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MULTILATERAL INVESTMENT FUND
NOT FOR PUBLIC USE**

HONDURAS

**EXPANSION OF BUSINESS NETWORKS FOR MICRO- AND SMALL
ENTERPRISE AND INTEGRATION OF PRODUCTION CHAINS**

(TC-98-10-37-7)

DONORS MEMORANDUM

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ABBREVIATIONS

ANDI	National Industrial Association
ANMPIH	National Association of Small and Medium-Sized Manufacturers of Honduras
CADERH	Centro Asesor para el Desarrollo de Recursos Humanos [Human Resources Development Advisory Center]
CERTEC	Centro de Recursos y Tecnología [Resources and Technology Center]
MIF	Multilateral Investment Fund
PDO	Private development organization
UNIDO	United Nations Industrial Development Organization
UNITEC	Central American University of Technology

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(TC-98-10-37-7)

EXECUTIVE SUMMARY

EXECUTING AGENCY: Centro de Recursos y Tecnología [Resources and Technology Center] (CERTEC).

BENEFICIARIES: The direct beneficiaries of this project will be some 3,424 microenterprises and small businesses served by CERTEC and by private development organizations (PDOs) to which the business network technology will be transferred.

OBJECTIVES: To increase the productivity and competitiveness of microenterprise and small manufacturers, promoting the organization of business networks and creating production links between them.

DESCRIPTION: Through the creation of business networks, transfer of a methodology for serving networks, and the formation of production chains for local organizations serving the sector; and the development of a methodology to serve local production systems, CERTEC will help 3,424 microenterprises and small businesses increase their levels of efficiency and competitiveness.

FINANCING:	Modality	Grant
	CERTEC:	US\$ 690,000
	MIF (Window III):	<u>US\$ 700,000</u>
	Total:	US\$1,390,000

EXECUTION	Implementation period:	4 years
SCHEDULE:	Disbursement period:	5 years

ENVIRONMENTAL AND SOCIAL REVIEW: This project includes activities to regulate the transfer and use of clean technologies as well as active participation by women in setting up business networks.

SPECIAL CONTRACTUAL CONDITIONS: The first disbursement will be subject to the following conditions: (i) presentation of the terms of reference for engaging a project leader and other consultants (paragraph 4.4); and (ii) presentation of a certified copy of the minutes of the partners meeting, placing on record the founding partners'

commitment to contribute equity in an amount equivalent to US\$20,000 (paragraph 5.6).

Contractual conditions during execution: (i) submit a business plan, to the Bank's satisfaction, during the first six months of execution, which will need to be updated annually (paragraphs 4.6 and 6.1); and (ii) the project includes two evaluations, an interim evaluation two years after signing the agreement, and a final valuation four years after signature the agreement, which must be submitted by CERTEC, to the Bank's satisfaction (paragraph 6.2).

Given the project's financial requirements, it is proposed that a revolving fund of 20% of the contribution be set up. However, disbursement will be made after review of the contribution (paragraph 5.5). The Bank may suspend disbursements if it is found that CERTEC has not fulfilled the goal of gradually removing subsidies (paragraph 5.4).

I. COUNTRY ELIGIBILITY

- 1.1 The Donors Committee declared the Republic of Honduras eligible for all types of financing under the Multilateral Investment Fund (MIF) on December 14, 1993.

II. BACKGROUND INFORMATION

A. Networks of microenterprise and production chains

- 2.1 For the purposes of this project, a business network consists of horizontal forward or backward integration intended to resolve production bottlenecks, by means of joint access to supplies of raw materials or the joint supply of products to the market. In turn, production chains consist of the micro-application of flexible specialization, integrating various companies by specialization, product and/or production process, i.e., vertical integration, although it sometimes includes integration for negotiations with suppliers or the sale of final products. 1/
- 2.2 In creating and developing business networks, companies 2/ are identified by selection criteria, 3/ and advised in defining the basic structure and work plans in the internal organization of the network. Technical assistance is also provided for the restructuring of production processes, the design and participative formulation of feasibility studies, improved management and financial tools and the strengthening of stable relationships between groups and the industrial manufacturing environment.
- 2.3 One component of the methodology consists of promoting a culture of savings. A key aspect of creating and legalizing groups is the weekly contribution which, depending upon the group's level of development, ranges from US\$10 to US\$20. These funds are invested

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- 1/ The concept of business networks or "clusters" and production chains was developed some years ago, with the most successful and well-known experiences being the industrialization of certain areas of Italy and other developed countries. The process to be applied by the project executing agency is based on the traditional concept, but has been adapted to Honduran microbusiness conditions.
 - 2/ Experience shows that at least 30 companies must be promoted in order to succeed in consolidating groups which initially range from 10 to 12 organizations, resulting in a final consolidation averaging between 8 and 10 companies.
 - 3/ Type of business, age, geographic location, company organization, production capacity, number of workers, sales performance, social integration, interest in participating in a network, and other criteria.

by the group in the working capital needed to promote network integration projects.

B. Microenterprises in Honduras and their short-term goals

- 2.4 According to a recent study by the Covelo Foundation, Honduras has 194,700 small, nonagricultural businesses, ^{4/} which account for 20% of GDP and employ some 456,000 people (i.e. 25% of the economically active population). One half of these operations are engaged in trade, 36% in manufacturing, 10% as service providers and 4% in sundry services.
- 2.5 Of the total, 85% are considered as being subsistence level, i.e., they create a maximum of one direct job; 14% are capital accumulation enterprises, generating between 2 and 10 direct jobs; and only 1% are small companies or companies in transformation with the possibility of creating up to 49 jobs. One half of all microenterprises and small businesses in Honduras are owned by women (50.3%), and their presence in manufacturing, especially relatively smaller and less developed companies, is particularly significant.
- 2.6 Despite the existence of some fairly old companies, the vast majority were created recently. In fact, 54% have been in existence for less than three years, suggesting high volatility in the sector, with companies being created and liquidated rapidly.
- 2.7 Productivity in the sector has been affected by a lack of technology, information and training infrastructure and close relationships with industry, which involves continual innovation in the sector. It is therefore necessary to offer support linking it up to other sectors, in order to improve the levels of linkage and productive complementarity and to stimulate a continual updating of the productive processes.
- 2.8 The ability of a local or national production system to successfully compete in a global market depends on its ability to develop links between the various business and institutional participants in the industry, which permits an appropriate response to market demands by complementing production capacities and generating economies of scale.
- 2.9 In this context, it has been shown through experience that business networks create a permanent environment of cooperation and complementarity between companies, serving as a catalyst for restructuring production in each company. In fact, business networks allow significant benefits to be achieved: enhanced

^{4/} "La micro, pequeña y mediana industria en Honduras" [Micro, small and medium-sized enterprises in Honduras], José María Covelo Foundation, 1996.

learning capacity, economies of scale, specialization and production complementarity, making the most of externalities in the local environment.

C. Complementarity with other projects

- 2.10 This project is compatible with the MIF project ATN/MH-5591-HO, approved on June 4, 1997, for business investment in training, executed by the Centro Asesor para el Desarrollo de Recursos Humanos [Human Resources Development Advisory Center] (CADERH), and specifically project ATN/MH-5128-HO, a MIF program for PROEMPRESAH, the objective of which is to support the transformation of microenterprises and small businesses into successful businesses. This latter program may be a strategic alliance with Centro de Recursos y Tecnología [Resources and Technology Center] (CERTEC), the executing agency for the present project (paragraph 4.1).

III. THE PROGRAM

A. Objective

- 3.1 The project's objective is to increase the productivity and competitiveness of microenterprises and small industry, promoting the organization of business networks and achieving production chains between them. In order to attain this objective, some networks will be served and developed directly; the methodology will be transferred and disseminated to institutions that offer technical assistance to micro- and small enterprises. Ultimately, the idea is to develop a local production development system methodology based on business networks.
- 3.2 Experience gained during execution of this project will be documented to serve as a basis for replicating it in the future.

B. Components

- 3.3 The project is divided into the following components: (i) business networks; (ii) transfer of methodology; and (iii) development of local production systems.

1. Business networks (US\$263,000)

- 3.4 Although the project does not assume an increase in the number of networks served, the networks should be renewed by means of a graduation from current networks and the incubation and development of new ones. The average time dedicated to consolidating a network is two years, and consequently 16 new networks will be created, directly serving 160 business owners, as specified in Annex I (Logical framework matrix). In order to achieve this objective,

technical strengthening will be required, which will ensure the transfer of technology and the strengthening of the business association methodology itself.

2. Transfer of methodology (US\$910,000)

- 3.5 Given the success reported by businesses served directly, but primarily the low operating capacity available to address all those interested in associating on a national scale through business networks, CERTEC has included as part of its business plan the possibility of transferring its methodology development to these organizations.
- 3.6 In order to carry out this task, personnel (paragraph 4.4) will be hired to provide the technical assistance for this transfer. This process will be carried out through the training and instruction of personnel as "network promoters". The training of such promoters will be based on both theory and field work directly with businesses during the process of group training. Thanks to this component, the promoters of 68 PDOs will be trained and 3,264 businesses will be served. 5/

3. Local production development systems (US\$119,000)

- 3.7 Production development systems consist in applying the technique of association by forming business networks within cities, in order to facilitate regional economic development, based on local comparative advantages through access to supplies and markets. By strengthening the regional economies and their negotiation capacity, it may be possible to establish alliances with other cities.
- 3.8 Although CERTEC has begun to make inroads into the field of local production system development, its efforts are still embryonic. For this reason, a pilot subprogram has been developed.

IV. PROJECT EXECUTION

A. Executing agency

- 4.1 The project executing agency is CERTEC, a private, nonprofit organization founded in June 1997 with a view to improving the competitiveness of companies and public and private entities involved in the development of industry in Honduras, with a focus

5/ There are approximately 600 PDOs in Honduras, of which about one half are registered; the majority work in production development structures.

on microenterprise and small business. It was created as a consequence of an agreement between UNIDO and the Honduran government.

- 4.2 CERTEC manages 8 direct networks consisting of 97 businesses in the machine tool, footwear and leather, garment making and agriculture sectors. It also has 12 indirect networks, managed through agreements with entities to which the network methodology is being transferred. Through these networks, CERTEC has access to over 400 microenterprises.
- 4.3 In addition, close relationships have been developed with entities of national and local governments, private national development organizations, marketing centers and business associations and technology and information centers such as the National Industrial Association (ANDI), the National Association of Small and Medium-sized Manufacturers of Honduras (ANMPIH), and the Central American University of Technology (UNITEC).

B. Execution

- 4.4 This project will be executed by a project leader, a business network coordinator, a local production development systems coordinator, an environmental consultant and the field personnel needed to train network promoters in other development institutions. The terms of reference for the project leader and the various consultants must be submitted to the Bank's satisfaction as a condition precedent to the first disbursement.
- 4.5 It will also have the support of two short-term consultants. One will be a technical consultant in business network methodology and production chains, and the other an administrative and financial consultant. The technical consultant will help consolidate the methods developed by CERTEC based on field work, and the administrative/financial consultant will help establish appropriate management information systems.
- 4.6 The process of graduation and renewal of the networks themselves, the specific operating mechanism for transferring the methodology to interested PDOs and the way in which research and promotion of the development of local production systems will be carried out are aspects that will form part of the updated business plan which CERTEC must submit, to the Bank's satisfaction, during the first six months of project execution. Other aspects of this business plan are the specific means in which CERTEC will continue to promote the participation of women in the creation of networks, and the specific support of the environmental adviser engaged through funding from the contribution supporting the three subprograms, to ensure that the production structures being promoted are consistent with the rules for the transfer of clean, or at least nonpolluting, technologies. This business plan must be reviewed annually, analyzing the extent to which the goals and objectives have been

fulfilled, and identifying relevant changes to it. A copy of the annual revisions must be sent to the Bank (paragraph 6.1).

C. Beneficiaries

- 4.7 The direct beneficiaries of this project are microenterprises and small businesses served directly by CERTEC in the cities of Tegucigalpa and San Pedro Sula and the areas they serve. Indirect beneficiaries will be microenterprises and small businesses 6/ served by the PDOs, which are national in scope, and trained by CERTEC. In all, it is estimated that 3,424 microenterprises and small businesses will benefit from this project.
- 4.8 The number of new entrepreneurs served directly by CERTEC is around 160, distributed into 16 new networks in the areas of leather and footwear, garment making, wood processing, agribusiness development and machine tools. These sectors were chosen based on sector diagnostics, with the common thread being the creation of jobs and the participation of women.

D. Project preparedness

- 4.9 CERTEC has already preidentified the project leader as well as possible trainers of network promoters. It also has an initial business plan. In addition, with respect to potential clients for the transfer of network methodology, CERTEC has been quite active in promoting its services and has already identified customers for its various services.

V. COST AND FINANCING

A. Cost

- 5.1 The project cost is US\$1,390,000. The MIF will finance US\$700,000 and CERTEC will contribute counterpart funding of US\$690,000. The counterpart funds represent 49.6% of the total project cost. A breakdown is given below.

6/ Indirect beneficiaries, i.e. those trained through the transfer of technology to the PDOs, are primarily rural microenterprises.

CATEGORIES	TOTAL	MIF	CERTEC	%
BUSINESS NETWORKS				
Consulting services	73,000	73,000		
Training and advisory support	87,000		87,000	
General support	103,000		103,000	
Subtotal	263,000	73,000	190,000	18.9
TECHNOLOGY TRANSFER				
Consulting services	153,000	113,000	40,000	
Training of network promoters	519,000	385,000	134,000	
General support	218,000		218,000	
Technology dissemination	20,000	20,000		
Subtotal	910,000	518,000	392,000	65.5
LOCAL PRODUCTION DEVELOPMENT				
Consulting services	79,000	79,000		
General support	40,000		40,000	
Subtotal	119,000	79,000	40,000	8.6
EVALUATIONS	30,000	30,000		2.2
CONTINGENCIES	68,000		68,000	4.9
TOTAL	1,390,000	700,000	690,000	100.0

B. Financial sustainability

- 5.2 The counterpart funding will come from equity contributions from the partners, international cooperation in the form of grants, and funding generated internally by CERTEC.
- 5.3 The international cooperation will come from the Government of the Netherlands, which has allocated a total of US\$300,000 to cofinance this project, which is the basis for CERTEC's business plan and strategic planning. This cooperation is in effect and the corresponding agreements have been signed.
- 5.4 CERTEC may be able to generate surplus financing by gradually reducing the subsidies it has traditionally granted to the beneficiaries of its programs (see Logical framework matrix) as well as through the increased productivity of its services. The reduction in subsidies will be achieved by promoting effective and adequate services for business needs. Based on the proven savings capacity of business owners, and economies of scale achieved through group services, it is estimated that the entrepreneurs

served directly by CERTEC will pay the entire cost of the service and a percentage of their profits in year 5 of the projections. Failure by CERTEC to remove these subsidies may result in suspension of the disbursements.

- 5.5 Since the CERTEC counterpart funding for the project is based on the internal generation of funds, disbursements will be approved after demonstrating the *pari passu* funding, taking into account a margin of flexibility of 10%.
- 5.6 CERTEC's only equity is represented by the funding which, upon completion of the UNIDO project, could be capitalized, and which totals barely US\$2,500. The remainder of its assets (US\$68,000) consists of profits generated through the execution of several projects from June 1997 to December 1998. It is therefore felt that the founding partners, who include influential individuals as well as unions such as ANDI and ANMPIH, should contribute equity funding. As a condition precedent to the first disbursement, the Bank must have received to its satisfaction a copy of the minutes of the meeting of the founding partners recording their commitment to make the contributions, which are estimated at the equivalent of one current minimum monthly wage per partner for two years, to a maximum equivalent to US\$20,000.

C. Disbursements

- 5.7 Project disbursements will be managed under a revolving fund for advances, equivalent to 20% of the contribution.

VI. MONITORING AND EVALUATION

A. Monitoring

- 6.1 Project execution will be monitored according to the business plan, which is oriented toward fulfilling the performance goals and standards noted in Annex I. CERTEC will also submit annual reports describing project execution for the preceding year.

B. Evaluation

- 6.2 An interim evaluation is planned two years after project startup, with a final evaluation upon completion, to be carried out by outside consulting firms engaged by the executing agency in coordination with the MIF and in which the performance indicators noted in Annex I (Logical framework matrix) will be evaluated. These evaluations will also emphasize the following aspects: (i) the type of beneficiary companies; (ii) the participation of women; (iii) the level of compliance in removing subsidies; (iv) fulfillment of the operating conditions necessary for

execution; (v) fulfillment of the business plan; and (vi) analysis showing how lessons learned apply to the development and maintenance of business networks for the transfer of methodology.

VII. JUSTIFICATION AND RISKS

A. Justification

- 7.1 The project is justified because it serves the sector through a new nonfinancial service developed by a local entity, and information now available in Latin America suggests that the possibilities of generating productive employment, future economic growth and improved income distribution depend upon the capacity of smaller companies to perform satisfactorily in a broader context. Changes in the international environment have been brought about by globalization of the economy and an ability to satisfactorily develop strategic alliances that allow better access to input and product markets. These changes undoubtedly have a major impact on company dynamics and their contribution to national development.

B. Risks

- 7.2 The project's major risk is its sustainability if one takes into consideration that to date, the execution of CERTEC programs have been practically 100% subsidized. ^{1/} This aspect will be looked at in detail in the interim evaluation. The results of this evaluation must be satisfactory to the Bank, otherwise it will not continue disbursing the contribution until such time as CERTEC makes the necessary changes.
- 7.3 This project faces the risk of an inadequate transfer of network methodology. To mitigate this risk, CERTEC must continue serving networks directly, so that feedback can be provided on its own technology, and the necessary adjustments can continue to be made.

^{1/} It should be mentioned that CERTEC tried to go about removing the subsidies by signing cooperation agreements with the networks that had been created. However, of the 8 networks in execution, 5 were seriously affected by Hurricane Mitch, causing CERTEC to reconsider its decision and postpone implementation until the first half of 1999.

VIII. SPECIAL CONDITIONS

- 8.1 Conditions precedent to the first disbursement: (i) submission, to the Bank's satisfaction, of the terms of reference for the project leader and the consultants for the project (paragraph 4.4); and (ii) submission of a certified copy of the minutes of the partners' meeting placing on record the founding partners' commitment to make equity contributions, estimated at the equivalent of one current legal minimum wage per partner for a period of two years, to a maximum equivalent to US\$20,000 (paragraph 5.6).
- 8.2 Contractual conditions during execution: (i) during the first six months of execution, the Bank must be sent the business plan (paragraph 4.6); (ii) CERTEC will annually send the Bank a copy of the revised business plan and its analysis (paragraph 4.6); (iii) the disbursements will be made upon verification that CERTEC has made a counterpart *pari passu* contribution to the project (paragraph 5.5); and (iv) the project provides for two evaluations – an interim evaluation two years after signing the agreement, and a final evaluation four years after signing the agreement.

LOGICAL FRAMEWORK MATRIX

DECLARATIVE OF OBJECTIVES	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
<p>program of nonfinancial business networks and the action chains, strengthen and micro- and small enterprise and servicing of 16 new networks at the rate of four per total of 160 new enterprises.</p> <p>of network technology to 68 million will form 408 businesses involving a total of 3,264 enterprises.</p> <p>ity of three local production systems in three cities businesses.</p>	<p>Number of networks actually formed in the country, which are expanding sales and enhancing their activities.</p> <p>transferred.</p> <p>Number of PDOs to which the technology was</p> <p>Number of cities in which local production development based on business networks was implemented.</p>	<p>Materials published</p> <p>Evaluation surveys</p> <p>Accounting records of CERTEC and the networks</p>	<p>Micro- and small enterprise are still combine in order to jointly create n advanced negotiation entities.</p> <p>Micro- and small enterprise are will the cost of the advisory and training required to formalize a business ne</p>
<p>achieve greater and more ration of micro- and small e formal economy.</p>	<p>Year 1: 50% of networks are renewed, 80 microenterprises, 40 prior to and 40 from year 1. Indirect microenterprises through PDOs: 672</p> <p>Year 2: 50% of networks are renewed, 80 microenterprises, 40 from year 1 and 40 from year 2. Indirect microenterprises through PDOs: 768</p> <p>Year 3: 50% of networks are renewed, 80 microenterprises, 40 from year 2 and 40 from year 3. Indirect microenterprises through PDOs: 864</p> <p>Year 4: 50% of networks are renewed, 80 microenterprises, 40 from year 3 and 40 from year 4. Indirect microenterprises through PDOs: 960</p>	<p>Registration of entrepreneurs trained and receiving technical assistance for the creation of networks.</p> <p>Microentrepreneur surveys</p> <p>Registration of theoretical and practical field courses with the PDOs.</p>	<p>It has been possible to design and the project satisfactorily.</p> <p>The services offered by CERTEC appropriate and meet the demands businesses.</p> <p>Business demand for the services been activated.</p> <p>Promotion and dissemination activ been effective.</p>

NARRATIVE OF OBJECTIVES	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
networks.	16 new networks are formed, such that upon network graduation, activity is maintained in eight networks.	Execution of the business plan Registration of participating companies	Demand for this type of nonfinancial is activated.
methodology.	68 technology transfer agreements are signed. 3,264 businesses associated into over 400 networks are managed.	Execution of the business plan Registration of participating companies Agreements with PDOs Registration of PDOs	Institutions, companies and consultants responsible for disseminating and this experience are identified and
production development systems	Agreements signed with three municipalities 75 businesses are served through regional programs	Execution of the business plan Registration of participating companies Agreements with city mayors' offices	International adviser is available to the process of reviewing and consulting the business network technology and production chains.
financial support.	US\$361,000	For all activities, the means of verification are the following: (i) CERTEC accounting records (ii) Audit reports (iii) Copy of the agreements	The project is approved.
national network consultant is	US\$26,000		The Government of the Netherlands provides its support for CERTEC, giving it the necessary resources to fulfill the commitments obligations required by the MIF.
consultant that will support administrative and financial management is engaged.	US\$7,000		The program dissemination and promotion activities have been effective.
external adviser, project head, coordinator and local production systems coordinator are	US\$272,000		The outside adviser has effectively contributed to improving the quality and efficiency of the services provided.
work training promoters are	US\$606,000		A reasonable number of development organizations, private enterprises and that will support the project through technology transfer agreements have identified.
tion of experience	US\$20,000		
ies and evaluations	US\$98,000		

PROPOSED RESOLUTION

**HONDURAS. NONREIMBURSABLE TECHNICAL COOPERATION FOR THE
EXPANSION OF MICRO- AND SMALL ENTERPRISE BUSINESS NETWORKS AND
THE INTEGRATION OF PRODUCTIVE CHAINS**

The Donors Committee of the Multilateral Investment Fund

RESOLVES:

1. That the President of the Inter-American Development Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Multilateral Investment Fund, to enter into such agreements as may be necessary with the Centro de Recursos y Tecnología, and to take such additional measures as may be pertinent for the execution of the project memorandum referred to in Document MIF/AT-_____ with respect to a technical cooperation program for the expansion of micro- and small enterprise business networks and the integration of productive chains.

2. That up to the amount of US\$700,000, or its equivalent in other convertible currencies, is authorized for the purpose of this resolution, chargeable to the resources of the Small Enterprise Development Facility of the Multilateral Investment Fund.

3. That the above-mentioned sum is to be provided on a nonreimbursable basis.