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EBS/83/236

CONFIDENTIAL

November 3, 1983

To: Members of the Executive Board  
From: The Secretary  
Subject: Peru - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with Peru, which has been tentatively scheduled for discussion on Monday, November 28, 1983.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Flickenschild, ext. 73081.

Att: (1)

INTERNATIONAL MONETARY FUND

PERU

Staff Report for the 1983 Article IV Consultation

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

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

Approved by E. Wiesner and Manuel Guitian

November 2, 1983

The Article IV consultation discussions with Peru were held in Lima in the period September 6-20, 1983. Representatives of Peru in these discussions included the Ministers of Economy, Finance, and Commerce; Agriculture; Labor; Industry, Tourism, and Integration; and Energy and Mines; the Vice Ministers of Economy and of Finance; the President, Vice President, and General Manager of the Central Reserve Bank of Peru; and the President of the National Bank and the External Debt Committee. The mission chief was received by the President of the Republic. The staff representatives were Messrs. van Houten (Head), Flickenschild, Jaramillo-Vallejo, Leimone (all WHD), Sheehy (ETR), and Ms. Fuentes (Secretary - BLS). Additional discussions with a Peruvian team headed by the Minister of Economy, Finance, and Commerce were held at headquarters during the period September 26-October 5, 1983.

Peru has accepted the obligations of Article VIII, Sections 2, 3, and 4. The previous Article IV consultations were conducted in Lima in August 1982 and were concluded by the Executive Board on December 1, 1982.

I. Performance under the Extended Arrangement, Recent Economic  
Developments, and Short-Term Prospects

On June 7, 1982 Peru obtained financial support from the Fund in the form of an extended arrangement amounting to SDR 650 million, or the equivalent of 264 percent of Peru's quota, for a period extending through May 1985. As of September 30, 1983 Peru had purchased SDR 265 million, the full amount it was entitled to under the phasing provisions of the extended arrangement.

The program underlying the arrangement, including the quantitative performance clauses for the period through February 28, 1983, was discussed in the document on use of Fund resources--Extended Fund Facility (EBS/82/77). Performance during the first program year and

the quantitative performance clauses for the period March 1, 1983-February 29, 1984 were discussed in the documents on consultation under extended arrangement (EBS/83/85, and Sup. 1).

1. Objectives and policies of the extended arrangement

The medium-term plan supported by the extended arrangement aimed at achieving a viable external payments position with a satisfactory growth performance and declining inflation. The achievement of these goals was based in large part on the improvement of resource allocation through the strengthening of market mechanisms. Emphasis was to be placed on removing the impediments to private investment in the basic sectors of the economy, designing a more efficient public investment program, opening up the economy, and eliminating price distortions. The balance of payments and inflation objectives were to be achieved through a flexible exchange rate policy, improved domestic demand management, in particular by reducing the fiscal deficit, and realistic interest rates. Inflation was expected to decline only gradually over the program period, principally because of the need to eliminate remaining consumption subsidies and the widespread de facto indexation in the economy.

During the first programming period, running through February 28, 1983, the performance of the Peruvian economy was mixed in terms of progress toward attaining the basic objectives of the program. Real GDP rose by less than 1 percent and the 12-month rate of inflation remained unchanged at 73 percent. The overall balance of payments registered a small surplus, however, principally because net capital inflows to the public sector were considerably higher than had been expected. Recourse to short-term foreign borrowing, which had not specifically been limited by the quantitative performance criteria of the first year program because they had not been resorted to on any significant scale earlier, provided the financing for a deficit of the nonfinancial public sector in 1982 that was considerably in excess of the planned level (8.6 percent of GDP compared with 4.2 percent).<sup>1/</sup>

The financial program for the second programming period, ending February 29, 1984, was designed to deal with the deviations of the previous year and return Peru to the adjustment path envisaged under the extended arrangement. Peru's external current account deficit was projected to drop from 8.3 percent of GDP in 1982 to 5.2 percent in 1983 (Table 1).<sup>2/</sup> To help achieve this reduction, the program contemplated continued flexibility in interest rate and exchange rate management and a decline in the overall financing requirements of the nonfinancial public sector from 8.6 percent of GDP in 1982 to close to 4.0 percent. Prudent demand management and wage policy were to hold inflation in check.

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<sup>1/</sup> Such borrowing has been brought under the ceiling on net indebtedness of the nonfinancial public sector in the second program year.

<sup>2/</sup> Excluding US\$146 million of interest payment obligations rescheduled by the Paris Club and socialist countries, the current account deficit in 1983 was programed to be 4.4 percent of GDP.

Table 1. Peru: Macroeconomic Flows

(in percent of GDP)

	1979	1980	1981	1982	1983	
					Prog.	Proj.
I. <u>balance of payments</u>						
<u>Current account balance</u>	5.9	-0.6	-6.7	-8.3	-5.2	-6.0
Trade balance	12.4	4.8	-2.8	-2.5	1.4	0.8
Factor payments	-6.7	-5.3	-5.1	-5.1	-7.1 1/	-7.2
Other services and transfers	1.2	-0.1	-0.8	-0.7	0.5	-0.2
<u>Capital account</u>	4.5	5.1	5.6	9.2	4.2	5.0
Private capital 2/	-2.1	3.0	4.5	1.4	1.0	-3.8
Nonfinancial public sector 3/	6.6	2.1	1.1	7.8	3.2	8.8
<u>Change in net official international reserves</u> (Increase -)	-11.4	-4.5	3.1	-0.9	1.0	1.6
II. <u>Nonfinancial public sector 3/</u>						
Central Administration						
Current account	3.6	2.4	0.2	0.1	0.5	-3.6
Revenues	(18.0)	(20.5)	(18.1)	(18.1)	(16.1)	(13.5)
Expenditures	(-14.4)	(-18.1)	(-17.9)	(-18.0)	(-15.6)	(-17.1)
Rest of nonfinancial public sector's operating surplus	0.7	-0.4	0.7	0.1	2.3	0.5
<u>Nonfinancial public sector savings</u>	4.3	2.0	0.9	0.2	2.8	-3.1
Less: Fixed investment	5.3	7.3	9.2	8.7	6.9	6.3
Other capital expenditures	0.7	1.1	0.1	0.1	--	--
<u>Overall deficit</u>	-1.7	-6.4	-8.4	-8.6	-4.1	-9.4
Net foreign financing	6.6	2.1	1.1	7.8	3.2	8.8
Net domestic financing	-4.9	4.3	7.3	0.8	0.9	0.6
III. <u>Savings and investment</u>						
<u>Fixed capital formation</u>	14.6	17.7	22.1	20.0	17.5	16.4
Nonfinancial public sector	5.3	7.3	9.2	8.7	6.9	6.3
Private sector 5/	9.3	10.4	12.9	11.3	10.6	10.1
<u>Investment = savings</u>	14.6	17.7	22.1	20.0	17.5	16.4
External savings	-6.9	0.6	8.7	8.3	5.2	6.6
National savings	21.5	17.1	13.4	11.7	12.3	9.8
Nonfinancial public sector	(4.3)	(2.0)	(0.9)	(0.2)	(2.8)	(-3.1)
Private sector	(17.2)	(15.1)	(12.5)	(11.5)	(9.5)	(12.9)
Memorandum item						
Annual growth rate of real GDP	3.8	3.0	3.1	0.7	-4.7	-6.8

Sources: Central Reserve Bank of Peru; and Fund Staff estimates.

1/ Includes US\$146 million of refinanced interest payments.

2/ Includes net borrowing by the financial public sector, net errors and omissions, and movements in nonofficial reserves.

3/ Includes short-term borrowing.

4/ Includes CENTROMIN and Tintaya.

5/ Includes inventory changes.

## 2. Performance under the extended arrangement in 1983

Faced with the serious difficulties caused by natural disasters, in early 1983 the Peruvian authorities cut public spending, tightened credit and interest rate policy, and increased the rate of depreciation of the sol to a pace somewhat faster than the rate of change of domestic prices. Official data initially indicated that the performance criteria as of March 31, 1983 had been met. Subsequent revisions of data revealed small deviations from the programmed path; the net international reserves of the monetary authorities fell short of the target set for March 31, 1983 and the net indebtedness of the nonfinancial public sector exceeded the limit set for that date (Table 2).

During the second quarter of 1983, fiscal management became more difficult. Central administration revenues ran below projection; the upward adjustment of a number of controlled prices lagged behind what had been planned; emergency spending in the stricken regions was undertaken; and special wage increases for the domestic security forces were granted. Again, official data initially indicated that the performance criteria for June 30, 1983 had been met. However, subsequent revisions of the data revealed that the limit on the net indebtedness of the nonfinancial public sector had been exceeded. The relatively small deviation from the limit understated the extent of the fiscal problem as domestic payments arrears (the only type of "financing" not explicitly taken into account in calculating the total of net indebtedness of the nonfinancial public sector under the 1983 program) rose by S/. 130 billion (equivalent to 0.5 percent of GDP) during the second quarter of 1983. Resort to such financing meant that the program ceiling was less effective than had been intended.

## 3. Recent developments and short-term prospects

The economic situation of Peru during the first nine months of 1983 was characterized by a deep recession and an acceleration of inflation. The most visible factors accounting for the recession and the increased rate of inflation were the natural disasters which have plagued Peru this year. The combination of flooding in the coastal regions of northern Peru and drought conditions in the southern highlands resulted in large losses of agricultural output. Mud slides interrupted communications and electricity supplies, causing declines in mining and petroleum output and contributing to a drop in manufacturing production. In addition, a shift in ocean currents resulted in a precipitous drop in the fish catch.

The decline in production stemming from the natural disasters compounded a situation characterized by weak external demand for Peruvian exports, a marked tightening of external capital markets, and an inflexible domestic productive apparatus on account of rigidities in the labor and capital markets, inadequate legislation governing land tenure, and conflicting signals to the export sector. As a consequence, real

Table 2. Peru: Performance Under Extended Fund Arrangement

	1983 1/	
	Mar. 31	June 30
(In billions of soles)		
<u>Total net indebtedness of</u>		
<u>nonfinancial public sector</u>		
Limit (adjusted) 2/	11,054.0	11,295.0
Actual	11,073.0	11,308.0 3/
Margin	-19.0	-13.0
<u>Net domestic assets of the</u>		
<u>monetary authorities 4/</u>		
Limit (adjusted) 2/	1,219.0	1,269.0
Actual	1,205.2	906.0
Margin	13.8	363.0
(In millions of U.S. dollars)		
<u>Net international reserves of</u>		
<u>the monetary authorities 4/</u>		
Target (adjusted) 2/	-210.0	-176.0
Actual	-241.3	48.6
Margin	-31.3	224.6
<u>Contracting of foreign debt</u>		
<u>1-5 years</u>		
Limit	300.0	300.0
Actual	8.0	86.8
Margin	292.0	213.2
<u>1-10 years</u>		
Limit	1,250.0	1,250.0
Actual	23.0	948.3
Margin	1,227.0	301.7

1/ Accounts denominated in foreign currency valued at US\$1=S/. 1,250.

2/ In accordance with the program provisions.

3/ Domestic payment arrears were not explicitly included in the program definition of the stock of net indebtedness and hence are not included here. The identified increase in such arrears amounted to S/. 130 billion during the second quarter of 1983.

4/ Central Reserve Bank and Banco de la Nación.

GDP for 1983, which in January 1983 was projected to rise by about 1/2 percent, was revised downward progressively to show a decline of about 7 percent (Table 3).

Table 3. Peru: Rates of Change of Selected Economic Indicators  
(In percent)

	1979	1980	1981	1982	Proj. 1983
Real GDP	3.8	3.0	3.1	0.7	-6.8
Nominal GDP	83.6	61.7	69.7	63.4	97.3
Consumer price index (December-December)	66.7	60.8	72.7	72.9	132.3
Exchange rate depreciation <u>1/</u> (December-December)	27.6	36.6	48.3	95.3	129.5
Terms of trade index	40.7	9.7	-15.3	-13.6	4.7

Sources: Central Reserve Bank of Peru; and Fund staff estimates.

1/ In terms of soles per U.S. dollar.

Inflation during the first nine months of 1983 rose to an annual rate of 130 percent, up from 73 percent in 1982. In the early months of 1983, the acceleration of inflation reflected shortages of basic foodstuffs caused by the abnormal weather conditions as well as corrective adjustments of controlled prices. Subsequently, inflation was fueled by the expanding deficit of the nonfinancial public sector.

Notwithstanding the adjustment measures mentioned earlier, the public sector finances came under increasing strain. Revenues continued to lag because of the drop in production, emergency outlays were initiated in the northern regions of the country, and defense and domestic security expenditures were raised in response to provincial unrest. While wage increases for most categories of civil servants were held below inflation as had been programed, wages of military personnel and police were increased sharply, and the indexation clauses in the wage contracts of workers in the large public sector enterprises caused wages in these sectors to rise much faster than planned.

Fiscal problems were compounded by delays in the adjustment of a number of controlled prices and utility rates. In February 1983 the private sector was permitted to import and trade wheat. However, because

the price of flour and bread remained controlled at levels that resulted in inadequate margins, the importation of wheat effectively remained in the hands of ENCI, the state marketing agency. Monthly increases in the price of rice were introduced only in May 1983, instead of in January as programed. The retail price of regular gasoline was increased in February 1983 to the equivalent of US\$1.10 per gallon and kept at approximately that level until September; prices of other petroleum derivatives were raised proportionately. In September, as part of a plan to slow inflation, prices of diesel fuel, kerosene, and liquified gas were frozen until the end of 1983, and the increase in the price of gasoline, other oil derivatives, and electricity rates was limited to approximately one half the rate of change of the immediately preceding months.

During the third quarter of 1983, the deviation of the public finances from the programed path became substantial. In the absence of corrective policy actions, it is projected that the overall deficit of the public sector in 1983 will exceed 9 percent of GDP, more than double the programed level (Table 4).<sup>1/</sup> About two thirds of the deterioration of the overall deficit is accounted for by slippages in the performance of the Central Administration, mainly as a result of lower tax revenues, emergency spending on disaster relief, additional outlays for defense and domestic security, and higher interest payments. The deterioration in the rest of the public sector's financial performance arises from delayed price increases, higher wages and salaries as well as investment outlays. The increase in the overall deficit is projected to be financed mainly by larger than programed external refinancing from socialist countries and the banks, use of the counterpart of the debt relief obtained from the Paris Club by the nonfinancial public sector,<sup>2/</sup> and larger than programed disbursements of suppliers credits.

The net domestic assets of the monetary authorities, which were generally kept below the program ceiling during the first quarter of 1983, began to expand quite rapidly in May and June. Nevertheless, the net domestic assets were held below the program ceiling on June 30 thanks to the disbursement to the Government of US\$200 million in bridge financing from foreign banks. During the first semester two financial institutions in Peru experienced difficulties and were liquidated or absorbed by other financial institutions. These difficulties reportedly led to some unease on the part of the general public that was reflected in a drawdown of dollar certificates of deposit by about 10 percent in the first four months of 1983, contributing to a lower than expected growth in bank liabilities to the private sector (Table 5). Since midyear, the net domestic assets of the monetary authorities

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<sup>1/</sup> More than 1/2 percent of GDP of the deterioration results from the decrease in the denominator of the ratio.

<sup>2/</sup> The original program had foreseen that Paris Club relief would accrue to the monetary authorities. Appropriation of that relief by the nonfinancial public sector constitutes a departure from the original understandings reached.

Table 4. Peru: Operations of the Nonfinancial Public Sector

(As percent of GDP)

	1979	1980	1981	1982	1983	
					Prog.	Proj.
<u>Central administration current</u>						
<u>revenues</u>	<u>18.0</u>	<u>20.5</u>	<u>18.1</u>	<u>18.1</u>	<u>16.0</u>	<u>13.5</u>
Income tax	4.0	6.1	3.9	3.7	3.0	2.4
Tax on goods and services	7.4	7.6	7.5	8.5	8.7	7.1
Import tax	2.2	3.2	3.8	3.5	3.1	2.7
Export tax	2.9	2.5	1.4	0.9	0.3	0.3
Other tax and nontax	1.5	1.1	1.5	1.5	0.9	1.0
<u>Central administration current</u>						
<u>expenditures</u>	<u>14.4</u>	<u>18.1</u>	<u>17.9</u>	<u>18.0</u>	<u>15.6</u>	<u>17.1</u>
Wages and salaries	4.0	4.8	5.3	5.2	4.5	4.5
Goods and services	0.6	0.7	0.8	0.8	1.1	0.8
Military outlays <sup>1/</sup>	3.2	4.7	4.2	5.4	3.8	4.4
Interest	4.1	4.3	4.5	4.1	4.0	4.7
Transfers	2.1	3.6	3.1	2.5	2.2	2.7
<u>Central administration current</u>						
<u>account surplus or deficit (-)</u>	<u>3.6</u>	<u>2.4</u>	<u>0.2</u>	<u>0.1</u>	<u>0.5</u>	<u>-3.6</u>
<u>Rest of public sector current</u>						
<u>account surplus or deficit (-)</u>	<u>0.7</u>	<u>-0.4</u>	<u>0.7</u>	<u>0.1</u>	<u>2.3</u>	<u>0.5</u>
<u>Public sector current account</u>						
<u>surplus or deficit (-)</u>	<u>4.3</u>	<u>2.0</u>	<u>0.9</u>	<u>0.2</u>	<u>2.8</u>	<u>-3.1</u>
<u>Capital expenditures</u>						
<u>(net of capital revenue)</u>	<u>6.0</u>	<u>8.4</u>	<u>9.3</u>	<u>8.8</u>	<u>6.9</u>	<u>6.3</u>
Central administration	4.2	5.3	5.1	4.0	3.1	2.3
Rest of public sector	1.8	3.1	4.2	4.8	3.8	4.0
<u>Overall public sector</u>						
<u>deficit (-)</u>	<u>-1.7</u>	<u>-6.4</u>	<u>-8.4</u>	<u>-8.6</u>	<u>-4.1</u>	<u>-9.4</u>
Central administration	-0.6	-2.9	-4.9	-3.9	-2.6	-6.0
Rest of public sector	1.1	-3.5	-3.5	-4.7	-1.5	-3.4
<u>Financing</u>						
<u>External</u>	<u>1.7</u>	<u>6.4</u>	<u>8.4</u>	<u>8.6</u>	<u>4.1</u>	<u>9.4</u>
<u>Internal</u>	<u>0.6</u>	<u>2.1</u>	<u>1.1</u>	<u>7.8</u>	<u>3.2</u>	<u>8.8</u>
<u>Internal</u>	<u>-4.9</u>	<u>4.3</u>	<u>7.3</u>	<u>0.8</u>	<u>0.9</u>	<u>0.6</u>
<u>Memorandum item</u>						
Total expenditures	51.5	63.3	59.7	57.5	...	...

Sources: Central Reserve Bank of Peru; and Fund staff estimates.

<sup>1/</sup> Includes wages and salaries of military personnel.

Table 5. Peru: Changes in Monetary Indicators

(In percent, or as indicated)

	Dec. 1978- Dec. 1979	Dec. 1979- Dec. 1980	Dec. 1980- Dec. 1981	Dec. 1981- Dec. 1982	Dec. 1981- June 1982	Dec. 1982- June 1983
<b>A. Monetary Authorities <sup>1/</sup></b>						
Net international reserves (in millions of US\$)	1,577	771	-611	184	-60	-261 <sup>2/</sup>
Net domestic assets <sup>3/</sup>	-259	-11	79	17	16	35
Liabilities to the private sector	87	96	16	35	6	--
<b>B. Banking System</b>						
Net international reserves (in millions of US\$)	1,564	707	-590	134	-85	-752 <sup>4/</sup>
Net domestic assets <sup>3/</sup>	-7	58	68	42	19	24
Net credit to the nonfinan- cial public sector <sup>5/</sup>	-33 <sup>6/</sup>	60	77	--	-9	4
Net credit to the private sector	57	77	91	53	33	28
Liabilities to the private sector	90	86	51	45	15	4
<b>Memorandum item</b>						
Consumer price index	67	61	73	73	30	56

Sources: Central Reserve Bank of Peru; and Fund staff estimates.

<sup>1/</sup> Central Reserve Bank and Banco de la Nacion.

<sup>2/</sup> Includes US\$79 million increase in external liabilities of the Banco de la Nacion on account of a shift from guarantees of foreign short-term debt into direct indebtedness as provided by Peru's refinancing arrangement with foreign banks.

<sup>3/</sup> In relation to the stock of liabilities to the private sector outstanding at the beginning of the period.

<sup>4/</sup> Includes US\$523 million increase in external liabilities for the same reason as given in footnote 2.

<sup>5/</sup> Excludes change in deposits of the nonfinancial public sector in the Central Reserve Bank on account of debt relief operations.

<sup>6/</sup> Includes reduction of outstanding net bank credit to the public sector as a result of the assumption by the public sector of part of the foreign debt by the Banco de la Nacion.

have exceeded the program limits, mainly reflecting sharply higher bank financing needs of the public sector, in part because domestic payment arrears incurred during the first semester of 1983 were reduced.

As part of a continuing policy to promote domestic savings, in April 1983 the authorities introduced an indexed savings instrument denominated in soles with an effective rate of return of about 98 percent per annum.<sup>1/</sup> Notwithstanding the higher nominal rates, the growth of bank liabilities to the private sector has been below expectations. The rate of growth of money and quasi-money in the first semester of 1983 was below that of the corresponding 1982 period despite the much more rapid rate of inflation--a development that is only partly explained by the sharp contraction in economic activity. Real liquidity declined substantially in the first half of 1983 and the trend observed since 1981 toward a contraction of the liquid forms of monetary assets accelerated. For the first time in many years, real quasi-money declined but at a comparatively slower rate so that the share of quasi-money in total liquidity continued to rise. As was mentioned already, there was, for the first time, a reduction in the dollar value of the holdings of U.S. dollar denominated certificates of deposit. Even though reflecting the rapid pace of exchange rate depreciation, U.S. dollar deposits at midyear rose to almost 45 percent of money and quasi-money, as against 39 percent at the end of 1982.

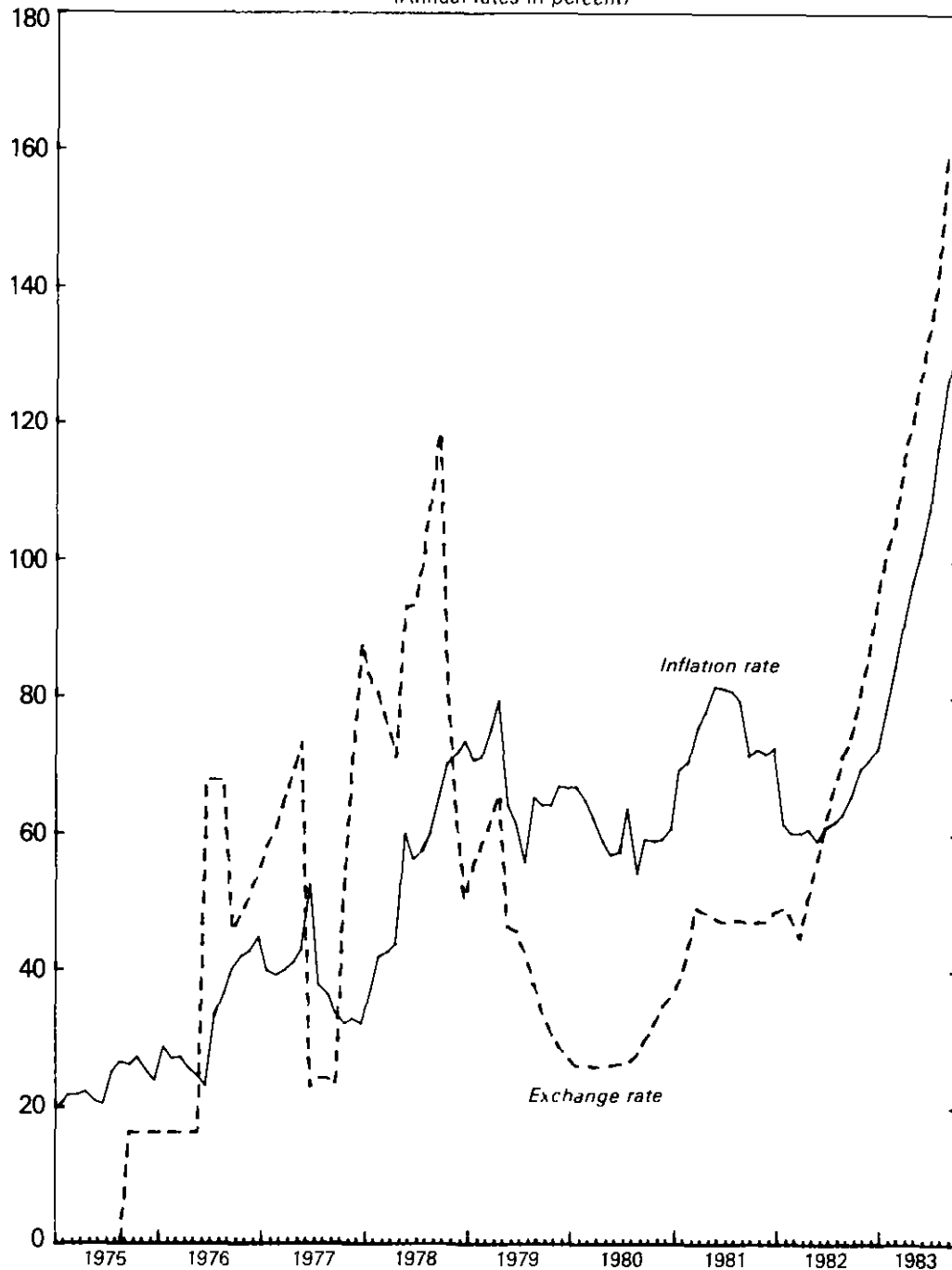
During the period January-July 1983 the sol was depreciated on a daily basis, without preannouncement, at a rate somewhat faster than domestic inflation (Chart 1). The real depreciation of the sol against trading partner currencies amounted to 4.5 percent in these seven months, or 11 percent since the initiation of the extended arrangement in June 1982 (Chart 2). On August 8, 1983, the sol was depreciated by 6 percent in nominal terms with respect to the U.S. dollar, which contributed to raising the cumulative real depreciation against trading partner currencies in the first eight months to 8.5 percent. Immediately thereafter, in a major policy shift ahead of nationwide municipal elections in mid-November, the authorities announced that, starting September 1983, the rate of depreciation of the sol would be reduced substantially below the rate of inflation along a preannounced path.<sup>2/</sup> The preannounced monthly rate of depreciation of the sol decelerated from 3.9 percent in September to 3.5 percent in December. This represented a monthly rate of depreciation less than one half the average domestic inflation rate in the June-August period. The new exchange rate policy was accompanied by a slowing of the rate of increase of controlled prices.

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<sup>1/</sup> The corresponding effective loan rate is 102 percent. On September 1, 1983, maximum rates on nonindexed deposits were raised from 55 percent to 60 percent, implying an increase in the effective annual rate from 71 percent to 80 percent for monthly compounding.

<sup>2/</sup> The August 1983 depreciation and the subsequent change in exchange rate policy were described in EBS/83/179.

CHART 1  
PERU  
INFLATION AND EXCHANGE RATE DEPRECIATION<sup>1</sup>  
(Annual rates in percent)

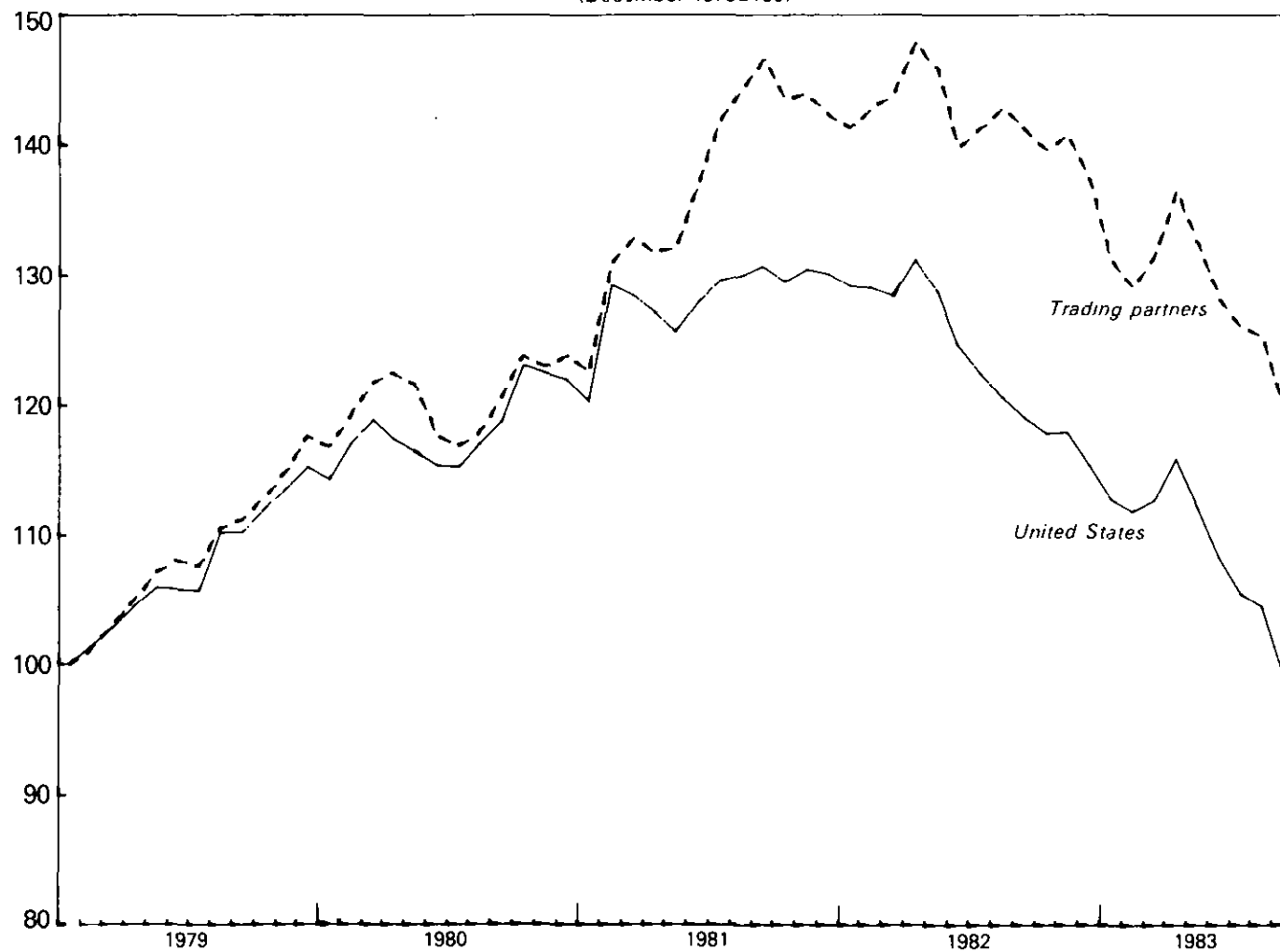


Source: Central Reserve Bank of Peru

<sup>1</sup> Inflation is measured by the rate of change of the Lima consumer price index over the preceding 12 months; similarly, exchange rate depreciation indicates the increase in the sales price of the U.S. dollar over the preceding 12 months.



CHART 2  
PERU  
REAL EXCHANGE RATE INDICES<sup>1</sup>  
(December 1978=100)



Source: Staff calculations.  
Increase in index indicates real appreciation.



The current account deficit of the balance of payments in 1983 is projected at 6.6 percent of GDP, lower than the 8.3 percent deficit registered in 1982 but considerably above the program target (Table 6). The trade balance is projected to shift to a surplus of 0.8 percent of GDP in 1983, from a deficit of 2 1/2 percent in 1982, mainly reflecting a drop of 25 percent in imports. Despite the first, small improvement in the terms of trade since 1980, the value of exports in 1983 is expected to fall by 10 percent, somewhat more than had been projected because of lower than expected mineral prices and smaller export volumes in the wake of the climatic disturbances. To help finance the external current account deficit, a number of agreements have been concluded with Peru's foreign creditors, including the commercial banks, official bilateral creditors under the Paris Club, and socialist countries. With the international banking community the authorities have reached an agreement that calls for the maintenance of the short-term exposure of foreign banks to Peru at the level existing on March 7, 1983, and the extension of a large medium-term loan to the Government of Peru covering US\$380 million in principal payments falling due in the 12-month period ending March 6, 1984, and new money of US\$450 million to be disbursed in three tranches before the end of 1983. The first tranche of US\$250 million was disbursed in early August. In anticipation of this disbursement, the foreign banks provided the Government of Peru with a US\$200 million bridge loan on June 30, 1983.

With the member countries of the Paris Club the authorities have reached an agreement for a rescheduling of the bulk of principal and interest falling due in the 22-month period from May 1, 1983 to February 28, 1985. The net debt relief accruing to Peru in 1983 under this arrangement is estimated at US\$440 million. The authorities also have approached several socialist creditor countries with a request to reschedule principal and interest payments due in 1983 (totaling US\$210 million) and beyond.<sup>1/</sup> Even with these arrangements in place, the net official reserve loss is expected to amount to US\$209 million, compared with the US\$179 million deficit that had been programmed.<sup>2/</sup> The deficit may well turn out to be larger because projected disbursements of US\$200 million from the foreign banks and US\$120 million under a structural adjustment loan from the World Bank may be delayed until 1984.

## II. Report on discussions

The authorities were seriously concerned about the depth of the recession and the accompanying large imbalances, including the acceleration of inflation to well over 100 percent and the ballooning of the deficit of the nonfinancial public sector to more than twice the programed level.

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<sup>1/</sup> Details of the renegotiations are described in Appendix VII of the accompanying report on Recent Economic Developments. The terms of the Paris Club rescheduling are also described in EBS/83/185.

<sup>2/</sup> Including a US\$79 million increase in foreign liabilities of the Banco de la Nación previously counted among external loan guarantees.

Table 6. Peru: Summary Balance of Payments

(In millions of U.S. dollars)

	1979	1980	1981	1982	1983	
					Prog.	Proj.
<u>Current account</u>	<u>953</u>	<u>-101</u>	<u>-1,728</u>	<u>-1,649</u>	<u>-929</u>	<u>-1,099</u>
Merchandise trade	1,722	826	-553	-494	244	128
Exports, f.o.b.	(3,676)	(3,916)	(3,249)	(3,293)	(3,030)	(2,953)
Imports, f.o.b.	(-1,954)	(-3,090)	(-3,802)	(-3,787)	(-2,786)	(-2,825)
Investment income	-931	-909	-1,019	-1,012	-1,271	-1,196
Public sector	(-490)	(-479)	(-533)	(-618)	(-860) 1/	(-740)
Private sector	(-441)	(-430)	(-486)	(-394)	(-411)	(-456)
Other services	10	-165	-317	-310	-102	-266
Transfers	152	147	161	167	200	235
<u>Long-term capital</u>	<u>656</u>	<u>462</u>	<u>648</u>	<u>1,199</u>	<u>1,199</u>	<u>1,578</u>
Public sector	617	371	388	994	1,130	1,600
Nonfinancial 2/	(758)	(363)	(325)	(877)	(715)	(1,468)
Disbursements	/1,035/	/1,155/	/1,522/	/1,872/	/1,895/ 1/	/2,619/
Amortization	/-277/	/-792/	/-1,197/	/-995/	/-1,180/	/-1,151/
Financial	(-141)	(8)	(63)	(117)	(415)	(132)
Private sector	39	91	260	205	69	-22
Direct investment	(71)	(27)	(125)	(48)	(43)	(31)
Loans	(-32)	(64)	(135)	(157)	(26)	(-53)
<u>Basic balance</u>	<u>1,609</u>	<u>361</u>	<u>-1,080</u>	<u>-450</u>	<u>270</u>	<u>479</u>
Short-term capital and errors and omissions (net)	-67	323	469	585	-893 3/	-1,239 3/
Allocation of SDRs	22	23	21	--	--	--
<u>Overall balance</u>	<u>1,564</u>	<u>707</u>	<u>-590</u>	<u>135</u>	<u>-623 3/</u>	<u>-760 3/</u>
<u>Monetary movements</u>						
Nonofficial reserves	13	63	-21	49	444	491
Assets (increase -)	(64)	(25)	(-44)	(-45)	(...)	(...)
Liabilities	(-51)	(38)	(23)	(94)	(...)	(...)
Official reserves	-1,577	-770	611	-184	179 3/	269 3/
Assets (increase -)	(-1,315)	(-703)	(847)	(-143)	(...)	(...)
Liabilities	(-262)	(-67)	(-236)	(-41)	(...)	(...)
<u>Memorandum items</u>						
As percent of GDP						
Current account balance	6.9	-0.6	-8.7	-8.3	-5.2	-6.6
Exports	26.6	22.7	16.4	16.7	17.0	17.7
Imports	14.2	17.9	19.2	19.2	15.6	16.9

Source: Central Reserve Bank of Peru.

1/ Includes US\$146 million of interest payments expected to be rescheduled.

2/ Includes rescheduling of public sector debt.

3/ Original overall balance target of deficit of US\$100 million in 1983 has been adjusted to reflect US\$523 million of nonbank external debt assumed by the banking system in the first half of 1983. Of this amount, US\$79 million is shown as an official reserve liability and US\$444 million is a nonofficial reserve liability. The overall payments deficit resulting from other transactions is estimated at US\$237 million in 1983, of which US\$190 million represents a loss of official reserves. The latter figure is directly comparable with the original target. The decline in net official reserves may be larger if US\$120 million in disbursements from a World Bank structural adjustment loan and US\$200 million in disbursements from foreign commercial banks are delayed until 1984.

The discussions centered on the factors that led to the present difficulties and on policies to bring the economy's performance into line with the objectives of the extended arrangement.

The authorities were of the view that the recession in Peru in 1983 was due largely to factors beyond their control. The weakness of foreign demand, low prices for Peru's principal exports, and tight foreign capital markets were seen as the main causes of the recession. The unusual severity of the downturn was attributed to the losses of production resulting from the climatic phenomena. These production losses, coupled with transportation difficulties because of flooding and landslides, led to scarcities of basic consumer goods and, along with corrective price increases, contributed to the acceleration of inflation in the first semester of 1983. The continuation of inflation beyond mid-1983 at a very high rate was attributed by the authorities to the widening of the deficit of the nonfinancial public sector and the de facto indexation to past inflation of a number of key prices, including the exchange rate, interest rates, controlled prices, and certain wage contracts. The authorities initially had placed most emphasis on the indexation element in explaining the persistence of inflation. This analysis had led them to announce in August the slowing down of the rate of change of key prices in the economy as a means of breaking the momentum of inflation. However, after additional data on the size of the emerging fiscal disequilibrium for 1983 became available, the authorities reassessed their earlier analysis and have attributed the exacerbation of the problem to the shortcomings in demand management. It was noted in this connection that the adjustment of demand policies had been delayed because of an inadequate data reporting system.

#### 1. Fiscal policy

The increase in the projected overall deficit to 9.4 percent of GDP is more than accounted for by a deterioration in the current account performance of the nonfinancial public sector, which is now expected to record a deficit of 3.1 percent of GDP instead of the surplus of 2.8 percent programed earlier (Table 4). Compared with this deterioration, the reduction of 0.6 percent of GDP in net capital expenditures over programed levels is minor. According to the authorities, the principal causes of the larger than programed deficit in 1983 are the adverse effect on revenues of the unexpectedly deep recession, the need to undertake reconstruction of the basic infrastructure in the northern regions affected by floods and mudslides, and the increased expenditures for the defense and police forces called forth by the domestic security situation.

Since late September, after new information had pointed to the emergence of a major widening of the public sector deficit, the authorities have undertaken an in depth review of the fiscal situation, and have been studying measures to return the public finances to the path of the extended arrangement in 1984. The measures under study include

a major revenue effort (including increases in sales taxes and wealth taxes) equivalent to 3 percent of GDP, a return to a realistic public sector pricing policy, and expenditure restraint.

a. Central Administration

Central administration revenues for 1983 are projected at 13 1/2 percent of GDP, compared with 16 percent in the program. The drop reflects smaller import duty receipts because of a shift in the composition of imports toward low tariff goods and the erosion of the tax base of the income and sales taxes resulting from the shift of economic activity from the formal to the informal sector. The authorities noted that part of the erosion of the base could be considered temporary because a significant segment of taxpayers had delayed their payments undoubtedly because of economic hardships. Nevertheless, tax amnesties granted to the stricken regions during 1983 and past periodic amnesties may have created expectations that another one might be granted in the near future. The authorities told the mission they were not considering another amnesty but strong political pressure existed for legislative action along these lines.

During the past year a program to improve tax administration was initiated with the technical assistance of the Fund's Fiscal Affairs Department. An office was created to be in charge of tax collections from the 600 largest corporate taxpayers in the Lima-Callao area. Although this office has not yet reached the stage of reviewing tax returns and assessing tax liabilities, it has been instrumental in creating an awareness of stricter control. In addition, the General Directorate of Revenues has initiated a system of frequent visits to companies and auditing on the spot to enforce compliance with the general sales tax. Lastly, a computerized system of cross checking information to assess and verify tax returns is in an early stage of implementation.

The authorities pointed to a much improved record of central administration expenditure control since such control was centralized in the budget office at the start of 1983. In the areas where spending exceeded program levels, special factors were involved. Outlays for goods and services and investment had been held to less than programmed levels, and general wage increases for civil servants were held well below the rate of inflation, as had been planned. However, certain sectors of the Central Administration, including teachers, health workers, police, and the defense forces received wage increases that exceeded inflation, and defense expenditures in general were higher than programmed. The larger than expected financing requirement contributed in turn to increased interest payments.

In April 1983 a medium-term reconstruction program was announced for the northern region, calling for total outlays of US\$520 million. Emergency spending under this program already has been initiated, financed in part by mandatory bond purchases equivalent to 10 percent of

earnings of salaried workers, and in part by delaying less urgent investment projects. It is expected that emergency expenditures will total approximately 0.4 percent of GDP in 1983.

b. Public enterprises

The authorities noted that, despite the substantial progress made in 1983 in raising the prices of goods and services marketed by public enterprises to realistic levels, these entities had not adjusted current operations in line with the needs of the adjustment program, and the investment outlays of the enterprises did not always conform to the approved investment plan. For these reasons, the authorities intend to extend centralized spending controls to cover the operations of state-owned enterprises. Since August 1982 the Ministry of Economy, Finance, and Commerce has been empowered to implement direct supervision over public enterprise operations. However, no special supervisors have been appointed yet. Nevertheless, in August 1983 a step was taken to control the enterprises: wage contracts are now subject to approval by the Ministry of Economy, Finance, and Commerce prior to registration with the Ministry of Labor.

The advances in increasing the prices of goods and services subject to control to realistic levels have fallen short of program projections. Despite the freeing in early 1983 of the prices of certain goods such as soybeans, sorghum, and sugar, important items such as milk, wheat flour, bread, petroleum derivatives, and rice remain subject to price control. In February 1983 the price of regular gasoline was raised to the equivalent of US\$1.10 per gallon and, until September, the price was adjusted monthly to maintain this level approximately in terms of U.S. dollars. The prices of other petroleum products were raised accordingly. Political opposition delayed the planned monthly increases in the price of rice until May 1983. The delay, together with a slowing of the rate of price increase from September 1983, has resulted in a projected deficit of the state rice marketing agency (ECASA) of 0.7 percent of GDP, compared with a zero deficit programed. Similarly, the failure to implement the free commercialization of wheat as planned added to the delays in the increases of the prices of other goods marketed by ENCI that are expected to result in a deficit of that enterprise of 0.4 percent of GDP instead of a balanced position as had been programed.

The policy of adjusting controlled prices with inflation, or faster than inflation in those cases requiring corrective price increases, came under strong criticism in 1983 as contributing to the maintenance of a high rate of inflation. As was mentioned above, in August 1983, in a major policy change, the price increases for regular gasoline, electricity, and controlled food items were slowed substantially below the ongoing rate of inflation, and the prices of kerosene, diesel, and liquified gas were frozen until December 1983. This policy shift was a significant factor in the larger than expected financing requirement of the state trading companies.

## 2. Monetary policy

Monetary policy during 1983 was aimed at protecting the balance of payments, containing inflation, and improving the efficiency of the financial system. Given the setbacks sustained by the economy, the authorities were not able to achieve their objectives to the extent anticipated. In particular, containment of inflation was made more difficult by the sharp increase in prices of basic commodities because of scarcities in the early months of 1983, and by the subsequent divergence of fiscal policy from the program. The authorities noted that the overall balance of payments performance had been more favorable in the first semester of 1983. After midyear, however, with public sector financing needs increasing sharply, the loss of official reserves had become larger than had been programmed.

The authorities called attention to the advances made in developing a more efficient financial system. Interest rate ceilings were unified and raised substantially, a certificate of deposit with monetary correction on the basis of an index published by the Central Reserve Bank was created, effective average legal reserve requirements on sales deposits were reduced, regulations governing the operations of different types of institutions were made more uniform, rules on foreign participation in financial institutions were relaxed, and mergers of financial intermediaries or their conversion into commercial banks were encouraged through tax concessions. On the other hand, a number of sectors that had been affected severely by the economic recession as well as the regions stricken by the natural disasters were granted credit subsidies. The authorities observed that these special credits constituted temporary relief measures that did not run counter to their objective of developing a unified financial market.

Deposit interest rates in Peru have become increasingly negative in real terms in 1983, notwithstanding substantial increases in nominal interest rates. Moreover, up until September 1983, the policy of depreciating the sol at least in line with domestic inflation resulted in higher returns on U.S. dollar denominated assets. As a consequence, the trend toward dollarization of domestic financial savings continued during 1983. The authorities are concerned about this trend as foreign currency deposits at domestic banks represent a potential claim on Peru's international reserves. They noted that in April 1983, at a time when a few local banks experienced financial difficulties, the volume of dollar deposits in the banking system declined by 10 percent, with a corresponding adverse effect on the level of international reserves. In subsequent months, the authorities aimed to restore confidence by bolstering the level of gross international reserves of the Central Reserve Bank through sales of silver (US\$67 million) accumulated in the 1979-80 period and by borrowing from the Andean Reserve Fund (US\$195 million). The authorities were of the view that these operations, together with the purchases under the extended arrangement, had helped to stabilize the market for dollar deposits in Peru after April 1983.

The authorities stated that they intend to continue pursuing policies to improve the efficiency of the financial system. They realize that the unexpected acceleration of inflation in 1983 gave rise to problems under their policy of setting interest rate ceilings on the basis of projected inflation. To avoid setting unrealistic interest rate ceilings in the future, the authorities have been reassessing their strategy with the objective of giving market forces a greater role in the determination of interest rates.

### 3. Wage policy

In order to curb pressures from the side of wages, the authorities reduced the rate of increase of salaries of government employees to below that of inflation. As a result, the average remuneration of civilian personnel employed by the Central Administration is projected to decline by 25 percent in real terms in 1983, following a 15 percent decline in 1982. At the higher salary levels, the decline was mitigated to some extent by a policy of special increases for certain categories of skilled civil servants with a view to retaining or attracting qualified personnel. Moreover, health workers, teachers, police, and the defense forces have received substantially higher wage increases in 1983.<sup>1/</sup>

Wage policy for the nonunionized private sector in 1983 continued to emphasize the protection of the purchasing power of the lowest paid workers. However, because the salaries of a number of public officials are determined as multiples of the minimum wage, the latter has not been changed frequently to avoid unplanned budgetary expenses. As a substitute, wages in the nonunionized private sector have been guided since February 1983 by a unit of reference, fixed at a level somewhat above the minimum wage. This unit of reference has been increased at a rate somewhat below the rate of inflation in 1983.

The authorities have little influence over the outcome of collective bargaining. The Ministry of Labor can intervene to resolve conflicts over renewal of contracts. In doing so, the Ministry takes into account the financial situation of the firm and the wage level of the employees and attempts to avoid substantially divergent wage settlements among industries. In addition, the Ministry has attempted, with little apparent success, to restrain wage increases in firms considered pacesetters by using moral suasion during the negotiation process.

Beginning in October 1982, as part of the effort to control the public sector wage bill, the Government instituted controls over new hiring and guidelines for wage increases. This initiative was reinforced in April and June 1983 with decrees requiring that proposals for salary increases and promotions be submitted to the Ministry of Economy,

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<sup>1/</sup> A detailed analysis of the wage determination process in Peru is contained in Appendix I of the accompanying report on Recent Economic Developments.

Finance, and Commerce for approval. In August a decree was issued stipulating that all increases in salary or supplemental pay of public enterprises, whether or not subject to collective bargaining, had to be submitted for approval to the Ministry of Economy, Finance, and Commerce and instructing the Ministry of Labor to reject any collective bargaining agreement in the public sector not approved by the Ministry of Economy, Finance, and Commerce. The authorities expected that the August 1983 decree would provide them with a way of limiting the wage increases in public enterprises. Limiting such increases had become a high priority as a number of the large enterprises have negotiated wage contracts that involve full indexation with respect to past inflation.

#### 4. External sector policies

Interest and exchange rate policies are closely linked. The authorities noted that their exchange rate policy up to the end of August 1983 had involved depreciation of the sol at least in line with domestic inflation. This policy had not been conducive to achieving interest rate parity, largely because inflation exceeded the ceiling maintained on domestic interest rates by a substantial margin. Freeing interest rates under such an exchange rate regime would have resulted in domestic real interest rates higher than those abroad.

Faced with mounting domestic pressures, the authorities announced on August 8 a new exchange rate policy to take effect on September 1, 1983. The sol was depreciated by 6 percent and a preannounced path of the exchange rate of the sol with respect to the U.S. dollar, involving a slowing of the rate of depreciation by about one half, was established for the period September-December 1983. The authorities were of the view that the slowing of the rate of depreciation, in conjunction with the partial freezing of controlled prices, would brake inflationary expectations and change relative interest rates in favor of domestic interest rates, which at the same time were raised by 5 percentage points. In late September 1983, in response to the staff's misgivings about the new exchange rate policy in view of the need to preserve competitiveness, the authorities initiated a reassessment of exchange rate policy.

The authorities have resisted strong pressure to impose exchange restrictions and to raise the level of protection of domestic industry. The exchange system has remained free, and the authorities have rejected demands to ban or otherwise restrict imports. However, in March 1983, the temporary import surcharge imposed in early 1982 was changed from 15 percent of the import duty to 10 percent of the c.i.f. value of imports, thereby raising the average unweighted tariff from 36 percent to 41 percent. The staff concurs with the authorities that both the original measure and its recent modification were taken for fiscal rather than balance of payments reasons. Given the difficult fiscal situation, the authorities did not expect that the temporary additional duty of 10 percent could be eliminated in the near term. However, they plan to continue reducing the tariff disparity through the elimination of duty exemptions.

Since the late 1970s, the authorities have supported nontraditional exports through a number of incentives. A direct subsidy in the form of tax payment certificates is paid on the f.o.b. value of certain nontraditional exports at a rate up to 22 percent, or up to 32 percent if the product originates outside the Lima-Callao area. In addition, the Central Reserve Bank provides concessional financing to exporters of nontraditional products. In mid-September 1983 textile products sold to the United States became ineligible to receive these export facilities in order to induce the United States to withdraw the countervailing duties imposed on such products in early 1983. The authorities plan to review the system of export incentives with the objective of ensuring that support for nontraditional exports is in accord with conventions under the General Agreement on Tariffs and Trade.

External debt management is accorded high priority by the Peruvian authorities. They noted that substantial progress had been made in establishing control over external borrowing by the public sector. Since 1981 the contracting of medium- and long-term debt had been brought under the control of the General Directorate of Public Credit (GDPC)<sup>1/</sup> and, in late 1982, GDPC's control had been extended to short-term debt. Public sector enterprises were required to register their short-term external indebtedness (except export prefinancing) with GDPC and to obtain GDPC's approval for the renewal, rollover or consolidation of such debt. Starting with 1983, public sector enterprises had to submit annual short-term borrowing programs (excluding export prefinancing) to GDPC for approval. One of the conditions for such approval is that new short-term debt may not be canceled through debt consolidation. The authorities also reported that, thanks to technical assistance financed by the World Bank, reporting delays on the disbursement of medium- and long-term loans have been reduced substantially. Considerable efforts have also been made to restructure the existing debt in an attempt to alleviate the debt service burden, as described above.

The stock of total external debt outstanding in mid-1983 amounted to about US\$12.7 billion, equivalent to 76 percent of GDP.<sup>2/</sup> Service payments on public and publicly guaranteed debt have risen considerably since 1979, and in 1983 are estimated at 55 percent of exports of goods and services. Projections of public and publicly guaranteed debt service on the basis of debt contracted through end-June 1983 and the expected level of new disbursements over the next five years indicate that the debt service ratio will remain approximately at this level (Table 7). In view of the high external debt burden, the authorities reaffirmed their intention to reduce Peru's reliance on foreign borrowing through policies which promote domestic savings, and to shift increasingly toward multilateral sources of finance, which normally carry easier terms than foreign market borrowing. As to other foreign

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<sup>1/</sup> For a description of control procedures, see S/L/32/211, pp. 55-56.

<sup>2/</sup> The growth in the debt/GDP ratio in 1983 is strongly affected by the drop in real GDP and the acceleration in the rate of depreciation of the sol.

Table 7. Peru: Public Sector External Debt Service Payments, 1979-88

(In millions of U.S. dollars)

	1979	1980	1981	1982	1983	1984	Projected		1987	1988
							1985	1986		
<u>Amortization</u>	<u>1,135</u>	<u>1,511</u>	<u>1,520</u>	<u>1,106</u>	<u>1,258</u>	<u>1,446</u>	<u>1,285</u>	<u>1,387</u>	<u>1,937</u>	<u>1,965</u>
Public and publicly guaranteed	1,006	1,209	1,312	1,048	1,164	1,326	1,108	1,161	1,754	1,786
Central Reserve Bank	129	302	208	58	94	120	177	226	183	179
IMF	(79)	(119)	(46)	(48)	(94)	(87)	(112)	(161)	(151)	(179)
Other	(50)	(183)	(162)	(10)	(--)	(33)	(65)	(65)	(32)	(--)
<u>Interest 1/</u>	<u>544</u>	<u>667</u>	<u>721</u>	<u>713</u>	<u>824</u>	<u>1,068</u>	<u>1,222</u>	<u>1,212</u>	<u>1,178</u>	<u>1,114</u>
Public and publicly guaranteed	384	492	525	530	661	903	1,047	1,048	1,033	988
Central Reserve Bank	90	93	87	83	89	95	105	94	75	56
IMF	(19)	(34)	(42)	(48)	(52)	(66)	(79)	(69)	(55)	(41)
Other	(71)	(59)	(45)	(35)	(37)	(29)	(26)	(25)	(20)	(15)
Banco de la Nacion	70	82	109	100	74	70	70	70	70	70
<u>Total</u>	<u>1,679</u>	<u>2,178</u>	<u>2,241</u>	<u>1,819</u>	<u>2,082</u>	<u>2,514</u>	<u>2,507</u>	<u>2,599</u>	<u>3,115</u>	<u>3,079</u>
Public and publicly guaranteed	1,390	1,701	1,837	1,578	1,825	2,229	2,155	2,209	2,787	2,774
Central Reserve Bank	219	395	295	141	183	215	282	320	258	235
IMF	(98)	(153)	(88)	(96)	(146)	(153)	(191)	(230)	(206)	(220)
Other	(121)	(242)	(207)	(45)	(37)	(62)	(91)	(90)	(52)	(15)
Banco de la Nacion	70	82	109	100	74	70	70	70	70	70
<u>Memorandum items</u>										
As percent of exports of goods and services										
Total debt service	39.5	45.1	53.1	43.4	55.3	58.9	53.5	52.0	58.7	53.8
Amortization	(26.7)	(31.3)	(36.0)	(26.4)	(33.4)	(33.9)	(27.4)	(27.8)	(36.5)	(34.3)
Interest	(12.8)	(13.8)	(17.1)	(17.0)	(21.9)	(25.0)	(26.1)	(24.2)	(22.2)	(19.5)
As percent of GDP										
Total debt 2/	67.8	54.2	48.5	56.0	82.3	...	...	...	...	...
Interest payments	4.0	3.9	3.6	3.6	4.9	...	...	...	...	...

Sources: Data provided by the Peruvian authorities; and Fund staff estimates.

1/ Includes interest on short-term public debt.

2/ Includes private sector debt.

creditors, the authorities intend to seek debt relief on maturities falling due in 1984. Agreements in principle have already been reached with the Paris Club and the USSR.

#### 5. Elements of structural adjustment

A major aim of the program under the extended arrangement is the improvement of the efficiency of the Peruvian economy. So far progress toward this objective has been uneven. Sizable corrective increases in relative prices have been implemented, but since September 1983 slippages have occurred, as described in previous sections of this report. Significant advances have been made in exposing the Peruvian economy to foreign competition, but the imposition of a 15 percent temporary tariff surcharge in early 1982 and its subsequent conversion into a 10 percent import tax in March 1983 were steps backward.

Recent developments in Peru have brought into focus the need for greater efficiency as a means of fostering economic growth. In this regard, the authorities noted with concern that a number of rigidities in the labor market, including certain aspects of the legislation covering employment stability and participation of labor in management and profits, have hampered manufacturing enterprises in achieving the degree of operational flexibility that seems needed. The authorities also were concerned about the adverse effects of existing policies with regard to controlled prices, state marketing, and land ownership on the recovery and future growth of the agricultural sector. The authorities shared the staff's view that to enhance domestic saving and capital formation required not only the re-establishment of financial stability, but also the progressive elimination of structural rigidities in the economy. Hence, they have embarked on a full review of existing laws affecting industry and agriculture with the intention of introducing corrective action.

The authorities' commitment to structural changes forms the basis for a structural adjustment loan from the World Bank that is expected to be discussed by the Bank's Executive Board in the coming months. The structural policies supported by this loan are fully consistent with the program under the extended arrangement and include the elimination of subsidies on publicly provided goods and services; mutually consistent interest rate and exchange rate policies that rely on market mechanisms and ensure competitiveness; continued trade liberalization; improved agricultural pricing policies coupled with clear land tenure laws and an enhanced flow of unsubsidized credit; and a shift to more labor-intensive methods of production by reducing the anti-labor bias of the current system.

### III. Staff Appraisal

Given the slippages in policy implementation in 1982, the program for 1983 was designed to return to the path contemplated in the extended arrangement. The adjustment in 1983 was to be carried out at a time of unfavorable external conditions. Export earnings were projected to be affected by weak world demand, and access to world capital markets was expected to remain limited. In early 1983, Peru's economic prospects deteriorated further as unexpectedly severe weather conditions led to sharp declines in production in agriculture, fishing, mining, and petroleum extraction. It is currently estimated that real GDP may drop by 7 percent this year, whereas a modest increase had been projected earlier.

Scarcities of basic commodities in the first months of 1983 led to a sharp increase in the rate of inflation, from 73 percent during 1982 to an annual rate of 140 percent in the first six months of 1983. Subsequently, the inflationary momentum was sustained by a growing deficit of the nonfinancial public sector.

The major elements in the projected deterioration of the public finances in 1983 to more than double the programed level of approximately 4 percent of GDP are (i) a sharp drop in the ratio of central administration revenues to GDP, (ii) an increase in defense expenditures in relation to GDP, (iii) emergency expenditures in the disaster stricken areas, and (iv) a deterioration of the financial performance of the public enterprises, in part because of the delayed implementation of increases in the prices of a number of controlled food items and the partial freezing of controlled prices since September 1983.

The larger than programed deficit of the nonfinancial public sector in 1983 has led to the temporary incurrence of substantial domestic payment arrears and--especially following their elimination in the third quarter of this year--the crowding out of the private sector in the financial markets. The result has been that the monetary program has come under considerable strain. In the first semester of 1983, the monetary authorities kept the growth of credit close to the program path by reducing the amount of credit available to the private sector in real terms. Since midyear, however, the financing requirements of the nonfinancial public sector have led to a larger than programed credit expansion and a loss in net official reserves.

A number of advances have been made this year in developing a more efficient financial system, including the unification of interest rates, the creation of an indexed saving instrument, the reduction of effective legal reserve requirements, and the relaxation of requirements for entry into the domestic financial system. However, these advances were to some extent offset by an expansion of subsidized credit lines by the monetary authorities, portfolio requirements to channel credit to agriculture, and the maintenance of negative real deposit rates notwithstanding substantial increases in nominal rates.

The exchange system has continued to be free from restrictions in 1983 but the level of protection against imports has increased somewhat as a result of the effective increase in the temporary import surcharge. In the January-August 1983 period the sol was depreciated in real effective terms by 8.5 percent. However, in a major policy reversal, the rate of depreciation of the sol was reduced by approximately one half in September 1983 as the exchange rate was preannounced through the end of 1983. At the same time, the adjustment of controlled prices was either suspended or slowed substantially. The aim of these measures, ostensibly, was to reduce the rate of inflation. However, the result has been that subsidies have reappeared and Peru's external competitiveness has been endangered.

The authorities have made further progress in establishing control over external borrowing by the public sector and in monitoring loan disbursements. They realize that the high debt service burden and international capital market conditions require increased reliance on domestic savings. Beyond efforts to promote such savings, the authorities intend to rely increasingly on concessional loans from the multilateral development banks and to seek further debt relief from their other foreign creditors. Member countries of the Paris Club and socialist countries already have indicated their readiness to provide debt relief for Peru in 1984 and the authorities have recently announced that they will also approach their foreign banks creditors.

The root cause of the major deviation from the program path in 1983 is the weak performance of the nonfinancial public sector. The magnitude of the deterioration of the public finances became known only with a lag because of the inadequacy of the reporting system. As a consequence, the development of remedial measures was delayed, and the imbalances became very large. The staff recommends that the authorities improve the reliability and timeliness of data in order to strengthen monitoring and implementation of economic policy. In this regard, the authorities' requests for technical assistance in the fiscal and monetary areas and for the assignment of a Fund resident representative in Lima are welcomed by the staff.

The staff urges the authorities to take strong fiscal action covering both revenue and expenditure to contain the fiscal imbalance looming in the remainder of 1983 and to set the stage for an improvement in the public finances in 1984. However, fiscal measures alone will not be sufficient to re-establish the economic program. Measures in this area need to be accompanied by the pursuit of a tight monetary policy geared to the containment of inflation, the return to a realistic exchange rate policy so as to restore competitiveness, the implementation of market-oriented interest rate policy, and the adjustment of prices of goods and services sold by the public sector.

These actions must be complemented by policies reducing substantially the rigidities that currently constitute impediments to production in Peru. These rigidities include laws guaranteeing the stability

of employment and the participation of labor in profits and management, arrangements for wage indexation, laws governing agricultural land property, and extensive state participation in commercial activities. The effects of these rigidities have been examined by the World Bank, and a structural adjustment loan is being contemplated in support of measures in these areas in order to improve economic efficiency.

In view of the need for substantial and far-reaching policy changes to stabilize the Peruvian economy, the staff considers that the principal policy actions in the fiscal, exchange rate, interest rate, and pricing fields should be put in place before further consideration is given to continued financial support from the Fund for the program of the authorities.

Fund Relations with Peru  
(As of September 30, 1983)

Status: Article VIII.

Quota: SDR 240 million. (Proposed Maximum Quota of SDR 330.9 million under the Eighth General Review.)

Fund holdings of Peruvian soles:	<u>As of September 30, 1983</u>	<u>Millions of SDRs</u>	<u>Percent of Quota</u>
Total		930.76	378.36
Of which: under CFF		(199.90)	(81.26)
EFF		(211.09)	(85.81)
SFF		(164.78)	(66.99)
EAR		(53.91)	(21.91)

SDR Department: Holdings: SDR 16.39 million or 17.95 percent of net cumulative allocation of SDR 91.32 million.

Exchange rate: September 30, 1983, S/. 2,041.09 per U.S. dollar. The exchange rate for the sol in the official market is adjusted on almost a daily basis, and the regime is classified as other managed floating. Transactions with certificates of deposit denominated in dollars provide a parallel market with a freely determined exchange rate. As of August 31, 1983, this certificate rate was 0.1 percent above the official rate. The representative rate for the sol is the midpoint between buying and selling rates in the official market. Since April 30, 1983 the Fund's holdings of soles have been accounted for at the rate of SDR 0.000687979 per sol, or S/. 1,453.53274 per SDR.

Gold distribution: Peru has received gold amounting to 105,266.981 fine ounces in four distributions.

Direct distribution of profits from gold sales: Peru received a total of US\$19.536 million in the period July 1, 1976-July 31, 1980.

Last consultation: The 1982 Article IV consultation discussions were concluded on December 1, 1982 (EB/82/155).

Peru--Basic Data

Area and population

Area	1,280,000 sq. kilometers
Population (end of 1982)	13.8 million
Annual rate of population increase (1978-82)	2.8 percent
Unemployment rate (July 1982; Lima Metropolitan Area)	6.6 percent

GDP (1982)

SDR 17.88 billion
US\$19.73 billion
S/. 13,766.7 billion

GDP per capita (1982)

SDR 950

<u>Origin of GDP</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>Pre1.</u>	<u>Proj.</u>
			(percent)	1982	1983
Agriculture & Fishing	14	13	14	14	14
Mining	10	9	9	9	10
Manufacturing	24	25	24	23	22
Construction	4	5	5	6	4
Government	8	8	8	8	8
Other	40	40	40	40	42

Ratios to GDP

Exports of goods and services	31.9	28.9	22.1	22.0	23.9
Imports of goods and services	25.0	29.5	30.8	30.3	30.5
Current account of the balance of payments	6.9	-0.6	-8.7	-8.3	-6.6
Central administration revenues	18.0	20.5	18.1	18.1	13.5
Central administration expenditures	18.6	23.4	23.0	22.1	19.4
Nonfinancial public sector savings	4.3	2.0	0.9	0.2	-3.1
Nonfinancial public sector overall surplus or deficit (-)	-1.7	-6.4	-6.4	-8.6	-9.4
External public debt (end of year)	41.8	35.1	31.4	34.9	50.9
Gross national savings	21.5	17.1	13.4	11.7	9.8
Gross domestic investment	14.6	17.7	22.1	20.0	16.4
Money and quasi-money (end of year)	20.9	25.0	26.1	27.8	25.3

Annual changes in selected economic indicators

Real GDP per capita	0.8	0.2	0.3	-2.1	-9.3
Real GDP	3.8	3.0	3.1	0.7	-6.8
GDP at current prices	63.6	61.7	69.7	63.4	97.3
Domestic expenditures (at current prices)	67.9	74.4	85.4	62.7	90.1
Investment	84.1	95.8	112.2	47.7	62.3
Consumption	65.0	70.2	79.3	65.8	96.6
GDP deflator	76.9	57.0	64.6	62.3	111.8
Cost of living (annual averages)	67.7	59.2	75.4	64.5	113.3
Central administration revenues	109.3	84.6	49.5	63.7	46.6
Central administration expenditures	63.5	103.5	67.1	56.8	73.7
Money and quasi-money	100.1	93.9	76.7	74.1	83.2
Money	78.5	71.3	48.4	35.8	124.6
Quasi-money	126.3	116.0	95.6	96.2	66.7
Net domestic bank assets 1/	-20.7	60.8	93.8	75.0	137.9
Credit to public sector (net)	-30.5	24.8	30.4	15.4	17.7
Credit to private sector	42.7	55.7	67.4	74.9	116.3
Merchandise exports (f.o.b., in U.S. dollars)	89.4	6.5	-17.0	1.4	-10.3
Merchandise imports (f.o.b., in U.S. dollars)	22.0	58.1	23.0	-0.4	-20.4

<u>Central administration finances</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	Prel. <u>1982</u>	Proj. <u>1983</u>
		(billions of soles)			
Revenues	552	1,019	1,523	2,493	3,655
Expenditures	570	1,160	1,938	3,038	5,276
Current account surplus or deficit (-)	110	121	19	5	-996
Overall deficit (-)	-18	-141	-415	-545	-1,621
External financing (net)	46	23	-9	407	...
Internal financing (net)	-28	118	424	138	...
<u>Balance of payments</u>		(millions of U.S. dollars)			
Merchandise exports, f.o.b.	3,676	3,916	3,249	3,293	2,953
Merchandise imports, f.o.b.	-1,954	-3,090	-3,802	-3,787	-2,825
Investment income (net)	-931	-909	-1,019	-1,012	-1,196
Other services and transfers (net)	162	-18	-156	-143	-31
Balance on current and transfer accounts	953	-101	-1,728	-1,649	-1,099
Official capital (long-term net)	617	371	388	994	1,600
Private capital (long-term net)	39	91	260	205	-22
Short-term capital and errors and omissions (net)	-54	386	448	634	-748
Allocation of SDRs	22	23	21	--	--
Change in net official reserves (increase -)	-1,577	-770	611	-184	269 <u>2/</u>
<u>International reserve position</u>		June 30 <u>1982</u>	Dec. 31 <u>1982</u>	June 30 <u>1983</u>	
		(millions of SDRs)			
Monetary authorities (gross)		1,580.6	1,660.0	1,916.7	
Monetary authorities (net)		539.3	760.2	499.6 <u>2/</u>	
Rest of banking system (net)		50.6	15.3	-475.8 <u>2/</u>	

<sup>1/</sup> In relation to the stock of money and quasi-money at the beginning of the period. Excludes contra-entry of SDR allocations.

<sup>2/</sup> Includes the assumption of guaranteed nonbank short-term foreign debt by domestic banks as provided by the agreement with foreign commercial banks.

