October 11, 1984

To: Members of the Executive Board

From: The Secretary

Subject: Final Minutes of Executive Board Meeting 84/67

The attendance on the attached page of the final minutes of Executive Board Meeting 84/67 (4/26/84) has been revised.

Att: (1)

Other Distribution:
Department Heads

NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/67

10:00 a.m., April 26, 1984

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	T. Ramtoolah, Temporary
	H. G. Schneider
	G. E. L. Nguyen, Temporary
A. Donoso	M. Teijeiro
R. D. Erb	
	T. Alhaimus
T. Hirao	T. Yamashita
J. E. Ismael	
R. K. Joyce	
A. Kafka	C. Robalino
G. Laske	
G. Lovato	C. P. Caranicas
R. N. Malhotra	A. S. Jayawardena
Y. A. Nimatallah	
	T. de Vries
A. R. G. Prowse	
	O. Kabbaj
	M. Camara, Temporary
	J. L. Feito
	K. A. Hansen, Temporary
	T. A. Clark
Zhang Z.	Wang E.

L. Van Houtven, Secretary
L. C. Collier, Assistant

1. Peru - Stand-By Arrangement; Purchase Transaction - Compensatory Financing Facility; and Exchange System . . Page 3
2. Executive Board Travel . . . . Page 38

Corrected: 10/11/84

Also Present

Administration Department: W. Bier. Exchange and Trade Relations Department: H. W. Gerhard, M. Guitian, D. A. Lipton. External Relations Department: H. P. Puentes. Fiscal Affairs Department: M. Casanegra-Jantscher. Legal Department: G. P. Nicoletopoulos, Director; P. L. Francotte, Ph. Lachman. Research Department: L. Alexander, K.-Y. Chu, N. M. Kaibni, E. A. Milne, A. Muttardy, A. Salehizadeh. Western Hemisphere Department: S. T. Beza, Associate Director; P. D. Brenner, M. Caiola, J. Ferrán, J. Jaramillo-Vellejo, L. M. Valdivieso, J. F. van Houten. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: H. A. Arias, C. J. Batliwalla, J. Delgadillo, S. El-Khouri, Y. Okubo, I. R. Panday, D. I. S. Shaw, D. C. Templeman. Assistants to Executive Directors: J. R. N. Almeida, R. Bernardo, G. Ercel, V. Govindarajan, D. Hammann, H. Kobayashi, E. Portas, M. Rasyid, J. Reddy, D. J. Robinson, A. A. Schoten, M. A. Weitz.

NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/67

10:00 a.m., April 26, 1984

J. de Laorisère, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	T. Ramtoolah, Temporary
	H. G. Schneider
	G. E. L. Nguyen, Temporary
A. Donoso	M. Teijeiro
R. D. Erb	
	T. Alhaimus
T. Hirao	T. Yamashita
J. E. Ismael	
R. K. Joyce	
A. Kafka	C. Robalino
G. Laske	
G. Lovato	C. P. Caranicas
R. N. Malhotra	A. S. Jayawardena
Y. A. Nimatallah	
	T. de Vries
A. R. G. Prowse	
	O. Kabbaj
	M. Camara, Temporary
	J. L. Feito
	K. A. Hansen, Temporary
	T. A. Clark
Zhang Z.	Wang E.

L. Van Houtven, Secretary
L. C. Collier, Assistant

1. Peru - Stand-By Arrangement; Purchase Transaction - Compensatory Financing Facility; and Exchange System . . Page 3
2. Executive Board Travel . . . . Page 38

Also Present
Administration Department: W. Bier. Exchange and Trade Relations Department: H. W. Gerhard, M. Guitian, D. A. Lipton. External Relations Department: H. P. Puentes. Fiscal Affairs Department: M. Casanegra-Jantscher. Legal Department: G. P. Nicoletopoulos, Director; P. L. Francotte, Ph. Lachman. Research Department: L. Alexander, K.-Y. Chu, N. M. Kaibni, E. A. Milne, A. Muttardy, A. Salehizadeh. Western Hemisphere Department: S. T. Beza, Associate Director; P. D. Brenner, M. Caiola, J. Ferrán, J. Jaramillo-Vellejo, L. M. Valdivieso, J. F. van Houten. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: H. A. Arias, C. J. Batliwalla, J. Delgadillo, S. El-Khouri, Y. Okubo, I. R. Panday, D. I. S. Shaw, D. C. Templeman. Assistants to Executive Directors: J. R. N. Almeida, R. Bernardo, G. Ercel, V. Govindarajan, D. Hammann, H. Kobayashi, E. Portas, M. Rasyid, J. Reddy, D. J. Robinson, A. A. Schoten, M. A. Weitz.

1. PERU - STAND-BY ARRANGEMENT; PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY; AND EXCHANGE SYSTEM

The Executive Directors considered the requests by Peru for a 15-month stand-by arrangement in an amount equivalent to SDR 250 million (EBS/84/57, 3/16/84; Cor. 1, 3/19/84; Cor. 2, 3/27/84; and Sup. 1, 4/25/84) and a purchase under the compensatory financing facility in an amount equivalent to SDR 74.7 million (EBS/84/59, 3/16/84; and Sup. 1, 4/24/84).

Mr. Donoso made the following statement:

A weak external demand and reduced export prices, high interest rates in world capital markets, and reduced access to foreign financing have seriously affected developing countries in the last three years, in particular those with higher external debt.

The situation of the Latin American developing countries has been especially difficult because of the contraction of regional trade due to the concentration of problems in the area. Among the Latin American countries, Peru has been especially pressured by unfavorable external circumstances, to which natural disasters were added in 1983 with serious effects on production.

After experiencing real rates of growth of about 3 percent in 1980 and 1981, production grew by 0.7 percent in 1982 but fell by 11 percent in 1983. About one half of the reduction in GDP in 1983 was related to natural disasters. The need to introduce reconstruction expenditures added to the difficulties of managing the economic situation when GDP was falling precipitously and complicated the implementation of fiscal and monetary policies.

The drastic change in the basic assumptions on which the 1983 program rested, and the deviations with respect to the programmed path, especially in the area of public finances, moved the Peruvian authorities to request a new stand-by arrangement.

The objectives of the economic program are the consolidation of the progress already achieved in the external accounts, the control of inflation, and the resumption of economic growth. It is expected that the development of the program will occur in the context of an improving external situation.

Following a decline in prices for its exports in 1982, Peru experienced some recovery in 1983 from which the country could not benefit because of the effects of the climatic disturbances and labor unrest. Thus the value of exports was lower in 1983 than in 1982.

From 1984 on a recovery is projected in the value of exports because of both price increases and higher volumes. The projections accompanying the request for an arrangement and use of the compensatory financing facility include an estimated increase in exports of 7 percent for 1984.

The implementation of the program for 1984 should be facilitated by the more favorable external environment as well as by the achievements in important areas that were obtained during the period of implementation of the extended arrangement. From the end of 1981 to date there have been reductions in real terms in the minimum wage, in the level of salaries of workers in the collective bargaining sector, and in the average remuneration for the civilian personnel of the Central Administration. The real value of the sol in terms of the U.S. dollar has been cut back to its 1979 level.

These elements are indicative of improvements in competitiveness which, in the context of a recovering external environment, should facilitate the process of adjustment. During the years of the extended arrangement there has been a permanent pursuit of improvement in the mechanisms to control public sector developments. Better control has been achieved over public sector expenditures in general and over wages and external debt contracting in particular.

The new program contains major corrections of fiscal, monetary, and incomes policies.

On the fiscal side the program contemplates a reduction of the overall public sector deficit equivalent to 6 percent of GDP. The total improvement is expected to come mainly from a reduction in the current account of the Central Administration, and about 2 percent of GDP from improvements in the current account of the rest of the public sector and from reductions in the capital expenditures of the public sector. Current and capital expenditures in 1984 will be lower in real terms and as a percentage of GDP than in 1980 and 1981, years in which GDP was still growing at annual rates of about 3 percent. Central administration current revenues are expected to recover from the 1983 low as a result of new revenue measures but will still be below the levels reached in 1980 and 1981. Thus, it is most probable that the fiscal situation as projected for 1984 will correspond to a structural surplus in public sector finances.

The monetary side of the program is also restrictive. It has been assumed that the real stock of money and quasi-money will grow with GDP by 4 percent in real terms during the year. The allowed expansion of net domestic assets of the Central Bank incorporates that assumption, an expected decrease in the rate of inflation from 125 percent (December-December) in 1983 to 70 percent in 1984, and the objective of constant international reserves.

Although considerable importance can be attached to restraint in fiscal and incomes policies to facilitate the reduction in the rate of inflation, very stringent monetary conditions should be expected from the program. In early 1984 all financial institutions were authorized to sell certificates of deposit with a freely negotiated rate of return. This and the use of auction techniques to channel resources controlled by the Central Bank to the rest of the financial system should facilitate the financing of the current account deficit and improve the internal allocation of financial resources.

With respect to wage policies the Government plans to limit its direct influence over private sector arrangements to the protection of the lowest income groups through the determination of the wage reference unit. Workers with remunerations above the maximum wage will negotiate with their employers individually or collectively in the unionized sector without the Government's interference.

For budgetary reasons, and to facilitate the adjustment of the economy, the Government has sought to increase its ability to influence wage awards in the public enterprises. Agreements in the public sector have been subjected to the approval of the Ministry of Economy, Finance, and Commerce.

It is the objective of the Government to treat wages with the moderation required to bring about the expected reduction of inflation.

In the external sector the Peruvian economy has already experienced an enormous improvement. From 1982 to 1983 the trade balance improved by $730 million to reach a surplus of $300 million in spite of a reduction in exports. In 1983, the current account deficit of the balance of payments amounted to $882 million, some $50 million below projections. Larger than expected short-term capital outflows explain most of the loss in international reserves in excess of the programmed reduction.

The fiscal and monetary policies to be implemented should make it possible to finance the current account deficit contemplated in the program for 1984 without losses of reserves.

In the context of a flexible exchange rate policy involving changes in the role of the sol in line with domestic inflation and moderate wage policies, strict demand management in 1984 should bring both a continued adjustment in the external situation and the resumption of growth.

In previous statements on Peru I mentioned how, because of exogenous developments last year, the economic situation of the country kept deteriorating beyond the most pessimistic expectations. With normal climatic conditions and a more favorable external environment the expected 4 percent increase in GDP for 1984 seems attainable. The Peruvian authorities are confident that under this expected scenario the implementation of their program will bring the financial stability and confidence that will allow the resumption of sustained growth for the country.

Peru has had the support of official creditors to reschedule debt payments. The authorities are thankful for this and especially to the U.S. authorities for the recent agreement to provide resources which will make possible the use of concessionary credits provided by international development agencies. The authorities attach great importance to this support and to the small adjustment in the allowed increase in the total indebtedness of the nonfinancial public sector, which will be financed with these resources.

On behalf of my authorities, I want to thank the management and the staff for the efforts developed in connection with Peru's program. I would also request the support of my colleagues for the proposals relating to the two arrangements under discussion and thank them for the willingness to take up the subject on such short notice.

Mr. Kafka said that in 1983 Peru had experienced the most difficult year in its recent economic history as a result of natural catastrophes and domestic security problems. Despite those difficulties, exemplified by the 11 percent decline in GDP, it had achieved a strong external adjustment; the current account deficit of the balance of payments had declined from over 8 percent of GDP in 1982 to 5.5 percent of GDP in 1983. In addition, there had been strong adjustment in the monetary field, with real money and quasi-money declining by 12.5 percent, and a depreciation in the real effective exchange rate of the sol.

The new Peruvian program deserved the Board's full support, Mr. Kafka stated. Peru's courage and decisiveness in executing the demanding program were self-evident. A major revenue effort had already taken place in the first quarter of the year, when several new tax measures had been implemented that were projected to raise central government revenues by 2 percentage points of GDP in 1984. Major cuts had been approved in current expenditures. The share of wages in the public sector would be reduced by almost 1 percentage point of GDP, and there would be a substantial decrease--1.6 percent of GDP--in military outlays.

Meanwhile, Mr. Kafka continued, the authorities were being careful to avoid as far as possible sacrificing future growth. The burden of cuts in capital expenditures had fallen on capital transfers to public enterprises, but expenditures on reconstruction would be maintained. Monetary policy was tight, with the ratio of money and quasi-money to GDP expected to remain constant. Combined with restrained labor policies and a tight fiscal policy, that policy stance would ensure that the rate of price rise at the end of 1984 would be about half the present rate.

He was pleased that the performance criteria for the nonfinancial public sector had been revised upward to include additional financing from the World Bank, Mr. Kafka remarked. Although a minor change, it showed flexibility, which was important for a good relationship between the Fund and member countries.

On the medium-term prospects of the economy, Mr. Kafka remarked that the paper had indicated balance of payments developments but had not described the behavior of the public sector, GDP, or inflation. He invited the staff to comment on the condition of the economy after the proposed stand-by arrangement was completed.

With respect to the request under the compensatory financing facility, Mr. Kafka noted that the test of cooperation had been met and that there was a clear balance of payments need. The shortfall was straightforward and was based mainly on nontraditional exports, reflecting the weakness of international demand and, in particular, a sharp decline in demand by other Latin American countries. To conclude, he warmly supported the proposed decisions.

Mr. Lovato commented that the serious economic problems experienced by Peru were largely due to factors beyond the authorities' control. The sudden dramatic drop in production in 1983 as a result of a series of natural disasters was a major factor underlying the large imbalances in the nonfinancial public sector that placed the economy under serious stress. The increased flow of financial assistance under the compensatory financing facility and in the credit tranches was therefore justified, and he supported both decisions.

The authorities would have to address some fundamental imbalances, Mr. Lovato remarked. In 1983 the nonfinancial public sector deficit had exceeded 10 percent of GDP, a worrisome development, and he welcomed the corrective measures recently implemented by the authorities. However, he noted that the deficit had been reached in a year characterized by exceptional circumstances, whereas the deficit of 8.5 percent prevailing during the previous two years was probably more representative. Moreover, any corrective action should take into account the need for a substantial amount of public investment in case of further serious natural disasters.

A reduction of 1 percentage point in public investment was planned, while public reconstruction spending was projected to increase, Mr. Lovato noted. He invited the staff or Mr. Donoso to provide more information on the sectoral distribution of the curtailment of overall public investment.

The entire increase in revenues should be achieved through indirect taxation, mainly through an increase in the general sales tax, Mr. Lovato observed. Given the importance of the fight against inflation and the likely negative effect that taxes would have on prices, he requested further details on the reasons for the specific tax measures adopted in the proposed plan and on the scope for direct taxation.

With regard to the fiscal deficit, Mr. Lovato noted that the authorities planned to rely entirely on foreign financing in order to devote available domestic credit to the productive sector. When the amount of private savings in domestic assets was fixed, and the domestic economic activity of the private sector had a fixed relationship to that amount, such a policy was the only way to preserve productive activity in the presence of a still large public sector borrowing requirement. But that was not the case in a country where there appeared to be considerable scope for inducing additional savings in domestic financial assets through both an increase in real interest rates that had been kept artificially low and the creation of new financial assets. Recent substantial outflows of short-term capital could be reversed, providing additional financing for the private and public sectors through assets denominated in domestic currency. Government deficit financing, although apparently providing short-term relief, was detrimental in the long run because of its effects on the overall foreign debt service. Additional savings instruments denominated in soles were needed, and he was pleased to note that efforts in that direction were currently being undertaken. He wondered whether those instruments had been favorably received by domestic holders.

To conclude, Mr. Lovato observed that the problems currently facing Peru seemed to be largely of a structural nature and to require more than short-run adjustment. In that situation, it seemed unlikely that a one-year program would be sufficient for the country to complete its adjustment process. Therefore he requested more information on the authorities' decision to request a stand-by arrangement, and especially on their intention to study and set up a program for making the needed structural changes.

Mr. Erb commented that he was pleased that Fund management and the Peruvian authorities had reached prompt agreement on a slight modification of the revenue measures before the Board, and he could therefore support the program. Nonetheless, there were some aspects of the measures, and of the program in general, that gave some cause for concern and that warranted close monitoring by the staff. During the discussion of the Article IV consultation (EBM/83/163, 11/28/83), his authorities had expressed sympathy for the extraordinarily adverse weather and other conditions that had plagued the Peruvian economy in 1983. There was no doubt that performance under the extended arrangement had been heavily influenced by those unfavorable developments. While exogenous factors were important, it had to be recognized that the serious failures in the program under the extended arrangement had also been attributable to inadequate economic policies, particularly with respect to fiscal performance. Questions could also be raised concerning past exchange rate and monetary policies.

He understood the strong desire of the Peruvian authorities to achieve positive real growth in 1984 after negative growth of 11 percent in 1983, Mr. Erb continued. In fact, prospects were reasonably good for the recovery of agriculture after the previous year's bad weather and for the revival of manufacturing and services industries following the previous year's exceptionally low level of activity. But it should not be necessary to prime the pump with large-scale public expenditures. A modest increase of 0.3 percent of GDP in additional investment expenditure financed by new highly concessional aid should help economic recovery without risking a further acceleration of inflation. Peru's performance in recent years showed a doubling of the inflation rate--from 59 percent in 1980 to 125 percent in 1983. Even if Peru were to achieve the targeted annual rate of 70 percent in December 1984, inflation in Peru would still remain very high by developing country standards.

The balance of payments situation also remained worrisome, Mr. Erb observed. Export volume had fallen in three of the previous four years and was expected to fall again in 1984. The balance of payments constraint had contributed to cuts in the volume of imports in 1982 and 1983, with a decline forecast for 1984. Fortunately, the decline would be much less than in 1983, and less critical to the recovery, since it would reflect cuts in military imports and lower food imports as agriculture recovered. Adjustment in the ratio of the current account deficit to GDP had also been slow. Although the ratio had fallen from 8.3 percent to 5.5 percent, which was somewhat better than the 5.8 percent target, most of the improvement had been in the form of import compression rather than of export growth; even with the reduction in the ratio to 5.3 percent in 1984, the deficit would remain rather high.

Key measures for correcting those continuing economic disequilibria were a sharp reduction in the public sector deficit, a realistic exchange rate, and a monetary policy that limited credit to the public sector and assured attractive real interest rates, Mr. Erb said. The reduction in the large public sector deficit, which at 10.3 percent of GDP in 1983 not only exceeded the target of 4.1 percent but was also higher than in 1982, was an important objective. Preliminary evidence for the first quarter of 1984 on both revenues and expenditures underlined the need for such fiscal restraint.

With regard to the new tax and administered price increases, Mr. Erb continued, the staff had maintained that the overall revenue effect would be sufficient to replace the revenue missing from the original program. Nevertheless, the increase in the import surcharge from 10 percent to 15 percent, although taken for fiscal reasons, was unfortunate when all were concerned about protectionism and the growth of world trade. Measures affecting the payment of corporate income tax and the current taxes collected by revenue collection agents involved solely the timing of tax revenues and constituted only a one-time revenue gain. Those factors highlighted the need for a thorough review of Peru's present tax system. For example, the ratio of income tax receipts to GDP had continued to fall from 6.1 percent of GDP in 1980 to only 2.7 percent in 1983, while there had been no deliberate attempt to reduce tax burdens. Therefore the review of tax administration and collection being carried out with Fund technical assistance was welcome. He asked the staff if it would also examine the consequences of the tax structure on tax revenues to find out, for example, whether high marginal tax rates encouraged tax evasion.

As to expenditures, Mr. Erb noted that the principal causes of the overrun in the 1983 deficit included an excess of military outlays and a higher than expected wage and salary bill for nonmilitary public employees. Both developments had been the result of policy choices. On wages, the 1984 budget law required that government wages be compatible with inflation objectives; the August 1983 decree, requiring salary increases in public enterprises to be submitted for prior approval by the Ministry of Economy, if rigorously implemented, should help to avoid further overruns. He realized, of course, that it was up to the Peruvian authorities to set their own priorities with regard to military and security expenses. However, given the overall fiscal restraint, high military expenditures must necessarily compete with other outlays for economic development.

On the exchange rate, Mr. Erb noted that the modest depreciation of the sol in 1982 and 1983 had not been enough to offset the rapid appreciation in the previous two years. The authorities planned to follow a flexible policy in 1984, with a rate of depreciation at least as rapid as the rate of domestic inflation. Nevertheless, the chart on page 12a in EBS/84/57 suggested that, despite the intention to depreciate the rate in line with the domestic inflation rate, the real effective rate vis-à-vis Peru's trading partners at the end of 1983, and possibly in 1984, would still be more appreciated than in 1978, the base year. He realized such calculations should be used with caution, but evidence could be drawn from the performance of nontraditional exports. Although those exports were expected to rise by almost 31 percent in 1984, a large share of that increase was due to exports to one country in connection with its debt rescheduling arrangements with Peru. An increase to other more competitive markets would be a better test. In addition, the projected figure of SDR 679 million for 1984 was not greatly different from the export figures of SDR 649 million and SDR 689 million for 1980 and 1982, respectively. Such figures raised serious doubts about the adequacy of Peru's present international competitive position, as did the continued resort to such distortive measures as export subsidies, concessional export credit, and the 15 percent import surcharge. Those factors emphasized the need to follow a flexible exchange rate policy. In addition, the authorities should reassess the continued need for the dual market arrangement.

With regard to monetary policy, Mr. Erb noted that the growth rate of M-2 was projected at 77 percent, despite net repayment of domestic credit to the public sector. While he endorsed the desire to provide adequate credit to the private sector, after the crowding out in 1983, that seemed a high figure. The maintenance of positive interest rates and the introduction of some new financial instruments to attract domestic savings would be important in achieving an increase in the gross national savings rate over the 1983 ratio to GDP of less than 12 percent, compared with the 18 percent ratio in 1980. Attractive real rates would also be required to avoid repeating the net capital outflow in 1983 of $1.1 billion, shown in the short-term capital and errors and omissions item in the balance of payments.

For the Article IV consultation discussion (EBM/83/163) in November 1983, Mr. Erb recalled, the report on recent economic developments (SM/83/235, 11/14/83) had noted that the share of dollar-denominated deposits in private sector liquidity had continued to expand through mid-1983 to almost 45 percent, and that the share of dollar-denominated lending to the private sector had increased from 26 percent in mid-1982 to 32 percent at the end of 1982 and to 37 percent in mid-1983. That evidence of growing "dollarization" of the economy underscored the importance of bringing money growth down and of achieving high interest rates, as well as improving the structure of financial instruments in the domestic currency.

The problem of inadequate data submitted to the Fund to demonstrate compliance with Fund programs warranted attention, Mr. Erb stated. Such problems had been discerned in 1983, and he strongly urged the authorities to improve the quality and timeliness of the data to help monitor progress and the Government's economic policymaking.

Peru was a member country that had made prolonged use of Fund financing, Mr. Erb observed; the Board had approved arrangements for the use of Fund resources in 1977, 1978, 1979, and 1982. Purchases had been made in seven of the past eight years. While he supported the new program for Peru, that aspect of the case merited attention. Part of the problem stemmed from the macroeconomic and exchange rate policy deficiencies that he had commented upon, but he also agreed with Mr. Lovato that there were important structural problems within the economy that were constraining both external balance of payments adjustment and domestic growth prospects.

As to the proposed purchase under the compensatory financing facility, it seemed clear that Peru met the tests of need and cooperation with the Fund, Mr. Erb stated. With regard to the temporary nature of the shortfall, it was less clear whether the shortfall was really outside the control of the authorities. For example, for a number of commodities, such as petroleum, copper, iron ore, and fish meal, there appeared to have been a definite downturn in exports since 1979. He wondered whether that reflected problems beyond Peru's control. The question was even more important concerning the largest shortfall for the nontraditional exports, where the question of competitiveness and the exchange rate arose. Similarly, the lagged investment spending that was identified as the cause of the shortfall in petroleum earnings might not be entirely outside the control of the authorities and perhaps was not temporary in character. Despite those misgivings, he could go along with the compensatory financing facility purchase.

While supporting the stand-by arrangement and the compensatory drawing, he had been critical of some aspects of the Government's adjustment policies, Mr. Erb concluded. Those comments reflected his authorities' concern that the success of Peru's adjustment efforts was of great importance and would determine the country's ability to return to a more stable balance of payments position and a vigorous and sustained rate of domestic economic growth.

Mr. Prowse stated that he supported both decisions. It was evident that 1983 had been a year of economic disaster for Peru. The problems had been building for the past three years, and the performance under the 1982 arrangement had fallen broadly out of line. A major cause had been the dislocations arising from natural disasters that had contributed to the serious decline in output and fiscal revenue, generated expenditures for reconstruction and relief, affected the use of international reserves, and helped to generate inflation. In addition, the recession in the external markets had contributed significantly to the deterioration in the Peruvian economy. However, there had been some slippages in policy through the years, especially in the performance of the public sector. The public sector deficit had reached unsustainable levels in 1980-83, and he believed that the programmed deficit for the public sector might also be unsustainable over the medium term. The government deficit was scheduled to decline substantially from the 1983 level, but he would be interested in the staff's perception of the position in the coming years. Against the background of the deficits over recent years, it was appropriate that the program should focus on fiscal adjustment.

It was also appropriate to insist on prior action in the areas of tariffs, pricing, public enterprises, subsidies, and tax measures, Mr. Prowse continued. Although reassured by those measures, like Mr. Erb he was disturbed by the declining trend of current revenues of the Central Government from 20 percent of GDP in 1980 to 14 percent in 1983. Of that total, income taxes had plunged as a source of revenue, declining as a percentage of GDP from about 6 percent in 1980 to under 3 percent in 1983, and, subject to new measures, were forecast to decline to 2.3 percent in 1984. The decrease reflected not only the negative performance of GDP but also the inadequate performance of the tax system. Peru must look seriously at the implementation of the reform of the tax system, including the yield from direct taxation. The measures for expenditure restraint seemed appropriate, and monetary growth, if implemented and controlled properly, would be supportive of the fiscal action.

On the external side, Mr. Prowse continued, the termination of the policy of preannouncing exchange rate adjustments based on inflation was welcome. The dual exchange system would persist, and he noted the staff's reasons for the acceptability of that system. With regard to external debt, the staff had forecast that the net debt service ratio would increase from 26.9 percent in 1983 to 55 percent in 1989 and that the total debt service would average about 55 percent. That burden was not compatible with a dynamic economy. Further rescheduling had to be anticipated, and he wondered whether a more forward-looking rescheduling would be possible in future discussions, although he welcomed the progress achieved in the recent agreement. It was also important to stimulate exports and, while the emphasis on strengthening the export sector was appropriate, to manage exchange policy so as to maintain competitiveness. In that connection, the re-establishment of a flexible exchange rate policy, with changes in the rate in line with the inflation rate, might not maintain competitiveness. In sum, the new arrangement with the Fund--and the Fund's approval of the program--was clearly only a new beginning and did not provide the opportunity to slacken adjustment.

The request under the compensatory financing facility met all the relevant criteria, Mr. Prowse remarked, and he was happy to support that decision. However, the sharp improvement in nontraditional exports had been explained by a two-year agreement with the U.S.S.R. that involved unusual terms of payment involving rescheduling. He inquired whether that arrangement involved a strict offset of loans against exports or whether part of the exports would be paid for through countertrade or in nonconvertible currencies. There would be no supply or production capacity constraints associated with those exports, but the staff had noted that drought conditions and insect infestation were expected to severely constrain the supply of cotton through 1984. As a major commodity to be exported under the agreement with the U.S.S.R. was cotton textiles, he asked the staff for clarification.

Mr. Nimatallah said that he supported both requests for the use of Fund resources and therefore endorsed the proposed decisions. It was clear that the request for a purchase under the compensatory financing facility met all the requirements of the compensatory financing decision. First, the shortfall had been caused largely by factors beyond the control of the authorities, for example, adverse weather conditions, weak external demand, the decline in the world oil price, and labor strikes. Second, the shortfall was temporary in character, and the projected upturn in the two postshortfall years was realistic. In particular, he agreed with the projections that had indicated a shortfall for petroleum exports during the shortfall year. Third, the requirement of cooperation for the drawing in the upper credit tranche of the facility had been met through the adoption of a stabilization program in support of which the authorities were requesting a stand-by arrangement.

The stand-by arrangement would replace the extended arrangement that had been approved by the Executive Board in June 1982, Mr. Nimatallah commented. The performance under that extended arrangement had been disappointing; domestic and external imbalances had worsened in 1983 due to adverse circumstances beyond the control of the authorities and to inadequate domestic policies. The program for 1984-85 aimed at correcting those imbalances; for example, a substantial reduction in the public sector deficit was expected, indicating that firm and steady adjustment efforts would be needed. He commended the authorities' courage in adopting measures to raise public sector revenues, and he hoped that they would persevere in their efforts to strengthen the revenue performance.

Strict discipline would have to be applied to control spending, Mr. Nimatallah observed. He invited the staff to comment on the results of the improvements introduced in 1983 in monthly budget control and program monitoring. He welcomed the introduction of a performance criterion relating to the net indebtedness of the nonfinancial public sector. It was realistic to include in the definition of that criterion any net increase in domestic payments arrears.

On monetary policy, Mr. Nimatallah continued, the programmed tightening of credit conditions was necessary to reduce inflation and to protect the level of official net foreign reserves. The programmed limits on the gross external indebtedness of the Banco de la Nación and COFIDE (a government-owned development corporation) in 1984 were welcome; that action would allow resources to be channeled to the private sector.

With regard to wage policy, Mr. Nimatallah considered that wage restraint was needed in both the public and private sectors. However, the staff paper had not presented specific information on the evolution of wages nor on the magnitude of wage increases contemplated during the period of the extended arrangement. He invited the staff to comment on that point.

He welcomed the authorities' return to a flexible exchange rate policy and their intention to reduce foreign commercial borrowing, Mr. Nimatallah said. It was clear that Peru would face a very heavy debt service burden for a number of years, and he was pleased that an agreement in principle had been reached with commercial creditors on debt rescheduling. He invited the staff to comment on the terms of that agreement, and the extent to which those terms had been incorporated into the program estimates.

It was vital to have good statistical information in order to monitor the progress under the present stand-by arrangement, Mr. Nimatallah stated. He encouraged the authorities to continue their efforts to improve the quality and timeliness of the statistical information. He was encouraged by the fact that a Fund resident representative had recently been stationed in Peru; data relating to some of the quantitative performance criteria for the first quarter of 1984 had already become available. In conclusion, he commended the authorities for adopting the stabilization program.

Mr. Schneider commented that for the third consecutive year the Peruvian authorities were presenting an adjustment program for which they requested the use of Fund resources. The performance record over the past two years had been disappointing as a result of both adverse external conditions and inadequate implementation of domestic policies. He had some lingering doubts about the feasibility of the present program, as Supplement 1 to EBS/84/57 implied that its full implementation was uncertain. On one hand, the staff appraisal indicated that most of the major fiscal revenue measures and corrective price increases had already been put in place in early 1984 and would yield additional fiscal revenues equivalent to 2 percent of GDP. On the other hand, the supplementary paper had mentioned measures that had been recently implemented to help ensure the planned reduction of the deficit of the nonfinancial public sector. Those new tax measures would yield approximately 0.5 percent of GDP. Although he presumed that the latest measures were in addition to the previous steps, he had some doubts about the additional character of those measures, and he would appreciate clarification by the staff of the reasons for their implementation.

There had been an apparently unsatisfactory development in fiscal revenues at the beginning of 1984, Mr. Schneider noted. Price increases, particularly for rice, had been scheduled to occur monthly, following an initial 25 percent increase in January-February 1984. At present, however, an increase was expected only at the beginning of May, together with a new system that would hamper the verification of the implementation of increases.

He was not entirely convinced that the program was a balanced one, Mr. Schneider remarked. The essential problem was clearly the viability of the balance of payments over the medium term, yet the program dealt almost exclusively with the control of domestic demand and disregarded the question of the adequacy of exports. Although the program was a cornerstone for achieving a sustainable balance of payments position, consideration of that issue had been relegated to a discussion in November in conjunction with the 1984 Article IV consultation. He wondered why such an essential issue had been postponed to the end of the program period and had not been made a performance criterion.

Peru faced a problem of external competitiveness, Mr. Schneider said; in 1984 exports were expected to be, in nominal terms, about 20 percent below their 1980 level, while the real effective exchange rate was still about 10 percent above its level at the beginning of 1980. Even allowing for the unusually high level of exports in 1980, it was apparent that exports were not performing very well. Decisive action on the export side was crucial also because of the medium-term balance of payments and external debt projections, which indicated that the external payments situation would remain very tight even with reasonably favorable assumptions about the growth of GDP and exports. Table 11 (EBS/84/57, Sup. 1) showed that the required medium-term capital inflows would amount to about $2 billion by the end of the decade. Peru's economic policies should thus be more consistent with a viable medium-term payments situation in order to obtain the needed external support. He believed that the Peruvian authorities would implement the program with determination; therefore he could go along with the proposed decision on the stand-by arrangement.

With regard to the request under the compensatory financing facility, Peru's estimated shortfall was both temporary and due to factors beyond the control of the authorities, Mr. Schneider stated. In addition, the requirement that the country should be willing to pursue appropriate policies to correct its balance of payments difficulties had been met for some time and Peru's recent decision to cooperate with the Fund underscored that willingness. He therefore supported the request for the purchase under the compensatory financing facility.

Mr. Feito said that he supported both Peruvian requests. During the past year a number of internal and external factors had resulted in a sharp deterioration of the economy in general and of public finances in particular. The measures implemented during 1983 to bring the economy back onto the adjustment path envisaged under the previous arrangement had proved insufficient in the face of the uncertain economic environment and the accompanying undermining of confidence. As a result, by the end of 1983, the macroeconomic outcome had been very disappointing. Real GDP had dropped by 11 percent; inflation had increased by more than twice the figure originally programmed; and the overall balance of payments had reached a clearly unsustainable position. Under the circumstances, the need for a substantial adjustment effort that would produce results in the shortest period of time was beyond any doubt.

The situation called for a substantial correction of public finances, Mr. Feito remarked. The existing public sector deficit could not be financed, given available foreign resources, without an undue increase in the inflationary tax on the economy. He therefore emphasized the need for a reduction in the fiscal deficit. He welcomed the information that the permissible deficit of the nonfinancial sector had been raised to accommodate additional long-term finance from the World Bank and other bilateral sources.

While the program addressed the inevitable need to carry out tight fiscal and monetary policies in an unfavorable economic environment, Mr. Feito continued, he welcomed the inclusion of a number of structural measures. Those measures would help to ensure the stability of the equilibrium sought under the short-run adjustment program. In economies where severe macroeconomic adjustment had been implemented to attain an equilibrium balance of payments position that could be financed with available foreign resources, there was a special need to ensure that the equilibrium would not vanish soon after the conclusion of the program. The supply side of the economy should be strengthened to ensure that the gains made in the short-run adjustment process were preserved and that the external balance was sustained without unduly recessionary conditions. In that respect, he particularly welcomed the flexibility planned in the labor legislation that would contribute to the elimination of existing rigidities in the labor market. The greater reliance on market forces to determine prices for certain agricultural products and the changes in the legislation on land ownership were also welcome. Those and other structural elements would contribute to a more efficient allocation of resources in the medium term, thus making the Peruvian economy less vulnerable to external shocks and more likely to achieve a stable balance of payments situation.

He joined Mr. Kafka in asking about the possible medium-term adjustment path for the economy once the arrangement had been concluded, Mr. Feito said. Although Table 11 in Supplement 1 (EBS/84/57) indicated probable medium-term balance of payments flows, the information should be supplemented by assumptions on the behavior of the public and private sectors over time. On previous occasions he had referred to the need for medium-term balance of payments, external debt, and fiscal finance projections, supplemented by data on private savings and investment. In that way it would be possible to monitor the consistency of different flow projections and to have a clearer picture of the main features and direction of the economy.

Mr. de Vries said that he felt uncomfortable about the program and the papers before the Board. Mr. Schneider had commented that he was not entirely convinced that the program was a balanced one, and he shared that concern. It was true that Peru had experienced a number of unfavorable circumstances: natural disasters, the difficult international situation, as well as policies that perhaps were not fully adequate and a track record that was not completely favorable. Mr. Erb had noted the length of time during which Peru had made use of Fund resources; the lack of improvement in the situation was thus perhaps even more striking. The figures in Table 9 (EBS/84/57) on selected economic and financial indicators showed a number of disturbing elements. Although the Fund had had arrangements with Peru for the past seven or eight years, the central administration budget deficit, in terms of GDP, had been 2.8 percent in 1980; it had risen in 1981-83 and was projected to reach 2.5 percent in 1984. The figures indicated that, even with a favorable outturn of the proposed program, there would be no improvement over 1980.

Concerning the current account deficit, the situation was even less favorable, Mr. de Vries stated. The deficit had increased steadily in percent of GDP and, according to projections, it would decrease by only 0.5 percent in 1984 under the program.

With regard to the debt situation, Mr. de Vries continued, external debt in terms of GDP was an important indicator because, compared with debt service ratios related to exports, the ratio did not rise as export opportunities declined. Peru's external debt in terms of GDP had increased steadily to 77.5 percent, and if the objectives of the program were reached, only a minor improvement--to 77.1 percent--was forecast for 1984.

In sum, it was not an encouraging picture for a country with which the Fund had had programs for many years, Mr. de Vries remarked. Those programs had clearly been unable to bring about even the prospect of a sustainable balance of payments position. If anything, the situation had deteriorated. Looking at some of the factors behind the unsatisfactory picture, there were, apart from natural disasters, some actions by the Peruvian authorities that were responsible. For instance, Table 4 in Supplement 1 (EBS/84/57) showed an increase in the overall public sector deficit, caused mainly by an even greater decline in central administration current revenues. As a percentage of GDP, the fall in revenues had been more rapid than the rise in the deficit. It was true that the Fund did not always counsel countries to increase the tax burden, but in Peru the tax burden had been light--20 percent in 1980 and down to 14 percent in 1983. Even after disregarding 1980, when special factors might have been at work, the tax burden in the remaining years had been falling more rapidly than the rise in the public sector deficit. Another indicator, pointed out by Mr. Erb, was inflation, which had doubled recently, and for which only a slight improvement was foreseen.

He welcomed the agreement that had been reached with the Peruvian authorities, Mr. de Vries remarked, but the birth of the program had been difficult. The discussion in the Board had been rescheduled and the paper formulating the decision had been distributed only the previous day. His experience with programs that were born with such hardships was that they had a very low life expectancy, because those difficulties often pointed to a lack of political commitment that could lead to an early failure of the program. The statistical prognosis for the program, therefore, was not favorable. In the past, the Board had often spoken diplomatically of the fact that the Peruvian authorities had engaged in what was called unproductive expenditures. But given the sizable external aid that was still required, perhaps the Board should express itself more clearly. Like Mr. Erb, he was concerned about the high military expenditures, and while it was the prerogative of the authorities to decide how to allocate their resources, if those decisions resulted in large military expenditures, the enthusiasm of other governments to help might diminish.

With regard to the request for compensatory financing, Mr. de Vries observed that when the exchange rate was wrong, there was always the suspicion that the shortfall was not largely beyond the control of the member. He noted that doubt, but supported the request.

On a more difficult matter, Mr. de Vries recalled that in another case a member's authorities had decided not to draw from the Fund, because they had met the performance criteria through window dressing, but not in a fundamental sense. The Peruvian case was more serious, because Table 3 (EBS/84/57) indicated that performance criteria had not been met as of March 31, 1983 for the net international reserves of the monetary authorities, or on June 30, 1983 for the total net indebtedness of the nonfinancial public sector; nevertheless, the drawings had been made, based on preliminary data.

He looked forward to the forthcoming discussion on the general aspects of reporting, Mr. de Vries continued. Mr. Polak had wondered why it had taken so long to write a paper on that subject, because the inevitable conclusion was that a country must repay the Fund promptly if it had drawn when it was not entitled to do so. He wished to remind Executive Directors of that basic position, although it was not at issue in the present discussion. If the Board approved the proposed decision without dealing with that matter, he emphasized that it would not be setting a precedent. On the contrary, cases such as that of Peru had prompted the Board to place the general subject on the agenda. He understood that as there was no Fund policy at present, no action had to be taken, and the Board's freedom to establish procedures for future similar cases was not affected. In conclusion, he supported the proposed decisions.

Mr. Joyce said that despite an array of Fund-supported programs since 1977, the Peruvian economy had encountered increased strains, particularly during the past few years. While the authorities had taken some important steps under the previous program, the economy had shown no real signs to date of moving toward a sustainable external position. Peru's situation had admittedly been made very difficult by adverse circumstances, including natural disasters, weak export markets, high interest rates, and reduced access to foreign financing. That litany of problems was not unique to Peru, but in Peru's case those difficulties had been exacerbated by inadequate flexibility and policy implementation, the lack of effective control over public expenditures, and an apparent inability to bring the fiscal situation under control.

Those failures had led to the breakdown of the adjustment program in 1983 and to the failure of earlier programs, Mr. Joyce remarked. The main goal of the authorities at present must be to encourage the development of conditions that would restore investor and producer confidence in the economy. That would be possible only if the authorities achieved greater control over fiscal policies than in the past and continued to pursue the structural reforms necessary to improve the economic efficiency and international competitiveness of the economy.

The measures outlined in the proposed stand-by arrangement would require a high degree of commitment and determination on the part of the authorities, Mr. Joyce observed. He welcomed the steps already taken, and he hoped that the additional measures envisaged would be implemented promptly, and would in fact prove adequate. Although he was not fully convinced of their adequacy, he was prepared to give the authors of the program the benefit of the doubt. In any event, successful implementation provided Peru with its best and perhaps only chance to lay a secure foundation for renewed growth. However, the achievement of an average rate of growth of 4 percent over the balance of the decade, and the ability to bring the current account deficit down to approximately 2 percent by 1989, would only be possible with continued access to external resources of about 10 percent of GDP a year. That amount of external support would be forthcoming only if foreign creditors were convinced that Peru's economic policies were consistent with achieving a viable medium-term payments position.

With regard to 1984 finances, Mr. Joyce noted that rescheduling arrangements to July 1985 were expected to be completed during the current year. That was clearly a key element in the financing plan for 1984, and he wondered if the staff could inform the Board whether rescheduling would occur as envisaged, and on what terms and conditions, particularly in relation to the Paris Club.

There were three main areas of adjustment, Mr. Joyce stated. First, in view of the key role that inadequate control over fiscal policy played in the failure of previous programs, the planned reduction in the budget deficit clearly was vital to the success of the new program. The level of government expenditures in the past, including major expenditures on defense and paramilitary forces, had aggravated external and internal imbalances and had placed serious constraints on private investment and on the private sector's access to financing. The substantial increases planned in the prices of goods sold by state enterprises would not only help to strengthen the weak financial position of those enterprises but would also reduce the strain on the exchequer. He welcomed those measures and he hoped that the authorities would ensure that pricing policies remained effective and flexible.

He also welcomed the determination of the authorities to maintain control over wages and salaries in large parts of the public sector in order to help moderate wage inflation, Mr. Joyce stated. He was pleased that the authorities had reaffirmed their intention not to maintain general wage increases or bonuses for private sector workers. Full wage indexation in the state enterprises should also be discouraged and possibly terminated. While the projected increase in government revenues would greatly assist efforts in reducing the fiscal deficit, like Mr. Prowse, he was concerned that the income tax revenues expressed as a percentage of GDP had declined from 6.1 percent to 2.7 percent and, despite the anticipated economic recovery, were expected to decline further to 2.3 percent in 1984. In part, that decline seemed due to inadequacies in the tax system rather than to an increased incidence of tax evasion. He therefore welcomed the technical assistance provided by the Fund to improve control over tax collection and, more important, to assist the authorities in conducting an in-depth review of the tax system. He hoped that some preliminary suggestions for improving the tax system could be developed by the time of the midterm review.

A key area of weakness in the previous program had been expenditure controls, Mr. Joyce remarked, due in part to delays in obtaining accurate data. The strengthening of monthly budgetary control and program monitoring should help to increase the authorities' ability to ensure that expenditures stayed on target. With regard to the accuracy and flow of information, he wondered if the authorities planned to implement any new measures that would avoid the problems experienced in previous years.

He was not reassured by information that partial data indicated that tax receipts in the first quarter of 1984 were below projections, Mr. Joyce added, and that local currency expenditures were greater than programmed. The outturn for the state enterprises during that period was unavailable.

Second, in the area of monetary policy, the determination of the authorities to ensure better control over inflation and to assure market-determined interest rates would be helpful, Mr. Joyce continued. The maintenance of positive real interest rates was essential to finance private sector activity through domestic savings and to avoid capital flight. The negative outflows of about $1.1 billion in 1983 indicated the urgency of the need to restore confidence in the private sector.

Third, with regard to external policies, Mr. Joyce commended the authorities for their decision to return to a flexible exchange rate policy. Although a flexible exchange rate, as with domestic increases in controlled prices, might result in a higher level of inflation in the short term, it should be possible to attenuate those pressures if adequate demand management policies were put in place. The exchange rate and pricing policies pursued in the second half of 1983 had placed dangerous strains on the economy, and the reversal of those strains was a prerequisite for the achievement of economic recovery and stability. In view of the continued heavy debt burden in coming years, it would be essential for Peru to implement its exchange rate policy in a manner that maintained the country's international competitiveness and promoted adequate inflows. The spread on the second exchange market for dollar certificates of deposit had reached 10 percent. Although the exchange rate policy could reduce that spread, it might be worthwhile for the authorities to assess the need for that market.

He was concerned about the continued role played by subsidies for nontraditional exports, Mr. Joyce commented. Notwithstanding the weakened position of that sector, such subsidies imposed a financial burden on the Government and were certain to introduce protectionist pressures against Peru and to reduce the sensitivity of those industries to market developments. Peru's tariff barriers had increased further in recent months. Although described as a fiscal measure, that action might affect neighboring authorities' disposition to purchase goods from Peru.

He supported the proposed stand-by arrangement and the request for a drawing under the compensatory financing facility, Mr. Joyce stated. Given the size of the shortfall accounted for by nontraditional exports, he did wonder about the extent to which Peru's exchange rate policy in the past had affected exports. The success of the program would depend on the continued determination of the Peruvian authorities, and like others, he was concerned about the rather limited view given in the staff paper of the medium-term outlook. Peru would need continued assistance and he would appreciate comments by the staff or Mr. Donoso on the medium-term prospects, assuming the successful conclusion of the present program.

Mr. Malhotra stated that he supported the proposed stand-by arrangement and purchase under the compensatory financing facility. Conditions in 1983 had been very difficult in Peru, as evidenced by the decrease in GDP of 11 percent, the high rate of inflation, and other adverse developments. With regard to the 1984 program, the Peruvian authorities had implemented several measures, especially in the fiscal area, in advance of approval of the stand-by arrangement. A major reduction was contemplated in the overall deficit of the nonfinancial public sector from a high level of 10.3 percent in 1983 to 4.1 percent in 1984. To that end, action had been taken by the authorities both to raise revenues and to cut expenditures. He commended the authorities' policy of reducing current expenditures rather than capital expenditures in order to ensure medium-term prospects for growth in Peru. However, he was concerned about overall revenue, and he invited the staff to comment on the apparent erosion of the income tax base. The ratio of taxes to GDP had fallen from 6.1 percent to a projected 2.3 percent in 1984. Perhaps the income tax contribution of some major corporate sectors had been high in the past, and when their profitability had been adversely affected, the yield had been reduced disproportionately. Otherwise, in an inflationary situation, when income taxes were levied on a progressive basis, the yield should increase. It was apparent that tax administration, especially of income tax, required urgent attention.

The program appropriately proposed to limit the expansion in broad money to the rate of real growth in GDP, Mr. Malhotra commented. However, because of the highly inflationary situation, it would be necessary to monitor the situation carefully to ensure that the growth of the money supply did not exacerbate the already high inflation rate. He was pleased that interest rates, which had been negative for several years, would be freed and determined by the market. It was important to keep interest rates positive, especially as there had been an outflow of capital from the country.

The intention to follow a flexible exchange rate policy was welcome, Mr. Malhotra said. In the past, the nominal depreciation of the sol had been well below the rate of inflation, yet the staff figures showed that there had been a real depreciation. Was that because the regional trading partners of Peru had had a much higher rate of inflation? If the weight of Latin America in Peru's trade was high, then the evolution of the exchange rate was understandable.

Like several other Directors, he believed that the situation at the end of the program under consideration would remain difficult, Mr. Malhotra stated. Table 9 of Supplement 1 (EBS/84/57) showed that GDP was expected to grow in 1984 by only 4 percent, returning to its 1979 level following the large decline of about 11 percent in 1983. With a population growth of 2.8 percent, real income per capita would decline by the end of 1984 by about 15 percent. The rate of inflation was expected to reach 70 percent in 1984, compared with 59.2 percent in 1980, 72.7 percent in 1981, and 72.9 percent in 1982, although it would be well below the rate recorded in 1983 of 125 percent.

Trade figures indicated that export volume would fall by 4.3 percent after a decline of 7.5 percent in 1983, Mr. Malhotra continued. Although exports in terms of U.S. dollars were expected to improve by 3.8 percent, the terms of trade over 1980-84 would remain unsatisfactory. On the other hand, he welcomed the major turnaround in public savings from minus 2.9 percent to 2.7 percent in 1984, although that level was still low. The current account deficit was projected at 5.3 percent of GDP, and interest payments were slated to be as high as 6.3 percent of GDP or 26 percent of exports of goods and services.

He joined other Directors in noting the importance of looking closely at the medium-term evolution of the Peruvian economy and at the role that the Fund envisaged for itself, Mr. Malhotra remarked. A major debt rescheduling would be essential in the future. Considering Peru's very high debt service obligations, it might be worthwhile to consider what kind of rescheduling it should attempt.

With regard to the request for a drawing under the compensatory financing facility, the criterion of need had been fully met, and the shortfall was due to reasons largely beyond the control of the Peruvian authorities. The task ahead was an extremely difficult one and it was important that the program be implemented effectively; he wished the authorities success.

Mr. Laske recalled that on April 6, 1984, the Executive Board had endorsed the decision not to discuss Peru's request for a stand-by arrangement and for a drawing under the compensatory financing facility because of uncertainties about the authorities' compliance with certain commitments that they had made in their letter of intent. The present discussion had been scheduled following assurances that that action, or substitute measures, had been taken. He hoped that the character and projected effects of those delayed actions provided sufficient assurance of the Peruvian authorities' determination to implement fully the program that they had set out in their letter of intent. The record of policy implementation under the canceled extended arrangement had not inspired confidence and he therefore approached the stand-by request with some hesitation. Like other Directors, he had also been struck by Peru's prolonged use of Fund resources and its limited progress over that period.

The new program focused appropriately on adjustments in the fiscal area and on the need to dampen the high inflation rate, Mr. Laske commented. Adverse weather conditions and other exogenous influences had put a heavy strain on the Peruvian economy and on public finances, but repeated slippages in policy implementation had also played an important role in the intensification of domestic and external imbalances. Those slippages had led to the complete collapse of the previous program. The present program aimed at a sizable reduction in the ratio of the net financing requirement of the nonfinancial public sector to GDP, because it was in that area that imbalances had been exceptionally severe, with the largest increase occurring in 1983. Measures to achieve that objective were concentrated heavily on the revenue side, but some action was envisaged on the expenditure side where the room for maneuver might be more circumscribed, with the possible exception of defense expenditure.

The economic policy memorandum of the Government specified as prior actions an increase in the general sales tax, the elimination of certain tax exemptions, the introduction of a tax on traditional exports, and adjustments in regulated prices and tariffs, Mr. Laske said. The implementation of some of those actions had been completed by April 6 and others had been replaced by different measures. The measures, as originally planned, would strengthen revenue by 3 percent of GDP. It was not clear whether the new combination of complex and widespread measures would produce the same results, in terms both of revenue gain and of providing incentives for rational economic behavior. When an aggregate target for revenue increases was distributed over a multitude of items, it seemed to carry a larger risk of being missed than when it was concentrated on a few central items. One of the measures reported by the staff--the shortened payment period for some indirect taxes--would produce revenue-raising effects only in 1984, and thus would not lead to a permanent strengthening of the public finances.

The modifications made to the method of adjusting rice prices might delay the elimination of the operating deficit of the marketing agency until later in 1984, Mr. Laske noted, with possibly detrimental repercussions for the deficit of the nonfinancial public sector. Electricity rates were programmed to be increased in line with, or even above, rises in production costs. The new system seemed to limit the size and develop the timing of those increases, and it was not clear whether the Government envisaged further increases if the price corrections proved insufficient to achieve the original targets.

A key objective of the program was a reduction in the inflation rate, Mr. Laske remarked, which would require not only a speedy reduction of the public sector's financing requirements, but adequate restraint in monetary policy. Intense inflationary expectations combined with low rates of interest had made sol-denominated financial assets unattractive. A slowdown, if not a reversal of the progressive dollarization of the Peruvian economy, would be facilitated if steps were taken to make interest rates positive in real terms at an early date. The only specific measure that could bring about positive real rates for investors appeared to be the creation of certificates of deposit with a freely negotiated rate of interest. It remained unclear what role indexed financial instruments would play and which measures would be taken to ensure that financial investments in sol-denominated assets would become more attractive than those denominated in foreign currencies.

The performance criterion relating to the net domestic assets of the monetary authorities in the 1982 program under the extended arrangement had covered the Central Reserve Bank and the Banco de la Nación, Mr. Laske observed. In the new stand-by arrangement, the same criterion applied only to the Central Reserve Bank, and he was not sure that the Banco de la Nación would be sufficiently constrained in its lending activity so that it did not undercut the monetary policy intentions of the authorities. It was surprising that inclusion of that bank in the performance criterion was no longer felt necessary after it had been considered essential for the extended arrangement program.

The deficit of the nonfinancial public sector would be covered exclusively by foreign borrowing in 1984, Mr. Laske remarked. That would ease the pressure in the domestic credit market and would make more financing available for the private sector, which had been short-changed in 1983. Nevertheless, he had some reservations. Peru's external indebtedness was extremely high; at the end of 1983, external debt had amounted to 77 percent of GDP and the debt service obligation would absorb as much as 63 percent of export receipts in 1984. Those relationships clearly indicated that foreign borrowing had to be limited. The medium-term projections for the debt service ratio assumed continued debt rescheduling; otherwise, the ratio would remain extremely high. It remained to be seen, however, whether the assumed debt rescheduling could be secured to the extent expected. Interest on foreign credit would surpass the expected trade surplus by a significant amount in 1984; interest costs were an important factor in determining the size of the current account deficit, which would remain almost unchanged from 1983 in nominal terms and as a percentage of GDP. The high and rising cost of Peru's external indebtedness and the modest improvement in the current account envisaged for 1984 demonstrated the urgent need for the authorities to avoid policy slippages.

He asked the staff for assurance that the measures described in the supplementary paper were equivalent to those originally set, Mr. Laske said. The reviews would provide an opportunity to evaluate the likely results of those measures and their adequacy with more precision. He also hoped that the authorities would remain in close contact with the Fund, particularly if developments indicated that deviations from the program projections were likely to occur. If that happened, the Peruvian authorities should start discussions with the Fund at an early stage about potential supplementary actions to keep the arrangement on track. In addition, close cooperation between the Peruvian authorities and the Fund would be essential because the requested drawing under the compensatory financing facility fell in the upper tranche, and would raise outstanding compensatory purchases to more than 80 percent of quota.

He was pleased to note the observance of the monetary and reserve criteria as of March 30, 1984, Mr. Laske said. He was, nevertheless, concerned that even small deviations from the program's path could put the arrangement in jeopardy. He supported the proposed decisions for the stand-by arrangement and the purchase under the compensatory financing facility.

In closing, Mr. Laske noted that the staff had stated that the data on the basis of which Peru had made purchases under the extended arrangement had had to be corrected, indicating on the one hand that improvement in the data collection system was urgent. On the other hand, the experience raised the question of whether Peru had been able to use Fund resources to which it had not been entitled under the terms of the extended arrangement. He invited the staff to comment.

Mr. Clark said that he recognized the serious and unexpected disruptions with which the Peruvian economy had had to contend in 1983 and that clearly had played a part in the breakdown of the extended arrangement. But he noted the comments in the staff appraisal that inadequate implementation of domestic policies had also accounted for some of the unfavorable results obtained in the recent past. Such slippages must be firmly resisted in implementing the new program, and he welcomed the back-loading of drawings and hoped that progress would be tracked closely. The statistical monitoring in 1983, especially of the fiscal side, had been unsatisfactory, and he urged strict observance of the new program.

He endorsed the staff appraisal and the general thrust of the program, Mr. Clark stated. One constraint that emphasized the general urgency of adjustment was the accumulated weight of external debt and the substantial servicing costs at present and into the medium term. That debt left little room for maneuver and would require a willingness on the part of the authorities to react quickly to unforeseen developments in the economy.

Annual rescheduling would probably be needed for several years, underlining the need to maintain the confidence of external creditors. The letter of intent and attached memorandum illustrated the authorities' awareness of that point. The authorities had stated that a major consideration in the design of the economic program had been to provide clear signals with respect to the desired direction of the economy over the medium term. He welcomed the steps taken to overhaul the institutional arrangements for public spending and tax administration, and he hoped that those changes would lead to an improvement in the provision of financial data to facilitate awareness of trends during the program period.

The program called for the pursuit of a flexible exchange rate in order to maintain the economy's competitive position, Mr. Clark noted. But he wondered whether maintenance was enough; the real appreciation of the exchange rate in the last quarter of 1983 suggested some erosion of competitiveness before the start of the program period. The containment of wage pressures as envisaged under the program might help to reduce the loss of competitiveness, but if further slippages occurred, the exchange rate should be looked at again.

On balance, he could support the request under the compensatory financing facility, Mr. Clark said. Although he accepted the present commitment of the authorities to implement a program in consultation with the Fund, he was unsure whether the track record, which must be considered in determining access to the second tranche of the compensatory financing facility, was satisfactory. In addition, a substantial element of the shortfall arose from manufactured goods, and--in line with his earlier comment on the exchange rate--posed the question of how far the shortfall was beyond the control of the Peruvian authorities. He invited the staff to comment on that point. Notwithstanding those reservations, he supported the proposed decisions.

Mr. Ismael stated that he supported Peru's request for the use of Fund resources under a stand-by arrangement and the compensatory financing facility. In doing so, he recognized the exogenous factors that had played an important role in accentuating the present internal and external difficulties faced by Peru. He was aware of the poor performance of Peru under the 1982 extended arrangement and the staff statement that "midway through the period of the extended arrangement, deviations from the program path had become so substantial that the possibility of attaining the objectives had become remote." He hoped that the authorities would make special efforts to ensure that adequate measures were taken to achieve the objectives of the new program. Taking account of the performance under the previous program, the proposed phasing of drawings was appropriate.

The performance criteria under the stand-by arrangement were adequate to meet the program objectives, although they left no room for slippages in the implementation of the program, Mr. Ismael noted. For many of the key elements in the program--for example, money, credit, and public finances--the base 1983 figures were described as projected or preliminary.

Because of the considerable lag between the reference period and the production of data, he asked the staff to comment on the technical difficulties that might be encountered in monitoring progress under the arrangement.

Wage control was crucial to the success of the program, Mr. Ismael commented. Wages and salaries accounted for about 40 percent of public expenditure and therefore constituted an important element in achieving the fiscal, price, and external objectives of the Government. While there was no performance criterion to control wages and salaries, he would nonetheless appreciate information from the staff on whether the Decree issued in August 1983 requiring ministerial approval of all public sector wage and salary increases was still valid. If so, he hoped that the authorities would make use of that instrument to help achieve the program objectives. He also asked the staff whether, in setting the credit ceilings for the public sector, the program envisaged any increases in emoluments in the public sector.

There had been a significant decline in the flow of long-term capital to Peru, Mr. Ismael noted. A structural adjustment loan from the World Bank had failed to materialize when emergency assistance could have played a vital role in dealing with the structural problems facing the country. Could the staff comment on the prospects and desirability of external assistance? Debt management was another key element in the program; the debt service ratio in 1984 was expected to reach 63 percent, and for the rest of the decade it would be in the range of 55-60 percent. Thus, it was difficult to envisage how Peru could maintain an open trade and exchange system and achieve a growth target of 4 percent a year. Like other Directors, he believed that further reschedulings of Peru's debt would be necessary. Moreover, new flows of long-term capital would be needed if Peru's economic problems were to be eased.

He was satisfied that all the requirements had been met for Peru to draw under the compensatory financing facility, Mr. Ismael said, and he could support the request. However, he noted that for the purpose of calculating the export shortfall, the staff had projected in EBS/84/59 that exports in 1984 would be SDR 3 million, representing a growth of 7 percent over 1983, while in EBS/84/57 exports in 1984 were projected to grow by 3.8 percent. He asked the staff to explain the difference in the rates of projected growth of exports.

Mr. Alhaimus commented that Peru's present request for a stand-by arrangement followed the severe difficulties it had encountered in implementing the medium-term program adopted in 1982. Those difficulties had included weakness in the external demand for exports, natural disasters, and domestic constraints. Considerable slippages had therefore occurred, with a sharp rise in the nonfinancial public sector deficit, a considerable decline in the GDP growth rate, inflation at double the projected rate, and a larger than expected overall balance of payments deficit.

The present program attempted to tackle Peru's domestic imbalances mainly through fiscal adjustment, Mr. Alhaimus observed. That approach was appropriate as the public sector deficit in the past two years had averaged 9 percent of GDP. It was encouraging to note that the principal revenue measures of the program, involving major tax increases and adjustments of controlled prices, had already been put into place to ensure the reduction of the deficit in 1984. Public expenditures would be restrained through measures covering both current and capital expenditures and a moderate wage policy. Such fiscal policies were expected to bring about a sharp fall in the currently high net financing requirement of the nonfinancial public sector. They would also contribute to the expected improvement on the external account, where the overall balance was expected to be in equilibrium in 1984 and the trade account was projected to improve markedly. The continuing fall in imports would not affect necessary inputs.

The high rate of inflation was a major area of concern that might have affected the decision not to effect a sharp depreciation of the exchange rate and that could have compounded the inflationary situation, Mr. Alhaimus remarked.

A clear-cut case for a purchase by Peru under the compensatory financing facility had been made, Mr. Alhaimus stated, and the estimated shortfall was over twice the requested drawing. It was interesting to note that one factor affecting the shortfall had been protectionist measures against Peru's nontraditional exports. He inquired whether Peru's practice, as reported by the staff, of pricing oil exports below world market prices would, inter alia, accelerate the process of depletion, given the capacity constraints, the low proven reserves, and the need for energy self-sufficiency over the medium and long term. To conclude, he supported the proposed decisions.

Mr. Camara said that he supported the decisions. The Peruvian request for use of Fund resources under the compensatory financing facility had met all the necessary criteria. There was clear evidence of a reversible shortfall caused by factors beyond the control of the authorities, including severe adverse weather conditions. The balance of payments need was not in doubt, and the test of cooperation had been met as evidenced by the stand-by arrangement before the Board.

The performance of the economy after three consecutive years of arrangements with the Fund had not been satisfactory, Mr. Camara stated. The program launched in 1982 had aimed at achieving a viable external position, high and sustainable economic growth, and declining inflation. Those objectives were far from being achieved: GDP had risen by less than 1 percent and inflation remained high. Similarly, performance under the 1983 program had aimed at correcting those deviations but had also fallen short of expectations, reflecting adverse weather conditions that, during the early months of 1984, had resulted in the loss of output, the scarcity of basic consumer goods, the acceleration of inflation, and the deepening of recession in Peru.

The fiscal situation had deteriorated progressively during 1983, despite the authorities' measures to contain the effects of adverse shocks, Mr. Camara commented. Even though expenditures had been reduced considerably, the shortfall in revenue had remained a serious problem. Moreover, a delay in the adjustment of a number of controlled prices and of utility rates had rendered the situation more difficult. The deficit of the nonfinancial public sector was estimated to have been about twice the amount programmed. It was not clear whether the targets had been too high or the performance potential of the economy had been overestimated. He hoped the reasons had been assessed correctly in order to ensure a satisfactory outcome of the present program. The elements of the 1984-85 program seemed adequate and the targets appeared feasible. He hoped that there would be room for flexibility so that possible slippages could be foreseen and measures taken to avert them.

On the external side, Mr. Camara continued, the balance of payments was targeted to be in equilibrium, contingent upon the removal of trade barriers in industrial countries. It was encouraging to note that the authorities intended to continue to avoid new restrictions on imports. The program projected that the current account of the balance of payments would be fully financed by medium-term and long-term capital inflows, which he hoped would materialize. As to external debt servicing, he noted that rescheduling had been arranged with a number of creditors for 1984, while progress had been made in establishing control over external borrowing by the public sector. He welcomed the return to a flexible exchange rate policy in Peru.

Mr. Hansen said that his authorities supported both decisions. While present difficulties were, to a large extent, due to severe weather conditions and to the prolonged recession in Peru's export markets, they were also due to substantial slippages in economic policies. He hoped that the present program would be fully implemented and that it would improve overall economic performance. Like other Directors, he would have appreciated a more detailed analysis of the impact of the program and of developments in the Peruvian economy in the medium term.

Mr. Zhang stated that he supported the request by the Peruvian authorities for a new stand-by arrangement and a purchase under the compensatory financing facility. He asked the staff to explain how the amount of the stand-by arrangement, equivalent to 75.6 percent of quota, had been determined. He presumed that it was equal to the amount that would have been purchased under the previous arrangement. Would disbursement consist entirely of ordinary resources?

The staff report stated that the new program incorporated a number of structural modifications to improve the allocation of domestic productive resources over the medium term, Mr. Zhang continued. Had the previous extended arrangement not included such medium-term structural policies, even though they should have been an integral part of that program? What had been the trend in private consumption in terms of GDP in the past few years, what was the projection for 1984, and how was the consumption of different income groups expected to change under the new stand-by arrangement? What had been the relation of consumption to imports? What measures in the new stand-by arrangement would affect incomes rather than wages? He believed that other incomes constituted a higher proportion than wages in total income.

With regard to the compensatory drawing, 83 percent of the total net shortfall was projected to be accounted for by nontraditional exports, Mr. Zhang observed. Since those exports consisted of diverse commodities that were affected by many factors in the export sector, did the staff have confidence in its projections of the shortfall, especially as those exports had amounted to only about 20 percent of total exports during recent years?

Mr. Ramtoolah said that his chair supported the proposed decisions.

Mr. Nguyen stated that, although he shared some of the concerns expressed by other Directors, he supported the requests by the Peruvian authorities.

The staff representative from the Western Hemisphere Department, replying to questions, recalled that in EBS/84/57 the staff had indicated that tax measures to provide revenue estimated at 2 percent of GDP for 1984 had been passed by Congress in mid-December 1983. By April 6, when the Executive Board had first been expected to take up the request for the stand-by arrangement, a number of those measures, specifically those referring to exemptions from sales taxes and to the wealth tax of 1-3 percent on automobiles and other consumer items, had not been taken, precluding revenue of 0.5 percent of GDP. Since that date, the authorities had drawn up a new package of measures that limited exemptions from sales taxes, although to a lesser extent than anticipated, and in addition to other measures, had implemented the tax of 1-3 percent on various luxury consumer goods. That package, projected to yield 0.5 percent of GDP, was comprised of measures that compensated for the lack of complete elimination of exemptions from sales taxes and for delays in implementation.

Pricing policies were consistent with the original program, the staff representative remarked. On April 6, a number of important measures, especially with regard to electricity and rice, had been delayed by one month, which was cause for concern because of the inflation rate of 120 percent a year. Specific pricing measures had since been taken; for example, electricity tariffs would be increased at a monthly rate of 10 percent, and the price of rice accounting for almost half of sales would be increased by 27 percent. Calculations for the year as a whole showed that because of the authorities' recent pricing measures, subsidies would be eliminated in the course of the year.

It had been possible to implement the revenue measures taken with ministerial or presidential authority, without waiting for the congressional session to begin, the staff representative explained. That pragmatic approach explained the lack of consistency of some of the measures. For instance, the staff only reluctantly had gone along with the increase in the import surcharge from 10 to 15 percent. A Fund technical assistance mission was assessing the impact of the proliferation of ad hoc tax measures on Peru's tax system, and it was expected that the mission's findings and suggestions for tax policy changes would be available prior to the midyear review to enable the authorities and the staff to discuss tax policy for the medium term.

Directors had commented on the dramatic decline in income tax revenue since 1980, the staff representative recalled. There had been a boom in metal prices in 1980, from which Peru had benefited enormously. The mining companies in particular had been very successful in 1979 and 1980, and their income tax payments had been very large. The GDP/tax ratio in 1981, at 3.9 percent, was a more appropriate basis for comparison. Nevertheless, there had been a decline in income tax revenue for several reasons. With higher rates of inflation, tax evasion had become a major problem in Peru. In 1983 and 1984 the recession had resulted in smaller profits for companies and thus income tax payments had declined. Another difficulty was that income tax exemptions had increased over time; exemptions were granted frequently for a number of years if companies were established in particular areas or were engaged in certain activities. The liberal tax exemption policy would have to be addressed in the review of the tax system undertaken with the help of the Fiscal Affairs Department.

An adequate level of interest rates, especially with inflation running at three digit rates, was extremely important, the staff representative remarked. Dollar-denominated savings instruments had increased enormously in the past few years and currently accounted for about half of the domestic financial instruments in the hands of the private sector. An effort had been made to provide a sol-denominated instrument that would be competitive with dollar-denominated instruments, by having the interest rate on the sol-denominated instrument freely determined in the market. At the beginning of 1984 authorization for such instruments had been given; however, the demand for them had apparently not been great. At the same time, the financial institutions reportedly were hesitant to issue such expensive savings instruments because they anticipated difficulty in relending the funds.

Most Directors had referred to the difficult medium-term outlook, the staff representative continued, and had mentioned that the program seemed to place more emphasis on short-term current account and fiscal adjustment. Perhaps that emphasis was conveyed by the detailed description of the fiscal measures contained in the paper. A strong fiscal effort was of utmost importance, following three years of serious slippages in attaining the public sector objectives, and was needed to re-establish the credibility of the program in Peru. As for the medium term, as the Board was aware, the extended arrangement was being canceled because the objectives were unlikely to be achieved in the remaining period of the arrangement.

Even though the program was framed in the context of a stand-by arrangement, the medium-term problems of Peru had been kept very much in mind, the staff representative went on. For example, the program incorporated a more realistic exchange rate policy. From August 1983 to February 1984, the exchange rate had moved at a rate below that of inflation, but at present the exchange rate was moving in line with inflation. In April 1984 the depreciation of the sol was 8 percent, and inflation 5.5 percent, illustrating the faster pace of depreciation of the sol. The exchange rate policy would be reviewed again at midterm.

There were other elements in the program, especially of a structural nature, that showed that the medium-term aspects had been considered, the staff representative commented. Those elements had been included in the previous arrangement but had not been implemented, and the staff believed that they remained fundamental to an improvement in economic growth. For example, in the agricultural sector, the staff and the authorities had agreed that a number of structural difficulties had to be corrected--including the provision of legal ownership to farmers of land distributed during the reforms of the early 1970s. Labor legislation also needed revision in order to give industry and manufacturing more flexibility in adjusting to a changing environment.

The World Bank had stopped structural adjustment loan negotiations because of Peru's failure in the past two years to implement structural reforms, the staff representative explained. However, the Bank would be willing to proceed with such a loan if the authorities would put in place medium-term policies it could support.

The Peruvian authorities found it difficult to take strong medium-term action because the Government would be in office only until July 1985, the staff representative remarked. The present Government believed that a number of actions would have to be decided at that time by the newly elected Government.

With respect to the medium-term projections, the staff representative pointed out that the current account deficit was forecast to move from 5.3 percent of GDP in 1984 to close to 2 percent in 1989. The public sector would have to reduce its financing requirements in line with that reduction to avoid crowding out the private sector during that period. With regard to exports, the staff had assumed a nominal growth of 6 percent, which was achievable and not overly optimistic. As to capital account financing, gross medium-term capital inflows would be about $2 billion a year, compared with amortization payments of about $1.5 billion. Those figures pointed to the need for rescheduling arrangements for the remainder of the decade. The World Bank, the Inter-American Development Bank (IDB), and the Latin American Development Bank, which had provided over $350 million in 1984, would provide funding for the remaining $0.5 billion.

Rescheduling arrangements had been included in the program for 1984, the staff representative said. With respect to the Paris Club, reschedulings were in place through April 30, 1984, covering 90 percent of both amortization and interest payments; 5 percent would be paid at the end of the period and another 5 percent would be paid as scheduled. There was an agreement in principle for similar refinancing for the period through February 28, 1985. The details would be worked out at a Paris Club meeting, requested by the Peruvian authorities, which was scheduled to take place at the beginning of June 1984. Moreover, the authorities had requested similar refinancing from the Paris Club through July 1985 to correspond with the period of the Fund program. An agreement with the U.S.S.R. would extend through December 1985, and similar agreements were being negotiated with other socialist countries. The banks had not fully accepted the proposed agreement for 1984, although the process of obtaining their participation was progressing. The amount of new bank money for 1984 was $200 million, which had not been distributed under the previous year's agreement with the banks because of Peru's failure to comply with the program agreed with the Fund. Of the $200 million, $100 million had been disbursed, and $100 million was subject to the Board's approval of the stand-by arrangement and a subsequent purchase by Peru. Other elements of bank rescheduling through July 1985 consisted of refinancing 100 percent of principal payments, rolling over short-term working capital into a medium-term loan, and maintaining commercial short-term credit lines.

The performance criterion on net domestic assets in the present program covered only the Central Bank for two reasons, the staff representative explained. First, the Banco de la Nación acted primarily as an agent and could obtain credit only through the Central Bank--which was covered by the program ceiling--or through borrowing abroad as the fiscal agent for the public sector. A new ceiling on the foreign indebtedness of the Banco de la Nación and COFIDE controlled the funding of the Banco de la Nación. Second, using that technique, the staff had avoided reporting difficulties, because the Banco de la Nación had a large number of branches throughout the country, making it difficult to compile aggregate data in a reasonable period of time. The change in the performance criterion should help improve the timeliness and accuracy of statistics.

The Ministerial Decree of August 1983 on the control of public sector wages and prices was still in effect, the staff representative noted.

It was difficult to discern the consumption patterns of different income groups in Peru, the staff representative from the Western Hemisphere Department commented, because the national income accounts were weak. Even in the Article IV consultation reports, the staff had not been able to show the distribution of income by various sectors because of the lack of information. Technical assistance in that area could be helpful.

The staff representative from the Exchange and Trade Relations Department noted that, with regard to drawings that had been made despite noncompliance with performance criteria, the Board would soon discuss a paper suggesting procedures for dealing with that problem on a general level. There had been a few other cases in addition to that of Peru, and the decision taken at the present meeting would not affect the freedom of the Board to establish and apply procedures to deal both with the prevention of such drawings in the future and with instances where those drawings had already occurred.

Access under the requested stand-by arrangement had no relationship to the amount of resources that had not been drawn under the canceled extended arrangement, the staff representative explained. There could be no presumption that undrawn amounts under a canceled arrangement were in any way committed or would be made available under a new arrangement. The new arrangement set a revised path for policies, had a different time horizon, and provided amounts in the light of the program, the balance of payments need, the period of the arrangement, and the general criteria on access discussed by the Board in December 1983. Many Directors had noted that Peru's problems would not be solved at the end of the arrangement, and that prospect was an important consideration for keeping access to Fund resources in line with the speed of recovery of the balance of payments. For those reasons it had seemed appropriate to set the amount of the stand-by arrangement at 75 percent of quota.

The staff representative from the Research Department commented that the projected figures for exports in the paper on the request under the compensatory financing facility had been stated in SDRs, whereas the figures in the paper on the stand-by arrangement had been given in U.S. dollars. The discrepancy in the figures reflected the appreciated exchange rate for the dollar for 1984 compared with 1983.

The question had been asked whether an inconsistency existed between one statement by the staff indicating that exports under the bilateral arrangement would not face supply constraints and another statement indicating that the recovery in cotton production--an export item under the bilateral arrangement--would be inhibited by the adverse weather of 1983, the staff representative said. A modest recovery in cotton production was expected, and supplies would be channeled to mill use in order to generate textile products. The effects of low supplies of cotton would be reflected in a substantial reduction in the volume of cotton exports but not in the availability of cotton for textile manufacture. With regard to that special bilateral arrangement, another question had been asked regarding the form in which payment would take place. It was a strict offset of loans against exports and no countertrade or currency payments were involved.

Several questions had been raised with respect to the factors determining the shortfall in exports, the staff representative recalled. The estimated shortfall in the present case was roughly twice the amount of the proposed purchase. While the stagnation of exports could not be denied, the compensatory financing request pertained to developments in 1983 in relation to a medium-term period. In the staff's judgment those developments had been largely outside the control of the member. For example, price developments in 1983 had been responsible for a substantial part of the shortfall. External developments, including the intensification of protectionist measures, had adversely affected exports such as textiles. But the overwhelming cause of the shortfall had been the natural disasters in 1983 that had affected virtually all products.

With regard to the role of the exchange rate in nontraditional exports, the staff representative observed that those exports had increased by 16 percent in 1982, when the real effective exchange rate had depreciated by 15 percent. In 1983 there had been a further exchange rate depreciation of 2.5 percent. The significant decline of 24 percent in exports of nontraditional products in that year was attributable to special factors other than exchange rate developments.

On the question of how much confidence could be placed in the projections for nontraditional exports in the staff paper, the staff representative from the Research Department explained that a substantial part of the projected growth was on account of the bilateral arrangement. If trade under the arrangement for both 1984 and 1985 were excluded, the growth rate for nontraditional exports would be only 10 percent a year. The staff believed that growth of that magnitude, which was roughly divided into 6 percent growth in volume terms and 4 percent in value terms, was a reasonable projection for those two years.

Mr. Donoso said that he agreed with Directors that stricter demand management did not solve all problems. A continuous effort to improve the allocation of financial resources had to be made, and any measures to improve the competitiveness of the economy would facilitate adjustment. Those considerations were of great importance to his authorities. There had been a systematic attempt to bring wages under control, and progress had been achieved in steadily improving competitiveness through that mechanism and the application of a flexible exchange rate policy.

The authorities planned to channel the financial resources that they controlled to the private sector through auction techniques, Mr. Donoso remarked. The introduction of financial assets with returns determined by the market would help to avoid capital outflows and improve the domestic allocation of resources. Although accelerated action would have been desirable, under the circumstances the proposed measures showed a strong effort to cope with the difficulties faced by Peru. Certain areas showed improvement compared with conditions two years previously. Therefore, Peru's new start was occurring at a more advanced stage in many respects.

There had been a significant deterioration in public finances during 1983, Mr. Donoso commented, with a subsequent increase in the rate of inflation and a loss of international reserves associated with the credit policies pursued following pressures on the financial markets from the public sector. The program for 1984 contemplated a drastic reduction in the deficit of the public sector and a tight monetary policy.

The natural disasters had been largely responsible for the departures from the program experienced in the previous year, Mr. Donoso explained. He hoped that 1984 would be different, and that significant progress would be made. The external situation was improving, which would also facilitate the implementation of the program. In general, the expected recovery in activity should provide an environment more favorable to the appropriate management of the economy. However, as many Directors had commented, the success of the program would depend on the commitment of the authorities, and in that regard he had encouraging information. The measures already implemented supported the necessary financing for the program, and the evolution of net domestic assets and international reserves during the first quarter showed the seriousness of the authorities' effort. Executive Directors' comments would be considered by his authorities in the implementation of their policies.

The economy of Peru was dependent on external factors and it could be severely affected by protectionist measures, Mr. Donoso stated, specifically, pressures to limit the free trade of copper, which represented 15 percent of Peru's exports. It should be a matter of special concern for the Fund that it was being argued that use of the compensatory financing facility enabled countries to introduce export subsidies, which led to unfair competition and therefore justified protectionist measures. Although he would be concerned about the effect on Peru's exports of such protectionist measures, he was especially worried that the pressure for protection could affect the operation of the compensatory financing facility or of any other Fund facility.

In spite of the Fund's clear opposition to protectionism, the institution was being depicted as facilitating unfair trade practices, Mr. Donoso remarked. It was ironic that a facility that had been created to provide access to financing for countries with balance of payments problems so that they would not apply trade restrictions or unfair subsidies on exports was seen as promoting that type of action. It was important for the Fund to clarify the general relationship between the compensatory financing facility and trade practices. Perhaps the Board could define the type of analysis required and, if agreed, request the staff to undertake the necessary studies. He proposed that the Board and management consider the problem.

The Chairman remarked that he too had been troubled by some indications linking the compensatory financing facility and protectionist efforts. If the Board so wished, a technical study on the topic, could be made.

Mr. Erb said that he supported the Chairman's remarks. In light of the Chairman's discussions with the President of Peru, and if the Chairman and Mr. Donoso agreed, it might be appropriate to convey to the President the sense of concern that most Directors had expressed about the economy's future prospects and the need to achieve better macroeconomic performance and to accelerate structural changes to open up the economy internally to a freer flow of goods.

The Chairman said that he would be willing to convey such a message.

Mr. Zhang inquired whether, in replying to his question, the staff representative was inferring that, under special circumstances, a country could use the Fund's ordinary resources, even though its purchases totaled 200 percent of quota.

The staff representative from the Exchange and Trade Relations Department said that he believed that the present arrangement could be financed entirely by ordinary resources. Normally, in cases of enlarged access, there was a relationship between ordinary and borrowed resources in the amount provided under stand-by or extended arrangements; in the present case, only ordinary resources were involved because the country's cumulative drawings under stand-by arrangements, including those that could potentially be made under the proposed stand-by arrangement, were below the country's quota.

The staff representative from the Legal Department explained that in many cases, the Fund provided balance of payments assistance to members that went beyond what was available to the member under the ordinary facilities of the Fund, because the members had large imbalances in relation to their quotas. The quota was therefore a type of test applied by the Fund. Enlarged access would be appropriate if the amount of the Fund's holdings outstanding under a previous stand-by arrangement plus the amount that the country could draw under a proposed stand-by arrangement would be in excess of the quota level, because the quota level was available to a member under the credit tranches. In the present case, 12.7 percent was outstanding on account of Fund holdings of Peru's currency resulting from drawings under a previous stand-by arrangement and 75 percent was being provided under the present arrangement. The total did not exceed the quota of Peru and therefore only ordinary resources would be provided to Peru. The amounts outstanding under other facilities were not taken into consideration for the purpose of the present stand-by arrangement.

The Executive Board then took the following decisions:

Stand-By Arrangement

1. The Government of Peru has requested a stand-by arrangement for the period from April 26, 1984 through July 1985 in an amount equivalent to SDR 250 million.

2. The Fund notes that the Government of Peru wishes to cancel the extended arrangement approved on June 7, 1982, as of the date on which the requested stand-by arrangement becomes effective.

3. The Fund approves the stand-by arrangement set forth in EBS/84/57, Supplement 2.

4. The Fund waives the limitation in Article V, Section 3(b)(iii) of the Articles of Agreement.

Decision No. 7679-(84/67), adopted
April 26, 1984

Purchase Transaction - Compensatory Financing Facility

1. The Fund has received a request from the Government of Peru for a purchase of SDR 74.7 million under the Decision on Compensatory Financing of Export Fluctuations (Executive Board Decision No. 6224-(79/135), adopted August 2, 1979).

2. The Fund notes the representation of Peru and approves the purchase in accordance with the request.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 7680-(84/67), adopted
April 26, 1984

Exchange System

Pending the conclusion of agreements for the rescheduling of Peru's external debt, the Fund grants approval of the restriction on the making of payments and transfers for current international transactions maintained by Peru, described in EBS/84/57.

Decision No. 7681-(84/67), adopted
April 26, 1984

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Directors without meeting in the period between EBM/84/66 (4/25/84) and EBM/84/67 (4/26/84).

2. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director and by an Advisor to Executive Director as set forth in EBAP/84/83 (4/24/84) is approved.

APPROVED: October 5, 1984

LEO VAN HOUTVEN
Secretary