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SOME FINANCIAL ASPECTS OF THE CONSOLIDATION
OF THE AGRARIAN REFORMS IN EL SALVADOR

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Final Report to
U. S. A. I. D./ El Salvador

by

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J. S.

Executive Summary

1. There are 3 acute, interrelated problems involving financial aspects of the land transfer in El Salvador's agrarian reforms:
 - a. The Phase I coops cannot possibly meet their land purchase payments at present interest rates and as presently structured.
 - b. The GOES has not been able to make its own scheduled payments for the land transfer either. It is badly behind in paying interest on the land reform bonds outstanding. It has been unable to complete many cases otherwise settled, solely for lack of funds for the cash part of the indemnization. And as of now, it has no funds allocated to redeem the five-year bonds, which fall due in 1985. If the GOES is to meet all of its financial obligations connected with the agrarian reform by Dec. 31, 1985, it needs some C/300 millions.
 - c. Many former landowners are highly illiquid, and some would find new and productive activities in El Salvador if they could sell the bonds they hold, even at a discount. (Some sold recently, at 60%.)
A buyout could lighten both GOES debt service and coop land debts.
2. The GOES could address the first problem itself by reducing the interest charged the cooperatives from 9.5% to 6%. This will not solve all of the problem; it will help more if it is made retroactive to 1980.
3. Resolving problems (b) and (c) requires real, additional resources which the GOES does not now have. It would be possible to bring in additional resources in a way such that the rest of the cooperative debt structure problem was resolved as well. (They would be allowed to pay their land debt with the bonds purchased at a discount.)

4. The amounts required to get current on interest, pay those first bonds that mature in 1985, and complete indemnization for the cases already approved and only awaiting funds for the cash down payment, add up to C/216 million, of which C/27 million are FINATA debts and C/189 million are ISTA obligations.
5. If about C/121 million more were available, ISTA and FINATA could settle all of the remaining indemnization cases. This would make the land reform much more nearly irreversible, permit ISTA and FINATA to transfer the land to beneficiaries and their cooperatives, and enable all concerned to get on with other things.
6. In addition, if still more resources were available, it would be highly desirable to fund a modest buy-back program for the bonds, through the market. Purchases of bonds would be made through banks, for coops, which would then turn in the bonds at nominal value to ISTA, as payment of their land debt. This measure would preserve the principle of paying for the land, yet effectively lower the cost so most coops would still have a positive cash flow and could show members tangible benefits each year.
7. The bondholders most anxious to cash in their bonds would also gain liquidity and have resources with which to farm their "reserve" lands, pay their bank debts, or invest in agro-industry or in other activities.
8. To ensure that the improvements are permanent, certain commitments and policies should be implemented by the GOES and the cooperatives. These would include improved management in the cooperatives, admission of more members in cooperatives that have excess land, prompt liquidation of coffee delivered to INCAFE, and other policy changes designed to encourage agricultural production.

INTRODUCTION

The Problems: There are three pressing, interrelated problems concerning financial aspects of the land transfer in El Salvador's agrarian reforms:

1) Most of the Phase I cooperatives cannot meet their land debt service as presently scheduled, largely for reasons beyond their control, and a general restructuring is essential.

2) The GOES is behind in paying interest on bonds already outstanding, and in disbursing cash and bonds to indemnify ex-landowners whose cases have already been resolved. (See Table 1, p. 14, for the amounts involved.) Nor does the GOES have funds with which to pay interest due in 1985, and to redeem the first bonds (which fall due in 1985), let alone pay the cash part of indemnization to the remaining ex-landowners whose cases are not yet settled.

3) Some of the bondholders want to cash in the bonds in order to invest in farming their reserve lands, or in agro-industry, etc. A buyout arrangement (through the market, at a discount) would increase their liquidity and decrease their hostility. It could and should be set up so that it would also help reduce the land debts of the reform beneficiaries.

The Questions: Should the GOES be left to deal with these problems as best it can? Or should USAID help the process, in part through a loan that brings in additional resources that help provide agricultural inputs badly needed by the entire sector, reform and others alike? If the latter, how could it be structured to reduce the campesinos' debts so they have a positive cash flow, and to enable bondholders to cash in the bonds at a discount if they prefer liquidity? What conditions should be required, of the GOES, the bond holders and the cooperatives, to make sure the operations are successful?

BACKGROUND: VALUATION AND COMPENSATION FOR EXPROPRIATED LANDS

El Salvador's land reform laws provide reasonable indemnization to the former landowners, by international standards. (See U. N. Secretary-General, 4th Report on Land Reform, New York, 1966, for my review of valuation and compensation arrangements in a wide range of countries.) The actual individual appraisal process was reviewed in both the Checchi II and the Nathan studies, and found generally sound. No evidence was found to suggest systematic over or under-valuation of expropriated land, though clearly there were some cases of each type.

There were a few cases of apparent over or under-declaration of land values for tax purposes, in 1976 and 1977, which in turn would lead to under or over-compensation. This does not appear to have been frequent. There are allegations that ISTA, between June 1982 and June 1984, may have raised the indemnization in three specific cases for reasons more political than economic. Yet in most cases, it does not appear that the cooperatives are unable to pay the agrarian debt solely because the compensation was set too high. Rather, the studies with which the debt service was scheduled were far too optimistic -- in particular, they failed to allow for the "protection money" that some cooperatives have to pay to guerrillas, or the cost of hiring guards, or the losses inflicted as the guerrillas burn or steal crops in their efforts to destabilize the GOES. Even where these extraordinary costs are not as significant, most cooperatives urgently need better management and better accounting and control of their costs. Without this, they cannot achieve the profitability envisioned in the original ISTA/DIECRA studies of the coops' ability to pay for the land they have received.

By law, the cooperatives must repay the amount of compensation awarded to the former owner, adjusted for any change in size and other assets transferred to the cooperative. There is no insurance available to most cooperatives,

against the risks of drought, flood, or acts of war, yet in any given year any of these causes may well prevent the cooperative from making profits with which to pay its land debt. Fortunately, when any of these factors causes a problem for the cooperative, the debt service schedule may be reconsidered and changed by ISTA's Board; this has already happened in a few cases.

1. Adjustment of Cooperative Landholdings

In many cases, the original debt assigned the cooperative needs to be changed because it includes some money for lands vulnerable to erosion, and the GOES has decided that this land shall be reserved for watersheds, parks, forestry, or some other activity yielding no profit to the cooperative, at least in the short run. This part of the land debt should be reassigned to an appropriate GOES agency, or the amortization extended for a longer time.

In other cases, the members of the cooperative (the former resident laborers, usually) have refused to accept the full number of families that the original hacienda could employ. In such cases, some of the land should be split off for another cooperative, formed with additional families, now landless. The land debt of the first cooperative would, of course, be reduced in proportion to the value of the land given up.

It is also probable that some cooperative farms are too large to use all their land efficiently, just as it was under the former owners. In such cases, the cooperative should be split into more efficient-sized units. In many cases, too, part of the land might well be sold to cooperative members in individual parcels. (Some coops reportedly now obtain revenue and reduce management problems by renting some of their land to their members.)

Although these adjustments in landholdings and debts are needed, the Nathan report is conclusive in observing that for most cooperatives, farming is simply not profitable enough to cover the land debt service as now scheduled. This problem is familiar to U. S. farmers as well, although they

do not have to face the violence, protection money demands, and some of the other costs faced by Salvadoran cooperatives (and other farmers as well). Even apart from adjustments in landholdings, most cooperatives urgently need a restructuring of their debts, as is demonstrated in the Nathan Report.

2. Service of the land reform bonds.

Actual payment by the GOES of the debt to former landowners, to date, falls far short of stated intentions. Interest payments on outstanding bonds are in arrears, and there are some 129 former owners whose compensation has been determined, but has not been paid to them because ISTA simply does not have the funds for the relatively small part which must be paid in cash.

One basic problem, of course, is that the GOES faces serious fiscal problems of its own in trying to restore peace and a healthy economy. The basic question, however, is "Of what value is the 'subsidiary and unlimited guarantee of the State' that backs the bonds issued by ISTA and FINATA?" The next question, obviously, "Do campesino beneficiaries have the security to work and invest in the land assigned them, when delays in GOES payment for it prevent the issuing of legal title to it, and leave open the possibility of a reversal of the whole process?" Insecurity for the beneficiaries thus may help keep cooperative earnings low, making it harder for them to repay the debt they owe the GOES for the land they received.

The balance of this report attempts to quantify these problems, and to analyze the major options for USAID, in seeking a resolution of these very basic aspects of the economic and legal foundations of the land reform.

3. Extent of the Overdue and Unfinished Compensation Problem.

It is clear that the GOES has not put a very high priority on getting and staying current on the service of the agrarian reform bonds, nor on finding the cash with which to complete payment to ex-landowners. The GOES certainly has other pressing problems, including defense, low world prices for

,export commodities, and an unstable legislative/executive political situation little suited for making hard fiscal decisions. The executives of ISTA and FINATA also may have had higher priorities in their dealings with the budget-makers, such as finding funds for payrolls. In practice, the GOES has not given a high priority to completing compensation to all former landowners, nor to making current interest payments on the bonds already issued.

The situation of the former owners of the nationalized banks is much better. The funds with which to make the March 1985 payments to bank stockholders are already in hand at the Fiscal Agency that will make those payments. The same Agency (an office at the Central Bank) would be glad to complete the payment of interest due last year on ISTA and FINATA bonds, but the GOES has not yet provided it with funds for the purpose.

Because the interest and cash part of indemnization has not been kept current each year since 1982, the amount now required has become quite significant -- some C/335 million would be needed this year to get current, meet 1985 obligations, and pay off the remaining ex-landowners. This is about twelve times the amount which the GOES is rumored to be budgeting for 1985.

Unfortunately, this makes it appear that the GOES does not consider it important to indemnify former landowners. It is possible that the lack of full and prompt payment of the indemnization specified by law even contributes to the climate of violence. And if the interest is unpaid, despite the GOES "unlimited guarantee" of payment of interest and principal on its bonds, land reform and others, can the citizen have confidence in other GOES promises?

We suggest USAID ask its attorneys to study whether unpaid former landowners could go to the Courts for restitution of the land to them, since it has not been paid for? The non-payment has reportedly already led some ex-owners to tell their former workers, now reform beneficiaries, that since no payment has been made to the ex-owner for the land, it does not belong to

the beneficiaries and never will. (As of mid-January 1985, this applies to some 129 cases where compensation has been determined but not paid, and to some 59 more cases where the amount has not yet been set.)

When the land hasn't been paid for, it cannot be transferred to ISAT, and ISTA cannot transfer it to the cooperative and its members. Even when it has been paid for but then the interest isn't being paid on the bonds, the workers and the ex-owner may well believe that the land will someday be returned to the ex-owner, either by court order or by the action of a future conservative government. This uncertainty probably discourages effort by the beneficiaries to invest in and improve the cooperative farm. The arrears on bond interest due and on cash down payments for cases already determined, also give the remaining ex-owners no reason whatever to bother bringing needed documents, or to negotiate seriously and settle the amount of compensation due them. Thus both economic and political considerations suggest the urgency of a study of the legal risks raised by the non-payment of the bonds, interest and cash down payments.

Option I: The GOES Moves On Its Own

Could the GOES address these three problems itself? The answer is "Yes," but only if the GOES were to decide to give them a greater priority than it currently gives in competition with defense and other programs.

1. Debt Restructuring for the Cooperatives.

The first problem, the need to restructure the land debt of the campesinos, could be addressed by the GOES, and it probably will be. Since the beneficiaries cannot pay the 1985 debt service anyhow, very little is lost by giving them lower interest rates, additional grace periods and longer terms. (The Farmers Home Administration is doing the very same thing in the USA today, to give U. S. farmers a positive cash flow.)

Likewise, the C/75 million in "Cartera" loans of 1980 could and should be simply written off by ISTA as uncollectible "social costs" of that tumultuous first year of the reforms. Little of this poorly-documented debt will ever be paid; so little is lost by writing it off. (According to the Nathan Report, ISTA in turn owes this money to the GOES, which issued a long-term bond a few years back and gave it to ISTA. ISTA then used the bond to pay off the BFA, which earlier repaid the other banks that provided the money in 1980. Therefore, the BFA presumably now holds the bond in its investment portfolio.)

2. GOES Service of the Debt Due to Former Landowners.

Getting current on the interest and principal repayments of the GOES debt to former landowners, however, requires real resources from somewhere, and so does any arrangement to cash in bonds before they mature, even at a discount. Getting current and completing cash down payments to former landowners would require about C/337 million, almost 13% of all the projected GOES expenditures for 1985. (It could have been done for less in 1984; in May 1985, the first batch of ISTA bonds falls due, for some C/60 million. The next ISTA bonds aren't due until 1990, though FINATA must retire small amounts of its bonds every year starting now. (See Appendix B for detailed schedules of ISTA and FINATA bond redemption.)

3. Discounting Land Reform Bonds in the Market.

A program to buy out the agrarian reform bonds at market value (now about 60% of face value) could easily absorb another C/500 million, or 20% of 1984 GOES expenditures. (About C/800 million will be issued, between ISTA and FINATA, when indemnization is complete.)

Many bondholders claim that they are eager to cash in the bonds, and several possibilities are contemplated in the laws and in ideas floating around San Salvador. For instance, the GOES could buy up the agrarian reform

bonds itself, say by selling state enterprises. It could force banks and savings & loan associations to auction properties they have foreclosed upon, with the financial institutions then holding the bonds in their portfolios. Entrepreneurs thus get enterprises to manage, and government and banks get rid of unprofitable assets they have no way of managing very well. This idea has been around for three years, with apparent political backing in both the PDC and ARENA, yet COSAIN has declined to sell its enterprises, and the banks have not seen fit to auction the foreclosed properties.

Instead, the main program of the GOES to help bondholders who want to sell, is to accept the bonds in payment of estate and gift taxes, and now in payment of almost all kinds of taxes that are overdue since 1983 or earlier.

According to a broker I interviewed on January 16, 1985, this new program has raised the market price of the bonds from around 40 to around 60, just in the last few months. Even though sales have picked up, compared to a year ago, the broker stated that the supply of bonds at 60 is still well in excess of demand. (The supply of bonds will be greater still if ISTA and FINATA finish paying indemnization in the cases already approved but pending for lack of the cash down payment.)

Thus even if the GOES can come up with some cash to buy bonds, any buyout should be postponed until after the "window" allowing the use of these bonds to pay overdue taxes closes, on February 28, 1985. Such use will reduce the supply of bonds for sale somewhat; since the "window" only opened in November, 1984, and it closes February 28, 1985, no figures are yet available on how many bonds have been turned in. (The scheme is a good idea if the opportunity is limited to a short time, and if there was little probability that the back taxes would otherwise have been paid at all.)

In any case, this use of the bonds will be offset as the supply of bonds will increase when pending compensation payments are made.

Option II: External Economic Assistance

The whole situation could be enormously eased, and an air of greater seriousness given to the financial arrangements surrounding the land reforms, if the USAID lends the GOES an additional US\$100 million on concessionary terms. The dollars could (for example) be used to finance the importing of agricultural inputs. The important thing is that the colones thus generated would be used to get current on interest, meet 1985 debt service, make all the pending indemnization payments, and to buy up some of the bonds and use them to help restructure the debts of the cooperatives.

1. Relevant Figures:

The Phase I coops are in general able to repay their production credits. (These were about C/172 million in the 1983/84 crop year, according to the Nathan Report.) The greatest problem here is the absence of any insurance scheme or writeoff arrangement for those cooperatives whose crops are reduced or wiped out by violence or natural disaster.

However, many coops object to repaying ISTA the 1980 "emergency" loans, whose receipt and uses are poorly documented (total, about C/75 million.)

Worst of all, almost all coops are simply unable to meet the agrarian debt as now scheduled. In principal and interest from now until 2010 A.D. the coops are supposed to pay close to C/2,000 million. More important than the total is the fact that the first amortization is due in 1985, for some C/120 million. Tentative profit estimates for 1984 suggest that the coops are unlikely to be able to pay more than about C/25 million, or about 20%.

About C/381 million in ISTA agrarian bonds are outstanding now, and about C/263 million will be issued to settle the remaining ISTA cases, for a total of some C/644 million. FINATA has a separate emission, of C/50 million in 7% bonds.

The first IQSTA bonds are due in May, 1985; some C/61 million in 5-year, 7% bonds issued for machinery, livestock and inventories. 1985 will bring other urgent needs as well: there is also overdue interest of C/ 28 million, further interest of C/ 28 million falls due in May 1985, and ISTA needs C/72 million in cash (including back interest) just to complete payment to ex-landowners for whom the amount of compensation has already been determined. It will also need an estimated C/30 million more in cash, to settle the other cases still pending. All of these needs add up to C/219 million for 1985. However, according to a senior member of the ISTA technical and planning staff, rumor has it that the GOES may have budgeted only C/20 million for 1985, to cover all of these outlays.

FINATA, too, is behind on payment of interest on its bonds, and on cash with which to cover the down payment for pending indemnization cases. Yet FINATA planners said that they do not expect to receive funds with which to make any payments on FINATA's debts, which themselves require at least C/23 million in 1985.

A. Total Funding Requirements

The projected 1985 sources and needs for funds for both ISTA and FINATA are shown in Table 1. The shortfall, if the agencies are to get current on debt service and to pay off all pending indemnization cases, amounts to C/337.1 million.

According to a public statement by the BCR, the projected fiscal deficit for 1985 is already C/750 millions. We did not have enough time to find out how much that preliminary budget contemplates for ISTA and FINATA debt service and indemnization. However, it seems unlikely that the GOES, facing many urgent problems, plans to provide C/337 million just to get up to date on interest payments and make compensation payments for pending cases.

Table 1

GOES OBLIGATIONS RELATED TO LAND TRANSFER IN THE AGRARIAN REFORMS

<u>Category</u>	<u>ISTA</u>	<u>FINATA</u>	<u>TOTAL</u>
	(millions of colones)		
1. Interest due but not paid, through 1984:	28.1	6.9	35.0
2. Interest due in 1985:	27.6	5.7	33.3
3. Bonds due for redemption in 1985:	59.8 (a)	2.0 (b)	61.8
4. Cash payments pending for indemnization cases settled, unpaid for lack of cash:	18.8	12.3	31.1
5. Interest payments due (1980-85) on bonds pending delivery, in those same cases.	<u>54.5</u>	<u>(c)</u>	<u>54.5</u>
6. Total resources needed to get up to date:	188.8	26.9	215.7
7. Cash payments estimated necessary in order to complete settlements with remaining former landowners:	30.0	57.9	87.9
8. 5-year bonds estimated to be issued as part of those settlements, due in 1985:	(c)	n.a.	--
9. Interest payments, 1980-1985, for all those settlements:	<u>(c)</u>	<u>33.5</u>	<u>33.5</u>
10. Total cash resources needed to complete the indemnization process in 1985:	30.0	91.4	121.4
11. Total resources needed in 1985 to get up to date and to complete indemnization	218.8	118.3	337.1

Sources: ISTA, FINATA and the BCR, Jan. 15 and 16, 1985. All figures subject to refinement, but orders of magnitude are firm.

Note a: Five-year Class A Preference bonds. The original emission of C/61 million, less C/1,166,200 turned in by banks for Bonos de Compensación. Only C/43,637,900 had actually been issued by Dec. 31, 1984. However, most of the rest will be issued as pending compensation is paid. The 5 years runs from May 1980, when the land was expropriated, not from the time the bonds are delivered to the ex-landowner. Thus some of these bonds will be due and payable by the time they are issued.

Note b: A sinking fund requirement.

Note c: Included in (1), (2) and (3) above.

Table 2

RESOURCES POTENTIALLY AVAILABLE FOR 1985 OBLIGATIONS

<u>Category</u>	<u>ISTA</u>	<u>FINATA</u>	<u>TOTAL</u>
	(Millions of colones)		
12. Payments now scheduled to be made by reform beneficiaries:	120	3.9	123.9
13. Percentage of these likely to be paid:	20% (a)	33% (a)	
14. Amount likely to be collected:	24.0	1.3	25.3
15. Budget support approved, debt service: (Highly unofficial and uncertain)	20.0	0.0	20.0
16. Total resources available, 14 + 15:	44.0	1.3	45.3
17. Less amount required (11, above)	<u>217.3</u>	<u>118.3</u>	<u>335.3</u>
18. Projected shortfall for 1985:	173.3	117.0	290.0

Sources: ISTA, FINATA and BCR, 1/15 and 1/16/85.

There was not enough time to obtain an indication from the appropriate office of the likely budget allocation for debt service, if any. Line 15 is merely an indication from ISTA and FINATA planning staff. All other figures subject to refinement, but orders of magnitude are fairly firm.

Note a: Estimated, from past experience. For FINATA, see Appendix C.

Note b: It would be desirable for both ISTA and FINATA to complete indemnization cases not yet settled, in 1985. However, they would not be able to do so without some reinforcement of staff. FINATA, especially, needs more personnel for valuation, survey and similar technical steps in the indemnization and adjudication process. The agency staff working on transfer to the beneficiaries, and registration of those titles, could also do with a good deal of reinforcing, to accelerate that process. The same is true for work on defining coop membership rights and responsibilities, and on restructuring many of the cooperatives' landholdings.

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It is even less likely that the GOES will increase the deficit by another C/280 millions in order to buy up the agrarian bonds now outstanding or to be issued, but not due to be paid off until after 1985. (We assume that this could be done at around 40% of nominal value of the C/700 millions we project will be outstanding when the 5-year bonds are paid off, and all pending ISTA and FINATA compensation cases have been completed and those bonds issued. However, some of the bonds will have already been retired by the current scheme allowing use of land reform bonds at nominal face value in payment of overdue taxes from 1983 and before.

B. Restructuring the Beneficiaries' Debt

The restructuring of the cooperatives' debt, on the other hand, could be done with very little real cost. At best, the coops are only likely to be able to pay about C/25 million in 1985 on the agrarian debt and the "Cartera," so restructuring would only cost ISTA about that amount of income that it might otherwise receive.

ISTA is supposed to hold such receipts in trust for future bond service, but this is not a realistic expectation in ISTA's own impoverished condition. If the GOES and/or USAID supply cash to enable ISTA to meet the debt service, ISTA could very reasonably be required to allow beneficiaries to turn in bonds bought in the market, in payment of principle and interest on the land debt. In turn, these would lighten ISTA's needs for funds in coming years, since it would already have retired those bonds.

C. Making a Bond Buyout Help the Campesinos

If resources were available for a massive buyout, bond prices might rise even above the present 60% of face value. However, that seems

'unlikely. It is also unnecessary. Some, but not all, of the holders have projects to invest in, and urgently need to sell the bonds.

Any buyout should first wait for the overdue tax "window" to close Feb. 28, whereupon the bond prices should fall back to 50% or less. Then it would be politically very important it not appear that the sole purpose of the program was to pay off the ex-landowners. The easiest, and the most just, way to do this would be to design the program as another step in lightening the bond debts of the beneficiaries. The phase I coops are presently scheduled to pay C/120 million during 1985, on their land debts. If they were allowed to pay in bonds at their nominal value, they could buy those bonds for C/60 million or less, and the debt burden would be cut in half.

If the cooperatives did not have C/60 million in cash for debt service, which is likely, whatever amount they do have -- say C/25 million -- will still buy at least double that amount in face value of bonds, in the market. Even this would enable those bondholders most eager to cash in their bonds, to do so.

Analysis

If the first option is pursued, with the GOES being left to do what it can with its own resources, it is likely that the situation will not improve at all. Rather, experience suggests that the GOES will fall farther and farther behind on interest payments, will fail to redeem the bonds maturing in 1985, and will be unable to come up with the cash to settle pending cases. In many of the 129 cases in which compensation has been determined but has not yet been paid, owners will give up hope of ever receiving compensation, and may well demand and get court orders returning the land to them.

The owners of the other 59 properties who have not yet settled will have no incentive to do so, and some may demand return of the land. In El Salvador and in Washington, the reform would be labelled a "mistake" and a "failure," though in fact the failure to pay would be a deliberate budget decision made by the GOES, which is overcommitted by the war, restrained by the IMF, and politically unwilling or unable to raise taxes.

Certain steps to make the bonds more useful are possible, requiring only administrative decisions -- e.g., sell state enterprises and force banks to sell foreclosed collateral, in exchange for agrarian reform bonds. These steps do not affect the total supply of money or credit, and they do not require budget resources. They simply lead to the exchange of one illiquid asset for another. Yet the GOES has not pursued this plan, and we do not expect it to do so any time soon.

The present policy of accepting bonds at face value in payment of overdue taxes actually reduces tax receipts, to the extent one thinks any of these taxes would otherwise be paid in cash. None of these measures will take care of the interest arrears, nor provide the cash down payment for compensation pending for many properties.

The second Option, with external financing, is much more likely to succeed in resolving both problems, as well as alleviating the foreign exchange situation of the GOES. In this option, beneficiaries would buy bonds, at a discount, and would thus get help in meeting their agrarian debts. The arrearages of interest would be eliminated, compensation pending would be paid, and many coops would have a positive cash flow and be able to meet their obligations. Restructuring would only be needed for a minority of cases, mainly those affected by the violence or in need of total reorganization anyhow.

Desired Complementary Measures (Conditions?):

1. Certain economic policies ought to be modified, to make investment in El Salvador more attractive and hence make it more likely that bondholders would invest, rather than buy dollars in the black market, and to make the cooperatives (and all other producers) more profitable. Chief among these would be:
 - A. INCAFÉ would be required to liquidate coffee delivered to it within 30 days, paying a blended price (from quota and non-quota markets). INCAFE would itself borrow from banks and bear the financial burden when it speculates that prices will rise. (This lower, more realistic price to growers should perhaps be timed to coincide with the payment of a higher exchange rate.)
 - B. The 1980 loans would be written off completely by ISTA. Those coops that already repaid in part would get refunds if ISTA were unable to document the appropriate use of the money in 1980.
 - C. The "Cuentas restringidas" would be limited to recovery of current production credit and current payments on investment loans from the banking system. ISTA would never again seize surpluses just because it needs the money, as it did last year, calling them "anticipated payments on the agrarian debt." (Coops might be required to authorize retention of current payments due on the agrarian debt, once it is written down through the project.)
 - D. The dollars provided through the proposed loan would be sold to importers at the parallel market rate, who would be allowed to sell the imported items at a corresponding price in colones.

2. Certain policy changes are also in order to be sure that the coops do not simply again fall into problems and become unable to meet the new, reduced debt service requirements:
 - A. CARA and ISTA would agree to extend the present grace periods by one year for all cooperatives, in order to have time to buy a supply of land reform bonds at a discount, and apply that same discount to the annual payments required of the cooperatives.
 - B. CARA and ISTA would agree to restore the coop management project to FESACORA, with ISTA's federations serving other purposes.
 - C. CARA and ISTA would establish a task force to study and propose rules defining coop membership, entry, exit, rights, etc., with participation by beneficiaries in the task force. (Might this be a role for ISTA's Federations?)
 - D. Each coop not at full cabida now would be required to accept new members or give up part of its land to others before its debt is adjusted downward, and before 1986 production credit is granted.

3. It is assumed that bondholders who cash in bonds (at a discount) will invest this money in the country, if the climate has become more attractive. However, that is at least in part beyond the control of the GOES, since the continuing civil conflict is a major disincentive. If the GOES does not adopt the policies prescribed in (1) above, or if capital flight is still a concern, then the GOES might well consider alternatives to a simple buyout at a discount. For example:
 - A. Bonds might be made discountable only through a bank, at a bank interest rate until their maturity, for persons who have a

specific project in which to invest. The BCR would make the colones available to the banks for this purpose; the banks would presumably be allowed to charge a fee for their services. A 25-year 6% bond due to be redeemed in 2005 A.D., if discounted at typical bank loan rates, would be worth about 40% of its nominal value.

- B. Bonds might be accepted in payment of current and overdue obligations to banks by persons with ongoing business operations, including but not limited to agriculture. Again, they would be accepted at discounted value, but the bondholder would become current on other obligations and presumably have improved liquidity.

Could this discount mechanism still lead to capital flight? Perhaps, but not often. Theoretically the bondholder could still buy dollars in the black market, with the cash with which he would otherwise pay his current bank obligations. However, if he did not have that cash, there would be no capital flight as a result of this use of the bonds. The general situation of the banks would be improved, since loans that otherwise might go bad would become current.

What would the banks do with the bonds? The GOES would reimburse the banks for the bonds at their discounted value, or it might even simply allow the banks to exchange them for the 12% "Compensation" bonds, as was done for other land reform bonds which the banks received in payment of debts to the banks secured by mortgages on land which was expropriated.

- C. As a third option to remove the bonds (and the debt service for them), banks and Savings & Loan Associations could be urged by the monetary authorities to auction off foreclosed collateral, accepting agrarian reform bonds at nominal value. The banks would sell to the highest bidder. They would then have two options: Hold the bonds until maturity, collecting 12% annual interest, as they are already able to do with agrarian reform bonds they received when mortgaged properties were expropriated. Or the GOES could offer to cash in those bonds at 40% of nominal value, plus 100% of any accrued interest.
4. One further suggestion concerns medium-term investment. As each coop builds its equity through land debt payments, it should be allowed to borrow against that equity for profitable medium and long-term capital projects. In this way, beneficiaries could see tangible new things happening, to their benefit, rather than merely seeing increases in their net wealth, on paper. (This assumes that AID, IDB or IBRD have provided the BFA with resources that can be loaned for medium- and long-run productive investments in agriculture and in processing activities. The land equity just makes the coop credit-worthy for these loans.)

SOME ISSUES FOR FURTHER DISCUSSION:

- 1) If funds are found for a buyout of the bonds, shall there be a publicized buyout offer for all bonds? Or would it be better as a much more discreet purchase, probably by the BFA, announced as being intended to enable cooperatives to pay off their agrarian debt in bonds?

I am concerned about the recent precedent of accepting the bonds at nominal value in payment of overdue taxes. If a general offer is made by the GOES, it strikes me as likely that bondholders will -- far from being grateful -- demand cash at nominal value.

If it is an offer through the BFA, for only a fraction of all the bonds outstanding at the time, then it will be seen as a business proposition -- "If you want it, fine, and if you don't want it, fine." Many will want it, but they will be quieter about the discount, thinking that they are getting at least something, and that some other bondholders will get nothing, at least for now.

- 2) In the initial briefing at the Mission, I was asked to focus on ISTA's debt and ISTA's beneficiaries. Shall we also address FINATA's debt service, which is significant, although much less than ISTA's?
- 3) What relative importance should be paid to getting the following done:
 - a. Payment of all the back interest.
 - b. Getting the 5-year bonds paid off punctually on May 19, 1985.

- c. Getting the cash and bonds disbursed to those former owners for whom the price has been set, but not paid, for lack of cash.
 - d. The same, for former owners dealing with FINATA.
 - e. The compensation of the remaining 90 or so Phase I cases, for which no definitive decision has yet been made.
 - f. The same, for former owners dealing with FINATA.
- 4) Do we really want to include a C.P. requiring the liquidation of all coffee by INCAFE? Clearly, something of this sort is urgently needed for the good of all coffee producers, and not just the cooperatives. Yet it will be a major upheaval in a GOES institution, requiring INCAFE to obtain its own financing, and to pay a lower, but more realistic price.

At the lower price, campesinos would still be able to make money growing coffee on small plots, just as thousands of land reform beneficiaries do in Colombia. But many large producers would find it unprofitable. El Salvador is unlikely to get International Coffee Agreement quotas for all the coffee grown, and non-quota coffee brings less than half the price of quota coffee, so a price averaging the two is in order. Those who cannot make money at that price should sell their coffee land in small parcels to campesinos who can grow coffee profitably at these more realistic prices, using family labor instead of hiring, as the medium and large coffee growers must.

The new, lower price should be introduced at the same time any adjustment in exchange rates is made, to soften the blow and avoid any reduction in INCAFE's price in colones. Let me know if you would like an analysis of this marketing issue, the alternatives, and the implications for INCAFE, the banking system, the GOES, and the small, medium and large producers.

.V/

APPENDICES

APPENDIX B

AMORTIZATION SCHEDULE, LAND REFORM BONDS

1. ISTA bonds: The first emission of ISTA bonds was for C/610 million, divided among four classes:

Class A, Preference These pay 7% interest and mature in 5 years;
 Class A Bonds. These pay 6% interest and mature in 20 years;
 Class B Bonds These pay 6% interest and mature in 25 years;
 Class C Bonds These pay 6% interest and mature in 30 years.

In August 1984, a second Resolution authorized the emission of another C/140 million, all in bonds of Class A, maturing in 20 years. The 1984 Decision modified the amortization schedule slightly, but only for this class of bonds. The present amortization schedule for each class of bonds is as follows:

<u>Year</u>	<u>A Preference</u>	<u>Class A</u>	<u>Class B</u>	<u>Class C</u>	<u>Totals</u>
1984	C/ ---	C/ ---	C/ ---	C/ ---	C/ ---
1985	61,000,000	---	---	---	---
1986	---	---	---	---	61,000,000
1987	---	---	---	---	---
1988	---	---	---	---	---
1989	---	---	---	---	---
1990	---	---	---	---	---
1991	---	40,000,000	---	---	40,000,000
1992	---	40,000,000	---	---	40,000,000
1993	---	40,000,000	---	---	40,000,000
1994	---	40,000,000	---	---	40,000,000
1995	---	40,000,000	---	---	40,000,000
1996	---	42,000,000	---	---	42,000,000
1997	---	42,000,000	---	---	42,000,000
1998	---	42,000,000	---	---	42,000,000
1999	---	42,000,000	---	---	42,000,000
2000	---	97,000,000	---	---	97,000,000
2001	---	97,000,000	---	---	97,000,000
2002	---	---	6,500,000	9,400,000	15,900,000
2003	---	---	6,500,000	9,400,000	15,900,000
2004	---	---	6,500,000	9,400,000	15,900,000
2005	---	---	6,500,000	9,400,000	15,900,000
2006	---	---	7,000,000	9,400,000	16,400,000
2007	---	---	---	9,400,000	9,400,000
2008	---	---	---	9,400,000	9,400,000
2009	---	---	---	9,400,000	9,400,000
2010	---	---	---	9,400,000	9,400,000
Totals	C/61,000,000	562,000,000	33,000,000	94,000,000	750,000,000

Note: All payments of interest and principal are due, for all classes of regular ISTA bonds listed above, on May 19 of each year.

Note: Many of the ISTA bonds issued as of December 31, 1984, according to the ISTA Fiscal Agency at the BCR, are still in ISTA's safe, awaiting delivery when cash is available for down payments, or awaiting other formalities. The BCR figures are:

Class A preference	C/ 43,637,900
Class A	422,675,900
Class B	18,244,500
Class C	<u>34,861,700</u>
Total	C/ 519,420,000

2. FINATA Bonds. Thus far, there is only one emission. All of these bonds pay 7% interest, mature in 20 years, and are subject to a gradual redemption plan. According to the "boiler plate" on the bonds themselves, the FINATA bonds to be retired each year must be chosen by "llamamiento o por sorteo," that is, by a lottery. The bonds whose serial numbers are drawn are paid off at par even though they have not yet matured.

Perhaps by oversight, there is no provision in the FINATA bonds, for their redemption through the market. The schedule is as follows:

1985	C/2,000,000
1986	2,000,000
1987	2,000,000
1988	2,000,000
1989	2,000,000
1990	2,000,000
1991	3,000,000
1992	3,000,000
1993	3,000,000
1994	3,000,000
1995	3,000,000
1996	3,000,000
1997	4,000,000
1998	4,000,000
1999	4,000,000
2000	4,000,000
2001	<u>4,000,000</u>
Total:	C/ 50,000,000

1. All payments of interest and amortization are due on Nov. 13 each year.
2. More than 75% of the bonds issued to date have been converted by banks into "Bonos de Compensación," which pay 12% annual interest and otherwise simply take the place of the original bonds. They are also due each year on November 13, starting in 1985.
3. Both FINATA and ISTA bonds are negotiable. At present, all of these bonds may be used at nominal (face) value for paying taxes overdue from 1983 or earlier. This "window" is supposed to be closed on Feb. 28, 1985; when this happens, the market value of the bonds will probably fall from around 60% (for many recent transactions) to 40-50% again, where they traded in a very thin market for the last several years.

3. "COMPENSATION BONDS" FOR FINANCIAL INSTITUTIONS

Many of the land reform bonds were not given to ex-landowners at all. Rather, whenever there were mortgage debts outstanding, one of the banks was named "Liquidating Bank" by ISTA. It received all of the bonds necessary to cover all of the mortgage debts outstanding (provided the appraised value and indemnization were that great), and divided them among the lending institutions according to their respective claims.

Since the loans had been yielding rates around 13-14% a year, the bonds (mostly paying 6% interest) were going to give the banks sharply reduced income. The GOES decided to create another class of bonds, for which banks -- but only banks, and not even other mortgage lenders -- could exchange the original land reform bonds they received. These new "Bonos de Compensación" would pay 12% annual interest. The annual payments of interest and amortization fall due on November 15 of each year, starting 5 years after their emission (which was on Nov. 15, 1981). The ISTA compensation bonds are to be amortized through a lottery or by purchase in the market, at no more than face value, according to the following schedule:

<u>Year</u>	<u>Amortization</u>
1987	C/ 5,000,000
1988	5,000,000
1989	5,000,000
1990	5,000,000
1991	5,000,000
1992	10,000,000
1993	10,000,000
1994	10,000,000
1995	10,000,000
1996	10,000,000
1997	25,000,000
1998	25,000,000
1999	25,000,000
2000	25,000,000
2001	25,000,000
Total	C/ <u>200,000,000</u>

Notes:

- 1) The amount shown for each year is to be amortized through purchase in the market, "At not more than nominal value of each bond," or through a lottery, in which those bonds whose numbers are drawn will be paid off at their nominal value, whether the holders wish or not.
- 2) Since bonds of this class simply replace the bonds of the other four classes, these amounts do not increase the total amortization to be paid, though they may conceivably alter the amounts in any given year.

Quantities of ISTA Compensation Bonds to 31/12/84:

<u>Bonds Turned In</u>		<u>Amount</u>
Class A, Preference (7%, 5 years)	C/	1,166,200
Class A (6%, 20 years)		93,111,100
Class B (6%, 25 years)		4,081,300
Class C (6%, 30 years)		<u>6,826,000</u>
Total issued to 31 Dec. 1984:	C/105,	184,600

NOTES:

1. The maximum authorized issue of these bonds is a total of C/200 million. As compensation payments are completed, it is very likely that many of the bonds will go to mortgage lenders, and will be converted into these bonds by the banks involved. The banks making the exchange receive 12%, 20-year bonds, regardless of the class of ISTA bonds they turn in for exchange.
2. All of these bonds were emitted on November 15, 1981, and bear interest from that date. Interest payments and partial redemption occur on November 15 of each year, rather than on May 15, as for the original land reform bonds.
3. These bonds are direct obligations of ISTA, with the "garantia subsidiaria e ilimitada del Estado." In addition, the State will pay the interest rate differential during the first 5 years, "if the cooperatives cannot pay it." There has been no effort to identify individual coops and determine whether they can pay -- the GOES has just accepted this obligation.
4. It is still not clear to me whether the GOES is also responsible for paying the difference between the 7% interest on the FINATA land reform bonds and the 12% due on compensatory bonds obtained by banks in exchange for FINATA bonds received when mortgaged land is expropriated or purchased.

In either event, FINATA's current budget appears quite insufficient to cover the 1985 obligations. The GOES will have to provide the funds if the 1985 interest is to be paid; the question is whether it will choose to do so by funding FINATA's operating budget adequately, or will leave that budget underfunded and make up the interest rate difference separately, in the budget of the Finance Ministry.

5. The amortization schedules should be reduced by the bonds exchanged for Bonos de Compensación by the banks -- and then increased by the debt service scheduled for the Bonos de Compensación. The matter is not simple, however, because the amortization date is different for the compensation bonds and for the other 4 classes. Also, some amortization of the compensation bonds is due every year starting in 1987, whereas once the A Preference series is paid off in 1985, no further amortization is called for until 1990 in the regular bond series.

6. The C/1,166.299 (out of C/61 million in A, Preference 5 year bonds) exchanged by banks for compensation bonds, will thus not have to be paid off in 1985 after all.
7. Normally, it will be in ISTA's interest to buy bonds in the market (i.e., at a discount) each year, rather than use a lottery to determine which bonds to pay off at nominal value each year. If possible, the laws or regulations should be changed to allow FINATA to comply with its amortization schedule in the market as well as by lottery.
8. The present proposal, however, calls for allowing campesino cooperatives to acquire land reform bonds in the market themselves, as part of the restructuring of their land debts. The cooperatives will turn the bonds in to ISTA in payment of the annual land debt service.

It will probably be necessary to adopt a formal Resolution to provide that bonds so acquired by ISTA may also count toward the annual amortization requirements. Thus if beneficiary cooperatives were to acquire bonds in the market for, say, C/40 million, and use them to pay off ISTA, ISTA would cover its amortization requirement in most years.

It is not so clear how the "carpentry" for FINATEROS might be done; probably the BFA or the credit cooperative groups would serve as the intermediaries, acquiring bonds in the market for payment of land debts. It might also be worth a legal study to determine whether FINATA could just on its own accept the bonds in payment, at their nominal value.
9. It is important to avoid double counting; remember that Compensation bonds held by banks reduce the other four series of bonds by like amounts. The total authorized is only C/750,000,000 for ISTA, including the C/200 million authorized in Compensation bonds. FINATA has only one emission authorized, for C/50 million, which includes both regular and Compensation bonds.

APPENDIX C

FINATA: COMPARISON OF SCHEDULED AND ACTUAL RECEIPTS

Campesino beneficiaries of FINATA are invited to choose their own payoff period, up to 30 years maximum. A substantial discount (33%) is given for any who pay off in cash. Beneficiaries are charged 10% annual interest on balances due.

Many beneficiaries, over-optimistic, chose to sign up for fairly short pay-off schedules, such as two, five, or ten years.

The following table compares scheduled and actual receipts for the first three years of the program; of course, the scheduled receipts will rise steadily as additional beneficiaries sign debt agreements during the process of granting definitive titles.

Table 4

<u>Year</u>	<u>Scheduled Debt Service</u>	<u>Actual Debt Payments</u>	<u>Amounts Overdue</u>
1982	C/ ---	C/ 3,684 (1)	C/ ---
1983	395,600	104,000	291,600 (2)
1984	2,200,000	696,400	1,503,600
1985	3,900,000		
1986	7,700,000		
1987	11,600,000		
1988	15,500,000		

Notes: (1) Payment in full, in cash, net of the 33% discount given for full cash payment upon receipt of definitive title.

(2) FINATA has hired "promotores" (whose basic daily wage is paid by AIFLD or campesino organizations), who receive 2% of the overdue land debt payments that they manage to collect from beneficiaries. As there are now about C/1,800,000 overdue, if all were collected the "promotores" would receive 2% of that, or C/36,000 in commissions.

General Note: FINATA usually pays 50% of total indemnization in cash and the balance in bonds; cash payment is 25% and bonds 75% when the holding is unusually large. Bondholders normally receive 7% a year in interest. Since the beneficiaries pay 10% a year interest, it would appear that FINATA should come out ahead. This is not the case, for two reasons:

- A. FINATA pays the indemnization first, and only after having done so can FINATA issue the definitive title and begin collecting from the beneficiary; and
- B. Most ex-landowners owed mortgage lenders at least 50% of the value of their land, and hence turn all the bonds over to the banks -- which immediately exchange them with FINATA for 12% "Compensation bonds." Thus FINATA loses 2% instead of making 3%, on that part of the land transfer financing. .

To be sure, FINATA pays no interest on the cash part of the land indemnization. The beneficiary repays the full price of the land, whether FINATA paid in cash or in bonds. In addition, many beneficiaries agree to pay their land debts in less than the 20 years that FINATA has to redeem the land bonds, though some take as much as 30 years. FINATA has not yet calculated the net balance of all these factors, which in any case may change as FINATA finishes compensating all former landowners, formalizes the land debt of beneficiaries, and collects that debt.

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APPENDIX D

BONDS RECEIVED IN PAYMENT OF TAXES, TO 31 DEC. 1984:

1. Interest coupons already due have been received, in payment of current taxes, for at least C/217,365. The Treasury sends these to the BCR, demanding payment of them from any resources ISTA and FINATA have for debt service.
2. Bonds have been received for payment of gift and estate taxes as follows, in a practice permitted by law from well before the land reforms:

Bonos ISTA	C/26,548,700
Bonos FINATA	4,028,800
Bonos CEPA (A Commission)	2,000
Bonos BFA	420,400
Bonos ICR (Instituto de Colonización Rural)	25,000
Bonos CEL (Hydroelectric Utility)	1,064,400
Bonos de FEDECREDITO	569,400
Bonos del Estado de El Salvador	<u>140,000</u>
Total, through 31/12/84	C/32,798,700

Note: A decree issued in November, 1984, authorized the payment of various overdue taxes, for calendar years 1983 and earlier, in land reform bonds at their nominal value, even before maturity. In practice, few if any bonds were received by yearend, but the period during which such payment is to be accepted runs until Feb. 28, 1985, and in some cases may be extended until the end of 1985. Thus there are no figures yet for the amounts of bonds received.

The immediate result of this decree was to raise the market value of the land reform bonds from around 40% of nominal value to figures around 60% of nominal value.

Isidro

356,300

Annual Amortized Payments

	15	20	25	30	50	100
1.0	1,864,854	1,432,835	1,174,051	1,001,883	659,665	410,229
1.0	2,165,894	1,737,950	1,484,872	1,319,169	1,004,918	818,266
1.0	2,662,236	2,254,270	2,022,653	1,878,432	1,640,435	1,555,964
1.0	2,838,883	2,440,652	2,218,742	2,083,666	1,873,544	1,812,029
1.5	3,302,979	2,934,087	2,739,718	2,629,084	2,482,910	2,456,630
1.0	3,399,425	3,037,071	2,848,539	2,742,817	2,607,845	2,585,818
1.0	3,796,332	3,461,610	3,296,677	3,209,896	3,113,529	3,102,793

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