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December 20, 1984

To: Members of the Executive Board

From: The Secretary

Subject: Peru - Staff Report for the 1984 Article IV Consultation

The attached supplement to the staff report for the 1984 Article IV consultation with Peru has been prepared on the basis of additional information.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion on Friday, December 21, 1984, they should contact Mr. van Houten (ext. 8624).

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INTERNATIONAL MONETARY FUND

PERU

Staff Report for the 1984 Article IV Consultation Supplementary Information

Prepared by the Western Hemisphere and the Exchange and Trade Relations Departments

(In Consultation with the Fiscal Affairs, Legal, and Treasurer's Departments)

Approved by E. Wiesner and Manuel Guitian

December 20, 1984

The purpose of this paper is to describe developments since the Staff Report for the Article IV Consultation was issued and to explain certain measures that have been adopted recently by the authorities.

The authorities have revised their projections for the deficit of the nonfinancial public sector in 1984, reducing it by about 1 1/2 percent of GDP to 8 1/2 percent of GDP. The reduction reflects a better than expected revenue performance in recent months and lower expenditures in certain areas. The Central Administration's current revenues are now expected to amount to 15.5 percent of GDP, 0.6 percent of GDP above the level projected earlier, largely as a consequence of improvements in tax administration implemented with assistance from the Fiscal Affairs Department of the Fund and the enactment of a special facility for the payment of taxes in arrears.

The estimate of the Central Administration's spending was revised downwards by about 1 percent of GDP in reflection of lower interest payments, defense outlays, and investment. One half of this reduction stems from the enactment of a provision that lowers the interest rate charged by the Banco de la Nacion (a state-owned bank) on its credit to the Central Administration during 1984 from 55 percent to 0.1 percent per annum;1/ it may be noted that this arrangement results in an improvement in the financial position of the nonfinancial public sector but does not alter the situation of the public sector as a whole. Military outlays are now projected to be lower by 0.2 percent of GDP as a result of the authorities' decision to slow down work under existing contracts

1/ The practice in recent years has been to consolidate the credits provided by the Banco de la Nacion to the Central Administration by means of a loan granted at the end of the year by the Central Reserve Bank with an annual interest rate of 0.1 percent. However, it used to be the case that the Central Administration would pay the Banco de la Nacion interest at a rate close to the legal maximum throughout the year.

with foreign suppliers. Lastly, investment expenditures were revised downwards by 0.3 percent of GDP, reflecting a slower use of foreign project loans because of the Central Administration's inability to generate sufficient local counterpart funds.

On December 15, 1984 Congress approved the 1985 Budget Financing Law which introduced, as of January 1, 1985, certain revenue measures, including: (i) a surcharge 1 percentage point on the value-added tax, which is earmarked for the municipalities; (ii) an effective increase of the tax on traditional exports through the introduction of a uniform rate of 10 percent; (iii) an increase in the prepayments on the property tax on firms, from 75 percent to 100 percent of the previous year's tax; and (iv) an increase of certain taxes collected by the municipalities, such as the taxes on urban real estate. At the same time, the law provided for the prohibition of certain imports, which will result in lower revenues from import duties. The list of prohibited imports, which covers more than 30 different commodities, includes those goods that were temporarily restricted in 1984, such as textiles, clothing, leather goods, wine, etc., and some other imports, such as certain kinds of automobiles and consumer durables. The authorities estimate that the revenue measures contained in the 1985 Budget Financing Law will have a net yield equivalent to 0.4 percent of GDP in 1985.

The 1985 Budget Financing Law also included other provisions, among which the following might be noted: (i) The Administration was authorized to increase by up to 2 percentage points the rates of the taxes administered by the General Directorate of Taxes (income, property, value added, and excise taxes). (ii) Ceilings were established on the prices that the Administration can set for oil derivatives; whereas, thus far, such prices have been set at the discretion of the Administration, as of January 1, 1985, they will be subject to a limit equivalent to US$1.25 per gallon of regular gasoline, compared with the present price of slightly less than US$1.00. (iii) Provision was made for the issuance of development bonds to be purchased by wage earners in amounts ranging from 5 to 12 percent of wages, with such bonds carrying a rate of return related to inflation; in 1983 and early 1984, wage earners were required to purchase reconstruction bonds, which carried a fixed interest rate of 50 percent, for the equivalent of 5 percent of wages. (iv) CONADE (a dependency of the Ministry of Finance, Economy and Commerce) was empowered to coordinate the pricing and wage policies of the public enterprises.

The Central Reserve Bank has continued the policy of not granting credit to the nonfinancial public sector and, as of December 15, 1984, it increased legal reserve requirements and domestic interest rates. In a step to tighten monetary policy further, the Bank introduced a marginal legal reserve requirement of 50 percent on soles-denominated deposits held by financial intermediaries, except development banks, savings and loan associations and the Banco de la Nacion. The maximum annual interest rate on non-indexed soles-denominated transactions was raised from 60 to 66 percent.1/ This measure was taken in an attempt to stem the shift of resources toward U.S. dollar-denominated certificates of deposit; these certificates had increased from less than 50 percent of total bank liabilities to the private sector at the end of June 1984 to nearly 55 percent at the end of November.

In recent months, the authorities have stepped up the pace of currency depreciation. On October 29 the sol was devalued by 2 percentage points in excess of the usual daily adjustment. Moreover, since the last week of November, the daily rate of depreciation has been raised to about 0.4 percent from 0.2 percent previously. On a monthly basis, the current rate of depreciation is close to 13 percent, up from about 7 percent during the year through November 1984; during that 12-month period, the rate of price increase averaged a little above 6 percent a month. The spread between the U.S. dollar-denominated certificates of deposit market exchange rate and the official rate widened from about 8 percent in September to more than 15 percent in mid-November. However, the acceleration of the pace of depreciation since late November appears to have had a dampening effect on the certificate market and the spread has narrowed to about 2 percent. Since the Staff Report was issued, the spread has often exceeded 2 percent and, in light of the changes introduced in late October (see SM/84/250, pages 21 and 27), has given rise to a multiple currency practice. Approval of this practice is not recommended.

Net international reserves of the Central Reserve Bank exceeded the program target by about US$340 million at the end of November. However, since midyear there has been a substantial accumulation of central administration arrears with foreign creditors. By the end of November, such arrears amounted to over US$300 million, of which about US$200 million were delayed interest payments. Peruvian officials have estimated that by the end of the year central administration arrears will amount to some US$410 million, of which US$260 million would be on account of interest and US$150 million on account of principal.