

PP KAB913

AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON D C 20523

11.15
ASSISTANT
ADMINISTRATOR.

MAY 16 1985

ACTION MEMORANDUM FOR THE ADMINISTRATOR

THRU: AA/PPC, Richard Deham *RBH for*

FROM: AA/LAC, Victor M. Rivera *BR*

SUBJECT: Honduras Economic Recovery Program (522-0283) PAAD
Amendment

ACTION: Your approval is required to authorize \$69 million in ESF grant funds for the subject program. Disbursement of these funds will be conditioned on progress in limiting domestic credit expansion, expanding utilization of the Central American payments system, and divestiture of public sector entities.

BACKGROUND: From its inception in 1982 through 1984 the ESF program in Honduras made available a total of \$131 million of ESF funds to the Government of Honduras (GOH). Through CY 1984 the program generated several actions by the GOH in the area of economic policy adjustment. It provided the impetus for the submission to and subsequent approval and passage by the National Congress of an Export Incentive Law, approval and passage of a Temporary Import Law, and approval of a Memorandum of Understanding which contains the principal terms for the partial renegotiation of the country's external debts. The Program also resulted in the formation of a Joint (GOH-USG) Economic Working Group, the JEWG, which has considered macroeconomic policy reforms and the passage of Decree Law 85-84 which constituted a stabilization package to reduce the Central Government's deficit and excess liquidity in the banking system.

On March 17, 1985 \$72.5 million of ESF from the FY 1984 Supplemental Appropriation was obligated through a new Program Assistance (Cash Transfer) Agreement (522-0283). The funds provided through this Agreement are part of a total \$147.5 million U.S. economic support program for FY 1985 which achieves further structural adjustments that are needed to help lay the base for long-term economic growth. These include progress on debt management, efforts to stimulate the flow of credit to the agricultural sector, limitations on the involvement of the parastatal forestry company in lumber

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marketing, conversion of specific tariffs to their ad valorem equivalent, efforts to establish a legal basis for the divestiture of public enterprise, and the establishment of a special payments mechanism for Central American trade.

To date \$55 million of the \$72.5 million have been disbursed. An initial tranche of \$35 million was disbursed upon signature of the Program Assistance Agreement and \$20 million was disbursed as a result of GOH action regarding the payments scheme. The remaining \$17.5 million will be disbursed upon full GOH compliance with Conditions Precedent to Disbursement contained in the Program Assistance Agreement which require progress on the structural adjustments mentioned above. Because some of these conditions require that legislation be prepared and submitted to the Honduran legislature, it is not expected the GOH will attain full compliance for several more weeks despite significant GOH progress on several of the required adjustments.

DISCUSSION: During meetings which were held in Washington on May 2-3, the Economic Subgroup of the U.S.-Honduras Bilateral Commission reviewed GOH compliance with the Conditions and Covenants contained in the March ESF Program Assistance Agreement and discussed conditions for disbursement of the remaining \$75 million of FY 1985 ESF. A framework of conditions for obligation and disbursement of the remaining \$75 million was accepted by both sides. This framework was ratified by the Ad Hoc Inter-Agency Group on Foreign Assistance, the "Schneider Group", on May 3, 1985.

Progress on compliance with the terms of the March Agreement may be summarized as follows:

(1) Competitive Position of Exports. The GOH has introduced the special payment mechanism for trade within Central America with coverage of certain categories of exports and imports;

(2) Debt Management. Regulations to permit issuance of fixed maturity bonds have been drafted and presented to the Central Bank governing board;

(3) Agricultural Credit. Legislation to permit agricultural land to be held by financial institutions up to four years as collateral has been drafted and presented to the Central Bank and other interested GOH agencies for review;

(4) Lumber Marketing. The GOH has held a number of meetings with COHDEFOR and other interested parties but progress has been slow in this area;

(5) Tariff Reform. The GOH has requested A.I.D. technical assistance to complete the tariff nomenclature conversion. The GOH hopes to complete conversion to BTN nomenclature and ad valorem tariffs by September;

(6) Divestiture of Parastatals. Legislation to establish a mechanism for divestiture has been drafted. Submission to Congress is tentatively scheduled to take place by May 18.

The framework agreed upon at the May 2-3 meetings establishes the general economic targets and the disbursement schedule for the \$75 million of ESF available in the FY 85 OYB. These funds, which will be obligated by amending the existing Program Assistance Agreement (522-0283), will be disbursed in three \$25 million tranches on or about May 22, July 30 and October 30. The general conditions governing these disbursements include: limiting domestic credit expansion; expanding utilization of the Central American payments system; and divestiture, reduction, or dissolution of decentralized public sector entities that continue to drain scarce public resources. Indicative targets which will be refined in negotiations between the Government of Honduras and the A.I.D. Mission have been established in each of these three areas (See summary results in Attachment I). The refined, time-phased targets will be incorporated in the Amendment to the Program Assistance Agreement as conditions precedent to the second and third tranches.

Specific aspects of the agreed upon conditionality framework must be clarified as follows:

(1). Net Domestic Credit Limits. This measure sets targets for credit expansion in both the public and private sectors. The targets are to be set on a baseline commencing May 30 and must be refined in the course of further discussions in Honduras.

(2). Expansion of Coverage of the Central American Payments Regime. This measure is designed to increase the amount of trade transactions covered under the existing Central American payments regime through a variety of mechanisms including: extending the payment regime's geographic coverage; expanding the types of commodities included under the payment

regime; expanding the existing system of self-financing of imports, and, possibly, allowing free convertibility of currency. The targets are set in terms of the overall increase in the percentage of the value of trade to take place at the market rate of exchange. Discussions between the Mission and the GOH will determine the most appropriate mechanisms to be used to obtain the targets.

(3). Divestiture and Dissolution of Decentralized Public Entities. The dissolution, divestiture, or reduction in some public sector enterprises is already included as a condition of the ESF Program Assistance Agreement. The new measure follows up on that condition by attaching more specificity and additional requirements for compliance with it. During the May 2-3 negotiations agreement was reached that the GOH will present legal instruments which will lead to the reduction or elimination of at least four public sector entities annually. The interim targets will be negotiated in Honduras and will be developed based upon practical planning and feasible implementation steps for achieving this objective.

In addition to the conditions discussed above the Economic Subgroup agreed on a number of other economic policy adjustments which will be incorporated into the Program Assistance Agreement as Covenants. These include: establishment of control over external borrowing; equalization of tax treatment for public and private firms; no increase in arrearages on external public or publicly guaranteed debt; no deterioration in net international reserves; and rationalization of credit functions by non-banking institutions.

Justification to Congress: These funds were identified in the in the FY 1985 Congressional Presentation as being obligated as \$69 million in grant funds and \$6 million in loan funds. No special Congressional Notification is required to obligate \$69 million in grant funds. A Congressional Notification is being prepared which will show that the remaining \$6 million will be obligated as grant rather than loan funds.

RECOMMENDATIONS: (1) That you approve the framework of terms and conditions for utilization of the \$75 million in FY 1985 ESF funds for Honduras as outlined in this memorandum.

APPROVE

DISAPPROVE

DATE:

James H. Novis

5/16/85

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(2) That you sign the attached Program Assistance Approval Document facesheet thereby authorizing the obligation of \$69 million ESF grant funds for the purposes described therein.

CG:HFry MMJ Date 5/15/85
PPC/PDPR:ARosenberg AK Date 5/15/85

ATTACHMENTS: Tab A -- PAAD Facesheet
Tab B -- Attachment I

Drafter: LAC/DR/CEN, RJordan: (07080):5/14/85:ext.23402

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ATTACHMENTS: Tab A -- PAAD Facesheet
Tab B -- Attachment I

Drafter: LAC/DR/CEN, RJordan:(07080):5/14/85:ext.23402

Clearances:

LAC/DR, CPeasley draft Date 5/14
LAC/DR, DBJohnson DBJ Date 5/14
LAC/DP, CZuvekas draft Date 5/14
LAC/CEN, PAskin draft Date 5/13
JWC ✓ PPC/PB, JWeber draft Date 5/14
ARA/ECP, SMyles draft Date 5/14
ARA, HKopp HK Date 5/15
GC/LAC, RMeighan RM Date 5/15
DAA/LAC, MDBrown _____ Date _____

CLASSIFICATION:

AID 112D-1	AGENCY FOR INTERNATIONAL DEVELOPMENT	1. PAAD NO. 522-K-602A
		Program No. (Grant) Proj. 522-0283
PAAD	PROGRAM ASSISTANCE APPROVAL DOCUMENT	2. COUNTRY Honduras
		3. CATEGORY Cash Transfer
4. DATE May 1985		5. OVS CHANGE NO. N/A
6. OVS INCREASE None		7. TO BE TAKEN FROM: Economic Support Fund (ESF)
8. APPROVAL REQUESTED FOR COMMITMENT OF: \$ 69,000,000		9. APPROPRIATION - LESA85-35522-KG31 (537-65-522-00-50-51) 72-1151037
11. TYPE FUNDING <input type="checkbox"/> LOAN <input checked="" type="checkbox"/> GRANT	12. LOCAL CURRENCY ARRANGEMENT <input type="checkbox"/> INFORMAL <input type="checkbox"/> FORMAL <input type="checkbox"/> NONE	13. ESTIMATED DELIVERY PERIOD FY 1985
14. TRANSACTIONS ELIGIBILITY DATE		15. COMMODITIES FINANCED

A/AID:M. Peter McPherson

AA(LAC) :Victor M. Rivera

16. PERMITTED SOURCE

U.S. only: _____

Limited F.W.: _____

Free World: _____

Cash: \$69,000,000

17. ESTIMATED SOURCE

U.S.: \$69,000,000

Industrialized Countries: _____

Local: _____

Other: _____

18. SUMMARY DESCRIPTION

The purpose of this program assistance is to provide immediate balance of payments support to Honduras. The \$69 million assistance (Grant) will be disbursed as a cash transfer into the account of the Government of Honduras (GOH) in the Federal Reserve Bank of New York. The funds will be disbursed in three tranches. The first tranche of \$25 million will be disbursed upon signature of the Amendment. Disbursement of the remaining tranches of \$25 million and \$19 million will be based on GOH progress in complying with mutually agreed upon Conditions Precedent. Subject to funds availability and Congressional Notification an additional \$6 million will be authorized at a later date.

Upon disbursement of the assistance, the GOH will deposit an equivalent amount of Lempiras from their own funds in a Special Account in the Central bank of Honduras. These Lempiras will be used for mutually agreed upon development purposes which are consistent with the Foreign Assistance Act, especially Section 103 through 106. The GOH will agree to make available within a period of twelve months of the disbursement, an equivalent amount of dollars to the private sector for imports of raw materials, intermediate goods and industrial spare parts from the U. S.

19. CLEARANCES

LAC/CEN: Paskin *[Signature]*

ARA/ECP: SMyles *[Signature]* ARA: HKopp *[Signature]*

FM: CChristensen *[Signature]*

GC/LAC: RMeighan *[Signature]*

GC: HFRy *[Signature]*

AA/PPC: RDerham *[Signature]*

LAC/DP: JOlson *[Signature]*

LAC/DR: DJohnson *[Signature]*

PPC/PDPR: ARosenberg *[Signature]*

DAA/LAC: MDBrown *[Signature]*

DATE

5/15/85

5/16/85

5/15/85

5/14/85

APPROVED DISAPPROVED

[Signature] AUTHORIZED SIGNATURE

5/16/85 DATE

M. Peter McPherson, Administrator

TITLE

CLASSIFICATION:

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ATTACHMENT I

FRAMEWORK FOR PROPOSED TARGETS AND DISBURSEMENT SCHEDULE
FOR FY 1985 ECONOMIC SUPPORT FUNDS IN HONDURAS

	<u>May 30</u>	<u>July 30</u>	<u>Oct 30</u>	<u>Annual Target (1985)</u>
Disbursements (\$ Million)	25	25	25	75
I. Agreed Limits on Change in net domestic credit (Cumulative-Lempira mil.)	100	150	200	300
Public sector	(05)	(10)	(15)	(25)*
Private sector	(95)	(140)	(185)	(275)
II. Agreed Targets for International Transactions Covered by special payments regime and/or expansion in auto-financing system	10%**	15%	20%	20%
III. Submission of Legal Instruments to eliminate and/or reduce Public Sector Entities	(to be determined)		Four Public Sector Entities Reduced or Eliminated	

For Example:

FINAVI
BANASUPRO
COHBANA
BANADESA
Retail Sales
Dairy Operations
Sugar Mill
Others

* Indicative level.

** Estimate - actual figure to be calculated and
appropriate proportions maintained.

IV. COVENANTS

-Establishment of system of control over external borrowing.

-Equalization of tax treatment for public and private firms.

-No increase in arrearages on external public or publicly guaranteed debt.

- No deterioration in net international reserves.

-Rationalization of credit functions by non-banking institutions.