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ROOM C-120 04

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/189

3:00 p.m., December 21, 1984

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	N. Toé, Temporary
	M. Lundsager, Temporary
	L. E. J. M. Coene, Temporary
	X. Blandin
	M. Z. M. Qureshi, Temporary
	M. Sugita
	D. Hammann, Temporary
J. E. Ismael	
	G. W. K. Pickering, Temporary
A. Kafka	C. Robalino
	A. S. Jayawardena
	A. Abdallah
	B. Jensen
Y. A. Nimatallah	
P. Pérez	
J. J. Polak	T. de Vries
	A. V. Romuáldez
	O. Kabbaj
J. Tvedt	
N. Wicks	
	N. Coumbis
	Wang E.

L. Van Houtven, Secretary
S. L. Yeager, Assistant

Fiscal Affairs Department. Discussions on a study that had been completed and presented to the authorities were ongoing. An expert from the Fiscal Affairs Department was currently in Lima and would return there at the beginning of 1985 for further discussions. The staff had indicated to the authorities the importance of tax reform and improved tax administration for any future program supported by the Fund.

Dollarization of the financial system was related to the inadequacy of domestic interest rates for sol-denominated instruments, the staff representative pointed out. Dollarization and inflation were also linked: both indicated a lack of confidence in economic management in Peru. As long as expectations of higher inflation as well as exchange rate depreciation persisted and interest rates remained inadequate, dollarization and inflation would continue.

The staff did not consider the fiscal target for the adjustment program to be overambitious, the staff representative commented. The program had allowed for an increase in foreign indebtedness relative to GDP of about 5 percent, assuming that additional spending by the public sector and by the private sector would be about 4 percent and 1 percent, respectively. It was considered important to give the private sector some room to expand because for almost three years it had been squeezed by the public sector, which had a deficit equal to 10 percent of GDP. The program therefore sought to rectify that situation to some extent by limiting the financing requirements of the public sector to about 4 percent of GDP in 1984.

The Deputy Director of the Exchange and Trade Relations Department observed that, in dealing with countries that had used resources on a prolonged basis, the Fund had required a strong adjustment effort as a basis for further assistance and had typically limited the scope of access to Fund resources, particularly when a rapid recovery in the balance of payments was not foreseen. As several Executive Directors had mentioned, some decisive policy action by Peru would be required before it could envisage entering into a new arrangement.

As to the existence of a multiple currency practice in Peru, the Deputy Director added, SM/84/250, Supplement 1 noted that the differential between the exchange rate in the certificate market and that in the official market was about 2 percent. The latest data, however, indicated that it had risen to about 2 1/2 percent, which, strictly speaking, gave rise to a multiple currency practice for which the staff was not recommending approval. If the differential fell below 2 percent, the multiple currency practice would be eliminated, of course; should it rise above 2 percent, however, a practice would arise again for which there would be no Fund approval.

With regard to the process of dollarization, the Deputy Director of the Exchange and Trade Relations Department observed, the alternative was inflation and capital flight. To the extent that domestic savings were retained in the economy for a period of time through dollarization,

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N. Wicks	
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	Wang E.

L. Van Houtven, Secretary
S. L. Yeager, Assistant

Also Present
Exchange and Trade Relations Department: M. Guitián, Deputy Director; D. A. Lipton. Legal Department: P. L. Francotte, Ph. Lachman. Western Hemisphere Department: E. Wiesner, Director; C. Atkinson, J. Jaramillo-Vallejo, J. F. van Houten. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: G. R. Castellanos, G. E. L. Nguyen, E. M. Taha, A. Vasudevan, M. A. Weitz. Assistants to Executive Directors: Chen J., J. de la Herrán, J. J. Dreizzen, A. K. Juusela, R. Msadek, J. A. K. Munthali, A. H. van Ee, A. Wood.

1. PERU - 1984 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/84/188, 12/21/84) their consideration of the staff report for the 1984 Article IV consultation with Peru (SM/84/250, 11/6/84; Cor. 1, 12/11/84; Sup. 1, 12/20/84; and Sup. 1, Cor. 1, 12/20/84). They also had before them a report on recent economic developments in Peru (SM/84/255, 11/19/84).

The staff representative from the Western Hemisphere Department, commenting on the coordination between fiscal and monetary policies in the 1984 adjustment program, stated that the program had been designed to provide a relative balance between fiscal and monetary management. As it had turned out, fiscal management had been much weaker than expected, and monetary policy had been tightened.

As to whether the revenue measures taken on December 15, 1984 represented the minimum adjustment effort needed to avoid further increases in external arrears, the staff representative recalled that in September 1984 the staff had estimated that, with a public sector deficit on the order of 10 percent of GDP, a revenue increase equivalent to approximately 3 1/2 percent of GDP would have to be effected in the remaining months of 1984 to reduce the deficit to 6 1/2 percent of GDP, an amount that could have been financed without incurring further delays in payments. The measures taken on December 15 had certainly been a step in the right direction, but to determine whether they would be sufficient to reduce payments arrears in 1985 would require a much closer examination of expenditure plans and additional revenue measures authorized by the December 15 budget law but not yet put into effect. The revenue measures that had been taken represented a yield of 0.4 percent of GDP for 1985. If the authority to increase rates and tariffs to the maximum permitted by the law were used, the increase in revenues to the end of the year would represent 2.3 percent of GDP for 1985.

On the exchange rate, the staff representative remarked, the faster crawl of recent weeks had led to a real depreciation of the sol. Assuming that the rate of inflation in December had been about 7 percent, the acceleration of the crawl, plus the mini-adjustments made earlier, implied that the sol had depreciated in real terms by about 10 percent in December. That represented a sizable adjustment. Peru's loss of competitiveness since the previous major depreciation in 1978/79 had been about 20-25 percent; the measures taken in December therefore restored somewhat less than half that loss. The staff would have preferred a major exchange rate adjustment through a step adjustment rather than through a crawl, because domestic interest rates would be correspondingly higher as a result of the faster rate of depreciation through the crawl.

An improvement in revenue performance was indeed a key to an improved overall fiscal performance, the staff representative commented. The staff therefore placed great emphasis on the improvement of tax administration and tax reform, currently under way with technical assistance from the

Fiscal Affairs Department. Discussions on a study that had been completed and presented to the authorities were ongoing. An expert from the Fiscal Affairs Department was currently in Lima and would return there at the beginning of 1985 for further discussions. The staff had indicated to the authorities the importance of tax reform and improved tax administration for any future program supported by the Fund.

Dollarization of the financial system was related to the inadequacy of domestic interest rates for sol-denominated instruments, the staff representative pointed out. Dollarization and inflation were also linked: both indicated a lack of confidence in economic management in Peru. As long as expectations of higher inflation as well as exchange rate depreciation persisted and interest rates remained inadequate, dollarization and inflation would continue.

The staff did not consider the fiscal target for the adjustment program to be overambitious, the staff representative commented. The program had allowed for an increase in foreign indebtedness relative to GDP of about 5 percent, assuming that additional spending by the public sector and by the private sector would be about 4 percent and 1 percent, respectively. It was considered important to give the private sector some room to expand because for almost three years it had been squeezed by the public sector, which had a deficit equal to 10 percent of GDP. The program therefore sought to rectify that situation to some extent by limiting the financing requirements of the public sector to about 4 percent of GDP in 1984.

The Deputy Director of the Exchange and Trade Relations Department observed that, in dealing with countries that had used resources on a prolonged basis, the Fund had required a strong adjustment effort as a basis for further assistance and had typically limited the scope of access to Fund resources, particularly when a rapid recovery in the balance of payments was not foreseen. As several Executive Directors had mentioned, some decisive policy action by Peru would be required before it could envisage entering into a new arrangement.

As to the existence of a multiple currency practice in Peru, the Deputy Director added, SM/84/250, Supplement 1 noted that the differential between the exchange rate in the certificate market and that in the official market was about 2 percent. The latest data, however, indicated that it had risen to about 2 1/2 percent, which, strictly speaking, gave rise to a multiple currency practice for which the staff was not recommending approval. If the differential fell below 2 percent, the multiple currency practice would be eliminated, of course; should it rise above 2 percent, however, a practice would arise again for which there would be no Fund approval.

With regard to the process of dollarization, the Deputy Director of the Exchange and Trade Relations Department observed, the alternative was inflation and capital flight. To the extent that domestic savings were retained in the economy for a period of time through dollarization, there was less pressure on resources and therefore less inflation and capital outflow; but to restore balance while reducing the scope of dollarization, domestic policies would have to provide incentives for preferences to shift in favor of sol-denominated assets rather than dollar-denominated assets. The key to the control of dollarization was therefore the quality of domestic economic management.

Mr. Jensen remarked that the Peruvian authorities were committed to redressing the internal and external factors that had hampered their adjustment efforts and had resulted in only partial implementation of previous policies.

Many Directors had expressed concern regarding the impact of the increasing proportion of dollar-denominated certificates of deposit in the liabilities of the banking system, Mr. Jensen recalled. Aside from the major effects of eroding and further complicating monetary policy, as had been emphasized by the staff, the Peruvian authorities wished to stress important related issues: the effects of dollarization on confidence and international reserves. For nearly ten years, it had been illegal for any Peruvian resident to hold foreign currency, in any denomination, whether within the country or abroad; and the sanctions had been severe. After the significant 45 percent devaluation in a three-month period between the end of 1977 and the beginning of 1978, a savings instrument called the "Dollar Banking Certificate" had been created to promote capital repatriation. Subsequently, the repatriation of funds had reached $1.4 billion by 1980. Those dollar savings deposits were held with the banking system, and since they were subject to a high reserve requirement, they had become the assets of the monetary authorities, constituting a large share of the country's international reserves. That stock had shown little variation at first, but, in the face of continuous inflation and with the new policy of compensating for devaluation in real terms actually in effect, lenders in Peru were at present increasingly seeking to protect themselves by resorting to that type of savings instruments. As a result, during 1984 the existing stock of dollar-denominated deposits had increased further by $350 million and currently stood at $1.8 billion.

The holders of those savings were diverse, coming from nearly all income levels, Mr. Jensen continued. Thus, any doubt cast on the complete freedom and permanency of those savings could have a pervasive effect on the balance of payments by inducing massive capital flight. A withdrawal of those deposits from domestic banks could lead to a rapid depletion of official international reserves.

As to the yield of those dollar-denominated savings, Mr. Jensen added, the "nominal earnings" of a holder of a dollar certificate consisted of the devaluation rate in dollars plus the international rate. Thus, when the sol was being devalued at a rate 20 percent faster than inflation--as was the case--and when the U.S.-denominated interest rate was only 9 percent, the real deposit rate was close to 30 percent. Those earnings were before taxes: income due to the exchange rate depreciation was considered a capital gain and as such was taxed, on average, at 35 percent.

As a result, the net yield--assuming no tax evasion--was more or less in line with inflation. Interest on all domestic currency deposits was free of taxes. Thus, at present, the concept of safety and/or expectations of more aggressive exchange rate movements made those instruments more attractive than their rate of return.

However, the authorities recognized that any disequilibrium or even expected disequilibrium between inflation, domestic interest rates, and exchange rates could only exacerbate the problem, Mr. Jensen remarked. On the other hand, the present exchange rate policy was vital to enhancing further the competitiveness of Peruvian exports and strengthening the balance of payments. While he agreed that a significantly less gradual exchange rate policy--for example, adjustment in larger steps--could achieve positive results, the present political limitation was understandable. The Peruvian authorities were equally concerned about the importance of the issue to overall decision making and resource allocation in the economy. They recognized that only consistent monetary and exchange rate policies and internal confidence in the economic and political situation could encourage the convertibility of those savings into domestic financial assets.

Regarding Peru's external arrears, Mr. Jensen explained that the only arrears that existed were those related to the Central Government and the Government's guaranteed portion of the debt of public state enterprises. All privately held external debt continued to be serviced normally, as foreign exchange was available for all external debt payment servicing. The Central Government confronted a delicate dilemma because of its shortage of domestic currency that had arisen in July 1984, when economic developments had been in accordance with the terms of the stand-by arranement, following Peru's second purchase in late June. Furthermore, all performance criteria with the exception of the one relating to the fiscal deficit had been continuously on track through the remaining months of the program. The Government had always maintained the will to bring the fiscal program back on track, and recourse to the Central Bank would have completely violated the program. At the same time, net capital inflows through June had been about $180 million less than programmed--including significant short-term capital outflows, owing to repayment of short-term credit lines.

By August, it had become evident that Peru could not comply with the fiscal targets, and the commercial banking community had immediately stopped the disbursement of the $100 million in new money due under the 1983 refinancing agreement, Mr. Jensen continued. Moreover, long-term official capital disbursements were running $100 million below the programmed amount. Furthermore, the 1984 refinancing understanding, which had been reached in principle only, had begun to falter as Peru failed to maintain a permanent dialogue with the banks; consequently, short-term, trade-related credit lines had been cut. Through September, $150 million of such credit lines had been repaid and lost. For the last quarter of 1984, another $138 million would have been repaid and lost. Thus, in total, about $350 million of short-term capital outflows for 1984 had resulted from the repayment of trade-related lines of credit.

The Peruvian authorities had stressed that recent developments in external arrears were in line with the principal aim of protecting the balance of payments and the level of international reserves, Mr. Jensen remarked. The political will was still to return to the path of adjustment and to resolve pending matters with the commercial banks as soon as possible.

Although major imbalances remained, Mr. Jensen concluded, Peru had achieved significant advances in such sensitive areas as real wages and salaries, the substantial elimination of subsidies and nontariff impediments to trade, more flexible interest and exchange rate policies, and a reduction in intervention by the state in economic matters.

The Chairman made the following summing up:

Executive Directors were in agreement with the thrust of the staff appraisal in the staff report for the 1984 Article IV consultation with Peru.

Directors noted that major adverse weather conditions in 1983 and the consequent fall in real GDP by nearly 12 percent, together with the difficult internal situation and other factors, including low prices for minerals and high interest rates, had created an unfavorable environment for the economy and had contributed to the problems faced in attaining the objectives of the stand-by arrangement with the Fund. They drew attention to the sizable slippages in the implementation of the program and the recent emergence of domestic and foreign payments arrears. Directors emphasized, however, that the fiscal imbalance--which in recent years, and again in 1984, had run at an annual rate of about 10 percent of GDP--was in their view the principal factor behind the poor performance of the economy, including the rapid pace of inflation, the fragility of the balance of payments, and the emergence of payments arrears. In this context, it was observed that, for the third year in a row, the public sector deficit had exceeded the level programmed and that it was clearly unsustainable.

With regard to the weakness of the fiscal situation in 1984, Directors drew attention to inadequate expenditure control in the public administration and in the public enterprises, wage awards above programmed levels, the inefficiency of the tax system, untimely tax cuts, the sharp reduction in the ratio of tax revenues to GDP, and delays in adjusting controlled prices. Directors stressed the urgency of action by the authorities to strengthen fiscal performance. In this connection, Directors encouraged the authorities to curb expenditure, and to raise revenue through an overhaul of the tax structure and improvements in tax administration. Directors noted that recent steps taken by the Congress provided scope for strengthening the public finances, but that specific measures would have to be implemented without delay to achieve the desired objectives. Directors also noted with concern that the operations and investment activities of the public enterprises added significantly to the public sector deficit, and they urged the authorities to strengthen their control over these enterprises and to limit their deficits.

Directors commended the Central Reserve Bank for the tight credit policy followed thus far in 1984 and welcomed the move toward more flexible interest and exchange rate policies. These policy actions, which should be strengthened and pursued vigorously, were viewed as having contained to some extent the balance of payments and price pressures occasioned by the fiscal disequilibrium and lax wage policy. Without a flexible interest rate and exchange rate policy, moreover, it would be difficult to check the preoccupying dollarization of the economy. Directors cautioned that, unless the tight credit policy stance were supported by decisive action to reduce the fiscal deficit, control wages, and reduce rigidities in the labor market, it would not be possible to avoid adverse consequences for growth and employment.

The medium-term outlook for the Peruvian economy, characterized by a high debt service burden and the deterioration of Peru's creditworthiness in financial markets, was viewed with considerable concern by Directors. A return to economic growth in a framework of financial stability and the restoration of Peru's international creditworthiness would require a strengthening of the public finances and an adjustment of relative prices. Directors noted that recent trends in the real effective exchange rate, developments in the second exchange market, the need to resort to higher import duties and import restrictions, and the subsidization of nontraditional exports had raised questions about the adequacy of the present exchange rate. In this respect, they welcomed the recent acceleration of the pace of exchange readjustment as a means of fostering the growth of exports needed to enable Peru to service its external debt. Directors urged Peru to eliminate its external payments arrears promptly and to reach agreement with its foreign creditors. They expressed their strong hope that Peru would soon find it possible to return to a path of adjustment policies that the Fund would be able to support.

It is expected that the next Article IV consultation with Peru will be held on the normal 12-month cycle.

APPROVED: October 23, 1985

LEO VAN HOUTVEN
Secretary

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Minutes of Executive Board Meeting 84/190

10:00 a.m., December 28, 1984

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
	M. K. Bush
	L. E. J. M. Coene, Temporary
B. de Maulde	X. Blandin
M. Finaish	T. Alhaimus
H. Fujino	M. Sugita
	B. Goos
J. E. Ismael	Jaafar A.
R. K. Joyce	
	H. A. Arias, Temporary
	A. S. Jayawardena
E. I. M. Mtei	A. Abdallah
F. L. Nebbia	
	J. E. Suraisry
P. Pérez	
J. J. Polak	T. de Vries
A. R. G. Prowse	
	A. A. Agah, Temporary
J. Tvedt	
N. Wicks	
	N. Coumbis
Zhang Z.	Wang E.

L. Van Houtven, Secretary
K. S. Friedman, Assistant

Also Present

P. Scherer, IBRD. Asian Department: C. Browne. Exchange and Trade Relations Department: M. Guitián, Deputy Director. External Relations Department: H. O. Hartmann. Fiscal Affairs Department: C. A. Aguirre, J. C. Tavares. Legal Department: J. G. Evans, Jr., Deputy General Counsel; S. A. Silard. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; K.-Y. Chu, N. M. Kaibni, E. A. Milne. Secretary's Department: A. P. Bhagwat. Treasurer's Department: A. M. Al-Samarrie. Western Hemisphere Department: S. T. Beza, Associate Director; J. M. F. Braz, D. N. Lachman, B. C. Stuart. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: E. A. Ajayi, G. R. Castellanos, D. Hammann, H.-S. Lee, G. W. K. Pickering, T. Sirivedhin, E. M. Taha, M. A. Weitz. Assistants to Executive Directors: E. M. Ainley, M. B. Chatah, Chen J., J. de la Herrán, J. J. Dreizzen, V. Govindarajan, Z. b. Ismail, H. Kobayashi, R. Msadek, B. Newman, E. Olsen, M. Rasyid, C. A. Salinas, Shao Z., L. Tornetta, A. J. Tregilgas, R. G. Toulmin, A. H. van Ee, E. L. Walker, Wang C. Y.

1. ARGENTINA - REQUEST FOR STAND-BY ARRANGEMENT; EXCHANGE SYSTEM; AND USE OF FUND RESOURCES - COMPENSATORY FINANCING FACILITY

The Executive Directors considered the restricted staff paper on Argentina's request for a stand-by arrangement equivalent to SDR 1,419 million (EBS/84/251, 12/3/84; and Sup. 1, 12/26/84), together with a staff paper on Argentina's request for a purchase equivalent to SDR 275 million under the compensatory financing facility (EBS/84/252, 12/4/84; and Sup. 1, 12/27/84).

The Executive Directors agreed to resume their discussion in the afternoon.

2. EXECUTIVE DIRECTOR

The Chairman bade farewell to Mr. Tvedt upon completion of his term on the Executive Board.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/84/189 (12/21/84) and EBM/84/190 (12/28/84).

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and Advisors to Executive Directors as set forth in EBAP/84/280 (12/20/84) and EBAP/84/283 (12/26/84) is approved.

APPROVED: October 23, 1985

LEO VAN HOUTVEN
Secretary