

SM/79/172

CONTAINS CONFIDENTIAL
INFORMATION

June 28, 1979

To: Members of the Executive Board
From: The Secretary
Subject: Peru - Staff Report for the 1979 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1979 Article IV consultation with Peru. A draft decision appears on page 15.

This subject, together with Peru's request for a stand-by arrangement (EBS/79/360, 6/28/79), has been tentatively scheduled for discussion on Monday, July 23, 1979.

Att: (1)

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PERU

Staff Report for the 1979 Article IV Consultation

Prepared by the Staff Representatives for
the 1979 Consultation with Peru

Approved by E. Walter Robichek and C. David Finch

June 26, 1979

I. Introduction

The Article IV consultation discussions with Peru were held in Lima from April 23 to May 11, 1979.^{1/} Representatives of Peru in these discussions were the Minister and Vice Ministers of Economy and Finance; the Vice Ministers of Energy and Mines, Industry, Commerce, Agriculture, and Labor; the President and General Manager of the Central Reserve Bank, and the President of the National Bank. The staff representatives were Mr. Jan van Houten (Head-WHD), Mr. Shailendra Anjaria (ETR), Messrs. Jorge Bonvicini, Frits van Beek, and John Whiteman (all WHD), and Mrs. Ana Stevens (Secretary-WHD).

II. Recent Economic Developments

1. Background

Peru has experienced severe financial difficulties in recent years due to the excessive expansion of domestic demand in relation to output. Beginning in 1975, several attempts were made to rectify the imbalance through measures designed to curb domestic demand and stimulate exports. Tax measures and adjustments in public sector prices were accompanied by depreciations of the sol. However, principally because of insufficient price adjustments, poor expenditure control and a deterioration in tax administration, the overall public sector deficit in 1977 was 10 per cent of GDP for the third consecutive year and the balance of payments deficit was unsustainable. A renewed effort was made starting in September 1977 with the introduction of a stabilization program, which was supported by a stand-by arrangement in the upper credit tranches approved by the Fund on November 18, 1977. The central element of this program was a sharp reduction of the public sector deficit to be achieved by curbing spending and raising revenue through tax increases, improvements in tax administration, and elimination of operating deficits of public enterprises. The rate of the sol was freed on October 10, 1977 and the system of foreign exchange allocations for private sector imports was abolished.

^{1/} Peru has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement.

Serious difficulties were encountered in observing the credit ceilings embodied in the program virtually from the time the stand-by arrangement was approved. Total domestic bank credit diverged increasingly from the programmed levels, the public sector being the major source of the excess credit expansion because of poor expenditure control and a serious shortfall in tax revenue. Even so, the overall public sector deficit was reduced somewhat in the first semester of 1978 after adoption in January 1978 of additional tax measures and adjustments in the prices of products marketed by the state enterprises.

With bank credit to the private sector also expanding at a rate faster than programmed, the demand pressures resulted in a further loss of net international reserves notwithstanding restrictions of access to foreign exchange starting in December 1977. After the sol depreciated by 41 per cent from October 1977 to S/. 138 per U.S. dollar in mid-December 1977, the depreciation was halted by an informal agreement among banks, with official encouragement, to peg the sol at S/. 130 per U.S. dollar and to limit sales of foreign exchange to the amounts available.

The net international reserves of the banking system declined by US\$120 million in the first semester of 1978, and the disposable gross reserves of the Central Reserve Bank were reduced to the equivalent of a few days of imports. Delays for payments lengthened and banks abroad were compelled to cover confirmed letters of credit which had matured. Meanwhile, the rate of inflation accelerated reflecting both demand pressures and adjustments of controlled prices; the cost of living index rose by 40 per cent in the first half of 1978, compared with an increase of 32 per cent for all of 1977.

2. The new stabilization program

Corrective action to halt the deteriorating financial situation was taken in May 1978. A comprehensive package of fiscal measures comprising new taxes, expenditure cuts, and new pricing guidelines for state enterprises, was announced, followed by a depreciation of the sol from S/. 130 to S/. 150 to the U.S. dollar and the subsequent introduction of a system of frequent small depreciations.

These measures set the stage for the negotiation of a new stabilization program in July 1978, which has been supported by another stand-by arrangement in the upper credit tranches approved by the Fund on September 15, 1978. In marked contrast to the experience under the previous program, Peru's observance of the current program has been very good from the start (Table 1). The performance criteria for Central Reserve Bank net international reserves and net bank credit to the public sector on each testing date have been met by a substantial margin. The net domestic assets of the Central Reserve Bank, which are subject to a continuous ceiling, have remained well below that ceiling; the limits on the contracting of external debt by the public sector have been observed, as have all the nonquantitative performance criteria of the program.

The sharp improvement in the financial situation of Peru is clearly brought out by the turnaround in the balance of payments. Following a deficit of US\$350 million in 1977 and US\$120 million in the first half of 1978, the balance of

Table 1. Peru: Performance Under Stand-by Arrangement

| | 1978 November 15 (S/. 160=US\$1) | 1979 March 31 (S/. 200=US\$1) |
|---|--|-------------------------------------|
| <u>(In billions of soles)</u> | | |
| <u>Net domestic assets of the</u> <u>Central Reserve Bank</u> | | |
| Ceiling <u>1/</u> | 200.3 | 259.3 |
| Actual | 181.6 | 223.2 |
| Margin under ceiling | 18.7 | 36.1 |
| <u>Bank credit to public sector</u> | | |
| Limit <u>1/</u> | 271.0 | 319.7 |
| Actual | 261.2 | 290.4 |
| Margin under limit | 9.8 | 29.3 |
| <u>(In millions of U.S. dollars)</u> | | |
| <u>Net international reserves of the</u> <u>Central Reserve Bank</u> | | |
| Target <u>1/</u> | -737.4 | -837.4 |
| Actual | -634.3 | -583.3 |
| Margin | 103.1 | 254.1 |
| <u>Contracting of foreign debt</u> | | |
| <u>1 to 5 years</u> | | |
| Ceiling | 135.0 | 135.0 |
| Actual | 39.1 | 76.0 |
| Margin under ceiling | 95.9 | 59.0 |
| <u>1 to 10 years</u> | | |
| Ceiling | 300.0 | 300.0 |
| Actual | 64.9 | 173.7 |
| Margin under ceiling | 235.1 | 126.3 |

Source: Central Reserve Bank of Peru.

1/ Adjusted in accordance with the criteria set out in Tables 1-4 of the Memorandum of the Government of Peru on Certain Aspects of its Economic and Financial Policies, annexed to EBS/78/447, August 18, 1978.

payments moved to a surplus of US\$200 million during the second half of 1978 (Table 2). For 1979 a balance of payments surplus of about US\$340 million is projected compared with US\$140 million programed.

The improvement in the trade balance has been dramatic, from a deficit of US\$440 million in 1977 to a surplus of US\$340 million in 1978, and a projected surplus of US\$990 million in 1979. The improvement in 1978 was the result principally of a US\$560 million compression of imports; in addition exports rose by US\$220 million, or 12.5 per cent. The import contraction reflected the decline in economic activity and the virtual elimination over the course of the year of petroleum imports, as a major spur to the main pipeline was put into operation. In addition, exchange rationing severely restricted imports and hampered the opening of letters of credit during the first semester of 1978. In 1979, imports are projected to rise moderately, but the level of imports is still expected to be as much as US\$150 million below programed. Exports, on the other hand, are projected to increase faster than initially expected. The depreciation of the sol in combination with a generous system of export tax rebates has resulted in a rapid expansion of nontraditional exports to a projected level of more than US\$500 million in 1979 from US\$375 million in 1978. In addition, the world prices of Peru's mineral and petroleum exports have risen sharply. The larger exchange receipts from higher copper and petroleum prices, however, are expected to be balanced to a considerable extent by larger factor payments abroad, since foreign owned enterprises produce and export the bulk of copper and petroleum in Peru.

The inflow of net long-term capital, which had been reduced in 1978 notwithstanding refinancing credits of US\$265 million, is projected to increase slightly in 1979 with debt rescheduling projected at US\$600 million and estimated disbursements of US\$100 million from a new World Bank program loan of US\$115 million. The net outflow on account of short-term capital movements in 1979 is projected at US\$300 million and is explained by changes in the financing of trade flows, principally by the reduction in the foreign financing requirement of most imports from 180 days in the second semester of 1978 to a projected 60 days in the second half of 1979. Nontrade related short-term capital outflows which had been large in 1977 and 1978 are expected to be small in 1979 as a result of the implementation of exchange and interest rate flexibility.

The key policy measures which account for the improvement in the balance of payments were the sharp reduction in the public sector deficit and the introduction of a flexible exchange rate in May 1978.

The overall public sector deficit was reduced from 10 per cent of GDP in 1977 to 7 per cent in the first semester of 1978, and to 5-1/2 per cent in the second semester (Table 3). The drop in the internal financing requirements was more pronounced, from 4-1/2 per cent of GDP in the first half of 1978 to 1 per cent in the second half. The performance during the first months of 1979 has continued to be strong, although not as tight as the large available margin of bank credit to the public sector would indicate, because of the unplanned transfer to the Central Government of S/. 10 billion in Central Reserve Bank profits (equivalent to one third of the available margin of bank credit to the public sector on March 31, 1979). On the basis of the performance to date and the

Table 2. Peru: Summary of Balance of Payments, 1976-1979

(In millions of U.S. dollars)

| | 1976 | 1977 | 1978 | | Year | Proj. 1979 |
|--|---------------|-------------|---------------|----------------|-------------|---------------|
| | | | First half | Second half | | |
| <u>Current balance</u> | <u>-1,192</u> | <u>-926</u> | <u>-187</u> | <u>-5</u> | <u>-192</u> | <u>138</u> |
| Trade balance | -740 | -438 | 40 | 299 | 340 | 988 |
| Exports, f.o.b. | (1,359) | (1,726) | (835) | (1,105) | (1,941) | (2,738) |
| Imports, f.o.b. | (-2,100) | (-2,164) | (-794) | (-806) | (-1,600) | (-1,750) |
| Investment income | -366 | -426 | -239 | -339 | -578 | -940 |
| Public sector | (-275) | (-300) | (-168) | -253 | (-420) | (-538) |
| Private sector | (-91) | (-127) | (-71) | (-86) | (-157) | (-402) |
| Other services | -143 | -118 | -15 | 5 | -10 | 9 |
| Transfer payments | 58 | 57 | 27 | 29 | 56 | 81 |
| <u>Long-term capital</u> | <u>622</u> | <u>711</u> | <u>204</u> | <u>218</u> | <u>421</u> | <u>495</u> |
| Private sector | 196 | 69 | 29 | 10 | 39 | 7 |
| Official loans 1/ | 522 | 648 | 182 | 212 | 394 | 494 |
| Refinancing credits 2/ | (--) | (--) | (127) | (138) | (265) | (639) |
| Other disbursements | (777) | (1,052) | (325) | (463) | (788) | (833) |
| Amortization | (-255) | (-404) | (-270) | (-389) | (-659) | (-978) |
| Other public sector | -96 | -6 | -7 | -4 | -11 | -6 |
| <u>Short-term capital and errors and omissions</u> | <u>-298</u> | <u>-134</u> | <u>-138</u> | <u>-15</u> | <u>-153</u> | <u>-297</u> |
| <u>Overall surplus or deficit (-)</u> | <u>-868</u> | <u>-349</u> | <u>-121</u> | <u>197</u> | <u>76</u> | <u>336</u> |
| <u>Change in international reserves (increase -)</u> | <u>868</u> | <u>349</u> | <u>121</u> | <u>-197</u> | <u>-76</u> | <u>-336</u> |
| Balance of payments | | | | | | |
| support loans 3/ | 165 | 222 | -- | -- | -- | -41 |
| Other international reserves of the | | | | | | |
| Central Reserve Bank | 421 | 83 | 125 | -17 | 108 | -141 |
| Rest of banking system | 282 | 44 | -4 | -180 | -184 | -154 |

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

1/ Loans registered with the General Directorate of Public Credit.

2/ Includes rescheduling. Refinancing loans which are a direct liability of the Central Reserve Bank are classified as a financing item under change in international reserves.

3/ Refinancing loans which are a direct liability of the Central Reserve Bank.

implementation of several additional measures described below in the section on the consultation discussions, it appears likely that the overall public sector deficit in 1979 will be reduced to 2 per cent of GDP as programed. The main factors accounting for the improved fiscal situation are sharp increases in taxation and prices of goods and services marketed by public enterprises from May 1978, along with the successful implementation of austerity in most areas of government spending. In addition, it appears that the deterioration in tax collections, which had contributed to undermining previous efforts of stabilization has been halted.

Table 3. Peru: Summary of Public Sector Operations
(As per cent of GDP)

| | 1976 | 1977 | Prel. 1978 | | Year | Proj. 1979 |
|--|-------------|-------------|---------------|----------------|------------|---------------|
| | | | First Half | Second Half | | |
| <u>Current surplus or deficit (-)</u> | <u>-0.1</u> | <u>-3.4</u> | <u>-1.4</u> | <u>-0.2</u> | <u>-0</u> | <u>4.0</u> |
| <u>Investment</u> | <u>8.9</u> | <u>6.6</u> | <u>5.4</u> | <u>5.3</u> | <u>5.3</u> | <u>5.7</u> |
| Capital formation | 8.7 | 6.4 | 5.4 | 4.8 | 5.1 | 5.6 |
| Financial investment | 0.2 | 0.2 | -- | 0.5 | 0.2 | 0.1 |
| Overall deficit (-) | -9.0 | -10.0 | -6.8 | -5.4 | -6.0 | -1.7 |
| <u>Financing</u> | <u>9.0</u> | <u>10.0</u> | <u>6.8</u> | <u>5.4</u> | <u>6.0</u> | <u>1.7</u> |
| External (net) | 2.7 | 5.5 | 2.1 | 4.3 | 3.4 | 3.9 |
| Of which. debt relief and program loans | (--) | (--) | (1.3) | (2.2) | (1.8) | (4.6) |
| Internal (net) | 6.3 | 4.5 | 4.7 | 1.1 | 2.6 | -2.2 |

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

The sharp reduction in the public sector's domestic financing needs considerably eased the problems of monetary management. However, the rate of nominal expansion of bank credit to the private sector exceeded the projected rate, reflecting both the lowering of the effective marginal reserve requirement in November 1978 and a faster-than-expected increase in commercial bank deposits related to the strong improvement in the balance of payments and the upward adjustment of interest rates to levels close to the rate of inflation. Even so, bank credit to the private sector declined in real terms by 19 per cent over the 12-month period ending March 31, 1979.

In contrast to the rapid achievement of the balance of payments objective, progress in reducing the rate of inflation and reactivating the economy has been slower. Inflation, after being halved between the first semester and second semester of 1978 to an average monthly rate of 3-1/2 per cent, jumped to 5 per cent per month during the period January-April 1979, before moderating to 3.6 per cent in May. The acceleration of inflation since December reflected primarily developments on the cost side, although a resurgence of high inflationary expectations appears also to have been a factor. The combined general wage adjustments for all public and private sector workers, effective January 1 and March 1, 1979, exceeded the programmed amounts substantially and a number of sizable adjustments under collective bargaining settlements were granted in the first months of 1979. In manufacturing industries, moreover, it appears that unit wage costs have increased sharply since a drop in capacity utilization has not been accompanied by a decline in the labor force owing to the laws guaranteeing job security. A good part of the inflation since January was attributable, as expected, to corrective adjustments of controlled prices for basic foods and petroleum products. In addition, unusually sharp increases occurred in prices of several food products which are not controlled, such as potatoes and vegetables, pointing to seasonal scarcities and shortages owing to structural deficiencies in the agricultural sector.

Reactivating the economy has proved to be difficult, as had been expected. The rate of open unemployment in the greater Lima area apparently has remained at about 9 per cent but the disguised unemployment rate is much higher, at about 40 per cent. There is little evidence of economic reactivation outside of mining, petroleum production, and nontraditional exports. In particular, manufacturing for domestic consumption and construction have continued to be weak. The growth rate of agricultural production remains low as it has been for a number of years, apparently reflecting serious structural problems. In all, real GDP in 1979 is projected to increase at most by 1 per cent following an estimated 2 per cent contraction in 1978. However, this growth on average for the year is consistent with a level of activity at the end of 1979 perhaps some 3 per cent higher than at the end of 1978, given that economic activity appears to have bottomed out around the middle of 1978.

III. Report on the Discussions

The Peruvian authorities were gratified by the remarkable progress made since midyear 1978 toward correcting the balance of payments disequilibrium and reducing the overall public sector deficit. However, they were concerned about the resurgence of inflation and the continuing weakness in several major sectors of the economy. Lowering the rate of inflation as quickly as possible was a principal objective, but the authorities also faced considerable pressure to speed up economic recovery and lower the high rate of unemployment by relaxing fiscal and credit policies.

In these circumstances, the consultation discussions focused on a review of the policy alternatives for dealing with these problems, within the framework provided by the stand-by program. The authorities recognized that the recovery

of investment from the low rate of the past two years was bound to be slow since a sharp upturn in public sector investment was constrained by the availability of local funds, while business fixed investment spending was being held back by the present low rate of capacity utilization in most sectors of industry and by uncertainty about the course of inflation and the outcome of the upcoming presidential election. The authorities agreed with the staff that a sustained upturn in economic growth and in employment was not likely to occur until the rate of inflation decelerated. A substantial decline in the rate of inflation would stem the erosion of real incomes, thereby helping to reactivate consumer demand. At the same time, it would greatly improve the climate for private investment.

Looking toward the medium term, the authorities have prepared a public investment plan through 1982 within the framework of a World Bank program loan of US\$115 million approved in May 1979. The investment plan gives priority to ongoing projects which contribute to the economic recovery and to new projects with a high rate of return in agriculture, export industries, energy, and mining.

1. Domestic policies

Although inclined to assign somewhat less weight to wage cost pressures and more to speculative price adjustments, the authorities were in general agreement with the staff on the causes of the resurgence of inflation over the January-April 1979 period. In designing their anti-inflation program they were determined to rely mainly on demand management and on import liberalization.

With respect to fiscal policy, the authorities plan to maintain the austere stance of the first ten months of the stabilization program. A careful review of the projections of the operations of the Central Government and the principal public sector enterprises for the remainder of 1979 revealed that several important adjustments remained to be made in order to achieve this objective. In the Central Government additional expenditures have arisen for interest payments on both the domestic and the foreign debt, and two additional wage increases of approximately 10 per cent each were planned for July and October. The staff was of the view that planned wage adjustments should be reduced to one increase effective in October, not only because of the need to limit domestic bank financing of the public sector, but also to avoid as much as possible wage pressures that are quickly translated into price rises. The two additional wage adjustments, if carried out, would be granted to all employees and workers in the public and private sectors and would become, as in the past, a starting point for additional wage demands in the private sector and public sector entities.

With only one additional wage adjustment in 1979 and no further increases in expenditure except interest payments, the Central Government's internal financing needs could be held to S/. 76 billion for the year, in line with the program. This outcome assumed, moreover, that the considerable improvements in tax administration since the start of the program period, particularly in the areas of sales and income taxation, were maintained during the remainder of the year. The authorities stated that they intend to continue emphasizing tax administration as a means to increase revenues and raise further the current surplus of the Central Government.

The revenue performance of the Central Government has been adversely affected by the rising volume of export tax certificates (CERTEX) granted for nontraditional exports. For 1979, the value of CERTEX was estimated to amount to 23 per cent of such exports, involving a loss of 7 per cent of central government revenue. The authorities stated that the level of the CERTEX was generous in view of the adequacy of the exchange rate, but it was considered necessary to stimulate exports by compensating for the high level of domestic taxation. It was thought unlikely that the CERTEX system could be changed in the near future since it was incorporated in the August 1978 law promoting nontraditional exports and was being defended strongly by domestic industry.

The authorities planned to limit the domestic financing requirements of the rest of the public sector to S/. 10 billion for 1979, twice the programmed level for the year, because of greater-than-expected difficulties in controlling the deficits of the State Petroleum Company (PETROPERU) and the main State Trading Company (EPSA). The stand-by limits on domestic bank financing of the public sector as a whole would still be met, however, because of the ample credit margin available at the beginning of the year. With respect to PETROPERU, quarterly domestic price increases for petroleum derivatives in line with changes in world market prices were planned, along with additional expenditure cuts. The projected deficit of EPSA, attributable principally to the low domestic prices of wheat and rice in relation to costs of imports, was to be covered by a combination of further price adjustments and a reduction from 150 days to 90 days of the credit period extended by EPSA on domestic sales of wheat and vegetable oil. Other enterprises and the social security system were projected to be net contributors of funds to the banking system. In the case of public sector mining enterprises, a review would be made to ensure that the gains from higher world metal prices were either used for priority investments or transferred to the Central Government.

In contrast to bank credit to the public sector, bank credit to the private sector since midyear 1978 has expanded somewhat faster than projected. The major source of financing for the faster growth, according to the authorities, was the expansion of liabilities to the private sector at a rate higher than projected, reflecting principally the sharp improvement in the balance of payments. The Central Reserve Bank moved gradually to counteract the unplanned credit expansion by holding rediscounts to commercial banks and the development banks below the programmed levels and by repaying outstanding swaps with local banks. In addition, the Central Reserve Bank initiated sales of Treasury bonds (Bonos de Inversion Publica) from its portfolio as a first step in developing open market operations. In reply to the staff's observation that these bonds are at present not suitable for effective monetary control since the Banco de la Nacion is obliged to redeem, at sight and at face value, any such bonds presented to it, the authorities indicated that while they recognized this weakness they preferred to proceed very cautiously in changing the established practices with respect to sales of securities so as not to disturb operations in the capital market.

In view of the importance attached to the creation of an effective open market the staff recommended that the authorities proceed with the testing of a short-term money market instrument not redeemable on sight but tradable in the market. As an additional measure to curb credit, the staff recommended that

reserve requirements on U.S. dollar denominated certificates of deposit be increased progressively over the course of the year. These requirements, currently at an effective average of 9 per cent, are a small fraction of the reserve requirements imposed on sol deposits.

The authorities commented that a major accomplishment had been the improvement in the allocation of financial resources brought about by raising interest rates from a highly negative level in real terms in June 1978 to a level close to the projected rate of inflation. Time deposit rates had been raised to a range of 35 to 39 per cent a year net of income tax, and the prime lending rate to about 50 per cent. The large spread was the consequence of the high legal reserve requirements, bank commissions, discounting practices, and the 17 per cent tax on interest and commissions charged by banks. The size of the spread had apparently led to significant financial disintermediation which had loosened monetary control. Little could be done to reduce the spread over the short run according to the authorities. They were not planning to raise interest rates any further at this time because they feared this would tend to raise inflationary expectations. Nevertheless, the staff urged that the level of interest rates be reviewed frequently in the light of changes in the inflation rate and in the depreciation of the sol.

2. External policies

The flexibility of the exchange rate has played a key role in the improvement of the balance of payments since the start of the stabilization program. During the second semester of 1978 the exchange rate was depreciated in line with the rate of domestic inflation. Starting in January, however, as an anti-inflationary measure, the rate of depreciation was slowed to roughly one half the rate of domestic inflation or to approximately 2-1/2 per cent per month on average. In addition, in order to curb exaggerated expectations of depreciation for 1979, the authorities beginning in February, initiated a policy of announcing the exchange rate one month in advance, extending the announcement to two months in advance beginning in March. At the same time, they let it be known that by the end of 1979 an exchange rate of S/. 250 would be appropriate, implying a depreciation of 27.6 per cent in terms of soles per U.S. dollar over a twelve-month period.

The authorities commented that the present exchange rate policy was appropriate since the sol had been depreciated much faster than domestic inflation relative to price changes in Peru's major trading partners during the second semester of 1978. They agreed with the staff, however, that the real appreciation of the exchange rate in January-May 1979 left little room for further appreciation, so that in the event that inflation was not reduced in coming months, the rate of depreciation would have to be speeded up in order to maintain Peru's export competitiveness and protect the balance of payments gains achieved. In any case, in view of the uncertainty, the authorities have decided against extending the period of announcing the exchange rate to more than two months.

The sharp turnaround in the balance of payments made possible the elimination during the first quarter of 1979 of all remaining payment arrears and the settlement of all forced overdrafts by foreign correspondents incurred during

the first semester of 1978 at a time of acute scarcity of foreign exchange. Consequently, in April 1979, the local commercial banks suspended the voluntary pooling of a part of their exchange receipts from exports. The pool had been set up in order to facilitate the prompt and orderly repayment of arrears and forced overdrafts. The good balance of payments performance, moreover, prompted the authorities to reduce the basic minimum financing requirement for most imports ahead of the schedule called for in the stand-by program. From 180 days in July 1978, these requirements were cut in several steps to 90 days on April 1, 1979, and the staff was informed that they would be reduced further to 60 days in coming months. The schedule in the stand-by program called for a reduction to 90 days by December 31, 1979. The minimum foreign financing requirements for capital goods imports have also been cut back substantially although the stand-by program had not contemplated any reduction.

The reduction in the minimum financing requirements, coupled with the return to normal conditions applying to the opening of letters of credit, substantially reduced the demand for U.S. dollar denominated certificates of deposits. Such certificates, which may be used to pay for imports without meeting the minimum foreign financing requirements, had been in great demand at the time when local banks either had stopped opening letters of credit--a prerequisite for obtaining foreign financing--or had required importers to purchase the certificates as a guarantee that the importer himself would be able to supply part of the exchange when the letter of credit matured.

The return to normalcy in the financing of imports, together with appropriate interest rate and exchange rate conditions, led to the elimination of the spread between the official exchange rate and the dollar certificate rate as of February 1979. The existence of this spread, which had been as large as 40 per cent in 1978, had given rise to a multiple currency practice. The authorities intended to maintain a policy of noninterference in the market for dollar certificates of deposits. In their view, a re-emergence of the spread between the official rate and the dollar certificate rate at some future time would provide a good indicator of the consistency of policies affecting the external sector.

Even though barriers to free access to foreign exchange were steadily being removed, imports in the second half of 1978 and the first quarter of 1979 remained well below the programed level. A review of the import system revealed that the level of protection of domestic industry was essentially unchanged from a year ago. Private sector imports were permitted, provided that the applicable minimum foreign financing requirements had been met and a specific import license had been obtained from the Ministry of Industry, Commerce, Tourism, and Integration. Such licenses were granted automatically to all registered importers for any articles which were on the so-called Permitted Import List. However, the great majority of domestically produced goods were excluded from this list, thus providing domestic producers with considerable latitude in setting prices.

As a major element in their anti-inflation policy the authorities planned to open up the economy to the competition of imports by eliminating most import prohibitions over a period of 10 to 12 months. As a first step, in March 1979, the National Register of Manufactured Products, which lists most domestically produced goods, was removed as an instrument of import control. Instead, the

items on the National Register were placed on a new prohibited import list valid until December 31, 1980. Should a product on the prohibited list not be available domestically in sufficient quantity or required quality, an import license would be issued with prior approval of the Ministry of Industry, Commerce, Tourism, and Integration. It was the intention of the authorities to remove each month approximately one tenth of the items on the prohibited list and place them on the permitted list with a tariff protection of at most 90 per cent. On May 31, 1979, a first group of 580 products, mainly higher priced consumer goods, was moved to the permitted list.

In reply to the staff's observation that the outlined path of import liberalization was slow in view of the urgent need to break inflationary expectations and curb speculative pricing decisions, the authorities explained that the intended elimination of import prohibitions (excepting a few luxury imports) represented a major reversal of import policy in Peru, and was being opposed strongly by important sectors of the economy. Under these circumstances, it was difficult to push the import liberalization process forward at a faster pace than planned. As an additional major aspect of import policy, the authorities noted the implementation in the near future of a tariff reform aimed at rationalizing the structure of tariff protection, lowering the average level, and limiting the maximum tariff to 90 per cent, in accordance with the agreement reached within the Andean Pact on common external tariff protection.

IV. Staff Appraisal

Since the start of the stabilization program in mid-1978, Peru has achieved a rapid turnaround in the balance of payments, from a deficit of US\$120 million in the first half of 1978 to a surplus of US\$200 million in the second half and to a projected surplus of US\$340 million for 1979. The key elements in this improvement have been the sharp reduction in the public sector deficit--from 10 per cent of GDP in 1977 to 6 per cent in 1978 and an expected 2 per cent in 1979--and the implementation of flexible exchange rate and interest rate management.

As was expected, progress in reducing the rate of inflation and in reactivating the economy has been slower. Inflation, after being halved between the first and second semester of 1978, accelerated during the period January-April 1979, primarily because of developments on the cost side. Sizable adjustments of controlled prices were made and larger-than-projected wage increases were granted in the latter period. In addition, shortages of several agricultural commodities developed and inflationary expectations remained high. With respect to economic activity, real GDP is estimated to have contracted by almost 2 per cent in 1978 and is projected to increase at most by 1 per cent in 1979. Export-oriented activities have been expanding strongly, but construction and manufacturing for domestic consumption continue to be weak.

Now that the balance of payments is no longer a pressing problem, the authorities have correctly shifted the emphasis of policy to lowering the rate of inflation which is considered necessary to achieve a sustained economic recovery and gains in real income. They intend to attain their objective by maintaining strict demand policies and by liberalizing the import system. The staff considers, however, that wage policy will also need to be more restrained than it was in the first quarter of the year if the wage-price spiral is to be dampened.

With respect to demand management, fiscal policy will need to remain austere during the remainder of 1979. This will require a scaling down of the planned central government general wage increases and a major reduction in the projected deficits of the State Petroleum Company and the state marketing agency through expenditure cuts and additional price adjustments for products selling below imported costs, or in the case of petroleum derivatives, below comparable world prices. In addition, the improvement in tax collections, which was a major factor in the satisfactory revenue performance since June 1978, will need to be sustained. The pace of bank credit expansion to the private sector has been somewhat faster than planned and will need to be restrained through a further tightening of rediscounts and a faster reduction of swaps with local banks. If additional measures prove to be necessary, the staff suggests that open market instruments be improved and that reserve requirements on foreign currency denominated certificates of deposit, which are a fraction of requirements on sol deposits, be raised.

A major element in the anti-inflation drive is the reduction in the very high level of protection of local industry. The authorities have outlined a plan to eliminate most import prohibitions over a period of 10 to 12 months, to rationalize the tariff system, and reduce the maximum tariff protection to 90 per cent. The staff welcomes this initiative and encourages the authorities

to proceed with the liberalization at a faster pace and set a lower target for maximum tariff protection in order to speed the dampening of the rate of inflation and improve the efficiency of the allocation of resources over the longer term.

Following its depreciation from S/. 130 to S/. 150 per U.S. dollar in May 1978, the sol was depreciated in frequent small steps in line with domestic inflation until the end of the year. Starting in January 1979, the rate of depreciation was held to one half the rate of domestic inflation in order to hold down the domestic costs of imported goods. Moreover, in February, the exchange rate was announced one month in advance, and beginning in March the announcement was extended to two months. The purpose of this exchange rate policy is to contribute to a slowing of inflation. A difficulty could arise, however, if inflation in coming months is not reduced to a rate closer in line with the announced rate of depreciation. In that event, a speeding up of the rate of depreciation will become necessary in order to maintain Peru's export competitiveness and to protect the balance of payments gains achieved.

The staff commends the authorities for the rapid elimination of payment arrears and the settlement of forced bank overdrafts. The basic minimum financing requirements have been reduced substantially ahead of the programmed schedule, and the staff welcomes the authorities' intention to lower these requirements further during the remainder of 1979. The return to normalcy in the financing of imports together with appropriate interest rate and exchange rate policies, have resulted in the elimination of the spread between the official exchange rate and the dollar certificate rate.

The actions taken by the authorities in the area of exchange rate management have resulted in foreign exchange becoming freely available, subject to meeting the remaining minimum financing requirements for imports, at the official exchange rate for all bona fide current payments and transfers.

V. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision relating to Peru's exchange measures subject to Article VIII, Sections 2 and 3 in the light of the 1979 Article IV consultation with Peru conducted under Decision No. 5392-(77/63) adopted April 29, 1977 (Surveillance Over Exchange Rate Policies).

2. Peru has liquidated its outstanding payments arrears and has eliminated the multiple currency practice resulting from the excessive spread between the official exchange rate and the dollar certificate rate. In addition, Peru has reduced the minimum financing requirements for imports, which involve a restriction on the making of payments and transfers for current international transactions. In the circumstances of Peru, the Fund grants approval of this restriction until December 31, 1980.

Fund Relations with Peru

Status: Article VIII.

Quota: SDR 164 million.

| Fund holdings of Peruvian soles: | As of May 31, 1979. | Millions of SDRs | Per Cent of Quota |
|-------------------------------------|---------------------|---------------------|----------------------|
| Total | | 460.09 | 280.54 |
| Under tranche policies | | (282.59) | (172.31) |
| Under CFF | | (123.00) | (75.00) |
| Under oil facility | | (52.66) | (32.10) |
| Gold distribution | | (1.84) | (1.12) |

| SDR Department: | As of May 31, 1979 | Millions of SDRs | Per Cent of Net Cumulative Allocation |
|-----------------|---------------------------|---------------------|---|
| | Net cumulative allocation | 57.535 | 100.00 |
| | Holdings | (19.634) | (34.1) |
| | Reconstitution obligation | -- | -- |

Exchange rate: May 31, 1979: S/. 221.00 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 one of adjustment according to a set of indicators. Transactions with certificates of deposit denominated in dollars provide a parallel market with a fluctuating exchange rate. As of mid-May this certificate rate was less than 1 per cent 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, 1979 the Fund's holdings of soles have been accounted for at the rate of SDR 0.00363507 per sol, or S/. 275.097866 per SDR.

Gold distribution: Peru has received distributed gold amounting to 78,953.188 fine ounces.

Distribution of profits on gold sales: US\$5.5 million received in the first two distributions of profits.

Last consultation: The 1976 Article VIII consultation discussions were completed in November 1977. A paper of Recent Economic Developments was distributed to the Executive Board in September 1978 to provide background information to Peru's request for a stand-by arrangement (SM/78/232, 8/30/78).

Peru--Basic Data

Area and population

| | |
|--|--------------------------|
| Area | 1,280,000 sq. kilometers |
| Population | 16.8 million |
| Annual rate of population increase (1972-78) | 3 per cent |

GDP per capita (1978)

SDR 501

Origin of GDP (1978)

(per cent)

| | |
|---------------|----|
| Agriculture | 13 |
| Mining | 10 |
| Manufacturing | 25 |
| Construction | 5 |
| Government | 8 |
| Other | 39 |

Ratio to GDP (preliminary 1978)

| | |
|-------------------------------------|------|
| Exports of goods and services | 23.0 |
| Imports of goods and services | 19.8 |
| Central administration revenue | 15.8 |
| Central administration expenditure | 20.8 |
| External public debt (end of year) | 49.8 |
| Savings | 12.1 |
| Investment | 13.9 |
| Money and quasi-money (end of year) | 20.6 |

Annual changes in selected economic indicators

| | 1976 | 1977 (per cent) | Prel. 1978 |
|---|-------|--------------------|---------------|
| Real GDP per capita | 0.1 | -4.1 | -4.5 |
| Real GDP | 3.1 | -1.2 | -1.8 |
| GDP at current prices | 38.4 | 36.8 | 59.0 |
| Domestic expenditures (at current prices) | 33.8 | 34.7 | 47.5 |
| Investment | 25.5 | 15.7 | 47.0 |
| Consumption | 35.6 | 38.6 | 47.5 |
| GDP deflator | 34.4 | 38.5 | 61.0 |
| Cost of living (annual averages) | 33.5 | 38.1 | 57.0 |
| Central administration revenue | 26.7 | 38.3 | 71.2 |
| Central administration expenditure | 35.3 | 46.8 | 49.5 |
| Money and quasi-money | 16.8 | 29.6 | 56.1 |
| Money | 21.0 | 24.7 | 46.3 |
| Quasi-money | 11.4 | 36.3 | 68.0 |
| Net domestic bank assets 1/ | 56.6 | 45.6 | 48.5 |
| Credit to public sector (net) | 28.9 | 20.4 | 18.7 |
| Credit to private sector | 17.4 | 19.1 | 26.9 |
| Merchandise exports, f.o.b. | 5.3 | 26.9 | 12.5 |
| Merchandise imports, f.o.b. | -12.1 | 3.0 | -26.0 |

| <u>Central administration finances</u> | 1976 | 1977 | Prel. 1978 |
|--|---------------------|-------|---------------|
| | (billions of soles) | | |
| Revenue | 111.3 | 154.0 | 263.7 |
| Expenditure | 160.4 | 233.2 | 348.6 |
| Current account surplus or deficit (-) | -11.3 | -39.0 | -27.3 |
| Overall deficit (-) | -49.0 | -79.1 | -84.9 |
| External financing (net) | 14.6 | 34.6 | 23.6 |
| Internal financing (net) | 34.3 | 44.5 | 61.3 |

| <u>Balance of payments</u> | (millions of SDRs) | | |
|---|--------------------|---------|---------|
| Merchandise exports, f.o.b. | 1,177.5 | 1,478.0 | 1,550.0 |
| Merchandise imports, f.o.b. | 1,818.9 | 1,853.5 | 1,278.4 |
| Investment income (net) | -317.4 | -365.2 | -461.4 |
| Other services and transfers (net) | -73.7 | -52.7 | 36.6 |
| Balance on current and transfer accounts | -1,032.5 | -793.4 | -153.2 |
| Long-term official capital (net) | 369.4 | 550.1 | 305.5 |
| Long-term private capital (net) | 169.6 | 59.2 | 31.0 |
| Short-term capital and errors and omissions | -252.5 | -75.1 | -63.8 |
| Overall surplus or deficit (-) | -746.0 | -259.2 | 119.5 |

| <u>International reserve position</u> | April 30 1978 | Dec. 31 1978 | April 30 1979 |
|---------------------------------------|--------------------|-----------------|------------------|
| | (millions of SDRs) | | |
| Monetary authorities (gross) | 233.2 | 360.4 | 362.2 |
| Monetary authorities (net) | -849.6 | -800.8 | -743.2 |
| Rest of banking system (net) | -89.2 | 14.0 | 78.6 |

IMF data (as of May 31, 1979, unless otherwise indicated)

| | |
|---|------------------------------------|
| Article VIII status | |
| Intervention currency and rate | U.S. dollar at S/. 221.00 per US\$ |
| Quota | SDR 164 million |
| Fund holdings of soles under tranche policy | 172 per cent of quota |
| Total Fund holdings of soles | 231 per cent of quota |
| Special Drawing Rights Department | |
| Cumulative SDR allocation | SDP 57.5 million |
| Net acquisition or utilization (-) of SDRs | -SDR 37.9 million |
| Holdings of SDRs | 34.1 per cent of allocation |
| Share of profits from gold sales | US\$5.5 million |

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