

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

EL SALVADOR

INVESTMENT SECTOR REFORM PROGRAM

(ES-0016)

LOAN PROPOSAL

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**EL SALVADOR
INVESTMENT SECTOR REFORM PROGRAM
(ES-0016)**

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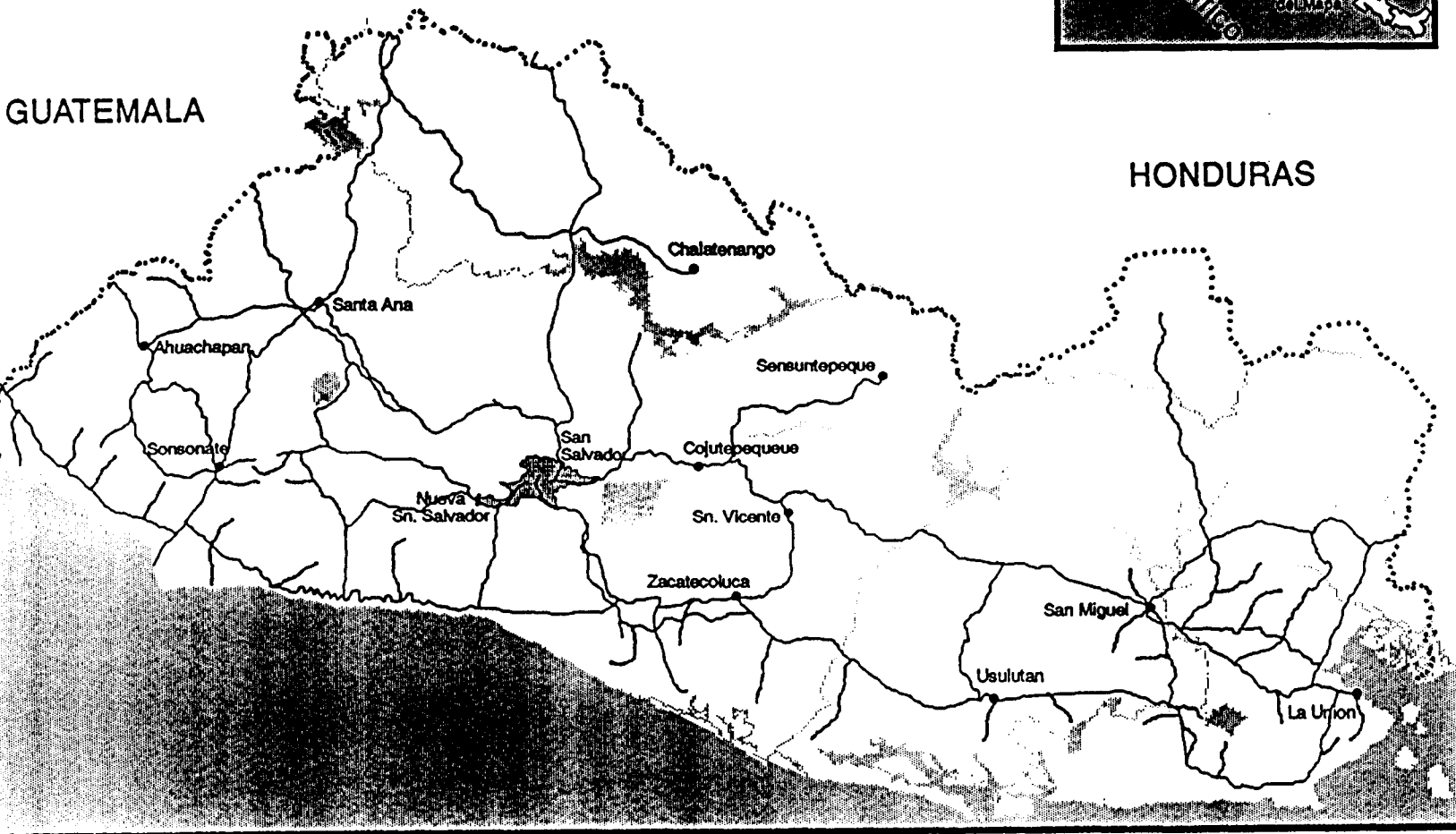
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1. Proposed Resolution
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El Salvador

DOCUMENTO DE PROGRAMACION



This map, prepared by the Inter-American Development Bank, has not been approved by any competent authority and its inclusion in the loan document has the exclusive objective of indicating the area of influence of the project proposed for financing.

EL SALVADOR

Basic Socio-Economic Data
Statistics and Quantitative Analysis
Economic and Social Development Department

Executive Summary

Social Statistics

Land Area (Km2)	1991	20,935
Population (Thousands)	1991	5,376
Population (Average Annual Growth Rate)	1982-1991	1.6
Rural (Percent)	1991	55.2
Density (Population per Km2)	1991	256.8
Vital Statistics		
Crude Birth Rate (per 1,000 Population)	1990	32.9
Infant Mortality Rate (per 1,000 Live Births)	1990	52.9
Crude Death Rate (per 1,000 Population)	1990	7.7
Life Expectancy at Birth (Years)	1990	63.6
Illiteracy (Percent)	1990	27.0
Primary School Enrollment Ratio	1989	78.0

Economic Statistics

Market Exchange Rate (Colones/US\$)	5-1992	8.2
GDP per Capita (Average Annual Growth Rate)	1982-1991	-0.4
Labor Force (Thousands)	1990	2,155
Unemployment Rate (Percent)	1990	10.0
Consumer Prices (Twelve Month Variation)	4-1992	8.1
NF Public Sector Overall Balance (As % of GDP)	1991	-2.7
Domestic Credit (As % of GDP)	1991	25.5
Balance of Payments (Millions of US\$)		
Current Account Balance	1991	-168
Trade Balance	1991	-706
Capital Account Balance	1991	-28
Change in Reserves (- Increase)	1991	70
Total External Debt (Millions of US\$)	1991	2,172
Total Debt Service (Millions of US\$)	1991	172
Debt to GDP Ratio (Percent)	1991	36.7
Debt Service Ratio (Percent)	1991	18.5

19 October 1992

EL SALVADOR

Basic Socio-Economic Data

1. Exchange Rates

Colones/US\$, End of Period Index 1980=100

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Market Rate	2.5	2.5	2.5	2.5	5.0	5.0	5.0	5.0	8.0	8.1
Real Effective Index	81.5	76.7	71.0	66.0	80.5	71.7	62.9	63.8	68.5	67.5

2. Prices

Average Annual Growth Rates in Percent

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Consumer Price Index	11.7	13.3	11.5	22.4	31.9	24.9	19.8	17.6	24.0	14.4
Wholesale Price Index	...	...	...	...	...	...	...	...	...	...

3. International Liquidity

Millions of US\$

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Reserves	130	180	186	199	189	206	181	286	435	307
Reserves minus Gold	109	160	166	180	170	186	162	266	415	287
Special Drawing Rights (SDRs)	2	0	0	0	...	0	0	0	0	...
Reserve Position in the IMF	...	...	...	...	...	...	...	...	...	...
Foreign Exchange	107	160	166	180	170	186	162	266	415	287
Gold (National Valuation)	22	20	20	20	20	20	20	20	20	20

4. National Accounts

Millions of 1988 US\$ 1988 US\$

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Gross Domestic Product	4771	4823	4917	4998	5032	5153	5231	5315	5477	5688
GDP Per Capita	1032	1034	1045	1048	1038	1044	1040	1034	1043	1058

Annual Growth Rates in Percent - Constant Prices

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
GDP Per Capita	-6.5	0.0	1.3	0.7	-1.0	0.9	-0.4	-1.0	1.2	1.1
GDP by Type of Expenditure (MP)	-5.6	0.8	2.3	2.0	0.6	2.7	1.6	1.1	3.4	3.5
Consumption	-7.2	0.6	4.0	4.0	0.5	1.1	1.4	1.4	1.8	2.4
Gross Domestic Investment	-10.2	-8.5	3.0	-5.6	21.5	-4.2	18.5	26.1	-29.2	18.0
Exports of Goods and Services	-14.8	19.8	-4.3	-3.9	-12.6	12.4	-9.4	-13.5	44.1	0.0
Imports of Goods and Services	-21.5	12.8	2.1	0.5	-2.8	0.4	-0.5	6.1	0.4	3.3
GDP by Sector of Origin (MP)										
Agriculture, Forestry and Fishing	-4.7	-3.2	3.3	-1.1	-3.1	2.1	-1.0	0.5	7.4	-0.1
Mining and Quarrying	0.0	-2.6	2.7	0.0	2.6	12.8	6.8	4.3	-8.2	11.1
Manufacturing	-8.4	2.0	1.3	3.7	2.5	3.0	3.0	2.5	3.0	4.9
Electricity, Gas and Water	-2.4	5.0	2.7	5.0	2.5	2.0	1.8	0.8	5.6	7.2
Construction	-4.2	2.0	-5.7	4.6	2.6	11.5	7.9	3.6	-12.8	10.1
Wholesale and Retail Trade	-12.0	2.1	1.9	0.5	0.3	1.4	0.4	3.4	3.1	4.2
Transport and Communications	-6.5	6.0	2.8	1.8	0.5	1.8	2.0	1.2	6.3	7.0
Financial Services	3.9	1.3	1.3	2.1	0.8	2.5	2.5	-2.5	2.3	3.3
Government	3.0	2.8	5.0	7.0	4.5	4.0	3.4	-1.1	1.6	3.1
Other Services	-11.5	-1.1	1.0	0.2	0.5	1.5	1.4	1.5	1.8	3.8

EL SALVADOR
Basic Socio-Economic Data

4. National Accounts (cont.)

Composition in Percent - Current Prices

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
GDP by Type of Expenditure (MP)										
Consumption	92.5	93.4	94.8	96.7	91.1	94.7	93.7	95.1	99.3	98.6
Gross Domestic Investment	13.2	12.1	12.0	10.8	13.3	12.4	12.8	15.3	11.8	13.4
Exports of Goods and Services	22.8	24.5	21.8	22.3	24.7	19.0	15.8	13.2	15.9	14.8
Imports of Goods and Services	28.5	29.9	28.5	29.9	29.0	26.1	22.3	23.7	27.1	26.9
GDP by Sector of Origin (MP)										
Agriculture, Forestry and Fishing	23.1	21.3	19.9	18.2	20.1	13.8	13.9	11.7	11.2	10.2
Mining and Quarrying	0.2	0.1	0.2	0.1	0.1	0.2	0.2	0.2	0.2	0.2
Manufacturing	15.4	15.5	15.8	16.4	15.6	17.5	17.6	18.1	18.6	18.7
Electricity, Gas and Water	2.2	2.4	2.4	2.3	2.1	2.1	2.0	1.9	1.9	2.3
Construction	3.4	3.4	3.0	3.0	2.8	3.1	3.0	3.1	2.6	2.7
Wholesale and Retail Trade	23.3	24.7	25.7	27.2	28.5	31.4	31.9	33.6	34.6	35.0
Transport and Communications	3.9	4.1	4.1	4.3	4.1	4.6	4.4	4.4	4.6	4.8
Financial Services	8.9	8.8	8.8	8.3	7.6	7.9	8.4	8.3	8.0	8.1
Government	11.7	11.6	11.7	11.2	10.0	9.5	8.7	8.4	7.9	7.6
Other Services	7.9	8.1	8.4	8.9	9.1	9.9	10.0	10.3	10.4	10.4

5. Non-Financial Public Sector

As a Percent of GDP

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Current Revenues	16.6	16.2	16.2	15.9	15.9	13.6	12.0	10.3	11.1	11.5
Current Expenditures	19.1	16.9	17.5	15.8	14.5	13.7	12.5	11.8	11.4	12.7
Current Savings	-2.4	-0.7	-1.3	0.1	1.4	-0.2	-0.5	-1.6	-0.3	-1.2
Capital Expenditure	8.1	8.8	5.2	4.4	5.9	2.8	3.9	4.3	2.2	3.2
Overall Balance (- Deficit)	-7.6	-6.0	-3.2	-2.2	-2.4	0.3	-2.6	-4.2	-0.4	-2.7
Domestic Financing	3.3	2.0	1.3	0.6	1.1	-1.1	1.5	2.6	-1.0	0.5

6. Monetary Survey

As a Percent of GDP

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Domestic Credit	53.1	53.8	46.9	42.2	34.3	32.8	30.5	29.6	27.6	25.5
Public Sector	15.8	18.6	14.3	11.0	7.5	7.1	5.5	5.8	7.2	7.8
Private Sector	37.3	35.3	32.6	31.2	26.7	25.7	25.0	23.8	20.4	17.6
Money (M1)	16.4	14.7	12.6	13.1	11.4	11.5	9.3	8.9	8.4	7.8

7. External Trade

Direction in Percent
Index 1980 = 100

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Exports of Goods (fob)										
Developed Countries	72.5	68.6	70.7	81.3	84.3	76.3	74.6	63.3	64.9	73.3
Developing Countries	27.5	31.4	29.3	18.7	15.7	23.7	25.4	36.7	35.1	26.7
Latin America	26.3	25.2	23.1	17.1	14.0	22.9	24.9	35.1	34.0	25.2
Imports of Goods (cif)										
Developed Countries	46.5	50.9	50.1	52.1	57.6	56.7	56.7	61.2	60.8	68.4
Developing Countries	53.5	49.1	49.9	47.9	42.4	43.3	43.3	38.8	39.2	31.6
Latin America	51.8	47.2	47.3	44.7	35.4	37.1	37.7	33.8	36.4	27.9
Terms of Trade Index	81.7	82.3	78.6	77.8	108.2	71.1	76.5	79.8	52.8	52.0

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Basic Socio-Economic Data

7. External Trade (cont.)

Composition in Percent

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Exports of Goods (fob)										
All Food	43.3	63.8	68.5	67.7	81.7	71.0	...	58.0	57.6	46.6
Agricultural Raw Materials	11.7	8.1	1.9	1.9	1.4	2.9	...	0.7	0.8	1.1
Fuels	3.1	0.9	2.7	2.5	1.1	1.3	...	1.4	1.5	0.7
Ores and Metals	2.2	1.5	2.1	2.2	1.1	2.3	...	3.0	2.7	3.2
Manufactured Goods	39.8	25.8	24.8	25.7	14.6	22.6	...	36.8	37.3	48.4
Chemicals	6.6	2.2	6.0	6.2	4.8	6.2	...	10.2	9.4	12.3
Machinery and Transport Equipment	3.0	10.4	1.6	1.6	0.9	1.5	...	2.5	2.7	3.7
Other Manufactured Goods	30.1	13.1	17.2	17.9	9.0	14.8	...	24.1	25.3	32.3
Imports of Goods (cif)										
Capital Goods	10.3	10.9	13.5	16.4	24.0	25.4	25.1	24.1	18.6	...
Consumption Goods	30.5	29.4	28.3	26.9	22.1	24.3	25.6	25.4	31.6	...
Intermediate Goods	59.2	59.7	58.2	56.7	48.5	50.3	49.3	49.7	49.8	...
Fuels	15.7	15.1	13.3	13.9	8.8	10.5	8.0	7.5	9.7	...
Other	...	...	...	...	5.3	...	...	0.8	...	...

8. Balance of Payments

Millions of US\$

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Current Account Balance	-120	-28	-54	-29	117	136	26	-174	-137	-168
Trade Balance	-100	-74	-189	-216	-124	-349	-356	-592	-600	-706
Exports of Goods (fob)	700	758	726	679	778	590	611	498	580	588
Imports of Goods (fob)	800	832	915	895	902	939	967	1090	1180	1294
Service Balance	-227	-225	-173	-156	-142	-54	-119	-127	-105	-133
Freight and Insurance	-57	-61	-63	-66	-61	-70	-68	-72	-82	-112
Travel	-72	-62	-45	-46	-32	-32	-20	-41	14	14
Investment Income	-119	-131	-134	-117	-120	-111	-118	-96	-124	-127
Other Services	21	28	69	73	71	159	87	81	87	92
Unrequited Transfers	207	272	308	344	383	539	501	545	569	671
Private	88	97	118	129	150	180	202	208	324	470
Official	119	174	190	214	234	359	299	378	223	179
Capital Account Balance	153	102	112	33	69	-61	62	151	20	-28
Non-Monetary Sector	124	135	120	81	31	-66	41	139	58	-50
Private Sector	4	-26	28	3	9	5	7	18	-2	42
Direct Investment	-1	28	12	12	24	18	17	13	2	25
Portfolio Investment	-1	0	0	0	-3	0	0	0	0	0
Other Long-Term	6	6	-10	-1	-1	0	-11	1	-4	17
Other Short-Term	0	-61	26	-8	-11	-14	0	4	0	0
Government Sector	120	162	92	78	22	-71	34	121	60	-92
Long-Term	185	283	82	88	45	-54	23	180	29	20
Short-Term	-65	-121	10	-10	-23	-17	11	-59	31	-112
Monetary Sector	29	-33	-8	-48	38	5	21	11	-38	22
Long-Term	0	-1	-1	0	1	-1	-1	0	0	0
Short-Term	29	-33	-7	-48	37	7	22	12	-38	22
Change in Reserves (- Increase)	29	-24	-7	-27	-44	-82	20	-103	-154	70
Errors and Omissions	-62	-50	-52	23	-142	7	-107	126	270	126

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Basic Socio-Economic Data

9. External Debt

	Millions of US\$ Ratios in Percent									
	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Total Debt	1443	1740	1826	1854	1851	1975	1987	2070	2133	2172
Long-Term Debt	1107	1507	1590	1660	1661	1739	1733	1857	1924	1964
Public and Publicly Guaranteed	974	1386	1476	1556	1578	1669	1678	1818	1898	1947
Bilateral	497	667	756	784	789	845	860	893	950	990
Multilateral	380	492	519	611	670	736	728	777	787	853
Bond Holders	25	38	29	19	10	0	0	0	0	...
Banks	58	170	156	121	91	71	68	111	119	104
Suppliers	5	10	9	10	9	8	5	5	5	0
Other Creditors	9	9	8	10	10	10	16	32	36	...
Private Non-Guaranteed	134	122	114	104	83	70	55	39	26	17
Use of IMF Credit	129	139	125	111	62	22	11	5	0	0
Short-Term Debt	206	94	111	84	127	214	243	208	209	208
Interest Arrears on Debt	0	0	0	2	4	5	9	23	6	...
Total Debt Service	129	202	237	259	286	260	203	170	214	172
Public and Publicly Guaranteed	68	156	199	201	188	192	166	137	183	...
Bilateral	33	61	75	80	72	79	76	59	49	27
Multilateral	30	31	36	50	65	71	66	64	106	24
Private Non-Guaranteed	30	21	10	18	28	15	20	20	17	...
IMF Repurchases and Charges	4	7	14	34	64	48	11	5	5	0
Short-Term Debt (Interest only)	27	17	14	6	6	5	6	8	9	9
Debt to GDP Ratio	42	47	49	52	44	43	38	40	38	37
Debt Service Ratio	15	22	25	27	27	27	21	20	24	18

... Not Available

0.0 Indicates that the amount is nil or negligible

EL SALVADOR
Basic Socio-Economic Data

Sources and Notes

Executive Summary

Social Statistics:

Land Area: Organization of American States (OAS), América en Cifras 1974.

Population: IDB estimates based on data from Latin America Demographic Center (CELADE) and United Nations Population Division.

Vital Statistics:

World Bank, Social Indicators of Development - 1991-92 Edition and Economic Commission for Latin America and the Caribbean (ECLAC), Statistical Yearbook - 1991 Edition.

Economic Statistics:

Labor Force: World Bank, Social Indicators of Development - 1991-92 Edition.

Unemployment: Programa Regional del Empleo para América Latina y El Caribe (PREALC).

1. Exchange Rates:

International Monetary Fund (IMF), International Financial Statistics (IFS).

Real Effective Index: IDB estimates based on data from the Banco Central de Reserva de El Salvador.

2. Prices:

IMF, IFS.

3. International Liquidity:

IMF, IFS.

4. National Accounts:

GDP in 1988 US Dollars: IDB estimates.

GDP by Type of Expenditure and Sector of Origin: Banco Central de Reserva de El Salvador.

5. Non-Financial Public Sector:

IMF based on data from Ministerio de Hacienda and Banco Central de Reserva de El Salvador.

6. Monetary Survey:

IMF, IFS (mid-year observations).

7. External Trade:

Trade by Direction: IMF, Direction of Trade Statistics (magnetic tapes).

Terms of Trade: ECLAC, Balance Preliminar de la Economía Latinoamericana, December 1991.

Export Composition: United Nations Statistical Division (UNSTAT) Commodity Trade (COMTRADE) Data Base; Exports include Re-Exports.

Import Composition: Banco Central de Reserva de El Salvador, Revista Trimestral. Fuels include Crude Petroleum.

8. Balance of Payments:

Banco Central de Reserva de El Salvador and IMF, Balance of Payments Statistics (magnetic tapes).

9. External Debt:

World Bank, World Debt Tables (magnetic tapes).

EL SALVADOR
OPERATIONS DEPARTMENT
OPS/IRO

IDB LOANS

APPROVED AS OF SEPTEMBER 30, 1992

	US\$Thousand	Percentage
TOTAL APPROVED *	1,266,391	100.0%
DISBURSED	956,592	75.5%
CANCELLATIONS	89,593	7.1%
UNDISBURSED BALANCE	309,799	24.5%
PRINCIPAL COLLECTED	343,574	27.1%
APPROVED BY FUND		
ORDINARY CAPITAL	443,103	35.0%
FUND FOR SPECIAL OPERATIONS	687,301	54.3%
SOCIAL PROGRESS TRUST FUND	37,688	3.0%
VENEZUELAN TRUST FUND	93,764	7.4%
OTHER FUNDS	4,535	0.4%
APPROVED BY SECTOR		
AGRICULTURE AND FISHERY	177,059	14.0%
INDUSTRY AND MINING	139,526	11.0%
TOURISM AND MICROENTERPRISE	0	0.0%
ENERGY	213,517	16.9%
TRANSPORTATION AND COMMUNICATIONS	222,178	17.5%
EDUCATION SCIENCE AND TECHNOLOGY	25,149	2.0%
PUBLIC AND ENVIRONMENTAL HEALTH	267,164	21.1%
URBAN DEVELOPMENT	31,208	2.5%
PLANNING AND REFORM	93,000	7.3%
EXPORT FINANCING	79,823	6.3%
PREINVESTMENT AND OTHER	17,767	1.4%

* Net of cancellations with monetary adjustments and export financing loan collections.

EL SALVADOR

Tentative Operative Program 1992- 1994

<u>Project</u>	<u>Name</u>	<u>Tentative Amount</u> (Millions of US\$)
Projects for 1992		
ES-0016	Investment Sector Reform Program (ISL)	90.0
ES-0060	Electricity Power Loan	130.0
ES-0020	Rehabilitation of Water & Sewerage Systems	<u>19,0</u>
Total for 1992		239,0
Projects for 1993		
ES-0073	Housing Program	45.0
ES-0024	Environmental Program	45.0
ES-0037	Global Microenterprise Credit Program	60.0
ES-0062	Social Investment Fund II Stage	60.0
ES-0014	Technical Education	<u>40.0</u>
Total for 1993		250.0
Possible Projects for 1994		
ES-0088	Energy Sector Program	100.0
ES-S/N	National Water & Sewerage Program	100.0
ES-0057	Multisectorial Credit Program	60.0
ES-0033	Agricultural Sector Program	<u>50.0</u>
Total for 1994		310.0
Grand Total		<u>799,0</u>

GLOSSARY

EL SALVADOR: INVESTMENT SECTOR REFORM PROGRAM (ES-0016)

BCR:	Banco Central de Reserva (Central Bank of El Salvador).
BFA:	Banco de Fomento Agropecuario (Agricultural Development Bank of El Salvador).
CPI:	Consumer Price Index.
FEDECREDITO:	Federation of Credit Unions.
FIGAPE:	Development Bank for Small Enterprises.
GAES:	Grupo Asesor Económico y Social.
GATT:	General Agreement on Tariffs and Trade.
GDP:	Gross Domestic Product.
GOES:	Government of El Salvador.
INAZUCAR:	Instituto del Azúcar. (State Sugar Marketing Company).
INCAFE:	Instituto del Café. (State Coffee Marketing Company).
INPEP:	Instituto de Previsión de Empleados Públicos.(Public Sector Pension Fund).
IPR:	Intellectual Property Rights.
IRA:	State Basic Grains Marketing Company.
ISL:	Investment Sector Loan.
ISSS:	Instituto de Seguridad Social.(Social Security Institute)
SAL:	Structural Adjustment Loan.
USAID:	United States Agency for International Development.

EL SALVADOR

INVESTMENT SECTOR REFORM PROGRAM

(ES-0016)

I. SUMMARY OF THE OPERATION

A. Loan Context

- 1.1 In a letter dated December 1, 1991, the Ministry of Planning of the Government of El Salvador (GOES) confirmed the priority attached by the Salvadoran Government to the proposed program and requested a fast-disbursing sector loan. This loan, an Investment Sector Loan (ISL), will play an important role in the overall development program that the GOES initiated in 1989.
- 1.2 In 1989, the GOES began to enlist international donor support for its economic adjustment program. An IMF standby agreement, the first since 1983, entered into execution in 1989. A World Bank Structural Adjustment Loan (SAL) was successfully negotiated the following year. These two projects will sponsor extensive GOES reform of macroeconomic policy including, among other areas, exchange and trade, price controls, direct and indirect taxes, interest rate and credit policy.
- 1.3 Most important of all, the GOES achieved an end to civil strife. After years of negotiation, the government achieved a comprehensive peace accord with the FMLN. Under its terms, Salvadoran society will be fundamentally altered. The National Reconstruction Plan (PRN), agreed to by both the GOES and the FMLN, and consistent with the objectives of the economic structural reform program mentioned above, is one of the most important products of the peace agreement. The PRN will focus on those areas of the economy and the society most affected by the civil war. Compensation and retraining programs will be offered to the ex-combatants of both sides. Physical infrastructure will be rebuilt. Health and education facilities will be improved. Lastly, the rural sector, for so long the center of the struggle, will be the focus of a program of integrated development. In short, the PRN is the instrument that will consolidate the peace effort and set the stage for an economic revival.
- 1.4 The ISL is in many ways the capstone for the GOES development program. First, it will support and complement the PRN by helping the GOES create a more favorable environment for economic growth and by providing financial resources to help offset the growing fiscal costs of the reconstruction program.
- 1.5 Second, the ISL will complement the stabilization and adjustment programs sponsored by the IMF and the World Bank. The macroeconomic programs supported by these two institutions are not sufficient to spur private sector led growth. Below the macroeconomic conditions lies a continuum of sector specific obstacles, each of which raises

transactions costs for private investors. With IMF and World Bank support, the GOES has already put into place the necessary conditions for a total framework, an overarching macroeconomic policy regime that adjusts relative prices to levels that provide the incentives for private sector led growth. With the ISL, the Bank will now support the government in the next crucial step, establishing the sufficient conditions for this framework by eliminating sector specific constraints to private sector investment.

B. Principal Aspects of the Loan

1. Rationale

- 1.6 Since 1989, the GOES has been particularly receptive to private sector investment, particularly foreign private investment. Three new laws were passed by the Legislative Assembly -- protecting foreign investment, promoting export growth and promoting free zone development -- providing a firm legal basis for this policy.
- 1.7 In spite of the improved legal framework, numerous institutional obstacles to private investment remain. The nature of these obstacles is such to significantly raise transaction costs for prospective private sector investors. Based on a private sector diagnostic study and other related analyses, and considering the activities of other donors, the Bank has selected four areas containing important institutional obstacles to private sector investment: (i) the financial sector; (ii) physical infrastructure; (iii) the legal and regulatory framework; and (iv) privatization. Other areas of institutional obstacles certainly exist. Many of these are the focus of other donor activity, such as that of the World Bank and USAID in the energy sector, in the trade regime and in fiscal administration.
- 1.8 The three areas selected to be the focus of the ISL are those in which institutional deepening will yield the highest social return to the Salvadoran economy as compared to any other area that could have been chosen. First, the ISL will assist the GOES in adding depth to the financial sector. This is perhaps the key issue area. Without improvements in the efficiency of financial intermediation, and the extension of formal sector finance and new financial products to the dynamic sectors of the Salvadoran economy, the growth process will be weighed down under increasing financial costs.
- 1.9 Next, the GOES will be supported in its efforts to provide an adequate administrative framework for the expansion of productive infrastructure in surface transport and telecommunications. In numerous surveys, private sector firms have reported that bottlenecks in these two areas are the principal factor -- next to finance -- raising the costs of meeting market demand for their goods and services.

- 1.10 Furthermore, this project will assist the GOES in addressing the myriad of legal, regulatory and institutional obstacles to the registration of new investments. Without a functioning intellectual property rights system, foreign investors will be loath to bring new products and new technologies to the Salvadoran economy. Without (i) modifications to the commercial code and other supporting laws and regulations, (ii) the strengthening of the commercial registry and (iii) the simplification of procedures relating to investment registration, new investors, domestic and foreign, will be burdened with high transactions costs in the start-up of new businesses.
- 1.11 Lastly, the GOES will move forward with the privatization of numerous assets outside the financial sector. Without this effort, there would be no clear signal from the government that the future growth and development of the economy rests with the private sector.

2. Program objectives

- 1.12 The ISL will support a broad range of policy reforms stimulating foreign and domestic private investment and improving the overall efficiency of the economy.
- 1.13 The financial sector component targets: (i) the successful conclusion of the bank privatization program; (ii) the continuation of appropriate monetary policies; (iii) the solvency and long-term viability of the state-owned development banks; (iv) the strengthening the emerging markets for term lending; (v) the strengthening of regulation and supervision of the financial sector; (vi) the strengthening of the contractual savings sector and (vii) modifications to the commercial code to permit new financial instruments.
- 1.14 The physical infrastructure component targets: (i) a global surface transport plan and (ii) a telecommunications sector plan.
- 1.15 The legal and regulatory component targets: (i) reform and strengthening of the intellectual property rights system; (ii) the strengthening of the commercial registry; and (iii) the establishment of a "one-stop-shop" for prospective private sector investors.
- 1.16 The privatization component targets: the privatization of state-owned assets outside the financial sector.

3. Program benefits

- 1.17 By the end of the project, El Salvador will possess a policy environment that is much more conducive to private investment. Most importantly, the GOES will have made great strides in establishing a private financial sector. The state owned banks and finance companies will have been privatized and new banks, both national and foreign, will have begun to enter the financial sector. The GOES

will have implemented a plan to restructure or liquidate the second-story, development banking institutions. The Superintendency of the Financial Sector will not be able to fully perform its function, but will have a new organizational structure and a growing cadre of trained personnel. The GOES will have a strategic plan for the insurance and pension sectors and will have begun to strengthen the financial and operational structure of the pension funds. A revised commercial code will permit new instruments of business finance.

- 1.18 As the ISL concludes, El Salvador will begin to benefit from improved productive infrastructure. A new telecommunications policy will have been presented to the nation. A surface transport plan will have been approved and the GOES will have begun to implement it.
- 1.19 By project end, El Salvador will have made significant progress in constructing a new legal and regulatory framework for private sector investment. A new intellectual property rights system -- the law, supporting regulations and a strengthened registry -- will be affording added protection to foreign and national investors. The one-stop-shop will not be in full operation, but the GOES will have succeeded in reducing the myriad of procedures asked to register investments.
- 1.20 Furthermore, the Salvadoran economy will have benefited from the return of state-owned assets to the private sector. Among the beneficiaries will there be approximately 1.5 million small farmers who will profit from a private marketing system in basic grains, sugar and coffee.
- 1.21 Finally, with the successful implementation of the ISL, El Salvador will be eligible for several benefits under the Initiative for the Americas. One attractive benefit, which will yield short-term cash flow relief for the financially pressed GOES, will be debt relief for part of the some US\$700 million in US bilateral official claims on El Salvador.

4. Program risks

- 1.22 The reforms contemplated in this operation will be time consuming and skill intensive on the part of the GOES agencies that will be tasked to put them into effect. Furthermore, in several areas -- telecommunications, the commercial code, the commercial registry, IPR, and the one-stop-shop -- the legal and regulatory framework will have to be changed to accommodate new policies and new institutions. Considering the period of legislative paralysis that normally precedes national elections, this task may fall to the next GOES administration.

5. Borrower and terms

- 1.23 The ISL is a fast-disbursing operation in the amount of US\$90 million to be released in three tranches, over a period of approximately 36

months. Disbursement of each tranche is contingent upon compliance of tranche-specific conditionality and maintenance of an appropriate macroeconomic framework.

- 1.24 The borrower will be the Republic of El Salvador. The executing agency will be the Ministry of Planning and the Central Reserve Bank. The proposed loan will be a fast-disbursing loan in the amount of US\$90 million to be disbursed in three tranches. The interest rate will be the Bank's standard variable rate. Amortization will be over 20 years, including a disbursement term of three years and a grace period of five years. A Credit fee equaling 0.75% per annum on undisbursed balances and an inspection and supervision fee equal to 1% of the amount of the loan will be applied.
- 1.25 The Ministry of Planning and the Central Reserve Bank will be the executing agencies for the program. The executing agencies will be responsible for the coordination and supervision of the policy actions to be taken by the different agencies of the GOES in relation to the various program components. Overall supervision of the ISL will be conducted by the Bank in order to evaluate compliance with the policy conditionality and the policy agenda agreed to on the basis of the policy matrix.
- 1.26 During negotiations of the conditions for the execution of the proposed program, the government transmitted to the Bank a policy letter which has served as the basis for structuring the operation and defining policy adjustments to be made, along with the actions to be taken to implement them. The text of the policy letter is included in Annex 5 hereto, and the policy matrix to be used to monitor program execution is included in Annex 4.

6. Waiver Requested

- 1.27 In regard to procurement procedures, the GOES has requested that purchases of petroleum be exempted from the requirement of international bids. In the opinion of the project team this request is justified. Accordingly, it is recommended that public bids for the importation of petroleum products and their derivatives be waived, for the reason that the prices of such products are negotiated in open, international markets.

C. Bank Strategy

- 1.28 The ISL fits well not only in the established macroeconomic context of GOES strategy, but is in line with the Bank's main objectives proposed in the Country Programming Paper. Among others is the objective to encourage increased participation of the private sector in the formulation and execution of GOES development and institutional reform strategies.

D. Other Multilateral Support

- 1.29 The IMF and World Bank programs are firm endorsements of the macroeconomic framework now in place in El Salvador. In late 1991, the GOES and the IMF negotiated the second standby arrangement since 1989. The IMF program calls for continuing the impetus of the reforms and reducing the fiscal deficit. The World Bank is supporting GOES economic reforms through its Structural Adjustment Loan (SAL). Approved in early 1991, it supports reforms in (1) the trade and exchange regime; (2) in the fiscal sector; (3) in the financial sector; (4) in the agricultural sector; and (5) in the social sectors. A follow-on SAL planned for 1993 will focus on public sector expenditure management, civil service reform and reform in the energy sector.

II. FRAME OF REFERENCE

A. Macroeconomic Framework

- 2.1 The Salvadoran economy was devastated during the last decade. A destructive civil conflict, the immigration of perhaps half a million of the country's best workforce, weak world commodity prices, the collapse of the Central American Common Market and a lack of effective economic policies plunged El Salvador into the worse economic crisis in its history. A few statistics will suffice to show the depth of the economic problem at the end of the 1980s. Annual GDP growth, which averaged 5.6% in the 1960s and 3.2% in the 1970s, had fallen to zero by 1989. Per capita GDP fell more than 26% between 1978 and 1989. The deficit of the nonfinancial public sector rose to the equivalent of 12% of GDP and remained high throughout the decade. Inflation, spurred by accommodative monetary policies early in the decade, rose to 32% in 1986.
- 2.2 For the most part, the authorities applied weak and inconsistent policies in an attempt to address these problems. Faced with escalating inflation, the BCR ceased its accommodative monetary policies late in the decade and applied draconian controls on the growth of money and credit. In order to contain a deteriorating balance of payments position, the authorities fixed the exchange rate and applied controls on capital movements and quantitative restrictions on imports. The fiscal deficit was met only with expenditure cuts, mainly in public sector investments. Although such measures achieved limited stabilization objectives, they did nothing to address the fundamental imbalances in the economy -- excessive dependence on import substitution and widespread state intervention - - and only stifled prospects for growth and recovery.

- 2.3 In 1989, the newly elected administration of President Cristiani launched a determined effort to pull the economy out of the doldrums. The government was determined to implement a program to stabilize the economy and achieve lasting structural adjustment that would lead to long-term economic growth. The emphasis was to eliminate the distortions of the 1980s, dismantle state intervention and relay on market forces to achieve economic objectives.
- 2.4 The first step in the economic program was to liberalize the exchange and trade regime. The fixed exchange rate was abandoned and in steps over a period of nine months, the Central Bank (BCR) implemented a managed floating rate system for the colon. Consistent with the flexible exchange rate system, capital controls were loosened and the trade regime was reformed. Prior deposits for imports and most import permits were eliminated. The range of nominal import tariffs was compressed from zero to 240% to 5-20%.
- 2.5 Most domestic price controls were lifted. The number of domestic products under price controls was reduced from 230 to six. Most notable was the freeing of basic grains prices upon which some 1.5 million small farmers depend for their incomes.
- 2.6 The GOES took major steps to improve the efficiency and performance of the financial sector. Nominal rates of interest were first raised to real positive levels and subsequently liberalized. The BCR overhauled its rediscount lines greatly reducing its reliance on preferential rates of interest and directed credit. These measures have increased financial savings and improved the efficiency of credit allocation in the economy.
- 2.7 With the passage of four new laws, the GOES began to create a new financial sector. The first two authorized a restructuring of the assets of the nationalized banks and nonbank financial intermediaries and the sale of these institutions to the private sector. To date, three banks have been privatized. The BCR itself adopted a new charter outlining operating procedures more consistent with a private financial sector. Notable among these are restrictions on the ability of the BCR to extend credit to the central government. Lastly, an independent superintendency was created to establish prudential guidelines for a private sector banking system.
- 2.8 The regime of direct and indirect taxation was also the subject of extensive reforms. The top marginal tax rates for individuals and corporations were lowered and the number of tax brackets reduced. Tax administration was tightened and numerous loopholes were closed. Low yielding "nuisance taxes", in particular export taxes on sugar and shrimp, were eliminated. The stamp tax was unified at a rate of 5% and greatly simplified. Late in 1992, the stamp tax was replaced by the more efficient value added tax. Many tax exemptions were eliminated, especially for public sector enterprises. Lastly, the GOES began a program to strengthen the entire fiscal administration

in the areas of tax collection, expenditure control and customs administration.

- 2.9 In addition to its efforts in the financial sector, the GOES began a comprehensive privatization program. The monopolies that were exercised by state companies in basic grains, sugar and coffee were abolished and a program was developed for the eventual sale of the assets of these companies to the private sector.
- 2.10 In general, these reforms were well received by the Salvadoran public and a rebound in economic performance soon followed. In 1990-91 the economy enjoyed the high GDP growth rates for two consecutive years, 3.4% in 1990 and 3.5% in 1991, the best performance since 1977-78. This was a boon to small farmers. In response to favorable weather and new basic grain policies, agricultural growth surged by 7.4% in 1990. Inflationary pressures began to subside in 1991-92. For the first six months of 1992, the increase in the CPI on an annual basis was 7%.
- 2.11 The GOES is well aware that this performance, impressive as it is, does not reflect the ability of the Salvadoran economy to achieve long-term sustainable growth. For that reason, the government has garnered international support to deepen its adjustment and recovery program. First, the government achieved formal endorsement of its liberal trade and exchange regime by its accession to the GATT. Next, successful negotiations with the IMF and World Bank has put those two agencies firmly behind the GOES long-term adjustment program.
- 2.12 With this wide range of donor assistance, the government has launched a major effort to deepen the adjustment process and in particular, to combat the precarious fiscal situation, the one major dark cloud on the macroeconomic horizon. Revenues are at present insufficient to cover the growing demands for public sector outlays, especially under the National Reconstruction Program, leading to an overall public sector deficit that will likely be equivalent to between 4% and 5% of GDP for 1992. The lack of adequate external financing for this deficit has caused difficulties in meeting Fund targets under the current standby arrangement. The GOES has responded with expenditure restraint and increases in public utility rates in electricity and water and the implementation of a value added tax to replace the system of stamp taxes. For the immediate future, these measures should reduce the fiscal deficit to levels that can be comfortably financed by external borrowing, reducing the need to rely on financing from the domestic financial system. For the longer run, the GOES is confident that program to strengthen fiscal administration, together with the program to rationalize the tax system itself, will provide the resources to meet the needs of a growing and developing economy.

B. Bank Lending Strategy

- 2.13 The ISL fits well not only in the established macroeconomic context of GOES strategy, but is in line with the Bank's main objectives proposed in the Country Programming Paper. Among others is the objective to encourage increased participation of the private sector in the formulation and execution of GOES development and institutional reform strategies.
- 2.14 In this regard, the proposed program will have a direct and positive impact on most of the operations in the Bank's program and will indirectly affect practically all the remaining projects. The privatization program under the ISL will increase the number of viable financial intermediaries and thus will have a positive direct impact on the three credit programs that are currently under study; the Global Microenterprise Program (ES-0037), the Multisectoral Global Credit Program II (ES-0057), and the Housing Program (ES-0073), as well as the Multisectoral Global Credit Program I, currently under execution. Furthermore, more adequate supervision and regulation with the strengthening of the superintendency of banks will increase the confidence of investors and depositors to utilize local financial intermediaries. With regard to the other operations in the Bank's program, the overall improvement in the incentive structure for private investment will attract private sector participation, particularly in large infrastructure programs like the proposed Energy Sector Program (ES-0088) and the National Water and Sewerage Program (ES-S/N). Lastly, the proposed ISL will support the activities of the National Reconstruction Plan through the improvement of the credit mechanisms for the productive sectors, as well as promoting job creations through private investments in the country.

III. THE SECTOR PROGRAM

- 3.1 The Bank will assist the GOES to build a complete framework conducive to long-term economic growth and development. A macroeconomic adjustment program in itself is not enough to spur private sector led growth. Below the macroeconomic conditions lie a continuum of sector specific obstacles, each of which raises transactions costs for private investors. With IMF and World Bank support, the GOES has already put into place the necessary conditions for a total framework, an overarching macroeconomic policy regime that adjusts relative prices to levels that provide the incentives for private sector led growth. With the ISL, the Bank will now support the government in the next crucial step, establishing the sufficient conditions for this framework by eliminating sector specific constraints to private sector investment.

A. Macroeconomic Framework

- 3.2 In order for the Bank to be able to effectively assist the GOES in addressing sector specific constraints to private sector investment, a sound macroeconomic policy regime must be in place. In this regard, the ISL will place special emphasis on successful implementation of the IMF and the World Bank programs. The former will help the GOES manage its very difficult fiscal problems as it attempts to implement the National Reconstruction Program. The World Bank Structural Adjustment Loan will be instrumental in assisting the GOES put into place key policy measures asked to for long-term economic growth.

B. The financial sector

- 3.3 Although the GOES has accomplished much with its reforms since 1989, the financial sector cannot yet efficiently intermediate between borrowers and savers. With the current organization of the BCR, the exercise of monetary policy often interferes with the efficient management of the rediscount facilities that provide development finance to the productive sectors of the economy. In addition to organizational problems within the BCR, the flow of development finance is hampered by the financial state of the state-owned development banks in agriculture (BFA), small and medium enterprises (FIGAPE), and credit unions (FEDECREDITO). The administration and structure of the contractual savings sector (pension funds and insurance companies) are weak, preventing this sector from developing into a source of long-term savings spurring growth in securities markets. Even though there is now the legal authorization for an independent bank regulatory agency, it does not have the structure and qualified staff to exercise prudent regulation over a private sector banking system.
- 3.4 Accordingly, there are six features of the financial sector requiring policy attention: (i) privatization of the bank and nonbank financial intermediaries; (ii) supervision and regulation; (iii) monetary and credit policy; (iv) management of development finance; (v) the legal basis for securities market growth; (vi) the contractual savings sector; and (vii) the development of new instruments of finance.

1. Privatization

- 3.5 The sale of state-owned banks and finance companies (financieras) is the crucial step in creating an efficient financial sector serving the growing credit needs of the productive industries of the Salvadoran economy. The GOES has already taken significant steps in this direction and this program will address the completion of what already has been achieved. Three banks, Cuscatlan, Agricola Comercial and Desarrollo, accounting for some 75% of total banking system assets, have already been sold to the private sector. The GOES has agreed to present an agenda for the completion of the privatization agenda. This agenda will schedule the sale of Comercio

and Salvadoreño by November 1992. Given the depth of its portfolio problems, the sale of Hipotecario will take place in July 1993, giving the GOES more time to recapitalize the institution and restructure its portfolio. The four finance companies (Ahorromet, Casa, Credica and Atlacatl) will be privatized by May of 1993.

- 3.6 The GOES realizes that in order to foster competition in the financial sector, the participation of foreign banks must be encouraged. To this end, the present moratorium on the entry of new financial institutions will be lifted in 1993, as the law requires. With the lifting of the moratorium, El Salvador will have accomplished what few other countries in this hemisphere have -- the complete liberalization of the financial sector, exposing it to the healthy effects of foreign competition.

2. Supervision and regulation

- 3.7 For a private banking sector to efficiently serve the needs of a growing economy, prudent regulation of banking activities is essential. For this purpose, the GOES decided to remove the supervisory functions from the BCR and the Legislative Assembly passed a law authorizing an independent Superintendent of the Financial Sector. The problem now facing the GOES is that the Superintendent does not have the capability to fulfill its role. The GOES, with USAID technical assistance, is now engaged in a multi-year effort to strengthen the administration and organization of the entire Superintendency and within it, to strengthen the capabilities of the division that will regulate banks and nonbank financial intermediaries. This project, however, will not cover other, very important segments of the financial sector. Accordingly, the ISL will expand the ongoing GOES project and strengthen the division that will regulate another important part of the financial system, the insurance companies and pension funds that make up the contractual savings sector. The key first step, however, is the completion and approval of GOES strategy to strengthen the Superintendency. The government has agreed to present this program as the approved strategy for the long-term strengthening of the Superintendency. Based on an approved overall program -- and most importantly, on an approved organizational plan -- the GOES will present a plan to strengthen the division that will regulate the contractual savings sector. This plan will include measures for staff training, the preparation of manuals and procedures, and the implementation of an information system. For the duration of the ISL, emphasis will be placed on the satisfactory progress in the implementation of this program.

3. Credit and interest rate policy

- 3.8 Central to the growth and development of the financial sector is a liberal credit and interest rate policy on the part of the central bank. As was mentioned above, El Salvador is one of the few countries in the hemisphere that has adopted complete financial

liberalization. The BCR has made great strides in this direction, in dismantling directed credit programs and in eliminating interest rate subsidies. However, several features of present policy regime still constrain efficient financial intermediation. First, the BCR continues to impose informal ceilings on loan rates and still offers several preferential rediscount lines. These are not significant distortions; but they do give inconsistent signals to the banking community. Therefore, the BCR has agreed to eliminate the informal interest rate ceilings. Only two preferential rediscount facilities will remain (forestry projects and student loans) -- they will account for less than one tenth of one percent of total credit flow - and the BCR will agree that no more will be granted.

- 3.9 The BCR imposes high reserve requirements on deposits in the banks and finance companies (currently 15% on savings deposits and 25% on demand deposits). Such actions are necessary in order to control monetary growth in the presence of large fiscal deficits and when other instruments of monetary policy are lacking. Nonetheless, high reserve requirements depress bank profitability and in general, raise the costs of intermediation. During the course of the ISL, the GOES will conduct a complete review of the effectiveness of its instruments of monetary policy.
- 3.10 The BCR has encountered some success in open market operations and, accordingly, has agreed to critically evaluate the current level of reserve requirements in the light of other, emerging instruments of monetary control. The analysis will touch upon: (i) reserve requirements as effective instruments of monetary control and deposit security; (ii) the level of reserve requirements as a function of asset quality; (iii) adopting the criterion of cost of funds to the banks when setting reserve requirements and/or paying interest on required reserves; (iv) wider sale of BCR monetary instruments in secondary markets; and (v) deposit insurance. To the extent that this analysis succeeds in pointing the BCR towards the use of other instruments to meet its money and credit targets without placing undue pressure on its already weak financial position, the reliance on reserve requirements will likely be relaxed.
- 3.11 The GOES currently imposes an 8% tax on the interest income from deposits held in the banking system by private companies. These are distortionary, since other depositors, individuals and households, are not taxed. The government has indicated its intention to review this problem within the context of the ongoing GOES review of the entire tax structure. The analysis will include at a minimum: (i) a thorough examination of the distortions in the present system; (ii) recommendations for reducing or eliminating the tax; (iii) the fiscal burden of its reduction or elimination; and (v) the possibility of disallowing the deduction of interest payments from net income before calculating firms' tax liability.
- 3.12 In light of the pressing need of the GOES for revenues to close the fiscal gap -- caused in large part by expenditures relating to the

implementation of the PNR -- the recommendations flowing from the overall tax review will be likely implemented only in 1994.

- 3.13 The BCR is technically insolvent, a condition that complicates the exercise of monetary policy in El Salvador. The financial position of the BCR has been weakened by the program to recapitalize the commercial banks and the finance companies prior to their privatization, as well as by meeting the financing needs of the central government. At the end of 1991, the capital of the BCR amounted to a negative US\$17 million. The assets of the BCR included accounts receivable from the GOES for US\$168 million in losses related to the restructuring of commercial bank portfolios. Moreover, the BCR registered additional losses of US\$162 million due to (i) exchange losses related to intermediating foreign loans; (ii) old credit programs at subsidized interest rates; and (iii) credit activities with the development banks, especially with the BFA related to the agrarian reform program.
- 3.14 The GOES will present a plan -- also requested by the IMF -- for the recapitalization of the BCR. The plan will likely involve the restructuring of the stock of outstanding GOES obligations to the BCR (possibly with a 40-year bond issued by the Ministry of Finance). It could also include an infusion of fresh capital for the BCR obtained by the GOES through foreign borrowing.
- 3.15 Moreover, the plan will consider, at a minimum, the following: (i) a calendar for the recapitalization of the BCR including dates and amounts; (ii) the payment of interest on any outstanding balances owed by the GOES to the BCR; (iii) interest rates positive in real terms; (iv) allowing any profits earned by the BCR to be capitalized independently of the recapitalization scheme itself; and lastly, (v) maintaining the capital of the BCR at levels constant in real terms and according to the criteria of the Basle Convention. The GOES has agreed that the plan will be in place by the end of the ISL.

4. Management of development finance

- 3.16 In the present operational structure of the BCR the exercise of monetary policy and the management of the rediscount lines for term credit to the private sector overlap. When the BCR is forced to meet short-term money and credit targets, activity in the term rediscount facilities is often sacrificed. Investment projects in the private sector have long gestation periods, and the frequent "start and stop" management of the rediscount lines can be very disruptive to private sector investment planning. The Bank and the BCR examined several remedies for this problem, including the establishment of an independent, multisector "second story" financial institution to manage development finance. After careful consideration of all the alternatives, it was decided that the BCR should reorganize its operational structure in order to separate and isolate the management of development finance from the day-to-day conduct of monetary policy. The result of this reorganization will be to constrain the

focus of monetary policy to short-term credit in the financial system, leaving flows of development finance untouched.

- 3.17 The reorganization of the BCR will follow in two stages. In the first stage, functions within the BCR will be clearly divided. This will involve the transfer of about 75 employees to the new development credit department of the BCR. Of these, 61 will come from the Credit Department and 14 from Accounting and Administration. BCR functions will include the formulation and exercise of monetary policy, economic studies and international economic relations.
- 3.18 Furthermore, the operations of the development credit department will observe the following principles: (i) lending only through the formal financial system; (ii) no direct lending to the non-financial public sector; (iii) supporting only lines of credit reflecting full cost recovery; (iv) lending only through entities under the Superintendency of the Financial Sector; and (v) lending not to intervene in the sectoral or institutional allocation of credit.
- 3.19 Subsequent to this reorganization, perhaps in 1994, the BCR will be in a position to consider in a second stage, the formation of an independent, second story development credit institution.
- 3.20 In addition to organizational problems within the BCR, the flow of development finance is hampered by the weak financial situation of the state-owned development banks in agriculture (BFA), small and medium enterprises (FIGAPE), and credit unions (FEDECREDITO). The GOES will soon conduct comprehensive analyses covering these entities.
- 3.21 With the assistance of the World Bank, terms of reference are almost complete for the analyses covering BFA, FEDECREDITO and FIGAPE. For BFA and FEDECREDITO these include: (i) the causes of unsatisfactory loan recovery; (ii) institution analysis; (iii) analysis of the overall financial situation; (iv) interest rate policy; (v) loan appraisal and recovery policy; (vi) guarantees; (vii) cost control; (viii) portfolio diversification; and (ix) portfolio classification, provisioning and internal supervision. Contractors from several Bank member countries have already been considered for these studies.
- 3.22 The BCR has also prepared terms of reference for a comprehensive analysis of FIGAPE. These include: (i) the reduction of administrative expenditures; (ii) policies to improve operating margins; (iii) credit appraisal and recovery practices; (iv) efficiency in the present structure of branch operations.
- 3.23 Based on the recommendations made in these analyses, the GOES will prepare action plans to liquidate or restructure these development banks. In view of the extensive work that will likely be necessary to comply with these recommendations, work that will go beyond the execution period of this loan, the Bank will only require that by the

end of the ISL, the GOES will have made significant progress in implementing the recommendations contained in the action plans.

5. A legal framework for securities markets

- 3.24 The recently inaugurated securities market (Bolsa de Valores) in El Salvador operates without a firm legal foundation. Realizing this, the GOES has solicited technical assistance in reviewing its first draft of a capital markets law. The GOES will redraft the law to include: (i) the issue of long-term instruments; (ii) procedures for supervision, accounting and auditing; (iii) a registry of issuing firms; and (iv) procedures for the establishment of markets for new instruments. During the ISL, the law will be presented to the Legislative Assembly and upon passage, regulations will be issued that will govern the operations of the securities markets.

6. The contractual savings sector

- 3.25 In El Salvador the contractual savings sector consists of the publicly owned pension funds -- ISSS and INPEP -- and 14 private insurance companies. The GOES recognizes the importance of this sector not only for the essential services that it provides to the Salvadoran population, but also for its role in providing long-term savings for the growth and development of the entire financial sector. The Bank and the GOES have been engaged in a series of studies to evaluate alternatives for strengthening the pension funds and the insurance companies.
- 3.26 The problem facing the contractual savings sector can be divided into two categories: strategy and operational efficiency. There is no strategy for the contractual savings sector. There is no vision as to how the pension and insurance sectors will fit into the Salvadoran financial system. No thought has been given to such questions as the appropriate number of institutions and the type and structure benefits that will be required to meet the demands of a growing Salvadoran population. Lastly, a legal structure, which would codify this vision and set operating guidelines for the sector, is totally absent.
- 3.27 In regard to operational efficiency, the contractual savings sector is going through a very difficult financial situation. With respect to the insurance sector, some of the major companies are insolvent, due in large part to the complete absence of law and regulation. In the pension sector, both ISSS and INPEP suffer high administrative costs due to very antiquated management structures. Next, there is evidence that rates charged for pension and health benefits are inappropriate given the actuarial risks. Clearly, a full actuarial study is needed for both institutions. Furthermore, reserves are poorly invested, in loans at subsidized rates and in other low yielding instruments.

- 3.28 Considering these problems, the Bank and the GOES have agreed that, over the long run, reform of the pension sector in El Salvador will embrace three distinct phases. In the first phase, the present structure of the pension system (i.e., two institutions offering similar services on a "pay-as-you-go" basis) will be left intact, but adjustments will be made to the operational and administrative structure of each pension institution to make them more efficient. In the second phase, the GOES will begin to examine alternatives to the present structure in order to rationalize services between the two institutions. For example, health benefits now offered by each institution could be combined under one administrative framework. Finally, in the third phase, the GOES will examine options for a comprehensive restructuring of the pension system. The pay-as-you-go system could be abandoned in favor of one or a combination of other systems that have been tried and tested in recent years. With respect to the third phase, one important conclusion that has emerged from the studies performed by the Bank and the GOES is that a fundamental restructuring of the present system may not be feasible until the financial sector in El Salvador has: (i) strong supervision and regulation; (ii) a strengthened insurance sector; and (iii) functioning securities markets. At present, none of these institutional features exist in the financial sector of El Salvador.
- 3.29 Accordingly, the GOES and the Bank have agreed that the ISL will encompass the first phase and the beginning of the second. The GOES will first be asked to form a national pension commission to provide the institutional framework within which reform of the pension sector will be guided ultimately through its three phases. Based on the results of the reforms in phase one (see paragraph below) and based on progress in institutional strengthening in the financial sector (supervision and regulation, the securities market and the insurance sector), the commission will be able to prepare a strategic plan for in-depth structural reform of the pension sector. This strategic plan will be presented to the Bank by the end of the program period.
- 3.30 Additionally, the commission will propose an agenda for phase one reform: a set of legal, financial and administrative measures to strengthen the operational efficiency of the two pension funds, ISSS and INPEP. In the legal area, the GOES, through the Commission, will draft legislation (i.e., amend the charters of each institution) and issue regulations to permit a wider and more flexible investment policy, prohibit investment of reserves in instruments of the GOES and the autonomous agencies, and enforce the collection of payments past due. In the financial area, the GOES will conduct full actuarial studies of ISSS and INPEP and based on these, prepare plans to improve the financial positions of the two institutions. Lastly, in the administrative area, the GOES will draft plans to, within each institution, improve informational systems and to separate operational from financial administration in the provision of health and pension services. All these measures -- legal, financial and administrative -- will be implemented by the end of the program period.

- 3.31 With respect to the other component of the contractual savings sector, the private insurance companies, the Bank and the GOES have reached agreement on the terms of reference for a comprehensive study of the insurance sector. The study will address: (i) the financial condition of the insurance companies; (ii) recommendations related to a new national policy towards the sector; and (iii) consistent with the policy recommendations, a plan for the financial restructuring of the sector and recommendations for the legal and regulatory framework. During the ISL the GOES has agreed to complete the study and prepare an action plan for the implementation of its recommendations.

7. The commercial code

- 3.32 As in many countries that have only recently shifted from statist, interventionist economic policies to a more open economy, El Salvador's legal and regulatory structure is in many respects contradictory. In spite of the improvement in the legal framework for private investment mentioned above, there still exists vestiges of the previous economic philosophy reflecting an interventionist approach towards business activity. The Commercial Code is a case in point, in view of the fact that financial intermediaries are restricted legally in the type of instruments they can market to support business activity and expansion. Lending secured by real property is virtually the only product that the banks are comfortable with. Other financial products, secured by inventories or by the cash flow of the enterprise itself, are very difficult, if not impossible, to negotiate in El Salvador.
- 3.33 The GOES will begin a series of actions to modify the Commercial Code in El Salvador in order to permit a wider range of financial instruments for the growth and development of private sector business activity. First, the GOES will identify the shortcomings of the legal and regulatory system that now prevent using commercial assets as sources of credit. In particular, the examination will focus on the absence in the Commercial Code of relevant provisions for inter alia:
- production loans
 - commercial pledges
 - pledges of equipment
 - pledges of installations
 - liens on inventory
 - liens on accounts receivable
 - liens on documents of title
 - borrowing against all forms of intellectual property rights and agreements
 - documentary letters of credit
 - independent or abstract bank guarantees
- 3.34 Subsequent to the examination, the GOES will prepare the text of amendments to the Commercial Code suitable for enabling the banking

system to issue secure credit against the type of commercial property discussed above. Lastly, the GOES has agreed to have this legislative package enacted into law before the end of the project.

C. Productive infrastructure

- 3.35 The state of productive infrastructure in El Salvador is another factor that is very costly for the private sector. Due to the civil war and to fiscal problems facing the GOES, maintenance and expansion of roads and ports have suffered. Furthermore, telecommunications services are poor. The state-owned telecommunications company, ANTEL, is not capable of providing the quantity and quality of telecommunications services that are in demand by modern business establishments. Accordingly, the GOES has agreed to build an appropriate institutional framework for the expansion of productive infrastructure in telecommunications and surface transport.

1. Telecommunications

- 3.36 Pursuant to a Bank/GOES study of ANTEL, the state-owned telecommunications company, it became clear that numerous policy issues related to the sector itself, and not just to ANTEL, require attention if the growing needs of the private sector for modern telecommunications services are to be satisfied. First, there is no agency or governmental body in El Salvador that reviews strategic telecommunications issues and formulates policy for the sector. Secondly, other key features of the telecommunications sector in El Salvador -- the regulatory function and ANTEL -- are inadequate to meet the demand for long-term growth in modern telecommunications services.
- 3.37 Accordingly, the GOES has agreed form a national steering committee to consider strategic issues in the telecommunications sector in El Salvador and to conduct a comprehensive diagnostic of the sector following terms of reference which will be jointly prepared by the Bank and the GOES prior to Board presentation. In this diagnostic all the salient issues in telecommunications policy will be analyzed. These issues will include -- but not necessarily be limited to -- (i) the functions of the policy making body; (ii) the structure of ownership (private versus public; national versus foreign); (iii) the degree of competition; (iv) a reorganization of ANTEL to permit the company to assume a new role in the sector; and (v) the regulatory function. Terms of reference for a reorganization of ANTEL have already been prepared and agreed upon. Subsequent to the completion of the diagnostic, the GOES will design an action plan through which the recommendations made in the diagnostic can be translated into policy. By the end of the ISL, the GOES will have made significant progress in implementing the new telecommunications policy framework.

2. Surface transport

- 3.38 One major problem facing the GOES is the reconstruction of the surface transport system which has suffered from over ten years of neglect. To make this task more manageable, the GOES will soon create a new vice-ministry for transport that will absorb the functions and responsibilities now found in several other ministries and independent agencies. Within this new administrative framework, the GOES will be able to coordinate the expansion and maintenance of roads and ports.
- 3.39 To meet this objective, the IDB and the GOES have prepared extensive terms of reference for a global transport study. These terms of reference outline a comprehensive analysis of traffic in the road network, on the rail system, in the seaports and in the airport. This analysis will yield recommendations for (i) pricing; (ii) a more rational system of transport subsidies; (iii) administration and maintenance; and lastly, (iv) an appropriate expansion plan for each transport modality. Of particular interest to the Bank will be recommendations for better integration of all the systems of surface transport and the possible privatization of ancillary services around the seaports. The GOES has agreed to conduct the global transport study and to have made satisfactory progress towards the implementation of its recommendations by the end of the ISL.

D. The legal and regulatory framework

- 3.40 The ISL will assist the GOES in improving the legal and regulatory environment for private sector investment by: (i) strengthening the system of intellectual property rights; (ii) establishing a "one-stop-shop" for new business registration; and (iv) strengthening the commercial registry.

1. The system of intellectual property rights

- 3.41 Although El Salvador is making determined progress toward reform of selected elements of its intellectual property system, there is still limited awareness of the beneficial impact which a system of strong safeguards could have on the economy. For example, foreign and domestic investment in information systems and in new industrial technologies would certainly be stimulated. Furthermore, for a variety of reasons, the actual intellectual property system is quite weak. There are inadequate resources provided for the functioning of the intellectual property registry, deficient protection for the rights of authors, a lack of trade secret protection and a weakness in trademark protection.
- 3.42 The IDB has assisted the GOES in identifying areas in which the existing intellectual property rights law can be revised to provide better protection for foreign investors in the areas of patents, trademarks, copyrights and trade secrets. The Bank has made some 60

specific recommendations for revision in the areas of artistic, literary and scientific property, in industrial property, in industrial or commercial secrets and for corresponding amendments to the criminal, civil and mercantile law.

- 3.43 The GOES has agreed to consider these suggested revisions in a new draft law, to present the draft law to the Legislative Assembly and upon approval, adopt regulations to enforce the provisions of the new law. The GOES will also make provisions to strengthen the IPR Registry in the areas of administration, finance and physical plant. The modernization of the Registry will be complete by the end of the ISL.

2. Investment registration (The One-Stop Shop)

- 3.44 There is a maze of law and regulation through which a prospective investor must weave to begin a business activity. The process of obtaining permission to operate a business in El Salvador is very long and complicated. Considering the documentation and permits that must be submitted with the various applications, an investor must deal with five to seven different agencies. Obtaining these licenses and permits may take as much as one year. The problem stems not only from the fact that several ministries and agencies are involved in the approval process, but also from the fact that those provisions of law and regulations that bear on investment registration are antiquated and in need of modification. Therefore, the simplification of private sector investment registration will consist of (i) analyzing the complete set of procedures now asked to for registering investments; (ii) actions to eliminate and/or simplify the legal and regulatory basis for these procedures; and finally (iii) an institutional framework for a one-stop-shop consistent with the new procedures.

- 3.45 The GOES has already made considerable progress in the analysis stage, having identified about 60-70 percent of the procedures required to register investment in El Salvador. The Bank and the GOES have agreed that the remaining 30-40 percent of the procedures (agencies) include the following:

- registration of intellectual property (Ministry of Economy);
- registration of foreign investment (Ministry of Economy);
- granting of incentives (Ministries of Economy and Finance);
- issuance of certificates of freedom from tax liability (Ministry of Finance and municipal tax authorities);
- issuance of tax identity number (Ministry of Finance);
- issuance of permits for duty-free importation of equipment (Customs);
- issuance of residency permits (Ministry of the Interior);
- issuance of employer identification number (ISSS);
- issuance of entry visas (Ministry of Foreign Relations);
- approval of employment contracts (Ministry of labor);

- authorization for transfer of shares to foreigners (BCR, Superintendency of Companies); and
- authorization for repatriation of profits and capital (BCR).

3.46 Based on the above set of criteria, and prior to first tranche, the GOES will complete a full diagnostic analysis of the procedures affecting the entry and operation of local and foreign investment, along with their respective implementing agencies.

3.47 Subsequently, the GOES will present to the Bank a complete set of proposals for streamlining (as necessary) each of the procedures analyzed above and a plan for restructuring the investment bureaucracy in the context of the revised procedural environment. Procedural reform will entail identification of the specific legislative and regulatory modifications required to enact the proposed reforms. The laws and regulations requiring change will likely include the following:

- Commercial Code and implementing regulations;
- Commercial Registry Law and regulations;
- Superintendency of Companies Law and regulations;
- Regulatory Law for Operation of Industry and Commerce;
- Immigration Law;
- Consular law; and
- Foreign Investment Law.

3.48 Lastly, based on the new procedural environment, the GOES will focus on a plan for restructuring El Salvador's investment bureaucracy. The objective will be to design a streamlined institutional structure for handling procedures related to approval and entry of new investment, along with a specific strategy for putting the new structure in place. The plan will cover the following elements:

- functions to be included;
- design of the institutional structure;
- implementation strategy;
- staffing;
- space and budgetary requirements;
- system development; and
- training.

3.49 By the end of the ISL, there will have been satisfactory progress in the implementation of the new procedural regime and the new streamlined institutional structure (the one-stop-shop).

3. The commercial registry

3.50 Beyond law and regulation, there is a very weak institutional apparatus to maintain records of financial transactions upon which the private sector depends for the enforcement of property rights. Due to a variety of reasons -- scarcity of trained personnel, antiquated procedures, inadequate physical facilities -- the

registries in which instruments relating to debt and land titles are not functioning effectively.

- 3.51 The GOES will initiate a program to transform the Commercial Registry into an institution that will be capable of efficiently recording and maintaining records of commercial transactions. The GOES will first analyze the strengths and weaknesses of the current institutional operations of the commercial registry. This analysis will include a review of the Law of the Commercial Registry and its regulations. The current volume of recordings on a weekly basis will be calculated, along with noting the number and qualifications of personnel involved in such work. A series of "tests" will be conducted to determine the ease and accuracy with which new recordings can be entered and old ones retrieved.
- 3.52 Following the review, the GOES will present a plan for transforming the commercial registry into an efficient institution for recording ownership in all forms of commercial property. The plan will include drafting pertinent amendments to the law of the Commercial Registry and/or its regulations. Additionally, the plan will identify needed improvements in staff development, informational systems and physical plant. Finally, by the end of the ISL the GOES will have implemented the plan for the improvement of the Commercial Registry.

E. Privatization

- 3.53 An effective program to privatize state-owned assets outside the financial sector is important not only to relieve the pressure on the fiscal posture of the GOES, but to give clear signals that the future growth and development of the economy rests with the private sector. In this regard, the sale of assets in basic grains (IRA), sugar (INAZUCAR) and coffee (INCAFE) is essential if private agricultural marketing systems are to develop in El Salvador. Accordingly, the GOES will present a plan of action for the completion of the sale of state owned assets outside of the financial sector. These assets include those now held by the holding company CORSAIN/BANAFI (the Hotel Presidente, the free-zone at San Bartolo, the sugar mill Jiboa and others) and those in the agricultural sector (IRA, INAZUCAR, INCAFE and others).
- 3.54 The plan will include an agenda for the sale of these assets and a clear set of regulations and procedures to govern the transactions. In fact, some sales have already occurred. The Hotel Presidente was sold early in 1992. We anticipate further actions through July of 1994. The free-zone at San Bartolo, some assets of INCAFE and three storage silos belonging to IRA should be privatized by July of 1993; the remainder, by July 1994. In summary, by the end of the ISL, there will have been satisfactory progress in the implementation of the GOES privatization plan.

F. Policy letter

- 3.55 The program will require satisfactory progress in the implementation of the policies included in the policy letter. A tentative list of issues to be included in the policy letter can be found in Annex II.

G. Financing of the program

- 3.56 the ISL will include US\$90 million to be structured in three tranches of US\$30 each. In addition, the ISL will be cofinanced by the Swiss Government which will provide a grant of the dollar equivalent of 10 million Swiss Francs. The three tranches will be disbursed over approximately 36 months. This amount represents approximately 40% of the Bank's lending program for the year. The proposed amount is justified based on the cost to the GOES of implementing the reforms and the fiscal deficit resulting from the costs of implementing the peace accords. Each tranche disbursement will take place upon completion of the conditions specified in the policy matrix and in the policy letter. The loan funds will be disbursed through a special account established and operated under an agreement between the GOES and the Bank.

IV. PROGRAM EXECUTION

A. Borrower and executing agencies

- 4.1 The borrower under this operation will be the Republic of El Salvador. The Ministry of Planning and the Central Reserve Bank will be the executing agencies for the program. The executing agencies will be responsible for the coordination and supervision of the policy actions to be taken by the different agencies of the GOES in relation to the various program components. Overall supervision of the ISL will be conducted by the Bank in order to evaluate compliance with the policy conditionality and the policy agenda agreed to on the basis of the policy matrix.
- 4.2 The GOES has already made significant progress in preparing for the implementation of the ISL. A supervisory unit has been created in the Ministry of Planning and considerable coordination has been effected among the ministries and agencies that will be involved.
- 4.3 Significant progress has been made in meeting first tranche conditions. The BCR has prepared documentation relation to the liberalization of interest rates and BCR rediscount facilities. A draft of a new IPR law is almost ready for distribution. The GOES has almost completed the procedural analysis for the one-stop-shop. During the most recent mission to El Salvador, the GOES informed the members of the mission that general agreement exists on all of the policy conditionality.

B. Policy Conditions

4.4 *The policy conditions for the disbursement of the first tranche are:*

The Macroeconomic Framework

- Macroeconomic performance consistent with the objectives of the program.

The Financial Sector

- a) Presentation of an agenda for the privatization of the remaining state-owned financial intermediaries (three banks and four finance companies)
- b) Presentation of an overall plan for the strengthening of the Superintendency of the Financial Sector that will include: (i) the organizational plan; (ii) the training plan; (iii) procedures and manuals; (iv) informational services; and (v) specific plan for the strengthening of the Intendency for banks and finance companies (financieras).
- c) Presentation of evidence that necessary measures have been taken for the liberalization of interest rates and the elimination of BCR preferential rediscount facilities.
- d) Initiation of a study to examine the extent to which open market operations can be substituted for high reserve requirements in the context of current monetary policy in El Salvador.
- f) Presentation of a plan for the reorganization of the BCR separating monetary policy from the management of development credit.
- g) Revision of the proposed Capital Markets Law to include modifications in the areas of: (i) issuance of long-term securities; (ii) supervision, accounting and auditing procedures; (iii) organization of a supervisory unit; (iv) a registry of issuing firms and (v) procedures for the creation of exchanges.
- h) Creation of a commission for the pension and social security sector to recommend, coordinate and execute national policies in the legal, financial, administrative and organizational areas.
- i) Preparation and adoption of an agenda for the analysis of legal and regulatory obstacles to the use of commercial property as collateral for lending.

Non-Financial Sectors

- a) Formation of a steering committee and agreement on terms of reference for a sector plan for telecommunications which will address, but not be limited to: (i) regulatory issues; (ii) ownership; (iii) competition; (iv) institutional strengthening of ANTEL; and (v) overall policy formulation.
- b) Revision of the IPR law to incorporate revisions agreed to between the Bank and the GOES.
- c) Presentation of an action plan to strengthen administrative and financial structure of the IPR registry.
- d) Presentation of a complete analysis of the procedural steps involved in the approval and start-up of private investment projects.
- f) Presentation of an analysis of the current operation of the Commercial Registry which will include, among other issues, a review of the law of the commercial registry and its regulations and a time and motion study to determine the ease and accuracy of recordings.
- g) Presentation of a work plan -- including a statement of rules, procedures and an agenda-- for the sale of state assets in CORSAIN and in the agricultural sector (IRA, INAZUCAR and INCAFE).

4.5 The Policy Letter

Satisfactory progress in meeting the terms of the policy letter.

Policy Conditions to be completed for the second tranche disbursement are:

4.6 The Macroeconomic Framework

Macroeconomic performance consistent with the objectives of the program.

4.7 The Financial Sector

- a) Adherence to the bank privatization agenda.
- b) Full implementation of the organizational plan recommended in the plan for the strengthening of the Superintendency of the Financial Sector and satisfactory progress in the implementation of the remainder of the plan.
- c) Complement the plan for the strengthening of the Superintendency of the Financial Sector with the addition of

a component to strengthen the Intendency for the Pension and Insurance Sectors.

- d) Maintenance of a liberal interest rate regime.
- e) Conduct a study on the current tax treatment of financial instruments.
- f) Implementation of the recommendations of the study on monetary policy.
- g) Presentation by the BCR and the Ministry of Finance of a plan to recapitalize the BCR.
- h) Implementation of the reorganization of the BCR.
- i) Based on agreed terms of reference, conclude diagnostic studies to determine the solvency and long term viability of the state-owned development finance institutions providing rural credit and credit to small enterprises. Present plans of action to implement the recommendations of the studies.
- j) Present draft Capital Markets Law to the Legislative Assembly.
- k) Presentation of draft laws and/or regulations for the pension institutions to: (i) rationalize investment policy; (ii) prohibit investment of reserves in instruments of the GOES and autonomous entities; (iii) rationalize the operational structure of ISSS and INPEP; and (iv) enforce collections past due.
- l) Presentation of financial plans to improve the financial situations of ISSS and INPEP including (i) a complete actuarial analysis of each institution; and (ii) the adoption of measures to protect the real value of technical and financial reserves and the elimination of GOES contributions to ISSS.
- m) Presentation of administrative plans for the pension institutions to: (i) improve information systems; and (ii) separate the operational and financial administration of health and pension systems.
- n) Initiate a study of the private insurance companies based on agreed to terms of reference that include: i) financial condition of the companies and ii) a new national policy for the insurance sector.
- o) Conclusion of the analysis and presentation of a legislative action plan for the modification of laws and/or regulations to remove the legal obstacles to the use of commercial property as collateral for lending.

4.8 Non-Financial Sectors

- a) Conclusion of the sector telecommunications plan and preparation of an action plan to implement the recommendations of the plan.
- b) Initiate global transport study based on agreed terms of reference that will cover roads, rails, seaports and airport and will include: i) load analysis; ii) pricing policy; iii) subsidy policy; iv) administration and maintenance; v) privatization; and vi) an expansion plan.
- c) Presentation of the revised IPR law to the Legislative Assembly.
- d) Satisfactory progress in the implementation of the action plan to modernize the IPR Registry.
- e) Presentation of an action plan for procedural reform and the institutional structure of a "one-stop-shop" for approval and start-up of private investment projects.
- f) Presentation of a plan to modernize the Commercial Registry, including pertinent amendments to the Law of the Commercial Registry and/or its regulations.
- g) Satisfactory progress in meeting the agenda of the work plan for the privatization of non-financial sector assets.

4.9 The Policy Letter

- Satisfactory progress in meeting terms of the policy letter.

Policy Conditions to be completed for the third tranche disbursement are:

4.10 The Macroeconomic Framework

- Macroeconomic performance consistent with the objectives of the program.

4.11 The Financial Sector

- a) Completion of the bank privatization agenda.
- b) Elimination of prohibitions on the establishment of new bank and nonbank financial intermediaries.
- c) Satisfactory progress in the implementation of the plan for the strengthening of the Superintendency of the Financial Sector.

- d) Satisfactory progress in the implementation of the plan for the strengthening of the Intendency for the Pension and Insurance sectors.
- e) Maintenance of a liberal interest rate regime.
- f) Implementation of the recommendations of the study on the tax treatment of financial instruments.
- g) Satisfactory progress in the recapitalization of the BCR.
- h) Satisfactory progress in implementing the action plans to restructure or liquidate the state-owned development banks.
- i) Adopt regulations for securities market operations.
- j) Presentation of a strategic plan to define the long-term structure of the social security sector.
- k) Issuance of regulations to implement the new legal structure for ISSS and INPEP.
- l) Satisfactory progress in implementing the financial plans for INPEP and ISSS.
- m) Satisfactory progress in the implementation of the administrative plans for INPEP and ISSS.
- n) Conclude study on the insurance sector and draft action plan for a financial restructuring of the sector and a new legal and regulatory framework.
- o) New provisions of the commercial code in effect.

4.12 Non-Financial Sectors

- a) Satisfactory progress in the implementation of the telecommunications action plan.
- b) Conclusion of the global transport study and satisfactory progress in the implementation of its recommendations.
- c) Adoption of regulations to implement the provisions of the new IPR law.
- d) Completion of the modernization of the IPR Registry.
- e) Satisfactory progress in the implementation of the "one-stop-shop".

- f) Implementation of the plan for the modernization of the Commercial Registry.
- g) Satisfactory progress in meeting the agenda of the privatization work plan.

4.13 The Policy Letter

- Satisfactory progress in meeting the terms of the policy letter.

C. Studies and institutional strengthening

- 4.14 Agreement has been reached between the Bank and the GOES on the studies, analyses and technical assistance that will be necessary during the execution of the operation. These are: (i) technical assistance for the strengthening of the Superintendency of the Financial Sector in the area of pension funds and insurance companies; (ii) technical assistance for the implementation of the one-stop-shop; (iii) technical assistance for the implementation of the new commercial registry; (iv) a study of appropriate instruments of monetary policy; (v) a study to establish the legal basis for new instruments for lending; (vi) an analysis of the development banks; (vii) a financial plan, including actuarial studies, for the two pension funds, INPEP and ISSS; (viii) a study of an investment strategy and interest rate policy for INPEP; (ix) a study of the insurance sector; (x) a sector study plan of telecommunications; and (xi) a global transportation study.
- 4.15 The funding for this effort, estimated at US\$ 3.0, will be provided by the GOES.
- 4.16 The execution of the studies and supervision over the technical assistance will be the responsibility of each of the ministries directly affected by the effort. Before the technical assistance or the studies are contracted, the Bank reserves the right to review terms of reference and the qualifications of the prospective contractors. Many of these studies and technical assistance will likely be eligible for funding under the Multilateral Investment Fund (MIF). It is understood that once these resources become available, the GOES will make proper application.

D. Program Execution

1. Execution

- 4.17 The borrower will be responsible for maintaining separate accounts in which transactions are posted that will facilitate requests for disbursements as well as the preparation of the project monitoring reports. The relevant documentation should include the detail necessary to identify the imported good: the exporter, the cost of the import in each category and the origin of the import.

2. Procurement Procedures

- 4.18 International public bids would be required for public and private sector procurements exceeding US\$5 million. Procurements for lesser amounts in the public sector would be conducted in accordance with procedures set forth in national legislation, providing they are not inconsistent with Bank policy. In awarding contracts in the private sector for amounts less than US\$5 million, established commercial practices will be followed, provided they are awarded based on an evaluation and comparison of price quotations of eligible suppliers from at least two countries, except in cases when direct contracting is allowed. The procurements will be subject to the procedures outlined in Appendix V of this loan proposal.
- 4.19 In light of the requirements stated in the paragraph above, the GOES has requested that purchases of petroleum be exempted from the requirement of international bids. In the opinion of the project team this request is justified, and based on policy determination GP-116-4, it is recommended that public bids for the importation of petroleum products and their derivatives be waived, for the reason that the prices of such products are negotiated in open, international markets.

3. Disbursements

- 4.20 As a consequence of the trade and exchange reforms in El Salvador, transactions relating to imports and sales of foreign exchange have been greatly simplified. Under the sector loan of the World Bank, the BCR has developed a new data base and set of procedures justifying import transactions under loan disbursements. The project team has determined that these conform to the norms and procedures of the Bank. However, it is recommended that the BCR augment these procedures with records containing the customs declaration, commercial invoice and the bill of lading for each import transaction. This will facilitate auditing of the program.

4. Audits

- 4.21 The borrower must present to the Bank, within 90 days after the last disbursement of each tranche, a complete statement of accounts relating to each tranche, certified by an independent accounting firm acceptable to the Bank, and conforming to agreed upon terms of reference.

5. Inspection and supervision

- 4.22 The bank shall set up the inspection procedures it deems necessary to ensure satisfactory progress of the program, and the borrower and the guarantor shall provide any cooperation required for this purpose. Of the amount of the financing, US\$.9 million from the proposed loan shall be allocated to the Bank accounts for general costs of inspection and supervision.

6. Ex-post evaluation

- 4.23 The ex-post evaluation will be conducted between six and twelve months following authorization to disburse the last tranche. To insure that the analysis is as complete as possible, it shall be conducted with the participation of Bank staff. Emphasis will be placed on evaluating the process of loan execution and compliance with the agreed policies. As far as possible, there will also be an evaluation of the immediate repercussions of the measures taken. The Operations Evaluation Office (OEO) shall participate in determining the specific details.

V. VIABILITY AND RISKS

A. Social impact

- 5.1 The proposed reforms in this operation will promote economic growth and consequently, a reduction in the level of poverty. Overall, the proposed policy measures will lead to greater private sector participation in economic activity increasing employment and personal incomes. Moreover, reforms in the financial sector will touch all income groups, but most of all, those that have been denied formal sector credit. With more efficient financial intermediation and greater depth to the financial sector, small entrepreneurs and low income households will have access to formal sector credit.
- 5.2 The major beneficiary of the policy reforms will be the low income population in the rural areas. The strengthening of credit delivery mechanisms in FEDECREDITO and BFA will expand the availability of formal credit to the 1.5 million small farmers in the rural sector, especially those that have experienced disruption in their economic life due to the civil war. The privatization of state assets in the agricultural sector will raise the efficiency of marketing systems for agricultural products and, thus, rural incomes.
- 5.3 The proposed policy reforms will also lead to improvements in physical infrastructure and a reduction in transactions costs for establishing new businesses. This will greatly improve the climate for small and medium enterprise development in El Salvador. With this will soon follow increases in employment and incomes in the urban areas of the country.
- 5.4 Nonetheless, in spite of these benefits, there is likely to be some short-term, adverse impact on incomes and employment stemming from the economic reform program. These have been anticipated by the GOES in its medium term plan. Accordingly, several special projects have been implemented to cushion incomes and employment of the affected groups. Among these is the FIS (Fondo de Inversion Social) under which small-scale projects in health, education, rural roads, sanitation and municipal infrastructure will benefit thousands of people in the rural areas of the country.

B. Risks

- 5.5 The reforms contemplated in this operation will be time consuming and skill intensive on the part of the GOES agencies that will be tasked to put them into effect. The program will require the GOES to contract technical assistance and conduct several studies in order to meet the policy conditionality, especially for the second tranche. Timing and resource availability will be crucial. To the extent that either or both are lacking, the ISL will suffer delays during supervision.
- 5.6 In several areas -- telecommunications, the commercial code, the commercial registry, IPR, and the one-stop-shop -- the legal and regulatory framework will have to be changed to accommodate new policies and new institutions. When the ISL is approved, there will be only 15 months remaining to the present administration before the elections in 1994. Considering the period of legislative paralysis that normally precedes national elections, there may be even less time available to the GOES to implement the legislative agenda specified in this operation. If time constraints prevent the present administration from concluding the conditions in the third tranche, it will be contingent upon the new administration to complete them.

EL SALVADOR: INVESTMENT SECTOR REFORM PROGRAM POLICY MATRIX

SUBJECT	OBJECTIVE	CONDITIONS TO BE MET BEFORE		
		FIRST TRANCHE	SECOND TRANCHE	THIRD TRANCHE
ECONOMIC FRAMEWORK				
Macroeconomic policies	Insure the implementation of a set of macroeconomic policies that will promote growth with price stability.	Macroeconomic performance consistent with the objectives of the program.	Macroeconomic performance consistent with the objectives of the program.	Macroeconomic performance consistent with the objectives of the program.
SECTOR DEVELOPMENT				
Financial Sector	Development of a market oriented financial sector.	Present an agenda for the privatization of the remaining state-owned financial intermediaries (three banks and four finance companies)	Adherence to the privatization agenda. Three banks and four finance companies at point of sale.	Completion of privatization of the remaining state-owned financial intermediaries.
Supervision and Regulation of the Financial Sector.	Strengthen the framework for the prudent regulation and supervision of the financial sector	Present a plan for the strengthening of the Superintendency of the Financial Sector. The plan will include: i) the organizational plan; ii) the training plan; iii) procedures and manuals and iv) informational services. and v) specific plan for the strengthening of the Intendency for Banks and Finance Companies (financieras).	Implementation of the organization plan recommended in (i) and satisfactory progress in the implementation of the remainder of the plan for the strengthening of the Superintendency of the Financial Sector described in the first tranche condition.	Eliminate the establishment of the bank and non-financial intermediaries.
			Complement the plan described in the first tranche condition with a component to strengthen the Intendency for the Pension and Insurance Sectors.	Satisfactory implementation of the plan for the strengthening of the Intendency for the Pension and Insurance Sectors.

EL SALVADOR: INVESTMENT SECTOR REFORM PROGRAM POLICY MATRIX

SUBJECT	OBJECTIVE	CONDITIONS TO BE MET BEFORE		
		FIRST TRANCHE	SECOND TRANCHE	THIRD TRANCHE
SECTOR DEVELOPMENT (Continued)				
Credit Policy.	Improve the efficiency of financial intermediation among the bank and nonbank financial intermediaries.	Demonstrate that the necessary measures have been taken for: i) the liberalization of interest rates; ii) the elimination of BCR preferential rediscount facilities.	Maintain a liberal interest rate regime.	Maintain a liberal interest rate regime.
			Conduct a study on the tax treatment of financial instruments which will include, among others; i) analysis of the distortions; ii) recommendations for eliminating or reducing the tax ; and iii) the fiscal burden of these actions.	Implement a study on the tax treatment of financial instruments.
		Initiate a study to examine the extent to which open market operations can be substituted for high reserve requirements in the context of current monetary policy in El Salvador. The analysis will consider, among others: i) cost of funds for the banks; ii) asset quality; iii) sale of BCR instruments in secondary markets.	Implementation of the recommendations of the study on monetary policy.	
			Presentation by the BCR and the Ministry of Finance of a plan to adequately recapitalize the BCR. The plan will include, among others, the restructuring of the stock of outstanding obligations of the GOES to the BCR.	Satisfactory completion of the recapitalization of the BCR.

EL SALVADOR: INVESTMENT SECTOR REFORM PROGRAM POLICY MATRIX

SUBJECT	OBJECTIVE	CONDITIONS TO BE MET BEFORE		
		FIRST TRANCHE	SECOND TRANCHE	THIRD TRANCHE
SECTOR DEVELOPMENT (continued)				
Development Finance	Create efficient delivery mechanisms for development finance to the productive sector of the economy.	Presentation of a plan for the reorganization of the BCR separating monetary policy from the management of development credit. BCR functions will include the formulation and execution of monetary policy. Development credit functions will include, among others, (i) lending with a multisectoral focus, (ii) lending only to entities under prudential supervision.	Implementation of the reorganization of the BCR.	
			Based on agreed terms of reference, conclude diagnostic studies to determine the solvency and long term viability of the state-owned development finance institutions providing rural credit and credit to small enterprises. Present plans of action to implement the recommendations of the studies.	Satisfactory implementation of the action plan.
Capital Markets	Promote the orderly development of new financial instruments for economic development.	Revise the proposed Capital Markets Law to include revision in the areas of: i) issuance of long-term securities; ii) supervision, accounting and auditing procedures; iii) organization of a supervisory unit; and iv) requirements for the creation of exchanges.	Present draft Capital Markets Law to the Legislative Assembly.	Adopt regulations for securities operations.

EL SALVADOR: INVESTMENT SECTOR REFORM PROGRAM POLICY MATRIX

SUBJECT	OBJECTIVE	CONDITIONS TO BE MET BEFORE		
		FIRST TRANCHE	SECOND TRANCHE	THIRD TRANCHE
SECTOR DEVELOPMENT (Continued)				
1. Savings	Promote the near-term strengthening and long-term development of the pension sector.	Creation of a commission to recommend, coordinate and execute national policies for pension and social security sector, particularly in the legal, financial, administrative and organizational areas.	Through this commission identify those policies that are crucial for the near-term improvement of the operational efficiency of ISSS and INPEP (taking into consideration the analysis of the consultants contracted for this purpose) and present action plan that will include, among other issues, the following: (a) In the legal area, draft laws and/or regulations to: i) rationalize investment policy; ii) prohibit investment of reserves in instruments of the GOES and autonomous entities; iii) rationalize the operational structure of ISSS and INPEP; and iv) enforce collections past due. (b) In the financial area, draft a plan for actuarial studies and corresponding plans to improve the financial situations of ISSS and INPEP.	Presentation plan to define term structure of social security. Issuance of laws to implement the structure. Satisfactory implementing studies and plans.

EL SALVADOR: INVESTMENT SECTOR REFORM PROGRAM POLICY MATRIX

SUBJECT	OBJECTIVE	CONDITIONS TO BE MET BEFORE		
		FIRST TRANCHE	SECOND TRANCHE	THIRD TRANCHE
SECTOR DEVELOPMENT (continued)				
	Promote the long term development of the insurance sector.		(c) In the administrative area, draft plans to: i) improve information systems; and ii) separate the operational and financial administration of health and pension systems. Initiate a study of the private insurance companies based on agreed to terms of reference that include: i) financial condition of the companies; ii) a new national policy for the insurance sector.	Satisfactory the implementation of administrative Conclude study and action plan for restructuring and a new regulatory framework
Financial Instruments	Establish the legal foundation for a expanded credit activity for private sector growth and development.	Based on an analysis and set of criteria agreed to between the Bank and the GOES, preparation and adoption of an agenda for the analysis of legal and regulatory obstacles to the use of commercial property as collateral for lending.	Conclusion of the analysis and presentation of a legislative action plan for the modification of laws and/or regulations to remove the legal obstacles to the use of commercial property as collateral for lending.	New provisions for Commercial Credit

EL SALVADOR: INVESTMENT SECTOR REFORM PROGRAM POLICY MATRIX

SUBJECT	OBJECTIVE	CONDITIONS TO BE MET BEFORE		
		FIRST TRANCHE	SECOND TRANCHE	THIRD TRANCHE
SECTOR OF THE PRODUCTIVE INFRASTRUCTURE				
Telecommunications	Improve the efficiency of the telecommunications sector	Formation of a steering committee and agreement on terms of reference for a diagnostic of the telecommunications sector which will address: i. regulatory issues; ii. ownership; iii. competition and iv. overall policy formulation. v. institutional strengthening of ANTEL	Conclusion of the sector diagnostic and preparation of an action plan to implement the recommendations of the sector diagnostic.	Satisfactory conclusion of the implementation of the action plan.
Transport	Improve the efficiency of the surface transport sector		Initiate global transport study based on agreed terms of reference that will cover roads, rails, seaports and airport and will include: i) load analysis; ii) pricing policy; iii) subsidy policy; iv) administration and maintenance; v) privatization; and vi) an expansion plan.	Conclusion of the study satisfactory to the implementation of the recommendations.
REGULATORY FRAMEWORK				
Intellectual Property Rights (IPR)	Strengthen the laws for intellectual property rights (protection for copyright, patents, trademarks and trade secrets) and the enforcement of these laws in order to provide greater incentive for foreign private investment.	Incorporation of recommended revisions to the current IPR law.	Present revised IPR law to the Legislative Assembly.	Adopt regulations to implement the new IPR law.

EL SALVADOR: INVESTMENT SECTOR REFORM PROGRAM POLICY MATRIX

SUBJECT	OBJECTIVE	CONDITIONS TO BE MET BEFORE		
		FIRST TRANCHE	SECOND TRANCHE	THIRD TRANCHE
REGULATORY FRAMEWORK (continued)				
		Presentation of action plan to strengthen the administrative and budgeting structure of the IPR registry including a training program and upgrading of the physical plant.	Satisfactory progress in the implementation of action plan to modernize the IPR Registry.	Complete modernization of the IPR Registry.
Improvement of Private	Improve the efficiency of private sector investment.	Based on a set of criteria agreed to between the Bank and the GOES, presentation of a complete analysis of the procedural steps involved in the approval and start-up of private investment.	Based on a set of criteria agreed to between the Bank and the GOES, presentation of an action plan for procedural reform and the institutional structure of a "one-stop-shop" for approval and start-up of private investment.	Satisfactory progress in the implementation of procedural reform and "one-stop-shop".
Commercial Registry	Transform the Commercial Registry into an efficient institution for recording ownership in all forms of commercial property.	Presentation of an analysis of the current operation of the Commercial Registry which will include: i) a review of the law of the commercial registry and its regulations; ii) a time and motion study to determine the ease and accuracy of recordings.	Presentation of a plan to modernize the Commercial Registry, including pertinent amendments to the Law of the Commercial Registry and/or its regulations.	Implementation of the modernized Commercial Registry for the mode of the Commercial Registry.
INVESTMENT				
	Strengthen the development of the market economy through the sale of nonfinancial assets under state ownership.	Presentation of a work plan -- including a statement of rules, procedures and an agenda -- for the sale of state assets in CORSAIN and in the agricultural sector.	Satisfactory progress in meeting the agenda of the work plan. The free - zone at San Bartolo and a significant number of assets belonging to IRA and INCAFE brought to point of sale.	Satisfactory progress in the completion of the remaining private work plan.

EL SALVADOR: INVESTMENT SECTOR REFORM PROGRAM POLICY MATRIX

SUBJECT	OBJECTIVE	CONDITIONS TO BE MET BEFORE		
		FIRST TRANCHE	SECOND TRANCHE	THIRD TRANCHE
PERFORMANCE IN MEETING PROGRAM POLICY OBJECTIVES				
		Satisfactory progress in meeting terms of the policy letter.	Satisfactory progress in meeting terms of the policy letter.	Satisfactory progress in meeting terms of the policy letter.

Mr. Enrique Iglesias
Inter-American Development Bank
Washington, D.C.

Dear Mr. Iglesias:

In order to provide continued support to improve private investment incentives, develop the financial sector and strengthen the telecommunications infrastructure, the Government of El Salvador would like to request an investment sector loan from the IDB for the equivalent of US\$90 million.

In support of that request, in this letter we have:

- (i) described the objectives and achievements of the Economic and Social Development Plan for the 1989-1994 period;
- (ii) outlined the National Financing Plan;
- (iii) described the specific measures to be taken prior to disbursement of the first tranche of the financing requested, and those to be taken subsequently by the Government; and
- (iv) detailed action to be undertaken by the Government in connection with macroeconomic performance and reforms consistent with the objectives of the investment sector program.

I. OBJECTIVES AND ACHIEVEMENTS OF THE ECONOMIC AND SOCIAL DEVELOPMENT PLAN FOR THE 1989-1994 PERIOD

During its three years of administration, the Government of El Salvador has implemented a stabilization plan to correct serious financial imbalances, as an essential step to restart the economy and reestablish the country's creditworthiness. The program has been accompanied by in-depth structural reforms designed to replace a protected and inefficient economic system of built-in privileges with a competitive and open one.

Overall economic activity

In 1991 the gross domestic product (GDP) grew 3.5 percent in real terms, reversing the trend toward stagnation that had prevailed in the past and surpassing the goals projected in the Economic and Social Development

Plan. This growth was achieved in spite of the adverse effects of the drought on the agricultural sector and the energy crisis that affected the country mainly in the third quarter of 1991. The economic spurt was accompanied by a substantial drop in inflation, which fell from 19.3 percent in 1990 to 9.8 percent in 1991. Prices rose more slowly in that year than at any other time in the past 13 years.

The upturn that had characterized 1991 continued into the first half of 1992, and the economic activity volume index expanded 7.5 percent in the period between January and April. That trend is consistent with the goal for economic growth set forth in the monetary program (4.5 percent).

Foreign exchange policy and the external sector

As of December 31, 1991, the balance of payments showed a surplus of US\$20 million equivalent, posting US\$466 million in net international reserves within the banking system and surpassing the goal established in the Government's programs. As of May 31, 1992, the balance on that account was US\$486 million. At the same time, exchange rate unification and stability were maintained, nontraditional exports expanded, and income from family transfers and from public and private capital rose, in response to more stable economic conditions.

Among the significant advances aimed at achieving an open, deregulated economy, the country acceded to the General Agreement on Tariffs and Trade (GATT) and continued to lower tariffs and to participate actively in subregional integration programs.

In addition, a free and competitive foreign exchange market continued to function, with participation by many exchange houses and the commencement of foreign exchange operations by the Central Bank on the open market, a situation that is reflected in a unified, stable exchange rate.

Although nontraditional exports expanded at a rate of 10.5 percent, the trade deficit widened as a result of plummeting world prices for coffee.

In 1992, within the context of the peace agreements, economic policy efforts were focused on improving financial and nonfinancial conditions to stimulate private investment and make the production sectors more competitive.

Preliminary results for 1992 show a significantly deteriorating balance of trade, which is attributable to lower international prices for coffee and increased imports as a result of a more vigorous economy and tariff cuts.

Public sector finance

The fiscal situation is showing signs of weakness. The deficit of the nonfinancial public sector (before donations) rose to 4.4 percent of GDP in 1991, principally because of higher domestic interest payments, budget transfers to the electricity service (CEL) to cover losses as a result of

drought and sabotage, and slower tax collections. Although revenues totaled 8.6 percent of GDP in 1991, they did not reach the figure projected.

The fiscal deficit did not exert inflationary pressure since it was financed largely by external sources in the form of loans on concessional terms. Domestic financing was restricted by the entry into force, in July 1991, of the new Statute of the Central Reserve Bank (CRB), whereby that institution was prohibited from financing public-sector deficits except in the form of advances to finance temporary cash flow shortages.

Public spending could potentially rise in 1992 with fulfillment of the peace agreements. In addition, certain public companies continue to place a financial burden on the public finances. With the entry into force of the goods and services tax (VAT), as well as the recent 30 percent jump in electricity rates, it is hoped that tax collections will rise. That would not be sufficient, however, to meet the significant fiscal requirements. It will also be necessary to adjust prices for other public services to bring them into line with their actual cost.

Monetary policy and credit policy

The aim of the monetary policy is to maintain liquidity at levels consistent with economic activity, to avoid exerting pressure on domestic price levels. Action in this area has been focused on replacing direct liquidity control mechanisms with indirect ones, for which purpose open market operations are being conducted.

The interest rate policy, in line with the liberalization of the economy, has sought to achieve the following objectives: to keep domestic rates competitive with other countries, boost domestic savings and improve the allocation of financial resources.

As part of the deregulation of financial intermediation, on July 1, 1991, the Central Reserve Bank standardized the statutory minimum reserves applicable to banks and finance companies, stipulating required reserves of 25 percent for sight deposits and 15 percent for term deposits and savings.

The Central Bank has pursued an active credit policy to meet the needs of the various economic sectors which are normally not served by financial institutions. In addition, the Central Reserve Bank took part in designing and executing financial rehabilitation programs for the agricultural sector to offset losses incurred as a result of drought and lower world prices for coffee and, more recently, helped implement a rehabilitation program for companies affected by domestic strife.

Social sector

The Government's social policy is aimed at combating poverty by implementing measures targeted to depressed sectors. The Chapultepec Accords and the Plan for National Reconstruction (PNR) will afford

significant support for these efforts. The Government's efforts to combat poverty are evident in its social compensation policies, which are based on the principles of allocating public spending to the poorest groups; decentralizing projects and having communities participate in their execution; and modernizing the ministries in charge of social affairs.

The ordinary budget for social development increased in real terms in 1991 and 1992, reversing the downward trend that had characterized the previous decade.

Below are highlights of the results achieved in 1991 under the social strategy:

- (i) 150,000 person/months of employment created;
- (ii) construction of physical infrastructure (paving, rural roads, new drinking water facilities, basic environmental sanitation) benefiting over 500,000 Salvadorans;
- (iii) nutritional programs serving some 500,000 persons (school-aged children, pregnant and nursing mothers);
- (iv) 32 new facilities opened to provide meals for senior citizens; and
- (v) community banks created, with special benefits for women heads of household.

In the housing sector, the Fondo Nacional de Vivienda Popular [National Low-Income Housing Fund] (FONAVIPO) has been set up to serve the most vulnerable groups, giving them access to land to enable them to build basic housing, and access to financing for housing at market rates, backed by a specific housing subsidy for the poorest groups.

In 1992 the Government's efforts are being directed toward strengthening peace within the framework of the Economic and Social Plan and the Plan for National Reconstruction. The Chapultepec Accords call for the creation of a forum for economic and social consultation as a means of ensuring participation by government, labor and business in achieving a series of broad-ranging agreements in order to secure economic and social development.

The Plan for National Construction

The execution of the Plan for National Construction (PNC) is a great challenge for the Government, and its efforts are focused on those areas and population groups most affected by the civil war. Projects and programs have now been identified for:

- (i) the "contingency stage" (US\$51 million, including US\$9 million for the purchase of land); and

- (ii) the "medium-term stage" for US\$745.7 million, and US\$427 million for expenses for democratic strengthening and to meet technical assistance needs.

II. FINANCING PLAN

In mid-1989, the country had total debts of US\$2,102.7 million, with arrears amounting to US\$169.4 million. There were very few sources of financing, the principal bilateral sources being the United States of America and, to a lesser degree, Venezuela.

To bolster the adjustment and economic recovery, a standby agreement was signed with the IMF and a structural adjustment program agreed with the World Bank, representing an endorsement of the Government's economic and social policy and a resumption of international cooperation.

Among the greatest challenges facing the country is the PNR, in view of the magnitude of resources required to implement it. The Government has established the following criteria for doing so:

- (i) sufficient external aid so that the economic and social program does not need to be sacrificed;
- (ii) concessional aid (donations or soft loans) at interest rates not exceeding an average of 4 percent;
- (iii) timely fast-disbursing aid to process emergency operations. Offers of assistance have been received from Japan, the United States, Norway, Sweden, Germany, Austria, China, Italy and Switzerland.
- (iv) minimal fiscal impact of the PNR.

III. PROGRAM TO MODERNIZE AND STRENGTHEN THE FINANCIAL SYSTEM

Since mid-1989 the Government of El Salvador, through the Central Reserve Bank, has been conducting a program to modernize the financial system, with the following objectives: (i) to streamline and clean up the assets of financial institutions so that they meet statutory requirements on creditworthiness and liquidity; (ii) to strengthen the Office of the Financial System Examiner [Superintendencia del Sistema Financiero] (SSF) to ensure its autonomy and efficiency in preventive supervision for those institutions; (iii) to establish a legal framework that will permit efficient and competitive intermediation by financial institutions; (iv) to sell nationalized savings and loan associations and commercial banks to the private sector under a system that will ensure democratic ownership of those institutions and their efficient administration; (v) to develop the stock market by creating new financial instruments; and (vi) to modernize the insurance and social security system.

The essential goal of the restructuring is to equip the country with efficient financial institutions which, in addition to bolstering economic growth, will make it possible to develop a high standard of competitiveness. In order to do this, three banks were taken over, four mergers took place - one between commercial banks and three between savings and loan associations - and official lending institutions were reorganized.

In addition, amendments made to financial legislation in the past two years establish a new regulatory and supervisory system that eliminates excessive state intervention. Still, provisions are included to ensure a reasonable degree of competitiveness and to preserve the stability and efficiency of the system. Accordingly, the Legislative Assembly approved the Law on Banks and Finance Companies, the Statute of the Office of the Financial System Examiner, the Statute of the Central Reserve Bank, and the Law on Rehabilitation and Strengthening of Commercial Banks and Savings and Loan Associations. In addition, it now has under study the new Stock Market Law, the Law on Insurance and Surety Institutions, and the revised Commercial Code.

Once the reform process had been entrenched, and in a new context of financial policy and healthy financial institutions meeting minimum standards on creditworthiness, liquidity, profitability and competitiveness, the final stage in the program was undertaken: the sale of shares in nationalized financial institutions.

As of September 30, 1992, all shares in the first three banks on sale had been placed successfully - Banco Agrícola Comercial, Banco Cuscatlán and Banco de Desarrollo e Inversión - totaling 500 million colones, and the main objective of democratic ownership of the banks had been achieved most successfully. These banks belong to 9,000 shareholders, of whom over 2,300 are employees controlling 17 percent of share capital.

A two-year period was set to entrench the rehabilitation and privatization of nationalized institutions. That period ends in July 1993, after which new national and foreign banks may be established.

IV. GOVERNMENT COMMITMENTS DURING THE PROGRAM

MACROECONOMIC ENVIRONMENT

The Economic and Social Development Plan (1989-1994) calls for macroeconomic stability as a fundamental prerequisite to facilitate economic development with price stability. The Government upholds its commitment to continue to implement the economic program endorsed by the International Monetary Fund and the World Bank. The main objectives for the medium term are:

- (i) to achieve a rate of growth in GDP of approximately 4 percent per annum for 1992;

- (ii) to maintain a stable price policy, leaving market forces to determine exchange rates and interest rates; and
- (iii) to adjust public spending levels and increase fiscal revenues to efficient operational levels.

FINANCIAL SECTOR

The Government's commitment to entrench the financial sector reforms covers the following areas:

- (i) privatization and opening up of the system;
- (ii) supervision and regulation of the financial sector;
- (iii) monetary and credit policy, tax treatment of financial instruments, and a solution to the CRB's financial situation;
- (iv) development finance;
- (v) stock market development;
- (vi) adjustments to enhance the efficiency of social security and private insurance institutions; and
- (vii) creation of new financial instruments.

Privatization

In the area of reducing state activity in commercial banking and finance companies, the Government undertakes to present an action plan to facilitate the privatization of the two remaining commercial banks, the Banco Hipotecario and the four finance companies still in government hands. Prior to disbursement of the second tranche, it will be demonstrated that this plan is being carried out according to the timetable established, and arrangements will be completed for the sale of the institutions in question. Prior to disbursement of the third tranche, the privatization process will be completed and action will be undertaken to phase out the operations of those institutions not privatized. Also, the Government undertakes to continue to open up the financial system by enforcing Article 143 of the Law on Banks and Finance Companies, which stipulates that new national and foreign institutions may freely enter the sector.

Prudential regulation

To supplement the support provided by USAID, cooperation under the program with the country will contribute to implementing a supervisory and regulatory system to ensure that the financial sector operates efficiently. Prior to disbursement of the first tranche, the Government undertakes to present a reorganization plan that will include a new organization chart, information systems, standards and updated manuals

for the SSF, as well as a specific plan to strengthen the Office of the Inspector for Banks and Finance Companies [Intendencia de Bancos y Financieras] (IBF). Prior to disbursement of the second tranche, the Government will implement the new institutional organization chart at SSF, will carry out training plans, adopt manuals, standards and information systems, and strengthen the IBF. Also, a plan will be presented to strengthen the Office of the Inspector for Insurance and Social Security [Intendencia de Seguros y Seguridad Social] (ISS).

Prior to disbursement of the third tranche, the Government undertakes to continue to implement the plan to strengthen the SSF according to the timetable established, as well as ensure that the ISS carries out appropriate supervision and control of the National Institute for Public Employees' Pensions (INPEP), the Salvadoran Social Security Institute (ISSS), and private insurance companies.

Monetary and credit policy

With respect to monetary and credit policy, the authorities would seek to achieve the following objectives prior to disbursement of the first tranche:

- (a) improve financial intermediation, to which end the Government undertakes to free interest rates and eliminate preferential lines of credit, with the exception of two small rediscount lines for education and forestry development; and
- (b) develop alternatives for monetary management, to which end the Government undertakes to initiate a study to reduce statutory reserve requirements by using operations on the open market. The study would cover, *inter alia*, (i) statutory reserves as an instrument for monetary regulation, liquidity management and bank security; (ii) statutory reserve requirements based on asset quality; (iii) adoption of lower reserve requirements and recognition of interest rates consistent with the cost of funds; (iv) issuance of instruments freely tradable on the stock market; and (v) creation of bank safety mechanisms (deposit insurance).

Prior to disbursement of the second tranche, the Government would perform a study on the tax treatment of monetary instruments, which would include, *inter alia*, (i) a review of inequalities in the taxation of financial instruments with respect to individuals and companies; (ii) elimination of taxes affecting companies unilaterally; (iii) amendment of tax legislation that allows companies to deduct financial interest before paying taxes. The authorities would also implement the recommendations made in the study on the use of open market operations for monetary control. Prior to disbursement of the third tranche, they would implement the recommendations of the study on the tax treatment of monetary instruments.

With respect to the recapitalization of the CRB, the Government will present prior to the second tranche a joint plan from the Ministry of

Finance and the CRB to achieve this objective, which will include, *inter alia*, (i) a timetable for capitalization, indicating dates and amounts to be contributed; (ii) an amortization schedule for GOES debt to the CRB; (iii) capitalization of CRB earnings independently of the amortization of debt owed by the Ministry of Finance; and (iv) the adoption of a policy to maintain CRB capital at an appropriate level in real terms. During the third tranche, the CRB will be capitalized according to the recommendations of the plan indicated.

Development finance

The goal to create appropriate mechanisms to serve national economic activities would be achieved by: (i) reorganizing the CRB and (ii) reviewing the situation at state-owned development banks.

In the first case, the CRB's monetary policy functions will be kept separate from its development lending activities. To this end, the Government undertakes to prepare, prior to disbursement of the first tranche, a plan to implement a clear division between monetary policy matters and administration of credit for production sectors. The plan is to include: (i) separating monetary policy-setting and implementation from development banking functions; (ii) allocating credit on a multisector basis; (iii) limiting credit for the nonfinancial public sector in accordance with the law; (iv) maintaining lines of credit with sufficient coverage for administrative and financial expenses; (v) using financial intermediaries supervised by the SSF in allocating credit; and (vi) eliminating direct credit to any nonfinancial public or private institution. Prior to disbursement of the second tranche, the Government will implement a plan to reorganize the CRB on the basis of a plan to be agreed upon with the Bank. In addition to the foregoing, the Government intends to create a second-tier financial institution independent of the CRB, and baseline studies have been conducted in this regard.

In order to improve lending systems for production sectors, the Government undertakes to conclude the diagnostic studies that will determine the creditworthiness and long-term viability of the Banco de Fomento Agropecuario [Agricultural Development Bank] (BFA), the Fondo de Financiamiento y Garantía para la Pequeña Empresa [Small Business Financing and Guarantee Fund] (FIGAPE) and the Federación de Cajas de Crédito [Federation of Credit Unions] (FEDECREDITO), based on the terms of reference agreed upon with the Bank. Prior to disbursement of the second tranche, the Government undertakes to conclude the assessments and studies and to present action plans to implement the recommendations agreed upon with the Bank. Prior to disbursement of the third tranche, the Government would take concrete action to reorganize, privatize or phase out the operations of the institutions referred to above. In addition, it would conduct a study on the Fondo Social de Vivienda [Low-income Housing Fund] (FSV) and prepare an action plan to reorganize its lending activities.

The stock market

As indicated in the preceding paragraph, the Government intends to develop a capital market by adopting a new Stock Market Law. In this connection, prior to disbursement of the first tranche, the Government undertakes to review the draft legislation in connection with the following aspects: issuance and classification of long-term securities; supervisory procedures, registration of issuing bodies, accounting and auditing; organization of a supervisory unit and procedures, and of facilities for stock market creation. Prior to disbursement of the second tranche, the Government undertakes to present the draft bill on stock markets to the Legislative Assembly. Prior to disbursement of the third tranche, the Government undertakes to issue the appropriate rules and regulations in connection with that law and to set up steering and administrative committees to facilitate stock market operations in the country.

New financial instruments

In order to lay the legal groundwork for an expansion in the range of lending instruments, the Government undertakes, prior to disbursement of the first tranche, to prepare and adopt an action plan to identify the regulatory and legal obstacles to the use of commercial assets as loan security. Prior to disbursement of the second tranche, that analysis would be completed and the implementation of measures based on the study would begin. Prior to disbursement of the third tranche, the Government undertakes to place in effect the regulatory framework for the use of commercial property as loan security.

CONTRACTUAL SAVINGS

Social security

Another program objective is to establish the elements necessary to develop a social security system appropriate to the country's needs. To this end, the Government undertakes to set up, prior to disbursement of the first tranche, a committee in charge of coordinating, reviewing and following up on social security policies, as well as reviewing legal, financial, organizational and administrative considerations in connection with the ISSS and INPEP. Prior to disbursement of the second tranche, the Government, through that committee, will identify those areas that require adjustments to enhance the operational efficiency of ISSS and INPEP, taking into account the recommendations of studies to be conducted in this connection, and will present the resulting action plans to the Bank. Among the issues to be covered are the following:

Legal considerations

Present draft legislation to ease rules on the investment of minimum cash reserves, ban the use of such reserves to invest in stocks, bonds or loans issued by the Government or state-owned enterprises, with the exception of the CRB; define and rationalize the institutional structure

of ISSS and INPEP; strengthen the ability of those institutions to recover overdue accounts expeditiously by equipping them with the legal powers and mechanisms required.

Administrative considerations

- (i) perform audits on companies to verify calculations of contributions;
- (ii) develop information systems, setting up individual files for those insured;
- (iii) improve services, including hiring private administrative and health services, if necessary;
- (iv) inform insured persons as to the status of their contributions and benefits; and
- (v) separate the health and pension systems and define them for financial and accounting purposes, to avoid overlapping or blending of their reserves, so that financial statements may be drawn up separately for each of them.

Financial considerations

- (i) improve the financial position of ISSS and INPEP, considering, *inter alia*, maintaining the real value of the minimum cash reserves and financial reserves of the ISSS and INPEP, reviewing the regulations on directed loans, and adopting market interest rates for INPEP lending operations;
- (ii) conduct an actuarial study of ISSS and INPEP to adjust employees' contributions, and maintain the practice of performing periodic actuarial reviews;
- (iii) eliminate the Government's direct contribution to ISSS.

To round out action in the area of social security, prior to disbursement of the third tranche the Government undertakes to: (i) present a strategic plan for a comprehensive redefinition of social security operations; (ii) once the legal amendments are in force, issue the respective regulations; (iii) demonstrate satisfactory progress on implementation of the action plan in the financial area; and (iv) initiate the adjustments recommended in the actuarial study and the training program for staff to be involved in the new systems.

Private insurance companies

Prior to the release of funds under the second tranche, the Government undertakes to begin the study on private insurance, which is to include: (i) an assessment of the companies' financial situation; and (ii) a project to implement a new sector policy. Prior to disbursement of the

third tranche, the Government undertakes to complete the study and present an action plan to restructure the sector, together with a project to implement a new legal and regulatory system for private insurance.

V. PHYSICAL INFRASTRUCTURE

Telecommunications

In this area, the Government undertakes to enhance the sector's efficiency by setting up a coordinating committee and by defining, prior to disbursement of the first tranche, the terms of reference for formulating a telecommunications sector assessment that would cover, *inter alia*: (i) the creation of a regulatory body; (ii) property rights; (iii) scope of competitiveness; (iv) identification of a policy-setting body; and (iv) institutional strengthening of the national telecommunications administration (ANTEL). Prior to disbursement of the second tranche, and once the assessment has been drawn up, the Government will proceed to prepare action plans to formulate new sector policy. Prior to the release of funds for the third tranche, the Government undertakes to demonstrate that satisfactory progress has been made in implementing the plan. To this end, and once the plan has been presented, the Government and the Bank will agree on parameters to define the degree of progress made in compliance with this requirement.

Transport

Prior to release of the second tranche, a study will be performed, in accordance with the terms of reference agreed upon with the Bank, encompassing infrastructure in roads, railroads, ports and airports. The study will cover: (i) the analysis of existing infrastructure; (ii) pricing policy; (iii) subsidies; (iv) sector administration and maintenance; (v) privatization; and (vi) expansion plans. Prior to disbursement of the third tranche, the Government undertakes to conclude the study and to attain satisfactory progress in implementing the respective recommendations.

VI. LEGAL AND REGULATORY MECHANISMS FOR COMMERCIAL ACTIVITIES

Among the legal and regulatory mechanisms affecting commercial activity, the Government undertakes to fulfill the following:

(a) Intellectual property rights

Strengthen the system of protection for intellectual property (copyright, patents, trademarks and commercial secrets) and the enforcement of legislation, in order to encourage and expand private investment.

To this end, prior to disbursement of the first tranche, the Government will assess the consultant's recommendations on draft legislation to protect intellectual property, will present an action plan to improve the administrative and financial aspects of

intellectual property registration, including programs for training programs and the improvement of physical facilities for the intellectual property registry. Prior to disbursement of the second tranche, the Government will place the draft legislation before the Legislative Assembly. Once this stage has been concluded, the Government would issue the appropriate regulations and complete the modernization of the intellectual property register before the Bank releases funds under the third tranche of the loan.

(b) Registration of private investment

Based on the criteria agreed upon with the Bank, the Government undertakes to present an analysis of the procedural stages required for approval and commencement of operation of the private investment register. Prior to disbursement of the second tranche of the loan, the Government undertakes to complete the analysis of the plan's components and present an action plan to reformulate existing procedures and establish the institutional structure to set up a "single window" that will facilitate the approval and effectiveness of private investment. Prior to disbursement of the third tranche, the Government undertakes to make a significant number of the changes recommended and to issue decrees and regulations to establish the "single window", keeping in mind that the intellectual property and commercial registers are important components of such a window.

(c) Commercial register

In order to attract private investment, the Government considers it an indispensable requirement to make the Commercial Register an efficient institution. Accordingly, prior to disbursement it will perform an analysis of its current functioning and review the Commercial Register Law and related regulations. At the same time, a study will be carried out to identify difficulties and improve reliability of data. Prior to disbursement of the second tranche, the Government undertakes to present a plan to modernize the Commercial Register and, if necessary, to amend the law and related regulations. Prior to release of the third tranche of the loan, the Government undertakes to implement the plan to modernize the Commercial Register.

VII. PRIVATIZATION

In order to encourage the development of the market economy, the Government undertakes to present, prior to the first disbursement, a work plan to include regulations, procedures and an agenda for the sale of assets owned by the State, particularly those held by Corporación Salvadoreña de Inversión [Salvadoran Investment Corporation] (CORSAIN) and bodies in the agricultural sector. Prior to the release of funds for the second and third tranches, the Government will demonstrate that the goals of the work plan are being achieved and that arrangements have been completed to effect the sale of the San Bartolo Free Zone and a major

part of the assets held by IRA and INCAFE. According to the Government's plans, this entails the sale of three IRA bulking plants and the INCAFE roasting plant.

VIII. INSTITUTIONAL STRENGTHENING AND STUDIES

In connection with execution of the various components of the investment sector program, the Government of El Salvador undertakes to furnish the resources needed to finance the studies and institutional strengthening required for the operation, in accordance with terms of reference agreed upon with the Bank. To this end, the Government will open a special account for deposit of the funds needed for these purposes. Notwithstanding the foregoing, the Government will request financing under the Multilateral Investment Fund for these studies and institutional strengthening activities. The activities in these areas would be as follows:

- (i) Strengthening of the SSF, in particular the ISSS;
- (ii) Technical assistance for implementation of the "single window" for investment registration;
- (iii) Technical assistance to improve Commercial Register operations;
- (iv) Study for the implementation of appropriate monetary control instruments;
- (v) Analysis to lay the legal groundwork for expanding the range of lending instruments;
- (vi) Assessment of state-run development banking;
- (vii) Development of a financial plan for INPEP and ISSS and implementation of actuarial studies for those institutions;
- (viii) Study for the adoption of a new policy on INPEP investments and interest rates;
- (ix) Study on the situation of private insurance companies and related legislation;
- (x) Assessment of the telecommunications sector; and
- (xi) Study for the optimization of the transportation system.

Prior to the hiring of the consultants to perform the studies and activities for institutional strengthening indicated above, the Government will make available to the Bank the terms of reference for the work to be done and the names and curricula vitae of the consultants. As agreed during the analysis of this operation, the Bank will, as needed, convey its position on those matters within a reasonable period of time.

IX. EXECUTION

The execution of the program will be entrusted to the Ministry of Planning and Coordination and the CRB. To this end, the Economic and Social Advisory Group will, during program execution, act as a liaison and coordinating body between the executing agencies and the Bank. The Group will be responsible for:

- (i) preparing the required information and certifying compliance at each step of loan processing;
- (ii) facilitating the timely provision of funds required for the studies mentioned in the preceding section; and
- (iii) supervising requests for disbursement and their application.

The Government has arranged for the required auxiliary personnel to be assigned to program execution, the CRB will act as a financial agent of the Government, and the loan disbursements will be administered and processed by the Credit Division of that institution.

Yours sincerely,

Mirna Liévano de Márques
Minister of Planning

José Roberto Orellana
President
Central Reserve Bank

PROPOSED RESOLUTION ^{1/}

EL SALVADOR. LOAN /OC-ES TO THE REPUBLICA DE EL SALVADOR
(Investment Sector Reform Program)

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the República de El Salvador, as Borrower, for the purpose of granting it financing to cooperate in the execution of: (a) an investment sector reform program, hereinafter referred to as the "Program"; and (b) a project for the importation of eligible goods, hereinafter referred to as the "Project". This financing shall be subject substantially to the following conditions:

1. Amount and Currencies: Up to US\$90,000,000, or the equivalent in other currencies, except that of El Salvador, which are part of the ordinary capital resources of the Bank, to pay for goods of external origin acquired through international competition, originating in the member countries of the Bank and for such other purposes as may be specified in the loan contract. Payments of amortization and interest shall be made in the currency or currencies specified by the Bank, in a quantity equivalent to the corresponding amount owed, calculated in units of account in terms of dollars of the United States of America, in accordance with provisions to be included in the loan contract.
2. Source of Funds: The ordinary capital resources of the Bank.
3. Guarantee: The general responsibility of the Borrower.
4. Credit Fee: 0.75% per annum on the undisbursed portion of the financing, which fee shall commence to accrue 60 days after the date of the loan contract and shall be payable in dollars of the United States of America on the same dates as the interest.

^{1/} The provisions contained in this Appendix I and in Appendices II, III y IV will be final only when the Board of Executive Directors has approved the loan proposal.

5. Amortization: The Borrower shall amortize the loan in a period of 20 years from the date of the loan contract, by means of semiannual, consecutive and, insofar as possible, equal installments. The first installment shall be paid 66 months after the date of the loan contract.
6. Interest: The Borrower shall pay interest semiannually on the daily outstanding balances of the loan. The first payment shall be made 6 months after the date of the loan contract. The Bank shall determine the rates of interest to be applied during the life of the loan, in accordance with the lending rate policy of the Bank.
7. Disbursement: The term for disbursement of the financing shall expire 3 years after the effective date of the loan contract. Disbursements shall be made in three tranches, each of which shall be in the amount of up to US\$30,000,000, or the equivalent in other currencies which are part of the ordinary capital resources of the Bank. Compliance with the respective conditions precedent shall be required before commencing disbursement of each of the tranches.
8. Special Conditions:
 - (a) The resources of the loan for the execution of the Project shall be utilized in their entirety by the Borrower through the El Salvador Reserve Central Bank, hereinafter "BCR", as financial agent for the latter. The execution of the Program shall be carried out through the Ministry Planning and Coordination of the Economic and Social Development, hereinafter "MIPLAN" or "Executing Agency", and the BCR. If modifications in the macroeconomic or sectorial policies described in the letter referred to in Clause 8(f) herein or in the legal provisions or the basic regulations concerning BCR or MIPLAN are approved which, in the opinion of the Bank, may substantially affect the Project or the Program, the Bank shall have the right to require the Borrower, BCR and MIPLAN to provide explanatory and detailed information in order to determine whether such modification or modifications have or may have an adverse impact on the execution of the Program or the Project. Only after hearing the Borrower, BCR or MIPLAN and assessing their information and clarifications, may the Bank take such measures as it deems appropriate in accordance with provisions to be set forth in the loan contract.
 - (b) The Bank shall initiate disbursements of the first tranche of the financing only when the conditions set forth in this Clause 8(b) have been fulfilled satisfactorily. For this purpose, the Borrower shall demonstrate that:
 - (i) its macroeconomic policy performance is consistent with the objectives of the Program;

- (ii) it has presented to the Bank a plan of action for the privatization of the remaining state-owned financial intermediaries (3 banks and 4 nonbank financial intermediaries);
- (iii) it has presented to the Bank a plan of action for the strengthening of the Financial System Superintendency, which shall include, inter alia, the following aspects: a) an organizational plan; b) a training plan; c) procedures and manuals; d) information system; and e) a specific plan for the strengthening of the Banks and Financial Institutions Intendency;
- (iv) necessary measures have been taken for: a) the liberalization of interest rates; and b) the elimination of preferential credit facilities;
- (v) it has started a study to analyze the extent to which open market operations can be substituted for high reserve requirements in the context of current monetary policy, including, inter alia, the following aspects: a) cost to the financial system; b) reserve requirements in view of the quality of assets; and c) issuance of freely marketable instruments;
- (vi) it has presented to the Bank a plan to separate BCR monetary policy functions from the management of credit for the productive sectors, including, among other aspects: a) granting of development credits with multisectoral criteria; and b) granting of credit only through intermediaries under the Superintendency of the Financial System supervision;
- (vii) it has presented to the Bank appropriate terms of reference for diagnostic studies to determine the solvency and long-term viability of the state-owned development institutions;
- (viii) it has revised the proposed Capital Markets Law to include norms in the areas of: a) issuance of long-term securities; b) supervision, accounting, registration and auditing procedures of issuing firms; c) the establishment of a supervisory unit; and d) requisites for the creation of exchanges;
- (ix) a commission has been created to take charge of the coordination, reviewing and follow-up of social security

sector policies and the reviewing of the legal, financial, organizational and administrative aspects of the Social Security Salvadorean Institute, hereinafter "ISSS" and the Public Employees Pension National Institute, hereinafter "INPEP";

- (x) it has prepared and adopted a plan of action for the identification of the regulatory and legal obstacles for the use of commercial assets as collateral for credit;
- (xi) it has created a steering committee and defined the terms of reference for the formulation of a Telecommunications Sector Diagnosis which shall include, inter alia, the following aspects: a) the regulatory entity; b) ownership rights; c) competition level; d) identification of the entity in charge of future sector policy formulation; and f) institutional strengthening of the National Telecommunications Administration, hereinafter "ANTEL";
- (xii) it has evaluated the recommendations issued by the consultant engaged to review the proposed Intellectual Property Rights Law for purposes of their inclusion in said law;
- (xiii) it has presented to the Bank a plan of action for the improvement of the administrative and financial aspects of the intellectual property registry, including training programs and improvement of facilities;
- (xiv) it has presented to the Bank, on the basis of criteria agreed upon with the Bank, an analysis of the procedural steps required for the approval and starting of operations of the private investment registry;
- (xv) it has presented to the Bank an analysis of the current performance of the Commercial Registry, which includes, inter alia, the following aspects: a) revision of the Commercial Registry Law and its regulations; and b) identification of the difficulties in the handling and lack of reliability of the Registry data;
- (xvi) it has presented to the Bank a working plan which includes regulations; procedures and agenda for the sale of state owned assets, particularly those of the Investment Salvadorean Corporation, hereinafter "CORSAIN" and institutions of the agricultural sector; and

- (xvii) satisfactory progress has been achieved in the compliance of the objectives and provisions set forth in the Sector Policy Letter referred to in Clause 8(f) of this Resolution.
- (c) The Bank shall initiate the disbursement of the second tranche of the financing only when the conditions set forth in this Clause 8(c) have been fulfilled satisfactorily. For this purpose, the Borrower shall demonstrate that:
- (i) its macroeconomic policy framework continues to be consistent with the objectives of the Program;
 - (ii) it has completed the steps to complete the sale of the remaining state-owned financial intermediaries (3 banks and 4 financial intermediaries);
 - (iii) it has implemented the Financial System Superintendency organizational scheme and is complying with the rest of the plan of action for the strengthening of said Superintendency, in accordance with the corresponding implementation schedule;
 - (iv) it has presented to the Bank a strengthening plan for the Insurance and Social Security Intendency of the Financial System Superintendency;
 - (v) it maintains a liberal interest rate regime;
 - (vi) it has carried out a study on tax treatment of financial instruments, which includes, inter alia, the following aspects: a) inequalities in the taxation of individuals vis a vis companies; b) continuation or elimination of tax; and c) fiscal effects of actions to be adopted;
 - (vii) it has implemented the recommendations of the study on monetary control policy;
 - (viii) the Ministry of Finance and the BCR have submitted to the Bank an adequate BCR recapitalization plan, which include, among other aspects, the definition of an amortization plan of the debt of the Government of El Salvador (GOES) with the BCR;
 - (ix) it has implemented the BCR reorganization plan;
 - (x) it has concluded and presented to the Bank the diagnostic studies to analyze solvency and long term viability of the state-owned development institutions

and plans of action for the implementation of the recommendations of these studies agreed upon with the Bank;

- (xi) it has presented the proposed Capital Markets Law to the Legislative Assembly;
- (xii) it has identified, through the commission established for this purpose, the legal, financial and administrative areas necessary to improve the operational efficiency of ISSS and INPEP, taking into consideration the studies prepared by the consultants engaged for that purpose and it has prepared and presented to the Bank the corresponding action plans, which shall include, inter alia, the following aspects:
 - 1) in the legal area, the proposed laws necessary to: a) flexibilize investment policy of reserves; b) prohibit investment in instruments issued by the Central Government and state-owned entities; c) define and rationalize the institutional organization of ISSS and INPEP; and d) strengthen the ability of ISSS and INPEP to collect past due debts in an expeditious manner by providing them with the necessary legal means for that purpose;
 - 2) in the financial area, measures to improve the financial situation of ISSS and INPEP, which include: a) the preparation of an actuarial study to readjust ISSS and INPEP both technically and financially; and b) measures to maintain the actual value of technical and financial reserves; and
 - 3) in the administrative area, evidence that it has progressed satisfactorily in overcoming the administrative deficiencies identified by the commission, including, inter alia, the following measures: b) the development of information systems for the separation and financial and accounting limitation of the health and pension regimes in order to avoid duplication and commingling in their respective reserves; and b) the introduction of individual registry systems;
- (xiii) it has started a study on private insurance which shall include, among others, the following aspects: a) a diagnosis of the financial situation of insurance companies; and b) recommendations for the implementation of a new policy for the sector;

- (xiv) it has concluded the analysis of regulatory and legal obstacles for the use of commercial assets as collateral for credit and has progressed satisfactorily in the implementation of the necessary measures to overcome those obstacles;
- (xv) it has concluded the Telecommunications Sector Diagnosis and has prepared an action plan for the preparation of the new sectoral policy;
- (xvi) it has started a study, pursuant terms of reference agreed upon with the Bank, on road infrastructure, railroads, ports and airports which shall include, inter alia, the following aspects: a) an analysis of the existing infrastructure; b) pricing policy; c) subsidies; d) sector administration and maintenance; e) privatization; and f) expansion plans;
- (xvii) it has presented to the Legislative Assembly the revised draft of the Intellectual Property Protection Law;
- (xviii) it has progressed satisfactorily in the implementation of the plan of action to improve the intellectual property registry, both financially and administratively;
- (xix) it presented to the Bank a plan of action for the reformulation of current procedures and creation of the institutional structure of the "one-stop-shop", which facilitate the approval and carrying-out of private investments;
- (xx) it has presented to the Bank a Commerce Registry modernization plan including, if necessary, draft amendments to the Commerce Registry Law and its regulations;
- (xxi) it has progressed satisfactorily in achieving the goals of the working plan for the sale of state-owned nonfinancial assets and it has completed the steps to carry-out the sale of the San Bartolo free zone; 3 Regulatory Supplies Institute's supply plants; and the INCAFE roasting mill; and
- (xxii) a satisfactory progress has been achieved in the compliance of the objectives and provisions set forth in the Sector Policy Letter referred to in Clause 8(f) of this Resolution.

- (d) The Bank shall initiate the disbursement of the third tranche of the financing only when the conditions set forth in this Clause 8(d) have been fulfilled satisfactorily. For this purpose, the Borrower shall demonstrate that:
 - (i) its macroeconomic policy framework continues to be consistent with the objectives of the Program;
 - (ii) it has completed privatization process for the remaining state-owned financial intermediaries;
 - (iii) it has eliminated the prohibition for the establishment of new banks and financial institutions;
 - (iv) it has progressed satisfactorily in the implementation of the plan of action for the strengthening of the Financial System Superintendency, according to the implementation schedule;
 - (v) it has progressed satisfactorily in the implementation of the plan of action for the strengthening of the Insurance and Social Security Intendency of the Financial System Superintendency;
 - (vi) it maintains a liberal interest rate regime;
 - (vii) it has implemented the recommendations of the study on tax treatment of financial instruments;
 - (viii) it is proceeding to the recapitalization of BCR in accordance with the recommendations of the Ministry of Finance and BCR plan;
 - (ix) it has progressed satisfactorily in the implementation of the plan of action to comply with the recommendations of the diagnostic studies of the state-owned development institutions agreed upon with the Bank;
 - (x) it has issued the Capital Markets Law regulations;
 - (xi) it has presented to the Bank a strategic plan for a comprehensive redefinition of the future operation of the social security system;
 - (xii) once the new laws concerning the financial, administrative and institutional reforms in ISSS and INPEP have become effective, appropriate regulations have been approved;

- (xiii) satisfactory progress has been achieved in the implementation of the plan of action to improve the financial situation of ISSS and INPEP, in accordance with the corresponding implementation schedule and it has started implementing the actuarial adjustments recommended in the study to readjust ISSS and INPEP both technically and financially;
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 - (xiv) it has trained the personnel to be involved in the new social security system;
 - (xv) it has concluded and submitted to the Bank the study on private insurance, along with a plan of action for restructuring the sector and an implementation project for a new private insurance legal and regulatory regime;
 - (xvi) it has become effective the new legislation for the use of commercial assets as collateral for credit;
 - (xvii) it has progressed satisfactorily in the implementation of the plan of action for the preparation of the new telecommunications sector policy;
 - (xviii) it has concluded the study on the transportation sector and it has progressed satisfactorily in the implementation of its recommendations;
 - (xix) once the new Intellectual Property Rights Law has become effective, appropriate regulations have been approved;
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 - (xx) modernization of the Intellectual Property Registry has been completed in accordance with the corresponding plan of action;
 - (xxi) satisfactory progress has been achieved in the implementation of the "one-stop-shop";
 - (xxii) the Commerce Registry modernization plan has been implemented;
 - (xxiii) satisfactory progress has been achieved in meeting the goals of the working plan for the sale of the remaining state owned assets; and
 - (xxiv) a satisfactory progress has been achieved in the compliance of the objectives and provisions set forth in the Sector Policy Letter referred to in Clause 8(f) of this Resolution.
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- (d) The resources of the financing may be used to compensate the Borrower for foreign currency expenses incurred in the acquisition of imported goods acquired within 6 months prior to the date of the loan contract, provided that requirements substantially similar to those of this Resolution and the loan contract have been fulfilled and that the amount does not exceed the equivalent of US\$45,000,000.
- (e) In order to utilize the resources of the financing to reimburse goods acquired after the effective date of the loan contract, by either the public or private sector, the system of international public bidding shall be followed in each case in which the value of such acquisitions exceeds the equivalent of US\$5,000,000. For purchases below such limits, acquisitions by the public sector shall follow the normal procedures established by local law to the extent such law does not conflict with the Bank's procurement policies and acquisitions by the private sector shall follow established commercial practices applicable to the goods in question; where possible, such acquisitions by the private sector shall be made on the basis of quotations from eligible suppliers from at least two member countries of the Bank. Acquisitions shall be subject to the procedures to be appended as an Annex to the loan contract. The provisions of this Clause 8(e) shall not apply to the use of the resources of the financing in the acquisition of crude oil and petroleum fuel products purchased in international markets.
- (f) The Borrower and the Bank have agreed that the substantial content of the Letter of Sectoral Policy of _____, 1992, from the Borrower to the Bank describing a plan of actions, objectives and policies designed to achieve structural adjustment of the investment sector, which states the Borrower's commitment to the execution of the Program and to the implementation of certain macroeconomic policies, is an integral part of the Program, for the purposes of Recommendation 1 of Appendix II.
- (g) The Bank shall establish such inspection procedures as it deems necessary to assure the satisfactory development of the Program and execution of the Project, and the Borrower shall extend all cooperation which is required for the most effective accomplishment of this purpose. From the amount of the financing, the sum of US\$900,000 shall be allocated for credit to the accounts of the Bank to meet expenses of general inspection and supervision.

RECOMMENDATIONS

- A. It is recommended that the following conditions, to be fulfilled to the Bank's satisfaction, be included in the loan contract, in addition to the conditions set forth in the Resolution:
1. The Borrower and the Bank shall meet at least quarterly, at the request of either party and on the date and place agreed upon, to exchange views on: (a) the progress achieved in carrying out the Program and compliance with the obligations set forth in Clauses 8(b), 8(c) and 8(d) of Appendix I; and (b) the consistency of El Salvador's macroeconomic framework with the Program. Prior to each such exchange of views, the Borrower shall furnish the Bank, for its review and comment, a report in such detail as the Bank shall reasonably request on the fulfillment of the obligations referred to in sub-paragraphs (a) and (b) of this Recommendation.
 2. The Borrower shall maintain separate accounting records and an appropriate internal control structure, to allow the Bank to identify imports financed with resources of the loan as well as the respective disbursements.
 3. With resources of the financing, no disbursement shall be made for:
 - (a) imported goods included in the groups or sub-groups of the United Nations Standard International Trade Classification (SITC) list referred to in paragraph VI of Appendix III;
 - (b) expenditures in Salvadorean colones or for goods supplied from El Salvador;
 - (c) imported goods acquired under contracts in an amount less than US\$10,000 equivalent;
 - (d) imported goods financed in foreign exchange, under medium or long terms;
 - (e) imported luxury goods;
 - (f) imported weapons; and
 - (g) imported goods for the use of the armed forces.

4. The Borrower shall present to the Bank, within 90 days following the last disbursement of each tranche of the Financing, a statement of account for such tranche detailing the imported goods which were the basis for the disbursement requests for the corresponding tranche. Such statements of account shall be duly certified, in accordance with terms of reference agreed upon with the Bank, by an independent firm of public accountants designated by the Borrower and acceptable to the Bank.
- B. Annexes substantially similar in content to Appendix III, The Program and the Project, and Appendix IV, Tender Procedures, shall be included in the loan contract.

THE PROGRAM AND THE PROJECT

(Annex A of the loan contract).

I. PROGRAM OBJECTIVE

- 1.01 The Program objective is to support the continuation of policy reforms started in the financial and telecommunications sectors; in the privatization of state-owned enterprises and in the improvement of the legal and institutional framework in order that, through its timely implementation, national and foreign investment is stimulated thus promoting economic growth with price stability.

II. DESCRIPTION

- 2.01 In accordance with the foregoing, the Program is aimed at: a) ensuring the adoption of adequate macroeconomic policies; b) concluding the privatization of financial institutions; c) establishing a prudential regulatory and supervisory system for the financial sector; d) supporting the continuation and deepening of the monetary and credit policy changes; e) creating appropriate mechanisms to address productive activities long-term financing; f) promoting the establishment and development of the stock market; g) preparing the necessary elements to develop an adequate social security system; h) creating the legal basis to expand the universe of credit documents; i) improving the telecommunications sector performance; j) creating the basis for the optimum performance of the transportation sector k) strengthening the intellectual property protection system; l) improving the commerce and private investments registries; and m) promoting the development of a market economy through the sale of current state-owned nonfinancial assets.

III. THE PROJECT

- 3.01 The Project consists of the importation of eligible goods by the public and private sectors in El Salvador. The eligibility criteria for such goods is set forth in Recommendation A.3 of Appendix II.

IV. FINANCING

- 4.01 The Bank shall finance the Project in an amount up to the equivalent of US\$90,000,000 in foreign exchange from its Ordinary Capital resources. The financing provided by the Bank shall be fast-disbursing and will be disbursed in three tranches, each of up to US\$30,000,000 or its equivalent in other currencies. Cofinancing will be provided by the Government of the Swiss Confederation as a nonreimbursable contribution in the US dollar equivalent of 10,000,000 Swiss Francs.

V. USE OF THE RESOURCES

- 5.01 The resources of the loan shall be used to: (a) reimburse 100% of the cost in foreign exchange of eligible imports, up to an amount equivalent to US\$89,100,000; and (b) meet the expenses of general inspection and supervision, up to an amount equivalent to US\$900,000.

VI. NEGATIVE LIST

- 6.01 The goods referred to in Recommendation A.3(a) of Appendix II are included in the following groups and sub-groups of the United Nations Standard International Trade Classification (SITC)^{1/}, including any amendment that may be made to these groups or sub-groups and of which the Bank shall notify the Borrower:

<u>Groups</u>	<u>Sub-groups</u>	<u>Description of item</u>
112		Alcoholic beverages
121		Tobacco, unmanufactured; Tobacco refuse
122		Tobacco, manufactured (whether or not containing tobacco substitutes)
525		Radioactive and associated materials
667		Pearls, precious and semi-precious stones, worked or unworked
718	718.7	Nuclear reactors, and parts thereof, fuel elements (cartridges), non-irradiated for nuclear reactors
897	897.3	Jewelry of gold, silver or platinum group metals (except watches, and watch cases) and goldsmiths' or silversmiths' wares (including set gems)
971		Gold, non-monetary (excluding gold ores and concentrates)

VII. PROCUREMENT

- 7.01 All procurement of eligible imported goods shall have been carried out allowing the free competition of goods originating in the Bank's member

See the Standard International Trade Classification, Revision 3 (SITC, Rev. 3), published by the United Nations in Statistical Papers, Series M, No. 34/Rev. 3 (1986).

countries, taking into account the provisions of Clause 8(e) of Appendix I. Accordingly, no conditions shall be imposed in the acquisition procedures or bidding conditions that might limit or restrict the offering of goods from those countries.

VIII. CONSULTING SERVICES

- 8.01 With respect to consulting services to be engaged by MIPLAN and BCR to undertake the studies associated with the Program, the Bank reserves the right to review and approve, prior to proceeding with the corresponding hire, the names and background of the firms or individual consultants selected, their terms of reference, and the agreed fees. This provision shall not apply when resources other than those from the Borrower are used for such contracts.
- 8.02 The studies and institutional strengthening activities to be carried out within the Program, with the Borrower's own resources, are the following:
- i) Strengthening of the Financial System Superintendency and particularly the Social Security and Insurance Intendency;
 - ii) Technical assistance for the implementation of the "One-Stop-Shop" for the registry of investments;
 - iii) Technical assistance to improve the Commerce Registry performance;
 - iv) Study for the implementation of appropriate monetary control instruments;
 - v) Analysis for the establishment the legal basis to expand the universe of credit instruments;
 - vi) Diagnosis of the state development banks;
 - vii) Development of a financial plan for ISSS and INPEP and implementation of actuarial studies for those institutions;
 - viii) Study for the adoption of a new interest rate and investment policy for INPEP;
 - ix) Study on the status of private insurance companies and corresponding legislation;
 - x) Telecommunications sector diagnosis; and
 - xi) Study for the optimum performance of the land transportation system.

TENDER PROCEDURES FOR SECTOR
ADJUSTMENT OPERATIONS

(Annex B of the Loan Contract)

(Investment Sector Reform Program)

I. APPLICABILITY

- 1.01 This procedure shall govern all procurement of eligible goods connected with the Project, whether carried out by the public or private sector. Procurement shall only be for goods imported from member countries of the Bank, as stipulated in paragraph 2.01(b).

II. PUBLIC SECTOR PROCUREMENT. AMOUNT ABOVE THRESHOLD

- 2.01 The procurement of goods carried out by the public sector ¹ in amounts greater than the equivalent of US\$5 million, must comply with the following requirements in order to be eligible for disbursements under the sector adjustment programs:

(a) International public bidding

The system of international public bidding shall be used. The procedures and specific requirements for the bidding shall permit the unrestricted competition of bidders from the member countries of the Bank. Consequently, no conditions that would limit or restrict the offer of goods or the participation of bidders from such countries may be imposed.

(b) Origin of goods

Only imported goods from member countries of the Bank will be eligible. The origin of a good shall be:

- (i) the country in which the material and/or equipment has been mined, grown, produced, manufactured or processed; and
- (ii) the country in which, through manufacturing, processing or assembly, another commercially recognized article results which differs substantially in its basic characteristics from any of its imported components. The nationality or country of origin of

¹ This sector includes enterprises or other institutions in which state participation is greater than 50% of the capital.

the firm producing or selling the goods or equipment shall not be considered in determining the origin of such goods.

(c) Notices of the call to bid and invitations to bid

Calls to bid published in the press must specify, at a minimum, the following information:

- (i) exact description of the goods for which the call for bids is being held;
- (ii) the office or place, date and time at which the bidding documents, including the bidding guidelines, plans, specifications, and draft contracts may be obtained;
- (iii) the office where the bids are to be delivered and the authority responsible for their approval and award; and
- (iv) the place, date and time at which the bids will be opened in the presence of the bidders or their representatives.

(d) Publicity

The call for bids shall be:

- (i) published in at least one of the most widely circulated newspapers in the country on at least three separate occasions. There must be a space of at least three calendar days between each of the three public notices; and
- (ii) published in a journal or specialized newspaper with wide international circulation; or in the United Nations journal entitled Development Business; or distributed to the embassies of the member countries. To that effect, the tendering entity shall deliver copies of the invitation to bid on the same date as the invitation is delivered to the national newspapers for publication. If there are no embassies, it shall be delivered to the respective consulates.

(e) Clarity of the documents

The bidding documents prepared by the tendering entity must be coherent and comprehensive. Particular care must be taken to ensure that the goods to be supplied are described with sufficient clarity and in sufficient detail. The cost of such documents must be reasonable.

(f) Free access to the tendering entity

The tendering entity shall be available, once the bidding documents have been collected by bidders and up to the time the bids are opened, to answer questions or clarify the bid documents for bidders. These

inquiries shall be answered promptly by the tendering entity, and clarifications, if any, made available to other interested parties.

(g) Standards of quality

If particular standards with which equipment or materials must comply are cited, the specifications should state that goods meeting other authoritative standards, which ensure an equal or higher quality than the standards mentioned, will also be accepted.

(h) Specifications for equipment: brand names

Descriptions contained in specifications should not prescribe brand names, catalog numbers or types of equipment of a specific manufacturer unless it has been determined that this is necessary to ensure inclusion of certain essential design, performance or construction features. In such a case the reference should be followed by the words "or equivalent," and a measure to determine the "equivalence" included. The specifications should permit offers of alternate equipment, articles or materials which would have similar characteristics and provide equal performance and quality to those specified. In special cases with previous approval of the Bank, specifications may require that a proprietary item be supplied.

(i) Currency Clause

The bidding documents should state the currency to be used in payment.

(j) Bid bonds

Bid bonds or other tender guarantees, if any, should not be set so high² or their validity stretched out over long periods, as to discourage suitable bidders from tendering. Bid bonds shall be returned as follows:

(i) to the winning party once the contract is executed;

(ii) to the second- and third-place bidders within a term of no more than three months from the date of the award or upon execution of the contract, if the latter occurs prior to such deadline. Nevertheless, if such bidders indicate lack of interest, the bond shall be returned within five days following the award; and

² Some bidding practices limit the amount of the bid bonds (tender guarantees) to 1% of the price of the contract. Others recommend that the agencies calling for bids set a fixed price in cash for all bidders instead of requiring the bidder to base his guarantee on a given percentage of the value of his bid. This is to avoid undue publicity of the price of each tender prior to the opening of the bids, should the amount of the guarantee or bid bond become public knowledge.

(iii) to other bidders within five days following the award.

(k) Deadlines for submission of bids

The deadline for submitting bids shall not be less than 45 calendar days from the date of the last publication of the invitation to bid or the date of availability of bidding documents, whichever is later.

(l) Confidentiality of bids

The officers in charge of receiving the envelopes containing bid registration forms shall verify that such envelopes are delivered properly sealed. These envelopes shall be kept in a safe place until the date set for their opening. Once opened, no copies shall be taken of these documents. Except as may be required by law, information relating to the examination, tabulation, clarification and evaluation of bids and recommendations concerning awards, may only be communicated to officials of the tendering entity officially concerned with the respective bidding procedures, after the public opening of bids and before the announcement of the award of contract to the successful bidder.

(m) Modification or extension of the bidding documents

Any modification or extension of the bidding guidelines, specifications, or the filing date must be communicated to all interested parties who are in possession of the bidding documents. In the event that such modification or extension is substantial, in the opinion of the tendering entity, there must be an interval of at least 30 calendar days between the date of notice to interested parties and the date bids are opened.

(n) Consultations should not modify the bidding documents

Consultations on the interpretation of bidding documents addressed to the tendering entity by interested parties may not be used to modify or expand the bidding guidelines and specifications. Consultations and replies thereto shall in no case cause a suspension of the term for presentation of bids.

(o) Opening of bids

Offers shall be submitted in writing in sealed envelopes. They must be signed by the legal representatives of the bidders and comply with the prerequisites set forth in the bidding documents. They shall be opened in public on the scheduled date and hour. Representatives of the bidders may attend the bid opening and shall be entitled to inspect the bids. Bids received after the filing date shall be returned unopened. The names of the bidders, the price of each bid, the term and amount of guarantees, and any substantial change submitted separately, before the deadline but after the principal bid is submitted, shall be read aloud. All of the above shall be recorded in the proceedings, which shall be

signed by the representative of the tendering entity and by any bidders present who so desire.

(p) Clarification of bids

The tendering entity may request clarifications from the bidders with respect to their tenders. Clarifications requested or given shall not alter the essence of the offer or its price, nor shall they violate the principle of bidder equality.

(q) Analysis and comparison of bids

(i) Purpose

Bids shall be analyzed and evaluated to determine whether they comply with the terms and conditions stipulated in the bidding documents, and the value of each bid shall be fixed for the purpose of awarding the winning bid.

(ii) Lowest evaluated bid

In addition to the bid price adjusted to correct arithmetical errors, the tendering entity may also consider other relevant factors in determining the lowest bid.

(iii) These factors should be expressed in monetary terms or, as a minimum, given a relative weight according to criteria specified in the bidding documents. No criteria may be used in bid evaluation that are not set forth in the bidding documents. The amount of escalation for price adjustments, if any, included in the bids should not be taken into consideration.

(iv) The currency or currencies in which the price offered in each bid would be paid if that bid were accepted, should be valued in terms of a single currency selected by the tendering entity for comparison of all bids and stated in the bidding documents. The rates of exchange to be used in such valuation should be the selling rates published by an official source, and applicable to similar transactions on the day bids are opened or at such later date (30 or 60 days after bid opening) as shall be specified in the call for bids.

(v) Regional margin of preference

The following regional margin of preference may be applied in the comparison of bids:

Where suppliers of a country (other than the country of the borrower) that is a party to an integration agreement,³ to which the country of the borrower is also a party, participate in such bidding, such suppliers of goods are entitled to a regional margin of preference utilizing the following criteria:

- (1) Goods shall be considered to be of regional origin if they originate in countries that are parties to an integration agreement to which the borrower is also a party and comply with the standards governing origin and other matters relating to trade liberalization programs established in the respective agreements;
- (2) The value added is not less than that stipulated for the national margin of preference; and
- (3) In comparing foreign offers the borrower may add to the price offered for goods originating in countries not parties to the respective integration agreement, either 15% or the difference between the import duty applicable to such goods when they originate in countries not parties to the integration agreement and that which is applicable to those goods when
 - they originate in countries which are parties to the agreement, whichever is lower.

(vi) Rejection of bids

The tendering entity shall reject all bids where no bids meet the intent of the specifications, or where there is evidence of lack of competition and/or collusion. The tendering entity may reject all bids if the low bids exceed the official estimate by an amount sufficient to provide reasonable justification for such action. In such cases, new bids should be requested from at least all who were invited to submit bids in the first instance and a reasonable amount of time should be allowed for the submission of the new bids. In the absence of a 100% performance bond, individual bids may be rejected in cases where the particular bid is so much lower than the official estimate that it is reasonable to conclude that the bidder will not be able to complete the works or supply the product within the specified time at the price offered.

³ For purposes of this provision, the Bank recognizes the following regional or subregional integration agreements: (i) Central American Common Market; (ii) Caribbean Community; (iii) Cartagena Agreement; and (iv) Latin American Integration Association. If the country where the borrower is located has signed more than one integration agreement, either the subregional margin of preference or the regional margin of preference may apply depending on the country of origin of the article to be procured.

(vii) Bid evaluation report

The tendering entity shall prepare a detailed report on the analysis and comparison of bids, describing precisely the reasons for selection of the lowest evaluated bid.

(r) Award of contract

The award shall be made to the bidder whose responsive bid has been determined to be the lowest evaluated bid.

(s) Notification of award and signature of the contract

The tendering entity shall notify all bidders of the award at the addresses they have provided within three working days after the date of the award. The contract to be signed shall not modify the winning bid or the terms and conditions stipulated in the bidding documents.

(t) Modification of the award

If for any reason the winning bidder does not sign the contract within the period set for that purpose, the tendering entity may award it, without a new invitation to bid, to the next lowest responsive bidder.

(u) Bidding declared null and void

The tendering entity may, on reasonable grounds, declare the bidding null and void.

(v) Effects of the declaration

Once the bidding is declared null and void, the tendering entity shall issue a second invitation to bid following the provisions set forth in this procedure. If the second bidding is declared null and void, the tendering entity shall establish the procedure to be followed for the procurement involved.

(w) Due process

This procurement procedure must guarantee the legal protection of bidders, establishing the right of administrative and judicial review.

III. PUBLIC SECTOR PROCUREMENT. AMOUNTS BELOW THRESHOLD

3.01 The procurement of goods carried out by the public sector in amounts less than the equivalent of US\$5 million, or any other smaller amount to which the borrower and the Bank may agree, must comply with the following requirements in order to be eligible for disbursement under sector adjustment programs:

- (a) It must be carried out in accordance with the procedures prescribed under local law.

- (b) When such procedures require public bidding, the latter must be acceptable to the Bank, and must therefore satisfy all the pertinent conditions and guarantees required under Chapter II of this Procedure.

IV. SUPERVISION BY THE BANK

The Bank reserves the right to conduct ex post supervision of the different stages and documents of each procurement connected with the Project, after the contract has been signed with the respective winning bidder. For this purpose, the borrower agrees to provide the Bank with all the documentation it may require regarding the procurement to be supervised. The Bank reserves the right not to make disbursements for goods which have been procured without complying with the regulations prescribed in this Procedure.

V. PRIVATE SECTOR PROCUREMENT

In order to be eligible for disbursement, the procurement of goods by the private sector:

- (a) for contracts whose amounts are above US\$5,000,000, public international bidding shall be required pursuant to the terms specified in Section 2.01 of these procedures; and
- (b) for contracts whose amounts are less than US\$5,000,000, purchases shall be made following established commercial practices and, where possible, on the basis of quotations from eligible suppliers from at least two member countries of the Bank.

VI. REIMBURSABLE IMPORTS

In order to be eligible for disbursement under the Project, all procurement of goods must:

- (a) have been carried out according to the regulations of this Procedure; and
- (b) have been carried out for goods not included in the categories of goods whose import the borrower and the Bank have agreed to exclude from the financing, as stipulated in Annex A of this Contract.