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FINAL REPORT

ON THE

EL SALVADOR INDUSTRIAL STABILIZATION/ RECOVERY PROJECT

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PREFACE

This report is the work of many minds and hands. Although the bulk of the material was developed and written by the Development Associates team, important contributions were made by officials of the USAID/El Salvador.

First, we wish to thank the Mission Director, Martin Dagata, for his counsel and guidance as we were developing this document. His close attention to our work was much appreciated. In addition, we must single out for gratitude Patricia K. Buckles, Chief, Private Enterprise Division (PRE), for her support and diligence in providing us with the materials and contacts needed in completing the first stages of the work and later for her guidance and editing assistance in putting together the final draft project document. Ernesto Altschul and Baltazar Ferreiro of the PRE Division also provided information, contacts, and advice. For their patience and untiring assistance, we are most appreciative.

We also wish to thank Don Boyd of the Office of Projects for his coordination, in Ms. Buckles absence, in helping arrange the team's written materials according to the format desired by the Mission and for assisting in writing some of the introductory pieces to several sections of the paper.

Our appreciation also goes to Cam Wickham, Mission economist, for his editorial work on the economic analyses done at the outset of the contract by the team's industrial economist. Mr. Wickham's written contributions are intermeshed with the analyses of the team economist and are found in the Background and Economic Analysis sections of the Project Document. His overview of the Salvadoran economy, disaggregations of some of the data, particularly the DRC calculations, by firm size, and his contributions to the discussion of comparative advantages were helpful and important inputs.

To Rodney Gallagher, economist and Project Team Leader for the Project Development Assistance Program (PDAP), USAID Barbados, and an employee of Coopers & Lybrand International Management-Consulting Services, we express our appreciation for his written and verbal contributions to the discussions of export and investment policy considerations and demand for foreign exchange.

We wish also to thank the Private Enterprise Division's secretarial staff for their invaluable contributions in preparing all the many narrative pieces, charts and tables which make up this project document. Particularly, we express our appreciation to Maria Teresa de Clairmont, Marta Bolanos, and Kay Bebout.

And finally, we wish to thank Dave Carter, Administrative Officer, and his staff for their logistical support to us in terms of housing, transportation, and, very importantly, the use of the computer.

As can be clearly seen, our final product is the result of a broad collaborative effort on the part of many different USAID people. We are grateful to have had this input.

I. INTRODUCTION

On November 9, 1983, the Development Associates team traveled to El Salvador to assist the USAID Mission in the development of the Industrial Stabilization and Recovery Project. The task was to provide AID with the background information needed in the development of various project-related documents. The team prepared quantitative and qualitative descriptions of El Salvador's non-traditional industrial sector, assessments of the constraints of manufacturing firms to increasing production and productivity, including their technical/managerial and credit needs, and reviewed the financial and service institutions assisting businesses of all sizes with particular concern for their capabilities to provide needed services. An integral part of the assignment was to gather, compute, and analyze economic information on the status of the Salvadoran economy and industrial activity including micro, small, medium, and large firms.

1. Context

These macro and micro-economic analyses by the Development Associates team were called for specifically in the contract agreement with USAID/ES. However, given the Mission's interest in developing a Project Identification Document (PID) for the Industrial Stabilization and Recovery Program by mid-December 1983, the final output of the work shifted from a draft report to the Mission containing the descriptions and analyses called for, to an enhanced project document. The document was designed to cover the information requirements of a PID, but would contain a considerably larger amount of the specific information and analyses required at the later formal Project Paper stage as a means of giving the Mission a head-start in program development. When the Development Associates team arrived, the Mission already had prepared a "PID outline" as the guide to the preparation of the design document. The outline was discussed at the first weekly "PID team" meeting on Saturday, November 12, at which time it was agreed that the AID and Development Associates staffs would integrate efforts in preparation of the project document according to the proposed outline.

In reviewing the specific elements of the contract and the PID outline, there is almost verbatim correlation between the two throughout the descriptive and analysis sections. The difference is that in developing the final product with AID, proportionately more effort was placed on the specifics of program design, strategy, and other specific PID requirements than originally was contemplated.

During the entire course of the work, the Development Associates team worked in close and constant collaboration with Mission staff, receiving excellent logistical support.

2. Methodology

The Development Associates team initially was composed of five specialists with varying expertise in policy and legislation, trade development, financial management, industrial economics and small business development. The policy and legislation specialist and industrial economist were assigned to the project for a week and a half and three weeks respectively. The remaining three team members worked with the Mission for the full five weeks.

The first major task was for the team to become familiar with the great amount of written material on Salvadoran business and economy to provide background and data sources for the ensuing work. For this a literature coordinator was assigned from the team to screen the hundreds of documents contained in the Private Enterprise Division (PRE) and develop reading lists divided into four principal areas. They were: general readings, small enterprise, trade development and agribusiness, and miscellaneous memos, airgrams, documents and files. In all, 113 documents were selected for review. The majority of these were used by the team in an initial effort to learn as much as possible from secondary sources.

Simultaneously, the Development Associates Industrial Economist began developing the data base for the macro-economic analyses. The data entry was aided by USAID staff, and by Central Bank computer facilities and staff that were made available for computation work.

Meanwhile, the rest of the team continued to work together developing its general knowledge about the Salvadoran economic, business, and political scene. During this initial phase of the work, the beginnings of the project concept were formed based on the Mission's perception of the project goal, as well as the team's initial assessments of the constraints facing industrial stabilization and recovery.

A week and one-half into the contract, the team began concentrating its efforts on the specific areas of responsibility of the individual members. Meetings with Salvadoran government officials and private sector representatives were carried out to supplement the reports, briefs and other secondary information gathered during the first days. The bulk of these meetings took place during the second and third weeks of work, although additional meetings with commercial banks and private companies, particularly, were held during the remaining time so as to continue to gather supplemental information.

The dearth of current and reliable data in many areas of inquiry made analysis difficult. However, through meetings, the team was able to update some information and add new information to alleviate the most obvious deficiencies.

The last two weeks were spent principally in writing the project document and making additions, changes and doing general editing as required. The AID production coordinator for the PID document did a substantial amount of the editing and coordination with the word processing unit. Also, an AID economist supplemented the initial economic analyses done by the team industrial economist.

The Development Associates team met on a weekly basis with the Mission project committee to discuss progress in project development and in discussing the major issues raised in the course of the work. We discussed such matters as the optimal type of financial intermediary to finance export development, the mechanism most appropriate for developing export trade, the demand for credit and foreign exchange, the potential for agribusiness development and export, the relationship to the Caribbean Basin Initiative, the potential for continued support of small and micro-business activities, the importance of these sub-sectors to employment, and the role of the private sector representative

organizations in project implementation vis-a-vis government organizations were some of the issues covered. These meetings were designed to keep other interested sections of the Mission apprised of the directions of the project and to make adjustments and modifications in project design as needed.

Upon completion of the final draft document, the Mission provided the team with diskettes containing all materials which had been entered into the Mission's word processor. This was done to facilitate the final writing and editing by the Development Associates team at the firm's headquarters in Arlington, Virginia.

3. Summary of Project Thrusts

El Salvador has been in the throes of a devastating economic decline over the last four years. Real output in the manufacturing sector has declined by 39% since 1978, underutilization of installed capacity is about 40-50% on the average, unemployment is running at between 40 and 48%, exports have declined in part as a result of stagnating Central American Common Market activity. There is a reduction in industrial activity and, as a result, foreign exchange earnings are down. Despite reduced foreign exchange earnings, imported inputs for industrial production as a percentage of output are on the rise in various sectors. This requires a greater proportion of available foreign exchange to be earmarked for industrial purposes in order to maintain industrial output at constant levels. Difficult policy decisions, therefore, need to be made with respect to foreign exchange allocations and exchange rates. Small and micro-businesses in manufacturing continue to operate by the thousands sustaining, it is calculated, approximately 140,000 jobs. There is reason to believe that these firms may be an important absorber of workers laid off from large firms. These smaller firms are very frequently not eligible for loans through the traditional credit system and those organizations that do lend to small firms are often illiquid.

The demand for credit greatly outstrips the supply available through small business financial intermediaries. The commercial banks do not generally lend to

this level of business. Unsatisfied demand for credit in the micro and small business subsectors is calculated for 1984 and 1985 at U.S. $18.4 million. This is a serious problem for these businesses and their ability to save employment and create net new jobs.

The essence of industrial stabilization and recovery in El Salvador, then, lies in addressing the following issues:

1. Employment saving and creation
2. Revitalization of the existing industrial base
3. Diversification into new, profitable industrial areas, and;
4. Generation of additional sources of foreign exchange through non-traditional exports.

4. Project Components

In order to address the major issues, a two-pronged program approach has been proposed. First the program will emphasize industrial diversification into production of non-traditional products primarily for export, taking particular interest in, but not limited to, Caribbean Basin Initiative (CBI) incentives for entry into the U.S. market. Initial focus will be placed on agro-industrial export products with low domestic resource costs (DRCs) (e.g., an indicator of comparative advantage vis-a-vis world prices).

The mechanism for carrying this out would be through trading companies established along general product lines. In order to facilitate the process, however, this project recognizes the need for a flexible financial intermediary mechanism. Without this essential component, which would channel both local currency and foreign exchange loans to export oriented firms, gearing up production for export and actually carrying out the effort will be jeopardized.

The second prong of the program is aimed primarily at revitalization and stimulation of small and micro businesses which produce principally for the domestic market, but which will also be encouraged to export products with comparative advantages according to the team's DRC calculations for small firms.

We wish also to thank the Private Enterprise Division's secretarial staff for their invaluable contributions in preparing all the many narrative pieces, charts and tables which make up this project document. Particularly, we express our appreciation to Maria Teresa de Clairmont, Marta Bolanos, and Kay Bebout.

And finally, we wish to thank Dave Carter, Administrative Officer, and his staff for their logistical support to us in terms of housing, transportation, and, very importantly, the use of the computer.

As can be clearly seen, our final product is the result of a broad collaborative effort on the part of many different USAID people. We are grateful to have had this input.

II. PROJECT DOCUMENT

1. SUMMARY

1.1 Problem

The predominant problem to be addressed by the proposed project is the decline in El Salvador's industrial production, and how to reverse it.

Three essentially unrelated phenomena have victimized the Salvadoran economy over the past five years: terrorism, collapse of the Central American Common Market (CACM), and world recession. Hardest hit has been the country's industrial sector. However, there is increasing evidence that the long economic slide is bottoming out, and that capital flight has become less of a problem. The perception is growing in El Salvador that the business community is seeking a new modus vivendi with Government as the post-nationalization trauma recedes with the passing of time.

Furthermore, a major new element of optimism has recently been injected into the complicated Salvadoran picture: The Caribbean Basin Initiative (CBI). Perhaps more intensely than their counterparts in other Caribbean Basin countries, Salvadoran officials and businessmen are grasping at the CBI promise as drowning persons might grasp a lifeboat. Yet once aboard, El Salvador--without substantial outside support--could find that penetrating extra-regional markets may be well beyond its reach. The country's current export structures, financial and commercial instruments, skills, incentive and product line currently fall substantially below world class.

What had been a problem of assisting the Salvadoran economy to stabilize and to begin the process of regeneration has suddenly become a matter of helping to ensure that this country is not left behind in the dash to exploit the newly opened USA market. In this effort, the problem will be twofold: how to hasten industrial recovery and diversification, and how to develop effective state of the art marketing strategies and systems in a region and world of rapidly growing competition.

Some analysts make the case that the same entrepreneurial skills that propelled El Salvador to the forefront of CACM exporters during the sixties and seventies will prove equally advantageous in CBI competition. But a closer look at what has lately befallen the nation's productive facilities and capacities, combined with the higher export performance mandatory for success in the CBI arena (as compared to CACM), reveals major deficiencies and gaps in Salvadoran productive sectors.

The financial resources required to rehabilitate Salvadoran industry have been calculated in various ways. At each successive measuring, the cost seems to rise. Schwartz, in an IDB report prepared early in 1983, wrote "It is estimated that it would require an investment of $250 million merely to bring plant and equipment to a standard which would enable production at 80% of the level of 1978."

But a more realistic way of figuring the cost of Salvadoran industrial rehabilitation may be by looking ahead to new opportunities instead of backwards at old plants in need of repair. The problem will be to find El Salvador's competitive edges and relative advantage in the 1980s; and not to be misled by what may have been the country's comparative advantages within CACM during the 1960s.

A further problem will be to determine which of the old plants are worth rehabilitating, not as nationalistic symbols but as profit-making ventures. It is important for the private industrial sector to know what the rules of the game will be under the new investment law. It is even more important that both public and private sector leadership let market forces guide them in the export expansion process.

A current fact, and future threat, is that Government of El Salvador (GOES) agencies are not equipped to facilitate or accommodate a major export push. Exchange rate policy is a net hindrance to foreign trade and confidence. Long-term credit is scarce. The recently created Ministry of Foreign Trade (MICE), although symbolically a plus, realistically is unlikely to accomplish much for the private sector in terms of comparative advantages.

Perhaps the most serious problem lying ahead will be the financial and credit structuring of El Salvador's recovery and export efforts. To quote from a July 1, 1983, report by the World Bank concerning its Export and Industrial Credit Project, "With the decline of the INSAFI (Institute for Industrial Promotion) and FIGAPE (Small Business Fund), the need to have an efficient institutional mechanism for investment financing in the productive sector will become more crucial as the political climate stabilizes." But the problem is not limited to the formation of a credit institution which can effectively underpin the export recovery and diversification program needed by El Salvador. Of equally tall priority as the export credit mechanism would be one or more closely associated private trading companies to do what neither government nor the small exporter can do alone: export at a profit.

It is the belief that the political climate has stabilized to the point where the chances of creating efficient institutional mechanisms for investment financing and export promotion and marketing in the productive sector are now better than they have been any time since the revolution. The problem lies in positioning these mechanisms in a flexible and responsive way to meet El Salvador's obvious and urgent need to export.

1.2 Project Description

The Project goal is to stabilize the Salvadoran economy by increasing the present levels of employment, production, and foreign exchange earnings. The Project purpose is to assist existing firms in the non-traditional industrial sector to rehabilitate and reactivate their productivity capacity and to increase the participation of small business in the economy. The sub-purpose is to increase foreign exchange, generate employment, and promote the use of installed capacity linked to the CBI. To achieve the project goal and purpose, project resources will be used to establish and support non-traditional exports to extra-regional markets. Project activities are grouped into six major components, as follows:

i. Credit to Export Firms

The Project will provide $35 million in foreign exchange credits for the purchase of raw materials, machinery, equipment, and related inputs for export production, especially in the agro-industrial and food processing sectors.

ii. Credit to Small and Micro-Businesses

The Project will provide $10 million in Project funds for credit assistance to small and micro-enterprises which produce principally for the domestic market, although export activities will be encouraged.

iii. Integrated Export Services

The Project will provide technical assistance and some grant funds to support the establishment of one or more viable commercial trading companies whose purpose is to provide international marketing and export management services for small, medium, and large businesses. Priority will, at first, be given to the food processing sector. At a later stage, services will be expanded to some other sectors demonstrating particular comparative advantages and large employment generation capacity. The trading companies will be largely funded by member firms, with each firm's contribution based on a formula that takes into consideration its size, sales volume, and export business potential. The balance of the first two years' operating costs will be funded by the project, which will also pay for the needed technical assistance to build the firms' capacities leaving in place viable private export trading operations.

iv. Institutional Development

The Project will finance technical assistance and training requirements of financial intermediaries and business service agencies which will be relied upon as delivery mechanisms for project activities. Financial intermediaries for exporters will benefit from technical assistance and training in credit analysis, project analysis, loan supervision, and export-import banking. Small and micro-business intermediaries (both financial and service

organizations) in both the public and private sectors will be provided with appropriate technical assistance and training to improve service delivery capabilities.

v. Investor Search

The Project will finance a 2-3 person contract Investor Search Team which will reside in El Salvador. These individuals will liaise with all relevant private and public sector agencies, work directly with local firms, and be responsible to USAID's Office of Private Enterprise. Their functions will be to: a) identify and facilitate investment prospects from U.S. and other international private sectors; b) assist in developing terms of reference and acquiring technical inputs for specific aspects of investment project design and implementation; and c) identify and coordinate personnel assistance from other U.S. organizations (IESC, VITA, etc.) to alleviate bottlenecks to external investment in local firms. To assure close and more successful follow-up with potential investors, the local Investor Search Team will be linked with a U.S.-based organization helping to follow-up on opportunities.

vi. Export Promotion

The Project will provide funding for a trade expert with experience in both the public and private sectors for one to two years to assist the Ministry of Foreign Trade in the following: a) development of an export policy formulation and analysis section in MICE, and assist in the recruitment of qualified professionals to staff the section; b) development of planning and analysis capabilities through design and implementation of appropriate training programs and provision of technical assistance; and c) assist MICE and the private sector in identifying short-term technical expertise for in-country technical assistance in production, export marketing, and quality control. In addition, selected mid-level professionals will be given training to up-grade their skills in investment promotion, development of promotional materials, trade fairs, and trade communication.

2. BACKGROUND AND PROBLEM DESCRIPTION

2.1. Macro-Economic Situation

The Salvadoran economy has been badly shaken by a variety of internal and external political and economic factors during the past four years. Armed conflict, acts of terrorism, the world-wide economic recession, contraction of the demand for exports within the Central American Common Market, the increased price of imports and high interest rates are among the principal reasons for the decline. Together, these forces have drained international reserves, reduced fiscal revenues, constrained bank credit and devastated the productive sectors. In addition, they have generated reinforcing contractions in other important economic activities such as private investment, the massive flight of capital and the drying up of external credit.

These elements have brought the economy to the brink of collapse. The extent of the crisis, as well as the requirements for successfully confronting it, are measured by the following key indicators:

2.1.1. The External Sector - El Salvador experienced a significant deterioration in both its current account and overall balance of payments position after 1978. As noted in Table 1, there were modest current account surpluses in 1979 and 1980. They were due both to record earnings from coffee exports and to tightening import restrictions on the part of the Central Bank. Due to high levels of capital flight, however, there were substantial deficits in the overall balance of payments in both 1979 and 1980. Net capital flows turned positive in 1981, owing to loan disbursements to the public sector. The current account balance shifted to deficit, however, leaving an overall short-fall of $132 million. Reductions in both the current account deficit and in the net outflows of capital in 1982 combined to produce a small surplus that year. A continuation of the trend is expected to result in a similar small surplus during 1983.

While dismal, these figures significantly understate the severity of the crisis. Far more severe balance of payments gaps were avoided only through the imposition of tight foreign exchange controls. These, in turn, led to precipitous declines in the levels of real imports. Between 1979 and 1982 imports declined by about

25 percent. These actions, in turn, resulted in the further contraction of income and employment.

The principal factors that have contributed to the deficits are the following:

- The impact of armed conflict and terrorism and the resulting deterioration of capital flows, exports and tourism. The latter, an important source of foreign exchange earnings in the 1960's and 1970's, has ceased to exist. The flight of capital between 1979 and 1983 is estimated at approximately $1 billion.

- The severe deterioration in the country's terms of trade. Between 1979 and 1981, the price of oil almost doubled, while the cost of other essential imports also jumped significantly. At the same time, the price of the traditional exports not only did not keep pace but actually fell precipitously. For example, coffee prices declined by about 30 percent, cotton 5 to 10 percent, while sugar prices remained roughly at the 1979 level.

- Contraction of both regional and extra-regional markets. The Central American Common Market (CACM) has declined substantially as a result of current account deficits, capital flight and the sharp reduction in private investment (in 1982, intraregional trade declined by about 15%, in current prices). The contraction of the extra-regional market has affected prices for traditional exports as well as the demand for manufactured goods.

- A nearly complete cut-off of foreign sources of credit in response to the violence and payments arrears. The country has been particularly hurt by the cancellation of foreign lines of credit to finance purchases of raw materials and intermediate goods. This, in turn, has resulted in a lower level of manufactured exports and a drop in foreign exchange earnings.

The continued presence of these factors makes the outlook grim for short-term improvements in the situation. The only bright spot on the horizon is the possibility that the Caribbean Basin Initiative will provide badly needed balance of payments support and facilitate the sale of manufactured exports in the U.S. market.

TABLE 1

DEFICIT OR SURPLUS ON CURRENT ACCOUNT - ($ MILLIONS)					OVERALL BALANCE OF PAYMENTS DEFICIT OR SURPLUS				
1979	1980	1981	1982	1983 1/	1979	1980	1981	1982	1983
21.4	30.6	-250.4	-169.8	-91.4	-101.0	-325.4	-131.6	22.3	N.A.

1/ BCR Projection

N.A. = Not available

2.1.2. Net International Reserves - As the nation has experienced balance of payments deficits recently international reserves have declined sharply. Table 2 shows that between the end of 1979 and the end of 1982 net international reserves have dropped from a positive $151 million to a negative $240 million.

TABLE 2

NET OFFICIAL INTERNATIONAL RESERVES ($ MILLIONS)

1979	1980	1981	1982	1983
252.4	151.4	-133.0	-240.1	-222.4

Source: IMF

2.1.3. Fiscal Deficits - As noted in Table 3, the GOES's fiscal deficits have increased markedly in recent years. After experiencing small deficits in the early to mid 1970's, deficit spending for the consolidated public sector rose to ₡354.3 million in 1979 and then nearly tripled again by 1981. The service payments on the debt, nearly all of which was financed by the Central Bank, have grown apace. In 1982 debt service reached $201.6 million, or about 6 percent of the consolidated public sector's budget, as compared to 3 percent in 1970 and 1980. Factors contributing to the rapid growth of the deficits include the following:

- Increased expenditures for employment generation in response to rising unemployment, social unrest and political pressures;
- Substantial increases in the wages of public employees in 1980;
- Stepped-up security expenditures to cope with increasing civil unrest;
- Reduced tax collections as economic activity, and especially foreign trade declines; and
- Financing of the agrarian reform program, plus nationalization of the commercial banks, and marketing institutions for coffee and sugar.

TABLE 3

CONSOLIDATED PUBLIC SECTOR BUDGETARY BALANCE
($ Millions)

1978	1979	1980	1981
-42.5	-72.7	-244.0	-263.2

Source: IMF

2.1.4. GDP Growth - As noted in Table 4, real GDP contracted by 1-1/2 percent in 1979, by an estimated 9 percent per year in 1980 and 1981, by 5 percent in 1982 and by a projected 2 to 3 percent in 1983. At the moment, the real GDP is of approximately the same magnitude as it was in 1972-1973. The population, however, has increased by an estimated 1.2 million in the interim. This implies that in terms of the real per capita GDP, the present level would be comparable to that of the mid to late 1960's.

TABLE 4

REAL GDP GROWTH RATE

1978	1979	1980	1981	1982	1983
6.4	-1.7	-9.0	-9.3	-5.1	-2.5 1/

Source: IMF
1/ Estimated

2.2. The Role of Intra- and Extra-Regional Trade in the Economic Development of El Salvador

The establishment of the Central American Common Market (CACM) in 1960 provided an important stimulus to the nation's development by creating a region-wide market, promoting economies of scale and encouraging investment by foreign firms interested in taking advantage of the broader market protected from outside competition by the Common External Tariff.

Between 1960 and 1968, total intra-regional trade grew at an average annual compound rate of 29%, while value added by the country's manufacturing sector increased at an annual rate of 9% in real terms and private investment spending increased by 8.9%.

The close interrelationship between El Salvador's intra-regional trade and the growth of its manufacturing sector is further demonstrated by the fact that approximately 87% of total intra-regional trade consists of manufactured goods. This represents 78% of total exports of the country's manufactured products.

Although the CACM has made a significant contribution to the country's development, certain structural weaknesses have become increasingly evident. These include the promotion of industries with high import coefficients that are not well suited to compete in world markets, the encouragement given by the tariff structure to assembly-type operations, and the promotion of import substitution activities in preference to those oriented toward the world market. After two decades of development based, in part on the protection provided by the tariff structure, the country now confronts a situation in which most of the easy possibilities for import substitution have been exhausted and some industries dependent on the tariff structure are inefficient and costly to support.

Another consequence of the country's rapid industrialization has been the increased dependence of the manufacturing sector on the importation of raw materials and intermediate goods. The latter category alone almost quintupled between 1970 and 1980. As a proportion of total GDP, total imports increased from 15% in 1960 to 33% in 1980.

Because of its increasing reliance on imports as a proportion of total output, the manufacturing sector has been particularly affected by the balance of payments crisis. The lack of foreign exchange has limited its ability to finance needed imports, thereby creating a constraint to production and export expansion which can help reduce balance of payments pressures.

Based on recent experience and a clearer understanding of the inherent weaknesses of the CACM, consensus is that El Salvador must develop a growth strategy oriented increasingly toward exports of non-traditional goods if the

manufacturing sector is to fulfill its role in the long-term economic development of the region. Such a strategy is important because increased emphasis on the export of non-traditional goods can help reduce the impact on the economy of external shocks resulting from fluctuations in world commodity prices for the region's traditional exports, encourage renewed foreign investment, and contribute significantly to solving El Salvador's balance of payments difficulties.

The Caribbean Basin Initiative (CBI), by establishing a free-trade zone for Caribbean Basin products, therefore, is a timely measure, and represents a major long-range opportunity for El Salvador to overcome its development problems and set the stage for its sustained growth as part of the world economy. A successful export drive during the twelve-year duty-free period of the CBI would assist in implementing a strategy of decreased dependence on the exports of traditional commodities, as well as helping to turn the industrial sector from its narrow reliance on the CACM toward the U.S. and world markets. Such restructuring, however, can only be achieved over the long-term.

The most urgent and immediate need is to provide emergency foreign exchange credit to finance the importation of raw materials and intermediate goods, with priority to be given to the extra-regional export manufacturing sector, especially in agro-industries. The current backlog of unsatisfied demand for this latter purpose alone is estimated at $150 to $250 million, while the total annual demand for raw materials and intermediate goods (also for the extra-regional export manufacturing sector alone) originating in eligible Free World countries is estimated at nearly $100 million.

2.3. Current Status of El Salvador's Private Sector

The private sector has traditionally played a dominant role in the Salvadoran economy. Since 1979, however, it has performed its functions under much more difficult circumstances. Among the many problems which adverse world markets and hostilities have left in their wake, the following have proven particularly bothersome for businessmen:

-- An acute shortage of foreign exchange with which to purchase raw materials and intermediate inputs. This has resulted in increased paperwork, long delays

and uncertainty as to whether or not specific transactions will be approved by authorities.

-- The cancellation of foreign lines of credit because of delays in repayment and an increase in the amount of risk perceived.

-- A severe contraction in domestic credit supplies, produced both by the downward trend in economic activity and by the financing from the monetary system of large public sector deficits.

-- Rebel attacks upon public utilities and transporation infrastructure have rendered more difficcult, more uncertain and more costly the production, storage and distribution of commodities.

-- Attacks upon business establishments, either openly or covertly by means of sabotage, and the targeting of businessmen and their families for assassination, execution or kidnapping.

-- Uncertainty about the future role of private enterprise owing to the sweeping agrarian reform; the nationalization of the commercial banks and the coffee and sugar marketing facilities; and the lack of a national plan setting forth public intentions and priorities.

-- Contraction in the market, both within Central America and abroad. In the case of the latter, the depressed prices of coffee and sugar are a major contributing factor.

2.3.1. The Manufacturing Sub-Sector

As illustrated in Table 5, the manufacturing sector's performance has been significantly influenced by the factors mentioned above. Indeed, with a 39 percent reduction in real output since 1978, it has been with the single exception of construction, more adversely affected than any other sector of the national economy. Even so, manufacturing remains an important contributor to the GDP. Its present share of 15 percent is surpassed only by those of agriculture with 27 percent, and commerce with 19 percent.

TABLE 5

EL SALVADOR TOTAL SUPPLY AND DEMAND
(Constant 1962 prices, millions of colones)

	1970	1975	1976	1977	1978	1979	1980	1981	1982 a/	1983 a/
OTAL SUPPLY	2,953.2	3,892.3	4,156.7	4,632.2	4,885.0	4,727.3	4,172.7	3,777.0	3,495.6	3,358.4
Imports of Goods & Services	559.6	769.4	909.8	1,188.4	1,220.7	1,125.7	893.7	804.0	677.7	627.6
ROSS DOMESTIC PRODUCT	2,393.6	3,122.9	3,246.9	3,443.8	3,664.3	3,601.6	3,279.0	2,973.0	2,817.9	2,730.8
Agriculture	627.2	787.3	725.2	751.3	856.6	887.4	844.0	763.9	716.1	725.4
Mines and Quarries	3.6	4.5	4.0	3.7	3.7	3.8	3.9	3.8	3.8	3.8
Manufacturing	438.3	578.0	628.6	661.5	691.5	663.8	557.9	470.9	442.3	420.2
Construction	63.8	128.0	115.9	157.1	165.1	141.5	92.6	91.4	80.7	79.6
Electricity, Water and Light	45.0	70.5	77.9	87.8	96.6	103.7	101.7	98.4	94.5	92.3
Transports & Communications	127.9	172.9	195.6	214.3	223.3	203.8	193.7	170.8	159.7	154.6
Commerce	565.6	709.2	770.9	803.4	819.3	779.0	690.9	595.0	563.4	524.0
Financial	51.0	77.7	88.3	101.5	103.9	106.1	97.0	94.0	92.7	90.6
Government	182.9	243.9	274.3	288.2	310.9	322.7	332.0	339.9	331.3	320.6
Other Services	288.3	350.9	367.1	375.0	393.3	384.8	365.3	345.8	333.4	319.7

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The decline in industrial output adversely affected employment in the sector as well, although not to the same extent. As noted in Table 6, between 1978 and 1982 employment in the main activities of the manufacturing sector fell by about 7,500, or by 12.9 percent. While the decline is far more moderate than the decline in output, care should be taken in interpreting the data. At best, this subsector includes only about 30 percent of the estimated 194,000 workers employed by the manufacturing sector as a whole. It is possible that the decline in employment for the entire sector would present a far different, less favorable picture.

Within this "formal" subsector of small, medium and large size firms, there are two activities--textiles and food, beverages and tobacco--which, taken together, account for nearly 60 percent of total employment. Another activity, chemicals, consistently has accounted for an additional 12 to 14 percent. By size, approximately 80 percent of the sector's nearly 200,000 employees work for firms with fewer than 200 workers.

As noted in Table 7, the larger firms since 1978 have steadily increased the proportion of their production oriented toward the domestic market. The movement simply reflects the impact of the reduction of exports within the CACM and to other countries. It should not be interpreted to mean any absolute increase in the size of the domestic market. Rather, it means only that domestic markets have contracted more slowly than foreign markets.

While the domestic market has increased in relative importance since 1978, so has the share of imported inputs in the cost of total inputs. As noted in Table 8, the largest user of foreign input--48 percent of total imports--is the petroleum and chemical products industry, which purchases more than 90 percent of its requirements abroad. Other important producers, such as textiles and agro-industries, on the other hand, obtain more than one half of all of their inputs from domestic sources.

In summary, in the face of declining economic activity and export markets, especially the CACM, the manufacturing sector has significantly reduced both output and employment. It has turned inward, selling mainly in a shrinking domestic market. It has also increased the relative use of imported inputs.

TABLE 6

Industrial Employment
Main Sectors

CIIU	ACTIVITY	1978	%	1980	%	1982	%
31	Food Products, Beverages & Tobacco	12,492	21.4	13,228	23.5	11,827	23.3
32	Textiles and Leather Ind.	21,237	36.6	19,817	35.2	18,176	35.8
35	Chemical Products	7,013	12.1	6,995	12.4	6,809	13.4
Others		10,358	29.9	16,195	28.9	13,940	27.5
TOTAL		58,050	100	56,235	100	50,572	100

Source: Industrial Survey 1982 MINPLAN

TABLE 7

Percentage of Production Sold to Domestic Markets

MAIN INDUSTRIAL SECTORS

CIIU	ACTIVITY	1978
1979	1980 1981	1982
31	Food Products, Beverages & Tobacco	94.1
93.8	92.4 94.8	94.3
32	Textiles & Leather Insustries	72.9
73.8	78.7 85.3	87.5
35	Chemical Products	78.6
79.9	83.2 83.7	91.5

Source - Industrial Survey 1982 MIPLAN

This reflects the impact of the reduction of exports due to the world recession in this period, especially the loss of the CACM.

TABLE 8

% Imported and Domestic Inputs

CIIU	ACTIVITY	1978 Domestic	1978 Imported	1980 Domestic	1980 Imported	1982 Domestic	1982 Imported
31	Food Products, Beverages & Tobacco	60.0	40.0	62.3	37.7	59.1	40.9
32	Textiles & Leather Industries	48.9	51.1	62.9	37.1	49.5	50.5
33	Wood and Wood Products	51.3	48.7	47.7	52.3	55.3	44.7
34	Paper, Paper Products & Printing	14.3	85.7	15.7	84.3	9.3	90.7
35	Chemical Products	6.5	93.5	5.7	94.3	5.0	95.0
36	Non Metal Mineral Products	58.1	41.9	54.3	45.7	59.8	40.2
37	Basic Metals	22.0	78	52.3	47.7	72.3	27.7
38	Metal Products, Mach. & Equip.	28.4	71.6	19.8	80.2	21.2	78.8
39	Other Industries	16.9	83.1	15.7	84.3	22.1	77.9
TOTAL		32.8	67.2	33.9	66.1	26.8	73.2

Source: Industrial Survey MIPLAN
Based on Tables A11, A13 and A15 in Annex.

2.3.2 Definition of Firm Size Parameters

As in many countries, El Salvador does not have a unified definition of firm size or agreed upon criteria for making these designations.

Each institution or association working with the different enterprise levels has differing ways of defining its target group(s). Some define firm size by numbers of employees; others by total assets. And when "total assets" is used as a measure, there is not uniformity in how this is defined either.

Thus, the Central Bank, the private associations representing business, financial intermediary institutions, and the training and technical assistance groups may speak of the problems of assistance to the micro, small, medium and large businesses, but each may be envisioning their services and the target groups in very different ways. This can create confusion and misguided program designs because of different interpretations of the constraints and needs of each level of business.

For this reason and to help clarify ensuing discussions, particularly at the smaller business end of the spectrum, we present a series of parameters for what is meant in this project by micro, small, medium, and large businesses. The proposed definitions are based on combinations of criteria currently being used by various organizations previously mentioned. This effort, we hope, will set the stage for unifying the definitions at the national level. This common understanding may help provide the basis for initiatives to improve the policy environment for small and micro businesses particularly affecting the various forms of assistance they receive as their importance to the overall economy is more clearly recognized by policy makers.

Official information in El Salvador on the size or importance of the small and micro business industrial subsectors is sparse and of questionable accuracy. Without clearly defining this subsector, programs for its increased involvement in the national economy will be difficult to design properly.

Because large and medium-size businesses are relatively more conspicuous in the economy and, therefore, more easily required to register with the Registro de

Comercio, they are better known in terms of their numbers, employment creation potential and value added contributions. They have received more incentives and access to resources, both human and capital, enabling them to do business more efficiently.

We propose using both number of employees and total assets in our definitions. This allows us to control for cases, for example, in which a relatively small firm in terms of numbers of employees may be highly capital intensive and should not be considered in the same category as most small labor intensive firms. We are assuming in our definition of "small" a relatively higher degree of labor intensity than in medium and large firms.

In terms of total assets for sole proprietorship, small, and micro-businesses, these would include all the entrepreneur's assets including his housing, since it often serves as the plant also. For medium and large firms, assets would include only those assets specifically used in the business operations.

Other definitions have involved firm ownership, management and control, use of domestic or imported materials in the production process, or production or sales volume. However, we believe that in trying to develop a unified definition to be used by several different organizations, it should be kept as simple as possible so as to be applied accurately and uniformly. For this reason, we are proposing the two variable formula despite its possible deficiencies.

Firm size is defined in the following way (all assets parameters would be reviewed bi-annually):

Micro-business:	Number of employees 1-4 and assets up to ₡50,000. Maximum assets per employee ₡12,500.
Small business:	Number of employees 5-39 and Assets between ₡30,000 and ₡500,000.

Average Assets per Worker		
9,000	Level I	Number of employees 5-9 and Assets between ₡30,000 and ₡75,000.
12,000	Level II	Number of employees 10-19 and Assets between ₡75,000 and ₡200,000.
14,000	Level III	Number of employees 20-29 and Assets between ₡200,000 and ₡400,000.
15,000	Level IV	Number of employees 30-39 and Assets between ₡400,000 and ₡600,000.
Medium business:		Number of employees 40-199 and Assets between ₡500,000 and ₡2,000,000
16,000	Level I	Number of employees 40-99 and Assets between ₡600,000 and ₡1,000,000.
16,000	Level II	Number of employees 100-199 and Assets between ₡1,000,000 and ₡2,500,000.
Large Business:		Number of employees 200 + and Assets over ₡2,500,000.

2.3.3. Profile of the Manufacturing Sector by Firm Size

A concerted effort was made to get up-to-date accurate information which would give a reliable picture of the relative importance of micro, small, medium, and large firms to the Salvadoran economy in terms of their numbers and contributions to employment. Unfortunately the most current information giving a breakdown by size of firm was from the Economic Census of 1979. Statistical information was compiled in 1978.

In the last four years there has been a great decline in formal manufacturing operations. Medium and large companies have closed or decreased production to an estimated 60% capacity. Underutilization of capacity is even greater in some industries. Therefore, employment as expressed in the 1979 figures is high for these companies. Furthermore, small and micro firms by all accounts have absorbed at a minimum a small amount of this displaced labor. One would conclude, then, that figures for these firms are low. Any use of this information (see Table 9), therefore, can only be illustrative of general relationships.

TABLE 9

BREAKDOWN OF SALVADORAN FORMAL MANUFACTURING SECTOR
BY INDUSTRIAL ACTIVITY AND NUMBER OF EMPLOYEES
SOURCE: CENSOS ECONOMICOS 1979 TABLES 3 and 14, Vol. I

CIIU Code	INDUSTRIAL ACTIVITY - # Employees	Micro 1-4		Small 5-9		Small 10-19		Small 20-49		Sub Total		Medium 50-99		Medium 100-199		Sub Total		Large 200 +		Sub-Total S - M - L		Total All Firms	
		# Firms / # Empl.	% Total / % Total	# Firms / # Empl.	% Total / % Total	# Firms / # Empl.	% Total / % Total	# Firms / # Empl.	% Total / % Total	# Firms / # Empl.	% Total / % Total	# Firms / # Empl.	% Total / % Total	# Firms / # Empl.	% Total / % Total	# Firms / # Empl.	% Total / % Total	# Firms / # Empl.	% Total / % Total	# Firms / # Empl.	% Total / % Total		
31	Food Products, Beverages, Tobacco	3,554	93.2	124	3.3	54	1.4	42	1.1	220	5.8	17	.4	11	.3	28	.7	12	.3	260	6.8	3,814	100%
		6,679	37.6	834	4.7	729	4.1	1,319	7.4	2,882	16.2	1,172	6.6	1,449	8.2	2,621	14.8	5,596	31.5	11,099	62.4	17,778	100%
32	Textiles, garments, leather products	3,309	92.1	96	2.7	52	1.4	59	1.6	207	5.7	23	.6	27	.8	50	1.4	25	.8	282	7.9	3,591	100%
	(en micro garmets 2,665/4186)	5,672	20.2	645	2.3	694	2.5	1,858	6.6	3,197	11.4	1,543	5.5	3,520	12.5	5,063	18.0	14,201	50.4	22,461	79.9	28,133	100%
33	Lumber, Wood Products, including Furniture	729	89.7	44	5.4	25	3.1	10	1.2	79	9.7	3	.4	1	.1	4	.5	1	.1	84	10.3	813	100%
		1,529	50.6	285	9.4	331	11.0	303	10.0	919	30.4	183	6.1	128	4.2	311	10.3	262	8.7	1,492	49.4	3,021	100%
34	Paper, Paper Products, Printing, Publishing	91	46.7	38	19.5	27	13.8	19	9.8	84	43.1	4	2.1	10	5.1	14	7.2	6	3.0	104	53.3	195	100%
		258	4.9	261	5.0	363	6.9	600	11.4	1,224	23.3	271	5.2	1,488	28.3	1,759	33.5	2,009	38.3	4,992	95.1	5,250	100%
35	Chemical substances, products; derivatives	72	41.4	17	9.8	15	8.6	31	17.8	63	36.2	23	13.2	10	5.7	33	18.9	6	3.5	102	58.6	174	100%
	of Petroleum; coal, rubber, and plastic	145	2.3	120	1.9	189	2.9	977	15.2	1,286	20.0	1,599	24.9	1,440	22.5	3,039	47.4	1,942	30.3	6,267	97.7	6,412	100%
36	Mineral Products, except Petroleum and	409	79.3	51	9.9	25	4.8	17	3.3	93	18.0	5	1.0	6	1.1	11	2.1	3	.6	107	20.7	516	100%
	Coal derivatives	1,122	25.4	362	8.2	310	7.0	476	10.8	1,148	26.0	400	9.1	793	17.9	1,193	27.0	956	21.6	3,297	74.6	4,419	100%
37	Basic Metals	-	-	2	25.0	-	-	2	25.0	4	50.0	1	12.5	3	37.5	4	50.0	-	-	8	100.0	8	100%
		-	-	11	1.8	-	-	54	8.8	65	10.6	53	9.4	492	80.0	550	89.4	-	-	615	100.0	615	100%
38	Metal products, machinery and equipment	474	76.6	54	8.7	33	5.3	26	4.3	113	18.3	15	2.4	7	1.2	22	3.6	10	1.5	145	23.4	619	100%
		1,143	14.2	358	4.5	455	5.7	764	9.5	1,577	19.7	1,017	12.7	1,029	12.8	2,046	25.5	3,263	40.6	6,886	85.8	8,029	100%
39	Other Manufacturing	108	74.9	9	6.3	10	6.9	8	5.6	27	18.8	7	4.9	2	1.4	9	6.3	-	-	36	25.1	144	100%
		241	16.6	59	4.1	134	9.2	249	17.2	442	30.5	487	33.6	280	19.3	767	52.9	-	-	1,209	83.4	1,450	100%
	TOTAL # Firms	8,746	88.5	435	4.4	241	2.4	214	2.2	890	9.0	98	1.0	77	.8	175	1.8	63	.7	1,128	11.5	9,882	100%
	# Employees	16,789	22.4	2,935	3.9	3,205	4.3	6,600	8.8	12,740	17.0	6,730	9.0	10,619	14.1	17,349	23.1	28,229	37.5	58,318	77.6	75,107	100%

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Recognizing these problems with the data, and that the numbers reflect only the formal manufacturing sector, we still can get some interesting perspectives.

Overall, 88.5% of all Salvadoran firms were in the micro sector of 1-4 employees representing 22.4% of total employment. Another 9% were considered small (5-49 employees) with 17% of the total number of employees. Medium firms (50-199 employees) represented 1.8% of all firms and 23.1% of employment and only 0.7% were considered large firms (over 200 employees) representing 37.5% of all employees.

TABLE 10

Firm Size*	Percent of All Manufacturing Firms	Percent of Employment
Micro (1-4)	88.5	22.4
Small (5-49)	9.0	17.0
Medium (10-199)	1.8	23.1
Large (200 +)	.7	37.5
Total	100.0	100.0

Source: Breakdown of Salvadoran formal manufacturing sector by industrial activity and firm size (Table 9).

*Note: Firm size as designated in Census Data.

Within various categories of manufacturing, it is interesting to note that micro-businesses lowest representations in terms of total firms are in CIIU category 34 (paper, paper products, printing, and publishing - 46.7%) and category 35 (chemical substances, products, petroleum derivatives, coal, rubber and plastic - 41.4%). Contribution to employment generation is even lower for the micro businesses in these categories; category 34-4.9% and category 35-2.3%. Medium and large firms, on the other hand, represent 18.9% and 3.5% of the total number of establishments respectively, and 77.4% of all employment in these categories.

Medium-size firms represent the biggest employment generator in the basic metals area, CIIU category 37.

Categories 34, 35, and 37 together represent 12,277, or 16.3%, of total employment. It is expected that these categories are relatively capital intensive when compared to the rest.

On the other hand, relatively labor intensive production in CIIU categories 31 (food products, beverages, and tobacco) and 32 (textiles, garments, and leather products) are the heaviest employment generators by far. Together they represent 45,911 of the 75,107 total manufacturing employment recorded, or 61.1%. The 35 largest textile companies (in the 50 and over employee range - e.g. medium and large firms) represent 10,174 of the 28,133 employees in category 32. The rest of employment generated in this important sector is rather evenly distributed over medium, small and micro-businesses. In categories 31 and 32, small and micro-businesses represent 99% and 97.8% of all firms respectively, and 53.8 and 49.4% of employment respectively, taking away the large textile firms.

Category 38, metal products, machinery, and equipment, is another important employment generator which contributed 8,029 jobs. The 10 large firms, representing 1.5% of the total, contributed 40.6% of the employment generated. Medium and large firms in this category together represented 5.1% of the firms and 66.1% of the employment generated.

Small and micro-businesses in category 33 (lumber and wood products, including furniture) are predominate. Of the firms, 99.4 are small and micro-businesses and generate 80.6% of the employment in this category.

Many other cross references and relationships can be drawn from the tables. In sum, however, certain expectations are confirmed from the breakdowns. They are:

1. Relatively few large businesses create a substantial amount of employment.

2. Large and medium-sized businesses proportionally are more heavily involved in and generate higher amounts of employment than small and micro-businesses in more capital intensive production activities.

3. Small and micro-businesses of the formal sector represent very high percentages of total manufacturing establishments and almost 40% of total manufacturing employment. (If informal sector were included, the figures would be much greater).

4. Small and micro-businesses created proportionately higher total amounts of employment in activites which lend themselves to labor intensive production, and which are closer to Salvadoran primary production.

In terms of this project, the information helps to support the need to address several levels of industrial and manufacturing activity, and will help focus the project properly, given the strengths and potential of each type of business.

Using the DRC calculations done for this project and correlating these with the breakdown information described, better targeting of products and firm levels for export or domestic production and analysis of relative projected employment impacts could be carried out.

2.4. The Importance of Small and Micro Businesses to the Salvadoran Economy and Society

The small and micro-business subsectors of the Salvadoran economy are increasingly being recognized as critical to the country's economic stabilization and recovery. It is clearly understood that these small, often unregistered, businesses account for a great deal of the employment generated, primarily in the low income groups that encompass the vast majority of the Salvadoran population.

According to 1980 figures, the economically active population (EAP) of El Salvador consisted of 1,553,786 people which represents 33.8% of the total population of 4,539,500 (see Table 11). Current unemployment figures range from 40-48% depending on which one talks. Given these figures as a backdrop in attempting to determine the importance of individually-owned small and micro businesses to the Salvadoran economy, reliable data on the numbers of enterprises[1/] and the amount of employment they create also is needed.

1/ Throughout this work we are speaking of non-agricultural production.

TABLE 11

EL SALVADOR: OCCUPATIONAL SITUATION
1978-1980

Occupational Situation	1978 People	1978 Percentages (1)	1978 Percentages (2)	1978 Percentages (3)	1980 People	1980 Percentages (1)	1980 Percentages (2)	1980 Percentages (3)	Difference 78-80 People	Difference 78-80 Percentages (4)	Difference 78-80 Percentages (5)
Total Population	4,279,268	100.0	--	--	4,539,500	100.0	--	--	260,232	6.08	3.0
Working Age Population	2,955,347	--	100.0	--	3,011,244	--	100.0	--	55,897	1.89	0.9
Economically Active Population	1,426,389	--	--	100.0	1,533,786	--	--	100.0	107,397	7.53	3.7
Total Employment	1,373,370	32.1	46.5	96.3	1,282,940	28.3	42.6	83.6	-90,430	-6.58	-3.3
Fully Employed	621,955	14.5	21.0	43.6	757,379	16.7	25.1	49.4	135,424	21.77	10.4
Underemployed	751,415	17.6	25.4	52.7	525,561	11.6	17.4	34.3	-225,854	-30.06	-16.4
Unemployed	53,019	1.2	1.8	3.7	250,846	5.5	8.3	16.3	197,827	373.12	117.5
First Time Unemployed	8,219	0.2	0.3	0.6	25,851	0.6	0.8	1.6	17,632	214.52	77.3

(1) Figures as a percentage of total population.

(2) Figures as a percentage of working age population.

(3) Figures as a percentage of economically active population.

(4) Percentage change between 1978 and 1980.

(5) Average annual rate of growth.

Source: Adapted from figures contained in IPROS: Subsistema Monitor del Empleo en El Salvador, Cuadro 15, September 23, 1983. Final Version; SIECA/ECID/IPROS-10-3110-6.80, Guatemala: Source of this format unavailable.

Unfortunately there is no trustworthy data available. One only has to review the numbers to realize that most calculations which do exist are not realistic. On the basis of one estimate, there were only 2,836 small businesses defined as having 5-49 workers, representing 5% of the total number of medium, small and micro businesses in the country. Assuming an average of 30 employees per firm, which is probably high, these companies would have employed together 85,080 people. The same data shows that there were 56,454 micro-businesses of 1-4 employees representing 94% of the total number of establishments in El Salvador 2/. Assuming an average of 2.5 workers per shop, this gives a total of 141,135 people employed by micro businesses. According to these statistics, therefore, small and micro firms of less than 50 employees created work for 226,215 people or approximately 14.5% of the EAP. These figures include commerce and services.

Given general agreement that small enterprises are a major employment generator, the figures presented above simply are not realistic. The team also attempted to use the latest Encuesta Industrial statistics. However, these figures also were not reliable. A major reason for the distortion is that the universe upon which the calculations are made is based on the Registro del Comercio. Very few small or micro businesses register and are thus excluded from the statistics.

The private associations of small business and artisans as well as FIGAPE and FEDECCREDITO believe, with reason, that there are many thousands of additional people employed in small and micro-business than the censuses would show.

FIGAPE's General Manager calculates from his experience (he is a director of FENAPES as well) that there are approximately 80,000 micro-businesses (1-4 employees), and 37,000 small businesses (5-20 employees) in the country. Assuming again an average of 2.5 employees per micro-business and 8 employees per small business, the total of employment generated by this strata would be 496,000 jobs 3/ which is equal to approximately 32% of the EAP. This calculation seems more accurate. If we assume that only one third of these jobs are in

2/ Estadistica y Censos: Ministerio de Economia, 1980; Breakdown by AID/ES/PRE staff.

3/ These figures do not include artesans, which CONAES (Consejo Nacional de Empresarios Salvadorenos) calculates informally to be some 300,000 people.

manufacturing, the others being in services or commerce, we still arrive at 163,000 people employed by micro and small manufacturing businesses.

If we consider that perhaps 20% of micro-businesses and 25% of small manufacturing businesses are registered with the Registro de Comercio, the basis for the Census information, we can calculate the following:[4/]

1. That there are some 43,700 micro businesses in manufacturing in El Salvador, and;

2. That there are about 3,560 small manufacturers in the country.

Once again assuming an average of 2.5 employees per micro-business and 8 employees average per small firm, using FIGAPES's definition of 5-20 employees as small business, we calculate the following:

1. That micro manufacturing businesses employ 87,460 people, and;

2. That small manufacturing businesses employ 28,480.

That is a total of 115,940 or about 71% of the previous calculation.

No matter which numbers are used, however, it is abundantly clear that the small and micro businesses in manufacturing are responsible for employing well over a hundred thousand and perhaps closer to two hundred thousand people in a war-torn society with a huge unemployment problem.

These businesses to a large degree have not shut down, have continued to employ people, and have helped keep the economy going. They have contributed to maintaining the supply of goods and services and have helped keep inflation under control.

4/ See Table 9 - Breakdown of Salvadoran Formal Manufacturing by Industrial Activity and Number of Employees.

Therefore, a major component of this project is directed toward increasing production and productivity of these firms through financial, technical and managerial assistance including export marketing.

3. CONSTRAINTS AND NEEDS

3.1. Firm Level

3.1.1. Capital Resources

Micro-Business:

Micro businesses are constantly in a working capital bind. They do not generally have access to formal credit institutions and are thus forced to borrow in the informal capital market, e.g., from money lenders, who frequently charge many times the going market rate of interest. Profit, whether it be for savings, reinvestment, or consumption is absorbed by the lender, meaning that small entrepreneurs cannot improve very much their production, productivity, or quality of life standards, since they are probably being decapitalized by the exhorbitant credit terms of the informal credit market. Depending on the loan purpose, most informal credit is for very short periods, days or weeks, at very high interest.

If the entrepreneur does not have access to credit from any source, including suppliers or advances from buyers, chances are there will be discontinuities in his production process due to bottlenecks created by lack of materials. He must wait for payment on previous production in order to buy materials in order to produce more. Much time is lost by these businesses on multiple and redundant collection trips to their outlets--often other small commercial establishments which, because of their own cash flow problems, also are unable to pay the producers up front. This vicious cycle creates pronounced inefficiencies reducing productivity, income, and employment opportunities.

Despite the obstacles, however, these micro businesses exist by the thousands and provide a livelihood for literally hundreds of thousands of people in El Salvador.

Small Businesses:

As with micro-businesses, small businesses also need credit. Yet despite increasing assets bases, productivity and profit potential in comparison to micro-businesses, small businesses in El Salvador also have historically lacked access to commercial bank financing. As with small business the world over, given that banks' transaction costs virtually are as high for small as for large loans and given that there is a greater perceived risk (although it may not be real) in lending to small borrowers, if given a choice, banks will lend to larger, tried and proven borrowers. Furthermore, the banks rely principally on guarantees to qualify loans which small businesses can often not provide. Small businesses are very limited in their guaranteeing capabilities, and banks will frequently take 2 or 3 times the loan amount in collateral, thus reducing the small enterprises credit "worthiness" to a fraction of its actual worth.

Level I small businesses, as we have defined them, represent the next step up from micro businesses. They primarily need working capital and some allocation for fixed assets. As firms grow, these requirements likely will change as they elect to increase production and productivity levels and, thus, profits through the use of more automated production methods. As this trend progresses, more credit needs to be earmarked for fixed assets in relation to working capital for Level IV small firms--just the opposite of Level I small businesses. But such credit interventions should not lose sight of relative factor costs and the importance of employment creation in developing nations.

Credit Demand: Micro and Small Business

There is no official credit demand information for these sub-sectors. Obtaining an accurate estimate had to be done principally on the basis of current portfolio information from the three most important institutions lending to these businesses as well as assumptions about relationships between current portfolio balances, unsatisfied demand and reflows.

In the case of FIGAPE (Fondo de Financiamiento y Garantîa para la Pequena Empresa), the base used was their unsatisfied demand figures from an April 1983

report delivered to IDB.* For FEDECCREDITO, we assumed that 50% of current portfolio balances represented unsatisfied demand which in turn was based on FIGAPE's 42% figure adjusting for FEDECCREDITO's liquidity crisis. Second year (1985) demand was calculated at 33% of 1984 demand, assuming that a large portion of unsatisfied demand would be covered in 1984 through AID and other donor financing and from reflows from short-term loans.

The calculations have also been based on those lines which are primarily geared to non-agricultural production and micro-empresas. Thus, we have estimated a two year 1984-85 credit demand as follows:

	Millions of ₡	
	1984	1985
FIGAPE	₡ 7.6	₡ 3.8
FEDECCREDITO		
Credito Popular	3.3	1.9
Rural Community Development	10.3	3.4
Urban Community Development	3.7	1.2
Sub-Total	17.3	6.5
Banco de Fomento Agropecuario		
Micro-Empresas Rurales Subproject	4.0	2.0
Agroindustrial (207 beneficiaries mini-fundia for non-traditional production. Geared toward newly formed associations for agri-processing facilities and equipment (would include foreign exchange loans)	2.7	2.2
Sub-Total	₡ 6.7	₡ 4.2
Total	₡31.6	₡14.5
	US $12.6	US $ 5.8
Total Estimated Demand for 1984-85 (Millions of US dollars)		US $18.4

*Informe Basico Preliminar para ser presentado a la Mision del BID - FIGAPE April 1983.

FEDECACES (Federation of Savings and Loan Cooperatives of El Salvador) is another potential lender, however, historically it has tended to orient its lending to consumer, housing, and agricultural loans. Its impact on demand projections for the type of productive credit in manufacturing that is of most importance here would be negligible. Also, in contrast to the other institutions which have serious liquidity problems as of 9/30/83, FEDECACES had US $1.9 million in its pipeline that had not been moved.

Medium and Large Business:

Major constraints for medium and large firms' access to needed capital include shortage of exchange, reduced credit worthiness due to the declining economy and general deterioration of individual bank portfolios. Refinancing has increased, resulting in a decrease in new credit supply. Anti-inflationary measures by the Central Bank also have affected local credit availability to the medium and larger firms. Another major constraint to medium-sized firms is the lack of technical assistance in project and loan preparation. This is especially true for applications for funds supplied by international credit organizations where credit analysis is more stringent. Some banks have admitted that they, too, could use additional training in credit analysis and loan processing in order to handle more efficiently loans to medium and large businesses, especially those engaged in foreign trade.

The problems and needs of the medium and large firms which are exporting revolve principally around foreign exchange. The balance of trade is in deficit approximately US $130 million and, unless exports are stimulated, will no doubt continue unfavorable. Assuming exports can be increased enough over the next three years to eliminate the unfavorable balance of trade, additional foreign exchange requirements for these medium/large firms will average US $45 million per year of which approximately US $13 million per year would be provided by a proposed World Bank loan. The elimination of the unfavorable balance of trade would bring capital resources back to 1979 levels.

As for local credit needs, there probably will be no increased demand over the next three years for medium to large firms in the industrial and commercial sectors unless exports are stimulated. Firms in the industrial sector are

suffering from serious underutilization of capacity and need the stimulation of exports in order to increase their production related expenditures and, therefore, raise local credit needs. It is not possible to estimate the increase in local credit demand that would result from increased exports during the next three years since the internal situation in El Salvador and foreign competition will heavily influence the ability to generate demand for export production and to attract foreign investments.

3.1.2. Human Resources

Micro-Business:

Micro-businesses in manufacturing generally are very basic kinds of operations with rudimentary levels of technology and management. They are sole proprietorships whose owners/managers are frequently workers who decided to start their own businesses due to lack of alternative employment opportunities, although many also are true entrepreneurs.

They do not often have training in good administrative procedures. Thus, they infrequently have any form of bookkeeping or other controls generally accepted as important to business. What information they do compile is often tucked away in their heads or scattered among pieces of paper and invoices stuffed in drawers in small, usually one-room shops adjacent to the family's living quarters. Cost analysis is not formally done--although entrepreneurs frequently have notions of earnings measured by whether income has been sufficient to cover materials and household expenditures. Often no division is made between business and household expenses.

Very simple general observations about management, administration and notions about what makes a production shop a real business are useful at the micro-business level. But essentially these are consciousness raising tasks which lay the foundation for more sophisticated steps when the entrepreneur is ready for them. And by their nature, these tasks are often as socially oriented as they are technical.

Small Business:

Small business owners are often skilled workers who have not had formal training in business management skills. In this respect they are similar to micro-entrepreneurs in the manufacturing industry; however, as their businesses have grown and become more complex, they have been forced to adopt more sophisticated management, administration and production methods.

These systems have often been implemented in a haphazard way. But despite inadequate formal management, because of the entrepreneurs' ingenuity, businesses continue to be able to function and compete. With small, appropriate injections of training and technical assistance, some rudimentary and straight-forward changes could make a big difference to business efficiency and productivity, as well as put entrepreneurs in better positions to expand and create more employment.

Medium and Large Business:

The principal constraints in large and medium industries that retard the efficient use of human resources, particularly for export production, are as follows:

- Lack of skilled technical expertise necessary to carry out export marketing and planning analysis which would allow these companies to enter or expand their export markets.

- Lack of trained personnel to carry out inventory procedures for the importation of raw materials and equipment. This causes a skewing of the firms' demand for foreign exchange, with the result that there is oftentimes a shortfall, resulting in the loss of export orders.

- Lack of trained personnel in these firms to identify overseas non-traditional markets and link this information back into the quality control at the product production level.

3.1.3. Technology and Information

Micro-Business:

Entrepreneurs often lack strong controls on materials use and quality control with resultant loses of profits and income. Also, micro-businesses use very low levels of technology in their production processes. Employees tend to be novices having low skill levels. With improved tools and better skills, human resources could be more productively used.

Technical and managerial assistance programs to these businesses are needed. But unless there is a clear, pragmatic (as opposed to conceptual) understanding by the entrepreneurs that improved management will make their businesses prosper, technical/managerial assistance may be largely a waste of time and resources. For these businessmen and women, administration, such as bookkeeping, is viewed as "down-time". Because it is not directly related to turning out something to be sold which in turn creates a better cash flow, micro-entrepreneurs generally are not likely to keep books consistently.

Programs, therefore, should concentrate first on those basic areas which will show direct and immediate impacts on profits. Elimination of waste through better ways of cutting lumber, cloth, or leather stock (a part of skills training) is one example. This training can be done quickly by low level promoters and technical assistance providers and the results may have a direct impact almost immediately on the entrepreneur's earnings. This makes him or her a believer in assistance. Once this kind of credibility is created by the program, there is more likelihood that attention will be paid to learning bookkeeping and other management principles.

Small Business:

There will be differences in constraints between Level I and Level IV small firms in management information, administration, and technology. As business operations become more complex with more raw-materials being purchased, as production increases and more employees are hired, and as the firm seeks new and

bigger markets, there will be needs for more and better information upon which to make managerial decisions and more highly technical production processes.

The Level I small entrepreneur may often have essentially the same business attitudes as the micro-entrepreneur. But for him, good accounting information collected through a simple bookkeeping system, better cost and income information, and better personnel and production systems are needed as the business becomes more complex. When new markets are sought, quality and production schedules also become more important.

As we move through the typology from Level I to Level IV small businesses, their complexity increases and within each firm there is more specialized division of labor. Most small businesses need some form of technical and managerial assistance to help them increase production, productivity, firm income and employment. If proper targeting is done, using the definition of firm size as a guide, the right kind and level of assistance should be provided to meet these needs and have an economic impact on the firm.

The kinds of assistance that will be used by the small businessman or woman must be based on an inventory of needs according to the specific level of business. There will be overlaps between continuous levels, but it will be very rare that a Level I and Level IV small business, for example, would require exactly the same type of assistance. At Level I bookkeeping would provide the kind of information needed for this size and complexity of business. Anything more will translate into wasted effort and resources which might be spent more effectively elsewhere.

Level III and Level IV small businesses will also require more technical assistance in terms of skills training for machine operators, plant layout, and improved production processes.

Medium and Large Business:

Large and medium firms suffer from many of the same constraints as smaller firms. That is, they are hampered in their search for new overseas markets, especially U.S. markets under the new CBI initiative, by a lack of experience in market penetration and development outside of the CACM; an expensive and

inadequate transportation system for their merchandise, especially to Western U.S. and Asian markets; lack of modern and more efficient machinery (due to lack of foreign exchange) which in the case of the food processing industry, would allow them to compete in the international markets while still maintaining their position as large users of labor.

3.2. Supporting Institutions Level

3.2.1. Capital Resources Assistance

Micro-Business and Small Business:

Several semi-autonomous intermediaries, FIGAPE, FEDECCREDITO, and the Agricultural Development Bank (BFA) currently lend to small and micro-enterprises. FEDECACES, the Savings and Loan Association Federation, also makes loans available for small business activity.

Despite internal management problems which have been amply described in other reports and evaluations, these institutions are capable of lending, and have lent, substantial amounts to small and micro-businesses. Some of their credit lines for micro-businesses require only moral or solidarity guarantees. Repayment in these lines has historically been excellent.

Having this kind of credit access is critical to small and micro-businesses. In this respect, El Salvador is far ahead of other countries in Latin America and the Caribbean.

This project offers an opportunity to improve the small and micro-enterprise credit systems as well as to attempt to expand lending to these sub-sectors through the commercial banking system. Incentives such as a guarantee fund and other enticements could be made available. A principal objective would be to interest commercial banks in testing a wider credit market, including lending to smaller firms. Details of the system will be developed at the next stage of project planning.

Small and micro-business finance service institutions unquestionably need improvements in their internal management. FEDECCREDITO has had serious problems in internal management of its loan funds and repayment rates in the past several years. FIGAPE has also had a recent change of management after several years of poor performance. And the BFA which has relied on CENTA promotion and technical assistance for its micro-enterprise credit line has had, as a consequence, some problems in identifying sufficient manufacturing projects. Too many loans have been made for commercial activities because the organizations find it easier to reach and promote these businesses.

Steps are being taken to improve the intermediaries' organization and management, to improve loan repayment, and to promote effectively credit programs. In the last several years, historically excellent repayment records have slumped in large part due to the economic and political problems of the country, but also due to poor internal management of the institutions. Overall, the intermediaries need credit analysis training for small scale business credit analysts within the system. This possibly could be coordinated nationally by the National Productivity Center (CENAP). The institutions also should have internal monitors financed by AID to provide supervision over institutional reforms and a move toward improved organization, management, and efficiency.

Medium and Large Business:

The monetary and credit policies of the El Salvador aim at creating conditions favorable for real growth of the economy,including increased production and an equalized balance of trade. In spite of past efforts, the economy deteriorated seriously after 1979, although a tendency toward improvement has been seen since late 1982.

A key factor in the planned economic recovery is the commercial banking system which bears the brunt of responsibility for financing production and foreign commerce, as well as for the supply of foreign exchange necessary to carry out production and commerce.

Prior to the banking reform of March 1980 which nationalized the commercial banks, banks were in the hands of a few wealthy families who restricted the use

of loanable funds made up principally of demand deposits to their own groups and largely in the areas of large agriculture and commerce. The reform was brought about to give credit and finance facilities to a larger segment of the economy, to carry out financing for the agrarian reform program, and to channel resources toward a more productive economy.

Visits to a number of commercial banks (more than three years after the nationalization) has left the strong impression that the banks are operating better and more efficiently now than before the Reform. Although profits of the banks have not improved, credit has been extended to a much larger segment of the economy and demand deposits have increased considerably. It appears that the social, political and macro-economic goals of the Reform are being met.

Under the Reform, the government became almost the sole shareholder of the commercial banks and thereby set up their Boards of Directors. There is a provision for selling 49% of bank shares to the public and to bank employees, but this procedure has had little movement since the Reform. According to the bankers, the banks have continued handling financial matters as before, though they have gone from several stockholders to one stockholder -- the government. The patrimony of the banks has been maintained respecting the functions of private enterprise. Each bank has its independent policy and the necessary element of competition is fostered among banking enterprises. Banks are encouraged to maintain loan portfolio structures, with their own resources, that will emphasize productive activities.

Prior to the Reform, many exporters obtained extensions on short-term export credits so that it would appear there were no arrears and at the same time medium/long-term debt was understated. Credit delivery has been considerably improved by the implementation of a credit application procedure (for rediscount through the BCR) whereby the commercial bank does all of the elaborate credit analysis, since it knows the client, and the BCR accepts the analysis and recommendation without delay.

At present there is no problem in delivering credit to customers. If they are in arrears they have been told they can refinance under the new "refinancing scheme" effective May 1983. If they do not take advantage of the refinancing provision,

which comes from the bank's own resources and offers attractive terms, they may not be allowed new credit.

For commercial banks' credit to small enterprises and start up operations, the banks will always require collateral or proven earning power to support loans since the banks are profit motivated and obligated to protect depositors. A communal guarantee fund could be set up (possibly by AID) to guarantee loans for small or new operators after they are examined as to feasibility, capability and direction of effort toward improving the economy. The amount of the guarantee fund allocated to a particular entrepreneur could be freed up as soon as the loan is repaid.

As for the foreign exchange picture, it is generally known that a shortage of foreign exchange exists which affects exporters of non-traditional products and importers of raw materials for domestic production (Table 12). The shortage is caused in part by foreign exchange being held outside the country (through increased invoices, etc.) as well as flight of capital. However, the principal reason for the shortage is a substantial decline in the value and volume of exports (Table 13). The unfavorable balance of trade (Table 14) is approximately US $130 million for 1983 as compared to US $106 million for 1982. It is expected that the 1984 unfavorable balance will be at the 1983 level and the 1985 unfavorable balance should decrease considerably if exports are stimulated. The key to the generation of foreign exchange is the increase of the export of non-traditional products which, in turn, depends upon marketing outside the CACM for demand generation. The overall objective is to eliminate the unfavorable balance of trade.

Since non-traditional export transactions are carried out in the parallel exchange market, the commercial banks are responsible for the receipt and disbursement of foreign exchange. The banks have been doing as much as possible to expedite the allocation of exchange to the non-traditional target groups. There is always a slow down when foreign exchange is scarce and since the applications must be carefully checked for invoice fraud, a bottleneck is created by personnel shortages in the BCR. However, the BCR is preparing a standard price list on some 400 items so that invoice pricing can be checked more rapidly. The commercial banks feel that they are handling their portion of the

TABLE 12

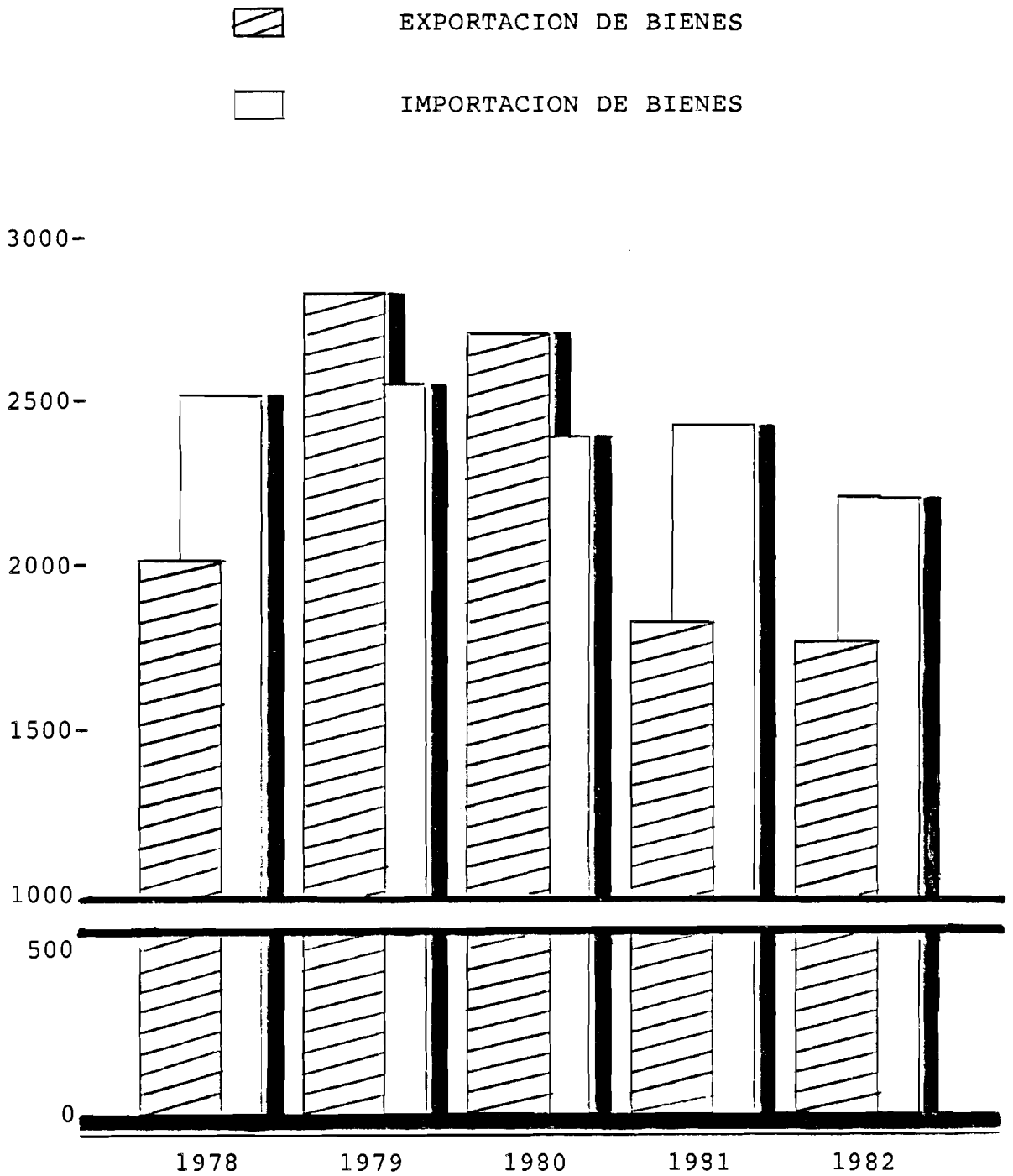
EL SALVADOR
FOREIGN EXCHANGE FORECAST

	**1983	1983	Actual 1982
Beginning Balance	11.5	11.5	2.3
Inflow:			
Traditional Products	414.6	359.7	380.4
Loans	234.2	239.7	307.3
Other (deposit, donations)	247.7	116.8	166.5
Total Inflow	896.5	716.2	854.2
Outflow:			
Imports	494.2	508.0	476.2
Debt service Central Bank	231.1	236.5	205.3
Debt service public sector	53.5	73.5	43.8
Regional debt - CACM	25.3	36.8	33.6
Others	102.9	46.2	86.1
Late Payments	- -	73.8	- -
Total Outflow	907.0	974.8	845.0
Balance Forecast	1.0	(247.1)	11.5

*Jan/Mar Actual
**Jan/Oct Actual

TABLE 13

EXPORTACIONES E IMPORTACIONES DE BIENES
(MILLONES DE COLONES)



Source: BCR Annual Report 1982

TABLE 14

EL SALVADOR, Balance of Payments

(Millions of US $)1/

	1970	1975	1976	1977	1978	1979	1980	1981	1982a/	1983b/
I. Trade Balance	41.5	-17.4	63.6	112.5	-148.8	178.6	178.8	-100.4	-106.5	-127.2
Exports, FOB	236.2	532.6	744.1	972.4	801.5	1132.3	1075.3	798.0	700.4	722.6
Imports, FOB	-194.7	-550.0	-680.5	-859.9	-950.4	-953.7	-896.5	-898.4	807.0	849.8
I. Net Services	-47.0	-102.7	-69.3	-121.3	-188.4	-208.6	-197.1	-210.5	-223.1	-241.4
Freight and Insurance	-19.5	-48.0	-54.2	-69.7	-78.7	-87.0	-65.5	-86.2	-76.0	-90.2
Travel Abroad	-12.0	-15.4	-13.4	-26.1	-66.5	-92.1	-92.7	-55.1	-44.0	-42.0
Miscellaneous Transport	-5.3	-	-3.0	1.4	3.0	3.6	6.6	-6.2	-8.0	-8.0
Insurance	-2.1	-4.0	-0.8	-2.2	-2.0	11.2	3.0	0.7	1.6	2.0
Investment Income	-8.8	-28.9	-18.1	-33.5	-60.5	-62.7	-83.7	-100.1	-119.4	-130.0
Government Operations	-0.8	-2.0	6.4	0.7	1.6	7.8	4.1	5.6	0.2	0.8
Other Services	-0.1	-4.4	13.8	9.5	14.7	26.2	39.4	30.8	22.5	26.0
I. Net Transfers	14.3	28.3	29.3	39.6	51.4	51.4	48.9	60.4	160.0	204.7
V. Balance on Current Account (I, II, III)	8.8	-91.8	23.6	30.8	-285.8	21.4	30.6	-250.5	-169.7	-163.9
V. Capital Account	6.1	131.2	74.6	1.4	314.4	-129.5	-226.8	171.4	239.8	269.6
1. Official and Bank Capital (1, 2, 3)	5.3	75.8	32.8	-16.2	128.7	103.3	186.6	262.6	269.0	298.2
Loans	8.2	138.5	70.5	72.3	149.0	116.8	232.4	344.6	366.7	451.2
Repayments	-6.2	-59.3	-38.1	-86.0	-20.3	-20.4	-51.0	-82.0	-97.6	-153.0
Other	-0.9	-3.4	0.4	-2.5	-	-	-	-	-	-
SDR Allocation	4.2	-	-	-	-	6.9	5.1	-	-	-
2. Private Capital	0.8	55.4	41.8	17.6	185.8	232.8	-413.4	-91.2	-29.3	-28.6
Direct Investment	3.1	13.2	31.1	34.7	33.7	-11.1	5.9	-	-	-
Long-Term Loans	3.6	21.0	25.3	16.5	33.8	24.2	9.3	-	-	-
Long-Term Payments	-4.6	-15.9	-15.8	-22.2	-21.2	-63.1	-51.3	-	-	-
Other Long-Term	-0.3	-1.3	0.8	2.4	3.6	-3.5	-1.0	-	-	-
Short-Term Capital Flow	-1.0	15.4	0.4	-13.8	135.9	-217.2	-407.0	-	-	-
3. Undetermined Capital	-7.4	8.6	-22.7	-32.0	-	-	-	-	-	-
/I. Change in Net International Reserves (V - IV)	7.5	48.0	75.5	-0.2	28.6	-108.1	-196.2	-79.1	70.1	105.7
II. Level of Net International Reserves	52.4	130.1	205.6	205.7	234.4	126.3	-69.9	-149.0	-79.0	26.7

/ Original figures in colones converted to dollars at exchange rate of 2.50 colones = USA $1.

/ Preliminary figures.
/ Central Reserve Bank Projection.

ource: Central Reserve Bank at El Salvador.

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import/export process very efficiently and are in a position to handle increased activity brought about by external market stimulation and increased credits from international funding organizations.

Limitations on credit no doubt present a major problem in the revitalization of the Salvadoran economy. The demand for credit has declined as a result of decreased production, foreign exchange shortage and loss of investments. As noted earlier, this is due to declining old markets and lack of new ones. Offsetting the decline is the shortage of bank deposits and the increase of credit demand of the public sector. As the demand for new credit went down, refinancing went up, demonstrating the slide in production and the deterioration of the bank portfolios. In addition, foreign private credits are no longer available. Once production for export begins to increase appreciably and, as a result, domestic demand increases, credit will no doubt become a serious problem for producers.

Credit demand may be divided into export credit and other credit. As for foreign exchange, we will assume that export demand will be stimulated to the point of eliminating the unfavorable balance of trade, and that a considerable credit demand will be created to purchase foreign exchange and finance export production as well as purchase capital equipment (Table 15). It is the opinion of commercial bankers and officials of the BCR that enough demand for credit will be created to more than offset the supply of export credit currently being contemplated by the World Bank and AID.

To demonstrate this, we could increase marketing output by an amount sufficient to add about US $250 million to exports and create credit demand as follows:

Increase in Production Costs	US $250 million
Increase in Imports	100 million
	US $350 million
Foreign exchange trade credit requirements (on 120 days)	US $110 million.

Foreign exchange for capital goods linked to additional production and capacity expansion is essential. In 1978, capital equipment imports amounted to US $87

TABLE 15

DEMANDA DE CREDITO DE EXPORTACION (NO TRADITIONAL)
LINEAS DEL BCR
-Saldos en miles de Colones-

Actividad Economica	30/IV/83	31/VII/83	30/IX/83	31/XII/83*
Industria Manufacturera	3,971	3,378	2,963	2,833
Comercio de Exportaciôn	12,884	11,477	15,724	15,037
Transporte	160	152	136	130
Turismo	20	-	-	-
TOTAL	17,035	15,007	18,823	18,000
Total Programmed by BCR				40,000

DEMANDA DE CREDITO DE EXPORTACION
POR TAMANO DE LA EMPRESA
LINEAS DEL BCR
-Saldos en millones de Colones-

Tamano	30/VI/83	31/VII/83	30/IX/83	31/XII/83
Pequena empresa	317	208	139	133
(Mediana empresa	-	-	-	-)
(				)
(Gran empresa	16,718	14,799	18,684	17,867)
TOTAL	17,035	15,007	18,823	18,000
Total Programmed by BCR				40,000

*Datos estimados.

Source: BCR Credit Department

million, which at current prices would be US $135 million. In 1981, imports of capital goods were US $39 million (per the IBRD). Based on these figures, additional capital goods investment to sustain additional exports is estimated at US $25 million. Therefore, the proposed total foreign exchange to stimulate exports is US $135 million or roughly equal to the unfavorable balance of trade of US $130 million.

However, indications are that in order to justify this conclusion, a formal credit demand survey among industries must be made as a requirement for project preparation. The World Bank has relied heavily on macro-analysis, the Ministry of Planning Industrial Survey and the BCR Research Department to satisfy themselves that the demand for credit will be more than enough to utilize the availability. The World Bank contemplates US $15 million in immediate short-term pre-export credits and only US $8 million per year over three years for medium/long-term credits to be administered by the Economic Development Fund of the BCR. These credits, in large part, will be used for medium/long-term loans to non-agricultural industry.

To insure economic recovery, a non-traditional export oriented production program is vitally needed. Such a program would create employment by taking advantage of idle or underutilized plant capacity. The new BCR "Refinancing Scheme" is making more medium-term money available so that the industrial sector can obtain better terms for its short-term liabilities. The current plans for medium/long-term financing by international development organizations will permit rehabilitation of existing equipment and replacement with better credit conditions. The commercial banks are presently reluctant to grant medium/long-term credit and BCR records indicate slack demand for long-term credit, in spite of the lack of foreign credits, except for refinancing, because of the decreased exports and below capacity factory operations.

Major constraints to access to needed capital include shortage of foreign exchange, reduced bank lending availability (due to declining economy), lack of foreign credits and increased refinancing on a more liberal basis. Restrictions on money supply by the IMF also has an effect on access to capital. Constraints on capital for small businesses principally come about because of lack of access to credit in the absence of guarantees.

On an institutional level, capital resources for medium and large firms are commercial and mortgage banks, the BCR, the Central Government and Private and Public Financial Institutions.

The principal constraints to the delivery of credit at the supporting institution level are as follows:

- Deteriorating economy causing capital shortages
- Lack of credit analysis
- Lack of collateral
- Lack of loaning power
- Poor administration and favoritism
- Foreign exchange shortage

The most difficult part about the foreign exchange, credit demand and other financial and banking activities in estimating future projections is the difficult and turbulent situation that El Salvador now finds itself in. The nationalized banking system is presumed to be working better than the old system, but that may not be obvious under the present political and economic situation, one which would put pressure on any banking system. In addition, fear exists now of a change in the management of the banking system after the March 1984 elections which could seriously disrupt the successful operation of the banks individually and the system as a whole. To summarize, the following are factors which could well affect the financial system as well as other activities:

Volatile political situation
Elections in March 1984
Security - access to domestic raw materials and labor
Flight of Capital (possibly increasing)

Constraints to access and efficiency of capital resources have indicated a need for technical assistance and training in the area of financial systems on an institution building and outreach basis. Some of the technical assistance and training recommended for the commercial banks are the following:

- Credit Analysis - A credit expert could be sent to provide thorough briefings in credit procedures.
- Loan Supervision - The credit expert could also give a short course in this area.
- Import-Export Procedures - A seminar could be held for the attendance of all financial institutions related to export/import activity.
- Project and Loan Preparation - This could be taught by the credit expert as a pass-through to prospective borrowers.

If a loan guarantee fund is set up, some business technical assistance and training for borrowers must be made available. This may be done through the National Productivity Center (CENAP) and will give the smaller borrowers a better chance to be successful and repay the loans.

At the institutional level the World Bank, as previously mentioned, is currently preparing an Industrial Credit Project for providing foreign exchange to rehabilitate existing financially viable industries. The Project was originally considered in 1979 and was subsequently modified to adapt to changing economic conditions. It is expected that the Project will be presented to the World Bank Board during the first half of 1984 and that disbursements will commence in the second half of 1984. The loan will be for US $40 million, $15 million for short term export credits and $25 million for long term financing for capital equipment and permanent working capital to both exporting firms and selected import substituting firms.

3.2.2. Technical and Managerial Assistance

A number of public and private organizations are either currently providing assistance to micro-businesses and small firms or would be interested in doing so.

The public institutions are Centro Nacional de la Tecnologia Agropecuaria (CENTA), and Centro Nacional de la Productividad (CENAP).

Private Institutions include: Fundacion Salvadorena para el Desarrollo (FUSADES); Federacion Nacional de Pequenas Empresas Salvadorenas (FENAPES); Union

de Dirigentes de Empresas Salvadorenas (UDES); and Consejo Nacional de Empresarios Salvadorenos (CONAES).

A small amount of technical/managerial assistance is being given to the small/micro-business sub-sectors by CENTA, but by all accounts its effectiveness has not been very high. For this reason, AID has financed several training seminars for CENTA micro-business extension workers in hopes of improving the institution's micro-business assistance capabilities.

CENAP is providing technical assistance primarily to large and medium-sized businesses. Its thrust is primarily technological and in quality control and management techniques. CENAP does not work currently with small and micro-businesses. However, it would be an institution to consider for coordinating some portions of technical assistance to Level III and IV small businesses. It would also be a possible site for coordination of assistance to financial intermediaries in credit analysis training, for example. CENAP could potentially coordinate provision of all technical (in its pure sense--e.g., technological) information and training to all levels of business.

As for general business management concepts, elementary bookkeeping, and sales and production assistance needed by micro and small businesses, (Levels I and II), FUSADES, FENAPES, and CONAES seem most interested in, or appropriate for, giving this kind of aid. FUSADES is currently viewed as a very important organization to coordinate assistance to these levels of business. The major problem is that none of these organizations currently has an institutional capability of actually becoming a technical/managerial assistance resource immediately.

This does not mean, however, that each organization could not develop the institutional capability relatively quickly to become a technical/managerial assistance resource.

Each organization has a wealth of entrepreneurial experience and expertise among its membership which could be formed into one or more talent banks which could be tapped to provide assistance to the appropriate business level and to train permanent promotion and extension staffs. This in-house talent could be

supplemented with short-term specialists to orient the organizations about developing indigenous expertise in providing this type of assistance. Substantial expertise already exists that only needs short-term kinds of external inputs to orient the system--not to run it.

For larger firms, Level III and IV small businesses, and medium-sized firms, UDES appears to be important in terms of its interest in export promotion and its general institutional presentation as an organization most familiar with this type and level of business activity in El Salvador.

3.3. Macro-policy Level

3.3.1. Policy Environment and Identified Constraints to Increased Production

In common with most other countries, El Salvador's trade policy is implemented through a variety of means, including allocation of credit, the application of exchange into policies, fiscal incentives, many of which are applied by a number of different government agencies such as, Central Bank, Ministry of Finance and the Ministry of External Economy. Not surprisingly, decision-making is slow and often decisions appear contradictory with state policy. In order to overcome these difficulties, there has to be a greater commitment by all agencies of government, and especially those which participate in trade-related policy issues, to increasing exports and diversifying El Salvador's economic base.

The principal constraints at the public policy level at the present time include:

a) the availability and cost of finance
b) exchange rate policy
c) official export promotion assistance
d) Export Development Law
e) Fiscal Incentives Law

Although credit facilities are restricted in El Salvador at the present time, they appear to be especially tight for exports of non-traditional export products to non-traditional markets. This situation exists despite the fact that the Central Bank has maintained an export credit facility, provided at a preferential

interest rate and access to local currency due to poor portfolios and credit qualification restrictions. These funds have been provided by IDB, private financial institutions and AID through BLADEX in Panama.

Because of foreign exchange shortages, GOES has introduced strict controls on the availability of foreign exchange and a dual exchange rate. Requests for foreign exchange from exporters of non-traditional exports do not rate as first priority. Delays often occur in transferring funds after the local currency has been deposited in the local bank. In general, companies are required to export more than 25 percent of their production if they are to be allowed access to foreign currency at the parallel market rate. Both the availability of credit and the availability of foreign currency appear, in the eyes of the private sector, to have decreased since the banks were nationalized, with long delays in the processing of applications and injustices in foreign exchange allocation.

The coordination of officially sponsored export assistance is now in the hands of the Ministry of Foreign Trade. This Ministry has the responsibility for promoting exports, but does not have a central role in the fiscal, monetary or financial aspects of the economy which have a key impact on the ability of the private sector increased exports. In general, it is agreed that MICE has little or no expertise in the area of export promotion.

Both the Export Development Law and the Fiscal Incentives Law, while containing many useful and essential features, both suffer from having been devised when the Central American Common Market was the most significant element in El Salvador's trade flows. In addition, a number of important features of the export law, for example: export insurance and a tax rebate system, have never been implemented. In general, the export law does not encourage El Salvador companies which traditionally serve either the local market or the CACM to begin exporting to non-traditional export markets.

3.3.2. Necessary Modifications to the Policy Environment

In response to these constraints identified in the public policy environment, it is obvious that a number of specific areas of public policy must be modified if

an industrial stabilization and recovery program is to be effective. The main changes in the policy environment are:

a) The Central Bank should attach greater priority to providing the hard-currency requirements of non-traditional exporters.

b) Provision should be made for the establishment of an export credit insurance program.

c) Changes should be made to the Export Incentive Law in order to extend incentives to those local companies who presently do not export a large proportion of their output, but who should be encouraged to make a start in exporting to non-traditional export markets.

d) The Investment Incentives Law should be re-drafted to encourage foreign investment, especially those companies which bring capital, technology and access to foreign markets.

e) Improved government coordination is necessary if the often conflicting policies adopted by different government departments and ministries are to be overcome. Establishment of an inter-agency group for Central Bank, Ministry of Finance, Ministry of External Economy and the Mixed National Committee on the CBI is recommended.

Few of these policy modifications are significant changes of the status quo although some technical assistance may be required to implement them (eg.: b, c and d above).

The San Bartolo Duty Free Zone was established and continues to be operated by the public sector. Due to economic and political development over the period since 1980, the Free Zone has seen a steady reduction in the number of firms using the facility until at the present time only three fully operational units remain. Due to the proximity of the Free Zone to the municipal airport, the vacant industrial buildings have in large part been taken over by the military.

The priority as the security situation returns to normal must be for the military to vacate the Free Zone and for efforts to be devoted to marketing the facility which exists. It is recommended that this marketing should form part of a more general initiative which would include privatization of the Free Zone, if possible, by involving an international corporation which, in joint venture with local business interests, would improve and upgrade the present San Bartolo operation and lay the basis for other private sector Free Zone operations elsewhere in El Salvador. Such a development would establish the base from which the local and the foreign private sector would be able to work in response to the rise in the rate of economic activity which it is expected will follow the drive for new, non-traditional export markets.

4. PROJECT DESCRIPTION AND RATIONALE

4.1. Goal and Purpose

The goal of the project is to stabilize the Salvadoran economy by increasing the present levels of employment, production and balance of payments. The Project purpose is to assist existing firms in the non-traditional industrial sector to rehabilitate and reactivate their productive capacity and to increase the participation of small business in the economy. The sub-purpose is to increase foreign exchange, generate employment and promote the use of installed capacity linked to the CBI.

4.2. Strategy

Based upon the foregoing analysis, it is clear that the basic thrust of the proposed AID Project should be to stabilize the Salvadoran economy by increasing credit availability, increasing the level of employment, improving the balance of payments and supporting the private sector by establishing new export industries to non-traditional markets in non-traditional products. The stimulation of exports will increase the use of presently under-utilized industrial capacity, capitalize on the potential trade benefits of the CBI, generate additional foreign exchange and put the economy on an export-led growth path.

To carry out this strategy, the project should:

- Provide a flow of credit for the export sector which will finance exports and essential imports of new materials, provide the funds for new machinery and capital equipment and yet ensure that the money is not used for re-financing of old debt;
- assist Salvadoran businessmen with the identification of export opportunities and ensure that the full range of export services are available, including export promotion;
- assist the Salvadoran small business sector through the provision of local currency, small loans and essential technical assistance to better enable the small businessman to penetrate local markets and wherever possible the export market; and
- improve the national policy environment to assure greater incentives to investment.

4.3. Project Components

4.3.1. Credit to Export Firms

A major element of the project will be the provision of $35 million in foreign exchange credits to be used for the purchase of raw material, machinery, equipment and related inputs into export production, especially agro-industries. USAID has considered a number of possible structures for implementing the export credit component, including the creation of a new financiera-type organization. However, given the strong considerations for rapid delivery and simplicity of design, strongest consideration is being given to two alternatives.

a) Cooperation with IBRD through the Central Bank.

The IBRD plans to provide $40 million to the Central Bank in 1984.

Approximately $15 million in short term loans would be provided to exporters for financing inputs required for export production. Loans would be 90-360 days covering up to 80% of exports to third countries and 50% of exports to other CACM members. Loans would be repaid in foreign exchange after completion of the export transaction. In the case loans are made to exporters earning soft currencies, BCR would undertake to exchange the soft currencies into dollars.

Approximately $25 million in long term financing for fixed assets investment and permanent working capital will also be provided to both exporting firms and selected import substituting firms, provided they have a positive net impact on the foreign exchange balance of the economy. This long-term fund would be disbursed at the rate of some $8 million annually for 3 years.

The funds would be channelled through a permanent second-tier institution with its own staffing, financial resources and separate accounting. This institution would be responsible for reviewing and approving investment projects submitted for financing through the banking system. The World Bank and the Central Bank have agreed to the reorganization of the Fondo de Desarrollo Economico (FDE) (a development fund currently operating within the Central Bank), to become the entity described above. The fund would be transformed into a separate entity with a director who would be responsible directly to the president of the Central Bank. The degree of autonomy of this new entity is still under discussion, as well as the interest rate structure which would eliminate subsidized interest rates for productive loans.

Since the IBRD funds are generally directed at the medium and larger industrial enterprises, the AID funds could serve as a complement by targeting the medium to smaller firms and agro-industry. However, while it may be reasonably assumed that both the IBRD and AID lines will be successfully drawn down over the projected time period, it is not certain that moving the export oriented funds from AID through this mechanism would be the best approach. Further understanding will have to be gained of the operating procedures, efficiency and independence of the restructured FDE before such a decision can be made. There is, in addition, a strong sentiment within the private sector that export credit could and should be channeled through a private institution.

b) BLADEX

During the course of project preparation, AID has discussed the possible role of the Banco Latinoamericano de Exportaciones (BLADEX) in providing the AID export credit funds both with BLADEX representatives as well as with USAID/ROCAP offices in Guatemala.

BLADEX's principal objective is to promote Latin American exports, primarily of non-traditional products by delivering short and some medium hard currency credit to private export sectors. It conducts its transactions through participating, shareholding commercial banks based upon pre-established lending criteria and terms and conditions mutually agreed to by BLADEX and the country's central bank. To date, there have been seven transactions involving four Salvadoran banks under the ROCAP program.

A typical transaction may be summarized as follows:

- a letter of credit, confirmed by the foreign bank, is opened in favor of the supplier at the request of the manufacturer.
- the raw materials or intermediate goods are then shipped to the manufacturer against the letter of credit. BLADEX then pays the foreign bank, in effect creating a loan to the domestic bank.
- at such point as the goods are manufactured and ready for shipment, the line of credit could be extended into the post-shipment phase.
- prior to shipment, the foreign customer would open a letter of credit through a foreign bank confirmed in favor of the manufacturer by the domestic bank. Upon presentation of shipping documents, the foreign bank is instructed to collect payment from the customer and forward it to the BLADEX.
- as the funds are received, BLADEX deducts the amount due it and forwards the net amount to the Central Bank which then forwards the equivalent in local currency to the domestic bank. The domestic bank, in turn, credits the manufacturer.
- the manufacturer is paid in local currency and the foreign exchange equivalent accrues to the Central Bank.

The BLADEX alternative appears to offer a means of effecting transfers of credit rapidly, with a minimum of bureaucratic involvement. Since it receives payment back in dollars, there is also the opportunity to extend the benefits of the initial inflow of dollars through creation of a permanent revolving fund within BLADEX. Moreover, there is the potential to secure agreement from BLADEX to provide, during the disbursement period of the AID funds, additive co-financing. That BLADEX is a private institution which has not figured in the recent strident debate over national economic policy may be a further advantage.

USAID will continue its dialogue with GOES government officials, private sector representatives and the IBRD during the coming months in order to determine the best mechanism for export credit delivery.

4.3.2. Credit to Small and Micro-Businesses

The beneficiaries of this component of the AID project would be small and microenterprises which produce principally for the domestic market, although opportunities to direct production towards export will be encouraged whenever possible. The enterprises in this group span virtually all the major productive sectors, urban and rural, and form a critical element of the national economy whose credit needs must be addressed. The uses of credit will be primarily for working capital for very small, labor intensive firms. Larger firms will need more for fixed assets.

It is proposed that $10 million in project funds be made available for credit assistance through the FDE of the Central Bank for pass-through to financial intermediaries. However, since the AID funds would be grants and not loans in the first instance, it is not necessary to follow the normal rediscount process as is usually done with the FDE.

The Credit Delivery System

As a result of the administative and management problems encountered among many financial intermediaries working with this stratum of business, it is deemed prudent at this stage not to earmark automatic funding for any one on-lending institution. Rather, such institutions would "compete" for the money on a continuing basis. The following modified "rediscount" system will not limit access to the funds to a pre-determined group of financial intermediaries. The FDE controlled passthrough funds would be open to any and all qualified financial intermediaries, including the commercial banks, should they be interested and in a position to enter the type of lending market contemplated in this program. This system would not even preclude the possibility of consortia of private small business associations forming small business finance arms as long as they could qualify for the program as financial intermediaries. Each financial intermediary would receive prior AID approval as a recipient.

The system as presently envisioned would function essentially as follows: AID would grant a sum of money to the GOES to be used for specific small business/ micro-lending projects on the basis of appropriate criteria. The FDE would grant primarily colon denominated loan money to approved institutions which would, in turn, be on-lent to final beneficiaries. The reflows from this money would then be channeled back into the institutions' revolving loan funds for continued use in its own system. The Central Bank would grant up-front funding to the institution which would then roll this money into previously designated credit lines for on-lending.

Loan applications of final beneficiaries would be reviewed and analyzed by the financial institution. The degree of review and analysis needed would be decided by the institution on the basis of loan size and purpose and other previously determined variables it believes to be important. (AID will be involved in determining these variables). If approved, the loan will be disbursed by the institution from the up-front funds which it received from the FDE.

All loans would then be accumulated in a "justification" file which would be reviewed by a loan committee assigned to the particular line in question. Reviews of loans and funds movement would be carried out at least every three months, or as needed before this, as the intermediary's first disbursement begins to run low.

The committee would be composed of FDE, AID, and financial intermediary personnel. The committee's primary function would be as a monitor of the credit activity utilizing AID funds. It would review the portfolio to be sure that all loan terms or any other grant conditions or intents were being met. Once the committee is satisfied that loans were properly made then the committee would authorize a subsequent disbursement to the institution which would enable the process to continue as usual without having to stop or slow down disbursements.

The intent is to leave the institutions with a high degree of operational autonomy while at the same monitoring progress toward improving operations. It is envisioned that the ability of final beneficiaries to receive their loans would only be disrupted by the review process if the intermediary was not

performing well. The proposed system would not interfere with the day-to-day lending process.

Care must be taken not to overburden the institutional capabilities of the intermediaries nor to stifle their enthusiasm and initiative. To achieve this balance, additional disbursements to the intermediaries from the FDE will be based on the effectiveness and hard work of the institution, but at the same time should be seen by it as an attractive way to build the assets of the organization on the basis of merit.

4.3.3. Integrated Export Services

A necessary complement to infusion of export credit will be assistance to key sectors in a broad range of management and marketing services. The project, therefore, will support the establishment of up to two commercial trading companies whose purpose is to provide international marketing and export management services for small, medium and large businesses, first in the food processing sector and at a later stage, for sectors which also show particular comparative advantages and large employment generation capacity.

A recent U.S. Embassy Economic Branch study shows the food processing and packaging industry has continued to be the strongest manufacturing subsector. Food processing accounted for approximately one-quarter of the industrial employment in 1981. Industry sources indicate that they are utilizing less than 50% of their installed capacity. The GOES has consistently supported diversification in the agro-industrial sector. The inherent strength of the food processing/packaging industry is based on a strong internal demand for basic dietary items and high export potential for other processed foods. This subsector has particularly high potential for creating employment. Agro-industries and in particular food processors are high users of direct labor as well as benefiting indirect labor through backward linkages to agricultural producers of non-traditional crops, many of whom are small producers.

Each trading company will be developed and largely funded by and within the business sector group utilizing technical assistance, with some grant funds provided by the project. Preliminary analysis has shown that firms in this

sector have a comparative advantage on the Domestic Resource Cost (DRC) and the Effective Rate of Protection (ERP) chart (see Table 10). Many firms in this sector are labor intensive and have a backward linkage into non-traditional agricultural production. Some of the firms are now exporting, but wish to increase the international portion of their business by entering new markets. These firms have a number of problems in common, including lack of foreign exchange, lack of knowledge of non-traditional markets outside of the CACM, and transportation costs. Following are illustrative examples of the size and type of firms that would form and utilize a trading company.

Firm A

This small canning plant produces products for both the domestic and export markets. Founded in 1981, it now employs 50 workers directly and provides jobs to another 50 individuals who work for small jobbers who supply inputs and services to the plant. Located in the Zapotitan Valley, approximately 23 miles northwest of San Salvador, the plant buys its vegetables from approximately twenty small produce farmers who belong to cooperatives in the area. The plant produces tomato ketchup, hot sauce, fruit cocktail, canned beans and corn for the domestic market. They export, principally to the U.S. market, canned baby corn, chili jalapenos, and palm hearts. Their sales volume has risen each year; (in colones) 1981 - ₡60,000; 1982 ₡1.2 million; 1983 ₡2.3 million. Exports represent 10% of sales. Problem areas for this form revolve around:

a) Personnel lack technical and business experience

b) Marketing - the identification of new overseas markets and export market contacts

c) Long-term credit and foreign exchange

Firm B

This frozen vegetable plant produces exclusively for export. Located in the Zapotitan Valley, the plant buys their product from approximately twenty-five vegetable farmers divided among 65% cooperatives and 35% private producers.

The plant employs 160 directly and provides jobs indirectly to approximately 50 more people who make the crates, wooden pallets, print the labels, truck the product to the port, repair the machinery, etc. The firm processes and freezes okra, broccoli, snow peas for the U.S. market. Its volume has been increasing each year. Exports, expressed in pounds, have been as follows: 1981 - 4.0 million; 1982 - 5.0 million; 1983 8.0-million; 1984 (est.) - 10.0 million.

Problems include transportation costs, foreign exchange and long- and short-term credit.

Firm C

This is a food processor of candy and salted snacks such as potato chips, corn products, peanuts and cashews. Located in San Salvador, this plant uses both imported and domestic raw materials for the finished product. Employing directly 1,600 people, the firm provides jobs indirectly to another approximately 2-3 hundred. It presently exports 25% of its production to the CACM, but is actively attempting to penetrate the California snack food market. Problems center around foreign exchange and transportation to the U.S. west coast. Foreign exchange is needed to import such things as cellophane for bags, cheese powder and powdered milk.

The trading company would work with and for the above member firms and other small and medium processors. Other export-oriented manufacturers would have a similar trading company. Each trading company might initially handle approximately fifteen firms ranging from small, medium to perhaps one large enterprise. The purpose of this would be to provide economies of scale to the smaller firms in the area of transportation and the importation of inputs.

The trading company will be funded partially by its member firms, with each firm's contribution based on a formula that takes into consideration its size, sales volume and export business potential. The balance of the first two years' operating costs will be funded out of the project along with the first two years' technical assistance.

The trading company will perform the following export management services for its members:

- Brokering of goods moving to and from El Salvador.
- Market analysis to identify foreign markets, qualified distributors and agents abroad, foreign competition, product and technical assistance.
- Promotional services such as product promotion, brochure and literature adaptation and translation, training of foreign sales agents, distributors and technical personnel.
- Trade documentation, import-export permits, and related paperwork.
- Transportation, in order to identify and access most appropriate methods of air, sea or ground shipments, including best rates and most appropriate containers.
- Warehousing to locate and access the most appropriate facilities in or near Free Trade Zones, ports, or production facilities.
- Legal review of purchase and sales agreements; assess legal status of firms under international law or laws of target country; review and advise on regulatory problems such as taxes, import duties and other import regulations; and facilitate third party undertakings such as payments from overseas customers, management contracts, agent agreements and agreements relating to raw materials or supplies.
- Taking title to goods, under specified conditions.
- Providing small and medium-sized producers and manufacturers of export products with lower cost imported raw materials and capital goods.
- Information to provide small and medium-sized businessmen with better knowledge of technical options.
- Provide a U.S. based purchasing and marketing subsidiary.

To further design the trading company structure, project financed technical assistance from trade economists will need to be provided for:

- Detailed investigation of types and background of food processing companies who will form the trading company, giving size, scope, and speciality;
- Detailed investigation of opportunities for increased export trade among the firms determined to be eligible for membership;
- Assessment of first year budget and source and size of investment needed to carry out the functions of each trading company;

- Estimates of total requirements and availability of skilled managerial staff and plans for needed trading;
- Schedule for setting up trading company, including funding, staffing, market survey, training, leasing of equipment for first years' operation;
- Cost estimates;
- Specifications of products to be exported; and
- Working capital needs.

Technical assistance and training will also be needed once the trading companies are established.

4.3.4. Agro-industrial Approach

Introduction

As agricultural output increases, new opportunities develop for providing goods, services, and markets. Farmers require additional farm inputs. Consumers require additional processing and marketing facilities for outputs. By providing a supportive environment for agro-industries, the GOES and the USAID Mission can improve the welfare of both the rural and urban populations and further stimulate non-traditional agricultural production and processing. Unfortunately, the country's agro-industrial sector has been severely weakened. The agrarian reform has temporarily disrupted the traditional network of producers, processors and marketers. This factor, combined with the continuing violence in the rural production areas, foreign exchange scarcities, depressed commodity prices and uncertain world economic conditions, has weakened the relationship between agricultural suppliers and buyers. The result, as shown by Tables 16-21, has been an increase in the importation of fruits and vegetables normally produced in El Salvador and a decrease in exports. However, opportunities do exist. Producers still need to purchase inputs and sell their production; processors still need the raw material of their trade. Following is a discussion of the mechanisms to accomplish this.

The Mission has in the planning phase a Rural Enterprise Development Office (REDO) project. This proposed project should be enfolded into the Industrial

TABLE 16

EL SALVADOR: VOLUME OF SELECTED IMPORT PRODUCTS
(METRIC TONS)

	1977	1978	1979	1980	1981
VEGETABLES					
Onion	4,068	4,956	5,959	8,483	9,564
Cauliflower	1,485	1,401	1,537	2,388	2,123
Lettuce	1,752	2,166	2,077	2,014	2,333
Potatoe	12,865	14,334	17,685	13,506	14,357
Cabbage	12,665	14,319	18,100	24,111	26,693
Tomato	4,283	5,276	5,976	8,244	7,383
Carrot	3,977	4,353	7,182	5,824	6,376
FRUITS					
Avocado	1,428	1,786	1,919	3,734	2,729
Banana	21,461	22,112	30,233	49,578	36,898
Orange	3,358	5,507	11,141	15,925	13,177
Plantain	22,698	24,806	26,003	26,391	28,734
DAIRY					
Milk	5,708	7,820	9,421	8,123	11,636
Butter	75	69	125	52	173
Cheese	376	524	684	571	922

Source: MAG, Anuario de Estadisticas Agropecuarias

TABLE 17

EL SALVADOR - IMPORTS OF RAW FRUIT 1981
(AMOUNT IN COLONES; $1 = 2.5 COLONES)

PRODUCT	AMOUNT
Avocado	3,055,019
Anona	1,126
Banana	7,020,113
Plums	731,522
Coconut	41,667
Peaches	1,666,565
Strawberries	354,358
Passion Fruit	2,897,842
Figs	25,409
Spanish Plums	490,417
Sweet Limas	20,862
Lemons	245,837
Majoncho	373,859
Tangerine	193,725
Mango	5,328
Apples	1,487,523
Apricot	276,843
Blackberries	156,255
Oranges	5,697,151
Nispero	93,826
Papaya	85,297
Platano	13,939,154
Pears	50,809
Perote	1,017,108
Tamarind	1,355,256
Grapefruit	423,779
Grape	246,031
Zapote	189,927
Melon	34,839
Watermelon	69,818
	42,068,115 Colones or $16,827,246

TABLE 18

EL SALVADOR - IMPORTS OF RAW VEGETABLES 1981
(AMOUNT IN COLONES; $1 = 2.5 COLONES)

PRODUCT	AMOUNT
Chard	3,588
Garlic	1,435,391
Alverja	231,234
Eggplant	11,965
Watercress	25
Brocolli	2,166
Sweet Potatoes	33,625
Onions	7,568,612
Cauliflower	1,264,134
Chilicayote	39,137
Sweet Peppers	308,390
Jalapeño	155,077
Hot Peppers	55,001
String Beans	688,890
Asparagus	1,500
Guiscoy	15,696
Broad Beans	525
Lettuce	1,919,871
Pacaya	362,067
Potatoes	11,918,131
Cucumber	162,236
Parsley	11,512
Leeks	6,839
Radishes	244,967
Beets	900,680
Cabbage	12,365,501
Tomatoes	4,027,793
Yucca	40,369
Carrots	4,409,113
TOTAL	49,168,568 Colones or $19,667,427

TABLE 19

EL SALVADOR: VOLUME OF SELECTED EXPORT PRODUCTS

	1977	1978	1979	1980	1981
Dressed Poultry (metric tons)	536.6	275.3	221.1	96.8	46.2
Chicken Eggs (thousands of dozens)	133.4	405.2	1,287.8	409.6	126.9
Cheese (metric tons)	62.5	37.7	56.2	17.1	10.5
Beef Cattle (thousands of carcasses)	20.7	54.3	52.7	18.5	7.4
as percent of domestic slaughtered	11	25	26	10	5
Melons (metric tons)	3,140.1	3,290.8	4,062.2	3,402.7	961.4
Okra (metric tons)	539.5	677.9	411.4	18.1	2,030.2
Watermelons (metric tons)	3,882.5	4,377.2	8,059.5	3,857.5	5,443.5

Source: MAG, Anuario de Estadisticas Agropecuarias

TABLE 20

EL SALVADOR - IMPORTS OF FOOD PROCESSING AND PACKAGING EQUIPMENT 1978, 1981, 1982

PRODUCT DESCRIPTION	1978 VALUE ($)	1978 US SHARE	1981 VALUE ($)	1981 US SHARE	1982 VALUE ($)	1982 US SHARE
FOOD PROCESSING						
Industrial refrigeration and cooling equipment	1,191,780	74.3%	351,316	31.9%	297,144	20.1%
Related cooling equipment	598,579	76.4%	104,999	47.3	1,632,202	6.9%
Ice and ice cream making equipment	151,197	98.3%	233,216	98.4%	89,444	89.4%
Coffee, meat, and spice grinders	23,921	87.8%	23,945	94.5%	4,312	75.5%
Pumps for liquids	3,217,712	82.8%	2,173,943	79.4%	1,560,757	89.1%
Related apparatus for movement of liquids	11,258	72.9%	6,193	96.5%	1,232	91.3%
Vaccum/pneumatic pumps	3,644,882	59.2%	2,027,310	59.3%	1,774,684	50.6%
Grain, cereal and vegetable grinders	172,551	38.1%	104,711	16.7%	43,212	9.0%
Machinery for baking, candy-making, meat-cutting, jam-making	1,472,623	61.9%	393,196	56.8%	476,960	51.5%
Sugar refining equipment	208,931	94.3%	41,331	94.2%	6,136	100.0%
Related sugar refining equipment	2,874,687	41.9%	369,133	68.8%	448,968	75.7%
Oil extraction and processing equipment	527,597	76.4%	127,869	49.6%	348,602	90.4%
Industrial ovens, toasters and driers	424,149	44.3%	213,300	83.5%	90,593	85.8%
Miscellaneous other	10,028,470	20.8%	4,726,435	26.8%	2,924,755	38.0%
SUB-TOTAL	24,548,337		10,896,897		9,699,001	

TABLE 21

EL SALVADOR - IMPORTS OF FOOD PROCESSING AND PACKAGING EQUIPMENT 1978, 1981, 1982
(Continued)

PRODUCT DESCRIPTION	1978 VALUE ($)	1978 US SHARE	1981 VALUE ($)	1981 US SHARE	1982 VALUE ($)	1982 US SHARE
FOOD PACKAGING						
Machines to wash, dry, fill, label, and cap/seal bottles, cans, boxes, bags, snacks and other containers; packaging equipment	2,392,694	49.7%	778,241	62.8%	698,898	52.6%
RELATED INDUSTRY EQUIPMENT						
Air conditioners/purifiers	2,300,052	81.9%	1,060,846	70.5%	1,667,737	67.9%
Laboratory instruments	426,250	62.2%	245,982	75.1%	131,012	51.1%
Weighing equipment	819,189	97.7%	71,243	88.3%	14,709	100.0%
Related weighing equipment	405,310	55.6%	161,303	63.9%	189,276	63.5%
Lo-boys, forklifts, hand-trucks	334,922	41.2%	76,844	12.7%	536,221	6.6%
Panel trucks	2,655,833	15.0%	499,755	48.1%	162,554	24.0%
Pickups (under 2 T.)	24,539,824	11.6%	1,632,276	19.0%	543,748	61.2%

Stabilization and Recovery project. The REDO project itself might be established with the lending institution and would essentially perform two tasks:

1) Serve as an interface and liaison between the private agroindustrial and agrarian reform sectors, identifying and promoting mutually beneficial projects.

2) Establish and administer a special fund to contract for pre-investment studies of qualified projects.

Essential to the success of the REDO is that it has the confidence of the private sector. Private entrepreneurs, motivated by profit, are expected to be the source of ideas and projects presented to REDO. REDO will consist of two professionals supported by locally contracted technical assistance. It will be housed in Bladex, FDE or the Financiera. Which institution will depend on which one is selected by the GOES and the Mission to become the credit vehicle under the project.

4.3.5. Institutional Improvement

As noted in the analysis of constraints and needs, the financial intermediaries and business service agencies which will be relied upon as delivery mechanisms for project activities possess varying levels of capacity to support project objectives.

A. Financial Intermediaries for Export

With regard to the commercial banks, which will be the principal conduits for export credit, there is a recognized lack of required efficiency and expertise. Credit analysis procedures are deficient and unsophisticated and for this reason credit tends to be extended to only the best risks. In addition, the commercial banks often lack ability to assist clients in the preparation of their loan applications as well as the paperwork required for export/import preparation and foreign exchange procedures. Project analysis for long-term industrial lending

is especially inadequate. Banks have had no funds nor time for appropriate training. To remedy these deficiencies, the following areas should be included in the technical assistance and training to be provided under the AID Project:

i) Credit Analysis - This area will cover thorough indoctrination in credit procedures and a course in the interpretation of financial statements, especially balance sheet, income statement, and cash flow as well as financial ratios. The past financial history of each applicant must be studied and a reasonable determination made of earning power over the life of the prospective loan. Modern business techniques in forecasting will be made available to the loan departments. At appropriate intervals during the training period the performance of the credit analysts will be reviewed by active checklisting and deficiencies will be corrected at once. A credit analyst expert along with appropriate training aids will be made available for this undertaking. Appropriate recommendation in this regard can be made by the USAID at the time of intensive review of the Project Paper.

ii) Project Analysis - Medium and long-term loan applications will be processed on the basis of project study. These loans usually cover the purchase of equipment and would require the following feasibility back up:

- Profitability study showing the contribution the new fixed asset will make to the firms' earnings;
- Cost analysis of in-service operation, including useful life and depreciation methods;
- Analysis of financial statements projected before and after the proposed purchase of equipment;
- Correlation study of possible loan repayment schedules related to useful life of the asset; and
- Industry study of the same type of equipment in other enterprises in the same industry. (Efficiency factors and production coefficients should be looked at in connection with firm size.)

iii) Loan Supervision - The area of loan supervision would not require as much formal training as the other areas mentioned above since it is more a matter of discipline than formal training. The most important elements of the training are:

- Guidelines must be established to indicate when outstanding loans need attention.
- Interviews have to be set up with borrowers as soon as a loan becomes an arrear. Based on experience and knowledge of the interviewer, alternative financing techniques can be found (including refinancing).
- If the loan supervisor is not a credit analyst, he or she should be trained in the use of tools such as financial ratios which serve to give warning to possible coming problems.

iv) Export-Import Banking - The foreign trade financing process is rather complicated and, to be carried out properly, requires intensive training which, when provided for the financial institutions, needs to be passed through to the exporting and importing firms. A complete standardization is required for the process to function properly since several institutions and clients may be involved in a single transaction. The training also must include the segment of the process related to foreign exchange whether through the commercial bank or directly with the Central Bank.

B. Small and Micro Businesses and Supporting Institutions

Any attempt to alleviate the credit, managerial and production constraints of small business and micro-enterprises must take into account differing levels of firm capacity. Some of these factors are peculiar to firm size and others are influenced by the type of economic activity in question. However, the following generalities can be made regarding technical/managerial assistance needs both at the firm and supporting institutions level.

1. Firm Level

At the firm level, the principal needs are:

a. Administration and Management:

i) Basic orientation to thinking of productive activity as business and consciousness raising;

ii) Rudimentary accounting and bookkeeping;

iii) Fundamentals of cost analysis;

iv) Human relations and personnel management; and

v) Basic marketing.

b. Production and Quality Control:

i) Rudimentary materials use;

ii) Work flow and simple plant layouts; and

iii) Method to assure constant quality.

c. Skills training and vocational education (mostly for larger small business):

i) Improved production techniques;

ii) Other technical/technological areas; and

iii) Administration and management for employees.

2. Service Institutions Level

The current micro-enterprise programs have relied on DIDECO and CENTA for outreach and technical assistance services. However, public sector institutions have not appeared to be very effective in loan promotion or technical assistance according to people close to the programs. Part of the problem has been due to the unsafe conditions in certain parts of the country, but to a large degree it has to do with the institutional capabilities to provide these services. The problem has been recognized and personnel from these agencies are receiving training. This training should be maintained and expanded to other organizations that have an interest and capability in aiding small entrepreneurs.

a. Public Sector service institutions such as CENTA, DIDECO, and CENAP generally need to receive assistance in the following areas:

i) Training all staff in the characteristics of the various levels of small and micro-enterprises;

ii) Training promoters, project analysts, and technical assistance providers in their function as "change agents;"

iii) Designing technical/managerial assistance methodologies for small and micro-businesses;

iv) Training all personnel in basic accounting, cost analysis, financial analysis, marketing, and quality control and production; and

v) Developing training modules in the areas described in number iv above.

b. The private associations representing small and micro-businesses such as FUSADES, UDES, FENAPES, and CONAES currently do not have the institutional capability to carry out their own formal technical or managerial assistance services. With external assistance as appropriate, their members and staff could develop service capabilities and technical expertise in small and micro-business assistance. It is likely that each organization, by its nature, would over time target a specific segment of the small/ micro-business sub-sector as well as specialize in particular types of services. Principal areas of need include all the five areas designated for public sector institutions as well as the following:

i) More sophisticated training in domestic and export marketing;

ii) Training and assistance in for-producer associations, including their administration and management; and

iii) Training and assistance in the establishment and operation of various kinds of market intermediary organizations.

3. <u>The Financial Intermediary Level</u>

Technical/managerial assistance is needed by mid and low level outreach and analysis personnel of financial intermediaries such as FEDECCREDITO, FIGAPE, and BFA in loan analysis, promotion, and general portfolio management in an effort to strengthen field staff capabilties to do effective and efficient work. This support will help to provide a firmer foundation for increased decentralized loan processing and stimulation of a responsive credit system to reach more people in remote parts of El Salvador.

At higher levels within the financial system and in cases where employees will deal with more sophisticated and larger loans, personnel need specific training as described previously in section 4.3.4.A.

Principal areas of need are:

i) Training in appraisal based analysis of small projects;

ii) Training in low level financial analysis to back up a reduction in guarantee requirements;

iii) Orientation to the characteristics of the various levels of micro and small business, their general problems and needs; and

iv) Orientation to promotion and technical assistance and management training techniques used by the public and private service and training institutions.

4. Further Analysis Needed During Project Preparation

Clearly, further assessment is required to determine accurately the types and levels of assistance required and the appropriate institutions to implement the proposed assistance program successfully. This work will be accomplished at the Project Paper development stage.

At the present time, it appears that a significant portion of export related training could be provided by local private universities and institutions which offer or could offer specialized courses. For example, the School of International Marketing in the University Dr. José Matias Delgado provides specialized short courses in export marketing and promotion, economic analysis, export documentation and other international business courses for those firms and individuals interested in exporting. Other educational institutions will be identified which have the capabilities on which to build. Once the schools have been selected,their role will be to act as the focal point for business seminars as well as the provider of training for the private sector firms. Course curriculum should include: accounting, business management, international marketing, inventory controls, financial analysis, economics, economic analysis of export processes, production economics, credit, transportation and risk

insurance, export documentation, technical English as used in international commerce. AID technical assistance could:

a) Up-grade faculty through long and short term training in third country, i.e. INCAE.

b) Finance long and short term business teachers to provide course work and curriculum strengthing. The long term individual will assist the school director in selecting training sites as well as develop practical export oriented courses that will be targeted for the small and medium sized businesses.

c) Finance seminars and workshops featuring successful businessmen experienced in exporting, export bankers, freight forwarders, transportation experts, etc.

Given the lack of accurate census data on small and micro-businesses, AID should consider assisting FENAPES in completing and tabulating a survey which the Comite de Exportaciones has commenced on micro, small and medium-sized businesses.

The survey will give a more accurate sense of the number of firms in these sub-sectors, the amount of employment created, types of products produced, production, factor costs, and value added information, as well as more specifically targeted information on capital, human resources, and technology constraints to improved efficiency and productivity.

Additional work should also be done with the private associations that represent businessmen and women in the micro, small and medium-sized business sub-sectors in order to more closely define each organization's objectives and capabilities.

This will be necessary in determining more precisely what the various roles of these organizations would be in the program and the kind of support AID might be able to offer them in terms of the services they hope to provide or helping them to strengthen their own institutional capabilities.

4.3.6. Investor Search

Despite the current perception by many foreign businessmen of the difficulties of investing in El Salvador, there are excellent possibilities for joint venture, production sharing and other investment arrangements with foreign firms. These possibilities are expected to increase significantly with the availability of the IBRD and AID assistance programs and the formal qualification of El Salvador under the CBI.

What is required to take maximum advantage of such opportunities is a facility which can link local and foreign entrepreneurs at the firm level so that mutual interests can be explored, problems defined and feasibility determined. No public or private organization in the country is so constituted that, even with additional assistance, it could carry out the type of sustained, technical support demanded by this task. Consequently, USAID believes it imperative that the project support the creation of an investor search facility.

One means of providing this service would be to utilize the IQC contracting capability recently made available through AID/Washington's office of Private Enterprise with two U.S. firms. Under this arrangement, the U.S. and international consulting expertise of these firms can be made to respond to specific requests for investment climate analysis, financial/capital/credit analysis, feasibility study analysis or preparation, industrial/commercial sector analysis, investment promotion planning and implementation, divestiture/ privatization planning and implementation, or U.S. business linkages.

While this is a significant capability, it would still be necessary to identify the specific assistance sought and to set forth its scope before an IQC work order could be issued. What is required is the presence of qualified individuals in the country itself to initiate contacts with firms, identify investment prospects and determine how best the linkage with external assistance and investors can be made. The AID project, therefore, will finance a 2-3 person contract Investor Search Team which will reside in El Salvador. These individuals will liaise with all relevant private and public sector agencies, work directly with local firms and be responsible to USAID's Office of Private Enterprise. Their function will be to:

- identify and facilitate investment prospects from U.S. and other international private sectors;
- assist in developing terms of reference and acquiring technical inputs for specific aspects of investment project design and implementation; and
- identify and coordinate personnel assistance from other U.S. organizations (IESC, VITA, etc.) to alleviate bottlenecks to external investment in firms.

These services should be backed up by a U.S.-based follow-through group either as part of the Investor Search Team or retained intermittently through the IQC mechanism. This latter function would assure close and more successful follow-up with potential investors as well as other U.S. organizations which may be involved in the investment, such as OPIC or FCIA.

The exact nature of the Investor Search Facility will be developed at the time of intensive review, but it should be noted that the existence of this mechanism can be of considerable value to USAID itself, through its flexibility in responding to changing investment conditions, without being constrained by any one particular institution or agency's agenda.

4.3.7. Export Promotion

Although it is the desire of the USAID to rely to the maximum extent possible upon the private sector and private agencies for implementation of project activities, there is a definite justification for assisting the Ministry of Foreign Trade in its role as the principal GOES entity responsible for export promotion. Among the duties to be carried out by MICE is that of overseeing the implementation of the new Export Development Law. This law, which has recently been modified to improve the incentives for Salvadoran firms to take an active part in the CBI, is part of the GOES program for national economic recovery. This program emphasizes:

- Export production of non-traditional goods;
- Streamlining of credit administration system;
- Rehabilitating enterprises in difficulties; and
- Increasing the use of installed capacity.

The proposed AID project is consistent with the new revised export development legislation and builds directly on many of its recommendations:

- Establishment of a program to train local businessmen and association officials in exporting;
- Better government coordination of its export relations activities between MICE, Ministry of Finance, Central Bank and the various national concerns for the CBI;
- Provision of training in export promotion to the private sector; and
- Provision of export promotion resources to both MICE and the private sector, but with greater emphasis on the links with the private sector.

Under the project, the role of MICE can be re-focused and strengthened through the judicious use of technical assistance and training. Although MICE now has the main GOES role in the promotion of exports, it must be encouraged to work more closely with the private sector and earn its confidence.

MICE's responsibilities would consist of:

- Monitoring the implementation of the Export Development Law;
- Export policy formulation and analysis;
- Promotion and involvement of El Salvadoran private sector in the CBI;
- Investment promotion generally and encouragement and promotion of joint ventures in El Salvador with U.S., European, and Japanese firms;
- Identifying participation and/or organizing trade fairs to promote El Salvadoran goods and services; and
- Working with private sector to simplify GOES export and import procedures.

MICE, however, lacks the skilled, experienced and technically trained personnel to carry out these functions. Consequently, AID will provide funding for:

a) A trade expert with experience in both the public and private sectors for one to two years to assist MICE in the following areas:

i) Develop an export policy formulation and analysis section and assist in the recruitment of qualified professionals for it;

ii) Identify qualified candidates for long- and short-term training in appropriate U.S. institutions in order to carry out duties in item a);

iii) Develop planning and analysis capability and identify candidates within and without MICE for further training in order to fill these positions; and

iv) Assist MICE and the private sector in identifying short-term technical experts for in-country technical assistance in production, export marketing, and quality control;

b) Long- and short-term training

Selected mid-level professional personnel will be given training to up-grade their skills in:

i) Planning and analytical capabilities in the export field;

ii) Investment promotion;

iii) Publications and other promotional material;

iv) Trade fairs; and

v) Communications.

5. SUMMARY PROJECT BUDGET

See Table 26.

6. SOCIAL & ECONOMIC ANALYSES

6.1 Social Analysis

This project includes participants and beneficiaries from the private sector, from entrepreneurs and owners of small and medium size firms to workers in these same firms. Beneficiaries also include small farmers who produce the agricultural product that is the raw material for processing plants.

a) Social Context

The social context within which this project will be implemented is one which is characterized by a vigorous private entreprenurial class dedicated to industrial development and an industrious working class. The civil disturbance in the country has caused a number of businesses to close down. The economic downturn has caused many firms to operate at less than full capacity.

In spite of the constraints, industries remain determined to regain their 1978 levels. Salvadorans historically have placed great emphasis on education, formal or informal, as a means of social mobility. Both the labor and the entreprenurial force place an emphasis on hard work and advancement by means of learning new skills in order to raise the level of the job they are doing. It is a tradition of the Salvadoran private sector to be viewed as the "Taiwanese" of the CACM. This business agressiveness will be harnessed under this project in order to expand exports.

b) Beneficiaries

The project activities will have an impact on workers in the factories and enterprises that will increase their capacity due to exports of their product, especially in food processing. Many of the workers in this industry traditionally have been women. Small producers, who either are members of cooperatives or private owners, will also be beneficiaries of the program. These producers, as suppliers of the raw materials for food processing plants, will be direct beneficiaries because they will have alternative markets for their products. Indirect employees of the affected industries will also be beneficiaries of this project. Those small firms and jobbers that provide goods and services to the primary firms will be obligated to expand their work force to meet this new demand.

It is calculated that small and micro manufacturing businesses in El Salvador create between 120,000 and 160,000 jobs. Indirectly these businesses therefore (not including commerce or services which abound in these sub-sectors) have an impact on the well-being of approximately 700,000 people based on 140,000 jobs created and 5 people per family unit.

This project will help to assure that small and micro-businesses receive the technical/managerial and credit assistance which they need to continue to operate. The project will provide the resources (both human and capital) for these businesses to expand production and productivity resulting in reduced underemployment and underutilization of physical capacity. It will also provide the resources needed to save existing jobs and to create net new jobs. The social implications of the employment and income impacts on beneficiaries and their families are high in a country experiencing 48% unemployment and internal violence. The importance of a project thus benefitting, in large part, the social class representing some 90% of the population (US 120/monthly or less), cannot be overstated.

c) Impact

The project is both feasible and consistent with the social environment in which it will operate. The project provides needed services to several groups within the private sector, such as micro and small businesses producing for domestic consumption and for those small, medium and large businesses involved in exporting. The increased export opportunities and services provided under this project will allow these industries to expand their exports.

Funds provided by the project to financial intermediaries for lending to small and microbusinesses will help meet unsatisfied credit demands by these businesses and reduce their need to borrow in the informal credit market. By assisting entrepreneurs to improve their business efficiency and productivity through increased credit access and technical/managerial assistance, the project will contribute to increasing total income (business and personal combined). Some of this increase will be reinvested in the business; some will be taken in the form of a "salary" increase. It is expected that a portion of increased business income will be passed on to employees in the form of wage increases as productivity increases, (e.g., the case of piecework: more working capital, more materials, more production, increased wages/units of production).

Both for the entrepreneur and for the employee, increased income increases the ability to save and at some point invest in improving the basic conditions of life through improved housing, nutrition, clothing and education.

6.2. Economic Analysis

It is normal for PID level economic analyses to set forth nothing more than the methodology and data requirements necessary for the analyses in depth that is undertaken during the later stages of project development. In the case of the proposed project, however, it is possible to include the initial stages of the economic analysis in the PID document. Not only will this material lay the foundation for the economic rationale for the project, but it will also present a clearer idea of what the later, more complete analysis will entail.

The analysis begins with the assumption that the reactivation of the industrial sector by means of export promotion is an efficient use of financial resources. This assumption is based upon the sector's previous levels of performance as well as the fact that post-1979 performance is overwhelmingly the result of factors that are exogenous to the sector itself. Assuming the political situation stabilizes and Salvadoran firms in the export sector can gain access to the U.S. market by means of the Caribbean Basin Initiative, there is every reason to believe that previous levels of performance can not only be attained but surpassed.

If the above line of reasoning is accepted, the question of which markets can be reached arises immediately. Expressed somewhat differently, it is a matter of which industrial activities can reasonably be expected to perform well in the U.S. and other third country markets. An additional consideration of great importance is determining a standard for measuring potential performance. Shall it be, for example, potential for growth, or for employment creation or for foreign exchange generation?

Concerning the first of these, i.e., the potential for growth, the determination of idle capacity by activity, appearing in Table 22, provides a preliminary indication of the extent to which each activity can be rapidly expanded. The importance of Sectors 31, 32 and 35 - food, beverages, tobacco, textiles, leather and chemical products - in total production is impressive. Their growth counted for far more in terms of absolute numbers than other quantitatively less important activities that have lower rates of capacity utilization, and thus have the potential for registering higher relative, or percentage rates of growth.

TABLE 22

Potential Increase in Production, Employment
and Imported Inputs

Given Idle Capacity - Assuming Fixed Coefficients
(Thousands of 1982 colones)

CIIU	ACTIVITY	% Capital Utiliz.	Prod.	Potential Inc. In Prod.	Emp.	Potential Inc. In Emp.	Imported Inputs	Potential Inc. In Inputs
31	Food Products, Beverages & Tobacco	.67	693,768	339,946	11,827	5,795	163,197	79,967
32	Textiles & Leather Industries	.82	390,901	85,998	18,176	3,998	110,494	24,309
33	Wood and Wood Products	.90	17,411	1,915	1,153	127	4,433	487
34	Paper, Paper Products & Printing	.63	242,849	143,280	4,740	2,796	108,066	63,759
35	Chemical Products	.79	989,456	267,153	6,809	1,838	751,417	202,883
36	Non Metal Mineral Products	.78	113,057	31,655	2,492	698	8,576	2,401
37	Basic Metals	.44	49,312	62,626	1,104	1,402	5,532	7,025
38	Metal Products, Mach. & Equip.	.50	100,314	100,314	3,790	3,790	43,356	43,356
39	Other Industries	.78	19,638	5,499	661	185	8,718	2,441
TOTAL		.70	2,616,707	1,038,386	50,752	20,629	1,203,789	426,628

Source: Our own calculations from MIPLAN data.

If operated at 100 percent of capacity, the manufacturing sector has the potential of producing an output which at current market prices amounts to approximately 3.6 billion colones. This figure is almost exactly 1 billion colones higher than the value of current output. Given the prevailing system of multiple exchange rates, the figure amounts to between $250 and $400 million. It should be stressed, however, that these figures represent the estimated value of additional manufactured products that could be supplied by El Salvador. It does not necessarily follow that foreign demand would be equal to or greater than this potential supply. Indeed, it must be emphasized that the idle capacity reflects, in significant part, an industrial structure specifically adapted to consumer and producer demand within the CACM. For reasons already discussed, there is no reason to believe that this regional market will be capable of providing anything like the stimulus in the future that it has furnished in the past. Given the country's limited land area and natural resources, together with its relatively large and growing population, it would appear that new export markets must be found if the economic achievements of the 1960's and 1970's are to be sustained in the 1980's and beyond.

Table 22 also provides useful information about the short- to medium-term prospects for employment creation in the various major industrial activities. Once again, the same activities that were preponderant in importance for growth possibilities are also those that have the greatest potential for employment generation. Overall, the major firms represented in the various activities have the estimated capability of creating 20,629 jobs. It is important to note that many of the smaller and micro enterprises are not included among those firms which provided the data for Table 22, but yet have a relatively high potential for creating additional employment. As shall be noted shortly, however, small and micro enterprises in general do not appear to have much potential for exporting.

Estimation of the foreign exchange generating potential of the various manufacturing activities is a far more difficult undertaking than that of the measurement of either growth potential or employment creation. It involves, in the first instance, the measurement of the domestic costs of potential exports. The costs, however, depend in turn upon the interaction between the demand for and the supply of productive resources, as well as upon the efficiency of the markets which allocate them. Once derived, these domestic costs must then be

compared with those for similar products appearing on international markets. If the markets are reasonably open and competitive, comparison of domestic and international prices will disclose the country's comparative advantage, or the lack thereof, in the production of any given commodity.

There are two very similar means for measuring the country's ability to export products in different activities with economic efficiency. They are the domestic resource cost, or DRC, and the Effective Rate of Protection, or ERP. The first of these, the DRC, measures the social cost in terms of domestic resources of generating one net unit of foreign exchange. Calculation of the DRC results in a ratio between the social cost of the domestic resources, and the social cost of the international resources used in producing any given product, both being measured in world market prices. When the two values are exactly equal - the breakeven point in the jargon of economists - it is just as cheap to produce the product domestically as it is to produce it abroad. Inasmuch as domestic prices are the numerator, any value between zero and 1 implies that the product can be produced domestically at a lower social cost, or sacrifice, than it can be produced abroad. Any DRC greater than 1, on the other hand, implies just the opposite. It is cheaper for other countries to produce the commodity than it is for El Salvador to produce it.

Calculation of the DRC usually involves the use of an input/output matrix. The matrix permits relatively easy measurement of both the direct and the indirect costs of production of products. Since none was available for the present excercise, the indirect social costs linkages were estimated at a very aggregate level. The results obtained provide a very rough indicator of the export possibilities for the different industrial activities undertaken in El Salvador.

The effective rate of protection, or ERP, on the other hand, represents the percentage increase in value added per unit in an economic activity that is made possible by the tariff and trade policy structure as opposed to the situation in which, with the same exchange rate, no tariffs exist.

In a theoretical sense, the DRC has been demonstrated to be equal to the ERP minus one. The latter measure is more frequently compared with the nominal rate of tariff protection, or NRP, which simply lists the direct tariffs applied upon

given commodities imports. The comparison enables one to observe the extent to which commodities are protected not only by direct tariffs, but indirectly through tariffs applied to the raw mateials and intermediate inputs imported for their production. The most important distinction between the two for present purposes is that the ERP is measured at market prices while the DRC is evaluated through the use of shadow prices.

Inasmuch as shadow prices reflecting social costs were not available, they also had to be estimated. For the important shadow price of foreign exchange, a coefficient of 1.5 was employed. This was to adjust for the estimated effects of the tariffs on marginal imports and for the impact of multiple exchange rates on imports. With this coefficient, the shadow price of foreign exchange would be closer to 4:1 than to 2.5:1. As a result of the calculation, all DRC values between 0 and 1.5 rather than 1.0, as discussed before, now represent social costs of production that are beneath those reflected in international market place for the commodities produced by that particular manufacturing activity.

Concerning the results which appear in Table 23, the DRCs and ERPs provide, as one would expect, a similar ranking. The fact that the DRCs are in fact rarely equal to precisely the respective ERPs minus one simply reflects errors of estimation or of reporting within the data available. There were four activities for which data were insufficient to permit calculation of the DRC and ERP. They were clothing, petroleum products, electrical machinery and other industries. Two of these activities, clothing and petroleum belong to important subsectors; 32 and 35. Within activity 32, however, textiles and leather account for more than half of total activity and both appear to have fairly strong comparative advantages. Petroleum products, on the other hand, account for most of the output in activity 35, since most petroleum is imported, it is highly doubtful that the country enjoys any comparative advantage in its production. It is, in other words, reasonably safe to assume a DRC value for petroleum in excess of 1.5, even though there are not sufficient data to arrive to a precise figure.

The activities which appear to have the most pronounced comparative advantages are those that can be grouped under the general heading of agro-industries, i.e., food, beverages and tobacco paper products, metals and chemicals. Activities 31 and 32 are among those that are closest to what could be classified as primary

TABLE 23

DRC and ERP Calculations

CIIU	ACTIVITY	DRC	NRP	ERP
311	Food Products	.79	1.24	1.86
312	Other-foodstuff	1.13	1.26	2.20
313	Beverage	.62	1.27	1.59
314	Tobacco	.61	1.27	2.08
321	Textiles	.71	1.00	1.76
322	Clothing	-.22	1.11	-
323	Leather Products	.38	1.16	1.39
324	Shoes	.30	1.00	1.31
331	Wood Products (Furniture)	2.63	1.04	4.92
332	Wood Furniture	1.51	1.04	2.64
341	Paper & Paper Products	.57	.81	1.81
342	Printing, Editorials	1.14	1.15	2.64
351	Chemical Products	.67	1.13	1.96
352	Other Chemicals	.99	1.12	2.08
353	Petroleum Products	-.25	1.13	-
355	Rubber Products	.40	1.13	1.41
356	Plastic	2.02	1.00	3.98
362	Glass Products	1.24	1.05	2.53
369	Other non-metal Minerals	.92	1.08	2.02
371	Basic Metals	.95	1.15	1.90
372	Other Metals	1.02	1.13	2.10
381	Metal Products (Mach/Equip)	2.11	1.13	3.97
382	Machinery (Electric)	6.32	1.14	12.45
383	Electric Machinery	-3.29	1.14	-
384	Transport Material	1.14	1.15	2.53
385	Professional Equipment	.78	1.15	1.59
390	Other Industries	-.06	1.20	-

Source: Our own estimations from MIPLAN data.

production and are also the most important in terms of labor absorption, not only directly but also indirectly through backward linkages to micro enterprises and other activities. They are also the largest contributors to industrial production, with impressive possibilities for increasing output and employment.

In a final step, the industry wide results were disaggregated by the size of the firm. This operation permitted the determination of comparative advantage not only by activity, but by the size of the firm as well. Table 24 presents the results for those firms that have 200 or more employees. Table 25, on the other hand, contains the same figures for firms employing between 5 and 199 workers. The absence of strong comparative advantage for the small and medium-size firms in all but a few activities is striking. The larger firms, on the other hand, do have pronounced comparative advantages in agro-industries, metals, paper and chemicals. The evidence serves to reinforce the widespread perception that the smaller and intermediate size firms will, in general, find it difficult to break into third country markets. This does not mean, of course, that they should not be considered an integral part of any strategy for the promotion of exports. Rather, it implies that without access to new technology and marketing facilities, they will be restricted to a narrower range of activities.

The calculations help to explain why El Salvador has benefited less than any other country from the CBI initiative thus far. The country was already exporting some products to the United States under duty free conditions, e.g., coffee, and had also had special restrictions imposed in the CBI legislation, e.g., sugar. The kind of products that other Central American countries were able to sell in the US market with the CBI, on the other hand, did not belong to the groups identified as having comparative advantages in El Salvador.

However, as the figures demonstrate, the agro-industrial subsector has potential to compete successfully at world market prices. Inasmuch as the potential has not been realized, however, the question inevitably arises as to precisely what has precluded these and other potential non-traditional exporters from breaking into the US market up to now. Part of the reason may well be explained by the fact that the comparisons are merely based upon costs, without taking into consideration such factors as product quality, the attractiveness of packaging and the efficacy of the marketing skills of their producers. Then, too, the

TABLE 24

DRC and ERP Calculations for Large Firms

CIIU	ACTIVITY	DRC	NRP	ERP
311	Food Products	.68	1.24	1.81
312	Other-foodstuff	.45	1.26	1.35
313	Beverage	.55	1.27	1.53
314	Tobacco	.61	1.27	2.08
321	Textiles	.65	.98	1.71
322	Clothing	-.15	1.15	.86
323	Leather Products	1.74	1.16	2.89
324	Shoes	.30	1.00	1.31
331	Wood Products (Furniture)	-.-	-.-	-.-
332	Wood Furniture	1.82	1.04	3.53
341	Paper & Paper Products	.57	.81	1.81
342	Printing, Editorials	1.11	1.15	2.58
351	Chemical Products	.43	1.13	1.63
352	Other Chemicals	1.05	1.12	2.18
353	Petroleum Products	-.-	-.-	-.-
355	Rubber Products	.36	1.13	1.34
356	Plastic	1.17	.86	2.76
362	Glass Products	1.21	1.06	2.40
369	Other non-metal Minerals	.90	1.08	1.99
371	Basic Metals	.87	1.14	1.79
372	Other Metals	1.02	1.13	2.10
381	Metal Products (Mach/Equip)	2.17	1.13	4.32
382	Machinery (Electric)	20.24	1.14	36.87
383	Electric Machinery	2.03	1.15	3.33
384	Transport Material	-.-	-.-	-.-
385	Professional Equipment	-.-	-.-	-.-
390	Other Industries	2.17	1.21	4.33

TABLE 25

DRC and ERP Calculations for Small and Medium Size Firms

CIIU	ACTIVITY	DRC	NRP	ERP
311	Food Products	2.32	1.26	2.52
312	Other-foodstuff	7.59	1.27	10.37
313	Beverage	1.41	1.26	2.26
314	Tobacco	-.-	-.-	-.-
321	Textiles	22.20	1.16	20.45
322	Clothing	1.19	1.00	1.90
323	Leather Products	.21	1.16	1.20
324	Shoes	1.53	1.15	2.40
331	Wood Products (Furniture)	2.63	1.04	4.92
332	Wood Furniture	1.32	1.04	2.09
341	Paper & Paper Products	1.31	1.16	2.82
342	Printing, Editorials	1.26	1.13	2.91
351	Chemical Products	4.13	1.13	6.79
352	Other Chemicals	.82	1.12	1.77
353	Petroleum Products	-.25	1.13	.72
355	Rubber Products	1.39	1.13	3.44
356	Plastic	-1.06	.98	-.43
362	Glass Products	1.70	1.04	4.26
369	Other non-metal Minerals	1.68	1.04	3.01
371	Basic Metals	-5.32	1.16	-6.76
372	Other Metals	-.-	-.-	-.-
381	Metal Products (Mach/Equip)	1.98	1.14	3.27
382	Machinery (Electric)	1.06	1.15	3.21
383	Electric Machinery	-.41	1.13	.39
384	Transport Material	1.14	1.15	2.53
385	Professional Equipment	.78	1.15	1.59
390	Other Industries	-.03	1.19	.96

calculations are based upon current costs, while comparative advantages may change through time, depending upon new circumstances, especially during and after crises such as the one now being experienced by El Salvador. It is always difficult to foresee which new non-traditional lines of exports may be successful.

The preceding analysis demonstrates that an industrial stabilization strategy based upon export promotion is a viable alternative to pursue in the case of El Salvador. Indeed, given the manufacturing sector's prior performance in the CACM and the new opportunities present in the CBI, the proposed project appears to be a particularly promising one. The economic analysis that will be developed for the project paper will use the preceding analysis as a point of departure. Given the present status of the Salvadoran economy, it will contain both macro and micro-economic components. The macro-economic component will analyze the effect of the project upon the resource gap, including consideration of the requirements for imported raw and intermediate products for processing by export oriented activities and effects upon investment, the GDP and employment. The micro-economic component will present a benefit/cost analysis of representative prospective investments of project resources at the firm level. It will also analyze the ability of the U.S. market for manufactured products to absorb the potential increase in exports resulting from the proposed project.

7. PROJECT PAPER DEVELOPMENT STRATEGY

During Project Identification Document (PID) preparation, it was determined that additional information collection and analysis needs to be completed for inclusion in the Project Paper. There will, therefore, be a need for TDY assistance in various areas during the project paper preparation stage. The sectors to be covered and the TDY inputs needed are outlined below:

7.1 Detailed Private Sector Analysis

A two-person team consisting of a Production Economist and a Credit and Financial Analyst should come to El Salvador for a one-month TDY. Their scope of work would be as follows:

a) In-depth survey 30-40 agribusiness firms (including food processing input industries, etc.); at least 10 each of small, medium and large to ascertain:

- Credit needs and availability -- long- and short-term; financing sources of credit;
- Foreign exchange needs and financing;
- Productivity -- real production costs and labor supply;
- Comparative advantage in world markets and among CBI nations;
- Guarantee and collateral requirements;
- Problems inhibiting Industrial Recovery; and
- GOES Policy constraints and policy changes needed.

7.2. Detailed Credit Demand Analysis

After the survey information results from the previous analysis in I above are available, two credit analyst experts should be employed for approximately three weeks to perform the following:

- Evaluate industrial credit demand;
- Estimate credit demand in other activities based on sampling (agriculture, commerce, construction, transportation, etc.); and
- Survey the commercial banks regarding credit supply. (May follow the survey format of the 3/9/83 Checchi Credit Report).

7.3 . Institutional Analyses and System Designs

Concurrently with the above Private Sector and Credit Demand Analyses, the following work will be carried out at the lower end of the business spectrum:

A. Credit Delivery System - Small and Micro-business Component

One small business credit specialist will be needed for three weeks to assist in the following areas:

- Design of the FDE passthrough system, including:

  -- design of the FDE/intermediary grant review process.
  -- composition and functions of the review committee.
  -- criteria for determining the size of "up-front" grant disbursements.

- Development of definition of final beneficiaries and loan terms;

- Review of institutional capabilities of potential financial intermediaries;

- Determination of conditions precedent; and

- Determination of other selection criteria for intermediaries.

B. Technical and Managerial Assistance and Promotion

One small business specialist will be needed for two weeks to assist in follow-up on work begun in the PID stage in the following areas:

- Determine existing and potential capabilities of public institutions and private groups and their potential respective roles.

- Determine specific institution building needs of these groups and organizations.

- Determine specific technical assistance inputs necessary during project implementation.

- Design and initiate small and micro-business surveys to fill information gaps for these sub-sectors.

* * * * *

This concludes the report in the El Salvador Industrial Stabilization/Recover Project. Following is a proposed Summary Project Budget that gives a breakdown of the GOES and AID funding for the various components.

TABLE 26

SUMMARY PROJECT BUDGET
(in thousands of dollars)

COMPONENTS & SUBCOMPONENTS	AID				
A. Financing for Sub-Loans	FX	LC	Total	GOES	TOTAL
1. Export Loans	35,000	-	35,000	-	35,000
2. Micro/Small Business Loans	10,000	-	10,000	-	10,000
Sub-Total	45,000		45,000		45,000
B. Technical Assistance & Training					
1. Integrated Export Service (Trading Company)	635	80	715	400*	1,115
2. Institutional Improvement:					
a) Credit					
-Training - credit analysis	30	20	50	30	80
-Training - Financial support services for Small & Micro Businesses	100	181	281	40	321
3. Small Business Revitalization					
-Institution Improvement	-	725	725	40	765
-Training	52	240	292	-	292
4. Business Training					
-Business School-International Business Curriculum	428	240	668	-	668
5. Investment Search	1,472	-	1,472	-	1,472
6. MICE					
-Investment Promotion	399	20	419	500	919
SUB-TOTALS	3,116	1,506	4,622	1,010	5,632
Contingency/Inflation			378		378
TOTAL			5,000		6,010
GRAND TOTAL (includes Loan Financing)			50,000	1,010	51,010

*Private Sector Equity

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