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

HONDURAS

PROJECT PAPER

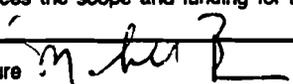
POLICY ANALYSIS AND IMPLEMENTATION

AMENDMENT NUMBER 4

AID/LAC/P-899
CR-386, 507, 744, 787

PROJECT NUMBER: 522-0325

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Agency for International Development PROJECT DATA SHEET				1. Transaction Code <input checked="" type="checkbox"/> A = Add C = Change D = Delete		Document Code 3			
2. Country/Entity Honduras				3. Project Number 522-0325					
4. Bureau/Office LAC		[05]		5. Project Title Policy Analysis and Implementation					
6. Project Assistance Completion Date (PACD) MM DD YY 08 28 97				7. Estimated Date of Obligation (Under "B" below, enter 1,2,3, or 4) A. Initial FY 8 7 B. Quarter [] C. Final FY 9 7					
8. Costs \$000 or Equivalent \$ 1 =									
A. Funding Source		First FY _			Life of Project				
		B. FX	C. L/C	D. Total	E. FX	F. L/C	G. TOTAL		
AID Appropriated Total									
(Grant)		3,000	500	3,500	28,350	4,000	32,350		
(Loan)									
Other	1.								
U.S.	2.								
Host Country			200	200		19,090	19,090		
Other Donor(s)			150	150		1,000	1,000		
TOTALS		3,000	850	3,850	28,350	24,090	52,440		
9. Schedule of AID Funding (\$000)									
A. Appropriation	B. Primary Purpose	C. Primary Tech. Code		D. Obligations to Date		E. Amount Approved This Action		F. Life of Project	
		1. Grant	2. Loan	1. Grant	2. Loan	1. Grant	2. Loan	1. Grant	2. Loan
(1)	Public Sector			7,000				8,800	-
(2)	Agriculture			9,050				16,150	
(3)	Private Sector			5,000				5,000	
(4)	Financ. Sector			2,400				2,400	
TOTALS				23,450				32,350	-
10. Secondary Technical Codes (maximum 8 codes of 3 positions each)							11. Secondary Purpose Code		
12. Special Concerns Codes (maximum 7 codes of 4 positions each)									
A. Code									
B. Amount									
13. Project Purpose (maximum 480 characters)									
To strengthen the Honduran capacity to formulate and implemen economic policies and administrative reforms.									
14. Schedule Evaluations MM YY MM YY Interim 0 9 9 4 Final 0 1 9 7				15. Source/Origin of Goods and Services <input checked="" type="checkbox"/> 000 [] 941 [] Local [] Other (specify) _____					
16. Amendments/Nature of Change Proposed (This is page 1 of a ___ page PP Amendment)									
This amendment reduces the scope and funding for the implementation of policy change in the financial sector.									
Approved by	Signature 			DATE DOCUMENT RECEIVED IN AID/W, OR FOR AID/W DOCUMENTS, DATE OF DISTRIBUTION					
	Title:	Director USAID/Honduras							Date Signed:

PROJECT AUTHORIZATION
(Amendment No. 4)

Name of Country: Honduras
Name of Project: Policy Analysis and Implementation
Number of Project: 522-0325

1. Background: Pursuant to Sections 103, 106, 531, and 534 of the Foreign Assistance Act of 1961, as amended, the Policy Analysis and Implementation Project was authorized on August 28, 1987 with an initial Life of Project ("LOP") contribution of \$12,000,000 and a Project Assistance Completion Date ("PACD") of August 8, 1994. It was amended on March 5, 1990 to increase the authorized USAID LOP contribution to \$16,350,000 and to add an agricultural sector component. It was further amended on July 21, 1992 to increase the total authorized USAID LOP contribution to \$26,350,000, expand the agricultural sector component to encompass natural resources, and extend the PACD to August 28, 1997. It was again amended on September 23, 1992 to incorporate a financial sector component and to increase the authorized USAID LOP contribution to \$32,350,000. The project has four components: public sector, agricultural sector, financial sector, and private sector. The first three components are under a Project Agreement with the Government of Honduras. The fourth component is under a Handbook 13 grant with the Consejo Hondureño de Empresarios Privados (COHEP).

2. Conditions Precedent

Paragraph 4 under section 4.1.B "Financial Sector Component" of Authorization Amendment No. 3, is hereby deleted. The first three Conditions Precedent (paragraphs 1 through 3) remain unchanged.

3. Other Terms and Conditions: All other terms and conditions of the Authorization, as previously amended, remain in full force and effect.



Marshall D. Brown
Mission Director
USAID/Honduras

Date: Sept 20, 1994

HONDURAS

PROJECT PAPER SUPPLEMENT
(Amendment No. 4)

POLICY ANALYSIS AND IMPLEMENTATION PROJECT
(522-0325)

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PROJECT PAPER SUPPLEMENT

(Amendment No. 4)

POLICY ANALYSIS AND IMPLEMENTATION

Financial Sector Component

I. SUMMARY

In light of severe reductions in Development Assistance funds, USAID/Honduras has decided to reduce the dollar amount and scope authorized for the Financial Sector Component of the Policy Analysis and Implementation Project (PAIP). This component, established at a level of \$6.0 million in DA funds, will be reduced to the currently obligated level of \$2.4 million. The component's activity level will therefore be cut back substantially. This Project Paper Supplement reprograms PAIP's Financial Sector Component.

II. BACKGROUND

A. Original Design of the Financial Sector Component

Project Agreement Amendment No. 6, signed by the USAID Mission Director and the GOH on September 29, 1992, added an \$8.64 million¹ financial sector component to the Policy Analysis and Implementation Project. This component was to increase the capacity of Honduran public and private entities to formulate and implement policies and related legislative and administrative reforms that improve financial intermediation. Ultimately, it sought to contribute to stimulating the savings and investment needed for sustainable economic growth. The component was to focus on four activities:

- * improved regulation & supervision of the financial sector;
- * promotion of financial sector reforms;
- * commercial bank strengthening; and
- * development of financial instruments.

The major implementing institutions were: the Central Bank of Honduras (BCH) and the Superintendency of Banks for the first area; the Honduran Council for Private Enterprise (COHEP) for the second; the Association of Banking Institutions and Insurance Companies (AHIBA) for the third; and the Honduran stock exchange for the fourth area. The project component had a termination date of August 28, 1997, the same as the project's PACD.

¹ The expected contributions were as follows: \$6.0 million in DA funds; \$1.14 million in GOH counterpart funds; and \$1.5 from private sector sources. This \$1.5 million was directly related to the commercial bank training component, which is being eliminated through this PP Supplement.

The Project Agreement for the Financial Sector Component of PAIP (ProAg Amendment Number Six) was signed with four Conditions Precedent (CPs). The first three were conditions to the so-called "first phase" of the project, and the fourth related to the "second phase":

1. Technical assistance aimed at improving the regulation and supervision of financial institutions was conditioned upon the *submission* of a new banking law, in form and substance satisfactory to USAID, to the Honduran Congress (Section 4.1);
2. Training and commodities for the Superintendency of Banks were conditioned upon the *passage* of the new banking law by the Honduran Congress (Section 4.2);
3. Disbursement of funds for activities designed to strengthen the Central Bank was conditioned upon the development and approval of a restructuring plan by the Central Bank (Section 4.3); and
4. Disbursements for the second phase of activities were conditioned upon an assessment of progress under the first phase (Section 4.6).

Conditions precedent specified in Sections 4.1 and 4.3 of the Agreement Amendment were met by January of 1993, thus permitting technical assistance to the Superintendency of Banks and technical assistance, commodities and training to the Central Bank. Since the Banking Law has not been *passed* (as of September 1994), as specified in the CP set forth in Section 4.2, there have been no disbursements to the Superintendency of Banks for training and commodities. The final CP (Section 4.6) has not yet been met, since the "second phase" of the component's activities was not to commence until January 1995.

B. Progress to Date

Despite the limitations in funding imposed by the Conditions Precedent, some progress has been made in strengthening the *regulation and supervision of the financial sector*. Staff of the Central Bank participated in training courses as well as in strategic planning seminars; a restructuring plan was developed and approved; and the Central Bank is now computerized and beginning to implement a newly designed management information system. Work remains principally in the areas of management information systems and staff training. A training plan has been prepared for the Central Bank and will be implemented beginning in 1994 with project funds.

As work with the Superintendency of Banks barely got off the ground (because of the CP discussed above), substantial assistance is still required in the areas of information systems, staff training and commodity procurement.

In the area of *promotion of financial sector reforms*, project staff worked closely with the Honduran Council for Private Enterprise (COHEP) to promote private sector support for the passage of a new banking law. A major conference was held (with funds from the

PAIP/COHEP Cooperative Agreement signed in 1988) to discuss the new law. As established in Project Agreement Amendment Number Six of September 1992, which added the Financial Sector Component to the PAIP Project, it was expected that the ongoing Cooperative Agreement with COHEP would be extended to help develop public consensus on needed financial sector reforms. However, this extension was never executed due to the expectation of funding cutbacks (which finally did occur in late 1993). No dollar funds from the Financial Sector Component of the PAIP were disbursed under this subcomponent. This subcomponent will be eliminated from the Financial Sector Component, as no further assistance is planned.

The *commercial bank strengthening* subcomponent never got off the ground because, although not a Condition Precedent, it was agreed that "this activity will commence after a revised Banking Law is approved by the Grantee [the Republic of Honduras]."² No funds from the PAIP Project were utilized for this subcomponent. However, with funds from the USAID-funded Export Development Services and Small Business II Projects, management seminars were conducted and a credit bureau was designed. The AHIBA – on its own – developed the training capability which was to be implemented under the Project upon enactment of the expected Banking Law. The Association of Bankers, once a lunch club, is now a well-respected and powerful organization. This subcomponent will also be eliminated from the Financial Sector Component, as no further assistance in this area is planned.

Finally, in the area of *development of financial instruments*, there were numerous activities: a capital markets strategy and a management information system for the securities department were developed (with project funds and from the centrally-funded LAC/TI project); an observational visit of Central Bank staff to Mexico's Central Bank took place (funded by GOH counterpart); bond auction procedures were modified to allow for the emergence of a secondary market (with funds from the Export Development Services Project). In the Fall of 1993, when Mission staff were considering a reduction of the Financial Sector Component, the Inter-American Development Bank was beginning to plan a large financial sector loan which was to focus principally on development of new financial instruments. Largely because of the IDB's entry, USAID decided not to continue its involvement in this area. This subcomponent will therefore be eliminated from the Financial Sector component.

III. REVISED DESCRIPTION OF THE FINANCIAL SECTOR COMPONENT

In light of severe budget cuts in USAID/Honduras' Development Assistance account, the Mission will reduce planned funding for and the planned duration of the PAIP/Financial Sector Component. Three of the four areas of emphasis will be eliminated, leaving only the area related to the *Improved Regulation and Supervision of the Financial System*. The

² See Project Agreement Amendment No. 6, Annex I.B., Amplified Project Description, Section 4.b.

termination date for this project component will also be shortened from August 28, 1997 to December 31, 1995. It is expected that the activities envisioned in this reformulated project component will have been completed by that time. The following sections of this Project Paper Supplement discuss the remaining activities to be accomplished under this component.

A. Goal and Purpose

The goal and purpose of the overall PAIP project remain unchanged. The goal of the project is to promote sustained economic growth and stability; its purpose is to strengthen the Honduran capacity to formulate and implement economic policies and administrative reforms. The purpose of the *Financial Sector Component* also remains unchanged: to increase the capacity to formulate and implement reforms that improve financial intermediation.

B. Revised Financial Sector Component Activities

The Financial Sector Component will focus on promoting continued improvements in the regulatory and supervisory framework, working with the Central Bank and the Superintendency of Banks. Specifically, it will continue to provide technical assistance, training and commodities to improve the regulation and supervision of the Honduran financial system.

The objectives of this activity are:

- * A Central Bank that has sufficient autonomy, an appropriate organizational structure, and adequate internal controls to regulate Honduras' financial system; and
- * A Superintendency of Banks that effectively and prudently regulates financial institutions to avoid insolvency, promote transparency of operations, and safeguard the deposits of the public.

The activities to be undertaken are described below.

1. Central Bank Activities

From April 1994 through December 1995, this component will finance approximately 16 person-months (PMs) of short-term technical assistance to the Central Bank to help implement its reorganization and strategic plans, strengthen its administration of international reserves, strengthen its ability to formulate economic analyses, improve its human resources development capabilities, and improve its capacity to analyze and develop laws and regulations governing the financial sector, including the Central Bank Law and the Insurance Law. A senior consultant will also be contracted to visit Honduras periodically and advise Central Bank managers on appropriate economic policies to respond to changing circumstances. Short-term technical assistance will be procured directly by USAID through

buy-ins to centrally-funded projects, based on an annual workplan approved by USAID. Technical assistance may also be procured locally by the Central Bank utilizing GOH counterpart funds. This technical assistance, however, must be approved in advance by USAID either as part of the annual workplan or by mutual agreement of USAID and the Central Bank should unforeseen needs arise. See Illustrative Technical Assistance Plan found in **TABLE 1**.

The component will continue to fund training for Central Bank personnel. A consultant has recently finalized a comprehensive training plan for the Central Bank which recommends that training be provided in areas such as macroeconomic adjustment and financial liberalization; collection, processing and publication of national statistics; bank administration; management of international reserves; open market operations; modern bank procedures; and human resources management. An illustrative list of training planned in these areas is found in **TABLE 2**. All training will be short-term and will take place in-country or outside Honduras at centers that specialize in central bank training. Such centers include the Latin American Center for Economic and Monetary Studies (CEMLA) in Mexico, the Latin American Association for Development Institutions (ALIDE) in Peru, The Economics Institute in Colorado, and the Federal Reserve Board in the United States. Dollar-funded international training will be arranged through USAID/Honduras' Training Office, while local currency funded training will be arranged directly by the Central Bank's Department of Human Resources. All training will be approved by USAID either through the Mission's approval of an annual workplan or by mutual agreement of USAID and the Central Bank should unforeseen needs arise.

Commodities will also be purchased under the project for specific Central Bank departments, including the Economic Studies, Credit and Financial Instruments Departments, and the Training division of the Department of Human Resources. Such commodities will include computer hardware and software and audio-visuals for the training auditorium. The purchase of computer software will be coupled with short-term technical assistance in the design of integrated information systems.

2. Superintendency of Banks Activities

The Financial Sector Component will provide specialized technical assistance to the Superintendency of Banks, currently under Central Bank administration, to upgrade its supervision of financial institutions. Some 23 PMs of short-term technical assistance, procured directly by USAID through buy-ins to centrally-funded projects or through direct contracts, will be provided to the Superintendency in areas such as improved inspection procedures, effective supervision, and procedures for intervention. **TABLE 1** provides an illustrative list of planned technical assistance to be procured with dollar funds.

As with assistance to the Central Bank, technical assistance may be procured locally by the Central Bank's Project Manager utilizing GOH counterpart funds. However, this assistance must have been approved in the annual workplan or through mutual agreement of the parties.

Training (both classroom and on the job) will be financed to upgrade the skills of Superintendency personnel in topics that will improve supervision. TABLE 2 provides an illustrative list of the training that Superintendency Analysts, Inspectors and Senior Management will receive.

Here again, dollar-funded training in the U.S. or third countries will be arranged by the USAID Training Office, in-country dollar-funded training will be procured directly by USAID, and in-country training funded with local currency will be arranged directly by the Central Bank's Human Resources Department on behalf of the Superintendency. The Central Bank's coordinator and the USAID project officer will ensure that equal training and professional development opportunities are provided to both men and women in both the Central Bank's and the Superintendency of Banks' training and human resources development programs.

Financial data derived from the supervised banks is maintained and analyzed on one outdated computer at the Superintendency of Banks (until a few years ago, all data was collected and analyzed manually). Under the amended Financial Sector Component, new computer hardware and software will be purchased in order to improve the Superintendency's ability to gather, process and disseminate financial information on a timely basis.

Disbursement of USAID funds for training services and commodities for the Superintendency of Banks will remain conditioned upon the passage of the new banking law.

IV. REVISED CONDITIONS PRECEDENT

The Project Agreement with the GOH will be amended in FY 1995 to reflect the changes that are described in this PP Supplement, including the reduction in the USAID contribution to the project, as well as changes in other components of the PAIP Project. As the redesign of these other components is, as of this writing, not yet complete, the eventual ProAg Amendment will *not* be signed immediately upon USAID approval of this PP Supplement.

When signed, the amended Project Grant Agreement will maintain the first three Conditions Precedent specific to the Financial Sector Component of the existing agreement. As noted, the first and third of these, the requirement for *submission* of a new banking law and the approval of a restructuring plan by the Central Bank, have already been met. The second condition is unmet and will remain in force:

- * Training and commodities for the Superintendency of Banks will continue to be conditioned upon the *passage* of the new banking law by the Honduran Congress (Section 4.2).

The fourth CP, however – the requirement that disbursements for a second phase of activities be conditioned upon an assessment of progress under the "first phase" (Section 4.6) – will be

eliminated. The rationale for eliminating this CP is two-fold: 1) the Financial Sector Component is being reduced in scope to the point that having a first and second phase no longer makes sense; and 2) the "second phase" was to run from January 1995 to August 1997. The revised project component will only extend through December 1995.

V. IMPLEMENTATION ARRANGEMENTS

The Office of the General Project Manager will continue to serve as the chief implementing unit for the regulatory subcomponent, all that will remain of the Project's Financial Sector Component. The Central Bank's Project Manager will submit for USAID approval a detailed annual workplan for calendar years 1994 and 1995. Counterpart funds will be administered through the Office of the General Project Manager.

The day-to-day implementation of the Financial Sector Component will continue to be managed by a Personal Services Contractor in the USAID Mission. A U.S. Direct Hire (USDH) project officer will have overall responsibility for monitoring the activity.

VI. PROCUREMENT PLAN

Under the revised project component, procurement of short-term technical assistance, training services, and computer equipment will be required. Specifications for this equipment will be developed by the General Project Manager and reviewed and approved by USAID before procurement of these commodities begins.

All technical assistance will be performed as a series of discrete, short-term tasks and will be procured either by USAID (for dollar funds) from centrally-funded projects or through direct contracts, or by the Central Bank coordinator (for counterpart funds). Central Bank regulations require that there be a formal public bid for any procurement above L. 3,000 (approximately \$400).

International training funded from the USAID contribution to this component of PAIP will be arranged through the USAID/Honduras Training Office in accordance with Handbook 10 requirements. In-country training will be arranged by the Central Bank's Office of the General Manager utilizing counterpart funds for local expenses. In the event expatriate consultants or trainers are utilized, USAID will use dollar funds to contract with these individuals directly.

Computer-related equipment and software will be procured directly by USAID, principally through the General Services Administration schedule. Supplies that can be purchased locally generally will be procured by the Central Bank's General Project Manager Office using funds from the GOH contribution to the project.

As noted, procurement for training services and commodities to the Superintendency of Banks will remain conditioned upon the passage of a new banking law acceptable in form and substance to USAID.

VII. FINANCIAL PLAN

The cost of the Financial Sector Component of the PAIP project will be \$3.54 million (reduced from \$8.64 million). The USAID contribution will amount to \$2.4 million and the GOH counterpart to the local currency equivalent of \$1.14 million. The private sector contribution of \$1.5 million has been eliminated as it pertained to the Commercial Bank Strengthening subcomponent, which no longer forms part of this project.³

An illustrative budget by line item is attached as TABLE 3. The Project Agreement Amendment signed with the GOH will specify that the Central Bank may change any of these line items by up to 15% without prior approval of the USAID Project Officer.

VIII. MONITORING AND EVALUATION

The project component will be monitored on a daily basis by a USAID/Honduras Personal Services Contractor (PSC) and a USDH employee to ensure that it progresses in a timely fashion. A performance assessment will be conducted in January 1995 to determine any adjustments for the final year of the project component. A final evaluation may be undertaken in December of 1995, the planned termination date for this activity, if it is considered necessary. Otherwise, the USAID/Honduras team will prepare a Project Assistance Completion Report (PACR) for this component.

³ When the Project Agreement Amendment is negotiated, the GOH may request a reduction in the required host country contribution to bring it closer in line with the 25% requirement (closer to \$800,000). A preliminary analysis indicates that the Financial Sector component would not suffer greatly from the reduction.

Table 1
ILLUSTRATIVE TECHNICAL ASSISTANCE PLAN

	<u>COST</u> (\$000s)	<u>PERS/MOS</u>
<u>REGULATORY FRAMEWORK</u>		
A. Central Bank		
- Economic Policy Consultant	30	3
- Improved Procedures		
* Central Bank restructuring	10	1
* Foreign exchange management	20	2
* Management information systems	30	3
* Economic Analyses/Statistics	40	4
* Legal Analyses	10	1
* Other	20	2
	160	16
B. Superintendency of Banks		
- Establish New Legal Unit	10	1
- Organizational restructuring	10	1
- Self-sufficiency strategies	10	1
- Inspection Methods	80	8
- Processing, Analysis and Dissemination of information	40	4
- Regulations, norms & procedures for new banking law	40	4
- Procedures for intervention, restructuring & liquidation	20	2
- Insurance company regulation	20	2
	230	23
TOTAL	390	

NOTE: The average person/month cost of expatriate technical assistance has been estimated at \$10,000 per month. This chart does not include possible technical assistance procured locally with GOH counterpart funds.

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Table 2
ILLUSTRATIVE TRAINING PLAN

<u>REGULATORY FRAMEWORK</u>	<u>ESTIMATED COST</u>
1. Central Bank	
- Workshop for Bank Executives on the role of a Central Bank in a Modern Economy	30,000
- Public Conference for Legislators and Public and Private sectors on the role of a Central Bank in a modern economy.	30,000
- Technical Training for Selected Central Bank Mid-level Managers in:	
* Macroeconomic theory	
* Monetary and Banking theory	
* International Finance	
* Econometrics	
* Financial programming	
<i>Overseas Training: 20 people @ \$10,000 (5 week module)</i>	200,000
<i>In-country Training: 300 p @ \$300</i>	90,000
SUBTOTAL	<u>350,000</u>
2. Superintendency of Banks	
- <u>Banking, for Analysts and Inspectors:</u>	
* evaluation of assets/financial analysis	
* loan classification	
* audit systems	
* inspection techniques	
* mercantile and banking law	
* intervention, merger, recapitalization and liquidation of banks	
<i>Overseas Training: 15 people @ \$3,000 (short course)</i>	45,000
<i>Overseas Training: 5 people @ \$10,000 (5 week module)</i>	50,000
<i>In-country Training: 50 people x 6 courses @ \$300</i>	90,000
- <u>Non-Banking Institutions, for Analysts and Inspectors:</u>	

- * types of non-banking institutions
- * supervision of non-banking institutions
- * norms for non-banking institutions

In-country Training: 50 people x 3 courses @ \$300 45,000

- Specialized themes for Top Management:

- * Supervision policies
- * Financial policies of banking institutions
- * Capital markets and its impact on financial institutions
- * Role of financial supervision in a modern economy

Overseas Training: 5 people x 2 courses @ \$4000 40,000

SUBTOTAL 270,000

GRAND TOTAL 620,000

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TABLE 3: POLICY ANALYSIS AND IMPLEMENTATION--Financial Sector Component
(REVISED BUDGET BY COMPONENTS)
(USD)

	USAID FUNDS				GOH COUNTERPART			
	EXPENDED FUNDS	TO BE EXPENDED			USAID LOP	EXPENDED (GOH)	TO BE EXPENDED	TOTAL GOH
		Central Bank	Superintendency	TOTAL				
Technical Assistance	301,000	160,000	230,000	390,000	691,000	0	200,000	200,000
Training	40,000	350,000	270,000	620,000	660,000	197,564	440,918	638,482
Equip & Commodities	249,000	100,000	300,000	400,000	649,000	98,271	203,247	301,518
Project Management	220,000	60,000	60,000	120,000	340,000		0	0
Evaluations	0	20,000	20,000	40,000	40,000		0	0
Audits	0	10,000	10,000	20,000	20,000		0	0
TOTAL	810,000	700,000	890,000	1,590,000	2,400,000	295,835	844,165	1,140,000

Note: The figures in this table for GOH counterpart expenditures represent the dollar value of expenditures that will be made in Lempiras. Per Section 3.2 of Project Agreement Amendment No. 6, the exchange rate used to calculate this dollar value is L. 5.97 = US\$1.00, which was the highest rate of exchange not unlawful in the Republic of Honduras on the date the GOH obligated itself to provide these funds, i.e., on September 29, 1992, the date of signature of ProAg Amendment No. 6.

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