as well as direct credit towards priority activities.

The ceilings on interest rates paid and charged by banks on deposits and loans, respectively, are designed to influence credit flows to targeted and priority economic activities, and to lower the cost of credit by controlling the maximum rates payable on deposits. The Monetary Board changes the maximum interest rates on loans as well as on savings and time deposits rather infrequently; the last across the board changes were made in January 1986 as part of the stabilization program. For loans, preference is given to both productive and short-term loans through lower interest rate ceilings in order to encourage borrowing for these purposes. At present, interest rates are 15% for most production loans for short-term and 17% on most medium and long term investment credits.

The rediscounts rates have generally been designed to provide a minimum of a 2% point spread for the lending institution. Larger spreads are employed, however, to encourage certain uses of rediscounting. For example, in order to encourage the financial institutions to undertake closer supervision of their loans (presumably to enhance their effectiveness and repayment), an additional spread of up to 2 points is offered. Currently, special rates are given for rediscounting selected preferred activities. For example, the rates are 10% for exports outside of Central America, 10% or less for loans made from the Economic Development Fund, and 7% for small-and medium-sized industry. Some refinancing loans are given even more preferred treatment with a six percent interest rate being charged. The encouragement of preferred activities is also accomplished by prescribing a longer repayment period.

Maximum interest rates on savings and time deposits are fixed for financial institutions. The rates are fixed to allow a spread compared with loan rates. Incentives are given to savers to make longer-term deposits by offering progressingly higher rates as the term of the deposit increases. The current rates for banks are 7.5% for savings, and from 11.5 to 15.5% for time deposits for 60 days to one year or more.

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B. Organization and Functions of the BCR and the PFI's

1. The BCR

As of the end of April 1986, the number of staff positions at the BCR Head Office was 809, of which 61 remained vacant. The number of staff positions at 7 BCR branches was 96, including 3 vacancies. The number of staff positions in the Superintendency of the Financial System was 142, of which 10 were not filled.

Besides the normal relationship of a central bank with its client "deposit money banks", the relationship of the BCR with the banca mixta has an additional dimension. The State has transferred its 51% ownership of the nationalized commercial banks' stock (bancas mixtas) to the BCR, making it the majority stockholder. The BCR conducts two formal reviews of each bank every year, which are held prior to the presentation by the banks of their annual and semi-annual reports to the General Stockholder Assembly. In these reviews, held with the President or one of the Vice-Presidents of the BCR, the BCR examines each bank's performance during the period, and determines policies and objectives for the next.

For the rediscounting of credits extended by the financial system, there are three sources of funds available to the BCR: its own funds (accounting for 78.3% of the flow of rediscounts in 1985), foreign institutions, such as A.I.D., IBRD, etc. (17.1%) and the Economic Development Fund (4.6%) Since 1979, as a result of armed conflict and economic deterioration, there has been a steadily increasing need to provide refinancing for loans that otherwise would have been in default. Some refinancing activities, however, are of structural origin. For example, since the BCR, by law, cannot lend with its own resources for periods longer than a year, most coffee production loans are usually refinanced at the end of each agricultural year to allow borrowers time while INCAFE markets the coffee production before paying for the crop.

At the end of 1985 BCR rediscounts were distributed across classes of institutions in the following manner: 37.5% to commercial banks and the Mortgage Bank, 53.5% to public financial institutions, including the BFA; and 9.0% to other private institutions, including FEDECACES and FEDECCREDITO.

Agricultural sector activities are important users of rediscounting facilities. During 1985, 65.8% (C449.1 million) of all new rediscounts were directed to this sector, which represented a substantial increase compared to the share of 44.1% (C387.6 million) registered in 1984. Of the agricultural sector total, 76.4% was directed to commercial banks and the Mortgate Bank, 19.3%s to public institutions and only 4.2% to other institutions. These rediscounts were heavily concentrated in five activities: coffee received 64.1%; cotton 16.5%; sugar cane was a distant third with 5.5%; while livestock (5.1%) and corn (5.0%) accounted for at least 5% of the new agricultural credit flows for the first time in the 1980's.

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2. The PFIs

Among the PFIs, the eligible recipients of the Project funds will be the banca mixta, Banco Hipotecario and the BFA. At the end of 1984, these entities had an outstanding agricultural credit portfolio of ¢ 1,368 million, of which the banca mixta accounted for 47.3%; Banco Hipotecario, 26.2%; and the BFA, 26.5%.

The organization and functions of these entities are covered in this section. Not considered as eligible recipients of the Project funds are three other credit institutions: The Federation of Credit Agencies (FEDECCREDITO and its affiliated "Cajas"; the Federation of Credit Unions (FEDECACES) and its affiliated credit unions; and the National Coffee Institute (INCAFE). None of these three entities is a banking institution in the true sense of the term. In particular, INCAFE is not even a "nonbank financial intermediary"; rather, it is a marketing agency. In addition there are specific reasons for excluding each of these institutions. In the early period of the agrarian reform, FEDECCREDITO and INCAFE provided significant credit to the Phase I cooperatives and were assigned 20 and 33 cooperatives, respectively, by the Monetary Board in 1980-81 and 1981-82. However, in recent years, their lending to the agrarian reform cooperatives has dwindled to insignificant proportions; they were assigned only 2 and 1 cooperatives, respectively, in 1984-85. FEDECACES has not done any lending to the cooperatives. None of the three institutions has extended any credit to Decree 207 (Phase III) beneficiaries.

a. Nationalized Commercial Banks (Bancas Mixtas)

On March 7, 1980, under Nationalization Decree 158, the nation's private commercial banks (excluding the Mortgage Bank) and savings and loan associations were nationalized. This was done to give the Government control over these institutions as well as to break up the effective power of their ownership which was concentrated in the hands of relatively few persons who were also large landowners and users of financial resources. With nationalization, at least 51% of the stock in each bank is owned by the Government, the other 49% of the stock was put up for sale, 29% was offered to private investors and 20% to the employees of each bank. Consequently, the commercial banks are often referred to as the mixed banks. At present, there are nine such banks. Private sector ownership of the banks is widely dispersed. According to law, no one individual or legal entity may hold stock in more than one bank, and in that bank it can hold no more than 1% of the total stock.

Each bank has a three person board of directors, with two representatives, president and vice president, appointed by the Monetary Board. The head offices of all the nine mixed banks are located in San Salvador. There are significant differences among the banks in terms of size and number of branches. For example, Banco de Comercio is the one with the most agencies outside the San Salvador metropolitan area. In contrast, Banco Financiero does not have any branch outside the capital city.

At the end of 1984, the combined loan portfolios for all commercial banks was ₡ 2,2 billion. Between 1980 and 1984, the combined portfolios grew at an average annual rate of 12.3% in nominal terms, a decline of 0.5% in real terms.

The commercial banks have channeled a substantial amount of resources to agriculture. Loans to the agricultural sector accounted for 17.9% of the combined portfolio at the end of 1984, having a high concentration in coffee, cotton and sugar cane. At the end of 1984, the respective percentages of total financing for these crops were 45.3, 19.7 and 9.6. At the end of 1984, an average of 20% of the sector's loan volume was for credit to beneficiaries of land reform. There was, however, considerable variance among institutions with respect to their lending to the reform sector. Lending to the reform sector was mostly directed to Phase I cooperatives. They also lent to Phase III beneficiaries, but on a much smaller scale.

Reliable and consistent figures are not available for the deliquency in the combined portfolio of commercial banks. However, six of these banks had an average agricultural portfolio delinquency of 10.6% as of 12/31/84. At the same time, the refinancing of agricultural sector loans rose from 23.4% to 39.3% between 1980 and 1984.

As for agricultural credit delivery systems, the banks follow standardized procedures for analyzing loan applications. Since most farmer borrowers have been bank clients for many years, the banks try to reduce paperwork. In most cases, traditional sector clients are expected to maintain at least 5 or 10% of their loans in demand deposits as compensating balances, which serve to raise the effective rate of interest. Most short-term production loans are secured by a personal guarantee and the expected harvest. Medium term loans use liens on assets as security. A large portion of the lending to the agricultural sector comes from financing out of BCR rediscount lines. In these cases, BCR procedures are followed. The banks monitor closely the use of credit by their clients, including farm visits by agents.

The banks have four sources of funds for financing their credit operations: their own resources, foreign loans, BCR rediscounts and the Economic Development Fund. The banks' own resources are by far the most important. At the end of 1984, they accounted for 77.3% of their combined loan portfolio, while BCR rediscounts amounted to 16.2%. For their agricultural sector portfolio the banks have depended heavily on BCR rediscounts. At the end of 1984, approximately 90% of their agricultural lending came from rediscount sources with the rest coming mostly from the banks' own funds.

The banks receive savings and time deposits at each of their offices. At the end of 1984 they had stocks of ₡809.6 and ₡1,137.1 million in savings and time deposits, respectively. Since 1980, the combined total of these two deposits has grown at an average annual rate of 37.7%. Over the period, there has been a shift from savings to time deposits, presumably due to the higher interest rates offered on the latter.

b) Banco Hipotecario (Mortgage Bank)

The Mortgage Bank (BH) was founded in 1935 as a commercial bank with the unique characteristic that it is empowered to issue interest-bearing, tax-free mortgage certificates to savers. These certificates are attractive to savers because they are guaranteed by the state and earn a competitive, tax-free, interest rate (13% on five year certificates and 14% on ten year certificates based on rates through 1/26/86). While it gives priority to lending to the agricultural sector, BH is a full service bank. It has a headquarters office, four branches in the capital and eleven outside the capital. All branches handle the full array of banking services, including the purchase and sale of mortgage certificates.

Some 98% of BH stock is owned by the Coffee Producers Association. The highest authority is an 11 person board of directors. The Bank's president is elected by this board subject to the approval of the Government. The Bank is administered by the general manager credit manager and manager of finance and operations.

At the end of 1984, the BH had an outstanding loan portfolio of ₡844 million. Between 1980 and 1984 the portfolio grew at an average annual rate of 3.8%. Measured in real terms it declined at an annual rate of 8.1%. At the end of 1984, loans to the agricultural sector accounted for 21.4% of the total portfolio, refinanced loans 43.9% and others 34.7%. If the agricultural portion of the refinanced portfolio is included, 39.8% of the portfolio would correspond to this sector.

The BH makes the large bulk of its agricultural loans to medium sized farmers who have not been affected by land reform. At the end of 1984, 40.0% of its agricultural sector portfolio was directed to the reform sector. It has outstanding loans to 31 Phase 1 cooperatives, of which 13 are located in zones of conflict and are inactive. Four cooperatives that were former clients of BH have been transferred to BFA. The BH has not lent to Phase III beneficiaries.

The BH has a serious delinquency problem. At the end of 1984, 20.0% of its portfolio was in arrears. For the agricultural loans, the problem is worse, with 31% of the loans being delinquent. In addition, 44.0% of the total portfolio corresponds to refinanced loans of which about half, 23%, are in the agricultural sector. The BH anticipates difficulties in recovering much of this portion of the portfolio.

The BH's credit delivery system is similar to those of commercial banks. Loan approval is reasonably rapid, taking about one week for production loans and a month for investment loans. Investment loans require collateral of land; production loans are guaranteed by the crop. Insufficient collateral and excessive indebtedness are the main reasons for denying credit. BH closely monitors the use of credit by its clients, including farm visits by bank agents.

The BH relies largely on its own resources for extending credit. At the end of 1984, 79.3% of the loan portfolio was financed from the Bank's own funds, 0.1% from the Economic Development Fund, 3.2% from foreign sources, and 17.5% from rediscounts from the BCR.

At the end of 1984, BH had total liabilities of C925 million of locally generated resources consisting of C621 million of deposits and C305 million of mortgage certificates. Some 84% of the total deposits corresponded to savings and time deposits. Between 1980 and 1984, BH experienced an average annual increase of 8.4% in locally mobilized resources, which was significantly less than the increase in its loan portfolio. The difference is accounted for by increases in external funding.

c) Banco de Fomento Agropecuario (BFA)

The Banco de Fomento Agropecuario (BFA) was established in 1973 as an autonomous public sector institution to provide financial and related services to promote development of the agricultural sector. It suceeded the Administracion de Bienestar Campesino (ABC) which had been established in 1962 under the Ministry of Agriculture to provide supervised credit and technical assistance to small-and medium-sized farmers.

BFA is governed by a Board of Governors composed of representatives of economic ministries, the presidents of BCR and BFA and the Agricultural Cooperatives Association. The Board of Governors establishes policies which are carried out by a Board of Directors and the BFA Management. One of the major tasks of The Board of Directors is the approval of large loans.

The BFA carries out its operations from its headquarters in the capital city and twenty-five branch offices located throughout the country. In addition, BFA operates an agricultural inputs division, which sells inputs to its clients and to third parties through stores at three different locations.

At the end of 1984, BFA had a loan portfolio of ₡529 million. Between 1980 and 1984 the portfolio had increased at an average annual rate of 13.5%, primarily due to large infusions of loanable funds from A.I.D. and IDB to provide credit to the reform sector. In real terms, the average annual rate of increase was less than 1%. As for the composition of the portfolio, non-agricultural loans represented 20.9%; refinanced loans, 18.9%; corn, 14.1%; cotton, 10.6%; livestock, 9.8%; and coffee, 7.7%. In 1984, almost 32% of BFA's contracted credit went to Phase I cooperatives and 5.2% to Phase III beneficiaries.

The BFA has a serious delinquency problem. At the end of 1984, 24.1% of the portfolio was more than 90 days past due. In addition, there is much disguised deliquency as reflected by refinancing. BFA has a complicated and time-consuming credit delivery system that requires the borrower to provide considerable documentation, as well as extensive supervision by BFA. The Bank has undertaken efforts to streamline the process by giving proven good clients a preferred status which reduces both borrower and lender transaction costs. The loan approval process is cumbersome. Loan applications for excellent clients under ₡50,000 are approved at the agency level but those of ₡100,000 or more (typical of Phase I credit) must have the approval of the Board of Directors, which can lead to significant delays in getting credit to the borrower.

In order to reduce its costs of lending to Phase III beneficiaries, the BFA has formed small groups (grupos solidarios) of farmers that receive credit as a unit, as well as accept joint liability for repayment. In some cases non-beneficiary small farmers are included as members of the groups. BFA has four basic sources of funds: capital, deposits, foreign assistance and government loans and grants (including BCR rediscounts).

Since 1980, it has increasingly relied on loans from AID and IDB. As of the end of 1984, BFA had received ₡170.2 million from USAID and ₡197.7 million from BID. Next in importance were BCR rediscounts which financed 23% of loans made by the BFA. BFA's total deposits amounted to C19.0 million at the end of 1985, of which 24% were demand deposits and 76% savings and time deposits. BFA has savings windows in only three of its offices: San Salvador, Sonsonate and La Libertad. It has expressed interest in extending this facility to several more branches.

C. Existing BCR Rediscount Mechanism

During the period 1980-84, the credit provided by BCR for agriculture was substantially more than half of the total credit received by the agricultural sector over that period. Each year, the BCR allocates rediscount funds, consistent with the annual monetary program, by establishing rediscount lines for specific economic activities, including agriculture. The BCR rediscount lines for financing agriculture are established in consultation with agricultural credit institutions and public sector institutions dealing with agriculture.

The needs for short-term production credits are determined on the basis of estimates of area sown, crop yield, and crop prices, using cost figures (differentiated by crop and type of soil) compiled by MAG. Other rediscount lines (e.g. investment, refinancing) are determined on the basis of a different set of considerations. Until 1985-86, the mechanism of the rediscount line for production credits may be summarized as follows:

1. Determining the amount for avío rediscount line per crop (subjectto the overall credit ceilings under the monetary program);

2. Formulating the normas (requirements) for each avío rediscount line;

3. Setting the quota for each PFI;

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4. Examining the eligibility, with reference to the norms, of the documents submitted to BCR by PFIs for each transaction;

5. Fixing the spread to be allowed to each PFI;

6. Giving BCR approval;

7. Executing the contract (containing the conditions of the rediscount and the repayment terms) between BCR and the PFI;

8. Disbursing the rediscount proceeds.

For Step 1, the amount of the avío rediscount line per crop is determined by the estimated area to be sown (MAG as well as banking system estimates) and the cost of production per manzana (MAG-DGEA, banking system and BCR own estimates). Until recently, the costs of production were determined for each crop by the Comisión de Costos Agropecuarios (MAG, BCR, banks).

For Step 2, the norms for each rediscount line would be determined according to established policies as well as reflecting new developments.

For Step 3, the quota for each bank is set in the light of: (a) liquidity position; (b) record of previous utilization of rediscounts; (c) credit demand; (d) growth in deposits; (e) amount of the bank's own resources to be used to provide avío financing for that particular crop (in addition to BCR financing). The decision is based on an evaluation of the above factors. Big banks often use more of their own resources than smaller banks to supplement BCR rediscounts for crop financing.

For Step 4, the process of determination of "eligible" paper for rediscounts (a traditional central banking function) involves an evaluation by the Financial Analysis Department of the documents submitted by the PFIs to BCR for rediscount. This documentation is supported by the PFIs own analysis of the credit worthiness of the ultimate borrowers (including utilization of previous credits and repayment experience). The BCR qualification process would be conducted with reference to the norms of the particular rediscount line and would take into account the credit experience of PFIs with respect to the ultimate borrower, the credit experience of BCR with reference to the PFI, and the extent of use of the bank's own resources to supplement the BCR rediscount line for financing the particular crop.

For Step 5, a 2% spread is allowed to each PFI and an additional spread of up to 2% is allowed, depending on the extent of effective credit supervision and overall efficient performance of the "Sección Agropecuaria" of the PFI.

For Step 6, the approval of the rediscounts up to C1 million is given by the BCR Credit Committee (consisting of the Second Vice-President, Gerente, Sub-Gerente and two Directors of Departments), which meets twice a week. Rediscounts exceeding C1 million must be approved by the Board of Directors.

For Step 7, after the PFI executes contracts with the ultimate borrower and communicates its acceptance of the rediscount terms to BCR, a contract containing the conditions of the rediscount and the amortization schedule is executed between the BCR and the PFI. The contract often includes more than one ultimate borrower with loans of the same maturity.

For Step 8, the disbursement is in the form of a "Cheque de Crédito" which is deposited in the PFI's account with BCR. Amortizations are effected through automatic deductions from this account.

Starting with the 1986-87 avío rediscount lines, the above procedure has been simplified in one important respect, namely, the elimination of step 4 - the qualification process. All the other steps of the above procedure remain unchanged. Under the new procedure, PFIs perform this function on behalf of BCR, in addition to their own scrutiny of loan applications. Instead of sending the documents to BCR, PFIs now send a list of loan applications they have approved (up to 25 or more beneficiaries in one list) and receive instant disbursement from BCR. The new procedure has reduced delays in BCR approval of rediscounts. In order to ensure compliance with its rediscount requirements, BCR conducts spot checks on a random sample of loans. In the case of noncompliance, the PFI concerned becomes liable for immediate repayment of the entire rediscount quota for the particular crop.

For 1986-87, BCR has not established an avío rediscount line for coffee because of higher coffee prices and improved liquidity of the coffee sector. Hence, the total amount of 1986-87 avío rediscount lines (including coffee), is likely to be less than in 1985-86, even though the total amount of 1986-87 avío rediscount lines for all crops (excluding coffee) is expected to be greater than in 1985-86. However, the PFIs are expected to provide substantial avío financing for coffee in 1986-87 without BCR rediscounts. Consequently, total bank credit for avío in 1986-87 may not be much less than in 1985-86. Moreover, BCR would provide the usual coffee marketing rediscount line to INCAFE in 1986-87.

In the traditional avío rediscount mechanism that prevailed through 1985-86, the Financial Analysis Department, in the Sub-Gerencia of Loans and Investments of the BCR scrutinized all applications received from the qualified PFI, to utilize the BCR rediscount lines. On the basis of the analysis, the Department's recommendations were forwarded to the BCR Credit Committee or the Board of Directors (depending on the amount), where the applications were approved or denied. In the new, simplified avío rediscount mechanism introduced for 1986-87, the Financial Analysis Department still plays an important role by conducting spot checks on a random sample of loans extended by the PFIs and rediscounted by the BCR, in order to ensure that BCR rediscount requirements have been met. In the case of the investment rediscount line for the reform sector and the rediscount lines for the manufacturing sector, this Department conducts an in-depth analysis of all rediscount applications. The Financial Analysis Department has 22 analysts, of whom five specialize in agricultural investments.

It is important to point out that the BCR avío rediscount lines are available to reform sector and traditional sector borrowers alike. There are no BCR instructions forcing banks (for example, through a quota system) to channel a specified volume of BCR avío rediscounts to Phase I cooperatives and Phase III farmers, nor does BCR provide any special incentives (such as wider interest rate spreads) for banks to do so. However, the BCR has tried, through moral suasion, and with some success, to persuade banks to treat the reform sector borrowers as privileged customers. The assignment by the Monetary Board of a certain number of cooperatives to each bank is based on the expectation that each bank would take care of the avío as well as the investment credit needs of the cooperatives assigned to it. In fact, however, the banca mixta has proved to be very reluctant to provide investment credits to the cooperatives. Another consideration in the assigment of cooperatives to banks was to make sure that the large cooperatives were assigned to big banks, in view of the legal requirement that no bank can make a loan to an individual borrower exceeding 30% of its capital and reserve.

In 1982, the BCR established a special rediscount line amounting to C9.75 million financed out of PL-480 funds, to provide investment credits channeled through the banca mixta, the Mortgage Bank FEDECCREDITO AND INCAFE (the two last mentioned institutions have hardly taken any part in this mechanism to agrarian reform cooperatives, with a repayment period of up to 15 years and at a rediscount rate of 7% and an interest rate of 10% paid by the cooperatives to the PFIs. Besides this 3% differential, no additional spread is allowed the PFIs. The rediscount mechanism is the same in both cases except that, unlike the avío rediscount lines, each application is scrutinized carefully for "calificación" in the case of the investment rediscount line. All the funds available for the investment rediscount line have been committed.

In the case of the BCR investment rediscount line for Phase I cooperatives, the primary responsibility for scrutinizing applications for rediscount has been that of the newly established BCR Coordinating Unit for the Credit Agents Program. This Unit was established in 1985, in order to induce the banca mixta to increase the flow of investment credits to Phase I coops. It consists of 3 credit agents plus the Unit Chief, who work closely with 20 credit agents assigned to the banca mixta under the administrative direction of the heads of the "Secciones Agropecuarias" of these banks.

The Unit works only on investment credits, not avío credits, to the cooperatives. It prepares investment projects for the cooperatives, analyses applications for financing under the BCR rediscount line for investment credits to the cooperatives, and conducts supervision of on-going BCR-financed investment projects in the cooperatives. The favorable recommendation of the Unit is a prerequisite for BCR financing of the investment projects of the cooperatives. It also provides some technical assistance related to investment projects and actively promotes changes in land use and cropping patterns.

At present, 133 cooperatives are being served by the Unit. The Unit tries to see to it that one of its credit agents invariably accompanies the credit agents assigned to the banca mixta on their visits to the cooperatives. The Unit has studied more than 300 investment projects so far. At present, it has an inventoiry of 86 investment projects, already studied and ready for financing, or in the pipeline, amounting to ₡24.4 million. No financing is currently available, since the BCR rediscount line for investment has been exhausted.

In the case of both the avío and the investment rediscount lines of the BCR, if the rediscount appplication of the PFI is denied by the BCR, the PFI can choose to deny the loan to its customer or to grant it out of its own resources. In any case, whether the BCR approves or denies the rediscount application, the PFI bears the risk for any losses arising from nonpayment of the loan.

D. Recommended Rediscount Mechanism

The following are the principal features of the BCR rediscount mechanism recommended for the channeling of the Project funds through the PFI's to agrarian reform cooperatives and Decree 207 beneficiaries:

1. For reasons mentioned in Section B of this Annex, three non-bank financial intermediaries - namely, the Federacion of Credit Agencies (FEDECCREDITO), the Federation of Credit Unions (FEDECACES), and the National Coffee Institute (INCAFE) - will be excluded from participation in this rediscount line. Among the eligible banks and financial institutions (banca mixta, Banco Hipotecario, and the BFA), the rediscount line will not be allocated by means of quotas or any other system of rationing. Access to the rediscount line will be determined by the BCR solely on the basis of the efficiency and performance of each participating institution rather than by any nonmarket discretionary mechanism. However, prior to its access to the rediscount line, the BFA must be in full compliance with all the conditions precedent and covenants included in AID Project 0263.

2. The rediscount line will be available for short-term production and medium-and long-term investment credits. It will not be restricted by crop or type of activity. The preference for investment credits will be implemented through an additional interest spread offered to the PFIs.

3. The rediscount line will be available for on-lending by the PFIs exclusively to reform sector borrowers (Phase I cooperatives and Phase III farmers). Within this category of borrowers, there will be no further restrictions (such as quotas) for any sub-category of borrowers. As an expression of preference, an additional interest rate spread will be offered to the PFIs in order to induce a reasonable flow of credit to Phase III farmers.

4. The interest rates charged to the final borrower will be the same as the maximum interest rate prescribed by the Junta Monetaria for that type of loan (currently 15% for production credit and 17% for investment credit), and will be adjusted promptly if there are changes in the maximum interest rates prescribed by the Junta Monetaria.

5. In addition to the interest rate spread of up to 4% allowed the PFI's in the avío rediscount funds, there will be spreads of 2% for investment credits to Phase I cooperatives, 3% for avío credits to Phase III farmers, and 5% for investment credits to Phase III farmers - plus a 1% spread in all the above cases, if the PFI provides at least 10% of the total loan out of its own resources. Thus, the maximum spread will be 10% for an investment credit to Decree 207 beneficiaries, where the PFI has put up its own funds equivalent to at least 10% of the loan. The BCR share of the spread is considered sufficient to compensate the BCR for the costs of managing the program and to capitalize the rediscount fund; the spread allowed the PFIs is deemed adequate to compensate the PFIs for their costs, to establish a bad debt reserve and to provide a remunerative risk premium.

   The interest rate spreads will be managed in a flexible manner and will be reviewed by AID and BCR from time to time in the light of experience. Changes will be made in the spreads if the actual flows of production and investment credit to the agrarian reform cooperatives and Decree 207 beneficiaries, as well as the actual willingness of the PFIs to put up their own funds to supplement the Project funds providing credits to the reform sector, indicate a need to change the structure of incentives. Similarly, in the case of a change in the maximum interest rates prescribed by the Junta Monetaria, the share of the BCR and the spreads allowed the PFIs will be reviewed.

6. The maturity structure will be patterned after the existing rediscount lines, with production credits having the same maturity (usually one year) as the corresponding production credits under the existing BCR avío rediscount mechanism and investment credits having the same maturity (5-15 years) as the corresponding investment credits under the existing BCR investment rediscount line for Phase I cooperatives.

7. There will be an "additionality" requirement in order to ensure that the rediscount line provide credit to the reform sector in addition to that currently made available to this sector out of existing sources of funds, domestic or external. To monitor compliance with this requirement, the BCR will seek to ensure that gross credit flow

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to this sector from all funding sources through the participating PFIs shows increases, every calendar year, over the previous calendar year by at least the equivalent of the dollar amounts of AID funding made available under this Project ($46.0 million). For the first calendar year of operation of this Project (namely, 1986), the base period will be the calendar year 1985. In the case of non-compliance, allowance may be made for mitigating factors, such as the requirements of the monetary program.

8. It is the responsibility of the participating PFI to undertake loan analysis, assess the creditworthiness of the ultimate borrower, complete the necessary documentation and present it to the BCR. The PFIs must bear any losses arising out of the nonpayment of loans financed by the rediscounts.

9. The BCR will determine the qualifications of the PFI based on its efficiency and performance, the eligibility of the transaction, and the creditworthiness of the ultimate borrower. The BCR will process the rediscount applications in the order received and approved. Approval of the applications and disbursement by the BCR will based on established criteria and conditions applicable to all participating institutions. The above is to be modified, as necessary, to be compatible with the simplified procedure introduced by the BCR in 1986-1987 (See Section C of this Annex). These BCR review procedures for the recommended rediscount line would follow the currently established procedures, as the case may be, for the avío rediscount line and the investment rediscount line for Phase I cooperatives.

10. The repayments of principal and interest would be credited to the rediscount fund for recycling. No part of the funds of the rediscount line may be used for refinancing.

E. Comparison between the existing and the recommended rediscount mechanism.

A comparison between the existing and the recommended mechanism clearly brings out one essential difference, namely that the modalities and operating mechanism of the recommended rediscount line will be non-discriminatory and market-oriented, while the existing mechanism has several built-in discretionary elements. For example:

1. The recommended rediscount line will be allocated among the PFIs, not through quotas or other administrative decisions but on the basis of the qualifications and performance of the PFI, the eligibility of the transaction, and the creditworthiness of the reform sector borrower. In contrast, in the existing mechanism, the avío rediscount lines are allocated among PFIs on the basis of a quota system. However, even in the existing system, there are rediscount lines without quotas for banks, such as industrial recovery, refinancing of coffee and cotton credits, exports outside Central America and investment in the reform sector.

2. The recommended rediscount line will not be restricted by crop or type of activity and will be available for any eligible production or investment credits. The preference for investment credits will be implemented through an additional interest rate spread. In the existing mechanism, there are separate rediscount lines (related to agriculture) established for avío credits, for specific crops, for investment, for refinancing, and for certain other purposes.

3. The recommended rediscount line will be not discriminate between Phase I cooperatives and Phase III farmers. It is expected that a reasonable volume of credit will flow to Phase III farmers as a result of the additional interest rate spread offered.

4. The recommended rediscount line will offer an incentive to the PFI (in the form of an additional interest rate spread), to provide at least 10% of the loan amount out of its own resources. In the existing mechanism, the extent of resources put up by the PFIs is a factor taken into account by the BCR in determining quotas in the avío rediscount lines.

5. In the recommended rediscount line, the interest rates for production and investment credits (currently 15% and 17%, respectively) are the same as the maximum rates fixed by the Junta Monetaria for these types of loans. These interest rates are referred to as the market interest rates. In the existing mechanism, many rediscount lines (especially those financed out of external resources or through the Economic Development Fund) provide for the borrowers to be charged lower interest rates than the maximum prescribed by the Junta Monetaria.

6. The PFIs will be allowed higher interest rate spreads in the recommended mechanism. In the recommended mechanism, the spread will be 4% for production credit to the agrarian reform cooperatives, 6% for investment credit to the cooperatives, 7% for avío credit to Decree 207 beneficiaries, and 9% for investment credits to Decree 207 beneficiaries (plus an additional 1% spread in all the above cases, if the PFI provides at least 10% of the total loan out of its own resources). In the existing mechanism, a spread of up to 4% is allowed in the avío rediscount lines, and of up to 5% in the investment rediscount line for the cooperatives.

7. The "additionality" requirement for the use of A.I.D. funds is peculiar to this Project. The existing rediscount lines do not contain such a requirement.

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In other important respects, the provisions of the recommended mechanism are the same as in the existing mechanism. For example:

1. The determination of the qualifications of the PFI based on its efficiency and performance, of the eligibility of the transaction, and of the creditworthiness of the ultimate borrower.

2. The responsibility of the PFI to undertake loan analysis, assess the creditworthiness of the borrower, complete the necessary documentation and present it to the BCR, and bear any losses arising out of the non-payment of loans financed by the rediscounts.

3. The maturity period of the loans. The production credit under the recommended mechanism will have the same maturity (in general, one year) as the corresponding production credit under the existing mechanism. The investment credits under the recommended mechanism will have same maturity (5-15 years) as the corresponding investment credit under the existing BCR rediscount line for financing investment expenditures of the cooperatives.

4. The repayments of principal and interest would be credited to the rediscount fund for recycling. No part of the funds of the rediscount line may be used for refinancing.

In conclusion, it may be stressed that, in the light of experience with the earlier Agrarian Reform Credit Project (519-0263), the structuring of the recommended rediscount mechanism is designed to convince and induce the PFIs to augment the flow of their resources to the reform sector. Thus, by the end of this Project, it is expected that the supply of credit to a broad segment of the reform sector will reach adequate levels, will not be further dependent on the infusion of external resources or BCR rediscounts, and will be self-sustaining and market-oriented. This will need, among other requisites, more active involvement of the PFIs (through their credit agents) in working with the reform sector, an effort to target the PAU/PRODEA programs towards making the Phase I cooperatives more creditworthy for this Project, and a more effective performance of the many public sector agencies currently providing services to the reform sector. In this context, the technical assistance and training activities described in Chapter III C, would make a significant contribution.

F. Assessment of the management capability to implement and monitor the Project.

1. In the BCR

A review of its implementation of existing <u>avío</u> rediscount lines and the investment rediscount line for the Phase I cooperatives, has led to the conclusion that the BCR indeed has the adequate management capability to implement and monitor the Project. This capability will be further strengthened as a result of the technical assistance and training inputs of the Project.

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The BCR has had long experience (before and after the 1980 structural reforms) in establishing and managing the avío rediscount lines. The mechanism utilized until 1985-86, as described in this Annex, involved a case-by-case examination of each rediscount application in order to determine the eligibility of each transaction. The well-developed criteria for determining the qualifications of the PFI, the eligibility of the transaction, and the creditworthiness of the ultimate borrower were applied with painstaking detail. Hence, this procedure emphasized thoroughness and precision at the expense of speedy disposal of the rediscount applications.

The simplified avío rediscount procedure introduced in 1986-87 has greatly speeded up the disbursement of the rediscounts. While it is too early to make a definite assertion on this point, available evidence indicates that there has been no significant sacrifice in terms of precision and thoroughness. The PFI's are used to the requirements and criteria of the BCR and have experience in implementing them. Besides, the BCR sanctions applicable to occasional non-compliance act as a deterrent against PFI laxity.

The BCR performance with the implementation of the investment rediscount line inspires confidence. Starting from scratch and in a very short period (about one year), the Coordinating Unit has proved its effectiveness. Even though the credit agents received minimal training (about a week) in the beginning, they have learned much on the job. Their analysis of the identified investment projects is of good quality and they have been able to give reasonable coverage to 133 cooperatives. In less than a year, the Unit was able to appraise enough investment projects to commit the entire funds of the rediscount line, while between 1982 (when the investment rediscount line for agrarian reform cooperatives was established) and 1985, there was very little activity. Moreover, the Unit has appraised many additional projects which have been approved to the extent that funds were available.

Both the Coordinating Unit (responsible for appraising investment projects of Phase I cooperatives) and the Financial Analysis Department (responsible for determining the eligibility of avío rediscount applications as well as for the purely financial analysis of investment projects of cooperatives) are staffed by competent professionals. The technical assistance and training component of the Project has been designed to augment the effectiveness of the Coordinating Unit and the Financial Analysis Department. These factors, as well as the fact that the modalities of the Project have been determined in consultation with the BCR officials, provide a reasonable assurance that the BCR would undertake effective implementation of this Project.

2. In the PFI's.

The management capability of the PFIs, particularly the bancas mixtas, will be adequate to implement and monitor this Project. Some doubt must be expressed about the BFA's present capability; however, the BFA would not have access to the rediscount line (see Section D of this Annex) unless the conditions precedent and the covenants included in Project 0263 are fulfilled (which would greatly improve the institutional effectiveness of the BFA). As in Section C of this Annex, the PFIs are discussed below in the categories of banca mixta, Banco Hipotecario, and the BFA.

a) Bancas mixtas

The nine commercial banks are important financial institutions in El Salvador. The banks are important lenders to agriculture. Lending to the sector is concentrated in short-term credit for traditional crops. An average of 20% of the banks' lending to the sector was to the reform sector, monthly Phase I. Delinquency is a problem for the banks, especially in agricultural loans. The banks have been successful in mobilizing savings, especially time deposits, and rely extensively on their own resources as a source of loanable funds. Although the government has a majority interest in the ownership of the banks, the banks still have a commercial banking mentality. State ownership does, however, give the government great leverage in using the banks financial resources to pursue the government objectives. In the 1960's and 1970's, the private banks in El Salvador were considered among the most-efficient and dynamic in Central America. Even after nationalization, each bank has retained its identity and its traditions.

The bancas mixtas have had ample experience in agricultural credit operations dating back to the pre-agrarian reform period. Since 1980, with the assignment of Phase I cooperatives, these banks have accumulated substantial, and on the whole satisfactory, experience of dealing with these cooperatives. They have made available increasing amounts of their own funds for production credit to the cooperatives, as well as relatively small amounts for investment credit to the cooperatives and credit to Phase III farmers.

The above factors, together with the banks' familiarity with BCR rediscounting procedures and the technical assistance and training component of this Project designed to strengthen their Agricultural Sections, support the conclusion that the bancas mixtas have the managerial capability to implement and monitor this Project. As described in the project paper text their capability to analyze investment proposals will be strengthened.

b) Banco Hipotecario

The BH is a major lender to agriculture, ranking second to the BFA. It has a relatively large network of branches. The BH directs a substantial portion of its loan portfolio to agriculture, but mainly finances traditional export crops. It has financed Phase I cooperatives. In this sector it has experienced mixed results. The BH has experienced serious delinquency.

Among all Salvadoran banks, the BH has had the most success in mobilizing local resources due to its authorization to issue interest free mortgage certificates which offer attractive returns. The bank largely uses its own resources to finance its lending. In spite of this, the bank has had serious liquidity problems, and relies heavily on the BCR to maintain the level of its loan portfolio.

While the BH is not institutionally as strong as the more efficient banks among the bancas mixtas, it can be rated as no worse than the weaker banks among the bancas mixtas. The BH has the same familiarity BCR procedures as the bancas mixtas and has greater experience in dealing with Phase I cooperatives. Hence, for the same reasons as those mentioned in the case of bancas mixtas and given the fact that its Agricultural Section would be a recipient of technical assistance and training under this Project, it will have the managerial capability to participate in this Project.

c) Banco de Fomento Agropecuario (BFA)

The BFA is the chosen vehicle of GOES for providing credit to the reform sector and has played a major role, under GOES directives in financing the agrarian reform cooperatives. It is the single most important provider of credit to the agricultural sector in general and to the reform sector in particular, accounting for 20% and 25% of total credit to these sectors, respectively. It has the largest network of branches in the countryside.

However, in spite of these clear advantages, the BFA has had serious difficulties in its financial performance and institutional capability (See "Evaluation of Agrarian Reform Credit Project in El Salvador," Vol. 1 Checci & Co., pp 263-275.) As a result, several conditions precedent and covenants were included in AID Agrarian Reform Credit Project (Project 0263), in order to improve its performance. The BFA would have access to the credit funds in this Project only after the fulfillment of these conditions precedent and covenants.

G. Credit delivery system

1. Between the BCR and the PFIs

This topic is synonymous with the recommended rediscount mechanism which is covered in Sections D and E of this Annex.

2. Between the PFIs and the ultimate borrower.

Most of the ingredients of this second stage credit delivery system (such as purpose, criteria for creditworthiness, eligibility and documentation requirements, interest rate, and maturity) have been covered in Sections D and E of this Annex.

It has been indicated in the above mentioned sections that, apart from the differences between the recommended and the existing rediscount mechanisms (enumerated in Section E), the operation of the production and investment transactions under the recommended rediscount mechanism, will be the same as the existing production and investment rediscount mechanisms, respectively.

It may be stressed that, apart from the modalities mentioned above, there are several other conditions whose fulfillment would be essential to the success of the Project. A selected list of the most important conditions would consist of:

1. Prompt implementation of the technical assistance and training component of the Project, in order to strengthen the credit delivery capability of the BCR and the PFIs.

2. More active involvement of the PFIs (through their credit agents) in working with the reform sector.

3. An effort to target the PAU/PRODEA programs towards making the Phase I cooperatives more creditworthy for this Project. The intention to associate ABANSA, BFA and the cooperatives organizations in the selection of managers is welcome.

4. A more effective performance of the many public sector agencies currently providing services to the reform sector.

5. Expeditious granting by ISTA of its guarantee (<u>aval</u>) needed for bank credit to the cooperatives.

FINANCIAL ANALYSIS

A. Review of BCR Financial Management Capabilities

A review of the Central Bank's financial management procedures, internal controls, and capabilities was undertaken by looking at the bank's structure, annual reports, and quarterly reviews, followed by a closer look at the departments of finance, credit and internal auditing. Emphasis was placed on reviewing the bank's system of handling agricultural sector rediscounts in general and reformed sector rediscounts in particular so that a statement could be made as to the bank's financial capabilities in safeguarding the projected infusion of resources.

The Central Bank has a manual of accounting applications for all financial activities carried out by the BCR. The manual is complete, concise, and up to date. The accounting manual of the Central Bank does not deal with audit procedures and internal controls but detail the purpose of each balance. Within the Bank there are also other manuals that deal with operations, credit, and administration. The Central Bank deals with a necessary minimum of financial procedures in place to carry out satisfactorily its operations.

The Central Bank has an internal audit staff of 24 people, 22 of which are professionals. The internal audit department of the Central Bank carries out reviews that relate to primary users (PFIs) but no secondary users (PFI loan recipients). The internal audit departments of the PFIs would normally review the use and status of funds to the end user. The Supertendency of Financial Systems can certify the authenticity of the use of funds and disbursements if the grant agreement includes a clause that stipulates such responsibility. Based on a brief review of several of their examinations, they first prepare a very detailed outline of the examination to be undertaken before doing the actual examination. It is recommended that the responsibility of certifying the use of funds be performed by the Supertendency of Financial Systems with the understanding that A.I.D. have the opportunity to review all examination outlines and procedures prior to the actual examination.

The BCR currently has the capabilities and capacity to handle the monitoring requirements of the project. For most lines of credit it currently produces daily reports of bank by bank status by reform and non-reform sector for production credit rediscounts. The daily reports are condensed and circulated weekly to top management. There are two basic weekly reports that are comprised by a page of data each. The first report, the one most useful for this project, is a listing of the status of the current BCR lines of credit. The second is a weekly evaluation of all the Central Bank's credits and investments. In addition to the computerized reports, the credit department prepares, either manually or with accounting machines, a number of other reports.

In addition to daily and weekly reports, there are monthly quarterly, semi-annual, and annual reports that detail the status of the BCR. There is no more that a three month delay between reporting dates and the publishing of the BCR quarterly reviews. Given BCR's mandate to supervise the PFIs and enforce the policies of the Monetary Board, the BCR has a considerable amount of data on the operations of the PFIs. Balance sheet and Profit and Loss statements of the mixed banks (provided monthly) are produced in greater detail than what is found in the individual bank's annual reports. All monthly reports are submitted to the Central Bank by the PFIs. For the purpose of this project, the most useful reports provided to the Central Bank by the PFIs are their semi-annual reports that deal with the end of period status (both balances and flows) for the reform and traditional agricultural sector. The quarterly report on the status of credit to the reform sector cooperatives includes data from all the banks with loans to that sector. 1986 is the first year for which this information is being provided on other than an annual basis.

One of the first steps to be undertaken by this Project will be the formulation of the monitoring system to satisfy the additionality requirement and to track the flow and distribution of funds.

B. Mixed Banks, Mortgage Bank (BH) and BFA Financial Statement Analysis.

The Central Reserve Bank is regulated by the March 25, 1982 Monetary System Law which assigns it the role of carrying out the activities under the control of the Monetary Board and enforced by the Central Reserve Bank.

The Balance Sheets and Profit and Loss statements for the mixed banks (consolidated), and BFA are presented as Annexes F-1 thru F-5. It is noted that the BCR quarterly review and BFA annual reports from which this information was obtained are readily available.

1 Balance Sheets

Loans and discounts to total assets increased slightly for the mixed banks while showing a slight decrease for the BFA. Since 1982 BFA has maintained a much greater ratio of loans and discounts to total assets than the mixed banks due to increases in the loan portfolio which were largely financed by increases in net worth. While the ratio of loans and discounts to net worth has increased for the mixed banks the opposite has been the case for the BFA due to large infusions of capital from A.I.D. and IDB loans.

Total deposits to total liabilities has increased annually for the mixed banks while the opposite has been the case for the BFA. The BFA depends to a large extent on soft loans and grants to finance its activities whereas the mixed banks are actively seeking whatever resources they can obtain. It is duly noted that local currency deposits for the mixed banks increased by almost a billion colones during 1985. The increase in local deposits experienced by the mixed banks was used largely to increase the amount of assets in loans and receivables. This would indicate that the mixed banks are playing an important role as financial intermediaries.

2. Income Statements

Income and expenditure data for the mixed and BH are presented as Annex F-4. Annex F-5 contains the same information for the Agricultural Development Bank. Total income for both the mixed banks, BH and the BFA was greater in 1985 than 1984. For the mixed banks the administrative costs did not increase at the rapid rate experienced in 1984 (14.5%), but at a very moderate 2.9% (1985). Holding down the 1985 administrative costs led to a record 47.1 million colones in profits for the mixed and mortgage banks, almost double the level of profit obtained in 1984. For the BFA, administrative expenses continued to climb and reached 39.3 million colones in 1985 versus 32.3 million colones in 1984. Profit for the BFA increased from the 1984 level of 4.9 million colones to the 1985 level of 5.1 million colones. Administrative costs in relation to assets was only 2.4% (159.5 million to 6,717.2 million colones) for the mixed and mortgage banks versus 5.5% (39.3 million colones) for the BFA. In general, the mixed banks and the BH are operating more efficiently and drawing upon a greater variety of resources than the BFA.

3. Credit Absorptive Capacity

The average yearly rediscount line for this project is $10.0 million which translates into additional funds of 50.0 million colones per year. During 1985 the mixed banks and the BH increased their loans and receivables from 3,055.9 million to 3,947.2 million colones, a 891.3 million colones increase. Based on this fact alone there does not appear to be any difficulty for the banking system to absorb an additional average yearly sum of 50.0 million colones.

C. Rediscount Line

During the life of the project $60 million will be placed into a BCR rediscount line for on-lending to intermediate credit institutions. The following is an analysis of the various spreads and their impact on the banking system.

The Central Bank is an experienced user of special rediscount lines of credit that support specific priority activities. Currently the interest spread between the PFIs and BCR is 2 to 4 points (generally 2) with a maximum rate of interest to preferred class A borrowers of 17%. Annex H-3A lists the various lines of credit and their corresponding interest rates to the PFIs and final users. Additionally the BCR, for some lines of credits, remits to the PFIs and additional spread of up to 2 points to those PFIs that have increased and improved their technical and supervisory capabilities, and maintained a good reporting and repayment profile.

Based on a review of current BCR costs to loan assets (1984 - administrative expenses = 31.5 million colones, loans = 1,781.7 million colones, admin. exp./loans = 1.8%) it is apparent that allocating 2 points to the BCR for administrative expenses is sufficient. In addition to covering administrative expenses, it is important that part of the spread be allocated for BCR capitalization of the credit line. The minimum spread allocated BCR for capitalization is the difference between the spread allocated to the PFIs and that which is over and above the 2 point spread for BCR administrative costs.

Widening the spread received by the PFIs will assist with the process of increasing the participation of reform sector clients into the formal banking system since the PFIs are compensated for administrative costs (emphasis on supervision) as well as for additional risk and bad debt reserve.

Calculating the minimum spread for PFIs can be accomplished by utilizing either global or agricultural sector administrative costs in relation to either the bank's total or agricultural portfolio. Important factors determining the additional spread necessary to reach a mixture of reform sector participants and projects depends on the PFIs' perceptions of the additional risks and costs of expanding their operations. In order that credit delivered to the various reform sector groups be increased, the spreads between Phase I and Phase III and investment and production loans will be different. Table F-1 provides a comparative summary of the total loan portfolio, administrative expenses, and net incomes of the PFIs for the year ending 1985.

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Table F-1 -

Loan Portfolio, Administrative Expenses, Administrative Expenses/Loan Portfolio and Net Income by Financial Institution in millions of colones in 1985

Institutions	Loan Portfolio	Admin. Expenses	Expenses/ Portfolio	Net Income
Banco de Fomento Agropecuario	494.7	39.3	7.9%	5.1
Banco Hipotecario 1	777.7	26.7	3.4%	0.5
Banco Cuscatlán	724.3	33.1	4.6%	15.3
Banco Agrícola Comercial	617.3	27.9	4.5%	16.1
Banco de Comercio	405.7	18.5	4.6%	3.2
Banco Capitalizador	337.9	15.5	4.6%	0.6
Banco de Crédito Popular	265.9	13.5	5.1%	1.8
Banco de Desarrollo e Inversión, S. A.	170.5	7.1	4.2%	2.6
Banco Mercantil	96.1	4.5	4.7%	1.0
Banco Financiero, S. A.	60.9	3.3	5.4%	1.0
Total	3,51.0	189.4		47.2

Source: Individual bank 1985 annual reports except 1) which is for period 7/1/84 - 6/30/85

A shown in the Table, the ratio of administrative expenses to loan portfolios among the PFIs covers a broad range, but most banks have administrative costs that are between 4.2 to 5.4% of their loan portfolios. To obtain a better grasp of administrative costs to loan portfolios, data on the agricultural sections of the mixed banks are analyzed further:

Table 2

Agricultural Department Administrative Costs in Relation to Ending Balance of Agricultural Portfolio in 1985 by Bank in 000's colones

Bank	Balance Ag. Portfolio 1	Ag. Dept. Admin. Costs 2	Costs/ Portfolio
Banco Cuscatlán	178,783	575.8	0.3%
Banco Agrícola Comercial	142,700	350.0	0.2%
Banco de Comercio	97,347	350.0	0.4%
Banco Capitalizador	89,524	270.0	0.3%
Banco Salvadoreño	90,617	260.0	0.3%
Banco de Crédito Popular	56,416	365.4	0.6%
Banco de Desarrollo e Inversión, S. A.	37,276	242.6	0.7%
Banco Mercantil	21,842	150.0	0.7%
Banco Financiero, S. A.	15,322	145.0	0.9%
Total	729,827	2,708.8	0.4%

Source: 1 BCR Finance Department from Individual banks
2 ABANSA Office of the Manager

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Table F-2 gives a rough indication of the administrative costs associated with agricultural sector loans. Excluded from the above costs for the agricultural departments are support staff costs. A maximum of a 2 point spread is appropriate for the PFIs to meet their administrative costs.

From the table below, it is shown that the smaller banks have a larger proportion of agricultural employees than the larger banks. Extrapolating from the previous table yields the result that the average size portfolio per agricultural employee is greatest among the larger banks and that the range of agricultural employee is greatest among the larger banks and that the range of agricultural portfolio to agricultural employee is between 11,173,900 to 3,064,400 colones.

Table F-3
Number of Employees, Agricultural Employees, Percent of Agricultural Employees to Total Employees, and Ag. Portfolio/Agricultural Employee in ('000) of colones by Bank as of the end of 1985

Institution	Employees	Agric. Employees	Percent Ag. Emp/	Portfolio /Ag. Emp.
Banco Cuscatlán	953	16	1.7%	11,173.9
Banco Agrícola Comercial	1000	16	1.6%	8,918.8
Banco de Comercio	600	13	2.2%	7,488.2
Banco Capitalizador	560	13	2.3%	6,886.5
Banco Salvadoreño	700	11	1.6%	8,237.9
Banco de Crédito Popular	528	10	1.9%	5,641.6
Banco de Desarrollo e Inversión, S. A.	260	8	3.1%	4,659.5
Banco Mercantil	160	7	4.4%	3,120.3
Banco Financiero, S. A.	128	5	3.9%	3,064.4
Total	4889	99	2.0%	7,372.0

Source: ABANSA, Office of the Manager

Based on the above summary information the spreads shown in Table F-4 appear appropriate when taking into account BCR administrative expenses and their capitalization requirements, and the PFIs administrative expenses and perceived risks associated with additional lending to the reform sector.

Table F-4
Initial and BCR Spreads - 1986/87

BCR administrative expenses	2 points
BCR fund capitalization (minimum)	4 points

Given the maximum interest rates set by the Monetary Board for the class of borrower within this project, 15% for production credit and 17% for investment credit, the initial interest rates and spreads shown in Table F-5 are recommended at the start of this program or until such time that the Monetary Board changes the interest rates or a review of the amount and type of lending indicates that a change should be undertaken.

Table F-5
Initial ICI and Borrower Interest Rates - 1986 - 1987

Borrower/loan type	PFI i%	Borrower i%
Cooperative - production credit	11%	15%
Cooperative - investment credit	11%	17%
Phase III - production credit	8%	15%
Phase III - investment credit	8%	17%

Continuous monitoring of the ratio between production and investment credit and cooperative and Phase III lending will be undertaken in order that adjustments to the spread can be carried out if too little or too much credit flows to one group of borrowers. Spread allocated to the PFI's can be adjusted as deemed necessary to influence the flow of credit. Any changes in the interest rate will not be automatically allocated to the spread of the BCR or PFIs until such time as an evaluation has been made as to the impact of the change.

The following is an analysis of the impact of the proposed spreads on th PFIs when three different levels of repayments rates are projected. Production and investment credits are handled separately.

Table F-6
Projection of Spread Impact Assuming an 85%, 90%, and 95% rate of Repayment for Production Loans

Assumptions: Production Credit (1 year) - 15% interest
Phase I Lending - 90%
Phase III Lending - 10%
PFIs receive the Maximum Spread
Interest collected from all borrowers
BCR rediscount funds used exclusively

	85% Prin. Repayment	90% Prin. Repayment	95% Prin. Repayment
Production Credit (15%)			
Disbursed	100.0	100.0	100.0
Amount Due	115.0	115.0	115.0
Repaid to PFI	100.0	105.0	110.0
Repaid to BCR	110.7	110.7	110.7
Gain or (Loss)	(10.70)	(5.70)	(0.70)

Table F-7
Projection of Spread Impact Assuming an 85%, 90% and 95% Rate of Repayment for Investment Loans

Assumptions: Investment Credit (5 years) - 17% interest
(2 yr. grace period w/annual interest payments, 3 yrs. equal installments
Phase I Lending - 100%
PFI's receive the Maximum Spread - 6 points
BCR rediscount funds used exclusively

	85%	90%	95%
Investment Credit (17%)			
Disbursed	100.00	100.00	100.00
Amount Due (yr. 1)	17.00	17.00	17.00
Repaid to PFI	14.45	15.30	16.15
Repaid to BCR	11.00	11.00	11.00
Gain or (Loss)	3.45	4.30	5.15
Amount Due (yr. 2)	17.00	17.00	17.00
Past due	2.55	1.70	.85
Interest on arrears	.43	.29	.14
Repaid to PFI	14.82	15.56	16.28
Repaid to BCR	11.00	11.00	11.00
Gain or (Loss)	3.82	4.46	5.28
Amount Due (yr. 3)	45.26	45.26	45.26
Past due	5.16	3.43	1.71
Interest on arrears	.88	.58	.29
Repaid to PFI	39.22	41.26	43.27
Repaid to BCR	40.92	40.92	40.92
Gain or (Loss)	(1.70)	0.34	2.35
Amount Due (yr. 4)	45.26	45.26	45.26
Past due	12.08	8.01	3.99
Interest on arrears	2.05	1.36	.68
Repaid to PFI	40.21	41.96	43.64
Repaid to BCR	40.92	40.92	40.92
Gain or (Loss)	(0.71)	0.34	2.35
Amount Due (yr. 5)	45.26	45.26	45.26
Past due	12.08	8.01	3.99
Interest on arrears	2.05	1.36	.68
Repaid to PFI	41.24	42.67	44.01
Repaid to BCR	40.92	40.92	40.92
Gain or (Loss)	0.32	1.75	3.09
Investment Portfolio Status (end of 5th year)			
Amount collected	149.94	156.75	163.35
Amount due	176.40	174.16	171.96
Past due	26.46	17.41	8.61
Amount repaid BCR	144.76	144.76	144.76
Total Gain or (Loss)	5.18	11.99	18.59
Ave. Annual % gain	1.01%	2.29%	3.46%

From the above analysis it is apparent that it is to the advantage of the PFIs to lend funds for investment activities instead of production given the same rate of repayment. Short term production credit is only feasible when repayment rates above 95% are expected. Medium and long term lending can be profitable to the banks if there is an extended grace period where interest is paid annually both by the client and the PFI. As can be seen from the above analysis, the grace period charging and collection of interest given a 90% repayment rate more than covers a bank's annual 2% charge for administrative expenses and leaves a small amount for bad debt reserves.

D. Repayment and Refinancing

Agricultural sector loan repayment is a problem associated with all the banks. It is difficult to calculate repayment rates when the lending terms, disbursements, repayments, and interest by sector are not known. In addition, the current levels of refinancing influence the repayment calculations if it is thought that the refinanced loans will probably not be paid. One must link the refinanced loans to the previous loans of a client in order to obtain historical information on what has happened.

The refinancing of fully matured loans for specific sectors and activities has been a policy of the Monetary Board since 1979. Refinancing of the agriculture sector in general and the reform sector in particular has been a political necessity in order to reduce instability and give the reform sector an opportunity to become established. There is a concern that the ever increasing levels of refinancing may foster an attitude that loans are gifts and thus negatively effect repayment rates. Because of the magnitude of the refinanced portfolio and the need to track all a client's loans, it is difficult to determine the real rates of repayment over time. In order to assist in breaking the rediscount/refinancing cycle, funds connected with this project will not be used for loan refinancing.

E. Interest Rates

Interest rates are established by the Monetary Board and are structured in such a way to influence the flow of credit to priority economic groups and activities. Since 1978 the Monetary Board has changed the interest rate structure 3 times, the last change having occurred on January 22, 1986. Table F-8 provides information on the various interest rate levels that have been in effect since 1978:

Table F-8
Maximum Interest Rate Structure Set by Monetary Board 1978/86

Class of loan	9/18/78 – 2/1/82 Nom.	Real	2/1/82 – 3/1/84 Nom.	Real	3/1/84 – 1/27/86 Nom.	Real	1/27/86 Nom.
Preferred Class A							
Short term	13	(1.2)	13	(1.0)	13	(3.0)	15
Medium/Long term	14	(0.2)	14	-	14	(2.0)	16
Regular Class A							
Short term	13	(1.2)	15	1.0	14	(2.0)	17
Medium/Long term	14	(0.2)	16	2.0	15	(1.0)	18
Class B							
Short term	14	(0.2)	18	4.0	16.5	(.5)	20
Medium/Long term	15	0.8	18.5	4.5	17	1.0	21

Source: P. 11 Rural Savings Mobilization/Agricultural Credit Project Report
Note: Nominal interest rates are substracted from the following: Average annual rates (9/78-1/82) = 14.2%, 2/82-2/84 =14.0%, and 3/84 - 1/86 = 16.0% est.)

An examination of interest rates shows that real interest rates have been quite low or negative and have not served as a mechanism for restricting credit flows. The main mechanism for influencing credit flow has been the rediscount policy of the Monetary Board which places restriction on the purpose and amount of each rediscount line administered by the Central Bank.

Based on the average rate of inflation in effect since 1978 the current lowest maximum interest rate charged preferred borrowers for production loans (15%) is fairly close to positive in real terms. Inflation during 1985 was at a new high and current projections are for an average annual rate of inflation of over 20% for 1986.

The Monetary Board has become more responsible towards changing interest rates. It should be noted that the Monetary Board increased by 2 points, the first time since 1978, the maximum interest rate for preferred class A (production) loans and that the current interest rate levels are at an all-time high. In addition, the Monetary Board took even less time to make an interest rate change than it had taken in the past. The increased responsiveness of the Monetary Board to economic conditions would seem to indicate that the next change in interest rates will be done in less time than what was taken before the last change.

F. Savings Mobilization

During 1985 the national currency deposits for the mixed banks and the BH increased from 3,381,330,000 colones to 4,340,502,000 colones. The percentage increase in deposits (28.4%) is the greatest relative increase during the 1980's. In addition, the BFA experienced a reversal in its decline of national currency deposits (16,869,000 to 19,022,000 colones), which is the first time this has happened since 1981. These substantial increases in national currency deposits came about even though there had been no changes to the maximum interest rates paid on savings and time deposits during 1985. Based on the new interest rate structure (see annex H-3B) and the history of savings mobilization in the 1980's, it appears that by the end of 1986 the percent increase in national currency deposits will be at a very high level.

Due to the effectiveness of the mixed and BH to mobilize savings it is worthwhile to assist the weakest institution (BFA) mobilizing savings, because BFA has the largest number of branches in rural areas and is the only bank in two provinces. Since the trend is towards increased savings, it is important that full utilization is made of BFA branches so that a broader population is provided with full service banking alternatives. Savings mobilization for the BFA is important if it is to become an institution that is less dependent on continued government assistance.

G. Disbursement and Verification Procedures

During the life of this project it is recommended that all funds for the AID/GOES rediscount line of credit be disbursed on a direct reimbursement basis upon submission of verifiable documentation to the USAID Controller through the Central Bank. Quarterly reporting of all AID/GOES credit contracted and disbursed by institution is required as well as a summary report on total agricultural reform sector credit contracted and disbursed during the same period of time.

The Central Bank currently has a number of forms that it is using for disbursing approved rediscount lines. The following modified format for replenishment of funds is sufficient, given the need to track disbursements and the relationship between amounts approved and disbursed for project monitoring:

Table F-9
Request for Replenishment of Funds
AID/GOES Reformed Sector Line of Credit

Quarter: ______________________________ To: ______________________________

	Amount Approved	Disbursed Previous Quarter	Disbursed Current Quarter	Total Disbursed	Projected Next Quarter

In the event that additional information is required that is in less detail than that provided through the coordinating unit, the following replenishment for that details status by institution and client can be used:

Table F-10
Request for Replenishment of Funds
AID/GOES Reformed Sector Line of Credit

Institution: ______________________________

Quarter: ______________________________ to ______________________________

Loan Account Number	Client	Amount Approved	Disbursed Previous Quarter	Disbursed Current Quarter	Total Disb.	Project Next Quarter

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ANNEX F-1

MIXED AND MORTGAGE BANKS AND THE
AGRICULTURAL DEVELOPMENT BANK
BALANCE SHEETS, DEC. 31 of 1981-1985
IN THOUSAND OF COLONES.

CATEGORIES OF ASSETS LIABILITIES AND NET WORTH					
ASSETS	3,804,780	4,310,590	4,894,610	5,43,352	6,717,160
CURRENT	3,611,380	4,096,300	4,660,100	5,123,375	6,337,121
Cash/Foreign Exchange	736,080	721,620	908,210	1,045,839	1,272684
Loans/Receivables	2,230,500	2,558,950	2,832,950	3,055,920	3,947,228
Other	644,700	815,730	919,580	1,,580	1,021,616
LONG-TERM	193,500	214,290	234,510	319,977	380,039
Fixed	20,200	19,980	23,300	23,316	24,402
Trust Funds					
(1)Med./Long-Term Loans					
Bonds	173,300	194,310	211,210	294,661	354,634
LIABILITIES + NET	3,804,800	4,310,590	4,894,610	5,443,351	6,717,159
LIABILITIES	3,395,600	4,072,060	4,655,440	5,199,219	6,450,008
CURRENT	3,340,990	3,749,740	4,284,840	4,776,829	6,042,563
Deposits Natl. Cur.	2,145,870	2,390,810	2,770,970	3,381,330	4,340,502
Deposits Foreign Cur.	4,800	17,940	10,660	26,297	26,926
Bonds					
Debt to Central Bank	555,620	601,080	750,560	603,107	812,178
Other	634,700	739,910	752,650	766,095	862,957
LONG TERM	254,610	322,320	370,600	422,390	4079445
Foreign Obligations	55,930	56,290	92,460	117,456	105,571
Trust Funds					
Bonds	198,680	266,030	278,140	304,934	301,874
NET WORTH	209,200	238,530	239,170	244,132	267,151
Initial Capital	86,810	169,260	179,260	179,262	185,812
Addition to Cap. Stock	28,120	27,480	28,100	29,261	30,187
Development Fund					
Capital Reserves	94,270	41,790	31,810	35,609	51,152

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Annex F-2

Categories of assets Liabilities and net worth	AGRICULTURAL DEVELOPMENT BANK 1981	1982	1983	1984	1985
Assets	590,323	529,550	463,054	635,546	649,308
Current	384,092	303,406	231,517	344,539	359,863
Cash/Foreign exchange	61,815	68,860	47,669	54,661	47,987
Loans/Receivables	148,066	135,400	172,203	181,865	171,507
Other	174,211	99,146	11,645	108,013	140,369
Long-Term	206,231	226,144	231,537	291,007	289,445
Fixed	9,816	10,104	8,766	9,869	29,697
Trust funds	2,670	3,061	3,332	4,554	3,873
(1) Med/Long-Term Loans	191,613	209,993	213,799	276,282	255,438
Bonds	2,132	2,986	5,640	302	437
LIABILITIES + NET WORTH	1,992,818	1,693,900	1,395,741	1,095,491	717,084
LIABILITIES	420,817	291,405	231,389	262,804	257,138
CURRENT	355,940	214,805	148,257	177,116	143,327
Deposits Nat'l curr.	39,217	33,859	25,221	16,869	19,022
Deposits Foreign curr.					
Bonds					
Debt to Central Bank	279,719	119,762	79,944	109,975	95,203
Other	37,004	61,184	43,092	50,272	29,102
LONG-TERM	64,877	76,600	83,132	85,688	113,811
Foreign obligations	56,107	67,439	73,700	75,214	104,017
Trust Funds	2,670	3,061	3,332	4,554	3,873
Bonds	6,100	6,100	6,100	5,920	5,921
NET WORTH	1,572,001	1,402,495	1,164,352	832,687	459,946
Initial Capital	80,038	92,243	106,306	126,945	170,349
Addition to Cap. Stock	3,341	3,834	5,932	8,947	11,335
Development Fund	86,127	142,066	219,427	236,849	278,262
Capital Reserves					

SOURCES: BCR Revistas 1981 - 1985 and BFA annual reports.

(1) = No division between loans (short, medium, long) on the consolidated balance sheet for the Mixed and Mortgage Banks.

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Annex F-3 .

FINANCIAL RATIOS
MIXED AND MORTGAGE BANKS AND
THE AGRICULTURAL DEVELOPMENT BANK
EL SALVADOR 1981/85

	---MIXED AND MORTGAGE BANKS ----				
RATIOS	1981	1982	1983	1984	1985
Loans and Discounts Total assets	0.59	0.59	0.58	0.56	0.59
Loans and Discounts Net Worth	10.66	10.73	11.84	12.52	14.78
Total Deposits Total Liabilities	0.60	0.60	0.60	0.66	0.68
Net Worth Ab. and Net Worth	0.05	0.05	0.05	0.04	0.04
Loans/Deposits	1.04	1.04	1.02	0.90	0.90
Current Assets Current Liabilities	1.08	1.08	1.09	1.07	1.05

	--- AGRICULTURAL DEVELOPMENT BANK ---				
RATIOS	1981	1982	1983	1984	1985
Loans and Discounts Total Assets	0.58	0.65	0.69	0.72	0.69
Loans and Discounts Net Worth	2.00	1.45	1.16	1.23	1.08
Total Deposits	0.09	0.12	0.11	0.06	0.07
Net Worth AB. and Net Worth	0.20	0.45	0.59	0.59	0.64
Loans/Deposits	8.41	10.20	15.30	27.16	26.01
Current Assets	0.99	1.41	2.24	1.95	?

ANNEX F-4

LOSSES AND ASSETS OF THE
COMMERCIALS BANKS AND HIPOTECARIO
(THOUSAND OF COLONES)

OPERATION INCOME	380,565	424,667	491,767	541,854	619,604
FINANCE INCOME	343,506	387,741	457,599	505,776	586,648
ADMINISTRATION INCOME	5,736	9,329	8,275	6,657	5,407
	22,183	21,856	21,294	20,999	20,933
	9.14	5,741	4,597	8,422	6,616
NOT-OPERATION INCOME	902	780	2,647	6,743	7,01
TOTAL OF INCOME	381,467	425,447	494,412	548,597	626,614
OPERATION EXPENSES	358,914	394,669	459,237	523,834	577.5
FINANCE EXPENSES	228,739	242.05	297,928	341,283	392,728
ADMINISTRATIVE EXPENSES	123.58	126,746	135,416	15,009	159,528
		21,597	21,147	22,469	21,183
		2,131	1,575		1,056
	6,595	2,145	3,176	5,072	3,025
NOT-OPERATION EXPENSES	456	446	527	1,084	1,967
TOTAL OF EXPENSES	359,371	395,115	459,765	524,918	579,487
	22,096	30,332	34,647	23,679	47,127

PREPARED BY: BCR

Annex F-5

	1981	1982	1983	1984	1985
Operational Income	54,396.0	53,986.6	73,528.4	78,433.1	81,142.4
Banking	39,644.5	39,960.8	56,590.4	63,135.0	63,601.8
Admin. Services	13,338.4	12,260.7	16,362.6	14,314.7	16,861.2
Previous Year	1,413.1	1,765.2	575.4	983.4	679.4
Non-operational income	819.9	853.8	676.5	1,578.2	1,840.4
Total Income	55,215.9	54,840.5	74,204.9	80,011.3	82,982.8
Expenses	52,520.8	52,605.5	70,772.1	75,062.2	77,625.7
Banking	26,551.0	21,131.9	38,834.2	38,853.3	33,509.9
Administration	22,142.4	23,704.0	27,011.8	32,266.9	39,315.9
Sales	2,743.4	2,652.3	2,876.4	3,540.8	4,156.7
Previous Year	2,743.4	2,652.3	2,876.4	3,540.8	4,156.7
	1,084.0	5,117.3	2,049.8	401.2	643.2
Non-Operational Expenses	907.4	70.2	157.0	61.9	238.8
Total Expenses	53,428.2	52,675.7	70,929.1	75,124.1	77,864.5
Profit or (Loss)	1,787.7	2,164.8	3,275.8	4,887.2	5,118.3

Source: BFA Annual Reports 1981-85

Agricultural Development Bank Annual
Profit and Loss statement 1981 - 1985

SOCIAL SOUNDNESS ANALYSIS

I. OVERVIEW OF REFORM SECTOR

A. Beneficiaries.

The agrarian reform which has been undertaken in El Salvador during the first half of this decade has represented a fundamental restructuring of access to land and to its fruits by the rural areas, but has by no means eliminated its generic causes, nor eliminated the misery in which the majority of rural inhabitants reside (FAO, 1986). However, a substantial proportion of the rural population has benefitted. Landless poor increased in number from 12 percent of the population in 1960 to 40 percent in 1975. Over 25 percent of this population have benefitted from the reform.

The reform was divided into three phases, two of which have been implemented, Table 1 summarizes the impact of the redistribution of land in these two phases. Over one-fifth of all land in production has been redistributed, totalling over 300,000 hectares. There have been approximately 95,000 direct beneficiaries, which represents over 570,000 total beneficiaries when family memebers are included.

B. Improved Well Being of Beneficiaries.

On the surface, it would appear that beneficiaries of Phase I have benefitted more in that they have received about four and one half times as much land (1.17 as./Beneficiary vs. 0.25 has./Beneficiary) and the amount of land redistributed to them is over two and one quarter times greater.

Table 1: Summary of Redistributive Impact of Agrarian Reform

	Phase I	Phase III	Total
No. Hectares Expropriated	220,000	97,000	317,000
% Total Land in Production	15.0%	6.6%	21.6%
No. Direct Beneficiaries	31,359	63,668	95,027
No. Total Beneficiaries	188,154	382,008	570,162
No. Has/Direct Beneficiaries	7.02	1.52	3.34
No. Has/Total Beneficiaries	1.17	0.25	0.55
% Rural Poor Benefitted	8.4%	17.0%	25.4%

However, Phase I beneficiaries do not have direct ownership of the land given to them. Rather, they belong to cooperatives which own the land. Direct use of the land varies by cooperative. Most cooperatives give members access to small plots called milpas which are farmed intensively, usually with food crops. It is considered a safety net by the farmers and is a custom continued from the pre-reform period when former owners did the same. Members view the milpa as a major benefit of cooperative association. In addition, some cooperatives rent parcels of land to their memebers and to non-members.

Another important benefit of coopetative membership is that it guarantees a permanent source of employment with relatively good wages and access to other social benefits such as schools and medical care. As will be discussed later, few cooperatives net suffucient profits to distribute returns to members after attending to their land purchase and other debts.

In sum,, the extent to which those affected by Phase I of the agrarian reform have actually benefitted in unclear. Available data suggest thet their socio-economic and self-sufficiency status may not have changed much.

On the other hand, Phase III beneficiaries have clearly improved their well being participating in the reform. An evaluation by PERA (1985) indicates that they not only have increased their incomes since 1982, but that they are also acting as small entrepreneurs and investing resouces in order to improve their patrimony. This contrasts with the tendency of the cooperatives of Phase I to divest resources received along with the land. Concretely, Table 2 indicates the considerable jump in income experienced by Phase III beneficiaries after receiving their land. Before the reform, 68 percent had net annual incomes of less than ₡2,000 while the number decreased to 34 percent in 1984. Whithin these strata, the greatest decrease (37%) was .

Table 2: Net Annual Income Levcel of Phase III Beneficiaries

	198		1984		
Net Income Strata	No	%	No.	%	% Change
Less than $C1,000	12,146	42	3,337	5	-37
$C2,000 - $C1,999	7,575	26	18,309	29	+ 3
$C2,000 - $C2,999	3,893	13	16,499	26	+13
$C3,000 - $C4,999	3,529	12	14,194	22	+10
More than $C5,000	2,122	7	11,269	18	+11

Source: PERA (1985:67)

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in beneficiaries that had incomes of less than $C1,000 per year. After the reform, 18 percent of the beneficiaries earned net annual incomes of more than $C5,000, per year as compared to only 7 percent in 1982. Similar increases in the number of beneficiaries with net annual incomes of from $C2,000 to $C4,000 are evident from 1982 to 1984. The average annual income in 1982 was $C1,854; in 1984 it was $C3,659 (PERA:67).

These marked increases are due in normal part to the fact that in 1982 a substantical portion of the earnings from exploitation of the land was received by the land owners as rent, either in cash or in kind. Those working the land are now able to use these profits as they see fit.

C. Access to Formal Credit Market.

Beneficiaries of Phase I have received credit through the cooperative structure, In 1985 total credit to the cooperatives was $C178,841,000. These funds were distributed among 258 cooperatives - 83.5 percent of all Phase I cooperatives. Credit to beneficiaries of Phase III has also

Table 3: Credit Transactions by Loan Size and Size of Property

(Manzanas)	Property Size							
	Less than 1.0		1.0 - 1.9 9		2 or More		Total	
Loan Size	No.	%	No.	%	No.	%	No.	%
Less than $C500	6,994	89	6,634	62	1,950	24	15,578	58
$C500 - $C1,000	807	10	3,500	33	3,100	39	7,407	28
$1000 - $C1,999	79	1	629	5	2,138	26	2,846	11
$C2,000 or More	---	--	---	--	889	11	889	3
Total	7,880	100	10,763	100	8,077	100	26,720	100

Source: PERA (1985:85).

increased significantly; however, it covers less than one third of of the land affected and is almost all granted by the Agricultural Development Bank. Most of these loans are small and are associated with small plots of land as shown in Table 3.

II. CREDIT FLOWS IN SYSTEM

A. Distribution by Intermediary Credit Institutions.

The distribution of credit to agrarian reform beneficiaries by reform Phase and by credit source is presented in Table 4. These data indicate that Phase I beneficiaries have been recipients of most of the credit channeled through the major credit institution. Assuming a constant flow

Table 4: Credit Distribution by Reform Phase and Credit Source

Credit Source	Phase I (1984/85)		Phase III (1985/86)	
	$ Colones	%	$ Colones	%
Agricultural Bank	59,824	33	24,852	95
Mortgage Bank	32,299	18	---	--
FEDECCREDITO	164	1	---	--
Commercial Banks	86,554	48	1,239	5
Total	178,841	100	26,091	100

Source: MAG (1985) SC - 1,000

of credit to the sectors from 1984 to 1986, over 87 percent of the creddit granted by these institutions was to Phase I beneficiaries. Most of this credit was granted by the Agricultural Bank and by the Commercial Banks. These were the only institutions to work with Phase III beneficiaries. However, the data also incicate that 95 percent of the credit granted to this sector was provided by the Agricultural Bank. It is the only formal credit institution attending to this sector. In contrast, the Commercial Banks and the Mortgage Bank are responsible for most of the credit granted to Phase I beneficiaries, Commercial Banks alone account for almonst 50 percent of the credit to this sector.

A possible explanation for this pattern of distribution of credit is found Table 5. In this table are presented data on the distribution of

Table 5: Production Credit Distribution by Sector and Crop

	Phase I (1984/85)		Phase III (1985/86)	
Type of Crop	$ Colones	%	$ Colones	%
Traditional Export	135,005	83	2,326	10
Cereals	20,433	13	20,208	86
Other	7,054	4	1,071	4

Source: MAG (1985) $ Colones - 1,000

production credit by reform sector and type of crop. The data clearly indicate that most tof the credit granted to Phase I beneficiaries is for traditional export crops (83%) while most of the credit granted to Phase III beneficiaires is for cereal crops (86%). Traditional export crops are cash crops and are associated with greater probabilities of loan repayment because they are more clearly identified with cash incomes. In contrast, cereal crops are largerly for local consumption by the producers and buyers in the national economy. Again, assuming that flows of credit were relatively constant from 1984 to 1986, the data indicate a clear tendency for the banks to grant credit for traditional export crops.

B. Intermediary Linkages at Beneficiary Level

Cooperatives are governed by administrative councils. These councils are elected by the members. Members continue to have inputs into the decision-making process of the cooperatives through annual general assemblies and other, non-mandated meetings. In addition to administrative councils, many cooperatives have hired managers and accountants to handle the business opetations and ISTA has placed cogestores (co-managers) at the cooperatives to participate in their management until they become self-sufficient. ISTA's role is major in that it has been responsible for land acquisition, land adjudication and the coordination of inputs and technical assistance from other government organizations to the cooperatives in addition to co-management (Wise, 1985). ISTA's overall role has given it considerable power in the cooperatives' decision-making processes.

Intermediation in credit markets in the Phase III sector is markedly different. Individual tenants on land were allowed to applly for up to 7 hectares of land which they rented or sharecropped. FINATA has resposibility for implementing this program. In that individuals were beneficiaries and individual loan requests small, some organization into solidarity groups has been done in order to reduce high transaction costs for both borrowers and lenders. The Agricultural Bank has promoted the organization of the Solidarity Groups (Grupos Solidarios) for this purpose. They have proven to be a succesful market intervention.

Table 6 details the participation of Phase III beneficiaries in solidarity groups. Twenty-one percent of those in the study conducted by PERA (1985) were members and another 10 percent were former members.

Table 6: Solidarity Group Participation-Phase III Beneficiaries

Membership Status	Number	%
Current Member	12,386	21
Former Member	5,686	10
Never Member	41,529	69

Source: PERA (1985:90)

Almost 70% percent had never belonged to a solidarity group. The importance of these groups as a mechanism to obtain credit is attested to be the fact that over 5,000 members had chaged from one group to another. The principal reason for changing groups is that other members in the previous group had been delinquent in their loan payments.

There are several other organizational mechanisms that have the potential to serve as intermediaries in the formal credit market at the beneficiary level in the Phase III sector. However, none of them appear to be particularly viable. Cooperatives are one potential organization. Table 7 gives the breakdown of participation in cooperatives by beneficiaries. Almost 92 percent of those belonging to cooperatives, belong to production cooperatives. This demonstrates the predominance in

Table 7: Phase III Beneficiary Participation in Cooperatives

Type of Cooperative	Number	%
Production	8,756	91.8
Service	220	2.3
Savings and Loan	561	5.9

Source: PERA (1985).

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and other production inputs by the beneficiaries. However, it is significant that only 1% percent of all beneficiaries belong to cooperatives; therefore, cooperatives represent a potential window to a relatively small segment of this population. Furthermore, over 46 percent of those who do not belong to cooperatives indicated that they would prefer not to join one/ Of these, 21 percent indicated that their preference was based on knowledge of negative expereinces with cooperatives, either by themselves or by acquaintances.

Farmer associations represent another potential intermediary organization. However, they also represent a limited window to access this population; only 8.5 percent of the beneficiaries belong to farm associations. Their potential is further limited by the fact that 54 percent of the beneficiaries have no interest in joining an association. Given the level of politization of these associations, it is doubtful whether the Intermediary Credit Institutions would be interested in using them to disburse credit/

A final potential link at the farmer level between the Intermediary Credit Institutions and the beneficiaries are Money Lenders and/or Middlemen who are active in the informal credit market. Middlemen lend almost exclusively to agricultural producers while moneylenders deal with a broader clientele that includes producers. The credit delivery system is uncomplicated and highly efficient, requiring little or no paperwork or collateral. That it operates effectively is attested to by the low delinquency rate in loan repayments. According to Ladman, et. al. (1986), the nominal interest rate charged by these lenders in 1984 was 24 percent. This is only 6 percent above the maximum rate fixed by the Monetary Board for formal market loans to the reform sector. In the past the Agricultural Bank has lent money to these lenders who in turn onlent to agricultural producers. The low borrower transaction costs may make this source of credit attractive to Phase III beneficiaries despite the slightly higher interest rates.

C. Actual Access and Use of Credit by Beneficiaries

In the Phase I reform sector, cooperatives have acquired, or are in the process of acquiring, title to the land turned over to them. Loans are made directly to the cooperatives and are based on project proposals. Members only have indirect access to the credit. There are several ways in which they ultimately receive the credit. The first is through wage labor they perform for the cooperative. Much of the production credit is used to pay for labor inputs in agricultural production. In addition, members benefit from the use of credit to promote social projects by the cooperatives. Examples include better housing, potable water, schools for the children, adult literacy classes, consumer shops and medical services (Fledderjohn and Torres 1985).

In contrast, Phase III beneficiaries have direct access to the credit. Some receive money directly from the Agricultural Bank, particularly if they have established good credit ratings. Transaction costs associated with these loans are minimized. Others, as was noted earlier, receive credit thrugh

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Solidarity Groups. Individual members of these groups are responsible for using the credit to farm their land parcels. The Solidarity Groups assume collective responsibility for repayment of loans and it is assumend that social control mechanisms, such as peer group pressures, stimulate farmers to repay their loans.

III. EFFICIENCY OF USE OF CREDIT

A. Phase I Cooperatives: Organization

As mentioned previously, the cooperatives which represent Phase I beneficiaries are managed by administrative councils which in turn may hire managers and/or accountants to assist them in the day-to-day business operation. They are joined in many cases by representatives of ISTA, the government agency responsible for carrying out Phase I of the reform. Legal terms of the expropriation define a management process which gives equal right and authority to ISTA and to the cooperatives (cogestion). When the title is assigned, an agreement is signed between the cooperative and ISTA which defines the length of the cogestion period. It vbaries from 5 to 25 years, but can be extended indefinitely by ISTA if it so desires. This structure gives the State some assurance that the cooperatives will be managed responsibly, and therefore, will attend to their land debt. A recent study by Prentice (1986) indicates that 45 percent of the cooperatives currently have full-time cogestores, and 27 percent do not have cogestores.

In many cases, however, the cogestor is resented by the cooperative members. He is viewed as an outsider and a meddler (Prentice, 1986). Since the cogestor has veto power over decisions taken by the Administrative Council and uses this power, they are often in conflict. This is exacerbated by the fact that the cogestor is often from outside the region and knows little or nothing about the cooperative members or their needs and practices. Cogestores are poorly paid and have little academic background or training to handle the cooperatives' business affairs. To make matters worse, they sometimes receive minimal backstopping from ISTA.

Little management capacity exists within the membership of the cooperatives. All members were agricultural laborers before the reform and had little or no farm management experience much less cooperative managment experience. Recognizing this fact the government has initiated with A.I.D.'s support a program to place managers and accountants in the cooperatives.

The goal of PRODEA, which was charged with this responsibility, was to place 200 managers and 200 accountants on a like number of cooperatives by the end of 1984. As of November, 1985, it had placed 131 managers and accountants of which 39 managers and 16 accountants had resigned (Comacho, 1986). Several problems were raised regarding the placement of managers in the cooperatives. Among those cited by Prentice (1986) are:

- The comparatively high salary of these personnel and the reluctance of cooperatives to pay them. Members resent outsiders receiving salaries much higher than their own. Others think that there are more productive uses for the money.

- The role conflict experienced by the manager. On the one hand, he is subordinate to the administrative council/. On the ohter hand, he must make management decisions which place him in a role superior to them.

- The preference of cooperative memebers for local personnel with practical experience. They lack confidence in outsiders and/or those who are highly educated.

- The professional inadequacies of the managers. Prospective managers are not given the skills/training required before joining the cooperatives.

- The big turnover of cooperative managers. This is occasioned largely by the resentment experienced from the cooperative members and the frequent conflicts that arise with cogestores in cooperatives which have them.

A recent study by PERA (Camacho, 1986) indicates that the success or failure of cooperatives may have little to do with the presence/absence of a cooperative manager. It showed that managerial stability is:

- directly related to increases in social services;
- unrelated to putting accountng controls into place;
- inversely related to production, productivity, and use of credit; and
- inversely related to profits.

These findings suggest that continuity of management from pre-reform to post-reform period is not necessarily good. These managers may be inclined to allow cooperatives to invest substantially in social services because of their identification of felt needs of the cooperative members. Similarly, when turnover in management is occasioned by conflict between managers and the membership over how to use resources of the cooperatives, this may be salutory, particularly if the conflicts arise over decisions to use them for productive as opposed to non-productive purposes.

The administrative councils consist of cooperative members. They may or may not have the best interests of other members in mind when they make decisions. Given that they generally lack management experience, they often define the best interests of cooperative members in non-productive terms. preferring to maximize short-run benefits for the members as opposed to long-run benefits by making favorable investment decisions/ In many cases, members of the administrative council have little understanding of and appreciation for the "spirit" of cooperatives. Many abuse their positions by making decisions which benefit themselves and their friends rather than the cooperative genrally.

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B. Work/Productivity Incentives

There are several factors which are disincentives to agricultural production on the cooperatives. One is that Cooperative members frequently define themselves as day laborers rather than as owners of the cooperative. Thus, their major goal is not to make the cooperative thrive, but rather to obtain first and foremost a permanent source of work with good salary and benefits (CLUSA, 1985). Another important factor is that most cooperatives cannot increase incomes when production and profits increase. Currently, most profits made by cooperatives are retained by external agencies to pay off cooperative debts (Camacho, 1986). Yet another factor is that individual members receive equal pay for therir labor regardless of how hard they work or how productive they are.

These factors impact on the ability and desire of managers and the administrative councils to treat the cooperatives as business enterprises whose goal is to maximize profits. They are under heavy pressure to emphasize the allocation of funds to provide short-run benefits to the membership. This may be in direct conflict with profit maximization goals and medium-and long-term investments.

C. Phase III Beneficiaries' Credit Use

Phase III beneficiaries are the direct recipients of production credit. Generally, they make better use of the credit because they have greater management capacity. Unlike beneficiaries of Phase I, in the past they have had to find credit, secure other production inputs and market their products. And since they own their land, they have incentives to maximize profits.

IV. CREDIT REPAYMENT

A. Rural Violence

Rural violence associated with the war has limited the ability of some farmers to repay their loans. In some areas, the guerrillas have burned crops and/or otherwise destroyed production. Many rural inhabitants have relocated in areas which are more secrue, having abandoned their crops in doing so.

B. Phase I Beneficiaries

Debt repayment by Phase I beneficiaries has not been particularly good. According to MAG (1985), 11 percent of the loans made to cooperatives were delinquent. However, another 33.7 percent were refinanced. Summing these figures, cooperatives were behind schedule on the payment of almost 45 percent of the loans which they had secured.

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Failure to repay loans is due to several factors which have already been mentioned, namely, (1) the lack of work incentives in the cooperatives which reduce productivity; (2) the emphasis on short-run gains for cooprative members which may or may not result in increased productivity; and (3) the geneal lack of management capacity in the cooperatives. When prices for traditional export crops.

Not all cooperatives have had problems repaying their loans. Those with credit from Commercial Banks appear to have been more responsible in repayment than those working with the Agricultural Bank. This is in no small part due to the greater creditworthiness fo the cooperatives working with the Commercial Banks. Weaker cooperatives were purposely assigned to the Agricultural Bank. However, it may also be due in part to the way in which the banks treat the cooperatives. The Commercial Banks focus on profit maximization while the BFA focuses on social and political goals as well.

It is important that future lending programs emphasize the need for repayment. With almost 45 percent of the loan portfolio to cooperatives presently in arrears, there is a real danger of creating a debt menality among the farmers. Obviously, this insidious condition needs to be addressed on other fronts as well. The agrarian debt of the cooperatives impacts on their use of credit.

C. Phase III Beneficiaries

It is genrally accepted tha Phase III beneficiary repayment rates are higher than those of Phase I beneficiaries. There are several reasons for this trend. First, Phase III beneficiaries perceive continued access to credit to be more problemmatical. They borrow heavily in the informal credit market and know that these sources of credit disappear if they do not repay. The Agricultural Bank has loaned to individual farmers in this sector who were otherwise good credit risks based on this assumption. Second, most of these beneficiaries are small farmers and may be less inclined to feels that they can "beat the system." Third, as was previously mentioned, the farmers have greater management capaicty, including the ability to manage money responsibly. Fourth' they make more productive use of the credit because they own the land which they are working.

V. CREDIT RATIONING THROUGH COMMERCIAL BANKS

A. Lending to Phase I Beneficiaries

The Commercial Banks may be averse to lending money to many of the cooperatives in this sector because of their lack of credit worthiness. This is illustrated by rankings of cooperatives by three different institutions found in Table 8. Assuming that only cooperatives found in categories A and B are sufficiently creditworthy, less thank half of the cooperatives fall into this category. Less than 40 percent fall into this category if one uses ratings of DIECRA and the Mortgage Bank.

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Table 8: Phase I Cooperative Ranking by Different Institutions

Ranking	DIECRA Number	DIECRA %	Agricultural Bank Number	Agricultural Bank %	Mortgage Bank Number	Mortgage Bank %
A	13	4	15	8	10	23
B	124	35	72	40	7	16
C	108	31	87	48	12	27
D	107	30	8	4	15	34
TOTAL	352	100	186	100	44	100

Source: Prentice (1986).

The Commercial Banks give various reasons why they prefer to not work with Phase cooperatives. The importance which they attribute to various problems associated with lending of cooperatives is summarized in Table 9. The three most salient reasons are lack of management capacity, lack of cooperative organization and lack of a sense of responsibility to repay loans. These rasons are consistent with other data bearing on the performance of cooperatives. They also suggest that technical assistance programs currently in place with the cooperatives are addressing the most salient problems, namely, improving management capacity and attempting to instruct the members about cooperative philosophy.

Table 9: Commercial Bank Managers' Rating of Problems Assoiated with Lending with Phase I Cooperatives

Reasons	Degree of Importance: Very	Some	Little	None
Lack of Management Capacity	79.2	10.4	10.4	--
Lack of Cooperative Organization	66.7	27.1	6.3	--
Lack of Sense of Responsibility to Pay	70.8	22.9	6.3	--
Inadequate Agricultural Technology	34.0	46.8	19.1	--
Dishonesty	48.9	31.9	17.0	--
Risk - Level of Profitability of Products	31.3	56.3	12.5	2.1
Civil Strife/Terrorism	60.4	29.2	6.3	4.2

Source: Ladman, et. al. (1986)

B. Lending to Phase III Beneficiaries

Phase III beneficiaries are more likely to repay loans. In that sense they are more creditworthy. However, there are several major issues associated with lending to them as well. These may be more problemmatic than those associated with lending to the cooperatives for, as was shown in Table 4, Commercial Banks currently provide only 5 percent of the credit granted to them through formal credit markets.

Table 10 summarizes the relative importance of problems which managers of Commerica Banks attribute to lending to Phase III beneficiaries. Aside from the divil strife/terrorism.

Table 10

Reasons	Degree of Importance Very	Some	Little	None
High Lending Costs	41.7	20.8	18.8	18.8
Risk - Profitability Level of Products	43.8	27.1	10.4	18.8
Poor Farm Management	25.0	37.5	31.3	6.3
Dishonesty	10.6	29.8	38.3	21.3
Inadequate Agricultural Technology	27.1	39.6	22.9	10.4
Lack of Capital Goods	33.3	10.4	33.3	22.9
Civil Strife/Terrorism	46.8	38.3	8.5	6.4

they are typical of most bankers' attitudes towards the small farmer. The two most salient factors are lender transaction costs and risk associated with the level of profitability of small farm enterprises. Most small farmers produce good crops - largely for subsistence - rather than case crops.

The Agricultural Bank has attempted to address the problem of high transaction costs through the formation of solidarity groups. they are imperfect, however, in the sense that they are not legal entities. It is questionable, therefore, whether they are legally responsible for repayment of loans and whether they have collateral to serve as guarantees for loans.

If the commercial banks are to increase their loan portfolio with beneficiaries of this sector, they will need to innovate ways of providing loans with lower costs to both the borrower and to the lender. One possible innovation would be to survey the potential borrowers of this sector, determine which are good credit risks, and then simply provide them with loans that require limited paperwork. This alternative would imply heavy initial costs for the survey of borrowers and possibly from some initial loan delinquency.

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C. Program Design Implications: Equity vs. Efficiency

The Commercial Bnaks have done a good job of moving money into the cooperatives. According to Ladman, et.al. (1986:109), they had loaned over 144 million colones to them by the end of 1984. It is conceivable that they could lend all of the credit earmarked for this sector to the coopratives. However, the extent to which they selectively loan to a limited clientele in this sector may be an issue. If funds are channeled through the Commercial Bank sector alone, they may eventually reach only a minority of beneficiaries because of the Commercial Banks' unwillingness to lend to less creditworthy cooperatives.

Although economically sound, this lending policy may not be socially or politically sound. It is likely to be less problematic if the Agricultural Bank and other intermediaries such as FESACORA and FEDECCREDITO receive credit lines form other sources and attend to the credit needs of the other cooperatives.

In additions' it may be necessary to provide incentives to the Commercial Banks to work with the less creditworthy cooperatives. Increased spreads in the discount rates provided by the Central Bank are an incentive built into the program. Assistance with the supervision and use of loan funds by the cooperatives may be another incentive.

The same problem exists with Commercial Bank involvement with Phase III beneficiaries. Contrary to their interaction with Phase I cooperatives, they have lent very little money to Phase III beneficiaries. It is perhaps unrealistic to expect that the Commercial Banks do much lending to this sector despite an even greater spread in the discount rate.

Assuming that the Commercial Banks work with 40% of the cooperatives and with double the number of beneficiaries with whom they currently work in the Phase III sector, funds provided by this project will reach 18,911 direct beneficiaries or about 20 percent of the total.

VI. SPREAD EFFECTS - PROGRAM DESIGN IMPLICATIONS

Money from this new line of credit is likely to be disbursed exclusively by the Commercial Banks and by the Mortgage Bank. Should these credit institutions require that borrowers use the credit to maximize returns to investments and should they require repayment, this may have a salutary effect on the use of credit by the other cooperatives. They may be more willing to correct their deficiencies in order to gain access to this service. Of course, this assuems that the Agricultural Bank and other intermediaries will not satisfy their credit demands using other souces of funding and with less rigorous lending policies.

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The project, as presently designed, does not include specific ways of working with Phase III beneficiaries. It is assumed that the intermediaries will determine how and to whom they will distribute the credit. Mention has already been made of the need for the banks to find innovative ways of reducing lending costs to both borrowers and lenders. They should be encouraged to experiment with alternative models. If successful ones are found, they will no doubt diffuse rapidly among intermediaries participating in this program.

VII. PARTICIPATION OF WOMEN

It is difficult to determine accurately the extent to which women will participate in the use of credit provided by this project. As in much of Latin America, in El Salvador the male spouse is considered to be the head of the household and represents the family farm unit in interaction with other societal institutions. Data presented by MAG (1985) suggest that about 10 percent of the members of Phase I cooperatives are women. Presumably, they have equal access to credit which is channeled to cooperative members through wages for labor.

It can also be assumed that wives and other family members have access to this credit through labor which they provide at peak harvest times. It is also fair to assume that women members benefit from other credit investments by the cooperatives to the same extent that their male counterparts do.

There are several ancillary projects which deal specifically with the well being of women living on cooperative lands. Each cooperative receives various kinds of promotional assistance from government agencies. As shown in the

Table 11

Types of Activities Promoted	Number	%
Assistance to Cooperative Leaders	231	41
Assistance to Women	69	12
Assistance to Youth	50	9
Assistance to Men	89	16
Facilitation of Other Government Programs	124	22
Total	563	100

Source: MAG (1985:115)

Table 11, 12 % of these assistance activities are targeted to women. This compares favorably with the 16 percent of activities devoted to men. Many of these activities are concerned with non-farm sources of income.

Initial Environmental Examination

I. BASIC PROJECT DATA

Project Location:	El Salvador
Project Title:	Rural Financial Markets
Project Number:	519-0307
Funding:	FY 85 to FY 89; $50 million grant
Life of Project:	Five years
IEE Prepared by:	C. Roberto Gavidia USAID/El Salvador
Recommended Threshold Decision:	Negative Determination
Date:	December 11, 1985

II. Project Description

The Purpose of the project is to increase the availability and productive use of credit in the reform sector. The rationale for the project at the purpose level is that reform sector farming enterprises are debt financed and their new owners, for the most part, have little equity or accumulated savings. Without access to credit, the reform beneficiaries are without a source of capital for short-term operating needs and medium-term investment purposes. These additional resources, to complement their labor, land and other fixed assets, are essential for significant increases in production and income.

Attainment of the project purpose will result in the following of end of project status:

1. Intermediary Credit Institutions' (ICIs) annual flow of credit will increase at least by the amount made available annually under the project.

2. Creditworthy reform cooperatives and other beneficiaries will increase their total agricultural credit at least by an amount made available through the Project.

3. The number of Phase I Cooperatives classified as creditworthy will increase.

4. Credit uses indicate increased investment and production capability.

The first two indicators above will demonstrate that credit was made available from the project and that it reached its intended recipients. It is essential that credit from the project not simply replace existing reform sector credit. During project paper preparation measurement guidelines will be developed to ensure that credit being made available from the Project will be in addition to present credit levels of the DCR and ICI's.

An increase in the number of creditworthy cooperatives assumes the continuation of GOES and USAID efforts to provide technical assistance, qualified management personnel and training to cooperatives. It also will require development of the qualitative aspect of this project which will include training and technical assistance to the credit agent units of the BCR and ICI's, thereby enhancing management support resources for reform cooperatives.

III. Achievements/Accomplishments

The principal outputs expected from this project are:

1) The rediscount credit line established in the Central Reserve Bank and functioning through ICIs.

2) A credit agent training program in place.

3) A Policy Component supported by public education activities.

4) The establishment of a pilot savings mobilization program.

There will be a training dimension to the project, consisting mainly of the credit agent training program, designed to institutionalize the program and improve financial market policy. This dimension would provide information to the BCR, ICI's and the reformed sector about the availability, benefits and managements aspects of the rediscount fund and provide information and advice to credit officials, bankers, and policymakers on agricultural credit, savings mobilization and financial markets. This could be accomplished through structured programs, seminars, meetings and informal visits.

The public education/policy component will involve discussions with GOES officials concerning factors important to project success such as the effects of macro-economic policies on credit programs, including exchange rate, pricing and marketing policies and broad aspects of the agrarian reform program. This component will be implemented through meetings and ongoing dialogue with key GOES officials, both within and outside, the reform sector.

A pilot savings mobilization program will be established in the reform sector involving BFA and possibly some credit unions. This would be undertaken as an experiment in mobilizing savings in the sector by using the existing savings windows at BFA and in credit unions. Based upon the success of the pilot program, consideration would be given to expand or discontinue the savings mobilization effort.

The project will have a projected life of five years. The objective would be to have the fund continue on its own upon the completion of this period. The policy component will promote efforts to improve the exchange rate, marketing and pricing policies.

IV. Inputs

The largest project input from A.I.D. will be the provision of about $46 million for the rediscount line to be established in the BCR. Funds would be made available from A.I.D. over a four year period (Year 1: $10 M, Year 2: $15 M, Year 3: $15 M, Year 4: $10 M) for use during the project's five year life. Although the interest rate(s) used by the BCR and other factors will affect the maintenance of the fund's real value, the use of the fund by ICI's should continue indefinitely. During the preparation of the project paper, the design team will address the structure and terms of the rediscount line in order to preserve the fund's real value.

The technical assistance to be provided includes one long-term advisor and substantial short-term assistance. The long-term person will be a specialist in credit administration and delivery and will work closely with the BCR, particularly its credit agent unit. He/she will work to upgrade the credit agent programs, both in the BCR and in ICI's. Short term technical advisors will provide additional support in strengthening the credit agent program as well as conduct studies to address other credit issuers and monitor and implement the pilot savings mobilization program. Technical advisors will play a key role in implementing the public education campaign.

Training will be provided to strengthen the credit delivery system. Key individuals in the BCR and ICI's will attend seminars on credit management and delivery and participate in other training activities, both in El Salvador and abroad. Efforts will be made to draw upon, the experience of successful credit distribution programs elsewhere in Latin America.

The GOES will contribute a minimum of 25% of the total project cost through its contribution to the reform sector rediscount line. The source of the GOES funds will be primarily ESF counterpart funds. The GOES contribution to training and other costs will be primarily of an in-kind nature.

IMPACT IDENTIFICATION AND EVALUATION

C. ATMOSPHERIC

1. Air additives	N
2. Air pollution	N
3. Noise pollution	N
4. Other factors	
	N

D. NATURAL RESOURCES

1. Diversion, altered use of water	N
2. Irreversible, inefficient commitments	N
3. Other factors	
	N

C. CULTURAL

1. Altering physical symbols	N
2. Dilution of cultural traditions	N
3. Other factors	
	N

D. SOCIOECONOMIC

1. Changes in economic/employment patterns	M+
2. Changes in population	L
3. Changes in cultural patterns	N
Other factors	
	N

1/ We use the following symbols:
- N - No environmental impact
- L - Little environmental impact
- M - Moderate environmental impact
- H - High environmental impact
- U - Unknown environmental impact
- \+ - Beneficial impact
- \- - Negative impact

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V. Impact Identification and Evaluation Form

Impact Areas and Sub-Areas	Impact Identification and Evaluation 1/
A. LAND USE	
1. Changing the character of the land through:	
a. Increasing the population	L
b. Extracting natural resources	N
c. Land clearing	N
d. Changing soil character	N
2. Altering natural defenses	N
3. Foreclosing important uses	N
4. Jeopardizing man of his works	N
5. Other factors	N
______________________	______
______________________	______
B. WATER QUALITY	N
1. Physical state of water	N
2. Chemical and biological states	N
3. Ecological balance	N
4. Other factors	N
______________________	______
______________________	______