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AGENDA**

EBS/89/13
Supplement 1

CONFIDENTIAL

February 23, 1989

To: Members of the Executive Board

From: The Secretary

Subject: Peru - Staff Report for the 1988 Article IV Consultation -
Supplementary Information

The attached supplement to the staff report for the 1988 Article IV consultation with Peru has been prepared on the basis of additional information.

Mr. Hardy (ext. 7158) is available to answer technical or factual questions relating to this paper prior to the Board discussion tomorrow, Friday, February 24, 1989.

Att: (1)

INTERNATIONAL MONETARY FUND

PERU

Staff Report for the 1988 Article IV Consultation
Supplementary Information

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

Approved by S. T. Beza and Eduard Brau

February 22, 1989

During December and January economic activity continued to contract and inflation was on a rising trend. Based on the latest available data the authorities expect a further substantial decline of real GDP in 1989, following a fall of close to 9 percent last year. Prices rose by 41.9 percent in December and 47.3 percent in January, and the Central Bank projects inflation at 30-35 percent in February.

During the last two and a half months the authorities have continued to implement measures aimed at reducing subsidies and narrowing the public sector deficit. As reported in EBS/89/13, changes were made in several controlled prices during December 1988 and a round of price, wage, and exchange rate actions was implemented on January 6, 1989, including a 29 percent devaluation of the controlled exchange rate (40 percent in local currency terms), increases of 60-70 percent in most public sector prices and an increase of 41 percent in the minimum wage.

In meetings in Washington during January, Peru's Finance Minister outlined the program of the authorities aimed at gradually stabilizing the Peruvian economy over the next few months, while the staff felt that adjustment along the lines suggested in the staff appraisal of EBS/89/13 would be more likely to succeed.

A further set of measures was implemented on January 31, which included a 24 percent devaluation (31 percent in local currency terms), the elimination of the 6 percent tax on export earnings, increases of 25-35 percent in prices of petroleum products and foodstuffs (which are largely imported), increases in other public tariffs of around 25 percent, and an increase of 24 percent in the minimum wage. No changes were made in controlled interest rates.

At the end of January the authorities also announced a program of price and wage adjustments for the period through May 1989 as shown below:

	As of Jan. 6	As of Jan. 31	Announcement		
			March	April	May
Official exchange rate in intis per U.S. dollar	700	920	1,100	1,250	1,400
Change (in local currency terms) (in percent)	40	31	20	14	12
Controlled prices					
Gasoline (intis per gallon)	970	1,250	1,500	1,700	1,900
Change (in percent)	61	29	20	13	12
Minimum wage (intis per month)	34,000	42,000	49,500	55,500	61,050
Change (in percent)	41	24	18	12	10

The public sector appears to have utilized very little domestic credit in January in contrast to previous months. While the measures implemented in December and early January probably helped reduce the deficit, domestic arrears of the public sector are believed to have increased significantly. For example, the Central Administration and other public entities reportedly delayed payment of a part of their wage bill for January.

The curb on public expenditure also resulted from the Central Bank's policy of sharply limiting credit to the public sector in January, which contributed to a significant slowdown in the growth of currency and broad money. Currency in circulation increased by only 6 percent during the month, and the banking system's net domestic assets (with all accounts valued at constant exchange rates) rose by about 10 percent.

As a result of the steep drop in activity, which sharply reduced import demand, and the credit policy pursued by the Central Bank, the exchange rate of the inti in the free market appreciated significantly in January and early February, moving from I/. 1,770 per U.S. dollar at end 1988 and over I/. 2,000 per U.S. dollar in the first few days of 1989, to around I/. 1,400 per U.S. dollar in recent days. Since the end of 1988 the spread between the official and the free market rates has narrowed from over 300 percent to around 50 percent. The strengthening of the free market rate may also reflect the impact of measures to increase the supply of foreign exchange in the free market by allowing all importers to have access to the 30 percent of foreign exchange earnings retained by exporters (prior to January the retentions could only be used for the exporter's own imports or sold to other exporters for their imports). As of mid-February, about 60 percent of imports

were being transacted at the controlled exchange rate, and the rest at the free rate.

In terms of cash flow, export receipts in January were not as badly affected by the mining strike as had been expected as the authorities were able to obtain some prepayments for future copper shipments. On the payments side, imports appear to have been running at about half the level of one year earlier, payments under the Latin American Integration (ALADI) clearing facility were about half the level that had been projected, and debt service payments were negligible. As a result, the Central Bank's net foreign asset position apparently remained broadly unchanged during the month.

To the extent that the measures implemented over the past few months have reduced the level of subsidies, they are positive steps. However, further major fiscal action is needed to establish a durable improvement in the public finances, which would permit the recent slowdown in Central Bank credit expansion to be sustained. In its absence, the policy of preannouncing key economic variables for the next few months may not be enough to change expectations. Moreover, in the present exchange rate system in which the controlled rate is perceived as overvalued, exports will continue to be discouraged and adverse movements in leads and lags will be encouraged. Furthermore, real interest rates remain highly negative and velocity is likely to continue to accelerate.