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EBS/89/149

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July 26, 1989

To: Members of the Executive Board
From: The Secretary
Subject: Peru - Real Effective Exchange Rate - Information Notice

Attached for the information of the Executive Directors is an information notice on the real effective exchange rate of the Peruvian inti.

Mr. Gilman (ext. 8524) is available to answer technical or factual questions relating to this paper.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

PERU

Real Effective Exchange Rate - Information Notice

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Exchange and Trade Relations Department

(In consultation with the Legal Department
and the Research Department)

Approved by S.T. Beza and Eduard Brau

July 25, 1989

The standard index developed in connection with the information notice system indicates that, as of April 1989, the Peruvian inti had appreciated by more than 10 percent in real effective terms since February 1989, the last occasion on which the Executive Board had the opportunity to discuss developments regarding Peru's exchange rate. 1/ The real effective appreciation between February and April 1989 is estimated to have amounted to 39 percent (Table 1 and Chart 1), due to a sharp acceleration in Peru's rate of inflation relative to partner countries (close to 100 percent), while the nominal effective exchange rate depreciated by some 30 percent over the period under consideration. 2/

At the Board discussion in February 1989, Executive Directors noted the poor performance of exports and urged the authorities to take steps to improve Peru's competitiveness, with the adoption of a market-related exchange rate system which could provide a realistic and credible exchange rate level. This exchange rate policy would need to be supported by strong fiscal and monetary policies in the context of a comprehensive adjustment program directed at correcting distortions in relative prices and eliminating the domestically-financed public sector deficit from the start.

1/ The 1988 Article IV consultation and review of Peru's overdue financial obligations to the Fund were discussed on February 24, 1989. The Chairman's summing up was circulated as SUR/89/13.

2/ For the purposes of the information notice system, the effective value of the inti is based on a composite rate representing a weighted average of the various rates noted below.

Since September 1988 Peru's exchange and payments system ^{1/} has consisted broadly of (a) a unified official (MUC) rate applying to a substantial portion of export receipts and import payments; (b) a market-determined certificate (CLD) rate applying to a portion of total export proceeds that could be retained by exporters for various uses or sold to other parties; (c) a free market rate applying to capital goods imports and various service payments, determined in the banking system; and (d) a parallel market rate applying to tourist travel abroad, "own funds" imports, and unauthorized transactions. A special export rate equal to 127 percent of the MUC rate that was established in early January 1989 for selected textile exports (cotton, wool, or alpaca). An additional exchange rate, which resulted from the imposition of a tax on export earnings, was eliminated in February 1989 when the tax was rescinded.

Starting July 1988 exporters have been permitted to retain 10 percent of their export earnings or receipts from pre-export financing in the form of certificates (CLD) which had a maturity of 90 days (180 days since February 28, 1989) and could be used to pay for specified imported inputs or could be transferred to other exporters for the same purpose. The retention rate was increased to 30 percent in late November 1988, 40 percent in April 1989, and 50 percent on June 5, 1989. Since early February 1989, CLD could be used to make external payments by all importers of goods or nonfinancial services, and since April 1989 they were made transferable to financial institutions, thus broadening the market for these instruments, and conversions in local currency at maturity of unused certificates were changed from the MUC rate at the date of issuance to the MUC rate at the date of maturity.

Exchange rate policy in Peru has been subject to wide swings over the last 12 months. As a result of a significant nominal depreciation in the second half of 1988, the real effective exchange rate for the inti at the end of the year was approximately only 10 percent more appreciated than in August 1985, which in turn had been the most depreciated rate, in real terms, in the last decade. This depreciation reflected the unification and adjustment of officially controlled rates in September 1988, substantial subsequent adjustments of the official rate, and a sharp depreciation of free market rates in the last quarter of the year.

At the beginning of February 1989, the authorities announced a four-month calendar of adjustments of the official MUC rate, to be made in conjunction with pre-announced adjustments in key domestic prices and the legal minimum wage, in an attempt to check inflationary expectations. The expected deceleration in inflation failed to materialize, and the inti appreciated rapidly as the adjustments to the

^{1/} The main features of the exchange system and policies being followed by the Peruvian authorities were last reported to the Board on the occasion of the 1988 Article IV consultation, on February 24, 1989 (EBS/89/13 and SM/89/351).

official MUC rate substantially lagged the rate of inflation. In addition, the free market exchange rate temporarily appreciated from around I/. 2,000 per U.S. dollar at the end of December to around I/. 1,250 per U.S. dollar in early March as import demand dropped sharply in response to a drastic decline in domestic economic activity and a tightening of credit policies, and demand for foreign exchange shifted from the free market to the CLD market as access to the latter market was substantially broadened. Reflecting these developments, during the first four months of 1989, the real effective value of the inti appreciated by about 75 percent, thus shifting from close to its most depreciated level of the last decade to its most appreciated level. In response, the authorities abandoned their schedule of pre-announced adjustments and during April began to make weekly changes to the official MUC rate. A further step adjustment to the official rate was made in mid-May, and since June 8 the authorities began depreciating the MUC rate about 1 percent each business day. After early April, the market-determined exchange rates also depreciated sharply in response to a weakening of credit policies and renewed uncertainties regarding the future direction of economic policies. As a result, the real effective exchange rate index tentatively estimated by the staff for May declined substantially from its April peak, but still remained considerably more appreciated than in earlier years.

Chart 2 shows the fluctuations of the various multiple rates in recent months. With the renewed depreciation of the free rates, the spread between the market-determined rates and the official MUC rate, which had narrowed to less than 5 percent in mid-March, widened to 40-50 percent in mid-June.

The disequilibria in the Peruvian economy have worsened since the beginning of 1989; real GDP in the first quarter was about 20 percent below the corresponding period a year earlier, while the rate of monthly inflation averaged over 45 percent during January-April, up from 27 percent during 1988. The rate of inflation declined to less than 30 percent in May, largely reflecting inadequate adjustments of a number of important prices for public sector goods and services. The decline in relative prices for key public sector goods and services since the end of 1988 has increased substantially the underlying public sector imbalances, aggravated by the continued erosion of the tax base.

Net international reserves of the Central Bank rose by about US\$350 million between December 1988 and May 1989, reflecting largely an improvement in the current account, as a consequence of a steep decline in imports and a rebound in mining exports after the strikes of late 1988. However, external arrears continued to accumulate, including to the Fund and the IBRD. Gross reserves at end May were about US\$1.2 billion, including gold and foreign exchange pledged against short-term credits. Readily available foreign exchange was about US\$340 million, or 7 weeks of imports.

Staff Appraisal

The sharp appreciation of the inti in real effective terms since December 1988 has weakened Peru's international competitiveness and discouraged exports at a time of severely depressed domestic activity. In addition, the continued reliance on multiple currency practices and complex administrative requirements are a further disincentive to exports. To address these problems, the authorities should adopt a unified flexible exchange rate aimed at securing an adequate level of competitiveness to promote exports and efficient import substitution, accompanied by a liberalization of exchange and trade restrictions. Such actions, if accompanied by appropriate financial and incomes policies in the framework of a comprehensive adjustment program, could lay the basis for generating a sustained economic recovery, mobilizing international support, and eliminating arrears and other payments restrictions. This in turn would help in re-establishing normal relations with external creditors, including the Fund and the World Bank.

Following the completion of the 1988 Article IV consultations with Peru on February 24, 1989, a staff team visited Lima at the request of the authorities during the period April 17-27, 1989 to analyze Peru's economic situation and to discuss with the authorities their economic and financial policies. A new cabinet took office in mid-May and in mid-July the Minister of Economy and Finance announced the Government's intention to increase selected taxes, raise salaries in line with inflation, reduce tariffs for selected capital goods imports, and slow the rate of daily adjustment of the official exchange rate. However, these measures have not yet been implemented. A further review of Peru's overdue obligations to the Fund is scheduled to take place no later than August 24, 1989.

Table 1. Peru: Real Effective Exchange Rate and Related Series

(Indices: 1980 = 100)

	Real Effective Exchange Rate <u>1/</u> <u>2/</u>	Nominal Effective Exchange Rate <u>1/</u>	Relative Consumer Prices (Local Currencies)	Exchange Rate In Terms of U.S. Dollars <u>1/</u>	Consumer Price Index (Seasonally Adjusted)	Consumer Price Index (Not Seasonally Adjusted)
Quarterly						
1983						
I	117.6	39.79	293.9	26.12	431.6	431.1
II	115.2	32.76	349.7	20.39	534.3	538.1
III	111.4	26.61	416.7	15.65	667.6	673.7
IV	113.4	23.53	478.3	13.27	804.6	793.2
1984						
I	118.9	21.57	548.2	11.73	961.4	961.0
II	114.2	18.06	628.9	9.50	1,149.4	1,155.6
III	113.4	15.82	712.4	7.75	1,359.7	1,367.7
IV	111.0	13.42	824.1	6.16	1,654.9	1,636.4
1985						
I	100.2	9.69	1,030.6	4.13	2,170.2	2,182.6
II	95.7	7.13	1,340.7	2.97	2,959.7	2,961.6
III	90.0	5.19	1,725.6	2.16	3,950.3	3,937.9
IV	89.5	4.76	1,863.5	2.02	4,426.1	4,405.8
1986						
I	93.6	4.66	1,992.9	2.01	4,915.5	4,980.8
II	104.1	4.56	2,263.3	2.00	5,641.5	5,621.3
III	110.2	4.31	2,533.7	1.94	6,409.9	6,318.1
IV	112.0	4.07	2,732.6	1.82	7,057.4	7,077.6
1987						
I	111.0	3.62	3,038.3	1.64	8,119.9	8,298.7
II	120.9	3.42	3,513.2	1.50	9,923.6	9,837.3
III	129.4	3.11	4,123.8	1.30	12,196.9	11,885.1
IV	115.1	2.46	4,670.1	1.04	14,434.0	14,578.1
1988						
I	103.6	1.66	6,231.0	0.68	20,195.0	20,747.7
II	111.2	1.19	9,272.4	0.47	31,772.0	31,392.8
III	110.1	0.64	19,970.8	0.23	73,606.7	71,668.9
IV	107.5	0.20	54,532.6	0.07	214,763.6	218,096.3
1989						
I	117.8	0.08	146,419.9	0.02	611,590.8	629,847.0
Monthly						
1989						
Feb. <u>3/</u>	119.0	0.08	143,206.6	0.02	596,927.3	605,213.4
Mar.	142.0	0.07	196,000.0	0.02	826,158.9	859,616.5
Apr.	165.3	0.05	285,809.6	0.01	1,222,189.7	1,277,390.2
Percentage change						
Feb. 1989- Apr. 1989	39.0	-30.4	99.6	-33.3	106.7	

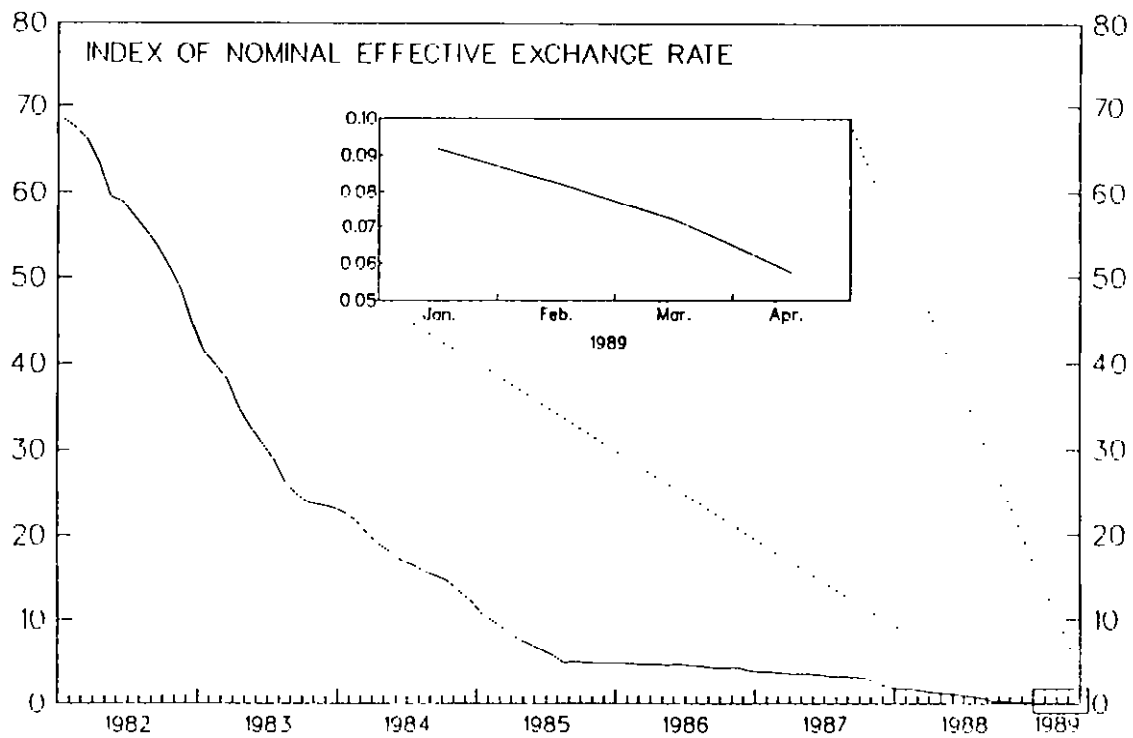
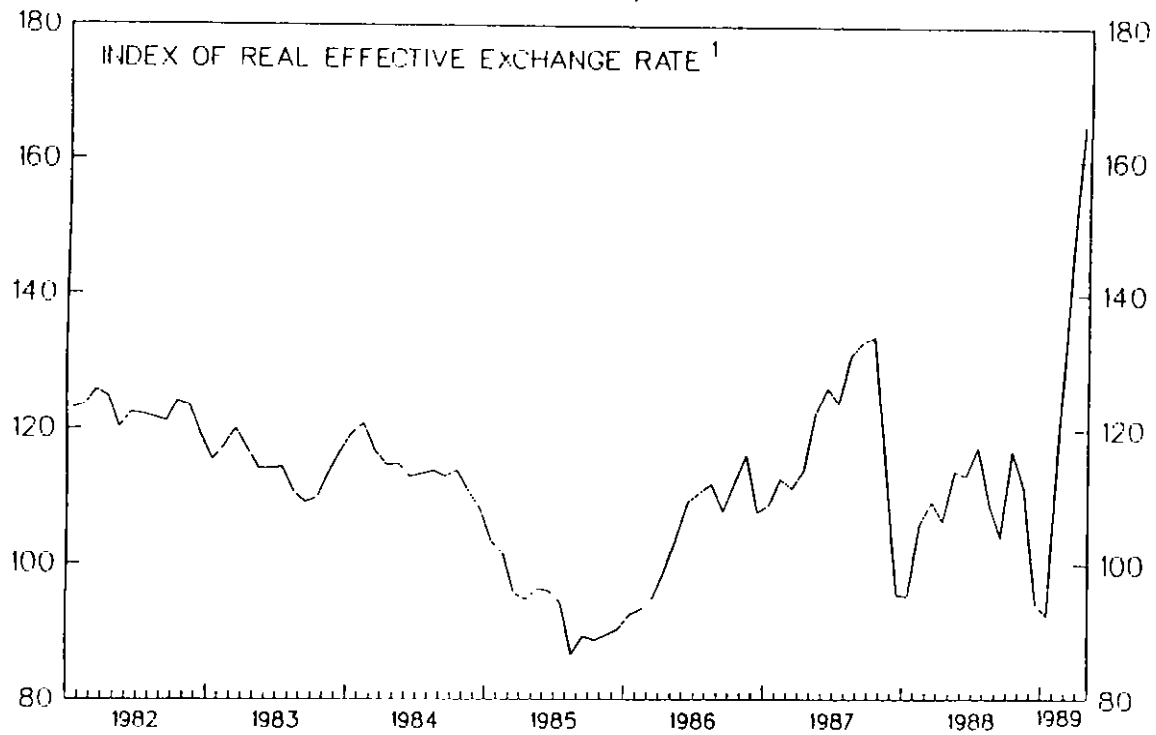
Source: Information Notice System.

1/ Increases mean appreciation.

2/ Using seasonally adjusted price indices.

3/ Date of latest consideration by Executive Board.

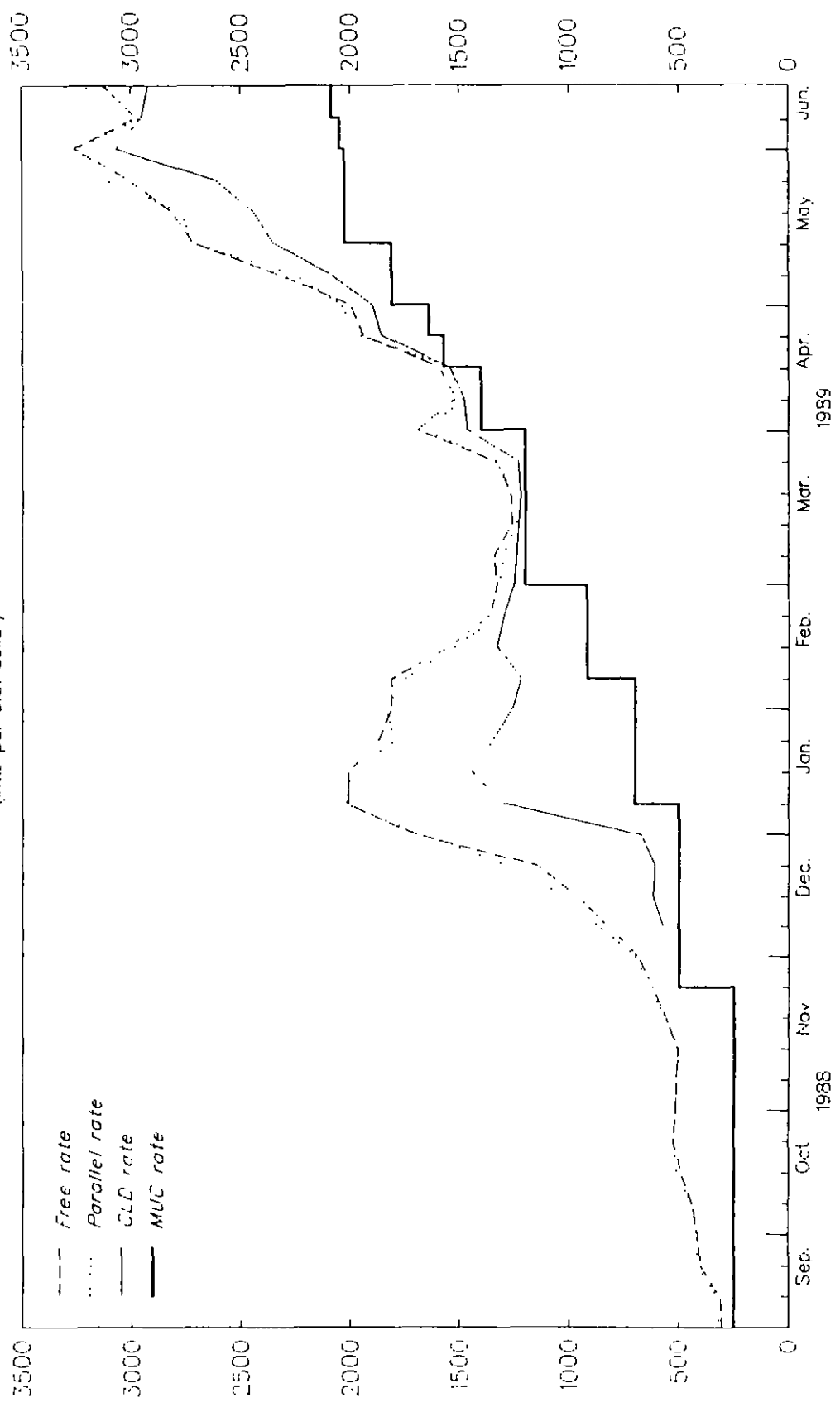
CHART 1
PERU
INDEX OF REAL EFFECTIVE EXCHANGE RATE
(1980=100)



Source: Information Notice System. Seasonally adjusted.

¹ Trade weighted index of average monthly nominal effective exchange rate deflated by seasonally adjusted consumer prices. Increase means appreciation.

CHART 2
PERU
WEEKLY EXCHANGE RATES¹
(Intis per U.S. dollar)



Source: Central Revenue Bank of Peru.
¹ Selling rate at end of period

