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July 26, 1988

To: Members of the Executive Board

From: The Acting Secretary

Subject: Final Minutes of Executive Board Meeting 87/161

The following correction has been made in the final minutes of EBM/87/161 (11/25/87):

Page 41, line 1: for " 2. EDUCATION ALLOWANCE - REVIEW"
read " 3. EDUCATION ALLOWANCE - REVIEW"

A corrected page is attached.

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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/161

10:00 a.m., November 25, 1987

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	A. G. A. Faria, Temporary
	Song G., Temporary
C. H. Dallara	M. K. Bush
	D. C. Templeman, Temporary
	J. Prader
	E. V. Feldman
	R. Morales, Temporary
	M. B. Chatah, Temporary
G. Grosche	
J. E. Ismael	J. Reddy
	J. R. N. Almeida, Temporary
T. P. Lankester	C. Enoch
	D. McCormack
Mawakani Samba	
	I. A. Al-Assaf
	L. Filardo
	M. Fogelholm
	D. Marcel
	G. P. J. Hogeweg
C. R. Rye	
	B. Tamami, Temporary
A. K. Sengupta	
	M. Sugita
S. Zecchini	

L. Van Houtven, Secretary and Counsellor
M. Primorac, Assistant

Also Present

C. Ferrari, General Manager and Member of Board of Central Reserve Bank of Peru; M. Balarezo, Assistant in the Financial Office, Embassy of Peru. IBRD: P. Bottelier, Latin America and the Caribbean Regional Office. Administration Department: G. F. Rea, Director; H. J. O. Struckmeyer, Deputy Director; C. Ahl, S. L. Chung, D. S. Cutler, U. P. Dimitrijevic. Exchange and Trade Relations Department: C. F. J. Boonekamp, E. Brau, S. B. Brown, D. Lee, L. M. Valdivieso. Legal Department: W. E. Holder, Deputy General Counsel; A. O. Liuksila, J. M. Ogoola, J. V. Surr. Secretary's Department: M. J. Papin. Treasurer's Department: D. Berthet, J. E. Blalock. Western Hemisphere Department: S. T. Beza, Director; M. Caiola, Deputy Director; J. Ferrán, Deputy Director; J. Leimone, S. J. Stephens. Bureau of Statistics: R. Lituma. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: P. D. Péroz, G. Pineau, A. Vasudevan, J. E. Zeas. Assistants to Executive Directors: F. E. R. Alfiler, A. A. Badi, R. Comotto, E. C. Demaestri, F. Di Mauro, W. N. Engert, S. Guribye, C. L. Haynes, M. Hepp, G. K. Hodges, S. King, V. K. Malhotra, D. V. Nhien, C. Noriega, L. M. Piantini, A. Rieffel, S. Rouai, D. Saha, G. Schurr, E. L. Walker, R. Wenzel, D. A. Woodward.

1. REPORT BY MANAGING DIRECTOR

The Managing Director reported briefly on his recent visit to Canada.

2. PERU - 1987 ARTICLE IV CONSULTATION; OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY

The Executive Directors considered the staff report for the 1987 Article IV consultation with Peru (EBS/87/229, 11/6/87; and Cor. 1, 11/24/87) together with a paper on recent economic developments in Peru (SM/87/186, 8/3/87). They also had before them a staff paper on the further review of Peru's overdue financial obligations to the Fund and following the declaration of Peru's ineligibility to use the Fund's general resources on August 15, 1986. (EBS/87/219, 10/15/87; and Sup. 1, 11/19/87).

Mr. César Ferrari, General Manager and Member of the Board of the Central Reserve Bank of Peru, made the following statement:

> I wish to point out that my presence at this Board today, as a member of the Peruvian Government, is an attempt to convey to you all our firm desire, as committed members of this institution, to intensify the dialogue that is a necessary precondition for attaining solutions to our common existing problems. In this context, we welcome this opportunity to help deepen awareness of Peru's social and economic difficulties and the efforts being made to solve them.
>
> I am pleased to convey to the staff our appreciation for the fruitful conversations that have taken place in the context of this Article IV consultation. They were undertaken with the professionalism that is characteristic of this institution, and which has certainly helped to enhance the dialogue with my Government as well as enrich the process of evaluation of the economic policies we are working out.
>
> However, we have to point out some differences on a few aspects of the staff's report. We believe the report does not necessarily convey the full complexity of the problems we are facing today. Nevertheless, we are in general agreement that a new set of policies is needed within the context of a comprehensive economic and financial program. It will represent a continuation of the economic program that was initiated when the new Administration took office in July 1985. We are already involved in the development of that program, which will continue with the mobilization of our domestic resources, but it will require the full cooperation and support of the international financial community.

In July 1985, the new Administration was faced with an economy in which production was paralyzed; industrial capacity was below 50 percent of its full utilization; underemployment and unemployment levels were at a peak; and total arrears surpassed $2.0 billion. At the same time, the private sector of the economy was near bankruptcy, or at least impaired, with a level of debts vis-à-vis the domestic financial sector that also compromised its existence.

That situation was combined with a high level of inflation, which at mid-1985 was at 280 percent. The level of inflation was clearly not generated by excessive aggregate demand. In the previous decade, Peruvian economic policy had been oriented to restrict demand, which by 1985 had reached the lowest level of the decade. In real terms, per capita GNP and per capita consumption were equivalent to 84 percent of the 1975 level and imports were 23 percent less than in 1975--using a GNP base of 1979, which is the present official base year. Inflation had a clear cost-push explanation. The main elements of this cost-push were the continuous devaluation of the exchange rate, the sustained increase in nominal salaries--although at a lower pace than that of the inflation rate itself, the persistent growth in nominal interest rates, and the constant increase of indirect taxes.

Aside from the above, Peru was also facing a growing problem of narcotic traffic and the most violent and destructive form of terrorism, both of which had reached levels that affected the social and economic behavior of our society. Additionally, and as a consequence, a lack of confidence in the political and economic future of the country developed in different sectors of society. In particular, economic agents had difficulties in acting according to criteria conducive to the progress needed by Peru.

In this context of recession, low capacity utilization levels, and inflation of a cost-push origin, during the first two years of the new Administration the authorities implemented an economic program geared to the necessary restoration of economic growth and reduction of inflation. The basis of that program was the full utilization of our production capabilities and the stabilization of industrial production costs.

One of the main instruments of policy was the expansion of domestic demand through the increase of disposable incomes, which was achieved by wage increases, mainly in low-income sectors. Decreases in indirect taxes and interest rate reductions were applied, along with the relative stability of the Peruvian exchange rate vis-à-vis the U.S. dollar, in order to avoid cost-push effects. Also, at the beginning of the program, a general freeze in prices was imposed to cope with inflationary expectations.

The results obtained have been positive, as the main objectives of the program were reached. GNP increased by 8.5 percent in 1986 and is expected to grow by 7 percent in 1987. The inflation rate was reduced to near 63 percent in 1986--although it has increased to about 100 percent for 1987--and the level of unemployment decreased by 28 percent in 1986, caused by a decrease in open unemployment from 11.8 percent to 8.2 percent, and a decrease in underemployment from 54.1 percent to 51.4 percent.

Nevertheless, some problems have appeared, basically of structural origin. The structure of the Peruvian economy is such that as soon as the economy begins to grow, imports grow faster than exports, and consequently balance of payments problems begin to develop. The inadequate structure of the industrial sector, which is highly dependent on imports of intermediate goods, meant that a needed resumption of economic growth was accompanied by an excessive reduction of international reserves.

Usually, a crisis of this type has been solved by a recession, which is eventually questioned by social unrest, and as a response to that situation a new period of expansion evolves. This type of stop-and-go economic behavior has characterized the Peruvian economy for at least the past 50 years, and it is the result of the inappropriate pattern of investment among different sectors of the economy, allocation of which occurred because of wrong market signals caused by different market imperfections of the Peruvian economy.

In this context, the high exposure of the Peruvian economy to exogenous factors of an international nature has also negatively affected the evolution of the economy. The sharp deterioration in the terms of trade--about 36 percent between 1984 and 1986--and specifically the decrease in the international price of oil exports were responsible for $300 million of the current account deficit in 1986.

The structural problem of the Peruvian economy also explains the revival of inflation of 1987. Since an important part of industry--steel, paper and boards, cement, and chemicals--began operating at full capacity, the increase in nominal demand pushed prices up in those sectors; because they produce intermediate goods for the rest of industry, these sectors began to experience cost-push inflation. In addition, the devaluation of the dollar vis-à-vis other major currencies caused a larger devaluation in the inti, which is pegged to the dollar, than originally planned. Moreover, inflationary expectations owing to balance of payments developments put further pressures on prices, particularly in services.

There is another important development in the economic performance of Peru, related to the fiscal situation. Up to July 1985, fiscal revenue was based mainly on indirect taxes. In order to change that situation, for reasons of equity and as a way of curbing inflation, indirect tax rates were reduced. However, direct taxes--income and property taxes--were not increased concurrently, resulting in a large decrease in fiscal revenues. Since fiscal expenditure in real terms remained at the same level, a mounting fiscal deficit for the nonfinancial public sector appeared. For 1987 the deficit will reach 5.9 percent of GNP.

Finally, at the beginning of the program, nominal interest rates were about 130 percent, but inflation was about 280 percent, resulting in a highly negative real interest rate. As a way of curbing financial charges to producers, nominal interest rates were progressively reduced to 50 percent by the end of 1986, while inflation had dropped to 63 percent. Consequently, the negativism of the real interest rate was sharply reduced. However, owing to the rebirth of inflation, the real interest rate has again become more negative.

The authorities are very aware that sustained economic growth is absolutely necessary to solve the problems of poverty and violence in their country and that that solution is the only way to guarantee the development of a democratic society in Peru. They are also aware that this can only be achieved with adequate levels of investment in the appropriate sectors of the economy, so as to reorganize its productive structure. Also, the authorities recognize the necessity of increasing their export capacity, in order to support a level of imports of goods and services, including financial obligations, compatible with a specific level of growth.

Economic growth is also necessary to attain higher levels of income, and consequently higher levels of personal savings, profits and, with a simultaneous improvement in management of the fiscal sector, public savings. That will provide the necessary domestic resources for increased investment.

In light of these objectives, our economic program for the next three years--a revised version of the National Development Plan 1986-90--gives high priority to economic growth, to the improvement of our export performance, and to the increase in the level and quality of investment expenditure, while moderating the upswing in domestic consumption.

For the appropriate development of the export sector, the main instrument will be the management of the exchange rate to guarantee adequate profits to exporters, in line with the required competitiveness in exports. At the same time, a reduction in the number of exchange rates will be made, in a move toward unification of the system. An important first step in this direction has already been taken; last October a devaluation of 26 percent was implemented along with a reduction of the number of exchange rates in existence. Furthermore, a system has been established to generate future exchange rate adjustments in order to guarantee a permanent undervaluation of the inti vis-à-vis the dollar. At present, considering the wholesale price index, the inti is undervalued with respect to the dollar by about 14 percent.

A simplification of the administrative requirements on trade transactions is also taking place so as to improve the efficiency of the external sector. Recently, the licensing requirement for the purchase of foreign exchange, which was operated by the Central Bank, has been eliminated. The licensing requirement on imports will gradually be simplified in order to encourage an increase in exports and a more efficient pattern of production in the industrial sector. Additionally, the temporary prohibition on remittances and dividends has been lifted for mining and petroleum operations. The system of tariffs and nontariff barriers on trade will be revised to reduce their effect.

Consistent with the importance the program attaches to the development of the export sector, free zones for export production will be created and administrative procedures in ports will be simplified.

Another important aspect of the economic program is an increase in traditional exports. For this purpose, legislation that will attract high risk investment is being studied. Moreover, a new oil law, which includes very attractive incentives, is under consideration in Congress and has already been approved by the Senate.

On the fiscal side, measures are oriented toward the reduction of the fiscal deficit of the nonfinancial public sector to levels of 4 percent of GNP by 1990. To achieve this goal, the authorities are aiming at an increase in the tax ratio of 8 points, to be achieved mainly through an increase in property and income taxes, the increase of the value-added tax from 6 percent to 10 percent, a reinforcement in the revenue service system, a temporary surcharge on imports, and the development of an income taxation payment system that would avoid the negative effects of inflation in the collection of taxes.

Increases in the prices of utilities and other goods and services provided by public enterprises, such as oil and oil derivatives, will be implemented. For that purpose, a strict timing of the adjustments will be followed. In addition, a freeze on new employment in the public sector will be executed. These measures are already included in the budget that has been presented to the Congress for approval and are expected to be made effective by January 1988.

Public sector investment will give priority to programs aimed at expanding the export base and to sectors in which a public presence is needed to increase productive capacity.

As mentioned above, the nature of the imbalances has its roots in the structural rigidities of the economy, for which a set of corrective policies has been defined. An industrial restructuring, aimed at increasing vertical integration and reducing the oligopolistic nature of the industrial sector, is being considered, increasing that sector's competitiveness through policies that will give emphasis to small and medium-size private enterprises and that will give informal economic agents access to the formal economy. Also, industrial decentralization will be undertaken in order to attain a more balanced development throughout the whole country and to reduce the negative effects that the overconcentration of industry is having on the capital city.

In this context, the administration of public enterprises will be moved out of Lima and located closer to main production centers. Additionally, one third of the existing public enterprises will be privatized and another third liquidated. Measures will be taken to increase the efficiency of the remaining enterprises so as to make them profitable.

Finally, a financial reform will be undertaken in order to achieve decentralization and a democratization of credit opportunities as well as a drastic change in the way that credit is allocated. Credit should be directed mainly to finance fixed capital investment instead of short-term working capital.

In this regard, increased funding of the financial system, with longer maturities, will have to be developed, which will require attaining real interest rates on deposits. There are two ways of achieving this objective--increasing nominal interest rates, or decreasing inflation. Since we plan to improve management of domestic demand, with cost elements moving accordingly, we expect that inflation will be reduced. If this occurs in a short period of time there will be no need to increase nominal interest rates, but if not, then nominal interest rates will have to be increased in order to fulfill the mentioned objective. We are fully aware that a program like the one described above must be implemented with the complete awareness of the population and the cooperation of the international community if it is to be successful.

Important steps have already been taken in this direction. Detailed and intensive conversations are being held with the World Bank, working toward an understanding that could permit the Bank to restore lending operations to Peru. In the last eight weeks, the Peruvian economic team came to Washington twice and one technical mission of the Bank went to Lima. At present, a team from the Bank is in Lima working out further details needed to reach a final agreement.

Additionally, our Minister of Economy and Finance met last week in Paris in an informal session with members of the Paris Club to explain the objectives of the economic policies of Peru and the progress attained so far, as the first step in the process of normalizing its relations with official creditors on a multilateral basis. At the same time, we have formally requested a meeting with the Advisory Committee of the private banking community to be held in mid-January 1988, in order to begin negotiations with them to solve our debt problem and the arrears situation. During the last two months, specific agreements have been reached with two banks on a bilateral basis.

Our authorities are willing to reassume during 1988, in a significant way, Peru's financial obligations to the Fund, depending upon the development of our economic program. We consider that the program will provide Peru with the capacity necessary to fulfill our obligations; for this purpose it is necessary not only to mobilize our own resources, as we have done during the last two years, but also to have the understanding and the support of the international financial community.

We are confident that the policies described and the steps already taken will have the support and cooperation of the entire international community and thus will make it possible for us to continue on the path of sustained growth with an appropriate income distribution pattern.

Mr. Almeida made the following statement:

We are happy that the Article IV consultation with the Peruvian authorities has been completed. We believe that this action is a very positive step toward the re-establishment of normal relations between the Fund and Peru. We are in broad agreement with the thrust of the staff report and therefore we will confine ourselves to a few comments.

First of all, we have noted a substantial decline in tax revenue--7.5 percentage points of GDP over the last two years--accompanied by a vigorous reduction in expenditures; commensurately, national and public savings have declined consistently since 1984, and the same pattern has been observed in investment. The staff seems to believe that the reactivation of the economy in 1986 and in the current year was effected by an increase in consumption well above the rate of economic activity, but we note that private investment increased substantially in 1986, mostly in the area of construction. It is clear that the public sector itself was mainly responsible for the decline in overall investment, following a pattern that has been present since 1982. In fact, the staff seems to believe that lower investments "were caused by a decline in the availability of foreign financing," but I fail to see the reasons for the decline in domestic investment. The authorities seem to have embarked on an ambitious social program that increased public consumption at the expense of investment. Perhaps the staff could provide us with some additional information on that matter.

In discussing the medium-term balance of payments scenarios, the staff suggests that an alternative option based on an adjustment program could have the support of the international financial community, and concludes that with the elimination "of arrears and the rescheduling of debts, Peru is likely to obtain at least as much, and probably more foreign exchange resources than under the present policy of limiting debt service payments, especially over the medium term." It is not said under what conditions so bold a statement can be true; I would be grateful if the staff could identify the specific sources of finance it is envisaging for that alternative option.

There is no question that Peru's current situation has been substantially aggravated by the behavior of its external sector: total exports declined by 14 percent and imports declined by 17 percent between 1983-85 and 1985-87, and this certainly has not improved resource allocation. In this regard we welcome the recent simplification in the exchange system promoted by the authorities.

We are looking forward to the authorities taking the comprehensive measures explained by Mr. Ferrari, and urge them to complete the process as quickly as possible; such an approach will certainly enhance domestic resource allocation, but additional external resources will be necessary if growth is to be sustained. As this chair has reiterated on numerous occasions, Fund policies for dealing with overdue financial obligations have not been flexible enough; we view the comprehensive adjustment program being formulated in the context of enhanced dialogue with the international financial community, including the Fund, as crucial to the normalization of relations between Peru and the international financial community.

Mrs. Filardo made the following statement:

We welcome the presence of Mr. Ferrari, in this first Article IV consultation discussion with Peru since 1984, and we are grateful to him for his statement. My authorities look with satisfaction on the Government's decision to resume this process of adjustment and exhort the Peruvian authorities to persevere along these lines.

During the past few years, when Fund missions were interrupted, the authorities pursued controversial economic policies, but the lack of information made communication with the international financial community more difficult. We are firmly convinced of the benefits to all parties, but especially to each member country, of regularly analyzing economic developments and the motives behind the policies enacted. Only with the cooperation of its members can the Fund further its purpose of promoting better international economic relations. We hope that a new period of fruitful relations between the Peruvian Government and the Fund may begin today.

We regret the failure of Peru to clear its financial obligations vis-à-vis the multilateral institutions and, in particular, the Fund. However, we also recognize that in spite of the effort the authorities made in the previous Administration to implement adjustment policies, they were unable to attract support from the international financial community for refinancing their debt. This led the Government to unilaterally restrict debt service payments, although that action was not justifiable.

We would like to describe our view of recent economic developments in Peru and of some of the issues facing the country's policymakers. Although we share many of the staff's opinions on past developments, we feel that the appraisal of economic prospects offered in the report is inappropriately pessimistic and that, instead of offering a deep analysis of possible outcomes for the economy, it falls into a worn-out call for full and prompt liberalization. This fact is particularly disturbing because, instead of conveying constructive advice at a time when local authorities are in the process of reshaping their economic program and initiating a dialogue with commercial banks and other creditors, the report offers an uninteresting and perhaps biased view of the real alternatives facing the economy.

Regarding past developments, we concur with the characterization of the decade beginning in the mid-1970s as a period with unsatisfactory economic achievements in most areas--declining per capita income, high levels of inflation, and mounting foreign debt. These results were, in part, the outcome of fiscal imbalances, shrinking domestic savings, worsening terms of trade, unfavorable climatic conditions, and finally, the interruption of access to external savings.

These developments, unfortunately, are not unlike those prevailing elsewhere. However, the new Administration which took office in mid-1985 decided to pursue a policy aimed at achieving fast growth in the short run instead of laying the foundations for healthier and, therefore, sustainable growth. The program launched to that effect took into consideration the conditions prevailing at that time, namely, the low percentage of capacity utilization in industry and the high rate of unemployment. Domestic demand was to be stimulated by increasing foreign savings, or at least limiting the resources transferred abroad; but given the lack of an agreement with foreign creditors, the authorities resorted to unilateral restraint of debt service, and in order to avoid leakages, a complex exchange system and protective trade measures were adopted.

In 1986 and the first part of 1987, economic activity rebounded; it is not surprising that as the economy gathered momentum, some of the controls began to manifest themselves as costly distortions.

The authorities' economic strategy has run its course, and at this juncture consolidation of some of the gains achieved requires policy changes. We share this conclusion with the staff, but the analysis which leads the staff to that conclusion provides an incomplete view of the state of the economy. In 1987, GDP will be only slightly above the level of 1982, though considerably higher than in 1985. The real effective exchange rate has appreciated with respect to its value in 1985, but is not very different from that prevailing in 1982. Imports, measured in dollars or as a proportion of GDP, will be lower than in 1982. Real wages will not reach their value of 1982--although salaries will be higher. In my view, the economy is not performing satisfactorily in 1987, but it does not seem appropriate to take 1985--a year which seems to have been atypical--as a point of reference, as the staff does. A broader picture indicates that, in many respects, the economy has returned to the way it was in 1982.

With respect to the current situation, we perceive the mounting fiscal deficit as one of the major immediate problems. On the one hand, the increased aggregate demand that the deficit generates is compounded by a permanent exogenous shock on exports, thus resulting in a significant current account deficit. On the other hand, the lack of both domestic and foreign savings is forcing the Government to resort to inflationary financing.

It is evident from the paper on recent economic developments that the current account improved substantially from 1982 to 1985 and that the deterioration that emerged in 1986 was a result of both the decline in exports, which reflected the reduction in the terms of trade index by 36 percent, and the increase in imports. It is unfortunate that at that time, after a serious adjustment effort, the authorities could not implement an economic program which, while envisaging growth, could have been oriented to reach external viability and rally the support of the international community.

In relation to medium-term prospects, the challenge to economic policy is to turn growth from an inward to an outward orientation without provoking a recession.

The two scenarios developed in the staff report appear to serve only to identify sources of tension, and do not constitute a guide to probable outcomes. The first scenario, only because of the dire results, is not worth discussing, and the second one is not sufficiently explained--the results are not even presented. In dealing with the second scenario, the staff simply enumerates a long list of possible economic policies to be implemented, which would result in an apparent positive outcome. This scenario assumes a normalization of Peru's relations, with foreign creditors rescheduling arrears to the banking system and canceling those with multilateral institutions. Although we agree that policy should move toward liberalizing and eliminating the system of subsidies and controls, the staff does not give any indication of the pace at which liberalization should take place. By the same token, notwithstanding the fact that the economic program which the authorities envisage needs to take into account payments arrears and, in particular, overdue obligations to the Fund, it would be interesting to hear from the staff how it expects that normalization to take place, in the context of the alternative scenario presented.

Finally, while endorsing the proposal in relation to the next Article IV consultation, my authorities encourage the Peruvian Government to adopt an economic program aimed at sustained growth and the re-establishment of external viability in the medium term. In this regard, we would agree with Mr. Ferrari that given Peru's political and social unrest, it is crucial to maintain economic growth. To this effect, it is advisable to contemplate the elimination of arrears to multilateral institutions and to reach an agreement with the remaining creditors. We are satisfied that the Government is taking steps in the right direction.

As regards Peru's overdue obligations to the Fund, we support the draft decision.

Mr. Lankester welcomed the authorities' decision to resume cooperation with the Fund, at least to the extent that the Article IV consultation discussion--the first in three years--was taking place. He also welcomed Mr. Ferrari's statement that Peru would like to restore full relations, including the payment of arrears, with the Fund and with other creditors, although that was to some extent, qualified.

However, his own perception of recent policy developments in Peru was somewhat different from Mr. Ferrari's account, Mr. Lankester stated. He agreed with Mr. Ferrari's analysis of Peru's structural problems, which certainly were very severe. He recognized that Peru had been adversely affected by a serious deterioration in the terms of trade over the past few years. He also fully understood the political imperative which had led the Peruvian Government to try to obtain a sharply increased rate of growth for the economy. However, he felt that the economic policies used to try to achieve the objectives had been seriously misjudged.

It appeared that the authorities intended to adopt a more balanced and appropriate set of policies, Mr. Lankester observed. While the direction of the policies was welcome, a great deal remained to be done, in terms of both design and implementation, if Peru were to effectively address the problems that had appeared over the past few years.

At the end of 1984, there had been a substantial trade surplus and a relatively small current account deficit, Mr. Lankester went on. Arrears had been substantial but manageable, and the external position had been improving appreciably. While there had been a large fiscal deficit, that had been largely attributable to a high level of fixed investment and public sector savings had been marginally positive. The fiscal position had also been showing strong signs of improvement. Inflation had been over 100 percent, but had appeared to have stabilized, and growth had been recovering well after the 12 percent decline in GDP in 1983.

By contrast, in both 1986 and 1987, the trade balance had been negative, and there had been a current account deficit of more than 6 percent of GDP, with the external position expected to improve only very slowly, Mr. Lankester said. Arrears were at levels that would seriously impede any efforts by the authorities to normalize relations with their creditors. The fiscal deficit was still greater than it had been in 1984, with a very much lower level of public investment and strongly negative public savings. Despite a steep decline from mid-1985 to mid-1986, inflation was once again over 100 percent, and rising rapidly. Economic growth had accelerated strongly in 1986 and the first half of 1987, but that appeared to have been achieved by the stoking up of domestic demand at an unsustainable pace. The economy now appeared to have run into a road block of accelerating inflation and a greatly weakened external position. Economic growth appeared to have virtually halted.

Exchange rate policy had been such as to bring about a serious deterioration in Peru's competitiveness and a major misallocation of resources, Mr. Lankester indicated. Domestically, demand-management policies had been far too lax. Public sector revenues had been allowed to fall by almost half, relative to GDP, in the past two years, while current expenditure other than interest payments had risen slightly. Investment expenditure had been cut drastically, but not enough to prevent a rapid increase in the fiscal deficit. Combined with highly negative real interest rates, the result had been a very rapid rate of growth in the monetary aggregates, which created the upsurge in inflation witnessed recently.

Clearly, major revisions of economic policy would be required if Peru were to regain sustainable growth and a viable external position, Mr. Lankester stated. The authorities' preliminary steps toward a more appropriate policy stance--most notably, the exchange rate changes carried out in October--were very welcome, but there was more to be done. Not only was further exchange rate adjustment required, but also considerable strengthening of fiscal and monetary policies was necessary.

On the fiscal side, there was an urgent need for a restoration of revenue receipts, following the very sharp decline over the past two years, Mr. Lankester said. As a preliminary measure, it seemed appropriate to restore the indirect tax rates that had been cut in late 1985 and early 1986, and to restore the real value of public sector prices and tariffs. A shift from quantitative restrictions to import tariffs could also bring about a significant improvement in revenues, as well as some improvement in resource allocation. In the longer term, a broader reform of the tax system seemed highly desirable, in order to extend the tax base and to permit a reduction of taxes on foreign trade without undue pressure on the fiscal position. Restraint on current expenditure would also be necessary, and investment expenditures should be limited to a level compatible with a viable fiscal position.

On the monetary side, such a tightening of the fiscal stance would help, but it would need to be supplemented by a liberalization of the financial system, and in particular, a restoration of real interest rates to positive levels, Mr. Lankester continued. As well as helping control inflation, that would encourage a reduction in capital flight, which had been witnessed over the past few years.

Liberalization of wage and price controls was also needed to make resource allocation more efficient, Mr. Lankester remarked. Recent increases in real wage levels had compounded the deterioration of external competitiveness and the fiscal position, as well as contributing to the acceleration of inflation through cost-push pressures.

A program as outlined could help the authorities achieve a normalization of relations with their creditors, Mr. Lankester concluded. That would be no easy task, given the serious damage done to the authorities' credibility and creditworthiness over the past two years, but the longer it was delayed, the more difficult it would be. He therefore strongly urged the authorities to make every possible effort toward regularization of their relations with all creditors. That could be greatly helped if a Fund program could be put into place, giving creditors assurance that appropriate policy measures were in effect.

Mr. Prader made the following statement:

> Judging from the staff paper, it seems that the Peruvian authorities have acquired a more realistic view of their economic situation. Their agreement with the staff on the fact that Peru's present policies are not sustainable is a first step in

the right direction. We are also glad to learn that this reassessment of policies has led to plans for a series of more appropriate measures for addressing economic issues.

Although the scope of these new measures is not as broad as the staff suggests in its alternative medium-term scenario, the main point is really that the Fund and the authorities seem to be using convergent definitions of Peru's basic problems and priorities, with agreement on the need to reduce the public sector deficit, restore external competitiveness, and normalize financial relations with Peru's external creditors.

This first evidence of a return to economic realism and rapprochement with external creditors is all the more welcome because Peru's domestic and external economic positions, as well as its political situation, have deteriorated further in several respects.

The inflation rate for 1987 will reach almost 100 percent, the current account deficit has risen, and gross reserves have declined. The very rapid growth of real GDP in 1986 and 1987, fueled by strong domestic demand, was largely due to a boosting of private consumption by generous wage policies and increased public consumption. During the same period, investment was low and national savings lost a lot of ground. The central bank not only seems to have monetized a large part of the steep increase in the public sector deficit, but has also had to bear the high cost of multiple exchange rates.

The Fund has repeatedly regretted the policies introduced in mid-1985 to reactivate the domestic economy, because of their negative effect on domestic and external equilibrium. The economic history of Peru shows that these failed policies are but the latest in a series of futile attempts to solve Peru's social and economic problems. The failure of the 1985 policies is easy to illustrate. For example, even a real growth rate of 8.5 percent in 1986 only pushed GDP to 3.9 percent above that in 1982, while gross domestic investment lagged at only 65 percent of its 1982 level. I agree with Mrs. Filardo that 1985 may not be the appropriate reference base for judging the present policies; it would be wrong to assign all the blame for the present situation to the present Government. There has been a long history of experimentation by successive teams of authorities with various options, and the present reassessment seems to reflect the exhaustion of still another set of these. The policies pursued since 1985, based on negative real interest rates, multiple currency practices and trade restrictions, inflationary wage policies, monetization of the public sector deficit, and so on, have turned out to be just as inappropriate as those they replaced.

I therefore recommend comparison of the staff's two sets of medium-term projections with the outcome of the authorities' policies and with an alternative Fund adjustment policy. Such comparison shows that adjustment accompanied by restoration of normal relations with creditors presents much more attractive prospects in the long run than continuation of the present policies. The comparison also shows that allowing domestic politics to dictate a country's relations with its external creditors does not provide a good basis for adjustment with growth. Sound policies could produce future benefits which will far outweigh the short-term gains to be obtained by limiting debt service and running arrears with the Fund.

In sum, we applaud the recent indications from the Peruvian authorities that they are rethinking their policies and planning to implement comprehensive adjustment measures, particularly in the area of exchange rates; we would welcome more detailed information on the policy changes they envisage and would like more time to make a clearer judgment on those changes. Although we recognize how difficult it is politically for the authorities to eliminate Peru's arrears to the Fund now, we fear that further postponement of this step will only delay the country's adjustment efforts. In the end, clearing Peru's overdue obligations to the Fund is the only way to reassure creditors sufficiently to persuade them to support Peru's adjustment with adequate financing. This is the message of the Turkish proverb which says, "No matter how far you have walked along the path of loss, turning back is an immediate gain." Therefore, on overdues, we have to support the proposed decision.

Mr. McCormack made the following statement:

I am pleased to have this opportunity to discuss economic policy developments in Peru. Today's meeting is an important first step toward restoring normal relations between Peru and the Fund. Certainly, it has been our feeling all along that Peru's long-term economic interests would best be served by remaining within the international financial system, and I am pleased, therefore, that the authorities have begun to re-establish a more normal relationship with the Fund. I wish to join other speakers in welcoming Mr. Ferrari among us and I thank him for his informative introductory statement.

We can generally agree with the staff's analysis and policy prescriptions. When the authorities implemented their economic program in mid-1985, based upon stimulus of domestic demand with the accumulation of external payments arrears to pay for that demand stimulus, there was every prospect that this program would provide an incentive to short-term growth. However, over the medium term, a program that expanded demand much faster than output while simultaneously introducing large real wage increases and price inflexibility would eventually place considerable pressure on prices, the balance of payments, and ultimately would result in dislocation and slower economic growth.

This is indeed the emerging result in Peru; the economy is significantly off course. After an initial sharp burst of strong economic growth, a number of the expected constraints to continued expansion are now beginning to emerge. Inflation has rebounded; investment and growth have leveled off, or even declined; and reserves are now falling quickly, despite the continuing accumulation of external arrears. The recent commercial bank nationalization has probably eroded domestic investor confidence further, making a fall in real GDP in 1988 all the more likely if significant policy changes are made.

The authorities themselves are becoming increasingly aware of the limits of the present strategy. Their intention to take comprehensive measures to address the present circumstances is therefore welcome, and certainly necessary. Given the seriousness of the situation, we would hope to see a more precise delineation in the near future of specific measures designed to place the economy on a more sustainable path. I agree with the staff that priority will need to be given, first, to bringing the public sector deficit under control quickly; second, to restoring external competitiveness by unifying the exchange rate and allowing it to find a more competitive value; and, third, by acting to restore normal relations with the international financial community.

On specific policy actions, a sizable increase in fiscal revenues, in order to deal with the large and growing overall public sector deficit, would seem to be of paramount importance. As the staff suggests, new revenue measures, as well as improved tax administration, will be required if the revenue to GDP ratio is to be restored toward its 1985 level. Specific measures to achieve these objectives need to be spelled out as soon as possible. Expenditures will have to be restrained. Efforts to improve the adminstration of public enterprises, and to increase their prices, will be required in order to generate savings from the public enterprises. Strong fiscal action would reduce the need for domestic financing of the fiscal deficit, and thus help to reduce inflationary pressures within the Peruvian economy. A firmer linking of further wage increases to real increases in domestic output would also help to diminish domestic demand and inflationary pressures.

On the external side, the authorities recognize that a major improvement in competitiveness is needed to strengthen the trade balance and the overall balance of payments position. Peru maintains a complex system of multitiered exchange rates and exchange and trade restrictions. Not only do these introduce numerous economic distortions, but they have not prevented what has now become a steady decline in the level of international reserves. Achieving a major improvement in competitiveness through adjustment of the exchange rate would be the best means of improving the current account and preserving international resrves. This approach would also limit the need for controls and restrictions. We emphasize, however, that adjustments to the exchange rate should be "across the board"--preferably within the context of a single unified exchange rate--rather than concentrated on an "export" exchange rate, if maximum benefit is to be obtained. The nominal depreciation and partial rationalization of the multitier exchange system in late October is an encouraging start; further action by the authorities, however, is clearly warranted.

In view of the resurgence in inflation, control of the rate of credit expansion must be an important element in the adjustment program. Controlling the government deficit and thereby reducing the public sector borrowing requirement will be beneficial in this respect. Reducing central bank losses, in part by rationalizing the operation of the multiple exchange rate system, would also help in the control of credit. The staff report notes that subsidized credit programs for the private sector have contributed to rapid expansion of credit, and a review of these programs would also be useful. While noting the arguments of the Peruvian authorities, we remain concerned by the highly negative real interest rates that have developed. A more realistic financial policy would, in our view, ease inflationary pressures, help foster domestic savings with which to fund investment, and reduce the incentives for capital flight.

Restoration of normal relations with the international community is essential if Peru is to draw on external sources of finance, which it will require for strong economic growth over the longer term. The staff report says that no concrete indications were given to the mission regarding when and how the arrears to the Fund might be eliminated. This lack of a concrete action plan is a matter of concern, not only because of the impact on the Fund's finances, but, more importantly, because the continuing failure to deal with Fund arrears is bound to impair Peru's capacity to mobilize new sources of financing in support of its growth and adjustment efforts.

We urge the authorities to put together concrete measures for dealing with Peru's arrears to the Fund. This will facilitate the normalization of relations with other creditor groups, including commercial banks and the Paris Club. Early action to improve relations with all creditors would be a positive sign of the authorities' serious intent to deal with the economy's severe imbalances. In this vein, we welcome the initiative already taken by the authorities to meet with the World Bank and the Paris Club, and the efforts they are making to reorient their economic policies.

Mr. Grosche made the following statement:

I welcome both the presence of Mr. Ferrari, and the fact that the first Article IV consultation discussion after almost three years is taking place. This is an important step toward a normalization of Peru's relationship with the Fund, and I hope that the authorities will continue to discharge their responsibilities to the Fund as required by the Articles of Agreement, including the transmission of timely and complete information.

On economic policy, I have little to add to the staff appraisal and the staff's recommendations, which I fully support. Let me only offer a few observations.

In the recent past, the authorities have tried to push economic growth, particularly by boosting wages. They introduced restrictions on key economic variables and suspended market mechanisms. All this has led to a resurgence of inflation, growing internal and external imbalances, and an erosion of business confidence. In addition, the controversial move to nationalize the private financial sector has created considerable disturbance. It may still take some time, coupled with unrest, until a series of contradictory lower court decisions on the legality of this move has been sorted out by higher judiciary bodies.

I certainly appreciate the desire of the authorities for a redistribution of income in favor of the rural population and their efforts toward an improvement of the overall standard of living. As the staff's medium-term scenario demonstrates, however, without a comprehensive and consistent set of policies, the Peruvian economy will soon slide into a recession followed by stagnation of economic activity and high inflation. Such a development would not be conducive to attaining the socioeconomic objectives of the authorities.

I am pleased to note, therefore, that the authorities have indicated their intention to take measures to reverse recent trends. At the same time, however, I fear that the measures considered by the authorities are not sufficiently strong to restore sustainable economic growth and financial stability.

Recent developments show a clear need for comprehensive measures in key areas such as fiscal policy, public enterprises, and monetary policy. The staff has, I think, rightly identified the key problems. In this context, I find the staff's alternative medium-term scenario very helpful. Measures taken under this scenario would aim at reducing price controls and introducing more realistic exchange and interest rates, thus providing the incentives needed to increase resource mobilization. As Mr. Almeida already noted, the staff's alternative scenario concludes by stating that: "With the elimination of arrears and the rescheduling of debts, Peru is likely to obtain at least as much, and probably more foreign exchange resources than under the present policy of limiting debt service payments, especially over the medium term." This conclusion is very important, given the views expressed by the authorities in the past that they were unable to service their obligations because of the expected fall in reserves.

I urge the authorities to seriously consider the staff's policy recommendations when reassessing their policy. As noted earlier, I appreciate the intention of the authorities to direct their efforts primarily to the poorer population, but even taking into account the prevailing social tensions, I feel that there is more scope, and certainly an urgent need, for adjustment.

Finally, it is with disappointment that I note Peru's still outstanding obligations to the Fund and, in particular, Peru's obvious intention to delay payments to the Fund further. In the face of economic problems the authorities should clear these arrears as soon as possible in order to enable the Fund to assist Peru more actively in overcoming its huge difficulties.

I can support the draft decision on overdue obligations.

Mr. Templeman made the following statement:

We welcome the presence of Mr. Ferrari, as well as the opportunity to review developments in the Peruvian economy since our last Article IV consultation nearly three years ago, while continuing to regret that such a long delay has occurred.

Given the chronic economic problems that had been encountered prior to that time, it is not surprising that the new Government was tempted to pursue a new strategy. Nonetheless, an approach based on deliberately inflating domestic demand, while attempting to repress inflationary forces and to contain the impact on the balance of payments through direct controls, carried with it serious risks from the outset.

The Peruvian experience shows that where there is some underutilized capacity it may be possible, by stimulating domestic demand, to increase growth rates temporarily. But inflation and balance of payments problems are likely to follow rather quickly, if prudent financial policies are not followed, and direct controls cannot work over an extended period of time without creating serious distortions.

An examination of the savings and investment pattern in Peru since the adoption of the new strategy in 1985 is revealing. For example, between 1985 and 1987 the ratio of fixed capital formation to GDP has fallen by nearly 3 percentage points. At the same time, the national savings rate fell by nearly 9 percentage points, especially owing to a sharp reversal in public savings. Peru became increasingly dependent on foreign savings--to the extent of more than 6 percent of GDP--largely in the form of the accumulation of massive arrears. These developments do not bode well for sustainable economic growth in Peru.

The inflationary pressures which continue to plague the economy are partly the result of the growing public sector deficit. In large part, this reflects the collapse of the revenue ratio by nearly 11 percentage points, against a decline in the expenditure ratio of about 6 percentage points, with the latter being mainly a reflection of a sharp drop in public investment. In view of the weakening in the revenue base to only about 11 percent of GDP, the need for implementation of tax reform seems clear. On the expenditure side, a shift in the mix of expenditures, away from current spending toward development spending, seems to be the main requirement.

In the monetary area, the employment of direct credit controls, coupled with very negative real interest rates, has fostered excess demand for credit, created disincentives for financial savings, and led to distortions in credit allocation.

Peru has experienced a sharp worsening in its current account and overall balance of payments position over the past two years. A combination of strong domestic demand stimulus and a rapid appreciation of the real effective exchange rate of the inti between mid-1985 and mid-1987 must account in large part for this development. The external deficit could very well be higher, were it not for the wide array of trade and payments restrictions and the extremely complex multiple exchange rate system. Also, the staff's medium-term scenarios clearly suggest that the continuation of Peru's recent policy stance is likely to jeopardize not only the balance of payments outlook, but also economic growth. In contrast, a possible alternative scenario is presented by the staff for avoiding such an outcome.

The unilateral adoption of the limit on foreign debt service payments of 10 percent of export receipts has led to the accumulation of external arrears which are expected to exceed $7.6 billion at the end of this year, including arrears to the Fund of more than SDR 350 million. Nonetheless, debt payments last year of nearly $500 million were made, equal to about 15 percent of exports. While this policy has temporarily made it possible for Peru to run large external payments deficits, this approach cannot succeed in the long run if Peru hopes to re-establish normal trade and financial relations with the rest of the world. This conclusion seems now to have been accepted by the authorities, at least in principle. But actual regularization of Peru's relations with its creditors, and especially with the Fund, is at a very early stage. This situation cannot help but adversely affect Peru's relations with creditor countries across the board, including their policies relating to the Fund, the development banks, bilateral aid, and trade credit.

To turn specifically to the continued grave problem of Peru's arrears to the Fund, first, we should not let our satisfaction with the conclusion of the Article IV consultations blind us to the fact that nothing has been accomplished in reducing Peru's large and growing arrears to the Fund. No significant payments except net SDR charges have been received for nearly a year; Peru continues to discriminate against the Fund; and we are told in the staff report that "the normalization of financial relations with the Fund could only come at a later stage and would be politically difficult." Clearly this remains a very unsatisfactory situation. It undermines the financial position and credibility of the Fund and forces other members of this institution, many of them in a more difficult financial position than Peru, to bear the financial burden. For example, the cumulative cost of burden sharing to Argentina, Mexico, India, and Brazil is now in the range of SDR 2.5-3.5 million each, and the total cost to debtor members of the Fund as a group is now approaching SDR 30 million in the form of higher charges on their borrowing from the Fund.

Peru's continued discrimination against the Fund in its debt service payments and its failure to fulfill its financial obligations to the Fund raise serious questions about Peru's interest in maintaining its membership in the Fund. We urge the authorities in the strongest terms to begin to deal with the arrears problem by promptly making substantial payments to the Fund and by immediately devising a plan for completely regularizing its arrears with the Fund.

Finally, Mr. Ferrari has explained to us the steps being taken by Peru vis-à-vis the Fund, the World Bank, the Paris Club and the Advisory Committee of the banks to regularize Peru's relationship with its creditors. Therefore, we believe that the Board should return to a review of this case no later than three months from now. Also, I would suggest that the language of the proposed decision contain a specific request for a substantial repayment as soon as possible as concrete evidence of Peru's intent with regard to its financial obligations to the Fund.

Mr. Marcel made the following statement:

The Board has had no opportunity to review Peru's economic situation since 1984. The resumption of the consultation cycle with the Fund is one element that could point to a possible change in the authorities' stance toward the international financial community. Two other elements can be mentioned in this respect: first, the informal meeting held in Paris on November 16 between Mr. Saberbein, the Minister of Economy and Finance of France, and Peru's major creditor countries; and second, the renewed contacts between the Peruvian authorities and the World Bank.

These signs are encouraging, but at the same time one must bear in mind that a complete normalization of financial relations with creditors can only be worked out in the context of a Fund-supported adjustment program. The accumulation of important external arrears and the recent deterioration of economic conditions, as described in the staff documents, are likely to complicate the reaching of an agreement among all the parties concerned. Nevertheless, the three-year economic plan, unveiled recently by the authorities, can be seen as a workable starting point for this necessary, lengthy, and difficult normalization process.

Regarding the economic policy followed since 1985, despite some positive results recorded last year, the most recent developments are cause for concern. For some time, at least, the reflationary policy carried out by the authorities yielded several favorable results. The growth rate reached 8.5 percent last year against a contraction of 12 percent in 1983. Strict price control combined with a lowering of public tariffs resulted in a significant, though artificial, dampening of inflationary pressures. Even the substantial pay raise has some beneficial impact on the buildup of private savings.

Nonetheless, as one may have anticipated, the reflation is now clearly petering out, while at the same time some worrying developments are emerging. The renewed inflationary pressures, the worsening of the current account, and the continuing rundown of international reserves are very telling factors in this respect. In addition, the vulnerability of the recovery is further enhanced by the growing isolation of Peru vis-à-vis most of its creditors. Such a situation is becoming less and less sustainable.

It is against this background that the three-year economic plan, recently announced by the authorities, must be examined. Two primary objectives are easily identifiable: first, the restoration of the payment capacity of the country; and second, the correction of the external imbalance. The thrust of the new policy is to keep the economic momentum through investment spending, in order to enlarge the production base which has been gradually used up in 1986 and 1987.

In this perspective, some of the commitments made by the authorities seem to be in line with several recommendations expressed in the staff report.

The contraction of the fiscal deficit to less than 4 percent of GDP by 1990 is to be achieved through a significant revamping of the tax collection system, with the assistance of the World Bank. However, up to now, no official announcement has been made, either on substantial revenue enhancement measures, or on the introduction of new taxes, not to mention the reduction of current public expenditures. Without any such supporting measures, one may fear slippages in the attainment of this objective.

The projected restructuring of the parastatal sector also appears to be in conformity with the goal of strengthening the productive capacity of the country. Likewise, the simplification of the exchange rate regime and the reform of the financial sector are in the right direction. However, at this stage, we would appreciate more detailed information on these measures. In addition, it would also be advisable for the authorities to clarify their intentions on some other crucial elements of their economic policy, such as their willingness to open up the economy, the progress that could be made toward a more market regulated economy, and the adoption of a more stringent credit policy. This information may give support to the impression that, as it stands, the plan announced by the authorities is still too broadly designed and needs to be further elaborated. For their part, my authorities are looking forward to considering a more precise, complete, and credible program of action. They are fully aware that the efforts needed are very demanding and they are prepared to support Peru in its courageous undertakings.

Mr. Sengupta made the following statement:

We welcome the presence of Mr. Ferrari, and his statement that Peru is willing to resume financial relations with the Fund and payments in a significant way in 1988, though these payments are to depend on the developments in the economic program.

The present consideration of the 1987 Article IV consultation report on Peru is a positive step toward the re-establishment of normal relations between the Fund and the authorities of Peru. The on-time settlement of net SDR charges is yet another indication of the authorities' preparedness to open the channels of communication with the Fund.

On reading the staff reports, and in particular, the staff appraisal, it becomes clear that the authorities recognize the need to take comprehensive measures to reverse the recent economic trends in the country. They have placed utmost importance on the achievement of a reduction in the public sector deficit, the restoration of external competitiveness, and the improvement of relations with the international community. The main planks of the strategy for policy correction are: raising government revenues through improvement of tax administration and broadening of the tax base; adopting a monetary and credit policy package that would result in a major reduction in inflation; and exchange rate action.

The staff seems to agree that policy corrections are being made, but suggest that further actions are needed in terms of both magnitude and character. One can see some differences in perceptions between the staff and the authorities.

First, in the fiscal area, it is clear that government expenditures have not risen in real terms since 1985, and the scope for any reduction here seems to be limited. In fact, there is a need for raising real public investment, which has declined since 1985. An important component of current expenditure is the wage bill. The increases in real wages effected since 1985, however, have not improved the living standards of public sector employees to any significant extent. These increases did not offset the erosion in real wages that took place in earlier years. This is also true for the private sector, where the real wage index in Lima at 87.9 in 1986 (1979=100) was lower than in 1983. The authorities seem to be generally committed to maintaining real wages as a central element in their incomes policy, and in the context of a continued rate of growth of economic activity. We accept the authorities' viewpoint. We note the staff's point that maintenance of real wages could well strengthen inflationary pressures, especially if wages form a dominant proportion of total costs. But we have not seen any concrete evidence in the staff reports to show that inflation in Peru is rooted in a wage-price spiral. We do not feel that wage policy has to be adjusted, even to restrict current fiscal expenditures. The data for 1987 show that current expenditures other than interest payments would show a decline from the previous year in terms of their share in GNP.

With regard to revenue-raising measures, I agree with the staff that in addition to tightening tax administration, specific tax measures are required. I have noted the staff's suggestions for increasing VAT rates and taxes on gasoline and other oil products. I hope these measures would not contribute to a price increase, even if it is on a one-shot basis.

On monetary and credit policies, the view was expressed by the authorities, according to the staff report, that in the past, "tightening of liquidity had had a disproportionate effect on activity without securing the desired deceleration of prices." We would have liked a more in-depth examination of this matter by the staff. The authorities are placing emphasis on directing available credit to priority sectors by special rediscounts and portfolio requirements as instruments of policy, thereby promoting credit flows into highly productive areas. In the authorities' view, a policy package that reduced inflation would be a more effective way to promote savings than merely increasing nominal interest rates. Given the large rise in real domestic private investment expenditures--18.2 percent in 1986, compared with declines in the previous four years--monetary and credit policies do not seem to be having an undesirable effect. The staff may care to reflect on this issue.

As for exchange rate policy, the measures taken in July and October seem to have lowered to 40 percent the cumulative appreciation of 60 percent that took place from August 1985 to July 1987. The intention to take further action to improve export competitiveness is welcome, but it should be ensured that depreciations do not fuel inflationary expectations.

The normalization of relations with foreign creditors is important to ensure larger inflows of foreign savings, which are crucial at this juncture, in view of the rapid decline in reserves in recent months. It is in this context that we can support the proposed draft decision on overdue financial obligations.

Mr. Zecchini made the following statement:

Economic prospects in Peru are rather bleak, as some positive developments of the past two years appear to be unsustainable without a major reorientation of macroeconomic policies. The sharp change in the orientation of economic policies in 1985 provided vigorous stimulus to GDP growth, but at the same time caused large imbalances in the external accounts, a resurgence of inflationary pressures, a drying up of savings, and shortages due to domestic supply bottlenecks.

The staff report is quite detailed in describing the causes and the consequences of the recent overheating of the economy, but is not exhaustive in specifying a set of recommendations to the authorities for policy changes. The 5 pages in the staff report--out of 27--devoted to the analysis of policy discussions and recommendations contain overly general indications about the necessary course of action. In particular, they do not give a full account of the quantitative scenario that might emerge in the coming years as a result of present economic trends and policies. In the case of Peru, which is a major debtor of the Fund, we would have expected a much stronger emphasis on specific policy advice to the authorities to assure the repayment of the overdue financial obligations in the near future. The Article IV consultation offers a unique opportunity to develop a discussion of policy corrections and to bring to bear the force of sound economic arguments in making lasting improvements in economic conditions.

Turning to specific issues, we agree with the staff that the adjustment of fiscal imbalances should be at the forefront of any policy adjustment. In the absence of a determined anti-inflationary strategy, the current policy of low interest rates can be sustained in the long run only if the pressure of the public sector borrowing requirement on the expansion of monetary aggregates is going to ease. The government strategy of fiscal adjustment does not seem very convincing, as its design is still at the stage of "intention" or "exploration." More emphasis on strengthening revenue sources is advisable. In the present circumstances, a reversal of the recent policy of lowering the ratio of tax revenue to GDP could help to ease the present pressures on domestic demand. It is also essential that any increase in revenue not support additional current expenditures but be devoted to restoring some investment projects and to raising public savings. However, progress on this front could depend on the feasibility of a broadening of the tax base and of an improvement in tax administration. On these two points the staff could provide an assessment of the actual scope for action.

Still on the fiscal front, the intention of the authorities to implement a policy of privatization of some public enterprises seems at odds with the recently announced nationalization of private banks. As confidence in government policy intentions has been eroding continuously, we wonder how the authorities intend to attract private capital to carry out the privatization plan. In this respect, we also wonder whether the Government is envisaging a recapitalization of such enterprises before selling them and if so how it intends to finance it.

Referring to monetary policies, the effectiveness of Peru's monetary management is limited by the magnitude of fiscal imbalances and by the policy of low interest rates. Moreover, the monetary stance does not appear adequate in the face of rising inflationary expectations, which are reinforced by doubts about the present economic management. Since a strong anti-inflationary strategy is lacking, the current accommodating stance of monetary policies may lead to an erosion of external competitiveness and to a lack of incentives for savings as real interest rates might continue to be negative. Under these circumstances a tighter control of credit expansion and a policy of positive real interest rates along the lines suggested by the staff is the only viable course of action. Furthermore, some depreciation of the inti seems necessary to restore some degree of external competitiveness.

Turning to external policies, the widespread system of quantitative control on external transactions together with the multiple exchange rate system tends to generate inefficiencies in resource allocation. The authorities should therefore dismantle these controls and pursue appropriate demand management which would minimize the consequences of such a dismantling on the external accounts. In this process of reaching macroeconomic consistency, exchange rate policy should be cautious, as excessive devaluation without supportive domestic credit policies will tend to be inflationary.

We agree with the analysis of structural weaknesses made by the Peruvian representative, and we know that Peru has suffered a sharp deterioration of the terms of trade. But in this light current economic developments and policies in Peru appear disappointing. The lack of a sustainable strategy does not enable the country to redress its imbalances and achieve sustainable economic growth. The Peruvian authorities should promptly reconsider their policies from a longer-term perspective. At the same time, they should pay more attention to the negative consequences that their overdue obligations to the Fund are having on other debtor countries. It is on this basis that a new phase of constructive and fruitful economic and financial cooperation between Peru and this institution can be started. Also, in this light we are in favor of Mr. Templeman's proposal to hold the next review in three months.

Mr. Sugita made the following statement:

I welcome the completion of the Article IV consultation with Peru, which indicates the preparedness of the authorities to maintain a minimally cooperative relationship with the Fund. Mr. Ferrari's presence and his opening statement confirm this point. I strongly hope that the authorities will intensify their efforts to normalize their relationship with the Fund by an early elimination of arrears to the Fund.

The staff report presents a dismal picture of the present economic situation in Peru. The policy of aiming at high economic growth by restricting external debt servicing resulted in high inflation as well as a further deterioration in the balance of payments. Price control and restrictive exchange and trade policies created widespread distortions and dislocations in the economy. A reduction in the savings ratio, which was brought about by a large fiscal deficit, artificially low interest rates, and unrealistic exchange rates, led to a significant decline in fixed capital investment, resulting in serious implications for future economic growth. Moreover, a continuation of restrictions on foreign debt servicing could affect the future ability of Peru to obtain external financing, which is essential for long-term economic development.

Implications of the present policies are spelled out in a gloomy medium-term scenario, which illustrates clearly the urgency of adopting and implementing a comprehensive adjustment policy. Such a policy has to include realistic exchange and interest rate policies, tax reform, strengthening of tax administration, expenditure control, monetary tightening, appropriate wage policy, and trade and exchange liberalization. In this connection, I note the authorities' awareness of the need for policy reorientation, but the reorientation would have to be much wider and stronger than that which the authorities are contemplating. I therefore fully associate myself with the analysis and recommendations of the staff.

In addition to the adoption of more orthodox policies on the domestic front, there is a strong need to normalize the relationship with external creditors. As indicated by Mr. Ferrari's statement, the authorities are apparently moving in that direction. Nevertheless, I have to urge the authorities to take swift and positive action to eliminate arrears, given that their arrears are inflicting harm on the cooperative character of the Fund and that the costs to the Fund are borne by the rest of the members.

I can support the proposed decisions with the amendment proposed by Mr. Templeman.

Mr. Hogeweg made the following statement:

It is now almost three years since we last discussed Peru in the Board in the context of an Article IV consultation. Unfortunately, during that period Peru has been on the agenda many times with respect to its arrears. The presence of Mr. Ferrari, and the fact that we can conclude the Article IV consultation, are indeed a most welcome first step in the long and difficult road that lies ahead.

The staff has provided us with excellent papers which give a clear description of the economy and its policies. From the report it is clear that the situation has deteriorated significantly in the past two years. The new Government that came to power in mid-1985 had the advantage of having the public's confidence. Unfortunately, the authorities then opted to embark on an adjustment program which, in terms of the Board discussion the other day on that subject, may be classified as adding heterodox elements to an orthodox policy stance, a stance that was the reverse of what was needed. In this way the authorities chose a set of policies which could at best bring an initial success. Peru is now facing high inflation, growing arrears, declining reserves, and huge underemployment. The staff's medium-term scenario shows an unsustainable situation, unless a drastic adjustment takes place.

The staff mentions that the authorities are well aware of the need for policy changes, but its recommendations rightly go much further. I agree completely with all the staff's recommendations and believe that the authorities should be urged to embark on a very comprehensive adjustment program, which should include a sharp reduction of the fiscal deficit with special emphasis being given to the revenue side. An improvement in tax administration and broadening of the tax base are both indispensable. In this connection, I note that the staff did not mention the underground economy in Peru, which probably is very large. It would be interesting to have the staff's assessment as to what extent this phenomenon has widened and how it is affecting the economic crisis.

While it seems that the authorities are in broad agreement with the staff on the fiscal side, on other isues, such as monetary and exchange rate policies, they clearly have different opinions. I can only reiterate what the staff has clearly emphasized. Monetary policy should be restrictive with positive real interest rates, preferably unregulated. Also, the importance of a unification of the exchange rate system at a realistic level, which would eliminate the heavy operational losses of the Central Bank, cannot be overemphasized.

The experience so far in Peru illustrates that price controls, a multiple exchange rate system, and a nationalized financial system cannot be substitutes for market mechanisms. Despite the fact that social, political, and security problems are enormously difficult, orthodox measures clearly are of paramount importance to restore normal relations with creditors, clear the arrears with the Fund, and achieve sustainable growth.

I would be interested to hear the staff's views as to the contribution, if any, that heterodox measures could make in Peru's case--of course, as a supplement to correctly tight orthodox policies. Could they still play a useful role given their apparent failure in the recent past or would they even be necessary to facilitate the correct orthodox policy stance?

Finally, two short remarks directed to the staff. The first concerns the GDP figures and the ratios based on these figures. It is well known and also emphasized by the staff that the exchange rate is clearly overvalued. In these circumstances, I wonder whether it is justifiable to use that rate to calculate GDP figures in terms of U.S. dollars. According to Table 2 in the staff report, GDP in U.S. dollars increased since 1985 by 73 percent and Table 6 shows a decline of the debt/GDP ratio from 100 percent in 1985 to 66 percent in 1987. It seems to me that this gives a misleading picture.

My second remark concerns the medium-term scenario. A table on the adjustment scenario which was mentioned in the text would have been welcome. I have the feeling that the sensitivity tests would be even more useful when applied to a scenario which is not evidently unsustainable in any case.

Let me sum up by reiterating that I welcome the Article IV consultation report, which gives a clear view of what went wrong and what is needed. I urge the authorities to move in a direction that can open the way to the elimination of arrears, allowing the Fund to play a greater and very much needed role. In the meantime, I support the draft decision on the further review following declaration of ineligibility. But as a follow-up to today's conclusion of the long-delayed Article IV consultation, I support a review after three months, rather than six, as suggested by Mr. Templeman.

Mr. Al-Assaf made the following statement:

Let me first welcome the presence of Mr. Ferrari on the occasion of the discussion of Peru's Article IV consultation. I am also pleased to hear, in the last part of his statement, that Peru intends to start normalizing its relations with the Fund in 1988. However, the fact that he made this normalization conditional on positive developments in the economy introduces uncertainty to the prospect of this intention being realized.

Several times, during our reviews of Peru's overdue obligations, this chair has presented the argument that Peru was not cooperating to the extent expected from a member in finding a solution to its payments arrears. We also urged that Peru was doing a disservice not only to itself but also to the borrowing members of the Fund, which are bearing the higher cost of the charges left unpaid. This point was well illustrated by Mr. Templeman; the staff report also makes it very clear.

To a large extent, I found that this frank and comprehensive report was, in essence, arguing our case. First, it shows that the emergence of arrears with the Fund in 1985 was the result of a deliberate policy choice rather than the consequence of a fundamental inability to repay. Indeed, during that period, net international reserves increased significantly and reached a comfortable level. Second, the deterioration in the overall economic situation of Peru is largely attributable to the policies of the authorities themselves. In addition, the report provides little encouragement on a possible improvement in Peru's ability to meet its external obligations. Export values appear very unlikely to increase as long as the exchange rate remains at its present level. The excess absorption resulting from the budget deficit will likely continue as long as the authorities are unprepared to implement the necessary measures on the revenue side as well as the expenditure side. Finally, monetary policy can only be described as accommodating.

The conclusion I draw from this consultation is that the best the Fund can hope for at this stage is that the authorities will eventually recognize that the interests of Peru are best served by a cooperative attitude. In this respect, I hope that the presence of Mr. Ferrari is part of this recognition.

As far as the Fund is concerned, I would like to make one suggestion: in view of the present orientation of the authorities' policies, as outlined by Mr. Ferrari, it might be useful to review the economic developments in Peru prior to the date of the next Article IV consultation, perhaps on the occasion of the next review of Peru's overdue obligations. Here, I can go along with the amendment presented by Mr. Templeman, concerning the review of overdue payments.

In addition, I think that the alternative medium-term balance of payments scenario prepared by the staff and mentioned by several previous speakers, which seems to present a much better alternative for Peru and the international community than the one presented in Tables 8 and 9 of the staff report, could serve a useful purpose. I would like, therefore, to request that it be circulated to the Board in an appropriate format.

Mr. Rye made the following statement:

The fact that the Peruvian authorities, after nearly three years, have finally agreed to completion of an Article IV consultation is most welcome, as is the presence of Mr. Ferrari.

The staff report confirms that Peru is mired in massive economic problems. The authorities' strategy, which has placed the emphasis on short-term growth, has run out of steam and has failed to lay the basis for any sustained improvement in Peru's economic performance. However, since I agree with the broad thrust of the report, and also with the comments of earlier Directors, particularly those of Mr. Lankester, Mr. McCormack, and Mr. Grosche, I can confine my remarks to three brief points.

First, I would emphasize the need for the authorities to adopt a comprehensive program of economic reform. So pervasive are Peru's economic problems that a piecemeal approach, however well intentioned and desirable the individual measures in themselves, is likely to prove futile.

Second, it would be hard to overemphasize the importance of moving quickly to re-establish interest rates at market levels. Sharply negative real interest rates have clearly been instrumental in reducing savings, and in encouraging excessive consumption and an unsustainable level of imports, and have no doubt also contributed to capital flight.

Third, I would suggest that the process of putting Peru's economy on a sound footing is bound to be a difficult and protracted one. I wonder whether the staff's alternative scenario, which of course is not spelled out for us in detail, is overly optimistic in its assessment of the potential pace and strength of improvement. A particular point is that so much damage has been done to relations with foreign creditors that their restoration will take much time and effort all round.

Finally, on arrears, the statement by Mr. Ferrari that Peru is willing to resume in 1988 full financial relations with the Fund is of some small comfort, modified as it is by his caveat that this can only occur "if economic developments allow." I would strongly suggest to the Peruvian authorities that a pledge of this intention, in the form of a significant early payment in respect of overdue repurchases and charges in the General Resources Account, would be enormously helpful in restoring a more normal relationship with this institution. With this in mind, I think the draft decision is too low key, and I would support Mr. Templeman's proposed amendments.

Mr. Fogelholm made the following statement:

The Nordic chair welcomes this long overdue Article IV consultation with Peru, which we have--on earlier occasions--regarded as the first necessary step toward normalizing Peru's relations with the Fund. There is no doubt in my mind--having read the staff report--that Peru would stand to gain considerably from such normalization.

I do appreciate the social concern which has guided economic policymaking during the last couple of years. It would seem, however, that the Government was ill advised to basically use a "quick fix"--primarily through boosting domestic demand--rather than assuming the more cumbersome and slower adjustment path to sustained growth and a viable external situation. The authorities have had to realize that the same rocky road that they tried to avoid is now in front of them. Thus, we welcome the reorientation of Peru's economic policies, as expressed by Mr. Ferrari.

Like other Directors, we do, however, feel that more action than that which is presently anticipated would be needed, in particular in the fiscal area. As others have elaborated in great detail on these policies, I will refrain from doing so. The restoration of international competitiveness through adjustment of the exchange rate would also seem to be necessary. We do hope that the authorities take serious account of the advice offered by the staff, to which we, by and large, can subscribe.

This being said, I must once again voice our strong disapproval of the unilateral way in which Peru has been and is still conducting, in particular, its debt policies. The ongoing discrimination against preferred creditors--the Fund and lately also the World Bank--is especially worrisome, and according to the staff report, Peru intends to continue this policy. We hope that Peru will soon realize the unsustainability of such behavior.

As I said at the outset, the finalization of this Article IV consultation is to be considered only a first step. Concrete actions are now expected from Peru, to which a swift and determined normalization of its relations with international creditors is crucial. This is also very much in Peru's own interest as it would, inter alia, positively affect investor confidence. Regarding Peru's relations with the Fund, the next and minimum requirement for a steady improvement in this relationship is that the country commence settlement of its arrears to the Fund. To this effect, Mr. Ferrari's statement is encouraging. I would, nevertheless, like to support reconsideration of overdue payments after three months and I can also support Mr. Templeman's proposal for amending the draft decision.

The Deputy Director of the Western Hemisphere Department said that, in suggesting that under the alternative balance of payments scenario Peru would have more foreign exchange resources than under the base scenario, the staff had had in mind a process that would occur over time; obviously, the speed of that process was uncertain. The statement was based on differences in the policy assumptions underlying the two balance of payments scenarios, particularly exchange rate policy. With a more active exchange rate policy, in the alternative scenario exports would be more dynamic and would result in additional foreign exchange which could then be used to finance a higher level of imports, consistent with higher growth.

The staff could make information on financing arrangements available to Directors, if they considered it useful, the Deputy Director indicated. The assumptions made by the staff in that respect seemed reasonable, including a rescheduling of principal with bilateral creditors on normal Paris Club terms, a restoration of credit lines from commercial banks, and additional resources from multilateral agencies. The growth performance in the two scenarios differed because the alternative scenario included a higher savings effort on the part of the public sector, with more investment, and accordingly higher growth. Additional gains would be achieved if market mechanisms were permitted to work more freely; no effort had been made to quantify that element in the alternative scenario, but it also would contribute to an improved outcome.

Private investment appeared to have been sustained in 1986, but its composition had changed, with a large increase in house building, the Deputy Director continued. Investment in plant and equipment in the private sector had not been very strong, which helped explain the growing capacity constraints experienced in a number of industries.

There had been a reduction in public sector investment, due partly to the reduced availability of resources from multilateral agencies like the World Bank and the Inter-American Development Bank, the Deputy Director said. It was not clear whether that reduction was also due to some policy intention on the part of the authorities; perhaps the Peruvian representative could answer that question.

There was general agreement that the recent rapid increase in demand reflected monetary, credit, and fiscal policy, the Deputy Director commented. However, another cause of the increased demand was the authorities' wage policy. In that sense, the inflationary pressures now appearing reflected the fact that capacity constraints had been reached, putting pressure on prices. Also, the movement in real wages in the past two years had largely been a mirror image of the real appreciation of the inti. If exchange rate policy had to be adjusted, there would likely be implications for real wages; while real wages were admittedly not the only element of income, and there could be other areas which might absorb part of the adjustment, it was unlikely that exchange rate adjustment could occur without some implication for real wages.

The tightened credit allocation rules would not necessarily have an undesirable effect on the level of private investment, particularly in the short term, the Deputy Director said. Rather, the problem was that the tightening of credit allocation rules might over time direct investments to areas that did not have the highest rates of return.

The existence of an underground economy was not a new phenomenon in Peru, although it might have intensified recently with the increase of government controls on the activities of the private sector, the Deputy Director indicated.

The lack of precision in the staff analysis and recommendations referred to by one Director was a reflection of the nature of the discussions that had taken place between the authorities and the staff, the Deputy Director of the Western Hemisphere Department concluded. The staff was ready to continue the dialogue, and as it gained better understanding of the authorities' policies it would be able to provide more precise information and to focus its recommendations.

Mr. Ferrari said that the Directors' comments had made him aware of the need for a greater flow of information on developments in the Peruvian economy to the Fund. That lack of information explained some inaccurate comments he had heard, particularly on the economic results of the last several years. Peru's growth rates had been impressively high and inflation, although growing in the second year of the new administration, was still at a lower rate than in previous years under the preceding administration. Employment had grown impressively, and even investment had grown rapidly over the past two years--22 percent in 1986, compared with a negative growth rate in the previous five years.

Problems in the fiscal area were essentially the consequence of the reform, begun in 1985 and not yet concluded, Mr. Ferrari added. The reform was connected with the reduction of indirect tax rates and was not accompanied substantially by any increase in direct tax rates. When that process was completed, the authorities would be able to resolve Peru's fiscal problems, which were not strictly related to the growth of the economy, but rather a response to the economy's structure. Whenever the economy of the country grew, imports increased more rapidly than exports; therefore, one of the policies established in 1985 was aimed at improving the external sector.

Economic policy naturally had to be fitted to the actual circumstances of the economy, and be adjusted as the economic situation changed, Mr. Ferrari went on. For example, the authorities had previously followed a policy based on increased demand, because they were facing a poverty-ridden population, as well as problems of violence, which required rapid, meaningful solutions that could only be brought about on the basis of massive growth in employment and in per capita income. Also, in order to compete internationally, a country had to aim at domestic growth and seek out areas in which competition was not so great. Until July 1985, Peru's economy had been paralyzed. Its industry was not working, and the new administration had to effect a recovery before it could enter the international market with any strength. That was why the authorities were now changing their emphasis from domestic to external demand.

The Chairman made the following summing up:

> Executive Directors welcomed the completion of the discussion for the 1987 Article IV consultation after a long interval, and the presence of the Peruvian representative, Mr. Ferrari, for that purpose. Directors expressed the expectation that future consultations would be held on schedule. While the consultation represented an important step in the restoration of relations between Peru and the Fund, Directors regretted the continuing increase in Peru's overdue financial obligations to the Fund. The lack of any significant payment by Peru to the

Fund's General Resources Account in over a year was a matter of serious concern, and Directors therefore welcomed the indication that the Peruvian authorities intended to resume in 1988 the discharge of financial obligations to the Fund, depending upon the development of the economic program. Directors also welcomed the intention of Peru to strengthen its cooperation with the Fund and took note of the authorities' desire to normalize Peru's relations with its external creditors. They urged that intentions be translated into prompt action to deal with Peru's external arrears, including swift and full payment of overdue obligations to the Fund. Delay in normalizing relations with the Fund would make it difficult for other creditors to support Peru.

Directors were in basic agreement with the staff's appraisal contained in the report for the 1987 Article IV consultation with Peru. The policies pursued in the past two years initially had produced a significant recovery in real GDP, capacity utilization, and employment, and a marked reduction in the rate of price increase. Subsequently, however, those policies, compounded by structural problems and deteriorating terms of trade, had led to widening fiscal and external current account deficits, growing inflationary pressures, substantial losses in international reserves, and large and rapidly rising external arrears. The recognition by the Peruvian authorities that those policies were unsustainable was encouraging. Directors welcomed the indications given by the representative of the Government that a new direction of policies was being elaborated, but they were not convinced that these measures would be strong enough to deal with the major imbalances in the economy. Therefore, they urged Peru to develop promptly a comprehensive adjustment program, tailored to its circumstances, designed to reverse the major declines in domestic investment and savings in recent years, to restore the basis for sustainable growth and balance of payments viability, and to permit a normalization of Peru's relations with its international creditors. The Fund stood ready to assist Peru in the elaboration and implementation of such an economic program.

Directors stressed the need to move decisively to reduce the deficit of the nonfinancial public sector, which had widened since 1985 because of the erosion of the tax base and a weakening of the finances of the public enterprises and despite major cutbacks in public investment outlays. Achieving the authorities' goal of restoring the revenue/GDP ratio to its 1985 level would require specific tax-raising measures and elimination of many tax exonerations, together with improvements in tax administration. Thus, a broad-based tax reform would be required, in the view of Directors. In addition, current expenditure would need to be restrained resolutely to provide room for a more adequate level of public investment. Substantial price adjustments and cost-cutting measures were also needed to improve the savings performance of the public enterprises.

Directors emphasized that, besides reducing the fiscal deficit, it would be important to eliminate central bank losses resulting from the operation of the multiple exchange rate system and from subsidized credit programs, in order to reduce price and balance of payments pressures. In addition to the pursuit of a tight monetary policy, Directors urged the authorities to aim at ensuring that interest rates were positive in real terms with a view to stimulating domestic financial savings and reducing the incentive for capital outflows.

Directors observed that the stagnation of exports was a major cause of balance of payments weakness and of the poor performance of the economy over the longer term. The restoration of conditions for export expansion and sustainable output growth would require the establishment of an appropriate structure of relative prices. Directors therefore urged the authorities to make further exchange rate adjustments so as to provide the basis for the resumption of export growth and efficient import substitution. In this context, they encouraged the authorities to move quickly to a unified flexible exchange rate system as an effective way of maintaining external competitiveness and at the same time reducing the operating losses of the Central Reserve Bank. Directors noted that a liberalization of Peru's highly complex system of multiple currency practices and exchange restrictions, together with reform of the trade system relying on import tariffs rather than quantitative restrictions, would help improve resource allocation. Wage restraint also would be necessary to strengthen competitiveness and curb inflation. More generally, Directors were of the view that economic efficiency and sustained economic growth would be enhanced by greater reliance on market mechanisms.

It is expected that the next Article IV consultation with Peru will be held on the standard 12-month cycle.

Mr. Templeman suggested that given the welcome attempts by the authorities to re-establish relationships with creditors--for example, an informal meeting with the Paris Club and an upcoming meeting with the commercial banks--it would be regrettable to wait six months to review Peru's overdue financial obligations; a three-month review would be preferable. He also proposed that the decision on Peru's overdue financial obligations contain a statement encouraging the authorities to make a substantial and prompt payment as concrete evidence of their new position toward the Fund.

Mr. Ferrari said that Peru was ready to fulfill its obligations to the Fund, depending on its economic situation. Therefore, the six-month period initially proposed by the Fund would be more appropriate, since at that time developments in the economy would be clearer; assuming they were positive, initial steps could then be taken.

The Chairman proposed a compromise of a review after four months.

Mr. Zecchini said that, in reference to Mr. Templeman's proposed amendment, the Board should not convey the impression that it was permitting a rescheduling of Peru's remaining obligations to the Fund on the basis of a significant payment by the authorities. He proposed an addition to paragraph 2 of the decision reading: "...and again urges Peru to take significant steps to make full and prompt settlement of those obligations."

Mr. Grosche supported Mr. Zecchini's point, he felt that the language in the decision, urging the authorities to make full and prompt settlement of all overdue obligations, was fully appropriate.

The Chairman suggested that he could contact the Peruvian authorities to convey to them the thrust of the Board's discussion and to try to develop with them significant measures which could be taken in order to improve and normalize relations between Peru and the Fund. The decision would then be amended to refer to a four-month rather than a three-month review period, with the rest of the wording remaining as originally proposed.

The Executive Board then took the following decision:

1. The Fund has reviewed further the matter of Peru's continuing failure to fulfill its financial obligations to the Fund in the General Resources Account.

2. The Fund notes with satisfaction the completion of the 1987 Article IV consultation discussions with Peru. However, the Fund deeply regrets the continuing failure by Peru to fulfill its financial obligations to the Fund in the General Resources Account, and again urges Peru to make full and prompt settlement of those obligations.

3. The Fund encourages Peru to adopt the comprehensive economic adjustment program that is required in Peru's circumstances.

4. The Fund will review the matter of Peru's overdue financial obligations to the Fund again not later than four months from the date of this decision.

Decision No. 8737-(87/161), adopted
November 25, 1987

3. EDUCATION ALLOWANCE - REVIEW

The Executive Directors considered a memorandum from the Chairman of the Committee on Administrative Policies containing recommendations for the annual adjustment of education allowances (EBAP/87/239, 10/30/87; and Sup. 1, 11/4/87).

Mr. Dallara made the following statement:

> We have brought this matter to the Board today not because of a particular concern related to the proposed adjustment in the education allowance for this year, but because of a broader concern with respect to the way in which the Fund's education allowance policy has actually been implemented. We have described our concerns in detail at various meetings of the Committee on Administrative Policies, but since many members of the Board are not members of that Committee I would like to take just a few minutes to touch upon these concerns.
>
> First, let me acknowledge that the Committee on Administrative Policies has taken a number of steps to address the concerns which we have articulated. In particular, the Committee recommended last year that staff members applying for an education allowance sign a statement to the effect that the study supported by the Fund will take place in an institution which will facilitate their child's eventual return to the home country, and this procedure is now being followed. In addition, the Committee recommended and the Board agreed that a re-examination should be undertaken of education allowances with respect to children studying at universities and other tertiary educational institutions in a third country. This re-examination, however, did not result in any change in the policy or its implementation, at least not at the Committee level. Consequently, we have been unable to support the proposed increase in the ceilings recommended by the Committee.
>
> Before elaborating upon our concerns, let me also recall the purpose of the education allowance as set forth in the Fund's General Administrative Order No. 21. This order states that the purpose of the allowance is to assist expatriate staff members "in educating their dependent children in the home country or in a manner intended to facilitate their eventual return to their home country." With this purpose in mind, we do not in any way question the need for an education allowance, and we fully support continuation of such a benefit as an important part of our expatriate benefit package.
>
> My authorities have had serious doubts, however, that education allowances are being provided in a manner fully consistent with the stated purpose. There are a number of features of the education allowance and its application, as they have evolved

over time following the guidance of the Board during earlier stages, that appear to us to introduce inequities into the way in which the Fund treats its employees. We believe, therefore, that some changes are in order to put the education allowance system on a sounder footing.

The first area of concern, and perhaps the easiest to address, relates to university education in third countries. The statistics which have been provided by the staff to the Committee on Administrative Policies in EB/CAP/87/5, Supplement 1, Table 1, show that a very small percentage of the total cases of Fund-supported university study in third countries in the 1986/87 academic year involved obvious cultural or linguistic linkages between the home country and the third country in which the education was taking place. In a large number of cases--in fact, in over half of the 49 cases--it is not easy to conclude from prima facie evidence that the repatriation objective of the allowance is being met. We do not doubt that there are cases in which, despite the lack of prima facie evidence, the education allowance is facilitating repatriation. In other cases, however, it appears less assured.

For example, we find that the Fund is supporting the study of a child from an anglophone country in the Pacific region at a tertiary institution in Paris and the study of students from five Spanish-speaking countries in Latin America at anglophone universities in Canada. It is simply not clear to us how the purpose of repatriation is being facilitated in these and similar cases, and I think that one really has to look away from the problem not to recognize that there are at least some serious questions being raised by such circumstances. We are all aware of the relative financial attractiveness that may be involved in sending a child to school in Canada rather than in the United States. Some important questions are raised when we see that education at the university level is financed partly by the Fund when it takes place outside of the United States, but not when it takes place in this country.

The second area of concern is the implementation of the education allowance policy for study at primary and secondary schools in the United States. In raising this, we recognize that the range of considerations facing parents with respect to the schooling of younger children is indeed a highly complex and very personal matter, and we recognize that many of these cases are even more difficult to reach clear judgments on than cases of study at the university level. Indeed, the evidence shows that a substantial number of children of expatriate staff members with Fund financial support are being educated in schools that obviously will facilitate repatriation because of the language of instruction at the school or the curriculum offered. For example, there were 48 children of Fund employees from francophone countries studying at the French International School with Fund support in academic year 1984/85. Here too, there are other cases where the linkages are less obvious but where traditional practices suggest that repatriation may be facilitated by enrollment in particular schools.

At the primary and secondary level, however, there are numerous cases, as at the university level, in which it is difficult on prima facie grounds to see any link between the choice of school and the objective of facilitating repatriation. For example, in the 1984/85 academic year, there were 19 children from francophone countries studying in such mainstream American schools as Sidwell Friends and Bullis.

While we believe that parental judgment should determine which school the children of staff members attend--and we do not in any way intend to question this principle--and while we believe that the Fund should not interfere with this judgment, we must make a distinction between interfering with parental responsibilities and ensuring that our allowances are used appropriately and in a manner consistent with our own Board's decisions. The Fund does not bear a responsibility to pay for education in any school under any circumstances. The Fund's only responsibility, as is clear from the General Administrative Order, is to pay for education that facilitates repatriation and thereby is consistent with the purpose of that order.

While we recognize that it may not be easy to adopt specific criteria for determining when study can be supported by the Fund and when it cannot, the current approach is, in our view, so liberal that the potential for abuse is considerable. We understand that the education allowance policy for study at the university level in third countries was broadened in 1980 partly for the benefit of members from countries where parents customarily educate their children in a language different from the national language--for example, in order to facilitate education at the university level in English for children who may be native to Sri Lanka. Another factor behind this 1980 judgment was to keep pace with the World Bank and the United Nations. Let me make clear that we see some legitimacy with respect to these objectives.

Before 1980 the education allowance for study in third countries was only provided "where the Director of Personnel deems the language and system of education to be substantially the same as in the home country." In 1980, the Board apparently decided to let staff members rather than the Director of Personnel determine whether or not repatriation was being facilitated. The Board, however, did not alter the purpose of the allowance.

It is not entirely clear to me that the Board sent fully consistent signals to management with respect to this allowance. In effect, the Board said that this allowance exists to serve a particular purpose and only that purpose, and yet it is not clear that the Board gave management the flexibility to ensure that the purpose would be fully served in every case. Consequently, we believe the seven years of experience since 1980 suggest the need to review the implementation of the policy.

To increase confidence in the fact that the policy is administered in a way fully consistent with the stated purpose, there are a number of approaches that could be taken. We have suggested these before in the Committee on Administrative Policies meetings and indeed have mentioned them here before in the Board. Let me mention only two at this stage. One approach could be the establishment of criteria for determining when education does or does not facilitate repatriation. The Administration Department could review cases in light of the criteria set forth, perhaps in a General Administrative Order, and could reach appropriate judgments as to whether or not individual cases conform with the criteria. A variation on this approach would be to go back to the system that had existed earlier, and to allow applications to be reviewed by the Director of Personnel without trying to establish any precise and clear-cut criteria. Of course, I can see how that may have some drawbacks, as I think the staff had indicated before, because it leaves too much room for judgment.

An alternative approach would be simply to eliminate allowances for study at the university level on grounds that a high majority of expatriate children attend universities in the United States, which makes them ineligible for an allowance.

In suggesting these alternatives, I would like to underscore that we are not in any way trying to limit parental choice. Rather, as I indicated earlier, we are simply trying to ensure that the Fund's education allowance is administered in a way which does not involve any inequities for Fund employees and in a way that is consistent with the stated purpose.

We, therefore, would ask the Board to request the Committee on Administrative Policies to review the alternatives we have suggested, and any other alternatives which may be presented by other members of the Board, management, or the Staff Association, and which can help ensure that the education allowance is implemented in a manner fully consistent with its stated purposes. If the Board does not see fit to agree, then we intend for our part to submit a formal request to management to ask the External Audit Committee to conduct a special audit of the administration of the Fund's education allowance policy in accordance with Section 20 of the By-Laws.

Mr. Faria said that the staff case for raising the ceilings under the education allowance policy for the 1987/88 academic year to attain the overall objective of covering 75 percent of tuition for at least 90 percent of the claimants had been cogently presented, even though the objective may not have been fully realized for the subset of claimants studying outside the United States. As such, he had no difficulty in supporting the proposed decision in EBAP/87/239, which would have been deemed approved by the Board on a lapse of time basis but for the objection raised by one Executive Director.

It was not clear to what extent the matter of revision of the third country provision should properly form the basis for current discussion by the Board, Mr. Faria observed. The staff had shown convincingly in EB/CAP/87/5, and Supplement 1, that there was no substantive basis for a revision in the application of the Board's policy in that respect as originally enunciated in 1980. Indeed, the implicit concern relative to the good faith of staff members--a matter on which it would be highly undesirable for the Fund to pronounce--was fully taken care of through the written assurances currently required of all members claiming the education allowance, and the proposed memorandum that would explain more fully to them what was entailed by such assurances. He recalled the observation made by the Deputy Managing Director during the Board discussion in 1980 on education allowance policy, and implicitly accepted by the Board--as referred to in EB/CAP/86/3, Supplement 2--to the effect that the policy underlying General Administrative Order No. 21 was not to force an eventual return of staff members' children to the home country, but to make it practicable for them to do so if both they and their parents so wished. That was in accordance with the staff's considered opinion that "... it would not be justifiable for the Fund to establish more elaborate procedural requirements for all applicants simply in the hope of identifying an occasionally questionable application."

It was necessary to eliminate the unedifying and persistent attempt to secure by attrition an outcome that could not be achieved by good argument leading to a Board consensus, Mr. Faria emphasized. Accordingly, he hoped that the Chairman's summing up of the discussion would lay the issue to rest by clearly reflecting the sense of the Board discussion that, a full review of university education in third countries having been undertaken, no change in existing policy was deemed to be warranted.

Mr. Marcel said that it seemed dangerous to change the present policy because the judgment of parents was the most appropriate in achieving the objective of facilitating the child's return to the home country. Furthermore, there were many sound and rational reasons for which parents sent their children to study in various countries, as examined in the staff report--for example, long-range considerations, the nationality of the staff member's spouse, the high cost of a good quality education in the United States, and cultural and historical links between the country of study and the home country. Judgment on the type and location of a child's education must continue to be that of the parent. A more restrictive policy would cause new inequities and would create bureaucratic difficulties in an area in which free choice was fundamental.

Mr. Hogeweg reiterated the position he had expressed at the most recent meeting of the Committee on Administrative Policies, namely, that the staff had convincingly explained why a change in policy was not advisable. The document in which that was done was not on the agenda for the current meeting, although it was highly relevant for the Board in judging whether or not additional requests should be made to the Committee. The Committee had spoken on EB/CAP/87/5 and Supplement 1, and had asked Mr. Dallara to specify, on paper, particular instances in which there was not prima facie evidence of compliance with the purpose of the Administrative Order; on that basis, the Committee had already agreed to examine such cases. Since examples had not yet been presented to the Committee, it was only appropriate for the Board to approve the proposed decision as would have been done on a lapse of time basis, and to leave it to the Committee to continue with its work as agreed upon during the most recent Committee meeting.

Mr. Mawakani said that as a member of the Committee on Administrative Policies, he approved the proposed decision, and fully supported the views expressed by both Mr. Marcel and Mr. Hogeweg.

Mr. Fogelholm understood that Mr. Dallara had made a two-part proposal: first, that the Committee on Administrative Policies be given the task of reviewing the ideas he had put forward, and, second, if the Board did not accept that proposal, he would make a formal request for the external auditors to take up the matter. The implications of the second alternative were unclear, and guidance from the staff on that score would be welcome. However, there was an internal committee of the Fund which was supposed to deal with such matters, and it seemed appropriate that the Committee on Administrative Policies discuss the issues as raised by Mr. Dallara. The Fund should be able to deal with such an issue internally.

Mrs. Filardo asked Mr. Dallara to explain his position, which seemed to differ from that of the rest of the Committee, with respect to his proposal to call in the External Audit Committee.

Mr. Dallara said that he had cited specific examples of abuse of the education allowance policy in his intervention and would be happy to provide further specific citations for the Board or for the Committee. While there did seem to be some willingness to examine the issues further in the Committee, if the Board were to give clear signals to the Committee that it should indeed investigate the question with a view toward ensuring that the policy was implemented consistent with its purposes, then that would provide the proper context for the Committee to do its work and to actually produce results. It was only as a result of frustration, in having failed to make the Committee recognize a legitimate problem, that his chair had developed the notion of calling on the External Audit Committee. It was the Board's responsibility, and not that of the Committee on Administrative Policies, to ensure that the Fund's policies were properly implemented. He had no intention of disrupting the process of administering the education allowance, and was more than happy to continue to support increases in the education allowance as recommended, if he could be convinced that the allowance was being used for the purpose for which it was intended.

In response to a question from Mrs. Filardo, Mr. Dallara said that he defined potential abuse as circumstances in which the education of the children did not facilitate repatriation to the home country.

The Chairman said that as the father of six, he was in favor of parents' liberty of choice in selecting an educational system for their children, but as the Managing Director of the Fund, he was ready to take any steps necessary to facilitate the work of Executive Directors who had doubts about the way in which Fund resources were being used. Since the U.S. chair had suspicions about potential abuses, it would be necessary to clarify that issue. It would have to be seen whether a review by the External Audit Committee, in accordance with the By-Laws as brought up by Mr. Dallara, was the most appropriate instrument for bringing the necessary clarity to the matter. With that qualification, the recommendations of the Committee as set forth in EBAP/87/239 were approved.

Mr. Dallara asked whether it was understood that the Board considered it appropriate for the Committee on Administrative Policies to further review the education allowance policy with a view toward correcting any problems which might exist.

The Chairman said that that had not been his understanding of the Committee's conclusions at its last meeting; however, the Board was able to reconsider the work of the Committee.

Mr. Dallara said that it had been his impression at the last Committee meeting, reinforced at the present meeting, that Committee members had been willing to look further into the issue, particularly if specific examples were brought to their attention. His proposal was that the Board ask the Committee to consider approaches which could help ensure that the education allowance was implemented in a manner fully consistent with its stated purposes, based on information provided by management.

Mr. Zecchini inquired as to whether Mr. Dallara wanted the Committee to examine specific instances pointed out by Mr. Dallara himself--in which case it would become an investigating committee, which was not an appropriate use of Board members' time--or whether he was asking for a general review of procedure. Mr. Dallara was not challenging management's implementation of the policy, because management had been complying with procedure. Rather, he was challenging the procedure. Therefore, could Mr. Dallara clarify exactly what he was asking of the Committee?

Mr. Dallara said that he was simply asking the Committee to ensure that the policy was implemented in a manner fully consistent with its purposes. He suggested that since Directors had not had all relevant documentation formally brought to their attention for the current meeting, the decision could be taken on the increase in ceilings for education allowances for the current academic year; the Board could return to the policy issue in several weeks with all relevant documents formally listed on the agenda, at which time Board members could decide whether further work by the Committee was appropriate.

Mr. Rye supported Mr. Dallara's suggestion that the Board endorse the new level of allowances as suggested by the Committee, and postpone the rest of the discussion until additional documentation had been circulated.

The Director of the Administration Department pointed out that all the relevant documents had been circulated to members of the Board, which had not focused on EBAP/87/5 because it had not been on the agenda.

The Executive Board then took the following decision:

a. The maximum allowance for tuition in the staff member's country of assignment shall be increased from $4,650 to $5,000 per annum.

b. The base maximum allowance for tuition and boarding for children studying outside the staff member's country of assignment shall be increased from $6,550 to $7,050 per annum.

c. When children are studying outside the staff member's country of assignment, the base subsistence grants at primary and secondary school levels shall be raised from $1,575 to $1,670 per annum, and at postsecondary level from $3,150 to $3,340 per annum.

In each individual case, the new ceilings will be in effect as of the first full scholastic year starting on or after August 1, 1987.

Adopted November 25, 1987

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/87/160 (11/23/87) and EBM/87/161 (11/25/87).

4. ASSISTANT TO EXECUTIVE DIRECTOR - EXTENSION OF OVERLAP PERIOD

The Executive Board approves the recommendations relating to the extension of the overlap period for the appointment of an Assistant to Executive Director as set forth in EBAP/87/253 (11/19/87).

Adopted November 23, 1987

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/87/255 (11/20/87) and EBAP/87/256 (11/23/87) and by an Advisor to Executive Director as set forth in EBAP/87/255 (11/20/87) is approved.

6. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/87/258 (11/23/87) is approved.

APPROVED: July 15, 1988

LEO VAN HOUTVEN
Secretary