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AUDIT OF
USAID/EL SALVADOR
BALANCE OF PAYMENTS PROGRAM

Audit Report No. 1-519-89-10
March 15, 1989

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March 15, 1989

MEMORANDUM

TO: Director, USAID/El Salvador, Henry Bassford

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

SUBJECT: Audit of USAID/El Salvador Balance of Payments Program

The Office of the Regional Inspector General for Audit/Tegucigalpa has completed its audit of the USAID/El Salvador Balance of Payments Program. Five copies of the audit report are enclosed for action.

The draft audit report was submitted to you for comment and your comments are attached to this report as appendix 1. The report contains four recommendations. Recommendation number four is closed upon issuance of the report. Recommendations one, two, and three remain open and unresolved on report issuance. Please advise me within 30 days of any actions taken to implement these recommendations.

I appreciate the cooperation and courtesy extended to my staff during the audit.

EXECUTIVE SUMMARY

In 1979, El Salvador experienced a sharp decline in economic activity mainly because of an armed insurgency. The United States Government responded with increasing levels of economic assistance. From 1979 through 1987, A.I.D. provided almost $1.2 billion for balance of payments support under four separate programs. The Government of El Salvador used these funds to finance imports, thereby reducing the country's balance of payments deficit.

The Regional Inspector General for Audit, Tegucigalpa performed a program results and compliance audit of the USAID/El Salvador Balance of Payments Program from January 1, 1985, through December 31, 1987. The objectives of the audit were to assess (1) progress in achieving the objectives of the Economic Support Fund and the Public Law 480 Title I programs, (2) if actions completed on eight prior Inspector General audit recommendations were adequate to allow the recommendations to remain closed, and (3) USAID/El Salvador and Government of El Salvador compliance with selected terms of the balance of payments' agreements.

USAID/El Salvador has made some progress in helping the Government of El Salvador achieve the economic objectives of the Economic Support Fund program. However, progress could be better measured and more might be made by improving program design. The accomplishment of the Public Law 480 Title I program self-help measures and objectives could not be determined because indicators to measure results and impact were lacking. USAID/El Salvador had not implemented two of the eight audit recommendations made in the Regional Inspector General for Audit/Tegucigalpa audit report on improving the Central Bank of El Salvador's systems for price-checking and attribution of import transactions to Economic Support Fund dollar assistance. Contrary to program agreements, the Central Bank did not assume full responsibility for preparing lists of eligible Economic Support Fund import transactions, and USAID/El Salvador had not taken all steps to complete the Title I loan agreements.

USAID/El Salvador has made some improvements during the last three years in its Economic Support Fund policy dialogue process. Because of political sensitivity in the Government of El Salvador to linking Economic Support Fund dollar assistance to specific economic policy reforms, USAID/El Salvador shifted, from using explicit conditionality in the Economic Support Fund grant agreements in 1985 and 1986, to the acceptance of an annual Government of El Salvador economic plan before signing the 1987 Economic Support Fund agreement. To monitor performance against the economic targets established in the Government of El Salvador plan, USAID/El Salvador met quarterly with Government of El Salvador officials to assess progress and policy adjustments.

USAID/El Salvador and the Central Bank have made significant improvements in their systems to attribute import transactions to Economic Support Fund dollar assistance since the last Inspector General audit. Among other things, the Central Bank had established a separate Economic Support Fund dollar assistance account and USAID/El Salvador had

contracted a consultant to review the eligibility of the transactions. We tested import transactions accepted by USAID/El Salvador for attribution and found no significant ineligible transactions. Also, the Central Bank has continued to improve the effectiveness of its price-checking system to prevent the overpricing of imports and the underpricing of exports in order to deter capital flight.

Although USAID/El Salvador had made some progress in helping the Government of El Salvador achieve the overall economic stabilization and recovery objectives of the Economic Support Fund program, USAID/El Salvador could reduce costly reliance by the Government of El Salvador on A.I.D. assistance by designing a more effective program and convincing the Government of El Salvador to adopt key economic policy reforms. Public Law 480 Title I self-help measures did not have adequate targets or indicators to gauge implementation progress or to measure their impact on improving the conditions of the rural poor. The Central Bank did not prepare the required lists of eligible import transactions financed with Economic Support Fund dollar assistance. USAID/El Salvador had not taken all steps to complete the Title I loan agreements.

The overall objectives of the Economic Support Fund program were to assist the Government of El Salvador in achieving economic stabilization and recovery; however, USAID/El Salvador has only partly accomplished the program objectives. USAID/El Salvador has had difficulty in convincing policy makers of the governments of El Salvador and the United States of the importance of establishing certain economic reforms because it had not adequately defined the overall program objectives in measurable terms and had not determined the economic costs of not adopting key economic policy reforms as required by the Foreign Assistance Act and a 1985 audit report. Unless USAID/El Salvador designs a more effective Economic Support Fund program and uses it as a tool to convince the Government of El Salvador to adopt important economic reforms, A.I.D. could have to materially increase funding to achieve the overall program objectives. The report recommends that USAID/El Salvador design a more effective Economic Support Fund program. USAID/El Salvador suggested that the recommendation be deleted or redirected to A.I.D./Washington and other agencies.

The Public Law 480 Title I program requires that the recipient country undertake self-help measures to improve specific conditions of the rural poor including expanding the agricultural food production of the small farmer as a condition to receiving agricultural commodities at concessional terms. The audit found that most of the self-help measures did not have adequate targets or indicators to gauge implementation progress or to measure their impact on improving specific conditions. This situation existed, in part, because USAID/El Salvador had not developed appropriate procedures for ensuring that self-help measures were described in clear and measurable terms. As a result, neither USAID/El Salvador nor the Government of El Salvador knew exactly what progress had been made in implementing the measures or what effect these measures have had on expanding agricultural food production or on improving other specific conditions of the rural poor. The report recommends that USAID/El Salvador adopt appropriate self-help measure procedures. The Mission did not believe the finding, as originally written, accurately or fairly presented the situation. However, the Mission did not provide any new evidence to refute the need for specific and measurable indicators.

Procedures for the Economic Support Fund agreements require the Central Bank to submit to USAID/El Salvador lists of import transactions financed with dollar grant resources. USAID/El Salvador or its designee is required to conduct an eligibility review of each transaction contained in the lists. The audit found that the Central Bank did not submit the required list because (1) A.I.D. did not require the Central Bank to do it, and (2) the Central Bank had no incentive to do it since A.I.D. contractors appeared willing to prepare the lists as part of their eligibility reviews. As a result, the A.I.D. contractors performed more work than would have been necessary if the Central Bank had provided import transaction lists. This may have increased the costs of the A.I.D. contracts. The report recommends that USAID/El Salvador require the Central Bank to perform its reporting responsibilities. USAID/El Salvador indicated that the Central Bank has submitted the required reports.

Public Law 480 Title I loan agreements between the Governments of the United States and El Salvador were not valid because certain prerequisites were not satisfied. The agreements for 1985, 1986, and 1987 were to become effective when an exchange of diplomatic notes indicated that both countries completed the internal procedures of ratification. There was no evidence that these specific notes had ever been exchanged because some USAID/El Salvador staff were confused as to what actually constituted the notes in question. Without valid agreements, USAID/El Salvador does not have legal recourse to enforce compliance with the agreements' provisions. The Mission agreed with the finding and recommendation and took prompt action to correct the situation.

Office of the Inspector General

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PART I - INTRODUCTION

A. Background

El Salvador experienced a sharp decline in economic activity in 1979 mainly because of an armed insurgency. The United States Government responded with increased levels of annual economic assistance increasing from $10 million in 1979 to $495 million in 1987. During this period, A.I.D. direct economic assistance totaled about $2.1 billion of which 56 percent (or almost $1.2 billion) was for balance of payments support (see exhibit 1). A.I.D. provided balance of payments support under four separate cash and commodity programs as follows:

Program	Amount ($000)
- Economic Support Fund	$ 893,900
- Public Law 480 Title I	263,014
- Public Law 480 Title II (section 206)	16,680
- Agricultural Act of 1949 (sec. 416[b])	4,100
	$1,177,694

The Government of El Salvador (GOES) used these resources to finance imports, thereby reducing the country's balance of payments deficit. The GOES used the remaining $900 million of direct A.I.D. assistance to support development assistance and other projects which had less of an immediate impact on the country's balance of payments deficit. A description of the four separate balance of payments programs follows:

Economic Support Fund (ESF) -- ESF resources, made available under the Foreign Assistance Act, promote economic and political stability in countries of strategic interest to the United States. A.I.D. uses its ESF program as leverage to encourage improvements in host country economic policies. The ESF program in El Salvador began in 1980. The overall objectives of the program were to support GOES efforts for the stabilization and recovery of the Salvadoran economy by financing essential imports for the private sector, promoting economic diversification, consolidating the agrarian reform, and engaging the private sector in reactivating the economy. By December 31, 1987, A.I.D. had obligated and disbursed $893.9 million for the ESF program under six ESF agreements 1/ (see exhibit 2 for details). The ESF agreements

1/ The first two ESF agreements were known as the Private Sector Support Program. The other four agreements were known as the Balance of Payments Support Program.

provided that the GOES would deposit the local currency equivalent of each dollar disbursement into a separate account. The GOES would then use these funds for purposes mutually agreed to by the two governments.

Public Law 480 Title I (Title I) -- The Title I program, authorized by the Agricultural Trade Development and Assistance Act of 1954, sells agricultural commodities using long-term low interest loans. In effect, the U.S. Government provides credit to the host government to import needed agricultural commodities. Since the initiation of the Title I program in El Salvador in 1980, the U.S. Government has loaned $263 million to the GOES for the importation of agricultural products (see exhibit 2 for details). A.I.D.'s purpose in providing Title I resources in El Salvador was to help provide balance of payments support, supply essential food imports, and keep essential social services and private sector activities operating. The GOES agreed in the Title I agreements to establish and undertake self-help measures to improve the socioeconomic conditions of the rural poor. The Title I agreements required the GOES and A.I.D. to jointly program the local currency generated from the sale of Title I commodities for developmental activities.

Public Law 480 Title II (section 206) -- This program, in contrast to the Title I program, provides agricultural commodities without cost to the recipient country. On June 3, 1983 the U.S. Government donated 12,500 metric tons of dried milk to the GOES. The purpose of the grant was to respond to a shortage of consumer milk because of a sharp decline in local production and a foreign exchange constraint limiting GOES imports. The GOES was to use the local currency proceeds to be generated from the sale of the milk (estimated at $16.7 million) for developmental purposes agreed upon by the two governments.

Agricultural Act of 1949 (section 416[b]) -- This program also provides agricultural commodities without cost to the GOES. On February 13, 1987 the U.S. government donated 34,864 metric tons of corn to the GOES under section 416(b). The grant was to offset the adverse effect on GOES exports from a cut in their U.S. sugar quota. The GOES was to use the local currency to be generated ($4.1 million) for agricultural development projects agreed to by both governments.

USAID/El Salvador managed the balance of payments program with a Balance of Payments Program Implementation Committee which reported to the Associate Mission Director for Operations. Within the USAID, the Private Enterprise Office was responsible for ensuring that the GOES used ESF dollars for eligible purposes and properly accounted for them. The USAID's Economic Office assisted in the planning and monitoring of the economic objectives of the ESF program. The USAID's Office of Project Planning and Development was responsible for managing the other programs.

B. Audit Objectives and Scope

The Regional Inspector General for Audit, Tegucigalpa (RIG/A/T) performed a program results and compliance audit of the USAID/El Salvador Balance of Payments Program from January 1, 1985, through December 31, 1987. The objectives of the audit were to assess (1) progress in achieving the objectives of the Economic Support Fund and the Public Law 480 Title I programs, (2) if actions completed on eight prior Inspector General audit recommendations 2/ were adequate to allow the recommendations to remain closed, and (3) USAID/El Salvador and Government of El Salvador compliance with selected terms of the balance of payments' agreements.

To accomplish these objectives, RIG/A/T reviewed records from and interviewed officials of the Central Bank and Technical Secretariat for External Financing of El Salvador and USAID/El Salvador, an A.I.D. contractor, and the United States Department of Agriculture. We selected statistical samples of Government of El Salvador import transactions financed from the separate ESF dollar accounts to verify that the transactions complied with the established eligibility criteria. We conducted audit field work from May 2 to September 1, 1988.

The total resources audited were $622.5 million consisting of $494 million provided under the ESF program and $128.5 under the Title I programs. This audit report does not include the results of a review on management's use of the local currency made available from the dollars or commodities provided under the balance of payments program. The results of that review is covered in a separate audit report. RIG/A/T limited its review of internal controls and compliance to the findings in this report and performed the audit in accordance with generally accepted government auditing standards.

2/ From the audit report entitled "Audit of Private Sector Support Program and PL 480 Local Currency Generations USAID/El Salvador, Audit Report No. 1-519-85-13" dated September 26, 1985.

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PART II - RESULTS OF AUDIT

USAID/El Salvador has made some progress in helping the Government of El Salvador (GOES) achieve the economic objectives of the Economic Support Fund (ESF) program. However, progress could be better measured and more might be made by improving program design. The accomplishment of the Public Law 480 Title I (Title I) program self-help measures and objectives could not be determined because indicators to measure results and impact were lacking. USAID/El Salvador had not implemented two of the eight audit recommendations made in the RIG/A/T audit report on improving the Central Bank of El Salvador's systems for price-checking and attribution of import transactions to ESF dollar assistance. Contrary to program agreements, the Central Bank did not assume full responsibility for preparing lists of eligible ESF import transactions, and USAID/El Salvador had not taken all steps to complete the Title I loan agreements.

USAID/El Salvador has made some improvements during the last three years in its ESF policy dialogue process. Because of political sensitivity in the GOES to linking ESF dollar assistance to specific economic policy reforms, USAID/El Salvador shifted, from using explicit conditionality in the ESF grant agreements in 1985 and 1986, to the acceptance of an annual GOES economic plan before signing the 1987 ESF agreement. To monitor performance against the economic targets established in the GOES plan, USAID/El Salvador met quarterly with GOES officials to assess progress and policy adjustments.

USAID/El Salvador and the Central Bank have made significant improvements in their systems to attribute import transactions to ESF dollar assistance since the last Inspector General audit. Among other things, the Central Bank had established a separate ESF dollar assistance account and USAID/El Salvador had contracted a consultant to review the eligibility of the transactions. We tested import transactions accepted by USAID/El Salvador for attribution and found no significant ineligible transactions (see appendix 2). Also, the Central Bank has continued to improve the effectiveness of its price-checking system to prevent the overpricing of imports and the underpricing of exports in order to deter capital flight (see appendix 3).

Notwithstanding the improvements already made, USAID/El Salvador had not implemented audit recommendations Nos. 4(b) and 6 in the last Inspector General audit report to establish a computerized system for selecting import transactions to be financed with ESF dollar assistance. The RIG/A/T follow-up review of these recommendations is contained in audit report No. 1-519-89-08.

Although USAID/El Salvador had made some progress in helping the GOES achieve the overall economic stabilization and recovery objectives of the ESF program, USAID/El Salvador could reduce costly reliance by the GOES on A.I.D. assistance by designing a more effective program and convincing the GOES to adopt key economic policy reforms (see finding No. 1). PL 480 Title I self-help measures did not have adequate targets or indicators to gauge implementation progress or to measure their impact on improving the conditions of the rural poor (see finding No. 2). The Central Bank did not prepare the required lists of eligible import transactions financed with ESF dollar assistance (see finding No. 3). USAID/El Salvador had not taken all steps to complete the Title I loan agreements (see finding No. 4).

The report recommends that USAID/El Salvador develop more effective programs to achieve the overall objectives of the ESF and Title I programs, have the Central Bank assume full responsibility for preparing lists of eligible import transactions, and take all steps to complete the Title I agreements by an exchange of diplomatic notes as required by the agreements.

A. Findings and Recommendations

1. USAID/El Salvador Needed to Establish a More Effective Economic Support Fund Program

The overall objectives of the Economic Support Fund program were to assist the Government of El Salvador in achieving economic stabilization and recovery; however, USAID/El Salvador has only partly accomplished the program objectives. USAID/El Salvador has had difficulty in convincing policy makers of the governments of El Salvador and the United States of the importance of establishing certain economic reforms because it had not adequately defined the overall program objectives in measurable terms and had not determined the economic costs of not adopting key economic policy reforms as required by the Foreign Assistance Act and a 1985 audit report. Unless USAID/El Salvador designs a more effective Economic Support Fund program and uses it as a tool to convince the Government of El Salvador to adopt important economic reforms, A.I.D. could have to materially increase funding to achieve the overall program objectives.

Recommendation No. 1

We recommend that USAID/El Salvador define the stabilization and recovery objectives of the program in measurable terms and determine the economic costs of not adopting key economic policy reforms in its Progam Approval Assistance Documents for the program.

Discussion

From 1951 through 1978 the real Gross Domestic Product (GDP) of El Salvador grew at an average annual rate of about five percent and real per capita GDP increased at about 2.2 percent per year (assuming a natural population growth rate of about 2.8 percent a year). However, starting in 1979 El Salvador experienced a sharp decline in economic activity mainly because of an armed insurgency. This caused a reduction of investor confidence and significant damage to the economic infrastructure. As the real GDP began to fall, the U.S. Government responded in the 1980s with increasing levels of economic assistance. Several uncontrollable factors have adversely affected the Salvadoran economy during the 1980s. The principal external factors were the armed conflict, the worldwide recession from 1981 to 1982, the breakdown of the Central American Common Market, unfavorable terms of trade, adverse climatic conditions, and the 1986 earthquake.

The overall objectives of the Economic Support Fund (ESF) program were to assist the Government of El Salvador (GOES) in achieving economic stabilization and recovery. To achieve these objectives, USAID/El Salvador used its ESF program to provide balance of payments support and as leverage to encourage economic policy reforms.

Even though A.I.D. has provided about $1.2 billion in balance of payments support since 1980, USAID/El Salvador has only partly accomplished the overall objectives of the ESF program. According to one USAID/El Salvador official, economic stabilization and recovery could mean achieving real per capita GDP growth for at least three years without compensatory balance of payments financing. However, El Salvador has been unable to achieve this growth without compensatory financing. During the last three years, real per capita GDP growth has fallen by an average of about 1.1 percent 3/ per year even with A.I.D. balance of payments support of about $220 million per year. Without A.I.D. balance of payment financing, real per capita GDP would have fallen by a much greater percentage.

Nevertheless, according to USAID/El Salvador officials, A.I.D. had made some progress in helping the GOES to improve the performance of its economy through its balance of payments program. A.I.D. helped to reverse the decline in real (absolute) GDP in 1983 by substantially increasing the size of its program to an annual average of 4.9 percent of GDP. From 1983 through 1987, real GDP has increased at an average annual rate of 1.7 percent (the real absolute growth in the GDP was less than the population growth rate during this period which meant that per capita GDP has continued to fall but at a slower rate than prior to 1983).

For the Salvadoran economy to make constant improvement, the GOES must implement the USAID/El Salvador proposed economic reforms. To improve the chances of getting the GOES to adopt economic reforms, USAID/El Salvador has made changes during the last three years in how it managed the policy dialogue process. Because of GOES political sensitivity to linking ESF dollar assistance to specific economic policy reforms, USAID/El Salvador shifted from using explicit conditionality in the grant agreements in 1985 and 1986 to the acceptance of an annual GOES economic plan before signing the ESF agreement in 1987. To monitor performance against the economic targets established in the GOES plan, USAID/El Salvador met quarterly with GOES officials to assess progress and policy adjustments.

However, the GOES did not adopt many of the USAID/El Salvador policy reform objectives or benchmarks because USAID/El Salvador did not convince policymakers in both governments of the importance of such reforms in relation to political, security, and social objectives (see appendices 4, 5, and 6). USAID/El Salvador could have made more effective arguments if the program design had defined the overall objectives in measurable terms and determined the economic costs of not adopting key policy reforms as required by the Foreign Assistance Act of 1961, as amended and a 1985 General Accounting Office (GAO) audit report.

3/ The percentage decline in real per capita GDP of 1.1 percent assumed a natural population growth rate of 2.8 percent per year. This decline in real per capital GDP would only be about 0.1 percent assuming a population growth rate of 1.8 percent that considers outward migration.

Section 621A of the Foreign Assistance Act requires a program design to include:

> ...the definition of objectives and programs for United States foreign assistance; the development of quantitative indicators of progress toward these objectives; the orderly consideration of alternative means for accomplishing such objectives; and the adoption of methods for comparing actual results of programs and projects with those anticipated when they were undertaken....

A 1985 GAO audit report entitled "Providing Effective Economic Assistance to El Salvador and Honduras: A Formidable Task" recommended that A.I.D. determine the estimated costs to finance future balance-of-payments deficits in El Salvador in the absence of additional macroeconomic reforms, particularly exchange rate adjustments. USAID/El Salvador did this in its 1986 Program Assistance Approval Document (PAAD). The PAAD estimated that had the GOES elected to continue its 1985 policies (instead of using a competitive exchange rate and controlling domestic demand and inflation) it would have required an additional $365 million in balance of payments support (in 1984 dollars) over a three-year period to offset the negative effects of bad policy on economic growth.

Although partially effected for the 1986 program design, USAID/El Salvador did not incorporate required design elements in its 1987 and 1988 PAADs. These ESF program designs did not define the overall economic stabilization and recovery objectives in measurable terms and generally did not determine the economic cost of alternatives (such as changes in A.I.D. funding levels, GOES economic policies, program timeframes, and assumptions about external conditions). 4/ This is not fully consistent with the Foreign Assistance Act and a 1985 GAO audit report.

Unless USAID/El Salvador includes the required design elements in its ESF programs, it has less chance of convincing the GOES or U.S. policymakers of the importance of its proposed economic reforms. If the GOES does not make economic reforms, USAID/El Salvador probably cannot achieve the overall objectives of its ESF program without a material increase in funding.

USAID/El Salvador must include the required elements in its ESF program design to be in full compliance with the Foreign Assistance Act and the 1985 GAO audit report. This will also provide more convincing arguments for needed economic reforms and enable measurement of progress toward the overall ESF objectives.

4/ USAID/El Salvador's 1987-1988 Action Plan prepared in 1986 defined the short, medium and long-term objectives of economic stabilization in measurable terms.

Management Comments

USAID/El Salvador stated that recommendation No. 1 reflected a lack of understanding by the auditors of the process of program design, development and negotiation. According to USAID/El Salvador this process involved preparing preliminary and final proposals (PAADs) for review by A.I.D./Washington and other agencies before final negotiation instruction are issued to USAID/El Salvador. The A.I.D. review of program proposals and negotiations with the GOES had to be responsive to the objectives of both governments. These objectives have centered around social and political stability in recent years. For these reasons, negotiations with GOES officials have been taxing, time consuming and fraught with controversial issues and sometimes required the participation of A.I.D./W officials.

USAID/El Salvador maintained that the objectives of its 1987 and 1988 ESF programs have been stated very clearly. The objectives were to enable the GOES to arrest the sharp decline in incomes while consolidating the democratic process and pursuing programs of social reform. In El Salvador this has meant: 1) arresting and reversing the fall in real GDP, and 2) reducing inflationary pressures -- both within the context of the Mission's long term goal of helping bring about an equilibrium in the balance of payments that is sustainable without recourse to extraordinary levels of external assistance.

USAID/El Salvador also stated that the balance of payments program objectives have been met because the fall in real GDP was arrested and reversed and the rate of inflation was lowered after 1986.

According to USAID/El Salvador, the implication that progress towards stabilization and recovery was compromised because its objectives were not defined in a more quantitative fashion ignores the long and tortuous policy dialogue that took place in 1986 and 1987. The 1986 PAAD and the GOES Economic Program included a well quantified set of objectives along with a discussion of the economic costs of not taking this proposed adjustment measures but success was not achieved because of social and political factors.

USAID/El Salvador stated that the 1987 PAAD was a well balanced document, and was so recognized in a recent GAO report. It quoted the GAO report as stating that "the program document for the fiscal 1987 cash transfer program in El Salvador contained criteria that the government of El Salvador has adopted in its calendar year 1987 economic plan.... The criteria in the El Salvador economic plan appeared to be sufficiently detailed to enable AID to measure reform progress."

USAID/El Salvador stated that the fact that it did not achieve all the objectives laid out in its annual action plan as mentioned in the audit does not weaken the conclusion that progress has been achieved.

USAID/El Salvador concluded its comments by requesting that recommendation No. 1 be deleted from the final report or redirected to a combination of A.I.D./W and other agencies involved in the decision making process with regard to negotiating instructions. USAID/El Salvador also questioned and rejected the appropriateness of having the RIG evaluate economic program policy given its lack of expertise in this area.

See appendix 1, page 2 for the Mission's full comments on this finding.

Office of Inspector General Comments

We do not agree that the recommendation should be directed to A.I.D./W and other agencies. Good management dictates that the program proposals prepared by USAID/El Salvador should define the stabilization and recovery objectives of the program in measurable terms and estimate the potential costs to both the U.S. Government and the GOES of not achieving key policy reform objectives. In this way, U.S. policymakers will have a better basis for making decisions during the program design and development process. This in turn could influence the negotiating instructions issued to USAID/El Salvador.

USAID/El Salvador defined what appears to be the economic stabilization objective of the program in its formal comments to the draft report. It stated that the Mission's long term goal is to help bring about an equilibrium in the balance of payments that is sustainable without recourse to extraordinary levels of external assistance. One USAID/El Salvador official made similar statements to us during the audit. However, the overall stabilization objective was not defined in the ESF PAADs. We are recommending, among other things, that USAID/El Salvador do this.

USAID/El Salvador also commented on the clarity and accomplishment of its short-term or annual program objectives. However, this did not explicitly address our finding which deals with the overall program objectives. For example, USAID/El Salvador cited a recent GAO audit report that stated that "The criteria in the El Salvador economic plan appeared to be sufficiently detailed to enable AID to measure reform progress." We agree with the GAO report. However, our finding is concerned with the overall ESF program objectives not short-term or annual objectives.

We take exception to USAID/El Salvador's statement that the RIG evaluated economic program policy. We did not evaluate economic program policy but rather performed a program audit; something we are very qualified to do. U.S. Government auditing standards for program audits provide that government auditors may:

- assess whether the objectives of a proposed, new, or ongoing program are proper, suitable, or relevant,

- determine the extent to which a program achieves a desired level of program results,

- assess the effectiveness of the program and/or of individual program components,

- identify factors inhibiting satisfactory performance,

- determine whether management has considered alternatives for carrying out the program that might yield desired results more effectively or at a lower cost, and

- assess the adequacy of management's system for measuring and reporting effectiveness.

The implementation of our recommendation would have several positive benefits. First, it will provide a better basis to measure the accomplishment of the overall economic stabilization and recovery objectives of the ESF program as opposed to short-term or annual objectives and targets. The USAID/El Salvador ESF PAADs provide an excellent progress evaluation of short-term or annual objectives and targets because these objectives and targets have been clearly defined in measurable terms. However, if management only analyzes the accomplishment of short-term objectives, this can give a misleading impression of long-term program success. For example, in evaluating short-term objectives USAID/El Salvador stated in its comments, and we agree, that it has been instrumental in significantly lowering inflation after 1986, which has contributed to economic stabilization. However one could question whether the ESF program has actually contributed to stabilization of the economy over the long term, if one looks at what has happened since the beginning of the ESF program. Inflation has increased significantly from an average annual rate of 14.6 percent between 1980-1982 to 26.4 percent between 1985-1987 (see Consumer Price Index in Exhibit 1).

Second, the recommendation would provide a better basis for United States and El Salvador policymakers to evaluate economic strategies. This could increase support to economic policy reform and substantially reduce A.I.D. funds needed by El Salvador for balance of payments support. Finally, USAID/El Salvador would be in compliance with the Foreign Assistance Act and the recommendation of the 1985 GAO audit report.

The A.I.D. Nonproject Assistance handbook, like the USAID/El Salvador ESF PAADs, did not adequately address the planning requirements of the Foreign Assistance Act. A June 1988 GAO audit report entitled "Improving the Impact and Control of Economic Support Funds" also commented on deficiencies in A.I.D.'s Nonproject Assistance handbook. These handbook deficiencies may have contributed to the shortcomings of the USAID/El Salvador ESF PAADs.

2. USAID/El Salvador Needed to Establish Effective Title I Self-Help Procedures

The Public Law 480 Title I program requires that the recipient country undertake self-help measures to improve specific conditions of the rural poor including expanding the agricultural food production of the small farmer as a condition to receiving agricultural commodities at concessional terms. The audit found that most of the self-help measures did not have adequate targets or indicators to gauge implementation progress or to measure their impact on improving specific conditions. This situation existed, in part, because USAID/El Salvador had not developed appropriate procedures for ensuring that self-help measures were described in clear and measurable terms. As a result, neither USAID/El Salvador nor the Government of El Salvador knew exactly what progress had been made in implementing the measures or what effect these measures have had on expanding agricultural food production or on improving other specific conditions of the rural poor.

Recommendation No. 2

We recommend that USAID/El Salvador develop and implement procedures to ensure that self-help measures are described in specific and measurable terms.

Discussion

An important objective of the United States assistance program in El Salvador is to have El Salvador achieve a level of economic stability and recovery which would negate the need for continued external economic support. Consistent with this objective is that El Salvador become more self-reliant in meeting its food production needs by improving its own production, storage, and distribution of agricultural food products. Congress intended that the Public Law 480 Title I (Title I) program of the Agricultural Trade Development and Assistance Act of 1954, as amended, act as the impetus for effecting such agricultural improvements, among other things. As a condition to receiving agricultural commodities at concessional terms, the Title I program requires the recipient country to undertake specific measures primarily aimed at expanding the agricultural production efforts of small rural farmers and at improving the country's agricultural food storage and distribution systems. In addition to direct agricultural activities, the Title I program has been amended to recognize as eligible self-help measures the reduction of illiteracy and the improvement of health among the rural poor.

The Title I program requires that specific commitments or targets be established as a means of measuring the extent to which the self-help measures have been implemented. A.I.D. guidance also specifies that USAID/Missions set these commitments or targets so that achieving them will not be automatic but will require special effort and would not have been undertaken if not for the Title I agreement. Finally, the Title I program emphasizes compliance with self-help measures, as underscored by the agreement's provisions which state that the United States may terminate the agreement if it determines that the recipient government has not adequately developed the self-help program. In this regard, the program requires that the recipient country annually report its progress in achieving self-help measures.

The audit found that the Government of El Salvador (GOES) had agreed to undertake certain self-help measures. However, most of the self-help measures did not have adequate targets or indicators to gauge the extent to which the measures had been implemented and their effect on improving the conditions of the rural poor (see appendix 7 for information on the 1987 Title I self-help measures).

This situation existed, in part, because USAID/El Salvador had not established effective procedures to ensure that the Public Law 480 Title I self-help measures were described in clear and measurable terms.

As a result, the audit could generally not determine what progress had been made in implementing specific self-help measures and what effect, if any, the measures have had on expanding agricultural food production or on improving other conditions of the rural poor.

A clear objective of the Title I program was to get recipient countries to undertake self-help measures that would, among other things, expand their agricultural food production capabilities. It is unclear what effect the self-help measures had on improving specific conditions of the rural poor because USAID/El Salvador had not ensured that the GOES had established appropriate targets or indicators for measuring progress in implementing the measures and for measuring their impact.

Management Comments

The Mission did not believe the discussion in the draft report provided an accurate and fair impression of its performance in regard to developing and implementing Title I self-help measures. The Mission identified four overall areas of concern. The Mission claimed that the report unfairly:

-- evaluated the self-heln measures in isolation from political, social, and other factors,

-- insinuated that only self-help measures related to food production were valid,

-- insisted that existing self-help measures did not contain methods for measuring progress in implemention and achievement of their objectives, and

-- made statements that self-help measures did not require a special effort on the part of the GOES.

The Mission provided detailed information including examples under each of the four areas to support its position. Based on its response the Mission requested that the recommendation be deleted. See appendix 1, page 6 for the Mission's full comments on this finding.

Office of Inspector General Comments

The RIG disagrees with the Mission's contention that the draft finding was not accurately or fairly presented. The discussion clearly describes the Title I legislative requirements pertaining to self-help measures. The underlying legislation and A.I.D. guidance clearly require Missions to ensure that specific commitments or targets be established as a means for measuring the extent to which self-help measures have been implemented and their impact on improving conditions for the rural poor. The Mission's comments and descriptions of the six 1987 Title I self-help measures support our statement that specific self-help targets or indicators have not fully been established. The RIG/A/T revised portions of the finding and the recommendation as a result of the Mission's comments. In addition, parts of the discussion that did not specifically relate to establishing specific and measurable indicators were deleted.

3. <u>The Central Bank Should Assume Full Responsibility for Compiling the Required Lists of Import Transactions</u>

Procedures for the Economic Support Fund agreements require the Central Bank to submit to USAID/El Salvador lists of import transactions financed with dollar grant resources. USAID/El Salvador or its designee is required to conduct an eligibility review of each transaction contained in the lists. The audit found that the Central Bank did not submit the required lists because (1) A.I.D. did not require the Central Bank to do it, and (2) the Central Bank had no incentive to do it since A.I.D. contractors appeared willing to prepare the lists as part of their eligibility reviews. As a result, the A.I.D. contractors performed more work than would have been necessary if the Central Bank had provided import transaction lists. This may have increased the costs of the A.I.D. contracts.

<u>Recommendation No. 3</u>

We recommend that USAID/El Salvador obtain evidence that the Central Bank has agreed to:

a. submit lists of transactions as required in the Separate Account Operating Procedures, for the current and successive Economic Support Fund agreements; and

b. prepare such lists using its own resources.

<u>Discussion</u>

The Economic Support Fund (ESF) grant agreements state that the Government of El Salvador (GOES) is to deposit the dollar grant resources provided under the agreement into a separate United States dollar account and to use these resources to finance certain types of imports. The Central Bank developed and USAID/El Salvador approved procedures governing the use of the ESF resources in the separate dollar account (Separate Account Operating Procedures). Among other things, these procedures (1) specify the type of imports that can be financed with funds from the separate dollar account, (2) require the Central Bank to submit to USAID/El Salvador a list of imports financed from the account, and (3) require USAID/El Salvador or its designee to review the eligibility of each transaction reported on the list and to take appropriate actions based on its review findings. From July 1, 1985 to May 31, 1988, USAID/El Salvador employed two successive contractors to perform the eligibility review at a total cost of $1,652,194. Under the two contracts, the contractors were required to review all transactions on the Central Bank's list of import transactions and to determine their eligibility in accordance with program criteria. After this review, the contractors were required to submit reports to USAID/El Salvador indicating or certifying the eligibility of import transactions.

The audit found that the Central Bank did not compile lists of import transactions for USAID/El Salvador's or its designee's review as required. Instead the Bank submitted to the contractors actual documentation supporting import transactions which the contractors used to perform their eligibility review.

The Central Bank did not compile its own lists of import transactions because (1) USAID/El Salvador did not require the bank to do it, and (2) the Central bank had no incentive to do it since A.I.D. contractors appeared willing to compile the lists of transactions needed for the Bank's eligibility review. A factor that affected the Central Bank's capability to prepare computerized, but not manual reports, was the October 1986 earthquake that adversely affected the Central Bank's computer operations until July 1988.

The Bank's failure to present lists of import transactions resulted in the contractors preparing the lists to facilitate their eligibility review and the preparation of final reports submitted to A.I.D. The preparation of the list required the contractors to enter data from supporting import documentation into their computer systems. This appeared to be a labor intensive task since the operating procedures required that 19 categories of information for each import transaction be considered as part of the eligibility review. From October 1985 through January 1988 the contractor reviewed 7,407 import transactions which corresponded to ESF agreements 519-0310, 519-0328, and 519-0345. The contractors, in effect, performed more work than would have been necessary if the Central Bank had provided an import transaction list. This may have increased the cost of the A.I.D. contracts.

Management Comments

USAID/El Salvador stated that the Central Bank has complied with the reporting requirements contained in the Separate Account Operating Procedures by citing numerous Central Bank letters transmitting the final reports to USAID/El Salvador and USAID/El Salvador letters accepting the reports.

USAID/El Salvador also stated that the A.I.D. contractor was not employed to prepare eligibility reports nor were they ever prepared by the contractor. USAID/El Salvador described in detail the contractor's scope of work and reporting requirements.

USAID/El Salvador concluded that there should be no related report finding and the recommendation should be deleted. See appendix 1, page 13 for USAID/El Salvador full comments on this finding.

Office of Inspector General Comments

Parts of the finding and recommendation were modified to improve clarity based on USAID/El Salvador comments.

We disagree that the Central Bank has submitted the final reports as required by the Separate Account Operating Procedures. The audit found that although the Central Bank had submitted reports, they were not the required reports because they listed transactions after, rather than before, the A.I.D. contractors' eligibility reviews.

We agree with USAID/El Salvador that the contractors were not employed to prepare eligibility reports for the Central Bank. However, our review disclosed that the contractors compiled the required list of transactions in their data bases from source documents provided by the Central Bank. Our conclusion is supported by a statement in the sole source justification prepared in June 1988 by USAID/El Salvador to contract technical assistance for the Central Bank. This justification stated:

> ...The reporting by the Central Bank is the responsibility of that institution, although the Bank has relied heavily on the reports, and since the October 1986 earthquake, the data processing system, of the technical assistance team. There had been no requirement of the technical assistance team to provide the Central Bank with the capability to conduct reviews of transactions and at this time the Bank does not have the capability to do so without the assistance of the technical assistance team.

4. USAID/El Salvador Needed to Validate Its Public Law 480 Title I Loan Agreements

Public Law 480 Title I loan agreements between the Governments of the United States and El Salvador were not valid because certain prerequisites were not satisfied. The agreements for 1985, 1986, and 1987 were to become effective when an exchange of diplomatic notes indicated that both countries completed the internal procedures of ratification. There was no evidence that these specific notes had ever been exchanged because some USAID/El Salvador staff were confused as to what actually constituted the notes in question. Without valid agreements, USAID/El Salvador does not have legal recourse to enforce compliance with the agreements' provisions.

Recommendation No. 4

We recommend that USAID/El Salvador:

a. identify all Public Law 480 Title I agreements which have not been legally consummated by the required exchange of diplomatic notes with the Government of El Salvador, and

b. provide evidence that the required diplomatic notes for each of these agreements have been exchanged.

Discussion

The Title I agreements between the Governments of the United States and El Salvador (GOES) contain 40-year loan provisions covering $128.5 million in commodities. In addition, these agreements contain other provisions which the GOES was to follow or implement. For example, the GOES was to undertake self-help measures to improve its production, storage, and distribution of agricultural commodities, to use the commodity sales proceeds to finance jointly programmed developmental activities, and to furnish certain reports on the commodity program to A.I.D.

The agreements for 1985, 1986, and 1987 were not valid because certain prerequisites were not satisfied. The agreements were to become effective when an exchange of diplomatic notes indicated that both countries completed their internal procedures.

Neither the agreements nor the related guidance defined the term "internal procedures", but some A.I.D. and United States Department of Agriculture staff interpreted it to mean that the agreement had been properly ratified by the GOES and that the signatories were properly authorized to bind the government to the loan agreement.

USAID/El Salvador staff stated that they may have mistakenly interpreted other notes related to the agreements as the notes in question. Certain employees stated that notes had been exchanged to amend the agreements and that these notes constituted the notes in question. However, these amendments generally dealt with changes in the commodity mixes or amounts covered by the agreements and not with internal procedures of either government.

As a result of not exchanging the notes in question, the agreements are not legally binding documents. To date, this legal technicality apparently has had no serious effect on program implementation; nevertheless, it has left USAID/El Salvador in a tenuous situation. Without valid agreements, USAID/El Salvador does not have legal recourse to enforce compliance with the agreements' many provisions. The agreements stipulated that their effective dates would be determined by an exchange of diplomatic notes. These notes needed to be exchanged to validate the agreements.

When this issue was brought to Mission management's attention, it promptly initiated a search for the subject notes. With the assistance of the GOES and A.I.D./Washington, the Mission located all the requested notes, except for those relating to the 1987 agreement. The Mission and the GOES exchanged the required notes and completed this requirement in September 1988. On September 30, 1988, the Mission provided the audit team with a complete package of all the subject notes. Mission officials stated that the October 1986 earthquake contributed partially to the problem and that in the future the Mission would maintain such notes in its main files.

Management Comments

USAID/El Salvador generally agreed with the finding and recommendation, and has taken prompt corrective action. See appendix 1, page 17 for the Mission's full comments on this finding.

Office of Inspector General Comments

Based on management actions, the recommendation was considered closed on the date the final report was issued.

B. Compliance and Internal Control

1. Compliance

We limited review of compliance to the findings presented in this report. The audit disclosed the following compliance deficiencies.

First, USAID/El Salvador did not fully comply with the Foreign Assistance Act in designing its ESF program. USAID/El Salvador did not clearly define the overall program objectives to measure progress towards the objectives (see Finding No. 1).

Second, USAID/El Salvador did not adequately develop and implement Public Law 480 Title I self-help procedures as intended by Title I legislation (see finding No. 2).

Third, the Central Bank never submitted the required lists of eligible import transactions financed by Economic Support Fund dollars (see finding No. 3).

Fourth, USAID/El Salvador and the GOES did not fully comply with the Public Law 480 Title I agreements' provision requiring the exchange of diplomatic notes (see Finding No. 4).

2. Internal Control

We found no internal control deficiencies in the areas covered by this audit.

C. Other Pertinent Matters

During the audit, the following other pertinent matters came to our attention. First, while the Central Bank has continued to improve the effectiveness of its price-checking system, partly by implementing prior audit recommendations, it can make further improvements. It should expand the number of export transactions reviewed and the review of petroleum imports should include not only the proposed prices but also the actual prices paid (see appendix 3).

Second, USAID/El Salvador accepted some import transactions for attribution to ESF financing under project 519-0345 even though the Central Bank authorized the transactions before the eligibility date of October 1, 1986. According to an A.I.D. financed consultant responsible for auditing the transactions, the USAID/El Salvador Deputy Director authorized the acceptance of these transactions although they were initiated prior to October 1, 1986, because they were paid by the Central Bank after October 1, 1986. USAID/El Salvador never modified the written operating procedures that established the eligibility criteria for project 519-0345 to reflect the Deputy Director's change in the eligibility date definition (see appendix 2).

Third, Public Law 480 Title I legislation intended to improve the conditions of the rural poor by requiring recipient countries to undertake self-help measures aimed at (1) expanding the agricultural production efforts of small rural farmers, (2) reducing illiteracy among the rural poor, and (3) improving the health of the rural poor. In our opinion, good management practices dictate that USAID/Missions select self-help measures that will, to the maximum extent possible, have the greatest impact on achieving the developmental objectives of the Title I program. The selection of self-help measures should be based on a comprehensive analysis which, among other things, identifies the (1) major obstacles or disincentives to achieving the Title I objectives, (2) actions required to eliminate, or at least mitigate, these constraints, (3) process for implementing these corrective actions, and (4) method for measuring both the progress in implementing corrective actions and the impact of these actions on achieving the Title I objectives. A USAID/El Salvador official stated that they did not select self-help measures based on this type of analysis. In our opinion, this could be because such an analysis is not specifically required by A.I.D. guidance. Instead of a comprehensive analysis, USAID/El Salvador selected measures mainly based on achieving the same or unaccomplished objectives of existing or terminated A.I.D. projects. As a result, there was less assurance that the most appropriate and effective measures had been selected to achieve the Title I objectives.

AUDIT OF
USAID/EL SALVADOR
BALANCE OF PAYMENTS PROGRAM

PART III - EXHIBITS AND APPENDICES

SELECTED ECONOMIC STATISTICS
FOR EL SALVADOR FROM 1979 TO 1987

DESCRIPTION	YEARS									
	1979	1980	1981	1982	1983	1984	1985	1986	1987	Total
1. In Millions of U.S. Dollars										
Total U.S. Government Economic and Security Assistance 1/	34	91	168	245	373	481	684	566	739	3,381
A.I.D. Direct Economic Assistance 2/	10	59	116	185	262	223	429	317	495	2,096
A.I.D. Balance of Payments Support 3/	-	3	69	120	176	149	273	190	198	1,178
Gross Domestic Product (current value)	3,443	3,567	3,459	3,462	3,623	3,845	4,056	4,250	4,404	NR 5/
Exports	1,132	1,075	798	700	758	726	695	755	591	NR
Imports	1,041	962	985	857	893	977	961	935	975	NR
Balance of Trade	91	113	(187)	(157)	(135)	(251)	(266)	(180)	(384)	NR
Non-Traditional Exports	335	350	261	218	208	227	175	169	209	NR
Balance of Payments Before U.S. Assistance	NA 4/	NA	NA	NA	NA	(139)	(121)	(62)	(165)	NR
Consolidated Central Government Deficit Before Grants (current value)	(46)	(275)	(381)	(295)	(321)	(226)	(152)	(126)	(170)	NR
2. Annual Percentage Change										
Real Gross Domestic Product	(1.7)	(8.7)	(8.3)	(5.6)	0.8	2.3	2.0	0.6	2.6	NR
Consumer Price Index	12.1	17.4	14.7	11.7	13.1	11.7	22.3	31.9	24.9	NR
Money Supply	8.9	5.5	9.9	10.2	10.1	20.0	28.1	29.5	7.5	NR
Credit to Private Sector	NA	(7.5)	5.9	12.9	9.7	10.1	26.2	21.8	8.2	NR
Credit to Public Sector	NA	145.0	37.5	9.8	(9.3)	21.0	10.4	3.8	8.5	NR

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1) Consists of U.S. Government direct economic assistance, economic credits and guarantees, and security assistance.
2) Consists of balance of payments support provided under ESF, PL 480 Title I, Section 206 of PL 480 Title II, Section 416(b) of the Agricultural Act of 1949, and other direct A.I.D. assistance.
3) Only includes ESF, PL 480 Title I, Section 206 of PL 480 Title II and Section 416(b) of the Agricultural Act of 1949.
4) NA means data not available.
5) NR means data not relevant.

EXHIBIT 1

Exhibit 2

FINANCING PROVIDED UNDER USAID/EL SALVADOR
BALANCE OF PAYMENTS PROGRAM AS OF DECEMBER 31, 1987

	Agreement No.	Effective Date	Amount ($000)
1. Economic Support Fund			
Loans			
	519-K-030	07/21/81	$ 24,900
Grants			
	519-0267	12/17/80	$ 405,000
	519-0310	05/30/85	190,000
	519-0328	06/16/86	117,000
	519-0345	07/08/87	30,000
	519-0348	08/28/87	127,000
		Total Grants	$ 869,000
		Total ESF	$ 893,900
2. Public Law 480 Title I			
	None	1980	$ 2,911
	None	1981	24,350
	None	1982	19,785
	None	1983	38,621
	None	1984	48,827
	None	1985	48,472
	None	1986	43,240
	None	1987	36,808
		Total Title I	$ 263,014
3. Public Law 480 Title II (Section 206)			
	None	6/3/83	$ 16,680
4. Agricultural Act of 1949 (Section 416)			
	None	2/13/87	$ 4,100
		Total Program	$1,177,694

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EXHIBIT 3

IMPORT AND EXPORT TRANSACTIONS
REVIEWED BY THE DEPARTMENT
OF INTERNATIONAL PRICES FROM 1984 TO 1987
COMPARED TO TOTAL IMPORTS AND EXPORTS
(IN U.S. DOLLARS)

========== IMPORTS ==========

YEAR	TOTAL IMPORTS	AMOUNT REVIEWED 1/	PERCENTAGE
1984	977,000,000	38,314,731 2/	3,992
1985	961,000,000	137,559,450 2/	14.314
1986	935,000,000	327,641,173	98.518
1987	975,000,000	770,462,167	79.022

========== EXPORTS ==========

YEAR	TOTAL EXPORTS 3/	AMOUNT REVIEWED 1/	PERCENTAGE
1984	726,000,000	487,000 4/	0.067
1985	695,000,000	5,433 2/	0.001
1986	755,000,000	25,467,426	3.373
1987	591,000,000	83,968,302	14.208

1/ Source: Monthly reports prepared by the Department of International Prices.

2/ Data is incomplete because the Central Bank did not have the information. The final figure should be larger.

3/ Includes traditional and non-traditional exports.

4/ Source: RIG/A/T audit report dated 9/26/85.

IMPORT, EXPORT AND BARTER TRANSACTIONS REVIEWED BY THE
DEPARTMENT OF INTERNATIONAL PRICES FROM 1984 TO 1987
COMPARED TO INCORRECTLY PRICED TRANSACTIONS 1/
(IN U.S. DOLLARS)

========== IMPORTS ====

YEAR	== TOTAL REVIEWED == NUMBER	AMOUNT	== OVERPRICED TRANSACTIONS == NUMBER	AMOUNT	EXCESS AMOUNT	PERCENTAGE 2/
1984	[illegible]	[illegible] 3/	111	9,382,500	1,480,460	[illegible]
1985	11,510	137,559,450 3/	241	7,877,629 3/	1,579,657 3/	1.148
1986	47,121	827,641,173	349	6,042,805	1,418,906	0.171
1987	39,727	770,462,187	54	4,140,989	454,489	0.059

========== EXPORTS ==========

YEAR	== TOTAL REVIEWED == NUMBER	AMOUNT	== UNDERPRICED TRANSACTIONS == NUMBER	AMOUNT	EXCESS AMOUNT	PERCENTAGE 2/
1984	16	487,000 4/	4	37,864	12,598	2.587
1985	43	5,433 3/	0	0	0	0.000
1986	590	25,467,426	2	71,780	40,620	0.159
1987	6,224	83,968,302	1	8,270	674	0.001

========== BARTER ==========

YEAR	== TOTAL REVIEWED == NUMBER	AMOUNT	== INCORRECTLY PRICED TRANSACTIONS == NUMBER	AMOUNT	EXCESS AMOUNT	PERCENTAGE 2/
1984	2	N/A 5/	0	0	0	0.000
1985	22	54,969 3/	2	N/A	N/A	N/A
1986	54	12,146,971	2	139,299	60,478	0.498
1987	70	11,821,952	1	351,000	70,200	0.594

========== SUMMARY SCHEDULE ==========

YEAR	== TOTAL REVIEWED == NUMBER	AMOUNT	== INCORRECTLY PRICED TRANSACTIONS == NUMBER	AMOUNT	EXCESS AMOUNT	PERCENTAGE 2/
1984	2,070	109,291,246	115	9,420,364	1,493,058	1.366
1985	11,606	481,810,315	243	12,227,763	2,281,824	0.474
1986	47,765	865,255,569	353	6,253,884	1,520,004	0.176
1987	46,021	866,252,440	56	4,500,259	525,363	0.061

1/ Data extracted from the monthly reports submitted by the Department of International Prices to the USAID Private Sector Office. Some figures were provided directly to RIG/A/T auditors by the Department of International Prices.
2/ Percentage of Excess Amount with respect to Amount Reviewed.
3/ Data is incomplete because the Central Bank did not have the information. The final figure should be larger
4/ Source for this figure: RIG/A/T audit report dated September 26, 1985.
5/ N/A means data not available from the reports. The Department of International Prices could not provide detailed data to the RIG auditors.

Exhibit 4

AGENCY FOR INTERNATIONAL DEVELOPMENT
UNITED STATES OF AMERICA A. I. D. MISSION
TO EL SALVADOR
C/O AMERICAN EMBASSY.
SAN SALVADOR, EL SALVADOR, C. A.

MEMORANDUM

27 FEB. 1989

TO: Mr. Coinage Gothard, RIG/A/T

FROM: Henry H. Bassford, DIR, USAID/ES

SUBJECT: Mission Response to the Draft Audit Report on the Balance of Payments Program

DATE: February 27, 1989

The subject draft audit report presents four recommendations. The Mission's detailed response to the recommendations is elaborated below.

Before coming to specific treatment of the recommendations I would like to comment on the manner in which this audit was conducted and how Mission observations were treated before and at the time of the exit conference.

First, as will be seen in the detailed response, the Mission has ample evidence and documentation to refute all of the recommendations and most of the observations presented throughout the report. All of this was presented to the auditors at the time of the exit conference and discussed with them informally on numerous occasions throughout the process. Mission evidence and arguments, however, were consistently and systematically ignored. To have to repeat all of this material all over again at this time, and to have not had any impact on the draft report as a product of earlier meetings, is particularly disturbing to a Mission staff which has been and continues to be stretched to the limit by the crisis environment in which we must operate in El Salvador.

Secondly, as will be noted in detail below, I am also disturbed by the implication presented in the report in the case of both the ESF and Title I programs, that somehow we must conform the formulation of our development strategy and programming to interpretation by the RIG. It is the business of the RIG to audit AID compliance with existing agreements and statutory, regulatory and policy requirements. It is not appropriate, in our judgement, for the auditors to assume the role of judge and jury over Mission planning and decisions taken in concert with AID/W and other agencies such as the USDA, OMB, Treasury, and the Department of State as to how resources will either be programmed or conditioned as long as we are in compliance with existing policy. Taken to its logical extreme, acceptance and implementation of this concept would have us submit projects, strategies, and negotiating positions to the RIG prior to moving forward, a notion we find untenable for obvious reasons. The auditors are experts in financial analysis, controls and compliance, not in economic development policy, planning or administration. This area, we believe, should be reserved to AID and to other agencies charged in one fashion or another with this responsibility.

We have a staff of highly dedicated professionals here who have consistently gone the extra mile in one of the most difficult and complex programs in the world under conditions of extreme stress. At the moment, we are probably one of the most heavily audited programs in the world. We have bent over backward to facilitate the work of the auditors and to respond as rapidly and as completely as possible to every question and request for assistance. With this in mind, to have our views and arguments ignored as completely as they have been in this report, is difficult to understand and very frustrating. We simply do not have time for what we believe can only be described as an exercise in futility.

DETAILED TREATMENT OF FINDINGS AND RECOMMENDATIONS

FINDING NO. 1:

> USAID/El Salvador needed to Establish a More Effective Economic Support Fund Program

RECOMMENDATION NO. 1:

> We recommend that USAID/El Salvador design a more effective Economic Support Fund Program that defines the stabilization and recovery objective of the program in measurable terms and determines the economic costs of not adopting key economic policy reforms.

This recommendation reflects an unfortunate lack of understanding of the officially sanctioned design, development and negotiating process related to ESF balance of payments programs. The way the process is supposed to be carried out, and consistently has been in the case of El Salvador, is that the Mission, first through concept papers (equivalent to a PID for such programs) and subsequently through Project Assistance Approval Documents (PAADs), presents preliminary and final proposals for structure and conditionality of the program to AID/Washington. Then, in inter-agency reviews normally involving the State Department, Treasury, OMB and sometimes the National Security Council, the program is examined and modified as warranted, given U.S. goals and objectives in the country and policy considerations. Only then are final negotiating instructions issued to the Mission.

In the case of El Salvador, complicated by an eight year old civil war and being a pivotal, high profile country involving U.S. National Interest in the ongoing Central American conflict

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situation, reviews have been conducted and instructions issued which per force have had to take into account a full gamut of economic, social, and political realities. Under these circumstances, negotiations held with GOES officials have consistently been taxing, time consuming, and fraught with controversial issues. For the 1987 program, singled out for criticism by the report for not incorporating "required design elements", due to inability to come to agreement with the GOES at the Mission level, final negotiations with the Salvadorans were held at a policy level (Assistant Administrator of LAC and other Senior Executive personnel) in Washington, D.C. The Agency, with participation and concurrence by State, the NSC, Treasury, and the DOD, negotiated what it considered to be an acceptable economic program, given the military, political and economic constraints faced by the GOES at the time with full recognition of competing political and development interests and forces at play. The final package represented a well considered and vetted judgement call concerning what could be carried out under the existing environment. In this case, as in others, the negotiation process had to be responsive to the objectives of the GOES, as well as those of the U.S. In recent years these objectives have had to center around social and political stability. ESF programs cannot, nor should they, be expected to operate in a vacuum outside the framework of limiting factors imposed by war, politics, and U.S. national interest.

While the draft report concedes that USAID/El Salvador had made progress in a very difficult environment, it nonetheless chides the Mission for not designing a more effective ESF balance of payments support program that leads to key economic policy reform. Specifically, the discussion argues that the Mission did not:

1) adequately define the overall program objective, referring it is assumed to the 1987 program and beyond, in measurable terms;

2) determine the economic costs of not adopting key economic policies as required by the Foreign Assistance Act and a 1985 GAO report;

3) use these analyses to persuade the GOES to adopt important economic reforms.

In other words, the conclusion was drawn that neither the GOES nor the U.S.G. was convinced of the importance of establishing certain economic reforms because the Mission had not adequately defined the overall program objective in measurable terms and had not determined the economic costs of not adopting key economic policy reforms. Accordingly, the report recommends that the Mission design a more effective program that defines the stabilization and recovery objective in measurable terms and determines the economic costs of not adopting key economic policy reforms.

Coming to specifics with respect to the merits of report's assertions, the objectives of the Mission's 1987 and 1988 ESF programs have been stated very clearly. These were to enable the GOES to arrest the sharp decline in incomes while consolidating the democratic process and pursuing programs of social reform. In El Salvador this has meant: 1) arresting and reversing the fall in real GDP and 2) reducing inflationary pressures - both within the context of the Mission's long term goal of helping bring about an equilibrium in the balance of payments that is sustainable without recourse to extraordinary levels of external assistance. To these ends ESF balance of payments programs have included monetary and related macroeconomic measures and targets, as well as structural reform objectives.

The balance of payments program objectives, in fact, have been met. Through the program the Mission has been instrumental in arresting and reversing the downward course of economic activity and significantly lowering inflation after 1986. In 1985 the economy was growing at a real rate of 2%, but inflation was climbing steadily as more and more foreign transactions were passed to the parallel market. In 1986, as the economy absorbed the full shock of the devaluation and uncontrolled money growth, the rate of growth dropped to 0.6% and inflation continued its rise to 32%. But in the following year firm stabilization measures were enacted, and inflation dropped to 25% while growth rebounded to 2.7%. It is important to realize that this was achieved in spite of the war, a major earthquake, a devaluation process during 1985-1986, a weak international economy and an extraordinarily difficult domestic political situation.

The implication that progress towards stabilization and recovery was compromised because our objectives were not programmed in a more quantitative fashion ignores the long and tortuous policy dialogue that took place in 1986 and 1987. There was never any question with respect to our objectives or the costs of not achieving them. In 1986 and 1987, there were extensive and comprehensive discussions within the US Mission to El Salvador, between the Mission and the GOES, and in Washington between the GOES and USG principals that evaluated the trade-off between economic reform and the political and social costs of such reform. The 1986 PAAD and the GOES Economic Program certainly included a well quantified set of objectives, along with a discussion of the economic costs of not taking proposed adjustment measures, but success was not achieved because of social and political factors. The exercise could not and did not capture the overriding importance of social and political realities. Consequently the 1986 economic program was not possible to implement. The decisions taken in 1987 reflected this reality, as did the negotiation process, which was exhaustive and held at the highest levels.

The 1987 PAAD was a well balanced document, a contention supported by the GAO in its recent review of ESF programs e.g., "the program document for the fiscal 1987 cash transfer program in El Salvador contained criteria that the government of El Salvador has adopted in its calendar year 1987 economic plan. ... The criteria in the El Salvador economic plan appeared to be sufficiently detailed to enable AID to measure reform progress."

The RIG's statement in one of the appendices to the draft report that, "the change in policy dialogue strategy [in 1987] was a tacit admission by the Mission that the GOES was willing and able to forego and circumvent conditions precedent and special covenants designed to force the GOES into desirable macro reforms because of the feared consequences of the reforms", could not be further from the mark. The shift in strategy was motivated by the conviction that more could be accomplished by convincing the GOES to include such reforms in their economic plan rather than confronting it with a set of conditions and deadlines with which it could not and would not comply given conditions prevailing at the time, i.e., war, increasing unrest and a highly charged and contentious political environment. This is a strategy that we pursued in 1987 and continued in 1988 and beyond, a strategy which has proved to be effective not only in El Salvador but in Jamaica and other countries as documented by the GAO, a strategy which has now been accepted at the highest levels of the U.S. Government. Nations will accept and implement conditions when they are their own, a time-tested concept that works. When the reform is internalized and the implementer assumes ownership of the action, it will happen. Artificially or arbitrarily imposed conditions rarely work in today's environment, if they ever did.

Lastly, achieving economic stabilization and, from that point, sustained economic growth is a process, normally a very long one depending on the political, social and economic circumstances facing the country in question. This was brought out clearly in the recent GAO report, where the authors stated that economic objectives will be delayed depending on the intensity of the political objectives in the country.

The fact that this Mission did not achieve all the objectives laid out in the annual Action Plan mentioned in the audit does not weaken the conclusion that progress has been achieved. We have only to cite the institution of the special dollar accounts in 1987, the adjustment of the tariffs and rates of the utility companies in 1987, the adoption of comprehensive stabilization programs in 1987 and 1988, the reduction of the inflation rate from 32% in 1986 to less than 20% in 1988, and a reduction of import prohibitions as evidence of gradual progress towards stabilization and recovery.

Based upon the comments presented above the Mission requests that this recommendation be deleted from the final report or redirected to a combination of AID/W and the other agencies involved in the decision making process with regard to negotiating instructions. The Mission also questions and rejects the appropriateness of having the RIG evaluate economic program policy given its lack of expertise in this area.

FINDING NO. 2:

> USAID/El Salvador needed to establish an effective Public Law 480 Title I Self Help Program.

RECOMMENDATION NO. 2:

> We recommend that USAID/El Salvador develop and implement Public Law 480 Title I self-help procedures for selecting eligible self-help measures, as intended by the Title I legislation, and a system encompassing the elements discussed in this report to measure implementation progress and impact of selected self-help measures.

The thrust of Recommendation No. 2, and the supporting discussion that the Mission had not developed self-help measures in a manner consistent with Title I legislation or that an adequate system to measure the program had been undertaken is specious. This inaccurate and unfair impression implied by the report is conveyed by:

- The draft report's persistence in evaluating the self-help measures (and their impacts) in isolation from economic, political, social, military and agricultural realities.

- The draft report's frequent referral to the singular, but inaccurate, validity of self-help measures which are "aimed at expanding the agricultural production efforts of small rural farmers and at improving the country's food storage and distribution systems."

- The draft report's insistence that self-help measures which were undertaken by the Mission "...lacked a method for measuring both the progress in implementing corrective measures and their impact upon achieving the objectives."

- The draft report's statements that the self-help measures "...did not require a special effort on the part of the GOES...were basically existing objectives or requirements of other projects." and that, "USAID hindered its self-help program by not negotiating the measures with the appropriate GOES officials."

Regarding the first point, that of evaluating self-help measures in isolation, the draft report found "no clear evidence that El Salvador had made progress in increasing per capita agricultural food production." Neither did the report find any significant decrease in per capita agricultural production despite adverse weather, a guerrilla insurgency, poor agricultural prices and reduced GOES budget expenditures for agriculture. To wit:

- Weather: During three of the last five years El Salvador has experienced crop damaging drought or flood;

- War: A guerrilla insurgency has inflicted an estimated $1.5 billion in damages to productive infrastructure (with agriculture particularly targeted) and has displaced thousands of farmers who have been forced to leave their land;

- Prices: Real producer prices for food commodities have decreased 6% per year since their 1977-79 average;

- Decreased agricultural spending: Because of the need to divert scarce Government resources to finance the war effort, the Ministry of Agriculture's budget dropped from 11.26% of total GOES spending in 1976 to 6.72% in 1986.

Despite these factors which would have forced agricultural production in most countries into a steep decline, if not a free fall, El Salvador's agriculturalists have turned in a remarkably good performance in maintaining food production at acceptable levels as illustrated by the following data:

- The USDA index of per capita food production (1976-78 = 100) indicates that Central America, as a region, has fallen to 88 while El Salvador has fallen to 96 (Costa Rica has fallen to 84);

- During 1978-80 (the "golden years" of agriculture in El Salvador), the country's ratio of imported to domestically produced food was 30.3% while from 1985-87 the country's imported food ratio was 31.8%;

- The USDA index of total food production (1976-78 = 100) indicates that while Nicaragua (which has also been affected by war) has fallen to 88, El Salvador has risen to 109;

- CIMMYT reports average corn yields in El Salvador (1983-85) of 2.1 tons/hectare while the yields of Costa Rica, Guatemala, Honduras and Mexico are 1.7, 1.4, 1.5, and 1.7 tons/hectare respectively;

- During the 1987/88 crop year, El Salvador produced 628.7 thousand tons of corn, the largest crop on record.

Regarding the second point, the draft report's frequent insinuation that only self-help measures related to food production are somehow valid, the Mission (in addition to reiterating the above litany of data which demonstrate the productive ability of Salvadoran food producers) again refers the draft's authors to "PL-480 Concessional Sales and Food for Development Programs: Terms, Conditions and Implementation Procedures" which still states, "The term self-help refers to measures that countries undertake to help develop their own economies. The current law emphasizes self-help measures aimed at improving agricultural production, health care (particularly in rural areas), and literacy."

There is nothing in the aforementioned to justify repeated judgements of inadequacy based on references to "...specific measures primarily aimed at agricultural production...", "the Title I program's primary objective of increasing agricultural food production", and "the important objective of producing more of its agricultural food..." (underlines added for emphasis). Indeed, the draft audit itself states, "In addition to direct agricultural activities, the Title I program has been amended to recognize as eligible self-help measures..." and goes on to repeat from the aforementioned source regarding valid, non-production oriented self-help measures. Moreover, the draft finds that five of six self-help measures were "...related to agricultural activities and one was aimed at improving the health of the rural poor." Given the overriding need to stabilize the economy, provide a safety net, finance agrarian reform, and provide time for democracy to take hold, direct increases in domestic food production were not the specific objective of USAID's self-help measures for El Salvador.

Finally, at the time of the exit conference, we were given to understand that the conclusion drawn about lack of progress on improved food production was based on a comparison of production statistics from 1979/80 to 1986/87, or one of the best years on record to one of the worst, 1987, when the country was plagued by a severe drought. Almost any other comparable time frame would have yielded entirely different results as was argued forcefully at the time of the exit conference by our Rural Development Office, a point which has been ignored in the draft report.

Regarding the third issue on the question of targets and measurement, the measures undertaken, their established targets and the means to measure their progress are summarized below (documentation on the measures and their measurement is copious). For example:

1. Ag Reform

Self-Help Measure:	Complete Phase I and Phase III of the agrarian reform, compensate former owners, and present an action plan for self-management of the cooperatives.
Target:	Titles to all the Phase I cooperatives (317) and all Phase III beneficiaries (56,188) and compensation paid to the former owners as determined by the due process of law. A plan for self-management to qualified cooperatives.
Measure of Progress:	Number of titles issued and reported by the land registry. (This information has been reported to Rep. Obey's Sub-Committee monthly since the reform's inception.) The Mission's action plan reports 53 cooperatives are now self-managing.

2. BFA Banking Operations:

Self-Help Measure:	Improve BFA banking operations and reduce the BFA's non-banking activities.
Target:	Increase BFA's capacity to analyze its loan portfolio, increase recuperation rates, reduce administrative costs, diversify its portfolio, capture savings, decrease non-banking activities.
Measure of Progress:	Monthly portfolio analyses and rate of recuperation reports. Weekly statements of savings/deposits and budgeted versus actual expenditures. Non-banking activity reports.

3. Private Investment

Self-Help Measure:	Encourage private agribusiness investment
Target:	GOES agricultural export and investment promotion regulations.

Measure of Progress: Legislation was passed and reported in the Mission's 1988 Action Plan.

4. Pests

Self-Help Measure: Determine existence of fruit and vegetable pests.

Target: Number of MAG/Centa (Ministry of Agricultural and Extension Service) personnel assigned to carry out joint USDA/GOES agreement.

Measure of Progress: MAG/CENTA Action Plan and Quarterly Reports.

5. Livestock Diseases

Self-Help Measure: Stop introduction and spread of exotic livestock diseases.

Target: Number of MAG/CENTA personnel assigned to carry out joint USDA/GOES agreement.

Measure of Progress: MAG/CENTA Action Plan and Quarterly Reports.

6. Public Health

Self-Help Measure: Improve immunization services through public health facilities.

Target: Design, implement and evaluate immunization services provided through its public health facilities. a) increase coverage and protection of children under age one and b) ensure efficient cost-effective use of health sector resources.

Measure of Progress: Periodic Ministry of Health reports, evaluations, and statistics.

Moreover, the draft audit states that, "...USAID/El Salvador had not...established an adequate system...to assess the impact on achieving program objectives." This is not true.

The impacts of the self-help requirements have been amply documented. For instance, seven evaluations of the agrarian reform and five profiles of its beneficiaries have been conducted by just one GOES office (PERA). The published results show--among other things--the size of landholdings, family size and composition (by age and sex), the construction materials used in housing (differentiating between floor, walls and roofs), family incomes, education levels, incomes from farming and non-farming activities, access to water and electricity, number of medical visits per year, the area planted and yields by crop, the number of livestock owned (including fowl), sources of technical assistance (including that on pests and diseases), sources of credit (mostly through the BFA's banking activities), marketing channels, the improvements in landholdings (including environmental and resource conservation measures), and to what agricultural organizations beneficiaries belong.

And each of the variables above can be correlated to when the beneficiary received his/her land title (a self-help measure), the source and amount of credit and/or technical assistance received (self-help measures related to the BFA and pest/disease control), and whether they market to a GOES entity or a private agribusiness (encouraged by another of the self-help measures).

With respect to the health measure, during the period 1987-1988 the Ministry of Health evaluated their system of immunization coverage. A meeting was held in November 1988 in which the regional MOH directors and the major donors participated. The following conclusions were reached:

- Immunization coverage for the major immuno-preventable diseases increased from 1985 to 1988 as follows:

  Less than 5 years of age (El Salvador)

	85	88
BCG	71	72
Polio	64	74
DPT	63	72
Measles	73	78

- Rates for children under one also increased during the period according to MOH statistics.

- It was found that community based approaches to immunization are more cost effective and reach a higher percentage of the target group than vaccination day campaigns.

Last, but very significant, through the Health Systems Support project, a dialogue with the MOH has come to fruition. The increasingly cost effective utilization of resources to expand rural and urban coverage of immuno-preventable diseases is manifested by two recent MOH immunization initiatives.

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"Bloqueo" and "Rastreo" are two new community-based techniques which have expanded immunization coverage. Both techniques involve house to house vaccination programs which have been carried out in high health risk areas of the 5 MOH regions. The improved coverage has also stimulated utilization of regular MOH health care facilities.

Finally, a nationwide household survey of the rural poor conducted in 1978 by Ohio State University was replicated in 1987, specifically to assess the impact of the agrarian reform, the agricultural credit program, programs of technical assistance to farmers and the general socio-economic well being of rural families after almost a decade of change and USG assistance. The results speak directly to the impact of the self-help measures, and they have been widely disseminated.

Given what we have seen to be the facts so far, it is simply inaccurate to say that "...USAID/El Salvador had not strictly applied the Title I criteria in establishing self-help measures nor had it established an adequate system to measure progress in implementing self-help measures and to assess the impact on achieving program objectives."

The targets, measurements and impacts of the various self-help measures of the USAID/El Salvador program are probably the most well documented, researched and reported (by USAID/El Salvador, the popular media, Congressional committees, advocacy groups, religious and international human rights organizations, academia, and the AID/W and RIG offices) of any in the world.

Regarding the Mission's fourth point of contention on the draft audit's findings, i.e. that the "...self-help measures (which duplicated the project objective's) did not appear to require a special effort on the part of the GOES" and that negotiations were not held with "...the appropriate GOES officials." It seems self-evident, but must be said here, that any significant change in El Salvador (especially regarding the involuntary transfer of personal property and access to scarce resources from powerful, traditional interests to formerly disenfranchised citizens) requires "special effort". It is simply a fact of life in this war-torn, politically charged environment.

If difficult, but desirable, changes are not adequately achieved through one means--a project, for instance--that does not lessen the need to continue to pursue the process of change, nor does it diminish the validity of using additional means--such PL-480 self-help measures--to achieve them.

The Agrarian Reform Support Project (0265) did not accomplish its objective of transferring all property titles. The two agrarian reform credit projects (0263 and 0307) did not (or have not, yet) totally achieve(d) their objectives, although to say that removing the BFA from non-banking activities was an objective of either project is inaccurate. Encouragement for the private sector under the current GOES has been less than enthusiastic. The need for combatting pests in crops which are only beginning to be produced in El Salvador may not be well recognized at every level of the GOES. Preventing the spread of exotic animal diseases may seem abstract to a fledgling democracy harassed by Marxist-Leninist terrorists and a budgetary crisis. But each of these objectives is developmentally sound, and none of them are excluded by letter or intent from the PL-480 Title I legislation. And each objective was agreed to by the Technical Secretariat for External Finance (SETEFE).

PL-480 Title I funds fall within the extraordinary budget of El Salvador. SETEFE is the GOES office within the Ministry of Planning responsible for the negotiation and management of the extraordinary budget. SETEFE negotiates on behalf of the Minister of Planning as the designated representative of the President of the Republic of El Salvador. Agreements negotiated by SETEFE are signed by the Minister of Planning. In El Salvador, many decisions, including those regarding the use of PL-480 Title I funds, are cleared (and sometimes later changed) personally by President Duarte. In the case of the BFA's agreement to decrease its non-banking activities, President Duarte, in his personal directive to the BFA President, declined to pursue the issue of the BFA's non-banking activities. A political necessity...a breach of faith? It may be either, but it is not a failure of USAID/El Salvador to negotiate with "the appropriate GOES officials."

Given the above facts, circumstances, and arguments, the Mission requests that the recommendation be deleted.

FINDING NO. 3:

The Central Bank Should Assume Full Responsibility for Preparing Reports on Eligible Import Transactions

RECOMMENDATION NO. 3:

We recommend that USAID/El Salvador:

a) have the Central Bank prepare and submit eligibility reports to USAID/El Salvador as required by the Separate Account Operating Procedures, and

b) phase out the responsibility of any A.I.D. contractor employed to prepare eligibility reports.

The recommendations are totally unsupported by the facts of the case. Regarding a), as will be shown in detail below, the BCR has in fact been complying with the reporting requirements contained in the Separate Account Procedures (see Attachment II).

Following are the specific Reporting Requirements for all BOPS Grant Agreements - by Project Agreement Number and Page and Separate Account Procedures:

Section 5.3 of BOPS Grant Agreements Nos. 519-0328 (on page 6), 519-0310 (on page 8) and 519-0345 (on page 5), entitled Reports, Records, Inspections, Audit state "The Grantee will: (a) furnish to A.I.D. such information and reports relating to this Agreement as A.I.D. may reasonably request." The specific and governing reporting requirements for the Balance of Payments Support Program (BOPS) Grant Agreements are specified in the Separate Account Procedures and are attached to and form part of all BOPS Grant Agreements. The Procedures differ slightly from one BOPS Agreement to another. However, the key words, as underlined below, are the same for all of the Agreements.

The reporting requirements for all BOPS Grant Agreements are found in Article IX. of the Separate Account Procedures, entitled BCR REPORTING. The reporting requirement for the Final Report Listing states quote "For the final attribution, the BCR will provide USAID/El Salvador, Private Enterprise Office, with a listing of completed and paid transactions for which full documentation resides in the files of the Exterior Department. Such listing will have a total value for attribution equivalent to all pertinent USAID deposits to the Separate Account plus any interest earned thereon."

The above statement is clear in intent and spirit. "The BCR will provide USAID/El Salvador, Private Enterprise Office, with a listing of completed and paid transactions..." The BCR has complied in full with the requirement as demonstrated by the following list of documents which may be found in the BOPS Program files located in the USAID/El Salvador Private Enterprise Office:

A letter from the BCR, dated January 19, 1987, signed by Alberto Benitez Bonilla, President, transmits the "informe final" for BOPS Project No. 519-0267 and its 10 Amendments. AID PIL No. 36, dated March 3, 1987, and signed by Mission Director, Robin Gomez acknowledges receipt of the Final Report and accepts the Report as in "complete fulfillment of the cited Grant Agreement" (see attached referenced correspondence).

BCR letter No. 1939, dated April 22, 1987, transmits the final report listing for Project 519-0310. A.D PIL No. 13, dated

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July 17, 1987, signed by the Deputy Director, Bastiaan Schouten acknowledges receipt and AID acceptance of the final report listing as complying with the terms and conditions for complete fulfillment of the Agreement and its Amendments.

BCR Letter No. 100263, dated March 28, 1988, signed by M. Choussy R., transmits the final detailed report for paid transactions for Project No. 519-0328. The report had additionally been verified and approved as eligible by the AID independent reviewer. AID PIL No. 4, dated May 9, 1988, signed by the Deputy Director Bastiaan Schouten acknowledges and accepts the final report as in full compliance.

BCR Letter No. 100451, dated May 27, 1988, signed by M. Choussy R., transmits the attached final report for Project 519-0345. AID PIL dated June 14, 1988, signed by Mission Director H. Bassford, acknowledges receipt and acceptance of the final report listing (See Attachment III which contains copies of all the aforementioned correspondence and Attachment IV, the BCR's final report listing for Project No. 519-0345).

With respect to recommendation (b): The A.I.D. contractor was not employed to prepare eligibility reports, nor were they ever prepared by the contractor. The Arthur Young and Tucker and Associates Contracts were entered into for the purpose of carrying out the A.I.D. "Independent Review, Price Verification and Certification of eligibility." The contractor's reports related to eligibility only as it pertained to the independent eligibility review and price verification. The following is quoted directly from the Tucker and Associates Technical Assistance Contract, dated June 1, 1987.

Quote from: Section C - Description/specifications/work statement:

C.1 <u>General Objectives</u>

> The Private Enterprise Office of USAID/El Salvador requires technical services to assist in the review and analysis of paid import documents submitted for attribution against the Private Sector Balance of Payments Program. The contractor is required to analyze and review representative transactions for compliance with the criteria specified in each Agreement that pertain. The purpose of the contract is to assure oversight personnel and USAID principals that the Balance of Payments Support Program funding is currently and will continue to be used for the purpose specified in the Grant Agreements.

There were five specific reports required by the terms of the SBA contract with Tucker and Associates, two of which make reference to "eligibility" as follows: c) "interim reports of

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eligibility review for each amendment and/or disbursement under the Program; and d) "final report of eligibility review and price verification review for Balance of Payment Support Programs analyzed under this PIO/T." See Attachment I which contains a copy of all reporting requirements of the AID Contract (See Attachment V, Copy of the Contractor's Utilization Report and Certification).

No less than seven times in the Draft Audit Report does the report confuse the terms of the Grant Agreements, the Separate Account Procedures and the AID Contractor's duties. The Mission expects that the attachments will serve to adequately demonstrate the errors contained in the RIG's Second Draft Audit Report of the Balance of Payments Support Program regarding the terms and conditions of the reporting requirements of the AID Contract versus the BOPS Grant Agreements and evidence that the BCR complied fully with the terms and conditions of the reporting Requirements of the Grant Agreements.

The Mission requests that the Draft Report be corrected on pages ii, iii, v (twice) of the Executive Summary and pages 6, 7, 8 and 21, 22, 23, 24 and page 28 of the body of the Draft Report to reflect that the BCR did prepare and provide (submit, furnish or otherwise turn over to AID), the required Final Listing of paid import transactions, thereby strictly complying with the terms and conditions of the Grant Agreements' reporting requirements. As neither the Mission nor the Auditors can require more than is stipulated in the Grant Agreements, there should be no report related finding and the recommendation should be deleted.

Under Compliance and Other Pertinent Matters:

Mission acknowledges that some (13 in number) import transactions were accepted by the Mission for reimbursement from the Separate Account under Project No. 519-0345 even though the Central Bank had authorized the transactions before the eligibility date of October 1, 1986. The transactions were not reimbursed from the Separate Account until after the eligibility date, however. The Mission will take measures to ensure that this does not recur in the future. Subsequent contracts for the Independent Review and Price Verification will stipulate that the contractor review the date each selected transaction was authorized by the BCR, to ensure compliance with the eligibility date criteria.

On page -ii- of the Executive summary, the Report states "Contrary to program agreements, the Central Bank did not prepare reports on eligible Economic Support Fund import transactions, and......" On page -iii- of the Executive summary these words appear "The Central Bank did not prepare the required reports on eligible import transactions financed with Economic Support Fund Dollar assistance.

The statements are not accurate on two counts: first, the BCR was not required by the terms of the Agreements to prepare the final listing. The word used in every Separate Account Operating Procedures Annex states that the BCR will provide USAID/El Salvador, Private Enterprise Office with a listing of completed and paid transactions etc.; and second, even if the auditors had been correct in stating that the BCR was obliged by the terms of the Agreement to "prepare," the AID reports, the BCR would have been in compliance with the terms, as the reports were prepared and provided by the BCR, as demonstrated by the attached documentation from the BOPS files.

Preparation of the reports was carried out at the Exterior and Electronic Data Processing (EDP) departments of the BCR and based on the BCR's selection of eligible transactions. The reports were printed on BCR Letterhead and hard covered in the BCR's Book Binding Department. The only element which was from an external source was the listing sheet which, although derived from the AID contractor's computer and printer, contained the complete transaction listing as selected by the BCR's personnel. However, the BCR's dependence on the contractor's computer for the transaction listing does not negate the fact that the BCR accepted full responsibility for the preparation and provision of the report.

The AID contractor did an excellent job of providing advice and consultation to the BCR. If, during the contractor's independent review, an ineligible transaction was discovered to have escaped the Bank's notice, the contractor called the transaction to the Banks attention. The BCR could then substitute another, eligible transaction in place of the ineligible one. The AID contractor also furnished various types of reports upon request, either from the BCR or AID. The contractor assisted the BCR to develop systems and procedures which the Bank uses to date. The contractor was also required to furnish A.I.D. with a final report for each Project. The contractor's report contained the results of the independent review and price verification and a statement certifying the results of the review. However, the auditors should not confuse what the contractor did with what the BCR did, or try to convey the impression that the AID contractor was carrying out the BCR's responsibility for either selecting eligible transactions or for fulfilling the BCR's reporting obligations. This was never the case.

FINDING NO. 4:

USAID/El Salvador Needed to Validate Its Public Law 480 Title I Loan Agreements.

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RECOMMENDATION NO. 4:

We recommend that USAID/El Salvador:

a. Identify all Public Law 480 Title I agreements which have not been legally consummated by the required exchange of diplomatic notes with the Government of El Salvador, and

b. provide evidence that the required diplomatic notes for each of these agreements have been exchanged.

The continued inclusion of this recommendation in the draft report is most surprising. As the last paragraph on page 27 states the Mission found or exchanged all the required notes and furnished the RIG with all the related documentation at the Exit Conference. This recommendation should have been deleted from this draft report. The Mission requests that it not appear in the final audit report.

cc:Fred Schieck:A/AA

ELIGIBILITY OF IMPORT TRANSACTIONS FINANCED WITH ESF DOLLARS UNDER PROJECTS 519-0310, 519-0328, AND 519-0315

Dollars provided by the Economic Support Fund (ESF) program are deposited in special accounts in four U.S. banks and used for financing imports for the Salvadoran private sector. Imports financed with ESF dollars have to meet criteria jointly established by USAID/El Salvador and the Government of El Salvador regarding source, product category, economic sector to benefit, and eligibility dates.

The current procedure for attributing import transactions to be financed with ESF dollars is as follows: the Central Bank of El Salvador selects the completed import transactions that meet the eligibility criteria, reimburses itself from the special bank accounts for the eligible amount, and reports these transactions to a Mission contractor. This contractor reviews the transactions and determines if they meet eligibility criteria. The contractor also prepares attribution reports 1/ for USAID/El Salvador.

We reviewed a sample of the transactions attributed to ESF Projects 519-0310, 519-0328 and 519-0315 to determine if they meet eligibility criteria. Due to the fact that more than half of the ESF resources were allocated to petroleum imports, we reviewed petroleum and non-petroleum transactions separately. The selection basis for the transactions reviewed was as follows:

Petroleum transactions: We reviewed all petroleum transactions for projects 519-0310 and 519-0315 because the population size was under 50, (17 and 13 transactions, respectively), and for project 519-0328 we selected 53 out of 69 transactions.

Non-petroleum transactions: We selected a sample size appropriate for a 95 percent confidence level, an expected error rate not over five percent, and a precision percentage of plus or minus four percent. These parameters were also used for determining the sample size for petroleum transactions attributed to project 519-0328. The individual transactions reviewed were selected using statistically valid random selection techniques.

1/ List of import transactions designated for financing with ESF dollars.

The following schedule shows the total number and dollar value of the transactions attributed to each project and the transactions reviewed by us.

Project No.	Petroleum Number	Petroleum Amount ($000s)	Non-Petroleum Number	Non-Petroleum Amount ($000s)
519-0310				
Universe	47	$142,022	2,257	$ 50,482
Reviewed	47	$142,022	109	$ 3,060
519-0328				
Universe	69	$ 61,623	3,713	$ 56,383
Reviewed	53	$ 46,855	110	$ 1,640
519-0345				
Universe	13	$ 23,222	148	$ 6,797
Reviewed	13	$ 23,222	61	$ 2,671

The review showed that all but one of the 396 transactions in our audit sample were eligible. The review also showed that while there were some errors in the calculation of the eligible amounts or in the information presented in the final attribution reports, such errors had no significant impact in the proper allocation of ESF resources. The Mission contractor in charge of reviewing eligibility satisfactorily responded to our inquiries regarding eligibility of certain transactions and errors found during our review.

However, our review uncovered a condition that could affect the eligibility of transactions attributed to Project 519-0345. We found that the eligibility date requirement was changed to include transactions initiated prior to October 1, 1986, as opposed to only transactions initiated on or after October 1, 1986 (as stated in the operating procedures that govern the attribution process for Project 519-0315). This change was made by the A.I.D. contractor without the Mission's written approval. This change supposedly had USAID/El Salvador Deputy Director's verbal approval, but the Mission never implemented the change through an implementation letter or an amendment to the operating procedures as we believe it should have.

IMPROVEMENTS IN THE OPERATION OF THE CENTRAL BANK'S PRICE CHECKING SYSTEM

In the Economic Support Fund (ESF) loan agreement 519-K-030 dated July 21, 1981, A.I.D. requested the Central Bank of El Salvador to establish a price-checking system to prevent the overpricing of imports and the underpricing of exports and thus deter capital flight. 1/ The effectiveness of the Central Bank's price-checking system has improved since it was established in 1982. Our first audit report of the ESF program, dated January 29, 1982, disclosed that the Central Bank had not implemented the planned price-checking system. Our second audit report, dated April 20, 1983, disclosed that the system had been established but that it was not operating effectively. Our third audit report, dated September 26, 1985, reported several deficiencies that were impairing the effectiveness of the price-checking system. This current audit disclosed that the prior audit report recommendations relating to price-checking were satisfactorily implemented, but that further improvements could be made to the system.

This is our fourth audit report on the ESF program. Since our first report, USAID/El Salvador and the Central Bank have been refining the price-checking system, sometimes in response to our audit recommendations or Mission-funded technical assistance, and other times on their own initiative.

Some of the most important actions taken during that period were:

- The price-checking unit was upgraded to a full department (Department of International Prices) and transferred to a more appropriate organizational location,
- The staffing of the Department of International Prices was increased, first from three to eight and later to the current level of 13 professionals,
- The number of price verifications has generally increased for imports, exports, and barter trade (see exhibit 1),
- The scope of the selection criteria has been expanded to currently include almost all import transactions, and work is currently being done on the selection criteria for export transactions,
- Price verification procedures have been improved and an operating manual prepared, and

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1/ According to the Mission's economist, capital flight is the short-term movement of money (capital) from one financial system to another in response to perceived political risks instead of such movement being in response to interest rates or profit differentials (i.e., various market phenomena).

- Price analysts have gained a lot of expertise in their respective areas due to slow staff turn-over.

With the improvements made since 1982, the Department of International Prices has been increasingly effective in deterring capital flight. For example, in 1986 and 1987, the Department of International Prices reviewed 89 and 79 percent, respectively, of the dollar value of all imports to El Salvador, compared to only four percent in 1984. In contrast, overpriced import requests have dropped to less than one percent of the amount reviewed in 1986 and 1987 as compared to about four percent in 1981 (see exhibits 3 and 4).

Data submitted by the Department of International Prices to USAID/El Salvador has generally shown a constant increase in the number or the value of transactions that were price-verified. The same data also shows a reduction in the value of overpriced import requests and the number of underpriced export requests (see exhibit 4). These results suggest that the Department of International Prices has been increasingly effective in deterring capital flight. The results of price verifications done by an independent auditor (although limited in scope) tend to support this conclusion. Last year, USAID/El Salvador again contracted a company to review the eligibility of import transactions proposed by the Central Bank for attribution to ESF dollars. This contractor price-verified about 66 percent of the value of those transactions. Except for seven petroleum transactions, the contractor found no overpriced transactions.

While significant progress has been made, we believe that further improvements are possible; for example:

- The review of export transactions should be further expanded to include most of the exports not related to coffee, cotton or sugar (which are price-controlled by the Government of El Salvador). According to exhibits 3 and 4, only 14 percent by value of all Salvadoran exports are currently price-verified compared to 79 percent for imports. We believe the Department of International Prices should continue to expand its review of exports.

- The Price Verification of petroleum imports should be expanded to include a review of the actual amounts paid in the transactions. Currently, price-checking of petroleum imports is done before the import takes place. Despite this being a correct practice for most imports, it is not a good practice for petroleum imports because of rapid changes in market prices. The end result is similar to not having done a price-check at all, because the prices actually paid may vary substantially from the proposed prices verified. To overcome this deficiency, the Department of International Prices should do a two-step review for petroleum transactions:

    1. The first step should be to determine whether proposed prices being used for placing the import order and opening the letter of credit are reasonable (this is currently being done); and,

2. The second step should be to determine whether prices actually paid for the petroleum were reasonable and consistent with market rates. The Central Bank should then refuse disbursement of the amount determined excessive or should seek reimbursement from the importer.

The above two areas were discussed with the management and selected staff of the International Prices Department, who agreed with our position. The department manager told us that, in fact, the Central Bank had started to work on increasing the level of review of export transactions, and possibly by early 1989 the Department would be reviewing most of the non price-controlled exports. The analyst in charge of reviewing petroleum imports stated he was very concerned about the lack of review of prices actually paid, and he expected the Central Bank to establish such a requirement in the future.

1985 ECONOMIC SUPPORT FUND
CONDITIONALITY STRATEGY AND PERFORMANCE

The agreement for the Balance of Payments Support Program for 1985, A.I.D. Project No. 519-0310 was signed May 30, 1985. The Economic Support Fund (ESF) strategy set forth in the 1985 Project Assistance Approval Document (PAAD) and continued in this grant agreement was to be used as balance of payments assistance to support the stabilization and recovery of the Salvadoran economy. The subobjectives were: (1) reattain economic growth and financial equilibrium, (2) constructively engage the private sector in reactivating the economy, and (3) accelerate the agrarian reform.

Conditionality management 1/ to be attained through successful implementation of policy dialogue issues in the action plan, was to be accomplished through section 2.1 (d) of the 1985 Balance of Payments Support Program grant agreement which was a condition precedent (CP) to first disbursement. This CP required evidence that the GOES had reached agreement on those measures necessary to reduce the balance of payments and fiscal deficits, reactivate the private sector, strengthen the macroeconomic management of the economy, and place the financing of the agrarian reform on a sound basis.

The initial CP permitted $100 million dollars to be released upon submission of a plan indicating that dialogue issues in the action plan, necessary to attain stabilization, would be implemented.

The rest of these grant monies ($90 million) was governed by CP 2.2(a) which required GOES to furnish A.I.D. with evidence that it had "attained substantial progress" in implementing the agreed upon measures submitted in compliance with Section 2.1(d). Substantial progress measures were laid out in a series of dated benchmark actions in the 1987-1988 Action Plan.

Section 3.2 of the grant agreement and section 1.1 of amendment No. 1 established the following schedule of disbursements:

	Millions
May 1985	$ 50
June 1985	25
July 1985	25
August 1985	30
October 1985	30
Amendment No. 1 Nov/Dec 1985	30
Total	$190

1/ The term conditionality management, as used in this appendix, refers to requiring desired policy reform measures to be undertaken as a condition for receiving the U.S. dollar grant disbursements.

Actual disbursements did not occur as planned. Actual disbursements for 519-0310 occurred as follows:

	Millions	Cumulative
June 29, 1985	$ 50	$ 50
August 2, 1985	25	$ 75
September 24, 1985	25	$100
November 22, 1985	30	$130
January 28, 1986	30	$160
March 10, 1986	30	$190
	$190	

The Mission delayed the last three disbursements because of a lack of progress in reaching the agreed upon goals contained in a Central Bank letter dated June 13, 1985, submitted as a condition for receiving this grant.

The CP to initial disbursement was satisfied and accepted by A.I.D. under Project Implementation Letter (PIL) No. 2 dated June 18, 1985. The release of the last $90 million was tied to progress in this GOES plan which had been tailored to the calendar benchmarks established in the policy dialogue section of the action plan for 1987-1988.

This letter established a plan for reducing balance of payments and fiscal deficits and strengthening the macroeconomic management of the economy, as well as measures to strengthen agrarian reform and proper management of ESF foreign exchange. (It was a promise of future action for which substantial progress was not made as measured by calendar year benchmarks in the 1987-1988 action plan).

This submission permitted A.I.D. to release $100 million of the $160 million original grant agreement monies (519-0310) by September 24, 1985. Amendment 1 to the agreement increased the total to $190,000,000 dated January 29, 1986.

Disbursements were made on the final $90 million of this grant after the A.I.D. Administrator waived this CP. This waiver was obtained as a result of negotiating actions occurring between September and November 1985.

As a result of not implementing these policy dialogue issues, contained in the Action Plan, the GOES fell far short of targets and overall economic conditions were not improved and the continued need and reliance on high levels of U.S. economic assistance for economic stabilization occurred.

1986 ECONOMIC SUPPORT FUND
CONDITIONALITY STRATEGY AND PERFORMANCE

A.I.D. Project No. 519-0328 (the ESF grant agreement for 1986) was signed June 16, 1986. The ESF strategy set forth in the 1986 PAAD and contained in this grant agreement indicated that funds would be used to support the efforts of the Grantee for the stabilization and recovery of the Salvadoran economy. The subobjectives were: 1) reattain economic growth and financial equilibrium, 2) promote diversification of the economy, and 3) consolidate the agrarian reform.

Conditionality management 1/, related to policy dialogue issues to reattain economic growth, was established as a special covenant in article 4.4 of the 1986 ESF grant agreement. This special covenant required the GOES and AID to review progress achieved by the GOES in its efforts to achieve the objectives in article I (as stated in paragraph one above), prior to disbursement of funds under this grant exceeding a level of $70 million. On July 31, 1986, Amendment No. 1 of the agreement increased the grant total to $117 million from the original $113 million.

This special covenant allowed AID to disburse $70 million of the $117 million on September 9, 1986, via Project Implementation Letter No. 1 dated September 4, 1986 based on the Technical Secretariat for External Financing (SETEFE) letter 910/86 (legal opinion), Ministry of Planning letter SETEFE 895/86 (designating official representatives) and Ministry of Planning letter SETEFE 911/86 (evidence of separate account).

The remainder of the grant monies ($47 million) was governed by Article No. 4.5 "Fulfillment of Covenants and Achievement of Agreement Objectives". It states: "The Grantee and A.I.D. agree that if substantial progress has not been achieved in the attainment of the objectives of Article I or of the other articles of the Agreement [as elaborated in policy dialogue objectives of the Action Plan] A.I.D. may, at its option, suspend further disbursement under this agreement, or within a reasonable time, terminate this agreement."

1/ The term conditionality management, as used in this appendix, refers to requiring satisfactory progress in achieving desirable economic reform measures as a condition for receiving U.S. dollar grant disbursements above the $70 million level.

The GOES monetary program approved by the Monetary Board on January 21, 1986, established the agreed upon performance targets for the 1986 ESF conditionality program. Five sets of targets were established for five different dates from December 31, 1985, to December 31, 1986. AID accepted these targets as well as economic policy, economic diversification, and agrarian reform consolidation measurements in Annex IV of the 1986 PAAD.

Section 3.2 of the agreement as amended set out a planned disbursement schedule for $117 million as follows:

	Millions
Immediate disbursement	$ 40
May 1986	30
August 1986	25
September 1986	22
Total	$117

Actual disbursements were as follows:

September 9, 1986	$ 70
April 28, 1987	47
Total	$117

As can be seen above, the last two planned disbursements were delayed 8 and 7 months respectively because of non-performance in achieving targets set in Junta Monetaria Publication of January 21, 1986.

In Ministry of Planning letter (SETEFE 323/86) dated March 10, 1985, the GOES proposed a system for monitoring and follow-up of the targets they established in a January 21, 1986 Junta Monetaria Resolution and the other activities agreed to in Annex 4 to the 1986 PAAD. Pages 17 and 18 of the 1988-1989 Action Plan list 15 policy dialogue objectives A.I.D. believed necessary to accomplish the targets established in the above document.

The Mission delayed the final disbursement of $17 million for up to 8 months because of the failure of the GOES to approach monetary targets established in Junta Monetaria Resolution dated January 21, 1986, which Mission officials attributed to the non-performance of many of 15 dialogue objectives.

Of the 15 benchmark measures contained in the Action Plan that needed to be implemented to reach dialogue objectives, only eight were accomplished or partly accomplished.

Benchmarks:	Planned Quarter	Planned Calendar Year	Actual
-- Introduce higher reserve requirements for bank deposits	1	86	Done April 1, 1986
-- Adopt consistent financial program for CY 1986 including quarterly target for Net International Reserves, Net Domestic Assets of the BCR, Net Credit to the Public Sector and International Payment Arrears	1	86	Done in 1987
-- Adopt tax package that raises coffee and selective consumption taxes, and rescinds the tax-exempt status of autonomous institutions	1	86	Not fully done
-- Comply with the April 30, 1986, targets for Net International Reserves, Net Domestic Assets of the BCR, Net Credit to the Public Sector and International Payment Arrears	2	86	Not done
*-- Accomplish devaluation of not less than ¢2/ 0.30 for each U.S. $1.00 by April 30, 1986, and an additional ¢0.30 by June 30, 1986	2	86	Not done
-- Complete a tax reform plan, which would serve as the basis for the CY 1987 budget	2	86	Not fully done
*-- Accomplish accumulated devaluation(s) of ¢1.05 for U.S. $1.00 by September 30, 1986	3	86	Not done
-- Adopt a comprehensive 1987 Economic Program prior to submitting its CY 1987 budget to the National Assembly	3	86	Done May 1987
*-- Accomplish accumulated devaluation(s) of ¢1.50 for U.S. $1.00 by December 30, 1986	4	86	Not done

2/ The symbol ¢ is for El Salvador colon; since January 1986 the exchange rate has been 5 colones to 1 U.S. dollar.

Benchmarks:

	Planned Quarter	Planned Calendar Year	Actual
*-- Eliminate import prohibitions	4	86	Not fully done
*-- Adjust utility rate structures upward in order to reflect higher operating and financial costs	2	86	Done 4Q CY87
*-- Adjust interest rates in light of expected inflation	1	87	Not done
*-- Phase out administered foreign exhange allocations on the basis of non-market priorities	1	87	Not fully done 1Q CY87
-- Negotiate an International Monetary Fund-sponsored adjustment program	1	87	Not done
-- Obtain resumption of the InterAmerican Development Bank lending operations	2	87	Not done

* - Considered key policy dialogue matters.

To break the impasse related to the halt in planned 1986 grant disbursements, the AID Administrator visited El Salvador in early September 1986. During his visit, GOES and AID agreed that disbursements could proceed on the basis of fiscal and monetary adjustments. This interim arrangement was superseded by the events of October 10, 1986, when a massive earthquake struck San Salvador. The Mission subsequently received AID Washington authorization to disburse the remaining $17 million. Page 33 of the 1987 ESF PAAD discusses this authorization.

The effect of the above actions was that the Government of El Salvador did not adopt the tough economic measures contained in the policy dialogue agenda which was a special covenant to receiving more than $70 million in grant assistance aid in 1986. These actions made it less likely that overall economic conditions would improve in the foreseeable future likely causing continued reliance on high levels of U.S. economic assistance for a longer period of time. The 1986 PAAD estimated the cost of current bad economic GOES policies (in 1984 dollars) to be about $365 million dollars for the three-year period 1986-1988. This means that to attain the same level of economic growth, the U.S. Government would need to give the GOES an additional $365 million in the absence of these reforms.

1987 ECONOMIC SUPPORT FUND CONDITIONALITY STRATEGY AND PERFORMANCE

The strategy set forth in the 1987 Economic Support Fund (ESF) Balance of Payment Program agreements reads as follows: to support the efforts of the Grantee for the stabilization and recovery of the Salvadoran economy. The subobjectives were as follows: 1) reattain economic growth and financial equilibrium, 2) promote diversification of the economy, and 3) consolidate the agrarian reform. To accomplish this strategy the USAID/El Salvador Action Plan for Fiscal Year (FY) 1988-1989 enumerated twenty-three policy dialogue issues, and the GOES submitted an Economic Plan to address these issues.

This GOES Economic Plan was supposed to satisfactorily address 23 policy dialogue objectives contained in the applicable Action Plan. The time frames for accomplishing these policy objectives as measured by benchmarks in most cases is still in the future. Below is a list of key policy dialogue actions followed by their supporting benchmarks:

Bench Marks	Planned 1/	Actual
--- Put in place a 1987 economic program with targets	Late 1Q CY 87	Done June 1987
--- Constitute Economic Committee technical staff	1Q CY87	Done
--- Set targets for non-traditional exports	1Q CY87	Done
--- Review first quarter 1987 economic program	1Q CY87	Not done timely
--- Increase National Power Company (CEL) rates by at least ¢2/ 0.05/kwh	1Q CY87	Done 1Q FY88
--- Form Refinancing/Recapitalization Commission	1Q CY87	Partly done

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1/ In this column, Q refers to one of the four quarters of the year, and CY means calendar year.

2/ The symbol ¢ is for El Salvador colon; since January 1986, the rate of exchange has been 5 colones to 1 U.S. dollar.

Bench Marks	Planned	Actual
--- Negotiate an IBRD[3] earthquake recovery loan	1Q CY87	Done Nov 1987
--- Attain an exchange rate of ¢7.00/$1.00	2Q CY87	Not done
--- Boost interest rates by 3 percentage points	2Q CY87	Not done
--- Eliminate import prohibitions	2Q CY87	Partly done
--- Negotiate an International Monetary Fund standby agreement	2Q CY87	Not done
--- Review second quarter 1987 economic program	2Q CY87	Done Aug/Sept 87
--- Negotiate CAESS[4] compensation	2Q CY87	Not done
--- Privatize coffee marketing	2Q CY87	Not done
--- Establish 1988 economic program	3Q CY87	Done 2Q 1988
--- Negotiate IBRD industrial export credit	3Q CY87	Not done
--- Implement investment promotion law	3Q CY87	Not done
--- Introduce floating rate monetary stabilization bond	3Q CY87	Not done
--- Pay CAESS compensation	3Q CY87	Not done
--- Complete third quarter review of 1987 economic program	3Q CY87	Done Oct/Nov 87
--- Establish regular and timely publication of economic information	4Q CY87	Done
--- Adopt export incentives consistent with the General Agreement for Tariff and Trade.	4Q CY87	Not done
--- Review and revise 1988 economic program	1Q CY88	Done April 1988

3/ IBRD is the Inter American Development Bank.
4/ CAESS is the San Salvador Electric Company

Many of the 23 benchmarks were not accomplished by the GOES because of their perceived social, political, and security implications and the short-term destabilizing consequences which GOES officials feared might accompany macro-economic reform actions.

The disbursements of the FY 1987 funds were to proceed relatively automatically, tied to the requirement of normal progress in implementation of the GOES Economic Program. The first three disbursements occurred as part of the "planned schedule made in support of GOES implementation of its 1987 Economic Program". Section 3.1 of the Grant Agreement for A.I.D. project number 519-0318 stated funds under this agreement will be made available in three separate disbursements. Section 3.2 states: "An initial disbursement of $30 million will be made at the request of the Grantee after satisfaction of the conditions precedent to first disbursement set forth in Section 2.1 (i.e., legal opinion, signature specimen, evidence of separate account). Apparently, because of the lateness in signing, an initial disbursement of $67 million was made September 18, 1987.

Only the fourth and final disbursement, scheduled for the end of September, could have been subject to delays. This disbursement "would be contingent on GOES action, as scheduled in the program, on utility rates, and on the programmed implementation of the monetary program."

Planned Disbursements Were:

	Millions
Initial disbursement	$ 30
August 30, 1987	37
September 30, 1987	60
After satisfaction of CPs	30
Total	$157

Actual Disbursements Were:

September 18, 1987	$ 67
November 10, 1987	60
March 16, 1988	30
Total	$157

The Mission authorized the ESF assistance for 1987 after the GOES submitted a second economic plan which addressed the 23 policy dialogue objectives of the Mission. These 23 policy dialogue objectives mainly addressed sectoral reforms which the GOES was more willing to accept than macro-economic reforms. By sectoral issues we mean, but not restricted to: (a) monthly meetings of export promotion committee; (b) granting tax exemptions; (c) setting up a system for rapid allocation of foreign exchange and credit to exporters, etc. By macro-economic issues we refer to policy changes such as setting up a system to maintain a competitive exchange rate, to liberalize trade, etc.

On page 21 of the 1987 PAAD the Mission stated: "The GOES prepared an economic program for 1987 early in the year. After review, the Mission concluded that it was an inadequate basis for authorization of the FY 1987 assistance. The program failed to address adequately either the fiscal or balance of payments implications of the sharp decline in coffee prices. The monetary program, ... was unrealistic. Altogether, the original program would have led to a further increase in inflationary pressures... possibly accelerating to the 40-60 percent range, and continued deterioration of export competitiveness."

Basically, for 1987, the Mission changed its policy dialogue strategy from using conditions precedent and special covenants within the grant agreements to achieve the desired reforms, to authorizing the grant contingent on an adequate economic program being prepared by GOES. This was done because of the GOES political sensitivity to linking ESF dollar assistance to specific economic policy reforms. On several occasions high level GOES officials had influenced high level US Government officials to modify program imposed conditions.

Documents in the 1987 PAAD and in the FY 1989-1990 Action Plan, which discuss 1987 results obtained in policy dialogue issues, make it clear the Mission abandoned the strategy of attaching policy dialogue matters as conditions (to grant agreements) because this strategy was ineffective in getting desired macro-economic reforms in 1985 and 1986; was an irritant in bilateral relations because the President of El Salvador strongly opposed accepting grant monies with conditions involving macro-economic reforms attached primarily for political, security, and social equilibrium reasons; the U.S. Ambassador to El Salvador did not support conditioning the disbursement of grant aid; the political, security, and military objectives of the U.S. Government took precedence over economic reform objectives and such reforms could only take place within the context of these other goals. In other words, there was insufficient coordination, planning, and agreement between A.I.D., Department of State, and higher decision makers as to what the U.S. government's economic goals, strategies and objectives should be and how to attain them.

On page 37 of the 1987 PAAD, the Mission states: "Given the failure of tightly conditioned assistance to achieve its goal, [i.e., necessary macro-economic reforms] we have drawn back from this approach." In our opinion, this change in strategy was recognition by the Mission that the GOES President must be committed to a program in order for it to be accomplished.

On page 36 and page 37 of the 1987 PAAD, the Mission notes the shortcomings of accepting an authorization approach containing only sectoral reforms because sectoral reforms will not stem the country's economic decline (presumably increasing the amount and length of time necessary to maintain a balance of payments program here). Mission officials further noted if the exchange rate was not adjusted and trade not liberalized, exports would decline further and employment would decline. If solutions were not found to the public utility deficit problem and to the central government's financial bind, no headway would be made against inflation. If interest rates were not increased to positive levels and the dispersion among rates not reduced, continuing overexpansion of credit and money, and attendant inflation and capital flight, could be expected.

The Mission sums up the shortcomings of the acceptance of the 1987 GOES plan by noting these sectoral reforms were not substitutes for macro-economic policy adjustments. The missing macro-economic adjustments in the 1987 GOES plan were needed to: 1) restore export profitability and competitiveness; 2) stimulate production; 3) reign in inflation; 4) stabilize balance of payments. (All of the conditions necessary to accomplish the long-term objective of ending balance of payments assistance to El Salvador enumerated in the 1987/1988 Action Plan).

The sectoral reforms of the GOES 1987 Economic Plan would only make a contribution to the efficiency of the economy and provide tangible evidence to the private sector of the GOES intent to stay out of production. This approach while desirable psychologically, had its shortcomings as noted on page 27 of the 1987 ESF PAAD. "The Mission considers the revised GOES economic program [it focuses on sectoral issues, page 36, 1987 PAAD] to be a major improvement over the original one. If carried out, it will result in a significant reduction in inflationary pressures, an improvement in public sector finances, and reduce the deterioration of export competitiveness compared with the previous program. It will not result in stabilization or vigorous growth of the economy, [the primary strategy and purpose of ESF grants] but it should stem the deterioration in macroeconomic indicators that has taken place over the past two years. Successful implementation at the macroeconomic level, however, will require consistent monitoring by the GOES, and a willingness to continue to take difficult decisions to keep the program on track."

1987 TITLE I SELF-HELP MEASURES AND THEIR ESTABLISHED COMMITMENTS OR TARGETS

Self-Help Measure	Stated Commitment or Target
1) Improve immunization services through public health facilities.	The GOES agreed to design, implement and evaluate immunization services provided through its public health facilities. a) Increase coverage and protection of children under age one. b) Ensure efficient cost-effective use of health sector resources. Funds will support expanded immunization services in rural as well as urban areas through improved primary care services provided through para-medical workers and fixed facilities.
2) Complete and consolidate Phase I and III of the Agrarian Reform Program.	GOES agreed to: a) Accelerate issuance of property titles to the Agrarian Reform Phase I Cooperatives, so that by December 1987 all cooperatives will have their definitive titles. b) Accelerate the issuance of titles to Agrarian Reform Phase III beneficiaries, so that by December 1987 all of the individual beneficiaries will have received their definitive titles. c) Take the necessary steps to complete the compensation of properties involved. d) To present to A.I.D. a detailed action plan for ensuring that the cooperatives enter into a self-management mode.
3) Concentrate the activity of the Agricultural Development Bank (BFA) on efficient banking activities.	The GOES agreed to instruct the BFA to conduct the following:

Self-Help Measure	Stated Commitment or Target
	a) Create the capacity within the bank to periodically analyze the liquidity of the bank's loan portfolio and other receivables. b) Take more aggressive action for recuperation of overdue loans and develop stricter requirements for refinancing. c) Develop specific plans to reduce the administrative costs of the bank. d) Investigate means to diversify the bank's loan portfolio. e) Accelerate implementation of the program to capture general deposits. f) Initiate a process which will decrease the dependency of the BFA on non-banking activities such as purchase and sale of agricultural inputs and purchase, storage, processing and sale of agricultural products.
4) Encourage the private sector investment in agribusiness	The GOES agreed to establish regulations designed to promote investment in agribusiness and diversified agriculture.
5) Determine the existence of pests that affect fruit and vegetable crops.	The GOES agreed to assign the necessary resources to implement the action plan submitted by the Ministry of Agriculture (MAG) to investigate with the cooperation of the United States Department of Agriculture, the existence of such pests and its possible eradication.
6) Stop the introduction and spread of exotic diseases to El Salvador's livestock herds	The GOES agreed to continue giving the the necessary support to MAG in order to prevent the introduction of exotic diseases into the country, which may endanger the livestock herds.

List of Report Recommendations

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Recommendation No. 1 — 6

We recommend that USAID/El Salvador define the stabilization and recovery objectives of the program in measurable terms and determine the economic costs of not adopting key economic policy reforms in its Progam Approval Assistance Documents for the program.

Recommendation No. 2 — 12

We recommend that USAID/El Salvador develop and implement procedures to ensure that self-help measures are described in specific and measurable terms.

Recommendation No. 3 — 15

We recommend that USAID/El Salvador obtain evidence that the Central Bank has agreed to:

a. submit lists of transactions as required in the Separate Account Operating Procedures, for the current and successive Economic Support Fund agreements; and

b. prepare such lists using its own resources.

Recommendation No. 4 — 18

We recommend that USAID/El Salvador:

a. identify all Public Law 480 Title I agreements which have not been legally consummated by the required exchange of diplomatic notes with the Government of El Salvador, and

b. provide evidence that the required diplomatic notes for each of these agreements have been exchanged.

APPENDIX 9

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