PD-KAB 591

MAY - 2 1985

ACTION MEMORANDUM FOR THE ADMINISTRATOR

THRU : AA/PPC, Richard Derham

FROM : AA/LAC, Victor M. Rivera /s/ Marshall D. Brown

SUBJECT: Program Assistance Approval Document: El Salvador Balance of Payments Support Program No. 519-0310

Action: You are requested to: 1) approve the subject program in the amount of $190 million; and 2) authorize FY 1985 grant funding of $160 million for the subject program from the Section 531 Economic Support Fund appropriation. Conditionality for this assistance is structured to leverage GOES action toward accelerating the pace of agrarian reform, reactivating the private sector, reducing balance of payments and fiscal deficits, strengthening the macroeconomic management of the economy and the management of ESF foreign exchange resources.

Discussion: Balance of payments assistance to El Salvador commenced during 1980, with a $20 million ESF cash transfer through the Private Sector Support I Program (519-0267). Subsequent amendments to this program provided for disbursements of an additional $385 million in balance of payments support, culminating with $65 million from the FY 1984 Supplemental Appropriation, in December 1984. Under the terms of that program, the Government of El Salvador (GOES) made equivalent amounts of foreign exchange available for importation from the U.S. of raw materials and intermediate and capital goods required by the productive private sector.

Under Private Sector Support I, ESF-generated local currency was used to support the A.I.D. priority areas of agrarian reform, employment generation, credit to the private sector, restoration of public services, and humanitarian assistance. Conditionality for that program pertained to GOES program and policy adjustments which supported social and economic reforms, stabilization of the economy, and assistance to victims of the conflict.

During 1984, the Mission's ESF conditionality strategy evolved into one which increasingly focussed on longer term economic recovery, resettlement, reorientation of basic services, and the development of democracy. The Mission presented this transition strategy for 1985 in its $65 million, final amendment to Private Sector Support I, which responded to concrete steps taken by the GOES to move import and export transactions to the parallel market, strengthen the agrarian reform, form a high-level economic analysis policy group and engage the IMF in preliminary discussions toward negotiation of a new Standby Agreement. USAID/El Salvador has since reported that progress has been made on all these fronts.

Because of the evolutionary nature of its strategy and changing conditions in El Salvador, the Mission was advised at the time of the last amendment review to submit a new PAAD for FY 1985. The Mission has submitted a PAAD laying out a $190 million program consisting of $160 million from the FY 1985 ESF appropriation and another $30 million in FY 1986 funds, which will preclude a time lag between the disbursement of the final tranche of FY 1985 and initial tranche of FY 1986 ESF balance of payments support. The Bureau concurs with this approach and plans to amend the program authorization at the appropriate time to include $30 million in FY 1986 funds, subject to the necessary Congressional action and OMB apportionment of funds.

The FY 1985/86 PAAD describes the economy of El Salvador as having made significant strides toward achieving stabilization and poised to move toward recovery. Restraints on non-defense expenditures and additional macroeconomic adjustments were among those measures taken by the GOES which, along with increased levels of private financial savings and growth in private investment, increased crop production, and continued U.S. economic assistance, led to an upturn in the economy during 1984. However, the GOES experienced a budget deficit in 1984 of over $145 million and it is projected that this deficit will widen to an estimated $274 million during 1985, foreign grants considered. Further, the Central Government budget will be stretched during 1985 in attempting to meet increased spending requirements for defense and public safety, debt servicing obligations and basic social services.

Conditionality for disbursement of funds under this PAAD leverages GOES action to deal with its balance of payments and fiscal deficit and to take other measures necessary to

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strengthen the macroeconomic management of the economy, to help reactivate the private sector, and to accelerate the pace of agrarian reform and consolidation of beneficiary rights. (These measures are specified in Annex VII of the PAAD. A copy of this annex is attached to this action memorandum.) Improvements in the control and management of ESF foreign exchange through the establishment of a Separate Account in the GOES Central Bank are also an objective of conditionality. Progress on all measures will be reviewed by AID and the GOES prior to any disbursements above the $100 million mark.

The DAEC reviewed the PAAD on April 12, 1985 and recommended its approval with the following modifications and guidance to the Mission:

(1) The PAAD will include a more explicit disbursement strategy, which sets more specific benchmarks and dates for achievement of actions by the GOES to improve the economy, strengthen the private sector's role therein and consolidate the Agrarian Reform. The Mission will report to AID/W on problems in the achievement of these actions by the specified dates, if and when problems occur.

(2) The DAEC determined that it was desirable to use a portion of local currencies generated under the program for compensation of former owners of agrarian reform lands. However, such utilization presents a policy issue which must be considered by the Administrator. If it should be determined that the funds cannot be used for compensation, the Mission will recommend other uses, the categories for which are delineated in Annex IV of the PAAD. We would propose to begin the resolution of the policy issue by consulting with concerned members of Congress. If you agree with the approach, such consultations will be initiated shortly.

(3) Measures for rescheduling of the private sector debt to domestic banks will be included in the side Memorandum of Understanding with the GOES. More specific discussion of those measures will be included in the PAAD.

(4) The PAAD requests continuation of the expansion of import eligibility under the prior ESF program to include Central American Common Market countries, excluding Nicaragua, and

Panama. The DAEC decided that import eligibility for commodity imports to be financed under the Program should be broadened to allow procurement of petroleum and petroleum derivatives from Geographic Code 941 countries. It was also decided that all commodity imports must be carried out by the private sector.

Recommendations: (1) That you approve the proposed 1985 program in the amount of $190 million with the understanding that the $30 million in FY 1986 funds will be authorized prior to the submission of a FY 1986 PAAD, and subject to the availability of funds.

(2) That you sign the attached PAAD facesheet authorizing $160 million in ESF grant funds for the Balance of Payments Support Program and expanding the eligible source and origin countries for dollar use attribution to include Central American Common Market countries, with the exception of Nicaragua, and Panama and, as regards the import of petroleum or petroleum-derived products, to Code 941 countries.

(3) That you approve initiation of consultations with concerned members of Congress on the use of local currencies for compensation of former owners of agrarian reform lands in El Salvador. A separate memorandum containg more information on this issue will be provided prior to your being requested to make a policy decision.

Drafter:LAC/DR, DAdams

PPC/PDPR: ARosenberg ____________ Date ______
GC : HFry ______ signed Date 5/8/85

Attachment: Tab A, PAAD facesheet and PAAD - $160 million ESF

Clearances
LAC/DR, LKlassen ______ Date 4/26/85
LAC/DR, CPeasley ______ Date 4/26
LAC/DR, ILevy ______ Date ______
LAC/DR, DBJohnson ______ Date 4/26
LAC/CEN, HWilkinson ______ Date 4/24/85
LAC/DP, JOleson ______ Date 4/30/85
GC/LAC, RMeighan ______ Date 5/1/85
ARA/ECP, RBeckham ______ Date 5/1/85
DAA/LAC, MDBrown signed Date 5/2/85

D.A.
LAC/DR: DAdams:(0652O):4/17/85:ext. 23402

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Attachment: Tab A, PAAD facesheet and PAAD - $160 million ESF

D. Adams
Drafter:LAC/DR, DAdams

PPC/PDPR: ARosenberg AR Date 5/7/85
GC : HFry [illegible] Date 5/6/85

strengthen the macroeconomic management of the economy, to help reactivate the private sector, and to accelerate the pace of agrarian reform and consolidation of beneficiary rights. (These measures are specified in Annex VII of the PAAD. A copy of this annex is attached to this action memorandum.) Improvements in the control and management of ESF foreign exchange through the establishment of a Separate Account in the GOES Central Bank are also an objective of conditionality. Progress on all measures will be reviewed by AID and the GOES prior to any disbursements above the $100 million mark.

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(2) The DAEC determined that it was desirable to use a portion of local currencies generated under the program for compensation of former owners of agrarian reform lands. However, ~~prior to use of any of these funds for compensation AID will consult with concerned members of Congress, and subsequent to these consultations the A/AID will be requested to make a policy decision on whether the local currencies can be used for that purpose.~~ should be If it ~~is~~ determined that the funds can not be used for compensation, the Mission will recommend other uses, the categories for which are delineated in Annex IV of the PAAD. ~~FYI. Preliminary discussions with Congressional staff are underway and we will be informing you soon of their status. If you are in agreement with this strategy, consultations with Congress will be initiated shortly.~~

[illegible] to [illegible] a policy issue which must be considered by the Administrator.

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We would propose to begin the resolution of the policy issue by consulting with concerned members of Congress. If you agree with this approach [illegible] consultations will be initiated shortly

CLASSIFICATION:

AID 1120-1

**PAAD**

AGENCY FOR INTERNATIONAL DEVELOPMENT

PROGRAM ASSISTANCE APPROVAL DOCUMENT

1. PAAD NO: 519-0310 519-K-608
2. COUNTRY: El Salvador
3. CATEGORY: Cash Transfer
4. DATE: April 12, 1985
5. TO: A/AID, M. Peter McPherson
6. OYB CHANGE NO.:
7. FROM: AA/LAC, Victor M. Rivera
8. OYB INCREASE:
TO BE TAKEN FROM: Economic Support Fund (ESF)
9. APPROVAL REQUESTED FOR COMMITMENT OF: $ 160,000,000
10. APPROPRIATION – 537-65-519-00-50-51 LESA85-35519-KG-31
11. TYPE FUNDING: ☐ LOAN ☒ GRANT
12. LOCAL CURRENCY ARRANGEMENT: ☐ INFORMAL ☒ FORMAL ☐ NONE
13. ESTIMATED DELIVERY PERIOD: FY 85
14. TRANSACTION ELIGIBILITY DATE:
15. COMMODITIES FINANCED:

16. PERMITTED SOURCE
U.S. only:
Limited F.W.: $160,000,000
Free World:
Cash: $160,000,000

17. ESTIMATED SOURCE
U.S.: $160,000,000
Industrialized Countries:
Local:
Other: CACM including Panama, excluding Nicaragua, Code 941 for petroleum

The purpose of this program is to provide the Government of El Salvador (GOES) with the foreign exchange necessary to help it stabilize the economy and move it toward recovery. The ESF strategy is one which supports GOES policies and programs designed to (i) reattain financial equilibrium and economic stability, (ii) engage the productive private sector in reactivating itself and in rebuilding the economy, and (iii) consolidate the agrarian reform. Conditionality for the program requires agreement between AID and the GOES on those measures necessary to strengthen the economy and the agrarian reform, and to ensure proper management of ESF foreign exchange. After signature of the program agreement, $160 million will be provided in tranches through a Separate Account in the Central Bank corresponding in amount to funding for the importation by the private sector of raw materials, intermediate and capital goods, spare parts and agricultural inputs from the U.S. and Central American Common Market countries, excluding Nicaragua, and including Panama. Petroleum products may be procured by the private sector from A.I.D. Geographic Code 941 countries. The GOES will agree to provide $160 million local currency equivalent for private sector credit, counterpart for USAID projects, the Agrarian Reform and other priority public sector programs complementary to the USAID program in El Salvador.

| 18. CLEARANCES | | DATE |
|---|---|---|
| LAC/CEN:PAskin | | 4/29/85 |
| ARA/ECP:RBeckham | | 5/1/85 |
| FM :CChristensen | | 5/3/85 |
| GC/LAC :RMeighan | | 5/1/85 |
| GC :HFry | | 5/6/85 |
| AA/PPC :RDerham | | |
| LAC/DP :JOleson | | 4/30/85 |
| LAC/DR :DJohnson | | 4/29/85 |

20. ACTION
☒ APPROVED ☐ DISAPPROVED

AUTHORIZED SIGNATURE: M. Peter McPherson, Administrator, AID
DATE: MAY 9 1985
TITLE

CLASSIFICATION:

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

LAC/DR-DAEC 86-19

Meeting of the
DEVELOPMENT ASSISTANCE EXECUTIVE COMMITTEE (DAEC)
Thursday March 6, 1986 --2:00 p.m.
Room 2248 NS

EL SALVADOR -- CY Balance of Payment Program ESF PAAD

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| LAC/CONT | JHoltaway | S&T/AGR | |
| LAC/AJDD | Tgieger | PRE/PPR | |
| ARA/ECP | RBeckham | DAA/PRE | |

LAC/DR: 2/29/86

CLASSIFICATION:

AID 1120-1

**PAAD**

AGENCY FOR INTERNATIONAL DEVELOPMENT

**PROGRAM ASSISTANCE APPROVAL DOCUMENT**

1. PAAD NO

2. COUNTRY
El Salvador

3. CATEGORY
Balance of Payments Program PAAD

4. DATE
February 1986

5. TO:

6. OYB CHANGE NO.

7. FROM

8. OYB INCREASE

TO BE TAKEN FROM:

9. APPROVAL REQUESTED FOR COMMITMENT OF:
$

10. APPROPRIATION –

11. TYPE FUNDING
☐ LOAN ☐ GRANT

12. LOCAL CURRENCY ARRANGEMENT
☐ INFORMAL ☐ FORMAL ☐ NONE

13. ESTIMATED DELIVERY PERIOD

14. TRANSACTION ELIGIBILITY DATE

15. COMMODITIES FINANCED

16. PERMITTED SOURCE
U.S. only:
Limited F.W.:
Free World:
Cash:

17. ESTIMATED SOURCE
U.S.:
Industrialized Countries:
Local:
Other:

18. SUMMARY DESCRIPTION

19. CLEARANCES | DATE

20. ACTION
☐ APPROVED ☐ DISAPPROVED

AUTHORIZED SIGNATURE | DATE

TITLE

CLASSIFICATION:

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1986 PAAD

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PAAD: CY 1986 BALANCE OF PAYMENTS PROGRAM

## I. INTRODUCTION

This document requests authorization of $147 million of Economic Support Funds, to be funded incrementally (i.e., $117 million in FY 86 and $30 million in FY 87), for balance of payments assistance to support the stabilization and the recovery of the Salvadoran economy during CY 1986. These funds will be used to finance the import of raw materials, intermediate, and capital goods essential for the functioning of the Salvadoran economy. The local currency generated will be used for agrarian reform compensation, expansion of selected lines of credit to the private sector and budgetary support of mutually agreed upon priority programs.

## II. BACKGROUND

Following the solid political, military, and economic gains of 1984, the country faced a new set of challenges in 1985. After his party's victories in the March elections by a surprising margin, President Duarte was dogged by a series of persistent military, political, and administrative problems. Guerrilla kidnappings of municipal officials slowed the projection of Government services and civilian authority into the conflictive areas. The September kidnapping of the President's daughter by the guerrillas diverted attention of top government leaders from day-to-day decision-making. Execution of important programs by key social service ministries was uneven throughout the year. Coordination among members of the President's Economic Cabinet, while vastly improved, was not adequate to deal with economic problems of the gravity facing the nation. Efforts to increase cooperation between the public and private sectors made some headway, but the traditional hostilities and suspicions remain. The President consequently enters the new year without having accomplished all that he had hoped.

During the year the guerrillas increased their attacks on the economy and returned to the cities to mount a campaign of urban terror. The assassination of four U.S. Marines, Salvadoran government officials, murders of innocent civilians, kidnapping of a member of the President's family, and vastly intensified indiscriminate attacks on transportation, communication, and public utilities, bear witness to the political-military challenges facing the country. The Salvadoran Armed Forces in 1985 had continued success on the battlefield due to increased professionalization, improved mobility and communications, augmented fire power, and better intelligence coordination. Morale in the guerrilla forces seems to be ebbing, and defections are increasing. The continuing death and destruction, however, bear grisly testimony to the damage that can be done by a relatively few committed individuals.

The modest acceleration of economic growth forecasted early in 1985 never materialized and time ran out on the temporizing measures the Government had taken to maintain some semblance of balance over the previous two years. Fueled by an easy monetary policy intended to accommodate large public sector deficits and to reactivate the private sector, inflation flared up and seriously destabilized the country's fragile economy. Official sources now estimate GDP growth of 1.6 percent for 1985 -- about the same level as registered in 1984.

By late 1985, the Government became increasingly concerned about continued lackluster growth and by the possibility that surging inflation would push the economy back into recession. To forestall this possibility, the President in mid-December began to finalize a comprehensive program for the stabilization and reactivation of the economy during 1986. This program -- announced in mid-January -- includes measures to stimulate production and employment, reduce the rate of inflation, establish a more realistic interest rate structure and a more realistic exchange rate, attack waste and inefficiency in the public sector, and revamp the tax system and public service tariff structures to provide an adequate foundation for both the present extraordinary war-time expenditures and the continuing of critical public service functions of the Government.

As a result of these economic policy measures and recent developments in world markets for coffee and petroleum, El Salvador's near-term economic outlook is more favorable than it has been since 1979. Provided that coffee prices hold at over $225 per quintal for the year and that appropriate policies are maintained, GDP growth in the 2.0 percent to 2.5 percent range is attainable. Foreign exchange inflows should be sufficient to achieve this rate of growth and permit substantial reduction of external payments arrearages and accumulation of more normal levels of reserves.

## III. OVERVIEW OF THE ECONOMY

### A. Yearend 1985

After some growth and tolerable inflation during 1984, the Salvadoran economy drifted off course during 1985. The momentum associated with 1984's solid reversal of El Salvador's five-year economic slide was dissipated, and the economy began to stall. The failure of growth to accelerate during the year is attributable to a number of factors, including a drop in exports, bad crop weather, and continuing uneasy relations between the public and private sectors.

Real GDP growth during 1985 of 1.6 percent is estimated based on preliminary data. Agricultural output fell by an estimated 2.4 percent (a sharp drop from the 1.2 percent growth reported for 1984), Manufacturing grew by 4.5 percent (up from 1.3 percent in 1984), and Construction grew by 12.0 percent (up from -5.7 percent in 1984). Growth rates of GDP originating in Mining, Utilities, Transport, Commerce, and Government were roughly at or below 1984 levels.

Recent reports that the 1985/86 coffee harvest is coming in well below the level assumed in the 1.6 percent estimate could result in a downward revision of 1985 real GDP estimates. Whatever the final 1985 figures show, however, the result will be disappointing in proportion to the stimulus applied to the economy. Banking system credit (in nominal terms) to the private sector as of November, 1985, was up by 26.2 percent over its November, 1984, level. The corresponding November, 1983 - November, 1984 increase was 11.4 percent. Apparently, there was relatively little real output response to this massive infusion of liquidity.

Price responses were altogether a different story. Inflation was well above levels recorded a year earlier. The most recent estimate for 1985 puts inflation, measured on an annual average basis (i.e., 12 month average of monthly CPI's), at 22 percent. By way of comparison, the annual average rate of inflation in El Salvador has never exceeded 20 percent in over 25 years. In 1984, the rate was 11.7 percent.

While sobering, this statistic tends to understate (due to the annual averaging process involved) the recent acceleration of inflation. A comparison of the value of the CPI in November, 1984, and November, 1985, shows that inflation surged to an annual pace of about 31.5 percent.

The main factor behind the inflation surge was rapid acceleration of the rate of growth of the money supply. The money supply grew by 29.3 percent between November, 1984 and November, 1985. This compares with a rate of growth of 16.3 percent over the corresponding period one year earlier. The surge during 1985 was driven by Central Bank purchases of foreign exchange to repay external debt and accumulate reserves, and a virtual explosion of credit. Due to the conjunction of these factors, the monetary base grew by 28.2 percent, November, 1984 to November, 1985, as against 12.6 percent November 1983 to November, 1984.

Contrary to popular belief, very little, if any, of the recent inflation can be blamed on the nominal effective devaluation of the colón caused by transfers of transactions to the parallel market. While the nominal value of the colón, evaluated at a blend of official and parallel market exchange rates, fell by 28 percent between November, 1984 and November, 1985, these devaluations clearly lagged rather than led the upsurge of prices. Nor do changes in world market prices of El Salvador's exports and imports explain high 1985 inflation rates. The blame for the unwanted surge of inflation must be laid at the door of excessively rapid expansion of the monetary base.

The rapid acceleration of inflation, speculation, and -- perhaps -- some loss of confidence in the near-term future of the Salvadoran economy, pushed the black market excnange rates to new heights. Prior to the end of 1984, the black market rate generally remained within 5 to 10 percent of the parallel market rate. The spread began to widen in late 1984 and continued to widen during much of 1985. At one point the black market rate exceeded ₡9.00 per US$1.00, over ₡4.00 above the parallel market rate of ₡4.85. The market

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settled down in the Fall when the black market rate dropped into the ¢6.00-¢7.00 range per US$1.00 in mid-November, and dropped below C6.00 in early 1986.

Unemployment and underemployment, though imprecisely measured, remained high. In 1985, according to MIPLAN, unemployment stood at about 32.6 percent, slightly below the 33.3 percent rate now estimated for 1984.

B. <u>Outlook for 1986</u>

The outlook for 1986 is better than at any time in the recent past, but still hinges upon a number of imponderables. With an appropriate economic program and the resources provided by high coffee prices, low oil prices, and disbursements of U.S. economic assistance, growth in the range of 2.0 to 2.5 percent can be envisioned.

The imponderables—such as they are known at the moment — present a mixed but overall favorable picture. On the down side, in September, Texas Instruments announced the closing of its manufacturing facility in the San Bartolo Free Zone. A several-day rain in early November destroyed perhaps 50 percent of the projected small 1985/86 cotton crop, which portends very weak 1986 cotton exports. The 1985/86 coffee harvest is disappointing and export stocks are seriously depleted. Other crops were also off, and food imports will have to be increased.

On the positive side, world prices for coffee have picked up markedly on the strength of the Brazilian drought, and oil prices in the mid-to-high teens can be expected for the year. The prospect that the IBRD will resume lending operations in El Salvador during the year also brightens the picture. The Summer 1985 Creditworthiness Mission was followed up by a February, 1986, Mission to discuss future lending operations. Provided the Government carries forward the announced 1986 economic program, we believe that there should be no obstacles to resumption of Bank lending. However, disbursements under any new lending program are not likely to reach significant levels before 1987.

Based on all of these factors, real growth in the range of 2.0 percent to 2.5 percent might reasonably be anticipated for the year. Agriculture — weather favoring — should have a good year. If coffee yields follow their usual biennial cycle, the 1986/87 crop should be good. High coffee prices will help. Exchange rate unification should also result in at least a modest increase in producer prices of other agricultural commodities. An apparent rebound of Manufacturing in the fourth quarter of 1985 should continue. The foreign exchange constraint should be much relaxed, and with some firming of the economic situation of El Salvador's regional trading partners, and internal demand that is likely to remain fairly strong, Manufacturing should have a good year. Construction may suffer a bit depending upon what happens to housing demand, but if business investment responds favorably — as it should — to policy coherence, construction sector output may grow modestly as well. Some parts of commerce could be hurt by increased selective consumption tax rates — particularly those dealing in imported durable goods. Overall, however, the effect should be minor.

Inflation should slow somewhat during the year provided the Government sticks to its program and carefully manages growth of liquidity in the economy. The program calls for 20 percent inflation (i.e., a 20 percent increase in the 12-month 1986 average CPI over the 12-month average 1985 CPI). This will require a substantial deceleration of inflation, which was running at an annual rate of about 30 percent as of December, 1985. To meet the 20 percent annual average target, the rate will have to be brought down relatively quickly to an annual rate of about 10 percent by December of 1986.

Control of liquidity will pose a particularly difficult problem. The foreign exchange operations of the Central Bank alone could add over 40 percent to the monetary base. This large increment is due to the effects of the planned devaluation of the official exchange rate, the relatively large quantity of Central Bank debt service falling due in 1986, the backlog of obligations to sell foreign exchange at ¢2.50, and the high price of coffee. The monetary authorities will have to use all of the instruments at their disposal to offset the effects of this large potential infusion of liquidity. This is feasible, but will require strict monetary discipline.

## IV. THE GOES' 1986 ECONOMIC PROGRAM

The Government's economic program for 1986 blends a production policy to reactivate and reorient the economy, financial stabilization, and an incomes policy to undercut opposition. As practical political-economy the program deserves relatively high marks. It addresses every one of the issues raised by the recent IMF Article IV Consultation mission. It is not, however, "textbook" perfect. It sets an initial unified exchange rate that is too low to restore El Salvador's lost competitiveness. It requires rationing of foreign exchange that could offset the benefits of unification. It relies heavily on import prohibitions and other quantitative controls. It includes increased subsidies, however carefully limited, and wage increases in some sectors that may spur inflation or curb employment.

### A. Overview

The 1986 program calls for improved performance on a number of fronts, including a reduction of the balance of payments deficit that permits relative stability of the exchange rate, a reduction of the fiscal deficit, a reduction of the rate of inflation, and an increase in employment. Specific targets for the next three years were established for some of these dimensions of economic performance. These targets call for a significant reduction of inflation (i.e., 20 percent for 1986 measured on an annual average basis - no mean feat

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given the high rate of inflation at yearend 1985), a greatly reduced deficit in the Current Account of the balance of payments (e.g., 6.5 percent of GDP, before official transfers and estimated family remittances), and reduction of the deficit in the Central Government ordinary budget.

To meet these targets, the program calls for policy initiatives in three areas: financial stabilization; income protection; and production growth/restructuring. Each of these areas is described below.

B. Financial Stabilization

Better balance between public sector receipts and expenditures and external sector receipts and expenditures is required to reduce inflation and accelerate economic growth. The program stipulates measures in four areas -- fiscal policy, exchange and payments policy, monetary policy, and credit policy -- to bring about internal and external financial balance.

1. Fiscal Policy

Two new revenue measures are the centerpiece of the 1986 fiscal package. The most important of these is the Coffee Windfall Tax. This is a temporary tax (one year) that will apply to the proceeds from 1986 coffee exports. A surtax of 15 percent of the FOB price will be levied on 1986 export sales. The combined effect of the new tax and high world market coffee prices is to boost projected 1986 revenues from taxes on coffee exports by about ¢850 million, to a conservatively projected total of ¢1.05 billion.

The other tax measure in the 1986 package extends the coverage and boosts the rates of the Selective Consumption Tax currently in force. The main purpose of this measure is to discourage imports of selected consumer goods. The estimated yield of these changes depends upon unknown demand elasticities. The Ministry of Finance estimates that these taxes will not produce a revenue increase during 1986 since imports of most of the taxed products have been prohibited for the year.

The 1986 fiscal package also calls for a number of other measures to increase revenues or restrain expenditures. Rates for services provided by public enterprises are to be raised -- in accordance with studies now in progress -- to cover the increased colón cost of servicing their external debt, and gradually to eliminate deficits. Tax administration is being strengthened, including stricter enforcement and sanctions for tax evasion, stepped up efforts to collect back taxes due but not paid, elimination of time extensions for the declaration and payment of taxes, and extending the coverage of the withholding system. Tax exemptions presently extended to Autonomous Institutions of the Government have been rescinded. Finally, the coverage of the austerity measures under which the Government has operated for the last several years has been strengthened and extended.

The program also calls for an overhaul of the tax system during 1986. The new system will rely on direct taxes more heavily than the present one, and will be designed to yield enough revenue to eliminate the requirement for net internal financing of the Central Government deficit.

2. Exchange and Payments Policy

The program unifies the exchange rate at ¢5.00 per US$1.00, and strengthens controls on convertibility in order to hold the new rate. However, the President has stated that the rate will be reviewed periodically (approximately every six months), and seems to intend that the system operate as an adjustable peg.

Imports of a large number of items have been prohibited for one year, and duty free imports circumscribed sharply. To reinforce these measures, legislation prescribing severe penalties for dealing in contraband and bounties for whistle-blowers has been presented to the Assembly. Foreign exchange will continue, under the program, to be assigned on the basis of a schedule of quotas and priorities.

A concerted effort is to be made to increase the share of the banking system of the Salvadoran foreign exchange market. A large volume of foreign exchange transactions involving primarily purchases and sales of remittances by expatriate Salvadorans now takes place outside the bank market (see also Section V.B below). Salvadoran bank branches are to be opened in U.S. cities with large Salvadoran populations in an effort to capture a larger fraction of the remittance flow.

Finally, the program calls for a crackdown on the black market for foreign exchange. Dealing in the black market would be a felony, punishable by imprisonments of varying lengths depending upon the infraction. A bill to make the necessary modifications to the penal code already has been submitted to the Legislative Assembly, where it has faced stiff opposition.

3. Monetary Policy

Four measures are being taken to increase the demand for interest bearing monetary assets, reduce credit demand, and to reduce the rapid rate of growth of the money supply. First, interest rates on time deposits have been increased by about 2.5 percentage points. Fox example the 180-day time deposit rate was boosted from 12.5 percent to 15 percent. Rates on other types of deposits will remain unchanged. Lending rates were increased correspondingly, although preferential rates have been established for small business and low income housing.

Second, the legal reserve requirement will be increased during the times of the year when the deposit banks usually have excess liquidity. Higher reserve requirements will apply between March and July than between August and February.

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Third, rediscount credit from the Central Bank will be tightened up. Rediscount rates were raised in line with the above-mentioned upward adjustment of interest rates and use of rediscount credit limited to lines that promote high priority Government economic policy objectives (e.g., support of restructuring and diversifying the country's export base).

Fourth, quantitative limits have been established, based on the Programa Monetario, much as the IMF would do in a standby agreement, to impose the necessary monetary and financial discipline required to meet the objectives of the stabilization program.

4. Credit Policy

The 1986 credit policy package calls for credit restraint. Two concrete measures are planned. First, net expansion of domestic banking system credit to the nonfinancial public sector is to be limited to ₡100 million. This represents a substantial decline from the ₡195 million extended in 1985.

Second, shortfalls in required reserves of the commercial and mortgage banks will be penalized harshly. The Central Bank maintained a tolerant attitude for the first nine months or so of 1985 toward reserve shortages. The depository banks responded predictably by expanding credit. The Central Bank moved to reverse this policy in the fourth quarter and pledges, under the 1986 program, to keep up the pressure.

C. Income Protection

The financial stabilization measures described above will affect the distribution of income, threatening the livelihood of certain economically vulnerable groups who are also traditionally supporters of the President's party. The most seriously affected are likely to be low income urban dwellers. To distribute the burden of adjustment more fairly and to diffuse political opposition, the program provides both for the subsidization of certain products and services, price controls, and adjustment of selected wages and salaries.

1. Prices

Consumer subsidies on basic foods and passenger transport are being maintained. Diesel fuel for passenger transport is continuing to be subsidized, so as to keep the basic passenger fare at ₡0.30 (the pre-1986 program fare was ₡0.25 per trip). Distribution of food through IRA outlets at controlled subsidized prices is being maintained.

Price controls are being enforced for a basic basket of goods and services. The program stipulates that price controls are to be applied flexibly and not in such a way as to discourage production. The price-controled food items include corn, beans, rice, lard, powdered milk, vegetable oil, margarine, eggs, chicken, wheat flour, beef, sugar and salt.

Other items on which prices are being frozen temporarily are noodles, milk, baby food, dehydrated soup, soap and detergents, matches, shampoo, toothpaste, toilet paper, sanitary napkins, stockings, clothing, fabric, school supplies, and medicines.

"Basic services" on which prices are to be frozen temporarily include housing renting for ¢750 monthly or less, interest payments on houses whose value is ¢60,000 or less, school fees, medical and dental services, transportation (i.e., as mentioned above, urban transport fares will be limited to ¢0.30 per trip, and an increase in 20 percent in interurban fares), and telephone, water, and electricity.

The price of petroleum products was boosted to reflect the increase in the colón cost of imports due to unification, with other cost elements adjusted to reflect minimum wage adjustments, interest rate adjustments, and the higher cost of keeping subsidized prices of diesel, LPG, and kerosine down. The price of hi-test leaded gasoline was increased from ¢6.40 to ¢9.70, with corresponding increases in the prices of most other petroleum products.

2. Wages and Salaries

Increases in selected minimum wages were provided. The rural minimum wage for adults was increased from ¢4.60 and ¢5.20 for women and men respectively to a unisex rate of ¢8.00 per day. Children less than 16 years old are covered by a minimum of ¢7.00. Minimum wages in commerce and industry were also increased. In San Salvador, the new minimum is ¢15.00 per day, an increase of 15 percent. In the rest of the country, the new minimum is ¢14.00, an increase of 18 percent.

Public sector wages and salaries were also increased. In addition to the ¢100 monthly increase for public sector employees announced by the President in November, 1985, an additional increment of ¢50 was announced. Employees earning ¢1,500 per month or less will receive the full ¢150 per month increase. Employees earning between ¢1,500 and ¢3,500 per month will receive only the increase of ¢100 per month announced in late 1985. Employees earning more than ¢3,500 per month will receive no increase. This amounts to an aggregate increase of about 17 percent. Private sector firms that are able to afford increases will be asked to grant increases of between 10 percent and 15 percent.

D. <u>Production Reactivation and Reorientation</u>

The heavy weight assigned to financial discipline in the program notwithstanding, it also provides for a major initiative to stimulate traditional exports and reorient the economy. The Government already has in place a number of program/projects/facilities intended to stimulate the economy. Many of them have not worked very well. The 1986 program calls for strengthened implementation, complemented by a limited number of new initiatives to fill in gaps in the reactivation/reorientation package. The

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program singles out three areas for special attention: production of basic necessities; promotion and diversification of exports; and a catchall category of other measures.

1. Production of Basic Necessities

The program calls for improved implementation of existing programs/projects for low-income housing construction and for food production. Under the housing component, a goal of 42,830 new "units", representing investment of ¢505.2 millions, is set for 1986. Under the food production component, quantitative benchmarks are set for accelerated implementation of existing projects involving technical assistance, marketing, storage, irrigation, seed/root stock production, credit, disease control, and rural sector infrastructure.

2. Promotion and Diversification of Exports

Traditional exports are to be promoted through higher producer prices (e.g., the producers price for coffee has been raised from ¢200 per quintal to ¢400 per quintal), special lines of credit (all traditionals), improved reliability of input supply, and technical assistance (e.g., pest control assistance in cotton, and coffee byproduct development). A particularly noteworthy element of this portion of the program is the statement that INCAFE is to be restructured to permit more private sector initiative in coffee marketing.

Non-traditional exports are being promoted (with AID support) through continued implementation of new credit lines established in late 1985 (e.g., production credit for watermelons, canteloups, vegetables, and pre export credit), technical assistance (currently being provided with AID support through FUSADES), and a new program of insurance against losses due to civil strife (to be established under the 1986 Local Currency Program with AID support). The new Export Promotion Law, which has been languishing in the Legislative Assembly since September, 1985, is to be passed and the provisions for a one stop export documentation center implemented promptly. A new Investment Law, cleaning up the legal tangle and confusion created by the 14 or so laws and bilateral investment treaties that govern investment in El Salvador, is to be drafted and enacted.

3. Other Measures

The program also calls for continued operation of credit lines serving sectors not mentioned above, and cleaning up a number of areas of unfinished business. The credit lines singled out by the program include a line for manufacturing, artisanal production, a replenishment of the <u>Fondo de Desarrollo</u>, and a line of credit for purchase of stock in industrial enterprises. The most significant actions called for to remove barriers impeding growth in key sectors is restructuring the finances of the agrarian reform (including restructuring the debts of agrarian reform beneficiaries, and settling obligations with former landowners).

## E. Assessment of the Program

The Mission supports the overall program outlined above. There are, however, several areas in which we would like to see it modified.

The most serious potential deficiencies are in the exchange and payments policy area. There are two aspects of the announced exchange and payments measures that should be modified. First, unification at 5 to 1 is too low. The case for a higher rate rests on purchasing power parity calculations, and comparisons with other indicators of the competitive value of the colón. Two recent purchasing power parity calculations show that the nominal exchange rate of the colón must be set higher than 5 to 1 to offset the cumulative effects of past internal inflation relative to external inflation. One calculation, based upon the method employed by the IMF, indicates that the rate of 5.25 per US$1.00 would have been appropriate for December, 1985. Another, based upon a method developed by USAID-funded consultants to the Government's Economic Advisory Group, indicates that a rate of ₡6.00 per US$1.00 would be more appropriate.

The case for a rate of 6 to 1 is buttressed by several additional arguments. First, 6 to 1 would bring the bank market rate within 10 percent of the black market rate. This would decrease speculative pressure on the colón, and increase the likelihood that the surrender of foreign exchange stemming from private remittances to the banking system would increase. Second, a 6 to 1 rate would more nearly reestablish the competitive position of the colón with the quetzal. Third, a rate of 5 to 1 provides almost no incentive to the production and export of new tradeables. Exporters previously earned at a rate of ₡4.85 to US$1.00, while securing some inputs at ₡2.50 to US$1.00. There will thus be no profit stimulus, although the simplification possible under a unified rate system — if it is not offset by the exchange controls that have been put in place — may have a modest salutary effect.

The second major deficiency in the exchange and payments area is a consequence of setting the rate too low: administrative rationing of foreign exchange is being instensified. The program contains three kinds of rationing which the Mission would like to see eliminated. First, the temporary luxury import prohibitions sacrifice tax revenue, and distort resource allocation by creating incentives to divert entrepreneurial energies and resources to contraband. There is also an ever present danger that the Government will become more — not less — dependent upon import prohibitions to maintain some semblance of external balance.

Second, the program calls for priority assignment of foreign exchange for merchandise transactions. This method is arbitrary, administratively cumbersome, corruption prone, and unfailingly generates the kind of economic distortions that have worsened El Salvador's economic problems.

Third, the program stipulates stiff prior deposit requirements for certain kinds of transactions, eliminates privately held (but banking system

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controlled) foreign exchange working balances, and closes the black market safety valve for transactions, otherwise legal, that could not be financed due to a shortage of exchange in the banks. These impediments threaten to disrupt trade, with serious consequences for employment, output, and growth.

Administrative rationing is directly contrary to the expert advice the Government has received. The Government's consultants advised it that unification of the exchange rate would produce economic benefits only if foreign exchange is allocated according to a single exchange rate that reflects accurately supply of and demand for foreign currencies. Full convertibility should be maintained in the merchandise account. Taxes should be used in place of quantitative controls to discourage transactions the Government wishes to restrain. The post unification rate should be adjusted promptly to clear the market with an increasing excess supply of foreign exchange--reflecting the fact that the present extraordinarily high coffee prices and compensatory balance of payments financing will decrease — perhaps dramatically.

The fiscal portion of the package seems sensible in the aggregate. Taxes have to bear the major part of the burden of closing the fiscal gap. Government spending as a percentage of GDP was about the same in 1985 as it was in 1980. In 1980, spending was roughly 90 percent of what would have been expected in comparison with other countries based on El Salvador's socio-economic characteristics. Spending for defense and public safety, in contrast, roughly doubled as a percentage of GDP. While such gross comparisons do not prove that deficit reductions could not be realized by expenditure cuts, they do indicate that the Government has paid far more than lip service to austerity, and that the scope for deficit reduction through expenditure cuts is limited. Confronted with the unenviable choice of methods for financing the budget gap, it took the responsible course: still more austerity to squeeze the gap further, limiting borrowing to levels consistent with monetary stability, and substitution of explicit taxes for the implicit inflation tax on which it has been relying.

The tax package makes sense from both an economic and a political perspective. The coffee surtax approximates a tax on pure rent, and thus should have no serious negative incentive effects. The Selective Consumption Tax will have negative incentive effects, i.e., discouraging the consumption of certain luxury imports, but this is hardly a serious economic criticism with a war going on. On the political front, the coffee tax has come in for heavy fire from the cafetaleros — who feel that they have suffered from a long period of exceptionally low producer prices due to past exchange rate policy. But with after-tax producer prices projected at over ₡400 per quintal (versus an average of ₡200 per quintal in 1985), this tax will not provide a rallying point for widespread political opposition. The Selective Consumption Tax is also unpopular in some quarters (e.g., among merchants with upscale clientele), but political opposition should be manageable.

The tax reform planned for 1986 is long overdue. In addition to boosting the yield of the system to more nearly cover present expenditure levels, more of the burden will be shifted to direct taxes and away from indirect taxes and will provide the basis for a reduction of the coffee export tax.

The incomes portion of the program, while calling for price controls and subsidies and perhaps a bit generous in the rural minimum wage adjustment, is a reasonable response to a serious practical political problem. The Left is looking for openings to mount a political assault on the Government. The Government's announced price controls and subsidies package is limited in scope and duration, and is specifically designed to blunt the sensitive issues relating to the prices of transport, housing, and basic food commodities. Nonetheless, this part of the package represents a potential threat to the overall success of the program and should be eliminated as soon as possible. The freeze on public service tariffs in the face of unification, wage adjustments, recision of tax exemptions, and interest hikes will result in large deficits if maintained for long. Some of the controlled price levels also imply huge subsidies that cannot be long supported. For example, holding the price of wheat flour constant in the face of unification would cost the Government over ₡70 million per year.

The tightened monetary and credit policy embraced by the program are absolutely essential. The accommodating policy that has been followed since 1984 was mainly responsible for the disappointing economic performance of 1985. As remarked above, unification, Central Bank debt repayment, high coffee prices, and exchange losses associated with retroactive exchange guarantees (granted by the Central Bank) will all add enormously to the liquidity of the economy. The program -- which includes interest rate increases, increasing legal reserve requirements, and limitations on Central Bank credit expansion and the granting of credit to the public sector -- represents a sensible strategy for bringing the growth of liquidity into line with overall 1986 program inflation and growth targets. However, the program does not go as far as it might in reducing bank credit to the public sector. A limit of zero net credit expansion should be attainable for 1986.

The Government does not yet have a consistent revised budget showing the cost of the proposed subsidies, wage adjustments, and economic reactivation/reorientation measures and reconciling these costs with overall financial control totals consistent with the program objectives. This reflects the speed with which the program was put together, and the need to build a consensus on principles before specific measures could be designed.

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Nonetheless, the lack of a budget is now a serious threat to the successful implementation of the program.

The production portion of the program represents a call for accelerated implementation of policies, programs, and projects--most of which are already underway or in the planning stages. These are all designed to support the reactivation and/or reorientation of the economy and, along with the generally favorable external environment facing El Salvador in 1986, should help to insure a reasonably good year.

## F. Strategy for Strengthening the Program

On the whole, the program falls within the range of acceptable practical responses to the economic problems the country faces. Its most serious potential weaknesses, as noted above, are an exchange rate that is too low and consequent over reliance on exchange controls, more banking system credit for the public sector than is desireable, and a program of subsidies and price controls that, if not adjusted promptly, threatens huge deficits. The Mission will attempt to get the Government to strengthen these aspects of the program through the complementary measures under the FY 1986 balance of payments program. Two points of attack, involving quarterly progress review and technical assistance, are planned.

First, the Mission will ask the Government to establish a joint quarterly review of performance against quantitative benchmarks. Quarterly targets will be set by March 1, 1986, for net international reserves, international payments arrears, net domestic assets of the Central Reserve Bank, and net credit of the domestic banking system to the public sector, as a condition precedent to the disbursement of funds authorized by this PAAD (see Section VIII. C). The Mission will reserve the right to approve the targets proposed by the Government in fulfillment of this condition.

Performance against these targets will be reviewed in formal, quarterly meetings of the Mission with the Ministry of Planning. If performance is better than required by the targets, the Government will be encouraged to revise targets to require continued strong performance. If performance falls short, the Mission and the Government will agree on the steps to be taken to bring performance back within the targeted range. In the event that performance fails to meet targets and the failure can be attributed to events inconsistent with the basic assumption under which the targets were formulated (e.g., failure to negotiate external loans, a sharp drop in the price of coffee), the Mission and the Government will agree on an adjustment of the targets.

Second, at the request of the Government, the Mission will contract experts in economic stabilization/structural adjustment. These experts will advise the Government in the monitoring of the 1986 program and on changes in the program that are necessary.

## V. BALANCE OF PAYMENTS

### A. Preliminary Estimates for 1985

The 1985 balance of payments outturn was strengthened somewhat in the closing months of the year by the dramatic increase in world coffee prices. In the first seven months of the year, merchandise exports were down 16.0 percent to $387.7 million in comparison with the same period a year earlier. Exports to CACM countries were off the pace of a year earlier by 33.6 percent, and exp rts to other regions lagged by 4.4 percent. Fourth-quarter coffee export prices were about $25 per quintal higher than the average price registered for the first nine months of the year, which gave a substantial boost to exports. Exports to the CACM -- particularly Guatemala -- may also have rebounded a bit in the last three months of 1985.

While final figures are still several months away, The Mission's current estimate of the 1985 balance of payments outturn is shown in Annex I, Table 1. As can be seen, the trade balance weakened due to a slight decrease in exports (i.e., a projected $709.9 million in 1985, down from $726 million in 1984) and a slight increase in imports (i.e., a projected $1,013.8 million in 1985 as against $977 million in 1984). As a consequence, the trade deficit is now estimated at $303.9 million in 1985, as compared with $251.4 million in 1984.

Coffee exports were at about their 1984 level (i.e., $447.5 million as against $449.8 million). This reflects, as noted above, a yearend surge in world prices due to the Brazilian drought. Had prices not increased, coffee export revenues would have been well below 1984 levels.

Cotton exports recovered somewhat from their extraordinarily low 1984 levels, largely on the strength of liquidation of inventories held over from 1984. Cotton exports of $29.0 million, as compared with only $9.2 million in 1984, are now estimated. Production of cotton has continued to fall, and the continuing glut on world markets portends diminishing revenues from this source.

Sugar export revenues have also been affected by a worldwide glut. Revenues from this source in 1985 amounted to an estimated $23.2 million, slightly less than the $25.9 million registered in 1984. Future plans call for increasing the production of alcohol from sugar and exporting in this form. Over the first seven months, alcohol exports (which are registered under the category "Other" in Table 1) totalled just over $1.0 million.

Shrimp exports during 1985 are estimated to have run considerably below 1984 levels (i.e., an estimated $13.8 million in 1985 versus $20.2 million in 1984). The falloff reflects the effects of prolonged strike affecting one of the major companies in the industry, a possible decline in the yield of the fishery.

Exports to the CACM also are estimated to be substantially less than the levels registered in 1984. Exports to these countries of $120.0 million, down from $157.2 million in 1984, are now estimated. The falloff reflects the slowdown of economic growth in the region and the continued locking up of the regional payments system due to accumulated arrears. It is possible that this estimate is a little low. CACM exports may have picked up a bit during the last months of the year, spurred by a general firming of the economic situation in Guatemala.

"Other" exports, which is comprised of exports of non-traditional products to countries outside of Central America, continued to do relatively well according to latest estimates. Indeed this category is the one consistently bright spot -- albeit still a very small one -- in El Salvador's balance of payments. Estimated revenues during 1985 are $76.4 million, up from $63.7 million registered in 1984. Growth in this area is accounted for by a wide range of products, including instant coffee, sesame seed, shoes, fresh fruit, canned vegetables, raw coconut, and others.

Merchandise imports are estimated to total $1,013.8 million for 1985, or about 3.7 percent more than during 1984. This is a little less than was anticipated early in the year (i.e., $1,051 million) based upon projections of 2.0 percent real GDP growth and an increase of 5 percent in the dollar unit price of imports. Lower than projected imports reflect a combination of lower than anticipated increases in import unit values (e.g., the price of oil has decreased, the U.S. producer goods price index was flat or fell for most of the year) and lower than targeted growth.

The deficit in the Services Account was lower in 1985 than it was in 1984 (i.e., a deficit of $142.2 million as opposed to $160.3 million in 1984). This is due mainly to the effect of exchange rate measures taken in December, 1984, and June, 1985, that placed many service transactions in the black market.

Net Transfers were up in 1985 over 1984 levels (i.e., $356.8 million in 1985 versus $320.2 million in 1984). This reflects an increase in the estimated level of disbursements of U.S. grant economic assistance and an increase in imputed private remittances. The increase would have been $60 million greater had all disbursements originally planned for 1985 been completed during the year.

The net effect of the above changes is to decrease slightly the deficit in the Current Account, i.e., from a deficit of $91.5 million in 1984 to a deficit of $89.3 million in 1985. The 1985 estimated deficit is about 3.1 percent of GDP, converted at ¢5.00 per US$1.00. Before grants of U.S. economic assistance, the estimated 1985 current account deficit is $292.7 million, or 10.5 percent of GDP (converted as described above).

The estimated balance on Capital Account in 1985 is slightly higher than in 1984. In 1985, the Capital Account shows an estimated surplus of $89.5 million (up from $65.5 million in 1984). This increase is based on an estimated increase in net official capital flows of $29.7 million (i.e., from $91.0 million in 1984 to $120.7 million in 1985). This estimated increase reflects an increase in disbursements of U.S. economic assistance loans, IDB loans, and the disbursement of a loan from the Federal Republic of Germany.

Net flows of bank capital fell further into deficit in 1985 (i.e., from a deficit of $21.6 million in 1984 to an estimated deficit of $39.0 million in 1985). This reflects continuing large scheduled amortization payments for the medium-term external debt contracted by the Central Bank in the early 1980's, IMF repurchase obligations and a conscious policy decision to reduce external indebtedness.

The estimated overall balance of the 1985 balance of payments shows a deficit of $0.2 million compared to a $26.0 million deficit in 1984. The deficit would have been much larger absent U.S. economic assistance. The overall balance, excluding estimated U.S. economic assistance disbursements, would have been -$311.5 million, as compared to -$314.3 million in 1984.

B. Projections for 1986

El Salvador's balance of payments is projected to show an overall balance surplus in 1986 primarily on the strength of anticipated high coffee prices and low oil prices. High coffee prices will boost coffee export revenues and should also thaw trade somewhat in the region. A subsidiary -- but nonetheless important -- factor will be the restraining effect of increases in selective consumption tax rates, prohibitions of imports of selected consumer goods, and restrictions on duty-free import privileges on imports of consumer goods. Expected drops in the price of petroleum and petroleum products -- which accounted for over $130 million of El Salvador's 1985 imports -- strengthen the outlook. However, it is sobering to note that, in spite of this good fortune, El Salvador's projected overall balance of payments for 1986 would show a deficit of $260.7 million in the absence of projected disbursements of U.S. economic assistance.

The details of the 1986 projection are shown in Annex I, Table 1. A 2.3 percent rate of real GDP growth is assumed in the calculations. As can be seen, an overall balance surplus of $110.0 million is projected. This seems at the present to be a reasonable estimate, although one cannot entirely discount the possibility that the final result could be quite a bit higher or quite a bit lower, depending upon a number of factors discussed below.

Merchandise exports for 1986 are projected to be about $60 million above 1985 levels due primarily to projected high coffee prices. Overall merchandise exports are projected to be $770.0 million.

Projected increases in coffee export revenues account for by far the greatest portion of the projected increase in export revenues. Coffee exports of $495.0 million are projected, up from an estimated $447.5 million in 1985. The actual result could be a bit higher depending upon the outcome of two key

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factors. The Mission's projection is based upon an assumed average export price of $225 per quintal. This is somewhat below current prices for future deliveries during 1986 (current prices for 1986 delivery range between $230 and $250 per quintal depending upon the delivery date). The average price assumed by the Mission may thus be conservative.

The second key assumption on which the Mission's projection rests is that El Salvador will export 2.2 million quintals during 1986, down from about 3.2 million quintals in 1985. Stocks are depleted and 1985/86 production is well below 1984/1985 leves. Some industry sources estimate 1985/86 production of as little as 1.8 million quintals, down about 50 percent from last year's estimated level. Others estimate production in the 2.1 to 2.6 range. INCAFE's most recent 1985/86 crop estimate is 2.1 million quintals. Stocks carried forward into CY 1986 were probably in the range of 100 to 300 thousand quintals. Allowing 200 quintals for domestic consumption, exports of 100 thousand quintals of the 1985/86 harvest during CY 1985, and for the possibility that between 100 and 200 thousand quintals of 1986/87 crop year production could be exported during 1986, an export quantity of 2.2 million for 1986 should be conservative.

Cotton exports will be way below 1985 levels. Salvadoran inventories are depleted, and 1985/86 crop year production will be well below the 1984/85 level. Substantially less cotton was planted in 1985, and a four-day rain in November may have destroyed as much as 50 percent of the standing crop. To make matters worse, the glut continues on the world market: 1986 export prices are expected to be about 14 percent below their 1985 levels. As a result, cotton export revenues are projected to reach only $4.0 million in 1986, down from the inventory liquidation inflated levels of $29.0 million in 1985.

Sugar export revenues are projected to be slightly above the estimated 1985 level (i.e., $25.0 million projected in 1986 as against $23.2 million estimated in 1985). While volume is projected to be off due to U.S. quota reductions, better average export prices are projected for the year.

Provided that the fishery has not been depleted, shrimp exports should rebound somewhat during the year. Shrimp export revenues of $20 million, up from an estimated $13.8 million in 1985, are projected for 1986.

The outlook for exports to the CACM should also be somewhat improved during 1986. Several of El Salvador's important trading partners (particularly Guatemala and Costa Rica) will also benefit from higher world coffee prices, which should stimulate regional trade. The economic situation in Guatemala may be settling down and the quetzal stabilizing, which also should help to revitalize trade. An unknown in this situation will be the effect of the new tariff nomenclature and system of common tariffs on trade patterns. On balance, a very tentative projection that El Salvador's CACM exports will reach a level of approximately $140 million is in order.

Continued growth of extra-regional non-traditional exports is projected for 1986, although here it is critical that El Salvador not be deceived by the temporary surge of foreign exchange availability due to coffee and oil prices, and continue to adjust its exchange rate flexibility to maintain its competitive position. Passage and implementation of a new export promotion law is anticipated early in the year, along with growing use of new lines of credit and a new civil strife risk insurance designed to encourage investment in new export industries. Several companies are reported to have promising new export projects ready to be launched during the year. Based on these factors, export revenues from this source are projected to reach $86 million for 1986.

Merchandise imports are projected to decrease during the year as a result of several restraining factors. The three most important are expectations that unit prices of most imports will not increase significantly, that the price of oil will fall from an average import price of about $28 per barrel in 1985 to an average price of about $18 per barrel in 1986, and that imports of consumer goods will be restrained by increases in the selective consumption tax, consumer goods import prohibitions, and new limitations on duty-free import privileges. Merchandise imports of $970.0 million, about $43 million below the level estimated for 1985, are now projected for 1986.

The 1986 trade balance is thus expected to show a significant improvement over that estimated for 1985. A deficit of $200.0 million is projected for 1986, down from an estimated deficit of $303.9 million in 1985.

The services account should also strengthen a bit during the year due to an anticipated reduction in interest payments on external debt, and restrictions on service payments included in the 1986 economic policy package. A net deficit in the services account of $140.0 is projected for 1986, about equal to the estimated deficit of $142.2 in 1985.

Net transfers are projected to show a large increase in 1986 based on three factors. First, disbursements of U. S. economic assistance will increase sharply due to the carryover of $60 million of ESF balance of payments support planned for disbursement in CY 1985. Second, the U.S. economic assistance portfolio will shift more heavily in favor of grant (as opposed to loan) assistance in 1986. Third, an increase in banking system receipts of family remittances from abroad is projected. Based on these three factors, net transfers of $460.0 million, up from $356.8 million in 1985, are projected for 1986.

The final figure could be somewhat higher or lower depending upon the success of the Salvadoran banks in increasing their capture of family remittances from abroad. Simple extrapolation of the trend of private remittances surrendered at Salvadoran banks between 1972 and 1978 implies that total remittances today may reach $350 million or more. Since 1980, only a small fraction of the estimated total has been exchanged at the banks. Imputed remittances account for over $115 million of the 1985 net transfers shown in Annex I, Table 1, with banking system direct receipts accounting for only about $15 million. The banks' take appears to be higher in years in which the parallel and black market rates are close together (perhaps 10 percent of total remittances

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versus 5 percent when the spread between the rates is relatively large). A portion of the remainder of these remittances is reflected in private capital (including net errors and omissions), mirroring the use of foreign exchange acquired in the black market to pay for imports of goods and services registered in the balance of payments. The balance of the remittances are held abroad or purchased by Salvadorans who want to exchange their Salvadoran assets for foreign assets or for contraband. Provided that the $350 million estimate is near the mark, recent data imply that by far the greatest portion (perhaps two-thirds) of estimated remittances now goes to these latter uses.

If total remittances are anywhere near as large as indicated by simple extrapolation, if the spread between the new unified exchange rate and the black market rate is kept small, if branches of Salvadoran banks are opened in U.S. cities with large Salvadoran populations, and if the Government is able to rebuild the confidence of the private sector, net transfers for 1986 could be well above the projected $460.0 million. These remittances could represent a wonderful opportunity, unavailable to most developing countries, to increase foreign exchange earnings rapidly.

Taken together, the projections described above imply a surplus on current account, on the order of $120.0 million, a marked turnabout from the deficit of $89.3 million registered for 1985. It must be kept in mind, however, that projected U.S. disbursements of grant assistance in 1986 amount to $310.0 million, $60 million of which represents carryover of ESF balance of payments disbursements scheduled originally for CY 1985. Absent these disbursements, the current account would show a deficit of about $190.0 million, or 5.1 percent of GDP (converting the dollar deficit at an exchange rate of 5 to 1). The 1986 deficit before grants is thus projected to be about 57.5 percent less as a percentage of GDP than the corresponding 1985 deficit.

The capital account result for 1986 is projected to be weaker than the estimated 1985 outturn (i.e., $-10.0 million projected for 1986 versus $89.5 million estimated for 1985). The projected decline is based upon an expected decrease in net disbursements of official capital, and a substantial decline in net bank capital due to the explicit decision of the Junta Monetaria to reduce short and medium-term non-concessional external indebtedness. If the IBRD resumes lending operations in El Salvador during the year, if the Government successfully negotiates a standby agreement to support its 1986 economic program, or if additional sources of loans that meet El Salvador's new borrowing criteria are identified, the outturn could be somewhat larger than we have projected.

The overall balance is expected to show a surplus, allowing El Salvador to begin to rebuild her reserves to more nearly normal levels and reduce external payments arrearages. An overall balance surplus of $110.0 million is projected, with a corresponding increase of $75.0 million in the country's international reserves and a substantial reduction of external payments arrearages.

## VI FISCAL SITUATION

### A. Preliminary Estimates for 1985

The estimated 1985 budgetary outturn for the consolidated Central Government is shown in Annex II, Table 1, Column (2). The Table shows an estimated overall deficit of ¢641.8 million, or approximately 4.5 percent of GDP. Before foreign grants, the corresponding figure is ¢744.0 million, or approximately 5.3 percent of GDP. The after grants deficit was financed by approximately ¢303 million in net external borrowing and approximately ¢338 million in net internal borrowing. Of the net internal finance, approximately ¢206.8 million came from the Central Reserve Bank.

When compared with 1984 budgetary results (see Annex II, Table 1, Column (1)), the 1985 after grants deficit worsened by over ¢200 million, while the before grants deficit improved by ¢40 million The worsening of the after grants deficit is owed primarily to the fact that ¢87.5 million of grants revenue registered in 1984 correspond to resources programmed for use in 1985. Thus, the estimated 1985 budget deficit, before grants, declined in relation to 1984.

The estimated fiscal improvement in 1985, though relatively small, is due principally to developments on the revenue side. Estimated 1985 current revenues increased by ¢339.1 million over their 1984 level. Three factors are responsible for this improvement. First, in August, 1985, the GOES introduced a tax package composed of the following measures: a) The unification of the stamp tax rate at 5 percent for most taxable transactions, which yielded an estimated ¢42 million on an annual basis; and b) the utilization of the parallel market rate to levy import related taxes, which yielded an estimated ¢150.1 million on an annual basis. The package is estimated to have yielded ¢63.8 million in 1985. The second factor behind the estimated revenue improvement was a collection of overdue coffee taxes generated from exports in 1983 and 1984. The third factor was a higher-than-expected inflation rate, which generated higher revenues from taxes levied on an ad-valorem basis.

The estimated expenditure side of the 1985 budget also shows substantial changes from 1984 levels. Estimated current expenditures increased by ¢215 million or 12 percent, while estimated capital expenditures increased by almost ¢200 million or 44 percent. Net lending is estimated to have declined ¢74.1 million or approximately 96 percent.

The estimated increase in current expenditures is attributable to salary adjustments approved in mid 1984. Between 1984 and 1985, the Central Government's wage bill increased by ¢271 million, or almost 27 percent. The wage bill also increased as a result of an increase in the size of the Armed Forces. Estimated current transfers were the only component of the current budget to decline in 1985. This decrease resulted from the fact that 1984 transfers included one-time obligations not carried into 1985.

Estimated capital expenditure increases result from a substantial increase in the extraordinary budget and budgetary increases in the ordinary budget, particularly those destined for Construction. Net lending is estimated to have declined by ¢74 million due to a reduction in the allocation of GOES resources for the liquidation of financial obligations related to the nationalization of the banking system.

The financing portion of the 1985 after grants deficit changed dramatically from the perspective of internal financing. While the 1984 budget utilized ¢194 million in internal financing, ¢99 million of which originated from the Central Bank, for 1985 the estimated corresponding figures are approximately ¢338 million in internal financing and approximately ¢207.0 million in Central Bank credit.

B. Projections for 1986

1. Budget Submitted September, 1985

The GOES submitted the 1986 Ordinary Budget to the Legislative Assembly in late September, 1985. This Budget called for a 3.7 percent increase in total expenditures in 1986. Total expenditures would reach ¢2,631 millions. The proposed expenditures would be financed with current revenues, which were projected to increase 8.5 percent over the projected 1985 level and to reach a total of ¢2,035 million, by the sale of ¢350 million in public investment bonds to the Central Bank, and by borrowings from the private sector amounting to over ¢120 million.

The functional allocation of the 1986 budget maintains the trend established over the last few years (see Annex II, Tables 2 and 3). Defense and Public Safety expenditures will comprise over one fourth of total outlays in 1986. In 1980, Defense and Public Safety expenditures comprised only one eighth of total outlays. The Health, Education and Agriculture budgets would comprise 28.4 percent of total 1986 outlays. In 1980, the corresponding figure was 35.6 percent. Debt service (principal and interest) increased its share of total outlays from 4.2 percent in 1980 to 18.5 percent in the 1986 proposed budget. Clearly, the war has had a major effect on the composition of the budget. The Ministry of Finance estimates that about ¢450 million in defense expenditures are extraordinary — that is, related to the war -- while only ¢275 million are ordinary. Other expenditures for social services have remained steady in absolute terms over the 1980-1986 period, although in real terms they have dropped markedly.

2. Projected Modifications

The 1986 comprehensive economic program and developments in the world oil and coffee markets make it necessary to revise the 1986 budget in several respects. In order to account for these recent developments and for the effect of the local currencies generated by the FY 86 balance of payments program, the budget described above was adjusted to reflect the following factors:

1) The unification of the exchange rate at ¢5.00 to US$1.00. This measure is projected to increase revenues by approximately ¢600 million, most of which would result from the improved revenue yield in coffee taxes. Ad-valorem tax rates on consumption were also adjusted to reflect a projected 20% inflation rate. The projected expenditure increases associated with the unification are likely to exceed ¢500 million according to Ministry of Finance estimates provided to the Mission.

2) An increase in the average FOB price of coffee from $130.00 per quintal to $225 per quintal for the year, at an export level of 2.2 million quintals.

3) The introduction of 15 percent emergency tax on the FOB price of coffee. The price increases and the new tax should yield approximately ¢270 million in fresh revenues.

4) The introduction of a new price structure for oil and its derivatives which eliminates a price differential that previously accrued to the Central Government. This represents an ¢80 million loss in revenues originally programmed for 1986.

5) A projected $10.00 reduction in the FOB price of crude oil. Under the new price structure, such a drop could yield a windfall of over ¢200 million in unbudgeted revenues.

6) Rate increases in the selective consumption tax.

7) The introduction of prohibitions for the import of luxury goods. This prohibition has two effects according to Ministry of Finance officials. The first one is to neutralize the impact of higher selective consumption tax rates, even reducing projected revenues. The second one is to reduce projected import tax collections. Higher import prices associated with the exchange rate adjustment combined with import prohibitions would limit import tax revenue. The net revenue revenue reductions could easily reach ¢35 million.

8) The elimination of the tax exempt status of autonomous public institutions. The MOF has not estimated the yield of this measure; However, additional revenues are not expected to exceed ¢15 million according to an MOF official.

9) Changes in the income tax withholding law which will increase the number of individuals subject to tax withholding. The MOF has not estimated this one-time revenue increase. The Mission estimates that this source would yield an additional ¢18 million in revenues, when combined with wage increases described below.

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10) Changes in the Stamp Tax Law which exempts medicines from paying Papel Sellado fees. The Ministry of Finance has not estimated the impact of this measure. However, it could result in a revenue loss as high as ₡2 million.

11) A new provision in the import tax law which exempts public transport vehicles from paying import duties. This measure is not expected to result in a significant revenue loss because the tax rates involved are small.

12) A Government wide wage increase that will result in a ₡240 million increment in the wage bill. The measure wouild also increase income tax revenues.

13) The GOES pays out ₡200 million on account of Agrarian Reform compensation obligations.

14) The GOES increases its subsidies for basic products. As of yet, the GOES had no idea as to the magnitude of the expenditures involved. On wheat alone, if the current subsidy is sustained, the GOES may have to disburse in excess of ₡70 million. For the current corn crop, IRA, the Government marketing agency, needs ₡35 million. Since IRA does not have sufficient resources, the GOES is forcing the Agricultural Development Bank (BFA) to finance the transaction as an investment rather than as a loan. It is unclear yet, where BFA itself will obtain the resources to finance this unexpected transaction, if one considers the BCR intentions to maintain a tight credit policy. The Mission roughly estimates that subsidies in 1986 may very well reach the ₡100 million level.

15) USAID provides ₡100 million in ordinary budget support and ₡140 million in special budget support for Agrarian Reform Compensation.

Table 4 in Annex II shows the details of the fifteen adjustments to the 1986 Ordinary Budget, as described above. These estimates and adjustments must be approached with caution since many were developed on the basis of still sketchy information. In fact, some of the factors taken into consideration such as the subsidies, some amortization payments and some revenues such as the oil windfall have not been taken into account by the Ministry of Finance. The most recent budgetary projection available from the MOF, which is likely to be the official one, shows a ₡16 million worsening of the overall deficit as a result of the combined effect of the 1986 program.

To project the Consolidated Budget, it is necessary to add projected expenditures, revenues, and financing of the Extraordinary Budget. There was, as of January 31, 1986, a proposed Extraordinary Budget for 1986. This budget is fully financed with grants and loans, and therefore does not change the financing requirements of the Ordinary Budget. It may, however, affect the monetary base. The estimated level of execution in the estimated budget is slightly higher than that estimated for 1985, and has been selected to be consistent with the financial constraints imposed by the goals of the 1986 program. Table 4 of Annex II shows the projected Extraordinary Budget.

Column (3) in Table 1, Annex II, shows the adjusted Ordinary Budget consolidated with a projected Extraordinary Budget. In relation to estimated execution in 1985, current revenues are projected to increase in excess of ¢1.3 billion (74.8 percent) while current expenditures, are projected to increase by about ¢800.0 million (41.2 percent). Capital expenditures are projected to increase by ¢47 million (7.3 percent), while net lending is projected to increase by ¢220.4 million. The net result of these transactions is a projected after grants overall deficit of ¢433.7 million, which is well below the deficit estimated for 1985.

The financing portion of the projected budget (see Annex II, Table 4) shows that expected external financing will be less than the after grant deficit. Internal financing requirements are likely to exceed by almost ¢97 million the amount of credit the BCR has programmed for the public sector. This projection suggests that further fiscal adjustments may be necessary to reduce domestic financing to the public sector and meet the credit targets of the monetary program.

3. Rest of Non-Financial Public Sector

The fiscal accounting of the rest of the non-financial public sector--i.e., the autonomous institutions such as ISSS, ISTA, and enterprises such as CEL, ANDA, and ANTEL--for 1985 and 1986 has not been compiled yet. However, a partial picture can be obtained by reviewing banking system credit data and the Capital Account of the balance of payments. For 1985, the rest of the non-financial public sector is projected to utilize ¢82.7 million in net banking system finance and ¢65.2 million in net external resources.

Together, these imply a deficit of ¢147.9 million. For 1984, the corresponding figures are ¢53.3 million in net banking system credit and ¢16.8 million in net external resources bringing the total to ¢70 million. The increase in banking system credit for 1985 may be directly related to the spillover of wage increases from the Central Government. For 1986, the economic program announced in January envisions no net banking system credit expansion, and a smaller utilization of external resources. This will only be possible if revenue generating institutions introduce service fees adjustments to accomodate increased costs associated with higher import costs and the loss of tax exempt status.

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## VII. AMOUNT REQUIRED.

### A. Currently Planned and Budgeted

The 2.0 percent to 2.5 percent growth projection assumed in Annex I reflects the situation that could be expected based upon currently available resources. The Mission proposes that this PAAD authorize $147 million required for CY 1986 to finance this growth. This includes $117 million of unobligated FY 1986 funds and $30 million of FY 1987 funds, subject to the appropriation of the latter. All of these funds will be disbursed through a separate account, the operation of which is described in Section X.

Based upon Central Bank projections of foreign exchange supplies and demands for CY 1986, the Mission plans disbursements during CY 1986 in seven tranches, as shown in Annex V. Only five of these disbursements involve FY 1986 ESF. The others involve either FY 1985 or FY 1987 resources.

### B. Requirements

The political, social, economic, and military progress registered in 1984 and 1985, after five tumultuous years, demonstrate that — with resolve and resources — the goals of the Jackson Plan are attainable in El Salvador. Salvadorans have demonstrated their resolve. They have made the difficult switch from a political system based on violence and repression to democracy. They have endured six years of falling real percapita incomes. They have struggled to overcome the suspicions and hostilities that historically have divided them. They have foregone minimum educational opportunities and access to basic health services. They have fought with increasing skill and tenacity and are winning the war. In the midst of what is still a volatile situation, they will undertake a difficult set of economic policy reforms.

In 1986, the country faces for the first time in almost ten years the prospect of some good luck. A large (i.e., approximately $60 million) but temporary boost in 1986 export revenues due primarily to high coffee prices and a large reduction of the country's 1986 oil import bill (i.e., about $45 million) are anticipated. This good luck could not have come at a better time. Higher coffee exports and lower oil prices will help to offset partially the shortfall in the U.S. economic assistance below NBCCA levels, and cutbacks in military assistance below minimum request levels. Economic assistance is now projected to be $43 million below request levels, and $170 million below levels estimated by the Mission in its request for a supplemental to be needed to meet Jackson Plan goals. Military assistance was cut back by $88 million from the level considered by the Embassy as a bare bones minimum; the GOES has no option but to make up the shortfall.

The stronger 1986 trade balance and pipeline disbursements — added to the reduced FY 1986 levels — should carry the country through 1986 with respectable growth, some accumulation of reserves, and a reduction in external payments arrears. It will not, however, begin to touch arrearages in the Central American Common Market payment system or domestic interbank arrearages. Public sector services in health, education, and public investment will have to continue to be held well below minimum acceptable levels.

It is sobering to realize that, absent high coffee prices and low oil prices, given the cutbacks, El Salvador could at best have expected another year of lackluster economic growth (i.e., somewhere in the one to one-and-one-half percent range), and that reserves and external payments arrears would have remained in the same sorry state they were in at the end of 1985. While the Mission agreed reluctantly to an overall FY 1986 funding cut of $43 million, it opposes any further reductions during FY 1986. It is critical that the momentum that has been built painfully over the last six years not be dissipated. U.S. resolve to support the Duarte government must not be seen as flagging. Otherwise, the divisive forces within Salvadoran society which have been contained at great cost will once again come to the fore and the weak consensus that allows the President to govern will quickly unravel.

The Mission also firmly opposes any reduction of FY 1987 request levels, which are the minimum required to win the war and maintain momentum toward Jackson Plan goals assuming normal commodity market conditions and projections of the status of the Salvadoran economy at that time. The factors that govern the basic size of the economy's resource gap are unchanged. The country is still fighting an internal war, the costs of which — with new enemy small unit economic sabotage tactics — are escalating; while it is making progress at diversification, it is still dependent upon the export of a few traditional products that, apart from an occasional good year, do not cover the nation's foreign resource needs; it is still working off a large balance of medium-term external debt contracted by the Central Bank (mainly prior to 1983) to meet the foreign exchange gap; a significant portion of the import bill is still driven by war-related destruction, and the country faces an enormous task in repairing the accumulated damage of the past five years; public expenditures for health and education are still significantly below pre-conflict levels.

## C. Relationship Between Policy Reform and Resources Required.

The recent report of the Controller General of the United States (Providing Effective Economic Assistance to El Salvador and Honduras: A Formidable Task) recommended that AID make a detailed analysis of the estimated cost to finance future balance of payments deficits in El Salvador in the absence of macroeconomic reforms, particularly exchange rate adjustments. The Mission has prepared such estimates and the results of this exercise are described below. It must be cautioned that any such projection is critically dependent upon a number of assumptions for which there is only a limited empirical basis. The results presented below are thus, while qualitatively correct and probably of the right order of magnitude, nonetheless subject to debate.

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The estimated costs presented here are estimates of the additional transfers of resources that would be required to achieve a given growth path in the absence of appropriate policy adjustments. The procedure followed to make these estimates involved three steps. First, a growth path for the economy was projected to 1988 under the assumption that El Salvador would follow appropriate economic policies. These policies include establishment and maintenance of a competitive unified exchange rate, and measures to control the rate of domestic demand expansion and inflation. It was assumed that the current account deficit (national income and products account definition) would be maintained at roughly present levels through 1988, and that international reserves would be held constant. The terms of trade, and all other exogenous factors that would shift the demand for El Salvador's exports were also held constant.

Second, two alternative growth paths were simulated. In one, it was assumed that the policy reform process became stuck at its position as of December, 1985. The multiple exchange rate system then in operation was assumed to continue through 1988, with the exchange rates then in effect operating throughout the period. The high rate of demand expansion of 1985 with the money supply growing at 30 percent per year, was maintained. In the second alternative, it was assumed that the President's 1986 program is implemented as announced, but that the exchange rate gets stuck after unification at ¢5.00 per US$1.00.

Third, the amounts of additional balance of payments assistance that would be required to offset the negative effects of bad policies on growth were calculated. These are the amounts of resource transfers that would be required to boost the economy from the growth paths calculated in the second step of the analysis to the growth path calculated in the first step. These figures constitute our estimates of the potential cost of bad policy.

The procedures and results of this exercise are set out in greater detail in Annex III. The most important conclusions are as follows. First, policy reform reduces considerably the requirements for balance of payments support. Alternatively put, good policy gets a lot more growth for the recipient country for the same amount of money. Had the Government elected to continue its 1985 policies, it would have required over $365 million (1984 dollars) in cumulative additional balance of payments support over the three year period 1986-88 to offset the negative effects of bad policy on economic growth. The policies recently announced by the Government for its 1986 program go a long way to reducing that cost. These policies reduce by about $190 million the cost of offsetting the negative effects of nonoptimal exchange rate policy on growth. A residual cost of almost $170 would remain however if the exchange rate were to become stuck after unification at 5 to 1.

## VIII. MEASURES TO BE UNDERTAKEN BY GOES.

### A. Overall Policy Agenda

The Mission is revising its Overall Policy Agenda for submission to AID/W for review in the 1987 Action Plan. The revised agenda will continue the economic, private sector, and agrarian reform policy issues that have dominated the policy dialogue over the last year. In addition, the dialogue will place increasing emphasis on steps that must be taken by the Government to prosecute the National Plan more vigorously, to accelerate the Judicial Reform process, to take greater responsibility for displaced persons, and to strengthen the delivery of key social services (i.e., health, education, and housing). Only a portion of the policy dialogue (economic, selected agrarian reform, and selected private sector issues) is included in the balance of payments program.

### B. Status of FY 1985 Balance of Payments Measures

The GOES set policy reform targets under the 1985 ESF Balance of Payment Support Program in seven areas: (1) Exchange Rate Unification; (2) Level and Financing of the Fiscal Deficit; (3) Management of Public Indebtedness; (4) Consistent Macroeconomic Management; (5) Private Sector Reactivation; (6) Restructuring of the Agrarian Debt; and (7) Definition of Agrarian Reform Beneficiaries Rights and Responsibilities. With one exception (limitation and financing of the fiscal deficit) the GOES has met or made significant progress on the targets it set. The fact that some of the measures have only partially been completed is attributable to the yearend crash effort to develop and sell a comprehensive stabilization program for 1986. This task monopolized the time of the key economic ministers and the President during the last two months of the year. Details concerning each policy reform area are presented below.

Generally satisfactory progress notwithstanding, the President has protested vehemently against the linkage of timetables for policy reform and disbursements of assistance. Disbursements were held up during 1985 pending completion of agreed upon measures. This so rankled the President that he instructed his Ministers that no agreements involving conditionality were to be signed in the future.

The conditionality issue began to build in late summer of 1985. By that time, the Government had fallen behind in meeting several of its commitments under the CY 1985 Balance of Payments Program. Some, it was clear, would eventually be met; but others — particularly the critically important deficit reduction targets — were clearly beyond reach given the few months remaining in the year (see below for a condition-by-condition rundown). The President advised the recently arrived Ambassador that the economy was not a priority concern and would be left for his sucessor.

The economic consequences of the Government's failure to meet economic conditions also began to become clear in the data at about this time. Data from the first seven months of the year showed that inflation was accelerating rapidly, that the balance of payments was deteriorating, that there would be another large fiscal deficit, and that there was some possibility that real output might began to decline again. In short, the data showed that the substantial progress made in stabilizing the economy during 1983 and 1984 was in serious danger of being reversed.

In order to sensitize the Government to the seriousness of the threat of growing economic instability, its causes, and its cures, the Mission wrote several short papers and circulated them privately to key economic ministers and advisors. These recommended a comprehensive economic program to stabilize the economy. In addition, since the GOES did not meet the fiscal conditions, disbursements under the CY 1985 program were held up until the Government came up with a credible plan for stabilizing the economy.

President Duarte brought the economic issue to the fore during his state visit to the U.S. in October. In separate meetings with him, the Secretary of State, the Undersecretary of State, and the AID Administrator, uniformly took the position that economic stabilization according to a definite timetable was essential to the success of the Duarte government as well as to the wellbeing of the nation. The President then argued that, while he recognized the need to make certain economic policy changes, he alone could decide what those policy changes should be and when they should be made. He argued the policy dialogue process was politically destabilizing his Government and that aid should be untied from conditionality.

Based upon these meetings, the AID Administrator authorized the reinitiation of disbursements on the understanding that the President Duarte would undertake a comprehensive economic stabilization program, including unification of the exchange rate. The USAID subsequently advised the GOES that all AID disbursements after January 1, 1986, would be at the parallel rate. President Duarte decided to proceed with a comprehensive economic program to be implemented in mid-January (see Section IV for a discussion of the program).

1. Exchange Rate Unification

Targets set under the 1985 agreement called for the GOES (i) to move a sufficient volume of additional transactions to the parallel market to attain a percentage of at least 60 percent of exports and imports and goods and services in the parallel market, (ii) to conduct an evaluation of the desirability of pursuing gradual shifts to the parallel market as a strategy for unifying the exchange rate, and (iii) to inform USAID by August 30, 1985, of the steps it would take to unify the exchange rate by yearend 1985.

In mid June, 1985, a significant volume of additional transactions was passed to the parallel market. According to Mission estimates, the measures that

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became effective then resulted in an estimated 58.7 percent of transactions associated with exports of goods and non-factor services being in the parallel market. The estimated proportion of imports of goods and non-factor services that will be in the parallel market as a result of the June, 1985, measures is 65.8 percent. These computations are based upon projected CY 1985 export and import transactions, as estimated by the Central Bank.

At the same time the Junta Monetaria reclassified transactions, it also changed the operation of the parallel market in several important ways. First, it increased the parallel market exchange rate from ¢4.00 per U.S. dollar to ¢4.50 per U.S. dollar, and announced that, thenceforth, the parallel market rate would "float" in a band 20 percent beneath the extra bank (i.e., black market) rate. While several adjustments were made in the parallel market rate in the weeks following the Junta Monetaria's decision, the rate became stuck in September at ¢4.85 per U.S. dollar. In the meantime, the black market rate broke through the ¢9.00 per U.S. dollar barrier before settling back into the ¢6.00 to ¢7.00 range.

Second, prior to the June, 1985, measures, there were a hodgepodge of multiple rates depending upon the nature of the transaction to be undertaken. For example, there was one mixed rate for exports to the CACM, there were reintegration coefficients by which sectors that received some proportion of their imported inputs at the official market rate were required to sell some approximately corresponding percentage of their export outputs at the official market rate, blended import transactions which required the importer to acquire 50 percent of his foreign exchange on the parallel market (or elsewhere if unavailable) and 50 percent on the official market (or elsewhere if unavailable). The June, 1985, measures simplified this confusing and administratively cumbersome array of multiple rates.

Third, the Junta Monetaria directed that additional preparatory work that would be essential for exchange rate unification be undertaken. Particularly important in this regard was the directive that efforts go forward with the revision of petroleum price control legislation.

These important steps taken, the movement toward unification began to stall. By the end of the Summer, there were strong signals at the cabinet level that the Government would renege on its commitment to unify by yearend. The President of the Central Bank stated flatly that he would oppose unification unless prior policies were put in place to reduce the fiscal deficit and control credit expansion. He doubted that the President would approve these policies. The Minister of Planning began to be increasingly indefinite about the future steps that would be taken to unify and when, if ever, unification would occur. In consequence, the Government missed the August 30, 1985, deadline for informing the Mission of its plan for unification, and this condition, along with the fiscal condition (see VIII, B.2), became a major hurdle to continuation of disbursements under the 1985 program.

This stumbling block was removed when President Duarte, as promised during his

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October, 1985, state visit to the U.S. (see above) proposed a comprehensive economic stabilization program for 1986, including exchange rate unification. The Government unified the exchange rate in January, 1986, at a rate of ₡5.00 per US$1.00, as one of the first measures implemented by the 1986 economic program.

2. Limitations on Size and Financing of the Fiscal Deficit

The GOES set performance targets on three parameters of 1985 fiscal performance: (i) Central Government overall deficit; (ii) Level of net internal financing of the Central Government deficit; and (iii) Level of expansion of net banking system credit to the public sector.

The deficit reduction target called for adoption of revenue increasing/expenditure reducing measures sufficient to reduce the Central Government deficit by ₡220 million at an annual rate. The target provided that the deficit could be reduced by a smaller amount provided that the shortfall were externally financed.

The net internal finance target called for limiting 1985 net internal finance of the Central Government budget deficit to its 1984 level. At the time the targets were established, 1984 net internal finance was estimated to be ₡153.9 million. This was approximately ₡100 million less than the level of net internal finance for 1985 envisioned in the Monetary Program drafted in May, 1985.

The net domestic banking system credit target called for limiting the expansion of net domestic banking system credit to the public sector (i.e., the Central Government plus the official autonomous institutions) to ₡100 million. This represented approximately a ₡100 million reduction from the level of net domestic banking system credit expansion envisioned in the Monetary Program drafted in May, 1985.

These targets were designed to be internally consistent. The deficit reduction target was projected to yield an annual cash deficit reduction of about ₡110 million. The net internal finance target permitted the overall deficit to go higher so long as net internal finance were limited to approximately ₡150 million. The net credit target insured that the Central Government deficit would not be reduced by simply shifting it (e.g., through a reduction of transfers) to other Government agencies and required that the full effect of deficit reduction measures be reflected in a reduction of net domestic banking system expansion to the public sector.

The GOES took several steps during 1985 to strengthen its fiscal performance. First, it maintained tight expenditure control. In the face of increasingly militant labor unrest, it refused to grant any increase in wages. It used force, when necessary, to break illegal public sector strikes. It maintained a hiring freeze.

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Second, it proposed legislation facilitating the reassignment of public sector personnel. This was intended to reduce the size of public payroll through attrition, while insuring that needed posts are filled. This legislation, which was strongly opposed by unions representing public sector employees, was passed by the Legislative Assembly after lengthy and acrimonious debate.

Third, it stepped up its efforts to collect taxes due but not paid. This yielded some results, particularly in the collection of unpaid taxes owed by INCAFE. Increased collection effort, and revenue buoyancy associated with higher than anticipated inflation, boosted 1985 revenues by ¢152.7 million above budgeted levels.

Fourth, it passed two tax increase measures. One of these raises import duties by calculating the duty owed at the rate of exchange pertaining to the transaction instead of the official exchange rate, as was formerly done. The other measure unified the stamp tax rate on most taxed transactions, thus raising the rate on some transactions from 3 or 4 percent to 5 percent. On an annual basis these two measures are estimated by the Ministry of Finance to yield an additional ¢192.1 million of revenues. The estimated additional yield during CY 1985 is about ¢64 million.

The effect of these deficit reduction measures unfortunately was offset by unbudgeted 1985 needs. The Salvadoran Constitution requires that sources of finance for all expenditures be identified in the budget submitted to the Legislative Assembly. When the 1985 budget was prepared and submitted in September, 1984, the GOES was unable to identify sources of finance for all of the expenditures to which it was committed. It solved the problem by simply not including these expenditures in the budget as originally submitted. To meet these unbudgeted committments, a supplemental appropriation was passed by the Legislative Assembly, increasing the expenditures in net lending for 1985 by an estimated ¢109 million.

The Mission estimated that the net internal finance required to cover a deficit in the Central Government's 1985 Ordinary Budget would have been ¢262 million, about ¢112 million above the performance target set by the Government.

Given the time remaining in CY 1985 (the tax and expenditure measures just described were passed in August, 1985), it was infeasible to require that the targets originally stipulated in the FY 1985 agreement be met. As is explained above (see VIII, B) these targets were subsequently waived on the understanding that the GOES would develop a comprehensive stabilization program and unify the exchange rate, by yearend 1985. These two substitute requirements were substantially met, as described in Section IV.

3. Debt Management

The GOES also took steps during the year to bring its mushrooming obligations to service internal and external debt under control. As provided under the

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balance of payments support agreement, an Interministerial Committee, constituted by the Ministers of Planning and Finance and the President of the Central Bank, was formed in May of 1985. This Committee was charged with estimating the total outstanding public debt, projecting the debt service obligations corresponding to this debt, and establishing global and institution specific limits on borrowing authority.

The Committee's technical staff prepared the requisite estimates and projections and recommended policies and limits. Among the recommendations were measures limiting annual external debt disbursements to ₡500 million, seeking renegotiating of short-term debts, prohibiting the borrowing by autonomous institutions that persistently run a deficit, and prohibiting private external borrowing. In addition, the Committee moved promptly to recommend certain global policy changes with respect to external indebtedness. Perhaps the most significant was the decision to limit additional public external indebtedness to loans of terms not less than eight years and to require that all loans contracted be on concessional terms.

However, the Committee did not act to establish quantitative limits on indebtedness by yearend 1985. Action on this front is expected early in 1986, and will be carried forward as a condition of the FY 1986 balance of payments program.

4. Monetary Program for 1986

The Government undertook to prepare the first version of the 1986 Monetary Program by September 30, 1986, prior to the submission of the 1986 Budget to the Legislative Assembly. In contrast, the first version of the 1985 Monetary Program was not available until January of 1985. The purpose of this change in timing was to get consistency in the Government's 1986 fiscal and monetary policies.

The Central Bank had prepared a version of the 1986 Monetary Program by early September and this Program formed part of the basis for debate within the Government concerning the 1986 Central Government budget and the financing thereof. The plan was a key element in firming the Central Bank's resolve to oppose large extensions of credit to the public sector, and to support tax increase and expenditure reduction measures for 1986. The plan was revised in December, 1985, to reflect the provisions of the 1986 economic program, and will be used as an instrument to monitor progress toward the plan's objectives.

5. Private Sector Reactivation

Although not embodied in a condition or covenant, during 1985 the Mission accorded high priority to improving public-private sector relations. This was accomplished by identifying four younger, moderate private sector leaders who could work with the President and having them meet quietly with him to discuss private sector concerns. The group subsequently was expanded to five private sector members. At the same time, the Mission, through the Minister of

Planning, encouraged a more formal periodic meeting between the titular heads of private sector organizations and members of the economic cabinet. After early signs that relations were on the mend, hostilities welled up abruptly in mid August. The Government pushed two tax increase measures through the Legislative Assembly without debate. It then attempted to impose technically-flawed controls on gross profit margins in selected industries. When the affected portion of the private sector protested, pointed out the technical flaws, and proposed discussion of alternative solutions, the public sector began a campaign of vilification against the private sector. The private sector in turn began an anti-Government campaign. Although a mutually agreeable solution was finally worked out with the intercession of the group of five moderates and the President of the Republic, public-private sector relations hit a new low. Relations were further strained by the handling of the kidnapping of the President's daughter. Many in the private sector were firmly opposed -- and openly critical -- of the final settlement.

As the year drew to a close, the Government appeared to be trying to improve relationships again. The President discussed the proposed economic program with the group of five and subsequently invited a larger group of private sector leaders for a discussion of the program. It is still too soon to tell what the effect of these consultations will be.

In the one explicit measure embodied in the FY 1985 balance of payments program agreement, the Government undertook to prepare and present to the Legislative Assembly a new law for the promotion of exports. The consultations between the public and private sectors took somewhat longer than foreseen, and indeed broke down completely in August as a result of controversy over margin control measures mentioned above.

Consultations resumed, and a bill was submitted to the Assembly in September. In what public sector moderates who participated in the consultations feel was a double cross, the private sector submitted its own competing legislation to the Legislative Assembly as well. Private sector moderates concede that this was a mistake. As a result, the bill was held up in the Assembly as hearings were held to work out the differences. The proposed bill subsequently was withdrawn and modified by the Executive Branch in December. The reworked bill was resubmitted to the Assembly as part of the legislation of the 1986 economic program. The bill before the Assembly permits private sector management/ownership of free trade zones (heretofore restricted to Government management/ownership), authorizes the establishment of a one-stop export documentation center, and provides tax incentives to exporters. It represents a significant improvement in the current laws governing export, and passage is expected early in 1986. Passage is a condition of the CY 1986 Balance of Payments Program.

6. Restructure the Agrarian Debt

The GOES undertook to study and effect a restructuring of the debt owed by agrarian reform beneficiaries. As agreed, an interministerial commission --

constituted by the Ministers of Planning, Agriculture, Finance, and the President of the Central Bank — was formed in May, 1985. This Commission formed a technical staff to study options for restructuring the land debt of the Phase I Cooperatives, for disposing of the emergency credits granted after expropriation in 1980 (i.e., the Cartera BFA/ISTA), and the procedures governing the excess use of escrow accounts set up for the Phase I Cooperatives (i.e., the Cuentas Restringidas).

The technical staff of the Commission completed its study and reported its findings and recommendations to the members of the Commission in September.

The staff's recommendations call for reducing the rate of interest on land debt to Phase I Cooperatives and Phase III beneficiaries from 9.5 percent per annum to 6 percent per annum. These interest rate reductions would be retroactive to the date of assignment of the property.

The staff also recommended an effective extension of the grace period, up to a maximum of five years from the date of assignment of the property. The precise grace period is to be established individually, based on the situation of each coop.

The repayment period would, according to the recommendations, also be extended up to a period of 50 years, again depending upon the capacity to repay.

To deal with the problem of the Cartera BFA-ISTA, the staff recommended that the rate of interest charged by ISTA be reduced to 1 percent or less, retroactive to the date that ISTA acquired the portfolio (i.e., February 15, 1982), and that a moratorium on payments of principal be granted until the debtor is able to service the Agrarian debt. The length of the moratorium and the individual repayment procedures are to be determined administratively by ISTA.

The Commission staff discovered in its review of the Cuentas Restringidas that the problem lay not in the operation of these accounts, but rather in a lack of clear general procedures for managing surplus funds of the Phase I Cooperatives. The staff recommended a general procedure, and also called for new legislation to reconcile inconsistencies in existing laws governing the financial operations of Phase I Cooperatives.

The Commission did not act during 1985 on any of the recommendations embodied in the report. However, the 1986 economic program of the Government includes restructuring of the Agrarian debt (including action on the Cartera BFA/ISTA and the Cuentas Restringidas) as one of the measures to be undertaken. The Mission expects action in each of the areas covered by the Commission's recommendations early in 1986, and proposes to carry forward this requirement of the FY 1985 program as a requirement of the FY 1986 program.

## 7. Beneficiary Rights and Responsibilities

The GOES formed a Commission, constituted by the Ministers of Planning, Agriculture, Finance, and the President of the Central Bank to review and define the rights and obligations of beneficiaries of Phases I and III of the Agrarian Reform. Aspects to receive special attention were the rights of participation and ownership of every member of Phase I Cooperatives, including considerations of the rights of transfer and inheritance, and, for Phase III beneficiaries, a reduction in the prohibition of transfers before 30 years hav passed.

A study of beneficiaries' rights and responsibilities and the carrying capacity of the Phase I Cooperatives was conducted and recommendations were made. The study concluded that beneficiaries of Decree 154 do not feel like owners but rather like day laborers; they think and work like unionized employees. The most that they expect from the Cooperative is a source of permanent employment with the best wages and additional benefits. The majority of the cooperatives are managed by a cogestor and a small group of technicians and directors, some of whom have little sense of collective responsibility. For the member, the milpa of 0.5 manzanas represents the most important benefit of being a member of the Cooperative.

The study also concluded that many cooperatives do not have sufficient working capital to take care of normal commercial transactions. Consequently, they are less productive and less profitable than they could be, given the good quality of the land which many possess. Moreover, the few which do make an operating profit make only enough to service their debts. There is nothing left for them to distribute among their members. At the present time, neither the directors, nor the cogestor, and especially not the members, have any clear incentives to reduce costs or to increase production or to accept more members to work on their assigned land.

The study recommended that nine measures be taken immediately:

(1) Create a Technical Carrying Capacity Unit to establish a minimum carrying capacity for each cooperative based on its capacity to generate permanent employment.

(2) Collect (over time) an initial entrance quota from new members, equivalent to the average accumulated contributions of present members, to provide working capital with which to operate when production credits are late or costs increase.

(3) Resolve the discrepancies between the legislation and the current practices of coops.

(4) Modify the present financial arrangements so that the campesinos receive, on time and in cash, a substantial portion of the profits from each harvest and provide them with a clear explanation of the financial management of the cooperatives.

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(5) Authorize the cooperatives to undertake experiments in new ways of organizing and administering their production and marketing. For example, they could form separate cooperatives for milk production, divide large cooperatives or those that have problems into smaller cooperatives, and try coffee production in small parcels so that low prices can be resisted.

(6) Liberate from ISTA those cooperatives that have demonstrated good administrative capacity, production and marketing, and designate a program and calendar to terminate cogestion in favor of self-management by the campesinos.

(7) Limit the payment of the debt to 50 percent of the annual profits after paying off the production credits while the potential profitability of the cooperatives is being studied and adjustment of the amount and terms of the agrarian debt is under consideration

(8) Declare that whatever is paid on the agrarian debt should also constitute the legal reserve of the cooperative because diminishing passive debt is a form of capitalization.

(9) In special cases, such as when the cooperative is very large, or cases in conflict areas, or where the lands are of very low quality, divide the cooperatives into more compact units or into solidarity groups of individual parcels.

The study further recommended that four additional measures be undertaken within three to six months when the requisite follow-up studies and analyses have been completed.

(1) Define clearly the rights of the members in case of death, accident, sickness, or resignation either voluntarily or involuntarily. In general they would collect their social contributions in money and whatever amount the Cooperatives have established as a retirement fund.

(2) Create a fund for rural social security, to take care of the retirement and work injuries or sickness of the campesinos. Each Cooperative would contribute an amount for each day worked and when the fund is established arrangements should be made for the retirement pay of the present members and those who are already retired or incapacitated. In the short term, the rural social security could begin with a service of preventive medicine.

(3) Abolish the regulations and laws which do not coincide with the traditions and customs of the campesinos which introduce an unjustifiable state paternalism. A commission should be established specially to carry out this task.

(4) Train the technical personnel of the Ministry of Agriculture and other institutions and relate promotion to service rendered to peasant producers.

An examination of the above recommendations makes clear that the study ranged beyond the immediate issues relating to beneficiaries' rights, and created a sense of complexity that may have diffused attention. Consequently, the specific condition to take steps to implement the study's recommendations on beneficiary rights was not implemented. Although difficult because of lack of consensus within the Government, the Mission believes that it is critical to the success of the agrarian reform program to define a workable set of basic property rights during 1986 and will carry this condition forward to the FY 1986 Balance of Payments Program. Several intermediate steps must be taken before rights and responsibility issues can be settled finally. These steps will be carried forward as conditions of the FY 1986 balance of payments program.

C. <u>FY 1986 Complementary Measures</u>

The package of complementary measures to be undertaken in 1986 is intended to complete and/or strengthen policy initiatives begun in 1985. The objectives of the measures proposed are to insure that the Government stay the course of the 1986 economic stabilization program -- adjusted as need be to meet changing conditions, to accelerate the process of reorientating the economy, and to continue recent progress made on completion of the Agrarian Reform. The specific measures to be undertaken are described below, and stated in the form being negotiated with the Government in Annex IV.

1. Economic Policy

a. The 1986 Economic Program

Performance of the 1986 program must be monitored regularly and corrective action taken promptly. Monitoring is an essential element . Two steps are needed to establish an adequate monitoring program. First, benchmarks for program execution must be established. These benchmarks should consist of a set of quantitative performance targets (quarterly or more frequent) for net international reserves (floor), international payments arrearages (ceiling), net domestic assets of the Central Reserve Bank (ceiling), and net credit of the domestic banking system to the public sector (ceiling). The GOES will establish these benchmarks by March 1, 1986. A set of proposed benchmarks is shown in Annex IV, Table 1.

Second, the Mission and the Ministry of Planning will meet quarterly to review performance against the performance targets and to discuss needed corrective action, if any. As a requirement in the loan agreement, the BCR will furnish monthly statements of assets and liabilities of the BCR, the commercial and hypothecary banks as promptly after the close of the month as possible, and a copy of the Weekly Monetary Report prepared for the <u>Junta Monetaria</u>, and a copy of the Weekly Cable prepared for the International Monetary Fund.

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The Mission will fund the hiring of two or three full time economists by MIPLAN and one or more short term expert consultants to assist with monitoring of the program and to advise the Government on any needed program adjustments.

b. Comprehensive Economic Program for 1987

The Government's 1986 program marks the beginning of the policy coherence and discipline required to stabilize, reactivate, and restructure the Salvadoran economy. The battle, once joined, must be continued. The Government will be asked to prepare and submit to USAID, a comprehensive economic program for 1987, similar in form and substance to the 1986 program. The program will be prepared in concert with the 1987 budget and 1987 Monetary Program to insure coherence of the program, and will be completed by September 30, 1986.

c. Debt Limits

The FY 1985 balance of payments program required the establishment of an interministerial committee on debt management to estimate indebtedness, project debt service requirements, and establish limits on borrowing authority. The latter were to be global, as well as broken down into limits on indebtedness of all entities with independent borrowing authorities. The requisite interministerial committee was formed, projections were made, and a debt limit and debt management policy was recommended. However, formal action on the policy recommendations was not taken. We are asking the GOES to act upon these recommendations by March 1, 1986.

2. Economic Diversification

Several steps should be taken during the year to accelerate the growth of production of non-traditional products for export. Foremost, the Export Promotion Law that has been before the Legislative Assembly in various forms since September, 1985, should be passed without further delay. The Government has included this law in the legislative package of eight bills submitted to the Assembly in January as part of the 1986 program. The Government has advised that this law will be passed by March 1. Given the history of difficulties in getting this law passed, passage will be a condition of the CY 1986 Balance of Payments Program.

Second, the Government will establish a cabinet level committee, chaired by the Minister of Foreign Commerce and comprised of key ministers and exporters, that will meet monthly to review progress in export development and resolve problems. The Committee should be formed by March 1, 1986.

Third, as an aid in gauging progress and identifying problems, a set of quarterly targets for extra regional non-traditional exports will be established and progress against those targets monitored regularly by the Committee.

Fourth, a joint public sector-private sector committee will be formed by April 1, to analyze the investment climate in El Salvador to identify ways in which investment can be promoted. Currently, foreign investment in El Salvador is regulated by approximately 14 different laws and, depending upon the nationality of the investor, may be subject to a bilateral investment treaty. This complex legal environment is an impediment to investment. In addition, the provisions of some of the current laws are thought to place El Salvador at a disadvantage in attracting investment for which it otherwise might compete. Among the facets of the investment climate to be considered are repatriation of profits, dividends, and capital, protection against nationalization and/or confiscation, residence and work permits for foreign managers/technicians, confidentiality of records, labor law requirements, and taxes, depreciation, and raw material importation procedures.

3. Agrarian Reform Consolidation

a. Compensation of Former Landowners

The GOES will attempt to become current in its payments to former owners of properties affected by the Agrarian Reform by December 31, 1986. The Government will make available at least ₡200 million from its own resources and from ESF counterpart local currencies to pay the cash compensation portion of cases pending settlement, cash compensation portion of cases scheduled for settlement during 1986, payments of some of the interest due through December, 1986, and redemption of Series A Preferred Bonds. Should funds be insufficient for reasons beyond the Government's control, the available funds will be applied to the foregoing obligations in the order listed.

b. Completion of Agrarian Reform Financial Restructuring

Under the FY 1985 balance of payments program, the Interministerial Commission on the Agrarian Debt (comprised of the Ministers of Agriculture, Finance, and Planning and the President of the Central Bank) studied the debt of agrarian reform beneficiaries and recommend a restructuring of this debt. The Government announced its intent to act on these recommendations under its 1986 comprehensive economic program.

The recommendations, if implemented, would accomplish all of the objectives sought by the Mission in on the 1985 program. Unfortunately, the Commission's recommendations -- while substantively sound -- call for procedures that the Mission believes will delay unduly the needed debt restructuring. Two of the most important steps called for (e.g., extending the grace period and extending the amortization period) can be taken only after ISTA makes a case-by-case determination. The Mission believes that an across-the-board approach not involving administrative discretion would be better. Accordingly, the Mission has proposed that the agrarian debt be restructured by March 1, 1986, as follows:

(i) reduce interest charged on agrarian debt to six (6) percent, retroactive.

(ii) extend grace period by five years.

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(iii) extend amortization period to fifty years.

(iv) implement procedures described in "Deuda Agraria, Cuentas Restringidas, y Cartera ISTA-BFA", November, 1985, for disposing of the Cartera ISTA-BFA and for managing surplus funds.

c. Beneficiary Rights

An Interministerial Commission on Beneficiary Rights was formed and a study was completed under the FY 1985 balance of payments program. The findings and recommendations of this study clearly indicate that major changes in the laws governing the Agrarian Reform will have to be made, and that the process of defining operational beneficiary rights will be more complex and time consuming than was thought when the complementary measures for the FY 1985 balance of payments program were negotiated. It should be noted that the definition of these rights will be very difficult because they affect a large number of individuals who are basically most concerned about the problems of day-to-day survival; involve the sensitive issue of the carrying capacity of each cooperative; and there is no consensus within the Government or society on how these issues are to be handled. We are asking that, at a minimum, by July, 1986, the GOES resolve, enact, and implement legislation required to define:

(i) how individuals not presently members of a cooperative may become members;

(ii) the rights of cooperative members who voluntarily quit the cooperative;

(iii) the rights of cooperative members who are involuntarily dismissed from cooperative membership;

(iv) the rights of transfer and inheritance of cooperative membership;

(v) a reduction in the minimum holding period prior to transfer required of Phase III beneficiaries from 30 years to 5 years.

d. Titling

Satisfactory progress has been made in titling of Phase I coops and the goal set by President Duarte in January, 1985, of completion of Phase I titling by yearend 1986 is within reach. Approximately 153 Phase I coops remain to be titled. The Government has agreed to complete Phase I titling by December 31, 1986. The only titles that are not expected to have been issued by that time are those for abandoned coops.

Phase III titling cannot be completed by the President's target date. Approximately 21,000 titles remain to be issued. It should be feasible to issue these titles by the end of 1987. The Government has agreed that, during CY 1986, not fewer than 8,200 beneficiaries of Decree 207 will receive definitive titles.

e. Land Registry Law

The current property registry system in El Salvador is a barrier to efficient titling of Phase III beneficiaries for two reasons. First, the system is based on the "Folio-Personal" method of registry. Property inscriptions utilizing this system are extremely detailed. Correspondingly, the registration process is complex and very slow. Second, Agrarian Reform Law requires that reform properties be registered free of any claims against them (gravámenes). Approximately 50 percent of Phase III properties fall into this category and can not be registered until legislation is passed which establishes the procedures to be followed in registering these properties; i. e., to free them of debts owed by their former owners.

Legislation to change the method by which properties are registered to the "Folio-Real" system was presented to the Legislative Assembly on September 15, 1985. It is presently "under study" by the designated Legislative Commission. There seems to be a lack of interest in its rapid approval. A draft law concerning the registry of mortgaged properties is in the hands of the Minister of Justice, awaiting submission to the Assembly.

We are asking the Government to enact new laws covering these aspects of land registry by April 1, 1986.

D. Disbursement Strategy

The management of the conditionality outlined above and disbursements under the Program will be difficult and will require the continued high level attention of the USAID and the Embassy. The President has repeatedly stated that he is, as a matter of principle, against tying at any conditions to disbursements. He has made it very difficult for his cabinet to enter into any commitments linked to disbursements. At the same time, the President's position -- that we agree on the strategic directions of his government and leave the details and timing to his political judgement -- has substantial merit. In view of this, the USAID proposes to establish basic agreement with the Minister of Planning to the conditions outlined above and in accordance with the indicative timetable set out in Annex IV. These will be included in an outline of the CY 1986 Economic Program and submitted to the USAID. We will then work with the cabinet (principall_ the Minister of Planning and Ministers of Agriculture, Finance, Central Bank and Foreign Commerce) in accord with the above indicative timetable and the disbursement schedule outlined in Annex V. As long as there is adequate progress we will not hold precisely to the timetable. Approximately half way through the Program (prior to any disbursment after $70 million, now timed for July), we will advise Washington of the status of the conditions as outlined herein and request authorization to proceed with disbursements.

Prior to signature of the Agreement, the GOES will submit an outline of their Economic Program containing the conditions and timing contained in Annex IV.

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This should be a condition of the authorization. In the month of March, 1986, the Mission will require that action be taken (a) to restructure the agrarian debt (including the adoption of uniform procedures governing the disposition of excess funds and disposition of the Cartera ISTA-BFA), (b) to establish public sector debt limits, (c) to enact an Export Promotion Law, (d) to establish a system for monitoring progress against 1986 economic program benchmarks; (e) to establish an export promotion committee; and (f) to establish a joint committee to study the investment climate.

In the month of April, 1986, the Mission will (a) meet with the Ministry of Planning on quarterly performance targets for the first quarter of 1986; and (b) require enactment of land registry laws.

Prior to any disbursements over $70.0 million (now scheduled for July), the Mission will submit a progress report to AID/W indicating the progres or lack thereof to date and await authorization for the remaining disbursements. The Mission will (a) meet with the Ministry of Planning on quarterly performance targets for the second quarter of 1986; and (b) ensure that adequate deposits for agrarian reform compensation have been made.

In the month of October, 1986, the Mission will require (a) that the Government's economic program for 1987 be completed; and (b) that adequate deposits for agrarian reform compensation will have been made.

In the month of November, 1986, the Mission will require (a) that quarterly performance targets for the third quarter of 1986 have been met and that any required corrective actions have been initiated, and (b) that deposits totalling ¢200 million for agrarian reform compensation will have been made.

does this capture all conditionality

There are two covenants which should be included in the project agreement to implement the above strategy. The first covenant should require the GOES to be in compliance with the requirements outlined ~~in the Economic Stabilization~~ Program. The second covenant should require the submission of the following ~~reports~~ from the Central Bank: (i) monthly statements of assets and liabilities of the BCR, and the commercial and hypothecary banks; (ii) copies of the weekly monetary report prepared for the Junta Monetaria; and (iii) copies of the weekly cable prepared for the International Monetary Fund.

## IX. CY 1986 LOCAL CURRENCY PROGRAM

The CY 1986 Local Currency Program which is largely funded by local currency generated under the proposed Balance of Payments Program is also currently being negotiated with the GOES. The proposed sources and uses of funds are shown in Annex VI. Once agreement is reached two Memoranda of Understanding, the CY 1986 ESF MOU and the CY 1986 PL-480 MOU, will be signed with the GOES.

The Program will be funded by colones generated under the proposed FY 1986 Balance of Payments Program ($147.0 million of ESF), the FY 1986 PL-480 Title I agreement signed with the GOES ($36.0 million), and its proposed amendment ($10.0 million), and the unexpended balance from the CY 1985 Local Currency Program (¢214.1). The total resources of the CY 1986 Program will be approximately ¢1001.5.

The uses of FY 1986 local currency are governed by two laws. Section 702 (e) of the authorization bill for FY 1986 (the International Security and Development Cooperation Act of 1985) governs the uses of ESF local currency deposits. That provision requires that the local currency deposits be used for projects assisting Agrarian Reform and the agricultural sector; Judicial Reform; employment generation; health, education, and other social services; infrastructure repair; and credits and other support for the private sector (principally for small and medium sized businesses). Particular emphasis is to be placed on Agrarian Reform and other projects in the agricultural sector. The provision specifically permits the use of funds for compensation under the Agrarian Reform program. Section 106 (b) of PL-480 governs the use of PL-480 generations. It requires that all Title I agreements include provisions to assure that sales proceeds are used for agreed-upon economic development purposes, with an emphasis on purposes that directly improve the lives of the poorest and their capacity to participate in the development of their country. The CY 1986 Local Currency Program will concentrate on the following areas: (A) public sector budget, (B) private sector support, and, (C) USAID operating expenses and program support. A brief summary of the emphasis to be given in each of three areas is provided, below.

A. Public Sector Budget

Local currency generations will support the GOES Extraordinary Budget and the Ordinary Budget. The Extraordinary Budget is managed by the Ministry of Planning (SETEFE) and constitutes the principal investment budget of the Government. Once agreement is reached in principle with USAID, SETEFE approves actions plans of the executive entities, disburses, monitors, and audits the uses of these funds. Local currencies in the Extraordinary Budget are used to reinforce A.I.D. projects and strategy objectives as well as to encourage other donor (e.g. IDB, IBRD) activities. The priorities are (i) GOES counterpart contributions to A.I.D. financed projects, (ii) the National Plan for restoring former guerrilla-held areas, (iii) GOES counterpart contributions to other donor projects, and (iv) other priority projects supporting Jackson Plan goals.

The Ordinary Budget is managed by the Ministry of Finance. The USAID and the Ministry agree upon line items in the budget in advance and subsequently reimburse the Ministry for expenditures made. Priority is given to the social sectors, agrarian reform, health, education, low-income housing, and judicial and governmental reform. A combination of budget austerity imposed by economic decline and mounting expenditures for war have squeezed the social sectors just at the time the new democracy represented by the Duarte Government must demonstrate that it is a viable alternative to the authoritarian system proposed by the guerrillas and can meet the needs of the majority of the Salvadorans. It should be noted that the current proposal calls for ¢140 million to the allocated to agrarian reform compensation.

## B. Private Sector Support

In order to assure the private sector adequate credit levels to stimulate private sector-led recovery as well as to assure the credit to support the reorientation of the economcy, USAID is again proposing that a substantial portion of the local currency program be allocated to private sector credit lines administered by the Central Bank. This component of the program has to be considered in conjunction with the GOES monetary program. By setting an adequate target for Central Bank credit to the public sector with an overall limit on total credit, the GOES is assuring adequate credit levels to the private sector. Within this overall program the local currency program assures priority for critical areas such as non-traditional exports and small business. Thus, the overall strategy is to maintain an adequate money supply availability of credit to diversify production (agricultural and industrial), increase non-traditional exports to extraregional markets (production and marketing) and expand small and medium size businesses.

One major new program will be the initiation of a private sector terrorism insurance program to encourage increased private sector investment in the Salvadoran economy.

## C. Operating Expense and Program Support

The Balance of Payment Agreement (No. 519-0310), Amendment No. 1, establishes a local Currency Operating Expense and Program Support Fund. The fund will be funded by ¢25.0 million in local currency. It will finance the local costs, over a 15-month period, associated with the operation and maintenance of the USAID Mission, including local salaries, housing and office rentals, and local operating costs. It will also fund the local costs associated with the A.I.D. programs such as training, local private voluntary agencies, and scholarships in El Salvador.

# X. PROGRAM MANAGEMENT

## A. Separate Account

Following the precedent established the previous fiscal year, the FY 86 Continuing Resolution (CR) requires that any ESF placed in the Central Reserve Bank of El Salvador be maintained in a separate account. In designing the procedures which will govern the Separate Account for FY 86, the Mission considered that the intent of this requirement was four-fold: (1) that A.I.D.-supplied ESF funds not be co-mingled with other BCR funds; (2) that

A.I.D.-supplied ESF funds finance specific eligible transactions; (3) that the cash transfer nature of the program not be altered; and (4) that the Separate Account mechanism be flexible enough to permit changes based on experience and developments which affect its efficiency. Further, the Separate Account mechanism was designed in order not to undermine the purpose of the assistance to be rendered.

Following the foregoing guidelines, the Separate Account will operate along the following lines, which are fully detailed in Annex VI of this PAAD. USAID will disburse funds directly into the Separate Account which, at the discretion of the BCR, may be distributed among several accounts at private U.S. banks and/or the Federal Reserve Bank System. The BCR has opened several accounts in U.S. commercial banks for this purpose. Disbursements, which will be made upon a formal request by the BCR and compliance with specific objectives of the program associated with the schedule of disbursements, will neither take place at a rate faster than that contemplated in the Grant Agreement, nor will they exceed the amounts established in the same agreement.

Before disbursements to finance imports are made from the Separate Account(s), the BCR will determine eligibility for financing in accordance with the program's eligibility criteria and will undertake price verification. A new feature of the program is the eligibility of the banking system to request reimbursement from the Separate Account for recent elibigle import transactions financed with the banks' own dollar resources. The rules governing reimbursement procedures, including transaction eligibility dates, are also detailed in Annex VII. In this regard, commercial banks may apply for reimbursement for imports financed under the TCIP. This modification to the system adopted last year fully recognizes and facilitates the role of commercial banks as financial intermediaries and key participants in international trade, while maintaining the accountability required of the Separate Account(s) mechanism. Supporting documentation for each import transaction financed under the program will be on file at the BCR and readily available to USAID for independent audit and price checking (see Section X.C., below). For final liquidation, the BCR will provide USAID/El Salvador with a listing of completed paid transactions for which full documentation will be available at the BCR. The Mission's Private Enterprise Office or its designee will conduct an eligibility review of all transactions submitted by the BCR. The final list submitted by the BCR will contain all the information outlined in Annex VII. In order not to inhibit the smooth disbursements of the program (and hence not undermine its objectives), USAID will make an a posteriori determination of eligibility for all transactions and of price verification for selected ones.

Should the AID review, which will be based on a review by a U.S. accounting firm, show unsatisfactory results, the BCR would be asked to either refund the Separate Account for the amount of the transactions found to be ineligible or to submit to A.I.D. substitute eligible transactions.

Although statutory requirements, including those of Section 604 of the FAA (regarding source, origin, and price tests) do not apply to the Separate Account, the Mission will continue to press for the maximum import transactions from the United States consistent with Salvadoran needs. Given the foregoing, the Mission proposes to continue with the following eligibility criteria for imports financed under the Special Account:

--That they be raw materials, intermediate goods, spare parts, agricultural imports, and capital goods from the United States, CBI-designated CACM countries, and petroleum from other code 941 countries;

--That they be for the use primarily of the private sector in the manufacturing, agricultural, agroindustrial, commercial, construction, transportation, services and energy subsectors of the economy.

Based on experience with the 1985 program the Mission believes that the Separate Account procedures laid out above represent a substantial improvement over the Separate Account mechanism established initially under the Program. The modified procedures are conducive to orderly disbursements into and out of the Separate Account without compromising the accountability required of the program. Nonetheless, changing circumstances may require additional modifications to the mechanism in order to ensure its smooth operation. The Mission will consult with AID/W on any major changes that may be required.

B. Source

The Mission proposes to continue with the source eligibility criteria utilized in 1985 which includes eligible items from the U.S., CBI-designated CACM countries, and Geographic Code 941 oil producing countries. One hundred percent of the value of eligible transactions involving petroleum and its derivative imports from 941 Code countries may be charged to the Separate Account(s). In such cases the BCR must reimburse three percent of the nominal value of the transaction to the Separate Account, which is the value of petroleum imports that the Mission estimates are used for military purposes.

C. Price Checking

As documented in the February, 1985 Arthur Young (II) report, BCR price verification is increasingly effective and broader in scope and has undoubtedly made the export of capital through under- or overinvoicing much more difficult than previously. Additionally, the recent exchange rate unification has reduced incentives to under- or overinvoice. Price checking is being conducted following the criteria developed by the Arthur Young team, (AY) as described in the February, 1985 report. For instance, all transactions involving $5,000.00 or more and/or involving duties in excess of 100 percent of value are price checked. There are in excess of ninety other criteria developed in the AY report from which the joint BCR/AY team have drawn and incorporated procedures into the price checking system.

In order to verify the effectiveness of the Price Checking Unit, USAID will perform price checking a posteriori on a selected group of transactions which USAID has already accepted as eligible for financing under the program.

D. Determination of the Colón Equivalent of ESF Dollars

The BCR will deposit in local currency and according to AID/El Salvador instructions, equivalent amount to the U.S. dollar disbursement(s), at the highest exchange rate which is not illegal.

The deposit of local currency must occur within two (2) working days from the BCR receipt of the telex from the USAID/El Salvador Controllers Office notifying of the disbursement(s).

The BCR must send evidence of such deposit(s) to USAID/El Salvador Controllers Office within five (5) working days from the day the local currency was deposited.

TABLE 1: BALANCE OF PAYMENTS
BALANCE OF PAYMENTS

| | 1983 | 1984 | 1985 | 1986 |
|---|---|---|---|---|
| EXPORTS | 743.6 | 726.0 | 709.9 | 770.0 |
| COFFEE | 410.5 | 449.8 | 447.5 | 495.0 |
| COTTON | 55.4 | 9.2 | 29.0 | 4.0 |
| SUGAR | 40.1 | 25.9 | 23.2 | 25.0 |
| SHRIMP | 13.8 | 20.2 | 13.8 | 20.0 |
| CACM | 168.1 | 157.2 | 120.0 | 140.0 |
| OTHER | 55.8 | 63.7 | 76.4 | 86.0 |
| IMPORTS | 891.5 | 977.4 | 1013.8 | 970.0 |
| CONSUMER GOODS | 262.9 | 276.4 | 292.1 | 250.0 |
| Nondurables | 234.2 | 238.4 | 253.8 | |
| Durables | 28.8 | 38.0 | 38.3 | |
| INTERMEDIATE GOODS | 524.4 | 568.8 | 585.2 | 570.0 |
| Manufacturing | 413.7 | 454.6 | 465.2 | |
| (petroleum) | 126.6 | 130.3 | 133.7 | |
| Agriculture | 52.4 | 57.3 | 58.1 | |
| (fertilizers) | 26.7 | 25.0 | 32.8 | |
| Construction | 51.4 | 50.6 | 54.2 | |
| Other | 6.9 | 6.3 | 7.7 | |
| CAPITAL GOODS | 104.1 | 132.2 | 136.5 | 150.0 |
| Manufacturing | 37.7 | 42.6 | 48.7 | |
| Transportation | 34.6 | 53.4 | 41.6 | |
| Agriculture | 9.9 | 13.0 | 20.0 | |
| Construction | 5.5 | 5.2 | 5.4 | |
| Other | 16.4 | 18.0 | 20.8 | |
| TRADE BALANCE | -147.8 | -251.4 | -303.9 | -200.0 |
| SERVICES, NET | -152.4 | -160.3 | -142.2 | -140.0 |
| TRANSFERS, NET | 271.5 | 320.2 | 356.8 | 460.0 |
| US Transfers | 162.2 | 186.0 | 203.4 | 310.0 |
| CURRENT ACCOUNT | - 28.7 | - 91.5 | - 89.3 | 120.0 |
| CAPITAL ACCOUNT | 257.5 | 65.5 | 89.5 | -10.0 |
| OFFICIAL CAPITAL, NET | 179.0 | 91.0 | 120.7 | 55.0 |
| US Loans (gross) | 78.6 | 68.8 | 88.9 | 63.5 |
| BANK CAPITAL, NET | 137.0 | -21.6 | -39.0 | -65.0 |
| US Loans (gross) | 27.5 | 33.5 | 19.0 | 7.2 |
| PRIVATE CAPITAL, NET | -58.5 | -3.9 | +7.8 | 0.0 |
| OVERALL BALANCE | 228.8 | -26.0 | -0.2 | 110.0 |
| CURRENT ACCOUNT BEF US | -190.9 | -277.5 | -292.7 | -190.0 |
| OVERALL BALANCE BEF US | -39.5 | -314.3 | -311.5 | -260.7 |
| CHANGE IN ARREARS | -28.3 | +33.8 | +12.6 | -35.0 |
| CHANGE IN RESERVES | +200.5 | +7.8 | +12.4 | +75.0 |

Table 1

El Salvador - Central Government Operations
Consolidated Budget
(millions of colones)

| | (1) 1984 | (2) 1985 (Est.) | (3) 1986 (Est.) |
|---|---|---|---|
| REVENUES (I + II) | 1919.8 | 2034.2 | 3322.2 |
| I. Current Revenues | 1536.8 | 1875.9 | 3041.7 |
| a. Tax Revenues | 1342.5 | 1617.9 | 2652.4 |
| b. Non-Tax Revenues | 194.3 | 258.0 | 389.3 |
| II. Capital Revenues | 383.0 | 158.3 | 280.5 |
| Of which: Foreign Grants | 381.0 | 102.2 | 240.0 |
| EXPENDITURES (I + II + III) | 2323.8 | 2588.5 | 3755.8 |
| I. Current Expenditures | 1797.0 | 2011.9 | 2840.6 |
| a. Wages and Salaries | 1006.0 | 1277.6 | 1616.8 |
| b. Goods and Services | 229.7 | 250.0 | 423.9 |
| c. Interests | 187.9 | 170.3 | 285.3 |
| e. Transfers | 325.1 | 270.0 | 439.6 |
| f. Other | 48.3 | 44.0 | 37.5 |
| II. Capital Expenditures | 449.6 | 647.4 | 694.8 |
| III. Net Lending | 77.2 | 3.1 | 220.4 |
| OVERALL DEFICIT (after grants) | -404.0 | -641.8 | -433.7 |
| OVERALL DEFICIT (before grants) | -785.0 | -744.0 | -714.7 |
| FINANCING (I + II) | 404.0 | 641.8 | 433.7 |
| I. Net External | 210.0 | 303.2 | 236.2 |
| II. Net Internal | 194.0 | 338.6 | 197.5 |
| Of which: Banking System | | 206.8 | |
| Other floating debt, Change in Deposits, etc. | | 131.8 | |

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Table 2
El Salvador - Central Government Operations
Ordinary Budget
(Millions of Colones)

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 (Est.) | 1986 (Prel.) |
|---|---|---|---|---|---|---|---|
| 1. LEGISLATIVE BRANCH | 0.9 | 0.8 | 4.2 | 6.3 | 7.0 | 6.4 | 7.0 |
| 2. JUDICIAL BRANCH | 17.8 | 19.9 | 19.2 | 18.8 | 20.9 | 27.3 | 26.6 |
| 3. CONTROLLER (CCuentas) | 7.7 | 8.1 | 7.8 | 7.8 | 8.5 | 9.2 | 9.3 |
| 4. ELECTORAL COUNCIL | 0.9 | 2.5 | 3.6 | 4.3 | 13.0 | 4.7 | 1.4 |
| 5. CIVIL SERVICE TRIBUNAL | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 |
| 6. ATTORNEY GEN. (FISCALIA) | 6.6 | 2.7 | 3.3 | 2.8 | 2.9 | 3.5 | 3.1 |
| 7. PUB. DEFENDER (PROCURADURIA) | 4.2 | 5.1 | 4.1 | 4.1 | 4.0 | 4.3 | 4.3 |
| 8. OFFICE OF THE PRESIDENT | 18.4 | 17.2 | 16.6 | 19.2 | 17.3 | 15.3 | 15.3 |
| 9. M. OF PLANNING | 23.2 | 30.2 | 24.4 | 15.1 | 12.9 | 17.1 | 14.7 |
| 10. M. OF FINANCE | 88.2 | 164.1 | 161.2 | 105.7 | 184.9 | 159.7 | 154.5 |
| 10a. DEBT SERVICE (Princ. & Int.) | 69.6 | 158.6 | 253.4 | 619.4 | 375.0 | 340.8 | 486.7 |
| 11. M. OF FOREIGN R. | 13.4 | 13.7 | 13.4 | 12.6 | 14.4 | 13.4 | 13.3 |
| 12. M. OF THE INTERIOR | 65.6 | 44.1 | 49.0 | 35.1 | 43.6 | 49.6 | 24.1 |
| 13. M. OF DEFENSE | 161.5 | 188.6 | 234.0 | 275.8 | 516.2 | 557.4 | 568.4 |
| 14. M. OF PUBLIC SAFETY | 75.1 | 110.9 | 120.7 | 121.1 | 144.3 | 171.2 | 176.3 |
| 15. M. OF JUSTICE | 29.9 | 26.6 | 23.4 | 23.3 | 25.8 | 26.4 | 25.9 |
| 16. M. OF CULTURE & COMM. | -- | -- | -- | -- | -- | -- | 53.6 |
| 17. M. OF EDUCATION | 371.6 | 367.8 | 353.2 | 330.2 | 373.2 | 436.9 | 402.3 |
| 18. M. OF HEALTH | 178.4 | 167.0 | 165.7 | 170.4 | 191.6 | 197.5 | 186.9 |
| 19. M. OF LABOR | 18.6 | 12.0 | 11.8 | 10.7 | 12.1 | 11.4 | 11.4 |
| 20. M. OF FOREIGN TRADE | -- | 2.5 | 3.1 | 3.4 | 3.4 | 4.5 | 3.7 |
| 21. M. OF ECONOMY | 141.7 | 171.0 | 114.3 | 46.6 | 26.7 | 29.2 | 22.5 |
| 22. M. OF AGRICULTURE | 133.9 | 148.4 | 171.7 | 159.8 | 182.6 | 193.8 | 156.8 |
| 23. M. OF PUBLIC WORKS | 217.3 | 256.7 | 187.9 | 208.2 | 200.4 | 257.2 | 262.9 |
| TOTAL | 1644.8 | 1918.8 | 1946.3 | 2201.0 | 2381.0 | 2537.1 | 2631.3 |

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GOESFUNC

Table 3
El Salvador - Central Government Operations
Ordinary Budget
(As a percent of Total)

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 (Est.) | 1986 (Prel.) |
|---|---|---|---|---|---|---|---|
| 1. LEGISLATIVE BRANCH | 0.1 | .0 | 0.2 | 0.3 | 0.3 | 0.3 | 0.3 |
| 2. JUDICIAL BRANCH | 1.1 | 1.0 | 1.0 | 0.9 | 0.9 | 1.1 | 1.0 |
| 3. CONTROLLER (CCuentas) | 0.5 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 |
| 4. ELECTORAL COUNCIL | 0.1 | 0.1 | 0.2 | 0.2 | 0.5 | 0.2 | 0.1 |
| 5. CIVIL SERVICE TRIBUNAL | .0 | .0 | .0 | .0 | .0 | .0 | .0 |
| 6. ATTORNEY GEN. (FISCALIA) | 0.4 | 0.1 | 0.2 | 0.1 | 0.1 | 0.1 | 0.1 |
| 7. PUB. DEFENDER (PROCURADURIA) | 0.3 | 0.3 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 |
| 8. OFFICE OF THE PRESIDENT | 1.1 | 0.9 | 0.9 | 0.9 | 0.7 | 0.6 | 0.6 |
| 9. M. OF PLANNING | 1.4 | 1.6 | 1.3 | 0.7 | 0.5 | 0.7 | 0.6 |
| 10. M. OF FINANCE | 5.4 | 8.6 | 8.3 | 4.8 | 7.8 | 6.3 | 5.9 |
| 10a.DEBT SERVICE (Prin. & Int.) | 4.2 | 8.3 | 13.0 | 28.1 | 15.7 | 13.4 | 18.5 |
| 11. M. OF FOREIGN R. | 0.8 | 0.7 | 0.7 | 0.6 | 0.6 | 0.5 | 0.5 |
| 12. M. OF THE INTERIOR | 4.0 | 2.3 | 2.5 | 1.6 | 1.8 | 2.0 | 0.9 |
| 13. M. OF DEFENSE | 9.8 | 9.8 | 12.0 | 12.5 | 21.7 | 22.0 | 21.6 |
| 14. M. OF PUBLIC SAFETY | 4.6 | 5.8 | 6.2 | 5.5 | 6.1 | 6.7 | 6.7 |
| 15. M. OF JUSTICE | 1.8 | 1.4 | 1.2 | 1.1 | 1.1 | 1.0 | 1.0 |
| 16. M. OF CULTURE & COMM. | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 2.0 |
| 17. M. OF EDUCATION | 22.6 | 19.2 | 18.1 | 15.0 | 15.7 | 17.2 | 15.3 |
| 18. M. OF HEALTH | 10.8 | 8.7 | 8.5 | 7.7 | 8.0 | 7.8 | 7.1 |
| 19. M. OF LABOR | 1.1 | 0.6 | 0.6 | 0.5 | 0.5 | 0.4 | 0.4 |
| 20. M. OF FOREIGN TRADE | 0.0 | 0.1 | 0.2 | 0.2 | 0.1 | 0.2 | 0.1 |
| 21. M. OF ECONOMY | 8.6 | 8.9 | 5.9 | 2.1 | 1.1 | 1.2 | 0.9 |
| 22. M. OF AGRICULTURE | 8.1 | 7.7 | 6.8 | 7.3 | 7.7 | 7.6 | 6.0 |
| 23. M. OF PUBLIC WORKS | 13.2 | 13.4 | 9.7 | 9.5 | 8.4 | 10.1 | 10.0 |
| TOTAL | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

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GOESFUND

Table 4
El Salvador - Central Government Operations
Consolidated Budget
(Millions of Colones)

Unification Adjustments # 5

| | (1) Ordinary Budget (Submit.) | (2) Salaries | (3) Oil | (4) ESF | (5) Compens. | (6) Coffee Price and Tax Effect | (7) Oil | (8) Export. (incl. Coffee) | (9) Import. | (10) Exp. | (11) Select. Consump. Tax | (12) Other Taxes | (13) Stamp Tax | (14) Autonom. Taxes | (15) Import Prohib. and Exemp. | (16) Subsid. | (17) REVISED | (18) DIFER | (19) EXTPAORD | (20) CONSOL |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| TOTAL REVENUES (I + II) | 2036.0 | | | | | | | | | | | | | | | | 3282.3 | 1246.3 | 39.9 | 3322.2 |
| I. Current Revenues | 2035.4 | | | | | | | | | | | | | | | | 3041.7 | 1006.3 | 0.0 | 3041.7 |
| a. Tax Revenues | 1791.0 | | | | | | | | | | | | | | | | 2652.4 | 861.4 | 0.0 | 2652.4 |
| Import Taxes | 250.3 | | | | | | | | 5.1 | | | | | | -25.4 | | 230.0 | -20.3 | | 230.0 |
| Export Taxes | 257.0 | | | | | 269.9 | | 523.3 | | | | | | | | | 1050.1 | 793.1 | | 1050.1 |
| Direct Taxes | 390.8 | 18.0 | | | | | | | | | | | | 15.0 | | | 423.8 | 33.0 | | 423.8 |
| Other Taxes | 892.9 | | | | | | | | | | | 69.8 | -5.0 | 0.5 | -9.7 | | 948.5 | 55.6 | | 948.5 |
| b. Non-Tax Revenues | 244.4 | | 32.4 | | | | 112.5 | | | | | | | | | | 389.3 | 144.9 | 0.0 | 389.3 |
| II. Capital Revenues | 0.6 | | | 240.0 | | | | | | | | | | | | | 240.6 | 240.0 | 39.9 | 280.5 |
| EXPENDITURES (I + II + III) | 2359.8 | | | | | | | | | | | | | | | | 3486.9 | 1127.1 | 268.9 | 3755.8 |
| I. Current Expenditures | 2076.1 | | | | | | | | | | | | | | | | 2603.1 | 727.0 | 37.5 | 2640.6 |
| a. Wages and Salaries | 1376.8 | 240.0 | | | | | | | | | | | | | | | 1616.8 | 240.0 | | 1616.8 |
| b. Goods and Services | 223.1 | | | | | | | | | 200.8 | | | | | | | 423.9 | 200.8 | | 423.9 |
| c. Interest | 197.8 | | | | | | | | | 87.5 | | | | | | | 285.3 | 87.5 | | 285.3 |
| d. Transfers | 278.4 | | | | | | | | | 61.2 | | | | | | 100.0 | 439.6 | 161.2 | | 439.6 |
| e. Other | | | | | | | | | | 37.5 | | | | | | | 37.5 | 37.5 | | 37.5 |
| II. Capital Expenditures | 264.8 | | | | | | | | | 198.6 | | | | | | | 463.4 | 198.6 | 231.4 | 694.8 |
| III. Net Lending | 18.9 | | | | 200.0 | | | | | 1.5 | | | | | | | 220.4 | 201.5 | | 220.4 |
| CURRENT SAVINGS | -40.7 | | | | | | | | | | | | | | | | 238.5 | 279.2 | -37.5 | 201.0 |
| OVERALL DEFICIT (Excl. Grants) | -324.4 | | | | | | | | | | | | | | | | -445.3 | -120.9 | -268.9 | -714.2 |
| OVERALL DEFICIT | -323.8 | | | | | | | | | | | | | | | | -204.7 | 119.1 | -229.0 | -433.7 |
| FINANCING (I + II) | 323.8 | | | | | | | | | | | | | | | | 204.7 | -119.1 | 229.0 | 433.7 |
| I. Net External | 57.3 | | | | | | | | | | | | | | | | 7.2 | -50.1 | 229.0 | 236.2 |
| a. Disbursements | 116.8 | | | | | | | | | 116.8 | | | | | | | 233.6 | 116.8 | 229.0 | 462.6 |
| b. Amortization | 59.5 | | | | | | | | | 166.9 | | | | | | | 226.4 | 166.9 | | 226.4 |
| II. Net Internal | 266.5 | | | | | | | | | | | | | | | | 197.5 | -69.0 | .0 | 197.5 |

01-Jan-84 BUDGET2

## ESTIMATE OF COST OF BAD POLICY

This annex explains in slightly more detail the method utilized to estimate the cost of failure to adjust policy appropriately to changed external conditions (see Section VII. C).

1. The Model

The costs of bad policy were estimated with the aid of a small simulation model of the Salvadoran economy. This model emphasizes the role of supply factors, particularly the supply of foreign exchange, in the determination of real output, and the role of demand factors, particularly the nominal money stock, in the determination of price levels.

The model contains two composite goods, an importable that is not produced in the economy, and an exportable-home good that is. It also includes two foreign exchange markets, a bank market through which all export proceeds are assumed to be liquidated (i.e., it is assumed that there is no export smuggling) at an officially determined rate, and an extra-bank market (i.e., the black market), which rate is assumed to apply (at least at the margin) to import transactions. The extra-bank market rate adjusts to clear supply and demand.

The production of the exportable-home good is assumed to require use of the importable. The higher the level of imports, the higher the level of real production that is achieved. Real output is thus, under the assumption of the model, constrained by the quantity of foreign exchange available. The latter, however, is responsive to price. A higher bank market exchange rate is assumed to stimulate exports, and thus increase the supply of foreign exchange available. More foreign exchange results in more production, which -- other things being equal -- reduces domestic price levels and the extra-bank market exchange rate, providing a further stimulus to production through the lowered cost of imported inputs.

The equations of the model and estimated parameters utilized in this exercise are shown in Table 1.

2. Results of the Simulations

The results of three simulations are reported in Table 2. To isolate the effects of policy on growth, the terms of trade and current account deficit (national income and product account definitions) were held constant at their 1985 levels. It also was assumed that there was no change in net reserves during the simulation period: all available foreign exchange inflows were used to finance imports.

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In simulation 1, labelled "Flexible Policy", policy parameters were adjusted to maintain a close relationship between the predicted extra-bank market exchange rate and the bank market rate. The rate of interest was boosted to 15 percent in 1986, and thereafter dropped back to 12.5 percent reflecting the assumption that inflation would be rapidly conquered under a "Flexible Policy" scenario. The rate of growth of the money supply was reduced rapidly to reflect assumed falling inflationary expectations.

The policy pursued in Simulation 1 roughly maximizes the amount of growth obtainable given the terms of trade and the flow of foreign investment reflected in the assumed fixed current account deficit. Simulations 2 and 3 depart from this optimal policy.

In Simulation 2, labelled "No Policy Change", the bank market exchange rate (a weighted average of the official and parallel market rates), the interest rate, and the rate of expansion of the money supply were maintained at their 1985 rates. As can be seen, growth is quite a bit lower under the "No Policy Change" scenario.

In Simulation 3, "Announced Plan", the bank market exchange rate, interest rate, and money supply growth are adjusted as originally announced for the GOES 1986 economic program. Growth is somewhat better than in the "No Policy Change" scenario, but still somewhat below the "Flexible Policy" scenario.

3. Cost of Bad Policy

The policies simulated in simulations 2 and 3 result in lower growth because they depress exports and, hence, reduce the quantity of productive imports that the economy can finance for a given level of foreign investment. To estimate the cost of the policy, we calculate the additional amount of foreign exchange that would have to be transferred to bring availability up to the level obtained in Simulation 1. Cumulating the cost over the three year period 1986-88, a three-year cost is obtained.

Table 1

EQUATIONS AND ESTIMATED PARAMETER VALUES

| FUNCTION | PARAMETERS | DEFINITION | VALUE |
|---|---|---|---|
| Export Supply | | X = A*rx**a1*X(-1)**a2 | |
| | A | scale | 41.948 |
| | a1 | supply elasticity | -0.105 |
| | a2 | lag | 0.619 |
| Import Demand | | M = B*rm**b1*M(-1)**b2 | |
| | B | scale | 1.866 |
| | b1 | demand elasticity | 0.108 |
| | b2 | lag | 0.860 |
| Export Rel Price | | rx = P/(ExPx*) | |
| Import Rel Price | | rm = P/(EmPm*) | |
| Production | | Q = C*M**c1*Q(-1)**c2 | |
| | C | scale | 3.337 |
| | c1 | output elasticity | 0.225 |
| | c2 | lag | 0.665 |
| Money Demand | | MO = k*v*P*Q | |
| | k | scale | 3.8710 |
| | v | velocity inverse | 0.3800 |

Table 2

SIMULATION RESULTS

Simulation 1 - Flexible Policy

| POLICY VARIABLES | 1986 | 1987 | 1988 |
|---|---|---|---|
| Money Supply Growth (%) | 20.0 | 10.0 | 10.0 |
| Bank Exchange Rate (Ex-index) | 7.30 | 7.60 | 8.40 |
| SIMULATION VARIABLES | | | |
| Real GDP Growth Rate (%) | 1.2 | 1.1 | 0.9 |
| CPI Growth Rate (%) | 17.3 | 6.9 | 9.0 |
| Free Exchange Rate (Em-index) | 7.35 | 7.66 | 8.50 |
| Exports (millions 1984 C) | 2362.4 | 2405.4 | 2436.1 |

Simulation 2 - No Policy Change

| POLICY VARIABLES | 1986 | 1987 | 1988 |
|---|---|---|---|
| Money Supply Growth (%) | 27.0 | 27.0 | 27.0 |
| Bank Exchange Rate (Ex-index) | 3.60 | 3.60 | 3.60 |
| SIMULATION VARIABLES | | | |
| Real GDP Growth Rate (%) | -0.2 | -1.0 | -1.6 |
| CPI Growth Rate (%) | 28.8 | 28.3 | 29.1 |
| Free Exchange Rate (Em-index) | 14.11 | 17.92 | 25.00 |
| Exports (millions 1984 C) | 2172.1 | 2051.0 | 1927.0 |

Simulation 3 - Announced Plan

| POLICY VARIABLES | 1986 | 1987 | 1988 |
|---|---|---|---|
| Money Supply Growth (%) | 17.0 | 14.0 | 11.0 |
| Bank Exchange Rate (Ex-index) | 5.00 | 5.00 | 5.00 |
| SIMULATION VARIABLES | | | |
| Real GDP Growth Rate (%) | 0.6 | 0.1 | -0.2 |
| CPI Growth Rate (%) | 15.1 | 13.3 | 10.5 |
| Free Exchange Rate (Em-index) | 9.29 | 10.34 | 11.94 |
| Exports (millions 1984 C) | 2275.0 | 2239.6 | 2194.9 |

## COMPLEMENTARY MEASURES FOR 1986 TO BE TAKEN BY GOES

### ECONOMIC POLICY

1. The 1986 Economic Program.

   Establish, by March 1, 1986, a process for monitoring progress on the 1986 Economic Program. Progress should be monitored against quarterly benchmarks for key economic variables, including a floor for net international reserves, a ceiling for international payments arrears, a ceiling for net domestic assets of the Central Reserve Bank, and a ceiling for net credit of the domestic banking system to the public sector.

2. Economic Program for 1987.

   Prepare a comprehensive economic program for 1987 prior to the submission of 1987 budget to the Legislative Assembly.

3. Debt Policy.

   Establish, by March 1, 1986, limits on the indebtedness for the public sector as a whole and for public sector entities with independent borrowing authority.

### ECONOMIC DIVERSIFICATION

(i) Pass, by March 1, 1986, an export promotion law and move expeditiously to make operational the incentives and export promotion facilities it authorizes.

(ii) Establish, by March 1, 1986, a cabinel level committee, chaired by the Minister of Foreign Commerce, on which key ministers and exporters will be represented, and meet monthly to review progress in export development and promotion.

(iii) Establish, by April 1, 1986, quarterly targets for extra regional non-traditional exports.

(iv) Establish, by April 1, 1986, a joint public sector/private sector committee to study the investment climate in El Salvador and recommend administrative and legal modifications to promote new productive investment.

AGRARIAN REFORM CONSOLIDATION

1. Compensation.

Make available ¢200 million from its own resources and/or local currency for compensation of former landowners whose properties were intervened.

2. Agrarian Debt.

Restructure, by March 1, 1986, the debt of agrarian reform beneficiaries as follows:

(i) Reduce interest charged on agrarian debt to six percent, retroactive.

(ii) Extend grace period by five years.

(iii) Extend amortization period to fifty years.

(iv) Implement procedures described in "Deuda Agraria, Cuentas Restringidas, y Cartera ISTA-BFA", November 1985, for disposing of the Cartera ISTA-BFA and for managing surplus funds.

3. Titling

By December 31, 1986, ISTA will have completed titling of the Phase I Cooperatives, except for those which have been abandoned. It is estimated that 153 active cooperatives have not been titled. By the same date, and consistent with FINATA's 1986 action plan, 8,200 Decree 207 beneficiaries will receive definitive titles to their parcels.

4. Land Registry Law

(i) By April 1, 1986, pass legislation pertaining to properties purchased by FINATA under Decree 207 which would allow these properties to be registered free of prior mortgages.

(ii) By April 1, 1986, pass legislation modernizing the land registry system.

5. Beneficiary Rights.

Enact and implement, by July 1, 1986, legislation required to define (i) how individuals not present members of a coop may become members; (ii) the rights and obligations of coop members who are dismissed involuntarily from coop membership or who chose to leave; (iii) the rights of transfer and inheritance of coop membership; and (iv) limit to five years from date of assignment of definitive title, the period during which Phase III beneficiaries' rights to dispose freely of their holdings are restricted.

Table 1

Performance Targets for 1986 Program*

| | Dec. 31 1985 | Apr.30 1986 | July 31 1986 | Sept.30 1986 | Dec.31 1986 |
|---|---|---|---|---|---|
| BCR Targets | | | | | |
| Net International Reserves | 349.2 | 823.6 | 754.4 | 481.2 | 902.7 |
| Net Domestic Assets | 912.1 | 146.6 | 215.1 | 549.0 | 511.1 |
| Net Credit Pub. Secto. | 1983.5 | 1983.5 | 1983.5 | 1983.5 | 1983.5 |
| Banking System Targets | | | | | |
| Net International Reserves | 813.2 | 1121.6 | 1060.0 | 802.2 | 1207.7 |
| Net Credit Pub. Sector | 2210.1 | 2210.1 | 2210.1 | 2210.1 | 2210.1 |

* Derived from Monetary Program approved by the Junta Monetaria on January 21, 1986.

## U.S. ECONOMIC ASSISTANCE TO THE LOCAL CURRENCY PROGRAM FOR 1986

| | | MILLIONS $ | MILLIONS ¢ | |
|---|---|---|---|---|
| **I. Projects that Generate Local Currency** | | | | |
| Source | | | | |
| FY 1986 Balance of Payments Project | | 145.0 | 660.0 | 1/ |
| PL 480 Title I | | 46.0 | 230.0 | 2/ |
| FY 1985 Balance of Payments Project 3/ | | | 36.5 | |
| - Reserve Fund | 36.5 | | | |
| TOTAL | | 191.0 | 926.5 | |

**II. Local Currency Preliminary Distribution**

| Uses | | MILLIONS ¢ PL | MILLIONS ¢ BALANCE OF PAYMENTS | |
|---|---|---|---|---|
| - Extraordinary Budget | | | | |
| - GOES/AID Projects Counterpart 4/ | | 75.3 | 2.0 | |
| - National Plan 5/ | | 38.6 | | |
| - Other Donor Counterpart (IDB, IBRD) 6/ | | 40.0 | | |
| - Priority Projects 7/ | | 76.1 | 46.9 | |
| - Ordinary Budget | | | | |
| - Agrarian Compensation | | | 140.0 | |
| - Social Sector Support | | | 100.0 | 10/ |
| - Private Sector Support 8/ | | | | |
| Domestic Reinsurance Fund | | | 240.0 | |
| - Credit Lines | | | 142.6 | |
| Industrial Sector | 100.0 | | | |
| Economic Development Fund | 20.0 | | | |
| Coffee Replanting | 20.0 | | | |
| Private Sector Fund (BCR) | 2.6 | | | |
| - AID Program Support 9/ | | | 25.0 | |
| TOTAL | | 230.0 | 696.5 | |

CALENDAR YEAR 1986
SCHEDULE OF PROJECTED DISBURSEMENTS

| MONTH | AMOUNT | SOURCE OF FUND | AUTHORIZED BY |
|---|---|---|---|
| JANUARY | 30 | FY 85 | FY 85 PAAD |
| FEBRUARY | 30 | FY 86 | FY 85 PAAD |
| MARCH | 40 | FY 86 | FY 86 PAAD |
| APRIL | 30 | FY 86 | FY 86 PAAD |
| JULY | 25 | FY 86 | FY 86 PAAD |
| SEPTEMBER | 22 | FY 86 | FY 86 PAAD |
| NOVEMBER | 30* | FY 87 | FY 86 PAAD |

* Subject to appropriation of funds by the U.S. Congress.

1/ Exchange Rate: $30.0 mill (US$1 : 2.5 colones) and $117 (US$1 : 5.0 colones)

2/ Exchange Rate US$1 : 5 colones

3/ The ¢36.5 mentioned as the Reserve Fund pertain to unprogrammed funds from the CY 1985 Local Currency Program

| | | | MILLIONS ¢ |
|---|---|---|---|
| 4/ GOES/AID Project Counterpart | | | |
| - Agrarian Reform Support | 519-0265 | RDO | 28.0 |
| - Water Management | 519-0303 | RDO | 3.8 |
| - Agrarian Reform Credit | 519-0263 | RDO | 24.8 |
| - Health Systems Vitalization | 519-0291 | HR/HA | 8.4 |
| - Education Systems Vitalization | 519-0295 | OET | 6.0 |
| - Population Dynamics | 519-0210 | HR/HA | 0.3 |
| - Industrial Recovery | 519-0287 | PRE | 4.0 |
| - Judicial Reform | 519-0296 | ODI | 2.0 |
| SUB-TOTAL | | | 77.3 |
| 5/ National Plan | | | |
| - Education | | | 8.0 |
| - Agriculture | | | 3.5 |
| - Interior | | | 5.0 |
| - Health | | | 7.0 |
| - Public Works | | | 6.5 |
| - Emergency Projects | | | 2.0 |
| - Combined Civic Action | | | 4.0 |
| - Administration | | | 2.6 |
| SUB-TOTAL | | | 38.6 |
| 6/ Other Donor Counterpart | | | |
| - IDB | | DPPO | 30.0 |
| - World Bank | | DPPO | 10.0 |
| SUB-TOTAL | | | 40.0 |

7/ Priority Projects

| | | |
|---|---|---|
| - ORE | | 65.2 |
| - CONADES | | 12.0 |
| - DIDECO | | 2.8 |
| - Democratic Initiatives | | 7.0 |
| - Agricultural Sector Support | | 4.7 |
| - Health Sector Support | | 9.8 |
| - EDUCREDITO | | 2.0 |
| - Working Capital Fund | | 19.5 |
| SUB-TOTAL | | 123.0 |

8/ Private Sector Support

| | | |
|---|---|---|
| - Domestic Reinsurance Fund | | 240.0 |
| - Private Sector Credit Lines | | 142.6 |
| Industrial Sector | 100.0 | |
| Economic Development Fund | 20.0 | |
| Coffee Replanting | 20.0 | |
| Private Sector Fund | 2.6 | |
| SUB-TOTAL | | 382.6 |

9/ AID Program Support 25.0

10/ Assumes that Public Sector credit from the banking system will be zero.

# SEPARATE ACCOUNT OPERATIONAL PROCEDURES

## I. U.S. DOLLAR DEPOSITS

Although the Mission believes that the Separate Account procedures laid out below will be workable, it is a new and untested evolution of the system established in 1985. Therefore, the Mission expects that modifications will have to be made based on actual experience, to make it comply, in as much as possible, with sound commercial banking procedures.

The Central Reserve Bank of El Salvador (BCR) will request disbursement from the Director of AID/El Salvador through a simple letter and financing request form AID 1130-2, indicating the U.S. Commercial Bank(s), Account Number(s), and Amount(s) to be deposited, or if requested, that funds be deposited in any of the FEDRESERVE banks. The Central Bank of El Salvador (BCR) has opened Separate Accounts in several U.S. Commercial Banks, for that purpose.

The USAID/El Salvador's Controllers Office, upon receipt of the BCR disbursement request will notify AID/Washington, via cable, of the BCR disbursement request and its specifics.

AID/Washington will deposit dollars from the Balance of Payments Support Program into the Central Reserve Bank of El Salvador's (BCR) Separate Account(s) at the U.S. Commercial Bank(s) chosen by the BCR as its correspondent bank(s). An initial advance will be provided against which liquidation of approved transactions will be made at the end of the program.

The BCR may, at its discretion, use the A.I.D. deposit(s) in the Separate Account(s) to establish Lines of Credit in foreign commercial banks to be chosen by the BCR.

AID/Washington will advise, by cable, the AID/El Salvador Controllers Office of the deposit(s) made, by bank, account number, amount, date and hour of deposit. It will be the responsibility of the USAID/El Salvador Controllers Office to inform the BCR's Exterior Department, within one (1) working day, via telex, of the banks, accounts, amounts, and date and hour of deposit(s) informed by Washington.

The Controllers Office will provide the Private Enterprise Office (PRE) and the Development and Program Office (DPPO), within two (2) working days, with a copy of the cable received from Washington and the telex sent to the BCR on the disbursement(s).

## II. LOCAL CURRENCY

The BCR will deposit in local currency and according to AID/El Salvador instructions, an equivalent amount to the U.S. dollar disbursement(s). The deposit of local currency must occur within two (2) working days from the BCR receipt of the telex from the USAID/El Salvador Controllers Office notifying of the disbursement(s).

The BCR must send evidence of such deposit to USAID/El Salvador Controllers Office within five (5) working days from the day of the local currency deposit.

The USAID/El Salvador's Controllers Office must provide a photocopy of the BCR's note and evidence of payment to the USAID/El Salvador Development Program Project Office (DPPO).

The BCR must deposit in a Separate Account(s) any differences between the amount of Local Currency originally deposited under the U.S. Dollar disbursement and the total amount of Local Currency generated by the BCR through the sale of the dollars to the importers.

The BCR must keep Separate Local Currency Accounts under each agreement or amendment under the Balance of Payments Support Program.

## III. RESERVATION OF SEPARATE ACCOUNT FUNDS

The BCR may reserve funds from the Separate Account(s) to pay for import transactions, eligible under the program, as long as it has the following documentation in its files at the Exterior Department:

a) Authorized F-10.
b) F-10 properly stamped by the Price Checking Unit to evidence Price Verification.
c) F-15 approved by the BCR (not necessary for suppliers credit transactions), and
d) Request for L/C opening, if applicable.

## IV. DIRECT PAYMENT FROM THE SEPARATE ACCOUNT(S)

### A) LETTERS OF CREDIT

1. A Salvadoran Importer will formalize a contract with a Foreign Exporter to purchase goods eligible under the program, and to be paid by the Letter of Credit mechanism.

2. The importer will request a Salvadoran commercial bank to open a Letter of Credit in order to pay the exporter.

3. The Salvadoran commercial bank will forward to the BCR Exchange Control Department the import permit request (form F-10), the form F-15 foreign exchange authorization request and a request to open a Letter of Credit.

4. The BCR Exchange Control Department will send the F-10 and F-15 requests to the Price Checking Unit, to conduct price analysis and verification.

5. The Price Checking Unit will return the verified F-10 and F-15 to the Exchange Control Department, properly stamped to indicate its findings.

6. The Exchange Control Department will authorize the import transaction and the F-10 and F-15 unless the Price Checking Unit has emitted an unfavorable opinion.

7. The Exchange Control Department will send to the BCR Exterior Department for its authorization, classification and registry under the Separate Account, the approved F-10 and F-15 as well as the original and one copy of the request for opening of the Letter of Credit. The request for opening of the Letter of Credit should clearly indicate that it is to be handled under the Separate Account. The total value of the approved Letter of Credit may not exceed the amount verified as appropriate by the Price Checking Unit.

8. The Exterior Department of the BCR after registering and qualifying the transaction, will return to the Salvadoran commercial bank the original of the request for opening the Letter of Credit, indicating with which foreign correspondent bank the Letter of Credit is to be confirmed. As proof of qualification for the Separate Account the Salvadoran commercial bank request for opening the Letter of Credit will have a number corresponding to the BCR Exterior Department Approval and two authorized signatures. The Exterior Department will file the copy of the request for opening the Letter of Credit and the F-10 and F-15.

9. The Salvadoran commercial bank will notify the foreign correspondent bank authorized by the BCR Exterior Department of the opening of the Letter of Credit to be paid directly with Separate Account funds.

10. The foreign correspondent bank will confirm the Letter of Credit and inform the exporter accordingly.

11. The exporter will ship the contracted goods to the Salvadoran importer.

12. The exporter will send the required shipping documents to the foreign correspondent bank in order to receive payment under the terms of the Letter of Credit.

13. The foreign correspondent bank having reviewed the shipping documents and ensured that they conform to the terms of the Letter of Credit, will pay the exporter as agreed, directly from the Separate Account funds.

14. The foreign correspondent bank will advise the Salvadoran commercial bank that payment has been made to the exporter and will send the pertinent documents to the same Salvadoran commercial bank.

15. The Salvadoran commercial bank will send to the BCR Exterior Department a copy of the Notice of Payment, the corresponding shipping documents, including the Import Certificate (or Customs Form) and payment in Salvadoran colones for the equivalent amount of U.S. dollars to cover the import transaction.

16. The BCR's U.S. correspondent bank will provide the BCR Exterior Department with a debit notice for each such Letter of Credit paid.

17. The exterior department will maintain a file of each transaction funded through this process which will contain at a minimum the following documentation:

    (1) Copy of approved F-10
    (2) Copy of approved F-15
    (3) Copy of approved L/C
    (4) Copy of commercial invoice
    (5) Copy of shipping documents (i.e. Airway bill, bill of lading, etc.)
    (6) Copy of Import Certificate (Póliza)
    (7) Evidence of payment to exporter (i.e., correspondent bank debit notification).
    (8) Evidence that foreign exchange was sold to the importer and the total local currency cost for such foreign exchange.
    (9) Evidence that Price Verificatin has occurred.

B) SUPPLIERS CREDIT

1. A Salvadoran importer will formalize a contract with a foreign exporter to purchase goods to be paid by the Supplier Credit Mechanism.

2. The Salvadoran importer will obtain the approval of the F-10 (Import Permit) directly from the Exchange Control Department of the BCR or through a local commercial bank.

3. The BCR Exchange Control Department will send the F-10 request to the Price Checking Unit, to conduct price analysis and verification.

4. The Price Checking Unit will return the verified F-10 to the Exchange Control Department, properly stamped and indicating its findings.

5. The Exchange Control Department will authorize the Import Permit (F-10) clearly indicating it as a transaction that qualifies for the Separate Account and return it to the importer.

6. The Salvadoran importer will request that the foreign exporter ship the goods.

7. The exporter will send the goods and corresponding documentation directly to the Salvadoran importer or through a local commercial bank.

8. The Salvadoran importer, having cleared the goods through local Customs, will request directly or through a local commercial bank, the authorization of the corresponding F-15 (Foreign Exchange Allocation) from the BCR Exchange Control Department.

   The Salvadoran importer or his local commercial bank will send to the BCR Exchange Control Department all corresponding shipping documentation, authorized F-10, Import Certificate or Customs form, attached to a request for approval of the F-15.

9. The BCR Exchange Control Department will verify that all documentation received conforms with the terms and conditions approved under the F-10 form.

10. The BCR Exchange Control Department will authorize the F-15 request and submit it to the Exterior Department for registry and allocation of funds.

11. The Exterior Department of the BCR, after registering and qualifying the operation for funding under the Separate Account will return to the Salvadoran commercial bank copies of the F-15 and Import Certificate. As proof of qualification for the Separate Account the Salvadoran commercial bank request for foreign exchange allocation will be given a number corresponding to the BCR approval and two authorized signatures. The Exterior Department will file the original F-10, F-15 and Import Certificate.

12. The importer will pay the Salvadoran commercial bank the value of the transaction in Salvadoran colones and the Salvadoran commercial bank will in turn forward to the Exterior Department all documentation pertinent to the transaction and a check in Salvadoran colones or authorization to debit its account for the equivalent amount in U.S. dollars to cover the import transaction.

13. The BCR Exterior Department will pay from the Separate Account(s) the amount authorized on the form F-15 to the Salvadoran commercial bank or its designee.

14. The Salvadoran commercial bank will pay or notify its foreign correspondent bank to pay the exporter.

15. The foreign correspondent bank will pay the exporter.

16. The foreign correspondent bank will advise the Salvadoran commercial bank that payment has been made to the exporter.

17. The Salvadoran commercial bank will send to the BCR Exterior Department a copy of the Notice of Payment received from the foreign correspondent bank.

18. The BCR's correspondent bank will provide the BCR Exterior Department with a debit notice for each such transaction paid.

19. The exterior department will maintain a file of each transaction funded through this process which will contain at a minimum the following documentation:

    (1) Copy of approved F-10
    (2) Copy of approved F-15
    (3) Copy of commercial invoice
    (4) Copy of shipping documents (i.e. Airway bill, bill of lading, etc.)
    (5) Copy of Import Certificate (Póliza)
    (6) Evidence of payment to exporter (i.e., copy of cancelled check, wire transfer, etc.)
    (7) Evidence that Price Verification has occurred.
    (8) Evidence that foreign exchange was sold to the importer and the total local currency cost for such foreign exchange.

## V. REIMBURSEMENTS

For all transactions meeting the eligibility criteria for funding through the Balance of Payment Support Program but which have already been paid from other than ESF funds by the local commercial banks, the BCR will be able to make reimbursement under the following procedures:

1. Transaction documentation will be submitted to the BCR Exterior Department. Such documentation will consist of as a minimum the following:

a) FOR LETTERS OF CREDIT TRANSACTIONS L/C

(1) Copy of approved F-10
(2) Copy of approved F-15
(3) Copy of approved L/C
(4) Copy of commercial invoice
(5) Copy of shipping documents (i.e. Airway bill, bill of lading, etc.)
(6) Copy of Import Certificate (Póliza)
(7) Evidence of payment to exporter (i.e. correspondent bank debit notification).
(8) Evidence that foreign exchange was sold to the importer and the total local currency cost for such foreign exchange.
(9) Evidence that Price Verificatin has occurred.

b) FOR SUPPLIER'S CREDIT

(1) Copy of approved F-10
(2) Copy of approved F-15
(3) Copy of commercial invoice
(4) Copy of shipping documents (i.e. Airway bill, bill of lading, etc.)
(5) Copy of Import Certificate (Póliza)
(6) Evidence of payment to exporter (i.e., copy of cancelled check, wire transfer, etc.)
(7) Evidence that Price Verification has occurred.
(8) Evidence that foreign exchange was sold to the importer and the total local currency cost for such foreign exchange.

2. The BCR Exterior Department will verify that all documentation is present, meets the Grant Agreement eligibility criteria and has been verified by the BCR Price Checking Unit.

3. The BCR Exterior Department will pay to its own account or that of the commercial bank, as applicable, the U.S. dollar amount of the total transaction from the separate account via bank check, wire transfer, or any other banking mechanism clearly referencing the transaction for which payment is being made. A copy of such cancelled check or wire transfer instruction or any other banking instrument shall be placed in the transaction file to be located at the BCR Exterior Department. The total cost of the transaction may include the cost of goods, shipping, handling, insurance and bank charges. When the TCIP program has been used, the interest charges payable may also be included in the amount reimbursable from the Separate Account(s).

4. Such transactions for which reimbursement is made by the BCR, as described above, will be listed as described in Section IX, entitled "BCR Reporting", and will be included as part of the final liquidation for the Balance of Payment Support Program disbursements to the BCR by AID.

## VI. ELIGIBILITY CRITERIA

The following criteria and corresponding code is to be applied for all types of transactions funded through the Separate Account(s) and reported to AID in listings prepared to evidence liquidation.

1. PRODUCT CATEGORY

| PRODUCT CATEGORY | Code |
|---|---|
| Raw materials | 1 |
| Intermediate Goods | 2 |
| Capital Goods | 3 |
| Spare Parts | 4 |
| Agricultural Inputs | 5 |
| Petroleum | 6 |

2. ECONOMIC SECTOR DIVISION

| ECONOMIC SECTOR DIVISION | Code |
|---|---|
| Manufacturing | 1 |
| Construction | 2 |
| Agricultural | 3 |
| Agroindustrial | 4 |
| Commercial | 5 |
| Services | 6 |
| Communications | 7 |
| Transportation | 8 |
| Energy | 9 |

3. AMOUNT

The maximum amount for each transaction eligible for funding from the Separate Account(s) shall be the total cost of the import to the importer payable in dollars for which the importer purchased dollars through the Salvadoran Banking System. Such cost may include but not be limited to the cost of goods, shipping, handling insurance and bank charges.

## VII. ELIGIBILITY DATES

Project 0310 - Balance of Payment Support Program.

A) Up to $16 million for transactions paid by the BCR between October 1, 1984 and May 9, 1985.

B) Up to the total of disbursements made under the program for transactions paid by the BCR or the local commercial banks after May 9, 1985.

VIII PETROLEUM AND DERIVATIVES

One hundred percent (100%) of the value of eligible transactions involving petroleum and its derivatives imported from 941 code countries may be charged to the Separate Account(s). In such cases, the BCR must reimburse to the Separate Account(s) within five (5) working days, the equivalent of three percent (3%) of the nominal value of the transaction which is considered to be ineligible under the program. Evidence of the reimbursement to the Separate Account(s) by the BCR must reside in the file of the petroleum import transaction. Reimbursements thus performed will be utilized to finance import transactions eligible under the program as specified in Sections IV and V, as applicable.

IX. BCR REPORTING

1. This section shall apply to all transactions funded thru the Separate Account(s).

2. For the final liquidation, the BCR will provide USAID/El Salvador with a listing of completed paid transactions for which full documentation resides in the files of the Exterior Department.

3. USAID/Private Enterprise Office (PRE) or its designee will conduct an eligibility review of all transactions presented for liquidation, reviewing documentation and evidence of payment, among other analyses. The final report will include but not be limited to the information as listed below. It is understood that the information required below may be subject to change by written notification of USAID/El Salvador.

a- BCR identification number,
b- F-10 number,
c- F-15 number and date of approval by the Exterior Department,
d- Amount of dollars charged against the Separate Account,
e- Name and NIT number of the importer,
f- NAUCA number,
g- Product category code,
h- Economic subsector code to which the product is going,

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i- Name of the exporter,
j- Country of origin,
k- Date of BCR payment,
l- Type of transaction (i.e., Letter of Credit or supplier's credit),
m- Date of payment to the exporter by the local commercial bank, (if applicable),
n- Import Certificate number and date,
o- Name of local bank,
p- Name of Separate Account(s) correspondent bank concerned,
q- Type of payment (i.e., direct or reimbursement),
r- Price Checking Unit finding on the F-10 or F-15 documents (i.e., favorable, unfavorable, etc.),
s- Amount of local currency paid by the importer for dollars disbursed from the Separate Account(s) by the BCR.

4. Listings evidencing the final liquidation of each disbursement by AID into the Separate Account(s) will be sent to USAID/PRE for review.

5. USAID/PRE, or its designee will accomplish an eligibility review of each transaction and conduct Price Verification of selected transactions.

6. Any unsatisfactory findings will be referred to the BCR for action to include but not be limited to the application of Sanctions, reimbursement to the Separate Account(s), and substitution with eligible transactions.

7. The final completed listing will indicate any differences between the amount of local currency originally deposited to the USAID account by the BCR and the total amount of local currency generated by the BCR through the sale of the Separate Account(s) dollars to the importers concerned.

8. The final completed listing after being approved by PRE or its designee shall be sent to the USAID Controller, who shall document the liquidation of the disbursement concerned and shall notify in writing the BCR of any local currency amounts yet to be made available from the proceeds of the sale of the dollars received under the program.

9. Within five (5) working days of receipt of such notification, the BCR shall cause to be deposited to the USAID local currency account at the BCR or other designated local bank such amounts of local currency as required and shall forward notification of such deposit to the Controller of USAID.

10. Following receipt of notification of such deposits, or in the absence of any amounts due, the USAID Controller's Office shall notify the BCR of the final acceptance of transactions as evidence of liquidation of the disbursement.

11. The BCR will maintain the files containing documentation for each such USAID accepted transaction for a period of not less than three (3) years commencing from the date of issuance of USAID's formal notification of acceptance of such transactions so documented.

MAR 5 1986

INFORMATION MEMORANDUM FOR THE ASSISTANT ADMINISTRATOR (LAC)

FROM : LAC/DR, Terrence J. Brown

SUBJECT: El Salvador -- ESF Balance of Payments Program (519-0310) PAAD Issues Paper

A DAEC on the subject PAAD is scheduled for Thursday, March 6, at 2:00 pm in the LAC Conference Room, 2248 N.S.

The PAAD requests approval of a $147.0 million balance of payments program to be implemented in collaboration with the Government of El Salvador (GOES) during CY 1986. Assuming approval of the package for the year, $113.0 million in FY 1986 funds ($4.0 million of the $117 million in the OYB is to be used as a country reserve for the Trade Credit Insurance Program) would be authorized pursuant to the findings and recommendations of the DAEC, with the balance to be authorized in FY 1987 funds early next fiscal year.

As with past programs, dollars provided under this action would be used to provide the GOES with the foreign exchange necessary to help it stabilize the economy and move it toward recovery. Program funds will be disbursed through a separate account in the Central Reserve Bank (BCR) of El Salvador to finance the importation of raw materials, and intermediate and capital goods essential for the functioning of the Salvadoran economy. The Mission proposes to continue the source eleigibility criteria utilized in 1985 which includes eligible items from the U.S., CBI-designated CACM countries, and A.I.D. Geographic Code 941 oil producing countries.

Under the 1985 ESF Balance of Payment Program, policy reform targets were set in seven areas: (1) exchange rate unification; (2) level and financing of the fiscal deficit; (3) management of public indebtedness; (4) consistent macroeconomic management; (5) private sector reactivation; (6) restructuring of the agrarian debt; and (7) definition of agrarian reform beneficiary rights and responsibilities. While progress was made under of some of the conditionality areas, delays in others finally resulted in the A.I.D. Administrator's waiving completion of conditions related to the the public debt question, implementation of certain recommendations on the restructuring the agrarian debt, clarification of the beneficiary rights question, payment of compensation for expropriated land. In return, the GOES agreed to undertake a comprehensive economic stabilization program, to include unification of the exchange rate.

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Following a year which saw lackluster economic performance, the GOES issued an Economic Stabilization Program in January 1986 which blends a production policy to reactivate and reorient the economy, the concept of financial stabilization, and an incomes policy. The 1986 program calls for improved performance on a number of fronts including a reduction of the balance of payments deficit that permits relative stability of the exchange rate, a reduction of the fiscal deficit, a reduction of the rate of inflation, and an increase in employment.

The Mission's conditionality strategy will seek to capitalize on advances made under the 1985 program and will concentrate on actions pertaining to one of three main areas: (1) economic policy; (2) economic diversification; and (3) consolidation of the agrarian reform. Key conditions which the Mission would ask the GOES to put in the Economic Program include:

-- Preparation of a comprehensive economic program for 1987 prior to the GOES's submission of its 1987 budget to the Legislative Assembly.

-- Establishment of limits on the indebtedness for the public sector.

-- Passage of an export promotion law and its implementation.

-- Establishment of a cabinet level export development and promotion committee which would guide and monitor progress under the export law.

-- Establishment of a joint public/private sector committee to help bring about new productive investment in El Salvador.

-- Provision of 200 million colones in GOES resources and/or ESF local currency for compensation of former landowners affected by the Agrarian Reform.

-- Restructuring of the agrarian debt to ease the financial burden of Reform beneficiaries.

-- Completion of titling under Phase I of the Reform, with 8,200 more Phase III beneficiaries receiving their titles by year end.

-- Enactment and implementation of legislation defining beneficiary rights under the Reform.

Disbursements will be made in five tranches (four from FY 1986; one from FY 1987). Prior to signature of the agreement, the GOES will submit an Economic Program for 1986 to A.I.D. which contains the conditions mentioned above, and others, and lays out indicative target dates for meeting those conditions. The Mission will meet regularly with the GOES to discuss performance against the targets and to make disbursements or adjustments, as might be indicated. Prior to any disbursements over $70.0 million, the Mission will submit a progress report to AID/W indicating the progress, or lack thereof, and obtain authorization for the remaining disbursements.

The Mission has proposed two Covenants for inclusion in the Grant Agreement to implement its conditionality strategy. The first would require GOES compliance on an on-going basis with the Economic Stabilization Program while the second would require a series of reports from the BCR on progress under the Program.

Local currencies generated under the program are to be programmed toward: (a) the public sector budget (counterpart to A.I.D. and other donor projects, the National Plan, and other priority projects under the Central America Initiative); (b) private sector support (primarily credit); and (c) Mission operating expenses and program support.

The following points were resolved in the Issues Meeting on March 4:

-- Use of program generated local currency for compensation under the Agrarian Reform will be deferred pending final approval by State and A.I.D. management.

-- Use of program-generated local currency in direct support of the GOES's National Plan will be deferred pending discussion of the Mission's strategy regarding the Plan during the Action Plan review.

-- It was agreed that the question of the Mission's strategy regarding tax reform is more appropriate to the Action Plan review. Accordingly, it will be discussed at that time rather than in the context of the PAAD review.

-- Mission representatives stated that the dates shown in Annex IV for meeting actions to be included in the Economic Stabilization Plan are indicative and do not represent firm benchmarks in time for which we will be seeking commitment.

-- The PAAD will require a brief IEE which will be prepared by LAC/DR.

Since the amount requested under this action is less than that shown in the FY 1986 Congressional Presentation, a Congressional Notification is not required.

The DAEC will discuss the following issues:

1. Conditionality Strategy.

The conditions precedent to disbursement proposed by the Mission appear to be very general in nature, particularly as regards specifics on economic policy points and, to some degree, on economic diversification. On the other hand, the PAAD lays out in some detail President Duarte's negative attitude toward conditionality, especially with respect to specificity of conditions and their timing. Should the conditions be made more specific? Or, in the alternative, should we recognize the possibility that the GOES will balk at even the proposed general conditions and prescribe a minimum fall-back position? will agreement state basic principles? objectives? areas of interest? timing/options

2. Economic Stabilization Program and 1986 Budget.

Is the stabilization program adequate? What other items should be included in the Stabilization Program? Is the estimated 45% increase in nominal central government expenditures for 1986 (Annex II, Table 1) consistent with the target of holding inflation in 1986 to 20%?

3. Price and Wage Policy.

The PAAD states that the price subsidies contained in the Economic Program represent a potential threat to the overall success of the program. While the PAAD states that the controls and subsidies package is limited in duration, it is not clear when or how the package will be terminated. Should resolution of the controls/subsidies issue be made a condition precedent to disbursement?

4. Exchange Rate.

The PAAD states that leaving the exchange rate stuck at 5:1 could result in a cost to the government of $170 million in 1986. While the PAAD refers to the possibility of addtional devaluations elsewhere, it is not clear that the GOES is indeed committed to going with an adjustable exchange rate regime. Should a mini-devaluation program or some other variable exchange rate regime be made a condition precedent to disbursement?

5. Special Account.

The procedures laid out in Annex VII to the PAAD describe a system somewhat different from that described in the FY 1985 PAAD and would allow for the inclusion of transactions of FY 1985 under the FY 1986 program. Does this run counter to what was intended in the FY 1986 legislation or any information that A.I.D. has given Congress on the account?

6. Capital Flight.

Substantial increases in payments of compensation could increase the chances of capital flight. How might these chances be reduced?

7. Sterilization of Local Currency.

Since ESF and PL 480 programs could generate as much as one billion colones during CY 1986, should some of the currency be sterilized to hold down inflationary effects?