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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 82/155

3:00 p.m., December 1, 1982

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	A. B. Diao, Temporary
	C. Taylor
J. de Groote	
	A. Le Lorier
A. Donoso	
R. D. Erb	
	S. R. Abiad, Temporary
	I. R. Panday, Temporary
	T. Yamashita
R. K. Joyce	
	J. R. N. Almeida, Temporary
	G. Grosche
G. Lovato	
R. N. Malhotra	A. S. Jayawardena
	S. El-Khouri, Temporary
	T. de Vries
A. R. G. Prowse	
G. Salehkhou	O. Kabbaj
F. Sangare	E. I. M. Mtei
M. A. Senior	
J. Sigurdsson	
Zhang Z.	Wang E.

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

Also Present:
Asian Department: W. G. L. Evers. Central Banking Department: L. M. Koenig. Exchange and Trade Relations Department: M. Guitian, P. Neuhaus, H. P. Puentes. IMF Institute: G. Oliveros. Legal Department: A. O. Liuksila. Western Hemisphere Department: S. T. Beza, Deputy Director; C. E. Sansón, Deputy Director; J. O. Bonvicini, F. Rubli-Kaiser. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: J. Delgadillo, P. D. Péroz. Assistants to Executive Directors: H. Arias, M. Camara, T. A. Connors, R. J. J. Costa, M. K. Diallo, G. Ercel, I. Fridriksson, G. Gomel, M. Hull, M. J. Kooymans, W. Moerke, V. K. S. Nair, Y. Okubo, G. W. K. Pickering, J. Schuijer.

1. PERU - 1982 ARTICLE IV CONSULTATION, AND REVIEW OF EXTENDED ARRANGEMENT

The Executive Directors continued from the previous meeting (EBM/82/154, 12/1/82) their consideration of a staff report for the 1982 Article IV consultation with Peru and the review of the extended arrangement for Peru (EBS/82/191, 10/19/82). They also had before them a report on recent economic developments in Peru (SM/82/211, 11/10/82).

Mr. de Vries remarked that the proposed decision was acceptable. Developments in the Peruvian economy in recent years had been mixed--favorable for a while, unfavorable for a time, and now favorable again. Recent developments in the public sector deficit were encouraging, but they had not been adequately supported by action in other areas. The authorities had adopted a number of difficult measures, but they had apparently paid insufficient attention to expenditure, and greater flexibility in that area would be most helpful; indeed, without it, the economy would not reach the take-off stage. It was of course true that the measures designed to improve the working of the private sector had been introduced in an unfavorable external environment that was beyond the control of the authorities.

Mr. Senior stated that he broadly agreed with the staff appraisal. The acceleration in economic growth in 1981 had been accompanied by a marked deterioration in the financial situation. Inflation had risen to 73 per cent, and the balance of payments had shifted from a significant overall surplus in 1979 and 1980 to a sizable deficit in 1981. The deterioration had been due in part to the temporary effects of the import liberalization, and in part to the decline in the terms of trade, but the main cause had been a weakening of the public finances, as the overall nonfinancial public sector deficit had increased from the equivalent of less than 2 per cent of GDP in 1979 to approximately 8.5 per cent in 1981.

Realizing that the financial situation was unsustainable, the authorities had adopted a comprehensive set of corrective measures, Mr. Senior remarked. The main objective had been to curtail spending, increase prices and tariffs in certain key areas in order to reduce subsidies, accelerate the rate of depreciation of the sol, and raise interest rates to competitive levels. Those measures, and the authorities' commitment to undertake a broad program of structural reform, supported by the extended arrangement approved in June 1982, aimed basically at improving the growth and employment performance of the economy, reducing inflation, and achieving a viable external position.

As of end-August 1982, Mr. Senior went on, Peru had more than fully complied with all the quantitative performance criteria and had acted consistently with the understandings concerning the exchange and trade system. Nevertheless, the objectives set out in the program supported by the extended arrangement had not been completely achieved, and there was some danger that serious departures might be evident as early as the end of 1982. Real GDP growth was expected to decline from almost 4 per cent in 1981 to slightly less than 3 per cent in 1982, and although inflation was expected to fall, it would remain at an annual rate of more than 60 per cent. In addition, the attainment of the desired reduction in the external current account deficit in 1982 was likely to require additional measures.

The failure to achieve some of the targets was traceable to a combination of external factors and internal slippages, Mr. Senior considered: the terms of trade had continued to deteriorate sharply; the world recession and high international interest rates had adversely affected Peru's economy; and certain prices in the public sector had not been adjusted sufficiently. However, it was not clear to him whether the adverse external conditions had not already been evident at the time when the extended arrangement had been negotiated. Moreover, the internal slippages had not been large enough to hinder significantly the attainment of the program objectives. Even more important, further restraint might have had a particularly adverse affect on growth without causing a marked improvement in inflation. It would be useful to have the staff comment on the compatibility of the performance criteria under the extended arrangement with the program objectives. The present case of Peru was a good example of the possibility that program objectives might not be completely achieved through no fault or lack of determination on the part of the authorities; a member country could conceivably achieve program objectives without fulfilling all the performance criteria.

The authorities' medium-term development strategy apparently was based on an increase in efficiency through a strengthening of market mechanisms, Mr. Senior remarked. In that connection, trade barriers had been sharply reduced, interest rates had been raised, subsidies on basic commodities and on officially controlled prices had been reduced, and other measures have been adopted to facilitate private investment in important sectors of the economy. In addition, the level and extent of protection had been significantly reduced, although the staff felt that the recently introduced preferential financing arrangements for nontraditional exports were inconsistent with the objectives of improving economic efficiency and of eliminating the distortions in the economy. The staff had noted that the reduction in certain benefits to exporters of nontraditional products in 1981 had been followed by a sharp decline in those exports, thus indicating the importance of the incentives for export growth. As he had stated on previous occasions, the Fund should be careful in assessing the adequacy of trade barriers and incentives in developing countries--compared with those in developed countries--and in making recommendations concerning the elimination of the barriers. While developing countries tended to promote infant industries in nontraditional export areas, industrial countries tended to protect senescent industries. In any event, financial incentives had been, and still were, widely used in industrial countries as an instrument for promoting export growth, and the Peruvian authorities had correctly taken a cautious approach to eliminating them in Peru. Trade barriers in importing countries created an obstacle to export growth, weakened commodity prices, and discouraged private investment in developing countries.

He agreed with the staff that inflation remained the most stubborn problem facing the Peruvian authorities, Mr. Senior commented. Only a determined effort involving different methods and policies could achieve substantial improvement in inflation. However, the widespread de facto indexation in the economy combined with the process of price liberalization and the policy of accelerated currency depreciation would obviously increase the difficulty in combating inflation; progress in that area could be achieved only gradually.

Mr. Taylor said that he, like the previous speakers, was pleased that thus far Peru had met all the performance criteria under the extended arrangement and that certain areas of the economy had performed well. Real economic growth in 1982 had reached almost 3 per cent, and the current account and public sector deficits had been reduced. However, the objectives that had been set six months previously had proved to be beyond immediate reach, and it was clear that a stronger adjustment effort would be needed if they were not to be lost sight of.

At the time of the adoption of the extended arrangement in June 1982, Mr. Taylor recalled, some Executive Directors had asked why the staff had recommended an extended arrangement rather than a series of stand-by arrangements. It had been his feeling that a radical shift in policy was not about to take place; rather, the policy stance existing at the time was to be strengthened. It had appeared that the restoration of external equilibrium would hinge mainly on demand stabilization rather than on a more comprehensive set of supply-side policies. Subsequent developments had reinforced his view. Indeed, the difficulty of the economic situation in Peru seemed to have increased. The most worrying aspects were the reacceleration of the rate of inflation and the slippage in the public sector accounts. He agreed with the staff that it might be impossible to achieve the program objectives without further determined corrective action, as the reacceleration in the rate of inflation suggested that demand management policies might still be excessively accommodative. The reacceleration was admittedly due in part to the depreciation in the exchange rate of the sol, but, on the whole, excess demand had probably been a more basic and pervasive contributing factor.

The authorities recognized that the overall public sector deficit in 1982 would probably be well above the target, Mr. Taylor commented. It was too late to act to meet the target for 1982, but early action would certainly be needed if the targeted reduction in the deficit for 1983 was to be met. In retrospect, much of the improvement in 1982 was apparently attributable to tight controls that had worked in the short run but that seemed to have weakened in the middle of the year. The Government had acted courageously in August 1982 to rein in central government expenditure, but central government finances were nevertheless expected to slip from an equilibrium level in the first half of 1982 to a deficit of approximately 2.5 per cent of GDP in the second half. An important factor in the fiscal slippage was the lag in eliminating the wheat and rice subsidies, and the recently adopted measures to ensure the elimination of the subsidies before the end of 1982 were welcome. The increases in oil product prices and the lifting of controls on bread prices were also commendable, and he hoped that they would have a substantial positive effect on the public sector deficit in 1983.

Although there were important structural problems facing the economy, Mr. Taylor said, he agreed with the previous speakers that top priority had to be given to combating inflation. The main challenge in devising a program for Peru was to know how best to deal more effectively with that central problem. Elimination of indexation would be a desirable step forward and should perhaps be an explicit feature of the program for 1983, but the main emphasis should be on further efforts in the fiscal field. Such action should help to improve the external accounts, but exchange rate action might also be useful, and he wondered whether the staff felt that there would be any merit in a one-step devaluation of the sol as a supplement to the sensible policy of gradual depreciation that had been maintained in the recent past.

Peru's external debt was worrying, Mr. Taylor commented, because of the apparent increase in the first half of 1982 of the use of short-term credit facilities. The switch to heavy use of short-term lines of credit was a dangerous development, however great the need to bolster reserves. Indeed, he wondered whether the ceilings on medium-term and longer-term official borrowing, together with the limits on net domestic debt of the public sector, might not have been instrumental in encouraging the recourse to short-term debt. If that was true, it would obviously be a most undesirable, and of course unintended, by-product.

It was unfortunate, Mr. Taylor said, that the key structural adjustments mentioned by Mr. Donoso in his opening statement had in some respects been reversed in recent months. Progress on tariff reduction had been offset by the substantial tariff surcharge; although a welcome addition to revenues, it was incompatible with the longer-term structural aims of the program. Mr. Donoso's assurance that the tariff surcharge was a temporary expedient was welcome. He hoped that the reversal in the reduction of export subsidies would also prove to be temporary.

Greater involvement of the World Bank in the present review of supply-side policy in Peru would have been useful, Mr. Taylor considered. A clearer delineation of the adjustment path over the remaining years of the arrangement with Peru would also be useful. Like previous speakers, he was greatly interested in the medium-term aspects of three-year programs. The staff could usefully provide indications not only of the prospective policy measures, as Miss Le Lorier had requested, but also of the staff's view on the likely achievement of objectives in the remaining years of a longer-term program, so that Executive Directors could have a clearer idea of the effort that the authorities still had to make in order to achieve a sustainable position in due course.

Some of the longer-term measures that the authorities were implementing should help to combat inflation, Mr. Taylor commented. The gradual elimination of distortions in the economy would certainly be helpful.

The reduction in subsidies had an immediate adverse effect on inflation, but, in the longer run, it would create better conditions for a less inflationary environment. Inflationary expectations were deeply ingrained in the Peruvian economy, and breaking expectations would make a major contribution to the counterinflation effort. In the circumstances, a natural policy alternative was firmer and sharper wage restraint, although to be fully successful it would have to be accompanied by strong fiscal and monetary policies.

In sum, Mr. Taylor said, some good steps had been taken and some progress had been made, but the program seemed to be beginning to run out of steam. It was vitally important to restore the momentum of the program and, to that end, emphasis should be placed on strengthening the fiscal effort.

Miss Le Lorier remarked that the full observance thus far of the performance criteria under the extended arrangement was ground for feeling that the outlook for the economy was basically favorable. Preliminary information indicated that the performance criteria for end-June 1983 might well be as fully observed as the performance criteria for the previous test period. However, it was still too early to know whether all the original expectations concerning the extended arrangement would be met. Recent experience suggested that the observance of performance criteria was not always a sufficient condition for successful adjustment as measured by the meeting of broader objectives of restoring and maintaining sustained noninflationary growth and external balance. Conversely, nonobservance of performance criteria was not necessarily a signal that little or no adjustment was taking place, as established by the papers prepared on the occasion of the latest review of recent extended and upper credit tranche arrangements (EBS/82/91, and EBS/82/98 and Supplement 1). Developments in the coming several months would have to be assessed before the Fund would be in a good position to judge the contribution of the adjustment effort. Ideally, the adoption of the targets for the second year of the program should provide an opportunity to make such an assessment.

She attached particular importance to the developments related to the nonquantitative, or structural, components of the program, Miss Le Lorier went on. She did not agree with Mr. Taylor that the program was characterized essentially by tight demand management. As in all extended arrangements, structural adjustment was an important element. The structural aspects of Peru's program were aimed at enlarging the scope for market mechanisms to increase economic efficiency. Peru's experience with structural adjustment had begun as early as 1980, and the staff had concluded in its present report that trade barriers had been reduced sharply, interest rates had been raised to positive real levels, financial intermediation had become more efficient, subsidies on the consumption of basic commodities and the scope of officially controlled prices had been reduced, and impediments to private investment in the agricultural, mining, and petroleum sectors had been removed.

The main question, Miss Le Lorier considered, was whether the present policies were consistent with the attainment of the medium-term targets under the program. Some further strengthening of the adjustment process might well be needed in response not only to developments beyond the control of the authorities, but also to developments within their control, particularly the management of public revenue and expenditure. The estimates for 1982 indicated that the objective of reducing the overall public sector deficit from the equivalent of 8.6 per cent of GDP in 1981 to 4.2 per cent in 1982 might not be reached; indeed, the target could be exceeded by more than one percentage point, mainly because of the unexpectedly large subsidy payments, the difficulties in reducing investment and other expenditures by various agencies, and the disappointing revenue performance. The planned increase in government revenue from 18 per cent of GDP in 1981 to 18.5 per cent in 1982 probably could not be achieved.

The weak financial position of the public sector was fully reflected in the financing need for 1982 as a whole, which could exceed the initial target by more than the equivalent of 1.5 per cent of GDP, Miss Le Lorier continued. Apparently all the additional financing needs would be met by domestic resources, but the report made no mention of their origin. If the bulk was provided by the banking sector, there might well be a breach of the limit on domestic assets of the monetary authorities; and the limit on net domestic indebtedness of the public sector in the second half of 1982 might also be affected.

The performance of the external accounts had been unexpectedly weak, Miss Le Lorier remarked. The objective under the 1982 program of stabilizing imports in nominal terms was obviously ambitious, particularly in view of the historic rates of increase, but the main cause of the deterioration of the current account seemed to have been the decline in exports in absolute terms. The external accounts were not yet a cause for concern, but the moderate departure thus far from the initial assumptions could, if continued in the coming months, have some effect on the authorities' ability to limit their recourse to international credit in order to achieve a net decline in the debt service burden. That possibility underscored the need for a further strengthening of the public finances, and the measures recently adopted to achieve that goal were certainly welcome. Were the measures likely to offset fully the effects of the unexpectedly small revenues and large expenditures?

Breaking the direct relationship between price increases and subsequent wage adjustments was a crucial part of the stabilization process, Miss Le Lorier considered. It was probably asking too much of fiscal policy to have it carry almost all of the burden of the counterinflation effort. Reforming the present system of indexation with a view to achieving an adequate reduction in the present excessive level of inflation should be given high priority.

The recent evolution of the balance of payments, including the efforts to liberalize imports, underscored the importance of maintaining a competitive exchange rate for the sol, Miss Le Lorier said. On the whole, the policy of depreciating the sol in small steps against the U.S. dollar--the currency of Peru's main trading partner--seemed to have been appropriate. However, she was unclear about the staff's judgment of the present exchange rate and the adequacy of the present policy. In its appraisal, the staff had concluded that the pace of depreciation should at least be in line with domestic inflation. On pages 14 and 15, the staff had noted that the concessional financing to nontraditional exporters had been considerably increased, although only temporarily, and had stressed that the trend was inconsistent with the general objective of improving the efficiency of the economy. The staff had also mentioned that the present exchange rate policy was designed merely to regain part of the competitiveness that had been lost by the movement of the sol in the previous several years. Did the statement in the staff appraisal that she had mentioned accurately reflect the staff's view on Peru's exchange policy?

Mr. Prowse stated that he agreed with the thrust of the staff's appraisal and accepted the proposed decision. All the performance criteria through end-August 1982, and apparently through end-September, had been observed, and he wondered why the authorities had delayed making a purchase to which they were entitled.

The slippages on the fiscal side were disappointing, Mr. Prowse remarked. They had occurred in part because of factors beyond the control of the authorities and in part because of their poor performance in certain areas. The fact that tax revenues had been unexpectedly small was not clearly the fault of the authorities, but they had clearly delayed the elimination of the subsidies on rice and wheat. The current plan to eliminate the subsidies before the end of 1982 and the likely positive effect on the budget and on recourse allocation were certainly welcome. Unless the subsidies were eliminated and the public enterprises in the mining sector improved their performance, the whole fiscal program might be thrown off track. In addition to the decision to eliminate the subsidies by the end of the year, the authorities had adopted other corrective measures, and the staff apparently felt that they would be able to maintain the thrust of fiscal policy in the coming period. In fact, however, additional adjustment on the fiscal side might well be required.

The authorities were to be commended on their exchange rate policy, Mr. Prowse considered. He agreed with the staff that a strong case could not be made for a major discrete adjustment of the exchange rate at the present stage.

Would exports be adversely affected by the authorities' intention to halt further credit expansion by the development banks and for the export and mining sectors? Mr. Prowse asked. He agreed with the staff and previous speakers that emphasis should be placed on combating inflation, but a further tightening of fiscal policy should not be seen as an alternative to direct action in the area of wages and salaries. In that connection, the staff's comments seemed to be inconsistent. On page 15 of EBS/82/191, the staff had stated that "thought is being given by the authorities to the possibility of achieving a major reduction of inflation by abandoning the system of granting public sector employees and nonunionized private sector workers quarterly wage increases more or less equivalent to the past or present rates of inflation." The words "thought is being given" were particularly striking when compared with the statement on page 20 that "the staff welcomes the intention of the authorities to abandon in 1983 the system of granting quarterly wage adjustments to public sector employees and nonunionized private sector workers." He hoped that the second, stronger, statement was the more accurate of the two conclusions, since it would be best for the authorities to abandon the system of indexation. Unless the system was eliminated, no amount of tightening of fiscal policy would achieve the desired outcome. Of course, eliminating such a system was in practice difficult to do, and, for social and other reasons, it might be best to phase out the system gradually rather than to abandon it in one move.

He agreed with Miss Le Lorier, Mr. Prowse said, that a member country could conceivably observe all the performance criteria under a Fund-supported program and fail to achieve the program objectives; and program objectives could be achieved without a member country's observing all the performance criteria. No one would probably argue that observing two or three quantitative performance criteria would in itself ensure the achievement of a program's objectives.

Mr. Joyce remarked that it had been particularly helpful to hold the Article IV consultation with Peru at about the same time as the review of the extended arrangement. He continued to feel that the program introduced at the time of the approval of the extended arrangement provided a sound basis for making the required structural adjustment. Unfortunately, achievement of the medium-term program objectives had been placed in jeopardy, largely by the failure of the authorities to bring inflationary forces under better control. The authorities had met all the performance criteria to date, but if Peru was to benefit from the structural reforms already introduced, steps reinforcing present policies would have to be taken. It was true that the difficulties facing the economy were attributable in large part to external factors--particularly low world prices for Peru's main exports--but it was particularly worrying that major slippages should have occurred in the early stages of the implementation of the program.

In the agricultural sector, Mr. Joyce commented, the authorities had increased both producer prices and the availability of credit. In the mining sector, the ongoing revitalization effort had clearly been helped by the progressive reduction in the ad valorem tax on mining exports and by the establishment of mechanisms for the participation of private capital in large-scale mining projects, which had previously been reserved exclusively for the state mining authorities. The recently adopted increases in the prices of oil derivatives were also welcome.

However, Mr. Joyce went on, developments in certain other areas were a cause for concern. In the trade area, the progress made in reducing tariffs had been partially reversed in early 1982 with the introduction of an across-the-board tariff of 15 per cent. The staff had mentioned that the tariff was a temporary revenue-raising measure that the authorities intended to eliminate by the end of 1982, but it was not clear to him from Mr. Donoso's opening remarks whether that was still the intention of the authorities. Moreover, the authorities' decision to increase the subsidy--in form of the preferential financing arrangements--for nontraditional exports was worrying. The subsidy had apparently helped nontraditional exports, which had increased from 22 per cent of total exports in 1981 to 25 per cent in the first half of 1982, but it seemed unwise to encourage export activities that would be dependent on subsidies.

The outturn on the fiscal side was obviously crucial for the success of the program, Mr. Joyce commented. The authorities were to be commended for the major tightening of current spending that had recently been undertaken to bring the overall surplus of the Central Government up to the June 1982 target level. He hoped that the proposed cut in government purchases together with the downward adjustment in the scheduled October 1982 wage increase for government employees would offset the projected shortfall in revenues and help sustain the targeted current account surplus for 1982.

It was unfortunate, Mr. Joyce went on, that important slippages had occurred in the implementation of fiscal policy. For instance, the operating surplus for the public sector outside the Central Government was below target, in large part because of delays in eliminating wheat and rice subsidies. The subsidies were admittedly a sensitive issue; there was general resistance by consumers to swift price increases. Still, the authorities should be urged to show determination in removing the subsidies. Another slippage had to do with the lack of effective control by the authorities over the activities of the parastatal enterprises. The large salary increases given by ELECTROPERU had far exceeded the official guidelines, had contributed to the failure of the enterprise to increase its savings, and was precisely the kind of action that government-owned companies should avoid. The staff had noted that in the first part of 1982 there had been poor control over the pace of execution of spending on some large-scale investment projects, which had previously been projected to be scaled down. The authorities had stated their intention to reverse the slippage by implementing additional cuts in the final four months of 1982, and he hoped that the cuts would indeed be made.

The recent progress in increasing savings through higher interest rates, and the restructuring of reserve requirements aimed at reducing the cost of intermediation, were welcome, Mr. Joyce said. However, as the staff had noted, the progress in reducing Central Bank intervention and credit operations--especially the concessional financing extended by the agricultural bank for nontraditional exports--had been slow, and the authorities should make every effort to deal with those problems in the coming period.

The incomes policy was of crucial importance, Mr. Joyce considered. As previous speakers had stressed, the level and pervasiveness of wage indexation must be limited. It was unclear to him whether or not the present incomes policy was to grant quarterly wage increases to public sector employees and nonunionized private sector workers basically in line with the rate of inflation. After all, the wage increases for public sector employees had been significantly less than the rate of inflation. In the private sector, however, wage indexation had probably become so pervasive and deeply ingrained that the voluntary wage and price guidelines might well prove to be insufficient. It would be useful to know whether the initial measures adopted by the new Tripartite Commission had been successful.

There seemed to be no clear strategy yet for reducing the high rate of inflation, Mr. Joyce remarked, and it was not reassuring to learn from the staff that the authorities were merely studying the merits of different strategies. He had assumed that the authorities had made more progress in fighting inflation than they actually seemed to have done so far.

Maintaining a flexible exchange rate policy would certainly be important, Mr. Joyce said. Even more important, the authorities would have to make every effort to reduce the high debt service ratio. They had stated their intention of increasing their reliance on long-term concessional loans, and they had explained that the contracting of loans for more than one year was expected to reach a peak in 1982/83 as investments in the energy and mining sectors were reduced. Nevertheless, he wondered whether the performance criterion on public sector debt was sufficiently tight; after all, the debt service ratio had been 44 per cent in 1981 and was estimated to have fallen only to 39 per cent in 1982. Finally, the proposed decision was acceptable.

Mr. Erb stated that he too could accept the proposed decision. The efforts that the Government had made to continue the structural adjustment and introduce other important policies in the face of adverse external developments were certainly welcome, but there had been slippages in some important areas. Previous speakers had noted the difficulties in fiscal policy. As for monetary policy, it was not fully clear to him how the interest rate system in Peru behaved. Some rates seemed to have been freed while others continued to remain under the control of the authorities. On page 14 it was mentioned that "to the extent necessary, the authorities planned to adjust interest rates in the future to reflect domestic inflation and developments in world capital markets." Which interest rates were under government control, and what criteria were used in adjusting interest rate levels?

Like Mr. Joyce, he was concerned about the recent increase in the degree of intervention in the financial intermediation process, Mr. Erb continued. The authorities could deal with the inflation not only by focusing directly on the system on indexation, but also by making a larger shift in monetary policy. In its appraisal the staff had mentioned that one such alternative--namely, quickly eliminating subsidies, scaling down sharply public spending, and breaking the close link between price and wage increases--might be the most appropriate if inflationary expectations were to be visibly dampened. That conclusion was worrying, because it contained no reference to monetary policy. It was true that the rate of increase in wages and prices could be reduced by limiting the indexing system, but that move would have to be accompanied by a dramatic reduction in the rate of growth of the money supply. Action on the fiscal front--and particularly steps to limit wage and price increases--would, together with an appropriate monetary policy, offer the greatest possibility of reducing the rate of inflation. It was very disappointing that the authorities were still thinking about ways of dealing with the problem of inflation even though the three-year program was well under way.

Mr. de Groote remarked that the staff report and Mr. Donoso's opening statement brought to mind several important Fund policy issues, the first having to do with the implementation of quantitative performance criteria in a country whose economic situation had been continuously deteriorating. The second paragraph on page 9 of the staff report contained a misleading statement: "In the first six months of 1982 adjustment policies were successfully implemented." Although the quantitative performance criteria had been observed, adjustment policies had not in fact been successfully implemented. The staff's conclusion was not fully consistent with the trend of the Executive Board's present thinking on the observance of performance criteria.

The failure to achieve the program objectives did not mean that the program was ineffective or ill conceived and should therefore be supplemented by other measures, Mr. de Groote went on. The demand management measures had in themselves not been inherently ineffective; they had become ineffective because they were, in the context of the Peruvian economy, insufficient. They would have to be supplemented by additional measures in the coming period. The Fund-supported program constituted only one portion of the total set of required policies. No one argued that the group of policies under a Fund-supported program would by itself achieve all the necessary adjustment. The only criticism that might be made of the Fund's approach to the Peruvian program was that the institution had not sufficiently stressed the need for an incomes policy, the elimination of subsidies, and other structural measures. If the present economic situation in Peru persisted, the Fund would inevitably have to consider whether the program could be maintained if it was being implemented technically but was evolving under generally unsatisfactory conditions, the adverse effects of which could be partially alleviated by further government action. He agreed with Miss Le Lorier that the observance of performance criteria did not in itself mean that the objectives of a Fund-supported program were being achieved. In addition, if performance criteria had not been observed, some program objectives might not have been achieved, even though the general economic picture of a country was improving. The authorities had to do more than observe a certain number of quantitative performance criteria, and the purpose of a review by the Executive Directors of a country's performance under an arrangement with the Fund was to enable the Directors to express their opinion on the additional measures that were needed besides those that a country was obliged to introduce in the particular policy areas covered by the Fund-supported program. He did not agree with Miss Le Lorier's second proposition; if a Fund-supported program was implemented but the performance criteria were not observed, some of the country's objectives undoubtedly would not be achieved. To assume otherwise would be tantamount to admitting that the conditions set out in the Fund-supported program were inappropriate or irrelevant, and there was no evidence to that effect in the present case.

The staff's discussion on demand management was somewhat hazy, Mr. de Groote commented, and understandably so, perhaps. In the final paragraph on page 19 it was noted that "Peru's inflation currently oscillates around 60 per cent per annum and--given the widespread de facto indexation in the economy--it would only yield gradually to more restrained demand management policy." It was difficult to reconcile that statement with the staff's conclusion in the same paragraph that a substantial reduction in inflation could be achieved as early as 1983 by a major tightening of fiscal and monetary policy. It would be impossible to achieve the structural adjustment that was the objective of the extended arrangement unless inflation was first brought under control. However, inflation probably could not be reduced while full indexation continued to be applied under conditions of growing internal demand. In the circumstances, exchange rate adjustment, the other main policy tool available to the authorities, was robbed of its potential usefulness because the import price effects of each adjustment were offset by the domestic income and price adjustments. Therefore, it was important to stress that the demand management policies under the program must be supplemented by policies aimed at eliminating subsidies, breaking the link between price and wage increases and at introducing structural improvements in the tax system. At the same time, the demand management policies themselves should be strengthened.

The indexation system was a de facto one, Mr. de Groote noted. Why was it not possible to eliminate indexation in the private sector?

The staff report seemed to contain a number of inconsistent statements on the appropriateness of Peru's exchange rate, Mr. de Groote continued. On the bottom of page 7 it was stated that the sol had appreciated slightly in real terms vis-à-vis the currencies of Peru's major trading partners, but on page 19 the staff had stated that it concurred with the authorities' intention to continue the policy of depreciating the exchange rate at least in line with the rate of domestic inflation, and it had noted that the sol had depreciated in real terms by nearly 10.5 per cent against the U.S. dollar in the 12 months ending April 1982. Finally, the proposed decision was acceptable.

Mr. El-Khouri remarked that during the previous two years the Peruvian economy had suffered from growing domestic imbalances that had exerted pressure on the balance of payments. In 1982, the authorities had moved courageously to reduce the imbalances by adopting an extended arrangement. At the time of the Board discussion of that arrangement, he had welcomed the authorities' determination to make adjustments in difficult circumstances, and the progress that the authorities had subsequently achieved was welcome. Nevertheless, the imbalances in the economy were still large, and the authorities should be encouraged to persevere in their adjustment efforts.

The authorities had taken steps to ensure that the deficit of the Central Government would be kept within the limit under the program, Mr. El-Khouri continued. The problem with the financial position of the public sector had been in the public enterprises, where the outcome for the operating surplus was likely to be well below the program target. It was clear that additional measures would be needed if the program was to remain on track.

The staff had been encouraging the authorities to adopt a particular strategy for dampening inflationary expectations, Mr. El-Khouri noted. On page 20 the staff had stated that

> the authorities are studying the merits of different strategies to tackle this problem. One such alternative, that of quickly eliminating subsidies together with scaling down sharply public spending and breaking the close link between price and wage increases, may be the most appropriate if inflationary expectations are to be visibly dampened. The staff would encourage the authorities to pursue the strategy, which may, if applied vigorously and quickly, permit Peru to benefit from the structural reforms recently undertaken to spur sustained growth and a higher level of employment.

That statement was rather strong. The authorities were being asked simultaneously to eliminate subsidies quickly, reduce public spending sharply, and break the link between wage and price increases. The implementation of such a strategy entailed obvious risks, and the staff could usefully comment further on the reasons why it felt that the strategy was warranted.

When the outlook for an economy was particularly uncertain, Mr. El-Khouri remarked, the staff usually negotiated with the authorities performance criteria for a period of six months, rather than a whole year. He wondered why the six-month period was not used more often, particularly as review missions usually visited a country midway through a program year and could conveniently set the performance criteria for the coming six months. In Peru, for instance, the review mission could have set the performance criteria for the six months through end-February 1983; such criteria would probably have been more in tune with the rapidly changing circumstances than the proposed criteria.

The authorities were to be commended for the various corrective measures that they had introduced and should be encouraged to continue their adjustment effort, Mr. El-Khouri said. The proposed decision was acceptable.

The Deputy Director of the Western Hemisphere Department said that the staff felt that there had been a large measure of adjustment in Peru in 1982. In relation to GDP the fiscal deficit had fallen from 8.5 per cent in 1981 to 5.5-6 per cent in 1982, a substantial adjustment indeed, when seen in the light of the unfavorable developments in Peru, notably the sharp fall in real domestic incomes because of the adverse terms of trade developments. The balance of payments had undergone a sizable adjustment as well. Although exports in 1982 were estimated to be approximately $400 million less than had been assumed in the program, imports had also fallen short of projections, and the current account deficit was still expected to decline from 8 per cent of GDP in 1981 to 7 per cent in 1982. The overall balance of payments was expected to be in surplus in 1982, compared with the programmed deficit of $100 million and one of $600 million in 1981.

There was no mismatch between the performance criteria and the objectives of the program for Peru, the Deputy Director said. To be sure, the adverse effects of the much larger than expected deterioration in the terms of trade had been compounded by slippages in policy implementation, principally in fiscal policy. To keep the balance of payments performance on track in those circumstances had required a more rapid depreciation of the exchange rate and a consequent faster domestic adjustment of public sector prices than had been foreseen, with adverse effects on inflation. Thus, through November 1982, the real depreciation of the sol against the U.S. dollar had been on the order of 13 per cent, and the depreciation vis-à-vis the currencies of other trading partners had been about 4 per cent. Probably the effective depreciation of the sol (against the currencies of all trading partners) which, as some Directors had noted, represented a more adequate measure of competitiveness than the relationship of the sol against the U.S. dollar alone, had been between those two figures. The authorities had thus relied heavily on the exchange rate to achieve the required adjustment in the external accounts.

The staff did not believe that there was room for an appreciation of the exchange rate, the Deputy Director remarked; nor did it feel that a one-step adjustment of the exchange rate was warranted. The appropriate exchange rate level was of course difficult to determine, but indications were that the exchange rate was again becoming competitive, and there was still something to be gained from vigorously pursuing the present exchange rate policy. The staff naturally hesitated to suggest halting a policy that had been successfully applied in favor of a policy that might increase the difficulties facing the authorities. Given the problem that the authorities had had thus far in effectively dealing with inflation, a one-step depreciation might well cause a new inflationary spiral.

The adjustment in the balance of payments, the Deputy Director commented, had brought in its wake a higher rate of inflation than had been expected. Many factors had played a role in that development, including the heavy indexation of wages and prices, particularly in the private sector. Wage and price developments were very sensitive to one another. The Government had attempted to contain public sector wage increases, but the Commission on Prices and Wages had not succeeded in coming up with workable guidelines. The guideline that would make the most sense in terms of controlling inflation would be one that took into account not only past inflation but also future inflation. The control of inflation would probably require a decline in real wages or a major decline in output. The authorities understandably wished to weigh carefully the cost of either of those two options. They realized, however, that inflation control had become of permanent importance given the harmful effects on the productive process of the present rate of inflation. Until now, the staff had been counting on an adjustment in relative prices to limit the adverse effects of inflation on resource allocation; it was obviously difficult for the economy to function properly with the present high rate of inflation, and the authorities' efforts to adjust prices, interest rates and the exchange rate were meant to offset those effects.

The discussion had suggested to him, the Deputy Director said, that the staff had perhaps given an excessively negative impression of the failure to adjust prices in Peru. It was true that prices had not been fully adjusted, but the lack of adjustment was not particularly large; for instance, the failure to eliminate wheat and rice subsidies and to adjust gasoline prices sufficiently had been of the order of 0.75-1 per cent of GDP. The effect of the terms of trade deterioration on the public sector had probably been in excess of 2 per cent of GDP.

In sum, the Deputy Director of the Western Hemisphere Department said, the staff favored a comprehensive approach to inflation control, one that would require the simultaneous use of a number of instruments. Eliminating subsidies, breaking wage indexation, and maintaining tight fiscal and monetary policies were key ingredients of such an approach. The effort on the demand side would have to hinge on restraining spending, sharply reducing the fiscal deficit, and permitting interest rates to play their proper role. Unless the fiscal deficit could be reduced quickly and sufficiently, interest rates might have to bear an undue burden of the effort to control inflation. The authorities viewed that strategy as the only workable one: it would ensure that any adverse effects of inflation control on real income and output would be of short duration and that confidence would be quickly restored.

The staff representative from the Exchange and Trade Relations Department recalled that Mr. Taylor had raised the difficult question whether the exclusion of short-term borrowing from the ceiling on medium-term and longer-term foreign debt had induced member countries to engage in such borrowing so as to remain under the ceiling. While such reactions to the debt ceiling had undoubtedly taken place on occasion, they did not represent a typical pattern. When the subject of external debt management had been discussed by the Executive Board in 1979, the staff had stressed that short-term borrowing usually took the form of trade credits and normally was not included in debt ceilings. On the other hand, some programs supported by the Fund had included short-term debt in the ceiling because it was considered that the debt represented a problem for the member countries concerned.

The consensus reached in 1979 had been to continue with the pragmatic approach of excluding short-term debts from the debt ceilings unless a particular problem with that kind of debt had arisen, the staff representative continued. It had to be acknowledged, however, that, in the recent past, difficulties had arisen with the implementation of that approach. In principle, the staff had been reluctant to see short-term borrowing included in the debt ceiling because it was much more difficult to monitor than medium-term and long-term borrowing. For purposes of debt management, the change in the stock of short-term debt was more relevant than the gross flows associated with that stock, so that extending the ceiling to cover short-term borrowing would require availability of stock, rather than flow, data. In addition, information on short-term debt was typically less readily available on a timely basis than information on medium-term and long-term debt. Another factor was that the staff did not wish to see debt ceilings interfere with the normal flows of trade-related financing. The staff was more concerned about general purpose short-term financing, such as bank loans with maturities of less than one year, which could create external debt service problems. But financial resources were fungible, and, in practice, it was difficult to distinguish one form of credit or financial flow from another. In Peru, the recent inclusion in the debt control machinery of authority to register and control short-term borrowing should enable the staff to consider the advantages of including short-term borrowing under the program's debt ceiling.

He agreed with Miss Le Lorier, the staff representative commented, that it was conceivable that a member country could observe all the performance criteria contained in a program without attaining all the objectives. It was also conceivable--but much less likely--that a country could achieve program objectives without observing the performance criteria. As Mr. de Groote had stressed, a program supported by the Fund was only one element--albeit an important one--of a country's total policy package. In any case, an issue of timing was involved, because it was possible that a program could be based on the assumption that observance of the performance criteria in one period only provided the basis for the objectives to be met at some time thereafter. However that might be, it was likely that a country's economic situation would be more favorable if it observed the performance criteria than if it did not. It seemed safe to conclude that observance of performance criteria was a necessary condition for the attainment of program objectives; by assuring that at least the necessary condition for the attainment of program objectives would be met, observance would ensure the credibility of the program.

Commenting on the relationship between performance criteria and review clauses, the staff representative said that the existence of major uncertainties regarding prospects for a member country's economy could make it hazardous to formulate performance criteria for, say, a 12-month period ahead. In those circumstances, the present guidelines on conditionality allowed for the formulation of a review clause to supplement performance criteria set for a relatively short period. However, the recent trend in the Executive Board had been to steer away from the performance criteria formulated to cover periods of under one year. Indeed, even programs covering just one year were to be presented in a medium-term perspective, which, although not involving performance criteria for an extended period, did require some quantification of economic objectives beyond the life of the program.

The staff preferred to set performance criteria for 12 months rather than 6 months for two main reasons, the staff representative explained. First, member countries always expressed a wish to know in advance the terms under which drawings could be made without Executive Board scrutiny or review. The staff attached considerable importance to being able to formulate a quantitative assessment of macroeconomic prospects for a period of at least one year, if only to influence the broad path along which the economy would move. By limiting the scope of performance criteria to only 6 months, the staff would in effect be giving up the possibility of influencing developments in the subsequent 6 months. A second reason for preferring 12-month performance criteria was that the number of negotiations with member countries would double if the period for which performance criteria were set were routinely cut in half. Besides the obvious staff constraints that such a course of action would entail, many countries already found negotiations on performance criteria excessively time consuming.

On the subject of the link between exchange rate policy and inflation, the staff representative from the Exchange and Trade Relations Department said that, as a general rule, when the main problem facing a member country was the need to control inflation, there were limits to the effectiveness of a flexible exchange rate policy because of the trade-off that existed between inflation control and downward exchange rate flexibility. In most cases, the exchange rate had to float downward in response to the prevalence of inflation due to shortcomings in demand management. Inflation control typically required strengthened demand management even when the exchange rate could be adjusted downward.

Mr. Erb said that he agreed with the staff that freeing interest rates was a necessary feature of monetary policy in Peru. However, the authorities' approach should combine the control of money aggregates with the introduction of wage and price measures designed to reduce the rate of inflation from the present high rate to a rate that could be controlled with the usual demand management policies. Hence, the interest rate would be one of the policy tools--not the only one--used in the effort to reduce the rate of inflation to a manageable effort in the short run. The discussion in the staff report on recent economic developments in Peru on monetary policy had been based in part on real growth rates of monetary aggregates. It seemed preferable to describe the situation in terms of nominal growth rates of the monetary aggregates. Expressing monetary aggregates in real terms rather than in nominal terms could lead readers to draw the wrong conclusions about monetary policy.

The Deputy Director of the Western Hemisphere Department said that he tended to agree with Mr. Erb that as part of the effort to control inflation, a tight rein on some monetary aggregates was essential.

However, some form of control over credit aggregates--in the program the net domestic assets of the monetary authorities had been used--would be in order, given the openness of the Peruvian economy. With the same money aggregate results, various balance of payments outcomes were possible. Credit was bound to be more amenable to control by the authorities than money.

Mr. Erb remarked that in a very open economy the question naturally arose of how the exchange rate should fit into the management of domestic monetary policy. An exchange rate that was meant to bolster an economy's competitive position and improve the external current account could constrain monetary growth rate objectives. In an open economy like Peru's, it might be wise to gear monetary policy to an exchange rate based on the monetary policy of another country with the same inflationary objective as that of Peru. The exchange rate would depend on the monetary policy of the country to which Peru wished to tie its domestic monetary policy.

The Deputy Director of the Western Hemisphere Department remarked that if the exchange rate was freely floating, thereby ensuring that balance of payments equilibrium would be achieved in a fairly automatic fashion, the control of the monetary aggregates--as opposed to a credit aggregate--would then become a critically important element in the effort to control inflation.

The staff representative from the Exchange and Trade Relations Department added that, in the circumstances that had been described, the money stock would move in precisely the same way as the stock of domestic credit. It was only when the exchange rate was freely floating that the money stock--which in that case was indentical with the stock of domestic credit--became a critical variable in the effort to control inflation. When exchange rate intervention took place, credit policy continued to be a relevant policy variable. If the exchange rate was formulated with a view to maintaining the country's competitive position, credit policy had to ensure that the economy actually demanded the money that was generated domestically.

Responding to a further question, the Deputy Director of the Western Hemisphere Department said that the status of the *de facto* wage indexation system was a particularly serious matter in Peru. The authorities had not yet made a final decision to terminate the quarterly adjustments, and the language in the staff appraisal welcoming the intention of the authorities to do so might be somewhat too positive.

Mr. Donoso remarked that Executive Directors clearly recognized the considerable effort that the authorities had made to deal with the difficulties facing the economy in the second half of 1982. The problems were traceable mainly to the need to match revenues with rising expectations, and to control expenditures, which had increased as a result of overextended investment programs in some public enterprises and of the failure to cut subsidies as quickly as had been thought necessary.

The authorities had taken a number of important steps to deal with the problems facing the economy, Mr. Donoso continued. The nominal increase in wages of central government employees in 1982 was estimated to be 12.8 per cent below the rate of inflation. The Government had considerable influence in wage developments outside the public sector. In addition, institutional steps had been taken to increase the control of the short-term debt of the public enterprises, and an effort was being made to centralize the profits of the public enterprises to improve control over their investment programs.

Although the increases in certain prices and the elimination of subsidies had not proceeded as quickly as had been hoped, Mr. Donoso remarked, important steps had been taken. The number of industrial items subject to regulation had fallen; bread, certain kinds of rice, and wheat had been taken off the list of price controls, thereby reducing subsidies. The prices of petroleum derivatives had been increased in the range of 50-70 per cent in 1982, well above the inflation rate of 45 per cent.

In the medium and long run, Mr. Donoso said, the authorities intended to push the needed structural reforms as quickly as possible and, in that connection, to make additional important adjustments on the demand side. The slowing of the implementation of reductions in tariffs and subsidies on nontraditional exports was a result of the financial program. As soon as financial equilibrium was restored, the authorities would be able to move quickly to reduce tariffs and subsidies. Similarly, the implementation of the financial program had delayed the achievement of the longer-term objective of widening the range of private sector activities. One of the costs of the authorities' failure to adjust immediately to the rising trend in expenditure was the unexpectedly limited availability of financing for the private sector, something that was clearly not in the country's best interests and that was inconsistent with the authorities' goals. Finally, under the provisions of the program, Peru would be able to make the next purchase upon the completion of the present review.

The Chairman made the following summing up:

> At the conclusion of the Article IV consultation with Peru and the review called for under the extended arrangement, Directors noted with satisfaction the efforts being made by the Peruvian authorities to adjust the economy to a deterioration in external conditions. They welcomed the measures taken recently to cut public expenditure, tighten domestic credit, and improve control of public foreign indebtedness.
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> However, Directors expressed concern that the fiscal performance in 1982 was likely to fall short of what had been expected under the program, mainly because of excessive spending in a number of public enterprises and of slippages in the planned adjustment of energy and food prices. Directors welcomed the effort being made to correct the overrun in expenditures, but emphasized that the intended elimination of the wheat and rice

subsidies before the end of the year was considered a crucial element of the program. The prompt adoption of realistic prices for energy and food was thought to be central to the achievement of an improvement in public sector savings and to a return of the performance of the public finances to the path envisaged in the extended arrangement. Some Directors remarked that the change in the situation of world capital markets indicated that Peru would need to be prepared to reduce its net reliance on foreign borrowing from the levels registered in 1981 and 1982. They cautioned in particular against excessive short-term borrowing abroad.

The substantial reduction in the overall balance of payments deficit from 1981 to 1982 was noted with satisfaction, but the limited improvement in the current account position was viewed with some concern. Noting the policy pursued by the authorities of depreciating the sol at least in line with domestic inflation, some Directors stressed the need for more flexibility in the exchange rate policy in order to obtain the needed improvement in the country's competitive position. Directors added that this exchange rate policy should be accompanied by a tighter credit policy and a more flexible interest rate policy to help protect the balance of payments.

Directors encouraged the authorities to step up their efforts to bring inflation under control. It was recognized that the need to make further corrective price adjustments, the extensive degree of indexation, and deeply ingrained inflationary expectations made this task difficult. But many Directors emphasized the importance of achieving a sustained deceleration in the rate of price increase and noted, with regret, the lack of progress made thus far in that crucial area. Directors agreed that the prompt elimination of remaining subsidies, together with a tighter control of public spending, a strict monetary policy, and a firmer wage policy, would be essential to bring inflation under more effective control. In this context, elimination of the system of quarterly wage adjustments for public sector employees and nonunionized private sector labor was seen by a number of Directors as an important measure. Directors also stressed the importance of appropriate structural policies to reduce economic rigidities.

Directors observed that continued liberalization of the trade system and pursuit of other market-oriented policies by the authorities would contribute to greater economic efficiency. In this regard, and while noting the detrimental impact of protectionism abroad on Peruvian exports and investment, a number of Directors expressed their strong hope that the use of the import surcharge and the export subsidies would be temporary.

In sum, Directors were of the view that, in spite of the measures already taken and of the compliance with performance criteria, there had been slippages on the fiscal side and on the inflationary front. In view of the external position of Peru, Directors felt demand management and other policies still needed to be strengthened.

The Executive Board then took the following decision:

The Fund and Peru have completed the review contemplated in paragraph 4(b) of the extended arrangement for Peru (EBS/82/77) and in paragraph 4 of the letter of April 2, 1982, attached thereto. No new understandings are necessary regarding circumstances in which purchases may be made by Peru until February 28, 1983.

Decision No. 7260-(82/155), adopted
December 1, 1982

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by Executive Directors without meeting in the period between EBM/82/154 (12/1/82) and EBM/82/155 (12/1/82).

2. EAST CARIBBEAN CURRENCY AUTHORITY (ECCA) - TECHNICAL ASSISTANCE

In response to a request by the East Caribbean Currency Authority (ECCA) for technical assistance, the Executive Board approves the proposals set forth in EBD/82/294 (11/30/82).

Adopted December 1, 1982

APPROVED: May 11, 1983

LEO VAN HOUTVEN
Secretary