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AUDIT OF
LOCAL CURRENCY GENERATIONS
UNDER USAID/PERU ECONOMIC SUPPORT
LOAN NO. 527-F-093

Audit Report No. 1-527-86-17
June 17, 1986

AGENCY FOR INTERNATIONAL DEVELOPMENT

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June 17, 1986

MEMORANDUM

TO : D/USAID/Peru, John Sanbrailo

FROM : RIG/A/T, Coinage N. Gothard

SUBJECT: Audit Report No. 1-527-86-17 on the Generation of Local Currencies under USAID/Peru Economic Support Loan No. 527-F-093

This report presents the results of our review of selected financial aspects of the above loan. Please advise us within thirty days of any further actions taken in response to the report recommendation.

Background

On May 11, 1984 AID and the Government of Peru (GOP) executed the above loan agreement providing $60 million under concessional loan terms to the GOP to assist the country's recovery from the economic problems resulting from the natural disaster of 1982-1983 known as "El Nino." During that period, dislocation of ocean currents off the west coast of South America caused floods in some areas and droughts in others. Of the three nations most affected (Ecuador, Peru and Bolivia), Peru suffered both floods in the North and drought in the South with significant damage to both its physical infrastructure and agricultural production. All this occurred during a period of generalized world recession and compounded Peru's already serious trade imbalances and foreign debt situation.

To help Peru address these problems, AID provided a concessional loan of $60 million disbursed in two equal tranches in June 1984 and June 1985. 1/ The dollar transfers were designed to assist the GOP to meet its foreign exchange obligations while the local currency generated in connection with the dollar transfers were planned to:

- provide liquidity for private sector business lending (75%);
- make available counterpart funds to cover the GOP's financial obligations to support AID's and other donors' development and reconstruction projects (23%); and
- help defray the local operating costs of the USAID Mission (2%).

1/ Although beyond the scope of this review, it should be noted that the U.S. General Accounting Office has issued a draft report on this same AID loan. The GAO report challenges AID's use of funds originally authorized for Syria, subsequently reobligated for disaster relief purposes in the Andean Region, for balance-of-payment/economic support purposes in Peru.

Audit Objectives and Scope

The Office of the Regional Inspector General for Audit based in Tegucigalpa, Honduras performed a limited-scope, compliance review of selected financial aspects of loan 527-F-093. Certain problems in the GOP's generation of local currency under this loan and USAID/Peru's monitoring of those aspects were disclosed during our review of three agricultural sector projects managed by the same USAID Mission, but which are the subject of three separate RIG/A/T reports.

Of specific audit interest were the implementation of that section of the loan agreement dealing with exchange rates and the generation, deposit of, and accounting for the local currencies made available by the GOP in association with the dollars transferred to it by AID under the same agreement.

Our review was made during two separate trips to Peru in March and May 1986. We reviewed pertinent files and records maintained by USAID/Peru on the subject of our inquiry and interviewed cognizant Mission personnel. Our review was limited to the local currencies generated under the first $30 million AID loan tranche, as the second $30 million had not yet been converted to local currency at the time the audit was made. The audit was made in accordance with generally accepted government auditing standards.

An exit conference was held with USAID/Peru officials on 9 May 1986. Comments offered by Mission representatives then and in response to our draft report (Lima 6853, 13 June 1986) have been taken into account in the preparation of this report.

Results of Audit

Our review disclosed that use of the lower "official" exchange rate produced fewer local currency units than had the parallel rate been used. We also noted that the Industrial Bank of Peru had used certain local currency generations for unauthorized purposes and that USAID/Peru needed to report on its stewardship of local currency trust funds. The Mission has taken action to correct the deficiencies noted during the audit.

Exchange Rate Provision - The text of the 527-F-093 loan agreement section dealing with exchange rates reads as follows:

> SECTION 5.3 Exchange Rate. Except as A.I.D. may otherwise agree in writing, the rate of exchange to be used in calculating the amount of Peruvian Soles [2/]

2/ The Peruvian monetary unit at the time the loan agreement was signed (sol, Spanish for sun) has, because of the effects of rampant inflation, been replaced by a new unit (inti, Quechua for sun), equal to 1,000 soles.

> Oro to be provided by Peru . . . shall be the highest lawful rate of exchange in Peru (i.e. the rate providing the most Peruvian Soles Oro per United States Dollar) on the date of each respective transfer or deposit of the Peruvian Soles Oro.

The key phrase, "highest lawful rate of exchange," quoted above differs somewhat from the formulation found in all other USAID/Peru loan agreements which call for the "highest rate which is not unlawful." The apparently subtle distinction in these two formulations becomes significant in pratice. For all exchanges of AID dollars to local currency in Peru AID relies upon the Embassy Budget & Fiscal Office to purchase local currency at the best available rate of the day. Under loan 093, the Central Bank of Peru established the rate of exchange used to generate local currency.

We were unable to determine, and Mission representatives stated they had not been able to determine, why the loan 093 exchange rate provision was stated as quoted previously. They reported that both the regional legal adviser who drafted the agreement and the current RLA were unable to shed any light on the origin of this language, except, they had pointed out, use of the standard AID exchange rate provision is not required for loans of this type. The Mission pointed out that this loan constitutes "program" or "non-project assistance" to the GOP. Consequently, local currency generated under this loan was produced at the rate used by the GOP Central Bank for selling dollars at the official rate of exchange in use on the day the local currency was generated.

USAID/Peru has acknowledged that use of this rate produced about 5% fewer units of local currency than had the best rate available (formerly known as the parallel rate, but now referred to as the financial market rate of exchange) been used. The opportunity cost in dollar equivalent terms resulting from use of the official rate under the first $30 million tranche was about $1.6 million. USAID/Peru has explained the GOP's use of this rate by arguing that the Central Bank was not authorized under Peruvian law to use anything but the official rate of exchange until 1 August 1985. On that date, the GOP officially recognized the existence of another lawful exchange rate and made it available for certain transactions, but not all.

A recent clarification and restatement of long-standing AID currency exchange policy by the Assistant Administrator for Latin America and the Caribbean was prompted by prior AID Inspector General audit reports on the same subject:

> [I]n all transactions involving the deposit of local currencies, whether pursuant to a balance of payments or other program agreement, the rate at which such local currencies shall be determined shall be . . . the highest rate not unlawful available to any person, entity, or class of transactions.

Further clarification on this matter holds that:

> [T]he right of AID is to the most favorable rate status. If a more favorable rate is available to other persons, entities, or classes of transactions, AID is also guaranteed access to that rate. AID will not agree to be placed in a category which yields a less favorable rate . . . [or one that is] identified or somehow specified under local laws as legal for AID, for other donors, or for certain transactions . . . .

It is the AID Inspector General's view that obtaining the highest rate of exchange which is not unlawful is in the best interests of the Agency and the objectives of the Foreign Assistance Act, unless it can be clearly demonstrated to the contrary.

Shortly after the present GOP administration took office in mid-1985, it issued "Supreme Decree No. 364-85-EF," effective 1 August 1985, recognizing the parallel rate of exchange as a lawful financial market rate of exchange in Peru. Because we believe that AID should always and everywhere assert its "most favored rate" status in the best interests of AID's programs and operations, we are recommending that USAID/Peru obtain the best available rate in Peru for generation of local currency under the second $30 million tranche of loan 093. At the time of our review, the best available rate was the financial market rate of exchange. If that rate is not used, the opportunity cost represented by the current spread between the official and financial market rates (25%) will amount to the local currency equivalent of about $7.5 million.

Recommendation No. 1

We recommend that USAID/Peru issue a separate implementation letter under loan 527-F-093 devoted exclusively to the subject of exchange rates officially notifying the GOP that the financial market rate of exchange (or the rate producing the most local currency units per U.S. dollar, if another more favorable rate were to become available) is to be used in the future generation of local currency under this loan.

Prior to the issuance of our draft report on this subject, USAID/Peru had formally assured the Assistant Administrator for Latin America and the Caribbean on two separate occasions that it will do all it can to obtain the best available exchange rate to calculate the generation of local currencies under the second $30 million tranche of AID loan 527-F-093. In response to the draft report the Mission advised:

In keeping with our previous discussions and assurances, USAID/Peru will comply with subject audit recommendation number one and issue an implementation letter under loan 527-F-093 on the issue of use of the financial market rate of exchange (highest legal rate) for use in future generation of local currency. This implementation letter will be issued in the near future in conjunction with our discussions with the GOP.

Peruvian Industrial Bank (BIP) - One-half of the $30 million first tranche disbursement under loan 093 was used to generate local currency for this institution in order to provide greater liquidity in its commercial lending operations for certain specified and mutually agreed upon uses. The local currencies generated by the Central Bank of Peru were made available to BIP in several installments that were completed by the end of 1984. Those generations were calculated at the official rate of the day they were generated. Had the parallel rate been used, about $665,000 more in equivalent local currency units could have been produced.

During December of that year, a consultant made USAID/Peru aware of the fact that BIP had diverted about one-third of the local currencies to uses not authorized under the AID-BIP industrial reactivation program. This caused the Mission to engage a local CPA firm to analyze BIP's handling of loan 093 local currency generations. The ensuing report quantified the amount of the diversions ($5.1 million) and eventually led to the establishment of a revolving trust fund within an autonomous BIP office to ensure the proper handling of the local currency generations and reflows thereof.

At the time of our review, nearly 1-1/2 years after the local currency diversions took place, BIP had yet to refund about $2 million in diverted 093 loan generations. However, USAID/Peru had insisted the refunds be made at a rate of exchange that will maintain the value of the original local currency generations made available to BIP. To date, BIP has repaid the revolving fund 60% of the amount diverted at the financial market rate of exchange, although it has never formally agreed to do so. In addition, USAID/Peru has advised the GOP that it will not agree to any further generations of local currency under loan 093 (the remainder of which are all destined for this program) until this problem has been resolved.

In our opinion, USAID/Peru has taken appropriate action to recover and maintain the value of 093 loan generations diverted to unauthorized uses. Under the circumstances, we find it unnecessary to make a formal audit recommendation on this matter. The USAID's position also sets a welcome precedent under this loan and serves to reinforce Recommendation No. 1 in this report.

Counterpart Fund Generations - This $15 million portion of loan 093 was also converted to local currency in several installments by the GOP Central Bank. The local currencies generated under this portion of AID loan 527-F-093 were calculated at the Central Bank's official rate for selling dollars on the day the local currencies were generated and deposited in a GOP special account designated Investment and Counterpart Funds (FIC). There loan 093 local currency generations were commingled with other funds (e.g. PL480 Title I sales proceeds). They were then disbursed, according to USAID/Peru officials, to reimburse the GOP for previous financial support provided to AID and other donor projects in Peru, in accordance with the terms of the loan agreement. Again according to Mission officials, the local currency generated under this portion of loan 093 had been fully disbursed from the FIC special account and attributed to eligible project support costs at the time of our review. Some $939,000 fewer equivalent local currency units were produced under this portion of the loan because a less favorable exchange rate was used.

We made note of the fact that the last generation of local currency under this portion of the loan took place shortly after the GOP recognized the parallel exchange rate as a lawful financial market exchange rate on August 1, 1985. On August 13, 1985 the Central Bank converted just over $3 million remaining under this loan portion at the official rate it used for selling dollars that day. Had the more favorable financial market rate been used to calculate this generation of local currency, about $600,000 more in equivalent local currency units would have been provided. This one transaction thus accounted for over one-third of the opportunity cost USAID/Peru reported as having resulted from the use of a less than the most favorable rate to calculate the generation of local currency under the first $30 million tranche of loan 527-F-093. We make particular mention of this transaction in order to underscore the importance we attach to the implementation of Recommendation No. 1 of this report.

Trust Funds - Shortly after the execution of loan agreement 527-F-093, AID and the GOP also executed a Trust Fund Agreement (TFA). The TFA specified that the equivalent of $1 million in local currencies generated under loan 093 was to be paid over by the GOP to AID to help defray expenses incurred locally by USAID/Peru.

The GOP did in fact make two separate payments of local currency to AID in January and March 1985. The dollar equivalent of those payments using the official rate of the day they were made totaled just over $941,000. USAID/Peru produced documentary evidence attesting to the good faith efforts of both AID and the GOP to make the full $1 million payment. However, the rapid decline in the value of the local currency vis-a-vis the dollar during the period between the time the payments were calculated and the time they were actually made caused a shortfall of $59,000, or 6% of the $1 million agreed upon.

The USAID/Peru Controller used the local currency provided by the GOP under the TFA to pay certain local currency operating costs incurred during the first three quarters of fiscal year 1985. At the end of that fiscal year he reported to AID/W that the equivalent of $836,800 3/ in operating expenses had been absorbed by local currencies made available to AID by the GOP under the TFA.

USAID/Peru officials also reported that, because funding of the GOP trust fund obligation out of international loan fund proceeds was probably illegal under Peruvian law (a discovery made after the TFA was executed), the local currencies paid over to AID under the TFA had never been deducted from, nor attributed to, the generation of local currencies under loan 527-F-093 by the GOP. In effect, the local currency payments made under the TFA could be considered GOP donations to AID.

The TFA requires USAID/Peru to report on its stewardship of these local currency payments annually. No such report had been made by USAID/Peru to the GOP at the time of our review. In response to the draft report, USAID/Peru advised that a "financial report indicating TFA local currency disbursements by Mission operating expense function has now been forwarded to the GOP Ministry of Finance."

Net Impact - In conclusion, if one were to consider the GOP's "donated" trust fund payments as an offset against the opportunity cost caused by the Central Bank's use of the lower official exchange rate (which the Central Bank would maintain was the highest rate it could legally use), the resulting net opportunity cost would be slightly more than 2% of the $30 million in local currency generations to date under loan 093. In our view, payments made by the GOP under the TFA (which required special authorizing decrees once it was discovered the payments could not be taken from loan 093 proceeds) constitute convincing evidence of the GOP's intent to comply with the terms and conditions of loan 527-F-093.

3/ This figure represents the total dollar value of AID local currency disbursements charged to the trust fund account.

APPENDIX 1

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