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I N T E R I M   R E P O R T

RURAL DEVELOPMENT AGRIBUSINESS FUND

527-159

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OUTLINE FOR INTERIM REPORT

RURAL DEVELOPMENT AGRIBUSINESS FUND

INTERIM REPORT - RURAL DEVELOPMENT AGRIBUSINESS FUND

Part One- Project Background and Detailed Description

A. Background

1. Introduction

In the FY 1978 Annual Budget Submission, the Mission submitted a PID entitled Agricultural Services Rediscount Fund for a proposed A.I.D. loan-financed project to establish in the Central Bank of Peru a facility for rediscounting loans made by financial institutions to sub-borrowers which produce, process or market agricultural products or provide complementary services to the agricultural sector. The PID was approved in August 1976 (State Cable 212819) and the PRP was submitted in October 1976. In reviewing the PRP, the DAEC raised a series of questions pertaining to the project design and asked that these be treated in an interim report. The purpose of this paper is to respond to those concerns, specifically the questions posed in State 296084. The issues regarding GOP policy, the proposed implementing agent, demand, and interest rates (points 1, 2, 3, 4 respectively of the cable) are treated in Part Two of the report and the questions regarding promotion and technical assistance (points 5 and 6) are discussed in Part One B, (Detailed Description). In addition, Part Three of the interim report addresses the credit aspects of the proposed FY 78 A.I.D. Loan for Development of Sub-Tropical Lands. This section is intended to respond to point 10 of State 296088 which also requested an interim report related to that project's credit component.

Finally, in the course of analyzing the DAEC issues, particularly with regard to the effective demand for project sub-loans by various groups and the credit supply situation including other donor initiatives which have surfaced in recent months, the Mission and GOP have reevaluated project components and concluded that some redesign is required in order for the Project to respond best to unsatisfied effective demand. Basically, it was concluded that the Project would fill a needed gap through an agribusiness focus - that is, a sub-lending program to industries processing and marketing the output of the sector. Accordingly, one of the categories of sub-lending contemplated in the PRP -- credits to small farmers for on-farm improvements for crop production -- has been dropped from the program. The rationale for the agribusiness strategy, the background on the agricultural sector and constraints faced by the target group, and the proposed design modifications are treated in Part One immediately following.

2. Agricultural Sector Overview

a. Recent Growth

In recent years the performance of the agricultural sector has been poor; in 1975, the sector grew at the rate of only 0.6%, compared to

2.3% and 2.4% in 1974 and 1973 respectively. While the sector still employs about 42% of the country's labor force, its contribution to total GDP has been decreasing, from 20% in 1960, to 15% in 1969, to 12.7% in 1975. The average annual sectoral growth rate of 1.8% for the 1973-1975 period contrasts with an overall GDP growth rate of 5.3% for the same period and a population growth rate of 3.1%. Domestic production of basic food items has failed to keep pace with the high population growth.

b. Constraints

During the past eight years, the GOP has implemented one of the most extensive agrarian reform programs ever undertaken in South America. The expropriation of large estates and the redistribution of land and the creation of worker-based associative enterprises will be completed this year.

The general disruptive atmosphere which can normally be expected to accompany massive land transfers and prior price policies which acted as a disincentive to domestic production may be cited as two factors which contributed to poor production performance in recent years. The practice of keeping the prices of basic food products relatively low has been eliminated, and, recognizing the need to stimulate production of staple commodities, the GOP has consistently raised support prices. Major upward price adjustment of foodstuffs occurred in July 1975, January 1976, June 1976, and March 1977, thereby restoring production incentives. Concerning the agrarian reform, the latifundia -- which impeded the economic utilization of available agricultural resources and labor -- have now been eliminated. Since the distributive phase of the reform is nearly completed, the disruption and uncertainties generated by the reform also have been reduced.

Nevertheless, serious constraints remain. A fundamental problem is the poor quality of land resources manifested in an extreme scarcity of cultivable land. Of the country's total land area of approximately 128.5 million hectares, only about 3% or 3.7 million hectares is under cultivation (including fallow lands), while 12%, or 15.1 million hectares represents natural pasture. The rest of the land area includes forests, jungle, mountains and desert. There is only about 0.38 hectares of farmland per rural person and 0.18 hectares per inahbitant, the lowest ratios in all of Latin America. Harsh topographic and climatic conditions inhibit the expansion of the amount of arable land. While vast amounts of unutilized land are available in the jungle and high jungle, efforts to develop these areas must await the completion of land transportation routes, and great differences in agro-economic potential exist among jungle regions. Expansion of land on the coast is very expensive, although the GOP is supporting the development of a number of large scale coastal irrigation projects. Some marginal increases in cultivable land in the sierra can be obtained through improvements in irrigation facilities and technological developments to reduce the time that land must lie idle.

Further constraints to increased production and income are imposed by low levels of technology, the low average level of farm management skills, and scarcity of physical infrastructure. Farm families, particularly in the sierra and high jungle, use primitive agricultural techniques with the result that very little surplus is available for sale after immediate family requirements are met. Factors of production in current use by most Peruvian farmers are minimal: unimproved seed from year to year, a depleted soil which must be fallowed regularly to restore a minimum fertility, and hand labor and animal power. Dependence on traditional farming methods is both a function of limited technical knowledge and an unreliable and fragmented system of delivering agricultural inputs to the end-user.

Difficult communications -- e.g., scarcity of all-weather roads, limitations of mountainous roads whose use is often interrupted by landslides, and the great distances that separate the widely scattered productive valleys -- contribute to a continued, low level of production technology. Government efforts to provide technical assistance to these farmers have been greatly reduced in efficiency in recent years as the extension service has been utilized heavily for agrarian reform activities. High operating costs due to communications difficulties for extension services and a general scarcity of trained extension personnel due to low salaries and budget constraints have led to a dearth of technical assistance for farmers.

The supply of short-term production credit provided by the Agrarian Bank has increased significantly in recent years (at an estimated real rate of 23% in 1973, 21% in 1974, and 34% in 1975) and the Bank is making concerted efforts to improve the timeliness of its delivery. However, a basic constraint to increasing production (and improving marketing) is the inadequate supply of medium-to-long term credit for on-farm improvement, equipment, storage facilities, etc. The needs for such credit are large in light of the heavy decapitalization which occurred in the sector due to the agrarian reform; former landowners, in anticipation of expropriation, sold fixed assets and deferred ordinary maintenance. Pent-up demand exists for, on the one hand, the expropriation process is virtually completed and land titles have been validated for many eligible independent farmers, enabling them to now plan their production activities and invest in on-farm improvements. On the other hand, the new associative enterprises have completed their formation stage, and are now entering a phase of consolidation and development, including the implementation of longer-term investment programs.

Final constraints are incomplete linkages within agribusiness systems and the absence of adequate physical infrastructure for the processing and marketing of agricultural production. Rural collection centers are almost totally inadequate, making it necessary for producers to seek out itinerant truckers who serve the areas as outlets for their surplus production, or to sell in small lots to hundreds of small, part-time buyers. The present system is costly, owing largely to high spoilage losses and transport cost. Inadequate market information and lack of competition among local buyers contribute to pricing inefficiencies which operate to the disadvantage of the small producer and raise consumer prices as well. The lack of processing capacity has prevented the expanded production of profitable crops and has resulted in foregone off-farm employment opportunities for Peru's rural population. Storage facilities that would reduce losses and eliminate peaks and valleys in the supply of various commodities are also lacking and represent a serious constraint to production and efficiency.

A major consequence of all of the above constraints is the high rate of rural underemployment. GEAR, a special study unit created in the Ministry of Industry and Tourism to study and implement measures to generate employment in rural areas, has estimated that two-thirds of the agricultural labor force in Peru is underemployed. The inability of the agricultural sector to absorb natural population increases, the extremely high inhabitant/land ratios, and the few off-farm employment opportunities are factors which have contributed to the heavy outmigration from rural areas to secondary and primary cities.

c. Agricultural Policy and GOP Actions

In the past year, a series of incentives has been implemented by the GOP to stimulate agricultural production. The increase in farm prices and new pricing policy have previously been mentioned. In addition, the major exchange devaluation (45% in July 1976) has caused significant price increases for imported grains, thereby providing a relative price advantage to local producers.

In support of the Ministry of Food's extension efforts, a new National Production System has been established by law. Briefly, it seeks to revitalize the extension system and unite producer groups and technicians of the Ministry of Food in a series of production committees from the local to the national level. The system is developing a national production plan which will influence the allocation of resources, including credit and technical assistance.

GOP development policy places highest priority on improving income distribution and integrating the country's rural population into the national economy through various programs designed to support and stimulate economic activities in rural areas. Consolidation of the agrarian reform, industrial decentralization, provision of basic social services and economic infrastructure, the development of natural resources in rural areas, the promotion of rural industries and tourism all aimed at reducing unemployment are among priority activities articulated in recent planning documents oriented toward the rural areas.

The GOP's 1975-78 Agricultural Plan further specifies priorities for agricultural development as follows: i) consolidation of the Agrarian Reform with the view of improving the organization and administration of the established associative enterprises; ii) establishment of the national production system, vertically integrated from national to regional to local levels, with the view of better channeling available inputs to meet specific crop production targets; iii) the incorporation of new lands for agricultural uses through colonization and irrigation projects; and iv) the improvement of the marketing system by facilitating the establishment of rural collection centers, silos, warehouses, and processing facilities to assure regular production flows and more stable prices. Recent pronouncements also stress the need to maintain adequate production incentives and to give priority to projects with a short-term production pay-off, to projects which will produce basic inputs and needed staples (foodstuffs), and projects which will integrate the production structure.

d. Other Donor Activity

Indicative of its commitment to agricultural and rural development, the GOP has invested substantial sums of internal and externally borrowed funds in rural infrastructure, particularly roads and irrigation. Other donor support for these activities has included loans from the IDB, IBRD, Germany, England, and Yugoslavia.

In the field of agricultural credit, both the IDB and IBRD have on-going and new programs to assist in the recapitalization of farm production units. The IDB's Loan No. 322 for agricultural credit, which was executed in June 1972 in the amount of $12.0 million, is now nearly fully disbursed. To continue its support, the IDB has just authorized a new loan for agricultural credit in the amount of $30.0 million. $20.0 million of the new IDB loan would be relent by the Agrarian Bank to an estimated 75 associative enterprises for the following purposes: i) on-farm installations for increasing production; ii) the planting of perennials; iii) land preparation and on-farm irrigation; iv) livestock acquisition; and v) the purchase of agricultural machinery. $10.0 million would be utilized for supervised agricultural credit for production purposes to the beneficiaries of the 12 irrigation zones developed with the assistance of the IDB's linea global (loan # 277).

The IBRD also is providing credit to the agricultural sector. IBRD Loan # 933, in the amount of $25 million, was initiated in September 1973 for financing medium and long-term credits through the Agrarian Bank to associative enterprises and individual farmers. The loan is expected to be fully disbursed by the end of 1977, and the World Bank is now appraising a new loan for similar purposes to help meet the large projected needs for longer-term agricultural credit through 1980. The new loan would be on the order of $40.0 million, with a significant portion earmarked for use by the coastal sugar estates.

3. Strategy of the Project

a. Strategy Statement

The strategy of the proposed Project is to alleviate major barriers, including the availability of medium- to long-term credit, technical assistance and promotion, to the development of agribusiness enterprises in Peru which have a direct linkage to small farmers and associative enterprises created under the Peruvian Agrarian Reform.

b. Target Group

Although the Project has been redesigned and now focuses on the development of agribusinesses, the target group and ultimate beneficiaries of the Project remain unchanged -- individual small farmers and members of associative enterprises created under the agrarian reform. The more profitable, export - oriented farmers and associative enterprises producing cotton and sugar are excluded from the target group. As a result of the proposed change in project design, however, benefits will principally accrue to the target group in an indirect manner rather than directly as originally intended (i.e., receipt of credit for on-farm improvements). A developed agribusiness sector is expected to create linkages which will benefit the target group by providing services and inputs required for increased production.

The lack of efficient agribusiness enterprises in Peru (e.g., agricultural marketing, processing and service industries) has been identified as one of the constraints to increased small farmer production. Without adequate transportation, processing, packing, storage, etc. and appropriate agricultural inputs, the market for small producers is unstable and insecure. By assisting with agribusiness development, potential benefits which could be derived from the Project include: provision of a convenient and orderly market for small farm production; greater stability in prices; reduced spoilage, wastage and loss associated with unprocessed produce; reduction in bulk, thus facilitating distribution and contribution of added value; conservation and concentration of nutritional values; and increased supplies, lower costs, and improved delivery of agricultural inputs. Taken together these benefits are expected to create the incentives necessary to increase small farmer production and, therefore, profitability and income. In addition, the agribusinesses can also generate off-farm employment opportunities since many processing activities are labor intensive.

c. Rationale for Agribusiness Focus

In selecting an agribusiness strategy, the Mission has been influenced by the following three factors: 1) the present gap between need and GOP and other donor activity oriented toward this critical area; 2) the existence of conditions faced by A.I.D.'s target group that could be alleviated through agribusiness development; and 3) the Project's propitious timing, given recent policy changes which have reduced constraints to agribusiness development in Peru.

The amount of credit channeled toward rural areas and activities associated with agriculture in Peru at the present time is severely limited. The scarcity of credit available for such activities represents a serious barrier to the improvement of incomes of the rural poor. The needs for such credit are large, particularly in light of the decapitalization which has occurred throughout the agricultural sector since the late 1960's as a result of the Agrarian Reform. Former landholders severely decapitalized their holdings, and the new associative enterprises created as a result of the Agrarian Reform generally did not have sufficient resources to recapitalize. Recently, external resources such as the previously mentioned IDB and IBRD loans for on-farm improvements have helped to alleviate some of the problems this has created. There are, however, additional critical areas and linkages to the sector which must be developed if productivity on Peru's limited land base and rural incomes are to improve. The other donors' credit programs are oriented toward on-farm investment programs to restore and improve the production potential of Peruvian farms, leaving the important gap of inadequate credit for agribusiness industries providing goods and services to the sector and processing or marketing output of the sector to be filled.

Secondly, improvements in the marketing of products produced by A.I.D.'s target group clearly are needed. Wastage, losses and spoilage of raw material foods grown by small farmers occur due to lack of adequate facilities for storage and processing. Because of transport costs and perishability, marketing of produce is sometimes feasible only in processed form. Agro-industry is seen as an important mechanism to raise incomes and promote development in rural areas given the ability of agro-industries to provide a stable outlet and thereby reduce marketing uncertainties for raw materials. The promotion of investments in industries which have direct linkages with the agricultural sector may also provide new opportunities to increase rural incomes by promoting the integration of the rural sector with key sectors of the economy. Opportunities for increasing rural incomes are likely to remain limited until stronger economic linkages are achieved between the rural and urban sector and among complementary components of the rural sector.

Concerning the Project's timing, the GOP has largely completed implementation of the basic changes in the pattern of economic development which have been designed to link economic growth with a broader participation of the population in the country's economic, social and political life. Understandably, such basic structural changes as the Agrarian Reform have resulted in uncertainty. For industrial establishments serving the sector this uncertainty, manifested in a hesitancy to invest in modernization programs and new ventures, has been compounded by industrial structural reforms promulgated in recent years such as the industrial community (1970) and social property (1974) legislation. Recently, the GOP has gone a long way toward countering the negative features of previous policies. At present, priority is given to increasing efficiency in the productive systems, and extensive efforts to restor confidence and dynamism in the private sector are being made. The industrial community legislation was greatly modified in early 1977, with the result that the present owners will be guaranteed managerial control of the enterprises.1/ Social property development is still supported but no more as the foremost priority sector, and it is to compete with the private sector on equal terms. Also, the labor stability law, a cause of low labor productivity, is in the process of being modified. With the elimination of these basic policy constraints to agro-industrial development, a development strategy with an agribusiness elements is considered timely and appropriate.

d. Constraints to be Addressed

The following table lists some of the major constraints which have been created or aggravated by agriculture sector decapitalization, along with the situations which have resulted from the various constraints. Four major constraints are identified: i) inadequate marketing facilities; ii) lack of agro-industrial processing facilities; iii) unreliable goods and service input industries; and iv) incomplete linkages within agribusiness systems.

B. Project Description

With the reorientation of the proposed Project toward a strictly agribusiness focus, some changes in the logical framework transmitted with the PRP become necessary. A revised logical framework is attached (Annex I).

1. Project Goal and Purposes

The goal of the proposed Project remains unchanged: to increase food production, employment and incomes of the rural poor, and improve nutrition. The Project will contribute to the Mission's agricultural sector goal by promoting investments in agribusinesses in such a manner as to maximize their impact on the rural poor. These investments will

1/ The original industrial community legislation provided for the transfer of a specified portion of annual profits of private companies to their workers in the form of shares until the workers acquired 50% of the firm's capital, and a corresponding number of seats on the Board of Directors. Workers also received an additional 10% of profits in cash. The effect of the new law is to limit distribution of profits to one-third of the share capital in the form of special stocks which would still allow for Board representation but would leave managerial control to the common stockholders.

Constraints to Increased Agricultural Sector Productivity and Rural Prosperity

Constraints	Manifestation	Consequences	Type of Sub-Projects Envisioned
1. Inadequate Marketing Facilities	Lack of storage facilities; inadequate farm to market transportation; lack of packing, sorting, grading, equipment, and refrigeration facilities, etc.	Lack of incentives to increase production of perishables (e.g. meat and milk) in most areas outside of area of influence of major markets; uneven product flows and market instability.	Rural collection centers (packing, sorting, refrigeration units); output warehouses; transportation facilities; slaughter houses; etc.
2. Inadequate Processing Available	Lack of processing facilities for agricultural production, and provision of basic inputs (e.g. balanced feed).	Low level of value added to agricultural sector; insecurity of markets during harvest season; spoilage high; low unit prices to producers; loss of by-products; lack of incentives to expand land under production.	Canning industries; creameries; freeze-drying facilities; oil extraction plants; feed mills; soap factories; etc.
3. Inadequate Goods and Services Input Industries	Lack of input warehouses, transport facilities, machinery pools, local manufacturers of agricultural tools and appropriate equipment, suppliers of improved seeds and pesticides.	Low productivity especially in remote areas; inability to achieve economies of scale through service centers designed to serve specific geographic areas; reliance on traditional technologies.	Small transport cooperatives or companies; machinery pools; local manufacture of implements and distribution of agricultural inputs, etc.
4. Incomplete Agribusiness System Linkages	Lack of proper quality and quantities of raw materials for certain agro-industries; breakdown in product flows from producer to processor dating from Agrarian Reform.	Bottlenecks to agro-industrial expansion and foregone rural income and employment opportunities.	Manufactures of inputs (crates, sacks) for agro-industry; contractual arrangements between processors and small producers to deliver technical assistance and improve product quality and assure sufficient quantities.

help to alleviate such constraints to increased small farmer income as limited product markets, the general lack of markets for agricultural inputs, and the dearth of agricultural-related service enterprises. A sub-goal has been added to the log frame as follows: to alleviate identified typical farm level constraints to increased small farm income through the expansion of markets for small farmer products and the provision of agricultural goods and services.

The purpose of the Project has been slightly modified to read: i) to establish in the Central Bank an effective facility for rediscounting loans made by financial institutions to sub-borrowers which process or market agricultural products or provide complementary goods and services to the agricultural sector, and ii) to establish a program of promotion and development of such agribusinesses, including appropriate technical assistance, which will maximize benefits to small farmers and the rural poor.

2. Project Elements

The proposed Project involves the development of: i) a rediscount mechanism within the Central Bank of Peru for refinancing loans made by participating financial intermediaries to eligible rural agribusinesses; and ii) a program for the identification, promotion, financing and provision of technical assistance and follow-up for such eligible enterprises.

a. Rediscount Fund

The Rediscount Fund will consist of a total initial capitalization of $14,700,000, of which $9,800,000 will be A.I.D. loan funds and $4,900,000 will be provided by the Central Bank. These financial resources will support the development of industries which demonstrate significant direct backward or forward linkages to the target group of small farmers and the food producing associative enterprises through the provision of goods and services and the expansion of markets.

Agribusiness activities which may be financed under the program can be divided into three categories, all of which will contribute to eliminating constraints which exist in the flow of produce from farm to market:

i) Agribusinesses which process raw materials grown by small producers and associative enterprises, including fruit and vegetable processing plants, canneries, freeze-drying facilities, etc.;

ii) Agribusinesses which assist in the marketing of small farmer and associative enterprise agricultural products, such as refrigerated storage facilities, warehouses, transportation, etc.; and

iii) Agribusinesses which contribute to improved small farm and associative enterprise agricultural production, for instance suppliers of inputs and improved technologies (tools, farm machinery, pumps, vegetable crates, pesticides, improved seeds) as well as complementary services. Service enterprises would include distributors and/or repair facilities for the above-listed inputs, input marketing services, construction services for low-cost silos and irrigation facilities, and rental services for farm machinery and land-clearing equipment.

To support the GOP's decentralization and regional development objectives, eligible agribusinesses will have to be located outside of Lima/Callao. Other urban locations will be eligible, however, since such enterprises can flourish only in areas which provide adequate infrastructure for power and transportation logistical requirements, labor pool availability and entrepreneurial talent. These prerequisites imply that the other urban centers of the country should be included in the geographic focus of the Project. Eligibility criteria for processing and marketing industries will require that a major proportion, defined as 75%, of raw materials be domestically produced. Eligibility criteria for input suppliers and complementary service enterprises will require that the principal activity of the enterprise, defined as a majority (greater than 50%) of sales, be directly related to agriculture. This provision would thus exclude financing for a firm which devotes only limited attention to the sector.

Apart from these general criteria, each sub-project will have to demonstrate that it will provide benefits to the target group through one or more of the following means:

a) Provide market and price equilibria for agricultural products;
b) Reduce prices of inputs;
c) Increase productivity of farm laborers, and provide more on-farm jobs;
d) Provide incentives to produce higher value crops;
e) Provide incentives to expand land under production;
f) Expand availability of agricultural inputs at reasonable costs;
g) Increase value-added to the target group (cooperative sub-projects);
h) Introduce new, more productive technology;
i) Reduce costs of inputs (crates, sacks) required for agro-industry which serves the target group.

b. <u>Promotion</u>

The Central Bank recognizes that promotional activities to publicize the program and actively involve intermediate credit institutions (ICI's) will be critical elements for the successful implementation of the

Project. To be sure, the design, coordination, and follow-up of promotional campaigns will be the most important tasks of the special unit which will be created within the Central Bank to administer the Fund. The staff assigned to this unit will include a full-time promotion specialist who will be responsible for coordinating and implementing the promotion program. The major components of the promotional efforts can be divided into three categories: media release, publications and direct contacts.

i. <u>Mechanics of Promotion Campain</u>

Specific promotional strategies are presently being studied by the Central Bank and CAMCO, Inc. (contracted to study operational aspects of the Rural Development Agribusiness Fund) and will be well developed prior to submission of the Project Paper. The general mechanics, however, are described below.

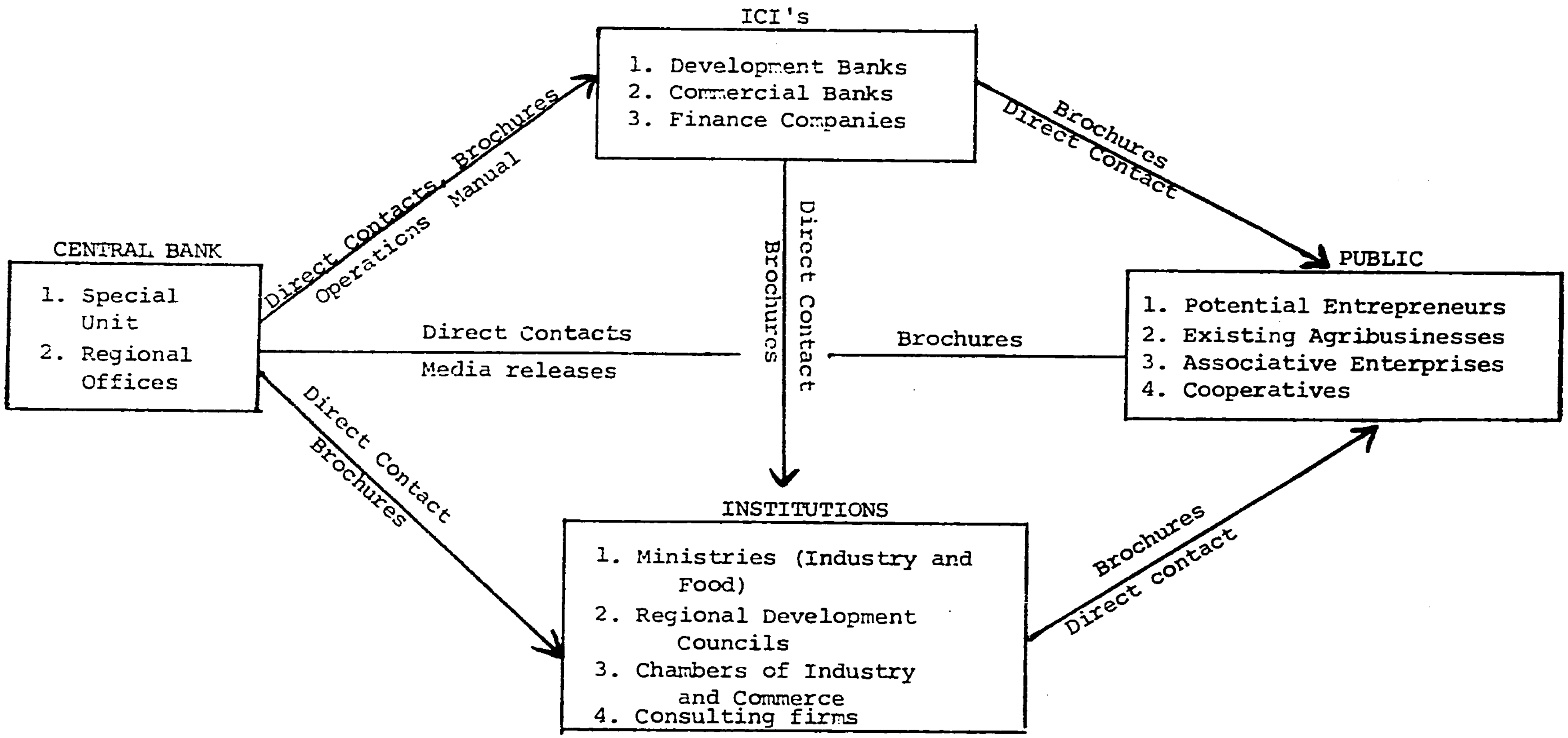
Once the Loan Agreement has been signed, an immediate campaign of media releases (radio, TV, and newsprint) will be undertaken by the Central Bank to announce the objectives of the program and availability of financial resources. This will be followed by the publication of pamphlets, brochures, and an operations manual -- all of which will be ready for USAID's review and approval as a condition precedent to disbursement following the signing of the Agreement. (The Central Bank will be responsible for the preparation and publication of these documents). Figure No.1 illustrates the major flows of information contemplated among the relevant sectors.

The media release campaign will be initiated from the Central Bank's office in Lima as well as its various regional branches, so as to obtain as much geographic coverage as possible. The operations manual will be the basic working tool between the Central Bank and the ICI's. It will specify, among other things, the eligibility criteria and impact determination guidelines that must accompany sub-loan applications. In addition, brochures and pamphlets will be published by the Central Bank to notify the public of program specifics and will be widely disseminated to existing agribusinesses, known potential investors, Regional Development Councils, local Chambers of Industry and Commerce, consulting firms, and such concerned Ministries as the Ministry of Industry and Tourism and the Ministry of Food. The Central Bank will also make the pamphlets and brochures available to ICI's for further distribution. Their contents will specify the major features of the new credit line with special emphasis on spelling out program objectives, types of eligible enterprises, sub-loan terms and conditions, and impact requirements. The names of participating ICI's will also be included.

The media release and publication activities will be followed by direct contacts by the Central Bank with the ICI's and potential entrepreneurs. The mechanics of these direct contacts will be

FIGURE No. 1

FLOW OF PROMOTIONAL INPUTS



patterned after the methodology employed by the Central Bank in assessing the demand for Project sub-loans - round table seminars in selected geographic regions with the simultaneous attendance of ICI's, concerned public sector entities, industry associations, and agribusiness representatives. These seminars will be staffed and funded by the Central Bank with the goal of reaching at least the branch manager level of all ICI's which are likely to participate. Follow-up seminars will undoubtedly be necessary as operational experience is obtained and will serve as a means of disseminating the results of Project evaluation.

ii. Promotion by ICI's

Most of the principal ICI's likely to participate under the Project already have departments which promote their credit lines and other banking services available to the public, and the additional promotion efforts required by the Project can be incorporated easily into their responsibilities. Where a participating ICI does not have a promotion department, it will be necessary to establish such a capability since promotion is a critical project element at this level. ICI promotion efforts with potential sub-borrowers will begin once the Central Bank's promotional seminars have been completed and the brochures and pamphlets have been distributed. Promotion by word of mouth is likely to be a common technique employed by the ICI's. A helpful start in this respect will be the joint participation of the ICI's and potential sub-borrowers at the Central Bank's promotion seminars.

iii. Sources of funds for promotion campaigns

The promotional efforts as now conceived will place a major emphasis on direct contacts among the Central Banks' special unit, its regional offices, participating ICI's, relevant institutions, and the public, The heavy initial promotion requirements will require a specific Central Bank counterpart allocation, and the Central Bank has agreed to finance these promotion activities with their own funds. The source of promotion funds, once Fund sub-lending is institutionalized, will be a portion of the interest spread retained by the Central Bank. Similarly, the ICI's will have to cover their promotional costs from the interest spread which they retain. Project analysis and discussions with ICI's indicate that the spread contemplated will be adequate to cover such costs and still provide incentives for ICI participation.

c. Technical Assistance

A project of this nature calls for technical assistance at various levels as described below. By focusing the Project on agribusiness development alone and eliminating on-farm production sub-lending, the technical assistance requirements become less diverse and more manageable.

i. Central Bank Level

The special unit to be established within the Central Bank is expected to consist of five individuals, supported by existing bank infrastructure including the five regional branches of the Central Bank.

The creation of a special unit at the Central Bank level will require some technical assistance inputs including short-term advisory services related to internal organization design, operational systems and promotional techniques which are presently being provided in part by consultants involved in the preparation of background material for the Project Paper. Additional short-term technical advisors will be required in the above areas as well as in evaluation and training. Advisors will assist in establishing the evaluation methodology and in carrying-out evaluations. The evaluation system will include a methodology for periodic data gathering and reporting on use of sub-loan funds as well as sampling to determine end-of-sub-project status. This system will provide information on the degree to which sub-projects alleviate constraints faced by the rural poor, improve incomes, and create employment opportunities. Up to $200,000 of the A.I.D. Loan will be available for technical assistance to the Central Bank.

ii. ICI's Level

Technical assistance to participating ICI's will be necessary since agribusiness financing will be a relatively new activity for many of the institutions and the data collection effort will be greater than what is normally required for project analysis. The ICI's surveyed are strong in financial analysis, and this capability should be readily transferable to the analysis of agribusiness sub-projects. However, assistance will be necessary in the areas of longer-term project economic analysis and the Project's specific impact analysis requirements to demonstrate the benefits which will accrue to the rural poor.

Project design will provide for this assistance through special courses which will be organized by the Central Bank to train ICI loan officers and branch managers in project evaluation techniques and impact analysis requirements. Short-term advisors probably from local universities or consulting firms, will assist the Central Bank in carrying-out these training programs. The cost of these training courses will be borne by the Central Bank.

In addition, ICI's may need to contract special expertise on occasion to assist in evaluating technological feasibility and overall merits of sub-loan applications. ICI's will absorb the costs of such technical assistance with a portion of the interest spread retained by the ICI.

iii. Sub-borrowers

For sub-borrowers, technical assistance will be required for the preparation of studies to support sub-loan applications. The methodology developed by the Industrial Bank under its rural enterprises program is likely to be adopted for the Project to assist sub-borrowers prepare feasibility studies, where necessary for larger sub-projects, and impact justification analyses for all sub-loans. The system operates by offering packages of three or more loan applications that require feasibility studies to a group of pre-qualified local consulting firms. The firms prepare proposals, and the firm with the best qualifications (experience) in similar types of projects is selected to perform the studies. Up to 4% of the Rural Development Agribusiness Fund's resources or approximately $600,000, will be available for such technical assistance, the cost of which will be passed on to benefitted sub-borrowers.

Apart from feasibility studies, the other technical assistance needs of sub-borrowers will be assessed by the participating ICI in the course of its review of an application for a sub-loan. In many instances, the ICI will have been an active participant in the sub-project development process and will have identified such needs at that stage, thus assuring that sub-loan design will cover them. With the sub-borrower, the ICI will also assess the possible sources of such assistance.

It is not possible to determine with any degree of accuracy how much technical assistance sub-borrowers will require. In the case of the less sophisticated entrepreneurs, particularly cooperatives, technical assistance in administrative, management and production matters will be important. Based on the limited experience of those banks (Industrial Bank, COFIDE, Agrarian Bank) that have worked with these entities, an estimated 15% of total sub-project cost may be needed for technical assistance. Such assistance should be considered supervisory in nature and its delivery should be a risk reduction element from the point of view of the participating ICI. On the other hand, in the case of existing agribusinesses which develop sub-projects serving the rural poor, technical assistance requirments of the agribusinesses will be of lesser importance. Some assistance is likely in production and technology fields. Technical assistance to sub-borrowers will be included as part of total sub-project cost and will be submitted in that form to the Central Bank when financing is requested.

3. Relationship to A.I.D. Priorities and Mission's Programs

a. A.I.D. Priorities

The proposed Project falls within the USAID's priorities for development assistance as the DAP identified the agricultural sector as the primary area of USAID concentration. USAID priorities include:

i) a commitment to develop and implement projects which focus on the poor majority; ii) priority emphasis on development of the agricultural sector and increasing rural incomes; and iii) assistance in the development and strengthening of institutions capable of mobilizing resources to the agricultural sector.

The proposed Project fits well within AID's general priorities as well, for the agribusiness aspects of food and nutrition programs recently have received great attention and emphasis. Agribusiness activities are being stressed, for it is recognized that if the well-being of lower income families is to improve, each element in the entire L.D.C. food chain and agricultural system must be healthy and capable of flexible growth. Small farmers need to be assured of ready markets and attractive prices for increased production, and system bottlenecks need to be eliminated in order to insure market demand and a consequent profit-stimulated supply. Reflecting this agribusiness priority emphasis, the proposed Project is similar in design to several recent A.I.D. loan programs, including the following: i) Latin American Agribusiness Development, Central America (1971); ii) Latin American Agribusiness Development, Caribbean Area (1975); iii) Rural Enterprises Development, Paraguay (1976); and iv) Regional Rural Agribusiness, Central America (1976). Analysis supporting these projects has indicated that sub-project activities which demonstrate strong linkages to rural economices based on agriculture can serve as efficient channels for the delivery of significant benefits to target groups of small farmers and the rural poor. The strategy of benefitting the rural poor through the development of agribusiness development projects is particularly tenable for Peru where, because of the agrarian reform and virtual elimination of the latifundia, there is little danger of the benefits from agribusiness development indirectly accruing to an unintended recipient - the large individual landowner.

b. Mission Programs

The proposed Project will complement both on-going and planned Mission programs supporting Peruvian agricultural development, all of which strive toward the attainment of the common sectoral goal of increased production, incomes, and employment opportunities for the rural poor. The bulk of the Mission's programs are oriented toward alleviating technological and management constraints faced by small farmers and associative enterprises in the production process. These projects include Sierra Water and Land Use, Corn and Soy Production on Small Farms, Treated Sewerage, Fresh Water Fisheries, the CENCIRA training project, and the proposed FY 78 Small Farmer Production Technology loan. The proposed Project will complement these activities by focusing on other elements within the agribusiness system, addressing the constraints of inadequate facilities for the processing and marketing of agricultural production. Such constraints are already severe and likely to worsen once GOP production programs including those supported by A.I.D. as well as the other donors' credit programs begin to result in an increased production pay-off.

The Project will be particularly supportive of two proposed FY 78 projects, Appropriate Rural Technologies and Sub-Tropical Lands Development. The former is envisaged as a grant pilot program to develop institutional arrangements for carrying-out appropriate technology programs and to develop and field test a limited number of specific rural technologies suited to A.I.D.'s target group. The proposed Loan could serve as an important financing source for the widespread manufacture of technologies (e.g. simple tools and agricultural implements) which are proven to be feasible under the grant program. Similarly, agro-industrial investment opportunities have been identified in the Tarapoto region, the principal center of the Sub-Tropical Lands Development project area. These potential sub-projects appear as logical candidates for financing under the Rural Development Agribusiness Fund and, if realized, could serve as an important stimulus to regional development in concert with the Sub-Tropical Lands project components.

The one on-going Mission program which provides limited funding for activities similar in nature to those contemplated under the proposed Project is A.I.D. Loan 527-T-058, Agricultural Cooperative Federations (Centrals) Development. The thrust of that program will be strengthening the organizational, financial, and institutional bases of up to 20 Centrals, and improving the integration of member associative enterprises into the second level federations and the services offered by the Centrals. USAID views the two projects as complementary rather than duplicative for the following reasons:

i) The universe of small farmers and associative enterprises in Peru is much greater than that to be benefitted under loan 058. The 20 participating Centrals will represent approximately 160 associative enterprises or roughly 50,000 farm families (as compared to an estimated 1,000,000 small farm families in Peru);

ii) While Centrals can offer important scale economies to member associative enterprises enabling them to purchase inputs in bulk and engage in primary processing activities, they should not be considered a substitute for all elements in the agribusiness system. Sophisticated processing activities as well as the manufacture of inputs are not likely to be feasible for implementation by Centrals, and the backward and forward linkages to and from the Central clearly need to be strengthened; and

iii) Nevertheless, it is already apparent that the agro-industrial primary processing sub-projects to be identified in development plans for the 20 participating Centrals under loan 058 will require financing far in excess of funding availabilities under that program. The development plans will have to prioritize agro-industrial sub-projects and loan 058 will be able to fund only the most needy and profitable sub-projects for each Central. There is no reason why other feasible and bankable sub-projects identified in the development plans could not be funded under the Rural Development Agribusiness Fund.

The proposed Project will also complement the Industrial Bank's Rural Enterprises Fund supported by A.I.D. Loan 527-W-057. The rural enterprises project is designed to facilitate the availability of credit and technical assistance in selected regions to those enterprises and organizations which have not previously received or had normal access to credit on reasonable terms and conditions. It provides funding for sub-projects in industry, services, and commerce with an emphasis on employment generation, value added, and consistency with regional development programs. The Rural Enterprises Fund is not specifically linked to agriculture, and the vast majority of sub-loans extended to date have been relatively small (i.e. less than $25,000).

The Rural Enterprises Fund and proposed Rural Development Agribusiness Fund thus differ with regard to philosophy and target sub-borrowers. The Agribusiness Fund will stress linkages to and from the agricultural sector, and in this manner seek to benefit the rural poor. Individual sub-projects will be relatively large, averaging on the order of $250,000. Technical assistance to sub-borrowers will be less critical than in direct lending to small entrepreneurs. The Rural Enterprises Fund will continue its orientation, on the other hand, of providing credit to small sub-borrowers in deprived geographic regions who have not qualified and been able to receive credit from alternative sources.

In the course of promoting the Rural Enterprises Fund, the Industrial Bank has identified numerous agro-industrial investment opportunities and financed under the Fund a limited number of agri-business activities. USAID, the Central Bank, and Industrial Bank have discussed at length the question of potential overlap and have concluded that no duplication of effort exists. Once the Agribusiness Fund becomes operational, the Industrial Bank will channel the agribusiness projects it develops to the Central Bank for refinancing. This will allow the Rural Enterprises Fund to concentrate on the requirements of small rural industries and trade which are not directly linked to agriculture, but which will generate jobs as a partial solution to the limited employment opportunities for sierra inhabitants.

Part Two - Project Analysis

A. Implementing Agency

The proposed Borrower and Implementing Agency for the Project is the Central Bank of Peru. The primary reason for selecting the Central Bank is the Mission's conviction that within Peru institutional channels capable of delivering benefits to the rural poor need to be established and/or strengthened. This is a common thread within many of USAID's on-going and proposed programs in the rural sector. Peru historically has had its share of difficulties in maximizing the use of external assistance. Concern for adequate institutional mechanisms must be of foremost importance in AID's efforts to facilitate the flow of benefits to the rural poor. Now that other donors have increased their lending for Peruvian agriculture, we must not overlook the potential adverse affects of overloading the handful of traditional institutions which presently serve the sector. The Central Bank views the vast network of the Peruvian banking system as a major potential conduit for stimulating agricultural development. A.I.D. can serve as a catalyst behind this concept and create an atmosphere for development by: i) seeing that the existing physical infrastructure and human resources are oriented toward solutions to problems faced by the rural poor; ii) seeing that resources including funds for longer-term lending, promotion and technical assistance are made available and that the proper incentives for their utilization are established; and iii) seeing that the GOP analyzes on a continuous basis the implications of overall credit policies affecting both the magnitude and sectoral allocations of credit.

The Central Bank originally estimated that there were 26 potential ICI's which might participate under the Project with over 360 offices located throughout the country outside of the provinces of Lima and Callao. The potential existing infrastructure consists of three state development banks, three associated banks, eight private commercial banks including foreign banks, six regional banks, and six empresas financieras. (see Annex II for a complete description of Peru's financial system). These will be the targets of the Central Bank's promotion campaign. Based on further Central Bank and Mission discussions with these entities, we believe we can reasonably expect perhaps nine of these to participate in agribusiness lending under the Project by the third year (this is reflected as an output in the Logical Framework, Annex I). In our view, the participation of as many as nine intermediaries would fully justify the Project's design along the lines of a rediscount or refinancing facility. Indeed, one could argue that as few as three or four ICI's participating and developing agribusiness projects which benefit the rural poor would indicate success in opening new channels and spreading the administrative workload among institutions. In any event, we are convinced that a refinancing facility which utilizes existing infrastructure as an outreach mechanism has validity for agribusiness sub-lending. The Central Bank is the only institution in Peru which is geared-up for and has experience in rediscount operations; it therefore is the logical implementing agent for the Project.

An argument advanced against involving LDC Central Banks in development is that special credit lines are outside their expertise and that such banks should concern themselves only with implementing overall monetary policy. The Central Bank of Peru refutes the view that the Rural Development Agribusiness Fund is beyond their purview. They cite as one of their basic objectives to promote credit availability and sectoral allocations of credit to insure economic growth, income increases, and a high level of employment. They are very interested in financing development and in seeing that the sectoral allocations of credit are supportive of the GOP's overall development strategy. At present, that strategy, as articulated in recent planning documents, gives priority attention to consolidating the gains of the agrarian reform, to increasing production, to arresting the growth of food imports, to integrating the production and marketing systems, and to stimulating regional development and decentralization. The Central Bank therefore believes it has a key role to play in influencing banking system allocations of credit away from the Lima/Callao area to the rest of the countryside. In short, they are enthusiastic over the prospects of participating in a program to encourage agribusiness development.

The Central Bank also points out that it is already involved with activities similar to those contemplated under the Project. The Project is administratively attractive in that the Central Bank has ample applicable experience with other rediscount operations and long-established relationships with the banking system. For example, the administrative feasibility of the rediscounting mechanism has been demonstrated in the successful operations of the Central Bank's on-going Selective Credit Program. The program was established in the Central Bank in 1971 in an effort to promote credit decentralization and regional development by refinancing projects approved by the state associated and regional development banks. The program is for short-term loans only (generally 180 days). The establishment of the Rural Development Agribusiness Fund is thus consistent with present Central Bank activity and the Bank's self-view of its role and responsibility toward Peruvian development.

Furthermore, the Central Bank is a prestigious institution that consistently attracts and retains high caliber, well-trained and versatile personnel. This, coupled with the important role the Bank now plays in overall GOP policy formulation and the strong interest in the proposed Project by the Bank's highest officials, lead us to believe that the Bank will be able to successfully assimilate the activities of the Rural Development Agribusiness Fund within its other operations. A.I.D. has had previous favorable experience with the Central Bank, and the Bank is familiar with A.I.D. loan implementation requirements. For example, the Bank acquired such experience in serving as the fiduciary for the CRECE fund established under A.I.D. loan 527-L-053 which was designed to assist small enterprises located in the Earthquake Disaster Area. The Central Bank capably fulfilled its responsibilities under the program.

The Central Bank is also the logical implementing agency because of its unique position at the center of the financial system, with responsibilities for strengthening banking institutions. It is therefore the best vehicle for organizing the delivery of technical assistance and training to ICI's in project evaluation and impact analysis techniques. The Central Bank does not carry-out direct lending, and its impartial reputation should facilitate its promotional and technical assistance activities among state and private banks and potential entrepreneurs.

The Central Bank is keenly aware of the absence of agribusiness development programs of the type proposed and the critical need for such programs. While new GOP planning documents are stressing the need for agribusiness development[1], such development has been impeded by the ill-defined responsibilities for promoting and administering agribusiness activities. Agribusiness falls under various sectors' jurisdiction, and there has been a tendency for numerous institutions to separately investigate and develop agro-industrial projects with little or no coordination. The Ministry of Industry and Tourism, Ministry of Food, and Ministry of Agriculture are all somewhat involved in agribusiness sub-project study and development, but many sub-projects with completed feasibility studies tend to die because longer-term credit is not available for financing. The Rural Development Agribusiness Fund could become the focal point for the GOP's new agribusiness emphasis. The promotional activities of the Central Bank could serve to tie together the activities and unify the strategies of diverse entities concerned with agribusiness development.

With the reorientation of the Project toward an agribusiness focus, the Agrarian Bank should no longer be considered as an alternative institutional channel for the Project. The Agrarian Bank's programs are directed toward agricultural producers, including individuals and associative enterprises, and by law the Bank can lend for certain agribusiness activities (i.e. agro-industrial processing or services) only when such activities are being undertaken by the producers or associative enterprises, including service cooperatives and Centrals, the agricultural cooperative federations. Agro-industry sub-lending to these groups accounts for less than one percent of Agrarian Bank annual lending activity. The Agrarian Bank would be an eligible ICI under the Project to the extent that it develops viable agro-industrial or service sub-projects meeting eligibility criteria. As noted, potential sub-projects are being identified and studied under A.I.D. loan 527-T-058 for Centrals far in excess of fundings availabilities under that program. However, apart from potential Centrals sub-projects, we do not foresee the Agrarian Bank participating to a major degree under the Rural Development Agribusiness Fund in the near term. This view is held given the Agrarian Bank's almost exclusive concentration on providing production credit and on-farm credit related

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1/ The GOP's draft plan "Tupac Amaru" for the period 1977- 1980 gives particular importance to agro-industrial development and metal working industries supporting agriculture.

to the production process and the fact that the Agrarian Bank will be heavily occupied developing, analyzing and effectively implementing the following: i) A.I.D. loan 527-T-058, Central Development, in the amount of $7.0 million with an equivalent counterpart contribution; ii) the new IDB loan in the amount of $30.0 million with an additional $20.0 million counterpart contribution; iii) the credit fund under A.I.D. loan 527-T-059, Sierra Irrigation, in the amount of $3.0 million ($1.0 million A.I.D. loan and $2.0 million counterpart); iv) completing IBRD loan 933, in the amount of $25.0 million); v) a probable new IBRD loan on the order of $40.0 million, with additional counterpart requirements; and vi) a credit fund to be established under the proposed A.I.D. Sub-Tropical Lands Development project. We do not believe the Agrarian Bank can be expected to do much more in the near term, as well as continue to expand and improve its traditional short-term crop production sub-lending activities.

In conclusion, the Mission believes the Central Bank possesses the capacity to successfully execute the Project. It has carried out development credit activities with no noticeable impairment to or erosion of the performance of its traditional functions. The addition of the Rural Development Agribusiness Fund to its activities will not create a major resource drain away from the Central Bank's financial and economic management duties The Bank has a keen interest in financing agribusiness development in support of the GOP's overall development strategy. AID's support of the Agribusiness Fund will help create an atmosphere for development not likely to otherwise exist by establishing a new institutional channel capable of benefitting the rural poor. A.I.D., which has financed similar programs elsewhere, can orient the Central Bank toward building eligibility criteria and impact analysis requirements into the operations of the Agribusiness Fund so that selected sub-projects genuinely alleviate constraints faced by the rural poor.

B. <u>GOP Credit Policy</u>

Various suggestions were made in the DAEC Review Cable of the PRP with regard to changes in GOP policy and potential policy changes to support the attainment of the Project's purpose; these suggestions also induced our more detailed review of Peru's financial system which is included in Annex II. In reviewing the desirability of policy changes, it is important to keep the Project's basic purpose in mind: to establish an effective rediscount facility, including appropriate technical assistance and promotion, for refinancing agribusiness sub-projects which benefit the rural poor. As discussed below, the Mission has concluded that some policy changes are indeed desirable and feasible to attain. In some cases, the Mission believes that the Loan, through appropriate Loan Agreement covenants, will be able to reinforce GOP awareness of the implications of alternative credit policies, and provide a framework for analyzing the effects of policies. Finally in certain cases the Mission and Central Bank have concluded that specific suggested policy changes in State 296084 are inappropriate.

1. <u>Legal Restrictions</u>

Presently, commercial banks in Peru are prohibited by law from lending at terms in excess of one year. While commercial banks can circumvent this by rolling over credits to effect medium-term financing, the restrictions have discouraged commercial banks from attempting developmental lending and appraisal of longer-term projects. The decree establishing the Rural Development Agribusiness Fund will specifically authorize all participating ICI's to engage in medium and long-term lending for agribusiness sub-projects.

2. <u>Portfolio Coefficients</u>

Loan portfolio requirements for commercial banks were instituted in 1969 and the present requirement is that the Lima-based commercial banks must allocate at least 60 percent of the total increase in credit (over a 1969 base) to first-priority and second-priority industries, or alternatively, must purchase Public Investment Bonds by the amount of the total deficiency. Industrial priorities are defined by Decree Law 18350 of July 30, and first priority industries are basic industries such as steel, non ferrous metals, chemicals, fertilizers, cement, paper, and essential capital goods; second priority industries are manufacturers of essential consumer goods for use in productive activities. In discussing portfolio coefficients, the Central Bank advised the Mission that the commercial bank loan portfolio requirements are presently under study by the Bank. Revisions are needed to up-date the credit baseline, to reduce the attractiveness of the alternative of purchasing bonds, and to redefine the priority sectors. We have been informed that the revision will probably create areas of priority along different guidelines from Decree Law 18350. We believe the following two policy changes are attainable and will aid in achieving the Project's purpose.

a. The Central Bank in revising the coefficient system should include agriculture and agriculture-related (i.e. agri-business) activities as a first priority activity.

b. Projects developed by commercial banks under the Rural Development Agribusiness Fund should be counted toward meeting the loan portfolio requirements even though the project financing will not be principally based on utilization of commercial bank resources.

3. Reserve Requirements

Until November 1976, legal reserve requirements applied to commercial banks were relatively complicated, consisting in minimum, basic, and marginal requirements on deposit liabilities without regard to the type of liability and a complicated set of regulations whereby a sizeable portion of reserves could be invested in securities of the state development banks. The GOP made sweeping changes in commercial banks legal reserve requirements in the period November 1976 - March 1977. The effect of these changes was to redirect the flow of reserves from commercial banks to the Central Bank rather than to the state development banks. The new system (see Annex II) is less complex and more in accord with the use of reserve requirements as an instrument of effective monetary policy to control the volume of money. The Central Bank is not anxious at present to experiment further with reserve requirements, and the Mission concurs that changes in the commercial bank reserve requirements for agricultural sector related loans are inappropriate. First of all, we note that legal reserve requirements relate to deposit liabilities rather than to loans (which are bank assets). Secondly, we support the Bank's view that reserve requirements are a more appropriate tool to influence the volume rather than the direction of credit.

4. Changes in Interest Rate Levels

During the period 1962-1975 interest rates remained relatively rigid in Peru with regard to credits and savings deposits. Throughout this period the maximum interest charge allowed to commercial banks on loans and overdrafts was 12 percent per annum plus a 1 percent commission. Interest rates on savings deposits (typically 5 percent) and time deposits (typically 7 percent) remained fixed throughout the 1962-1975 period.

Important changes were made in interest rate levels in 1976 and 1977. The Central Bank was empowered to make changes in a broad array of interest rates on loans and deposits by means of Decree Law 21504 (May 25, 1976).1/ Annex II, Table IV indicates the basic interest rates paid on the major types of deposits and fixed-yield securities issued by Peruvian financial intermediaries as of June 30, 1976, as of July 1, 1976 and as of March 1, 1977, and Annex II, Table V indicates the basic interest charges on the major types of credits extended by Peruvian financial intermediaries at these same dates.

The basic interest charge on short-term credits was raised from 12.0 percent per annum to 17.5 percent per annum. The basic charges for medium and long-term credits were also increased, but the magnitude of increase and absolute rates of interest vary greatly depending upon the financial institution, upon the purpose of the credit and, in some instances, upon borrower characteristics.

The relative rigidity in the structure of interest rates during the period 1962-1975 was maintained in the face of substantial fluctuations in the rate of inflation, and furthermore interest rates were low in comparison with an

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1/ Decree Law 21504 modified Article 59 of the basic charter of the Central Bank iving that institution the power to increase interest rates up to maximum set by the Executive Power by means of a Supreme Decree emitted by the Ministry of Economy and Finance. Previously the charter stated that the Central Bank could not authorize interest rates which exceeded the maximum established by general and specific laws.

average annual inflation rate of approximately 10 percent. Low real interest rates could exist because profits relate principally to the spread on the funds loaned by financial intermediaries rather than to absolute interest rates, which may be positive or negative in real terms (i.e. the interest rate less the rate of inflation).

In any event, the Government of Peru has become convinced that higher interest rates are necessary to prevent large-scale disintermediation and has increased interest rates twice in the past year. While it would not be realistic to expect the Government to enact positive interest rates in real terms immediately, the recent changes mark a major shift in policy. The Government has indicated that it does have the longer-range goal of moving toward positive real interest rates, a goal that may be obtained by successive reductions in the rate of inflation and/or further increases in institutional interest rates.

The Mission believes that the proposed Loan could be utilized to reinforce the Central Bank's demonstrated concern for an adequate interest rate structure through the negotiation of the following:

a. A confirmation of the GOP's longer term goal of moving to positive interest rate levels in real terms;

b. an agreement to periodically review progress toward meeting this longer-term goal;

c. an agreement to establish for the Rural Development Agribusiness Fund interest rates in line with the rates available in Peru for comparable types of credit; and

d. an agreement to adjust interest rates for the Rural Development Agribusiness Fund whenever necessary to maintain parity with comparable credit lines.

Based on the above, we now foresee an initial interest rate level for Project sub-loans greater than the rates originally contemplated in the PID and PRP. Likely rates are further discussed in section D.

5. Indexing

The indexing of interest rates on medium-term loans to a rate of inflation is at present a practice that is not employed or permitted on any credits made by Peruvian financial intermediaries. The GOP has adopted strong measures to contain inflation and wishes to avoid any formal indexing which could institutionalize or perpetuate inflation. However, the lack of indexing does not signify that interest rates have been stable. As noted, during the past year, two significant upward adjustments were made in interest rates on all types of deposits and credits. It is significant that interest charges on outstanding loans (including medium-term loans) were increased as well as the interest changes applicable to new or potential loans. (There are some exceptions to this rule, e.g. some outstanding credits of the Housing Bank). Apart from a possible theoretical basis for indexing, we see no reason in favor of indexing the principal and interest charges on one credit line when all the other credit lines are not so indexed and compelling reasons why indexing should not be applied to one credit line in isolation from all others. However, interest charges on loans from the Rural Development Agribusiness Fund should be adjusted (both in regard to outstanding and potential loans) when there is a generalized increase or decrease in interest charges. These adjustments should be relatively automatic and triggered by general readjustments of interest charges on the assets and liabilities of Peruvian financial intermediaries. By applying interest rate changes to outstanding loans, a variant of inflation correction is built into the program.

6. ICI Counterpart

The Central Bank accepts the principal that, from the point of view of making more resources available, it would be desirable for ICI's having access to the Fund to provide counterpart funds to the projects they submit to the Central Bank for Fund financing. This could be accomplished by limiting the percentage of a sub-loan eligible for rediscount to some percentage less than 100 percent of the amount lent. However, they point out that currently the lending system faces severe liquidity problems and that an overly stringent contribution requirement would be counterproductive to achieving the Project's purpose if ICI's refrain from participating for lack of resources. Since agribusiness lending will be a new activity for many ICI's and given the present liquidity problem, the Central Bank prefers to initiate the program with a high rediscount rate - 90%, with 10% to be contributed by the participating ICI. This represents a change from the 100% refinancing proposed by the Central Bank during PRP preparation. Based on discussions with ICI's and the Bank's knowledge and analysis of overall liquidity, the Central Bank is convinced that 10% is the maximum contribution that can be expected of ICI's at the present time.

In establishing the Rural Development Agribusiness Fund the Central Bank will need to continuously analyze the adequacy of the various incentives available, including rediscount percentage and interest rate spreads, to achieve the desired level of ICI participation. Through Project evaluations, a framework will be established for periodically assessing these variables. Such evaluations may lead to recommendations for upward or downward adjustments in the ICI counterpart contribution requirements.

C <u>Demand Analysis</u>

The following techniques have been utilized to verify the existence of demand for Project funds: i) a survey of potential participating ICI's; ii) field survey work by a team from the Central Bank; iii) a review of potential sub-projects being promoted by sectorial institutions (Ministry of Industry and Tourism, Ministry of Food); and iv) field survey work by the USAID and contracted consultants to confirm the Central Bank's demand projections.

The discussions with potential ICI's and the Central Bank resulted in the decision to reorient the Project's design toward an agribusiness emphasis. Many ICI's were enthusiastic over their prospects for developing and financing abribusiness sub-projects which would benefit the rural poor, and all agreed that such financing was sorely needed.

However, the ICI's were more hesitant to commit themselves to participating in direct sub-lending to small farmers and the rural poor. Most concluded that the nature of the two types of lending-direct lending to small farmers for capitalization to expand production and lending to agribusinesses serving small farmers -- differed greatly with regard to necessary financial incentives, guarantees, and sub-borrower technical assistance to off-set risk. USAID concluded that the original Project design was overly ambitious in attempting to benefit small producers both directly as sub-borrowers and indirectly as ultimate beneficiaries. When it became apparent that other donors were actively addressing the problems of on-farm capitalization credit, USAID and the Central Bank chose to re-direct the Project toward agribusiness sub-lending.

Following these discussions, a Central Bank study group was organized to undertake field surveys to assess potential demand. The group focused its efforts in identifying new sub-projects which would alleviate at least one of the following constraints: inadequate marketing facilities, insufficient processing facilities, and inadequate goods and service industries serving rural areas. These conditions were chosen for study as they are contributors to the following sectoral problems: i) a slowdown in the rate of growth of agriculture sector productivity; ii) scarce employment opportunities; and iii) low income levels among small farmers working individually-owned plots and associative enterprises created as a result of the Agrarian Reform.

The Central Bank team travelled to selected areas (including Cuzco, Puno, Arequipa, Trujillo, Piura) to investigate investment possibilities. Contacts were made with local banking institutions, public sector entities such as the Ministry of Industry, Ministry of Food, and Ministry of Agriculture, local development committees, and local societies of industries. Round table seminars were held with representatives from these entities to discuss the objectives and principles of the Rural Development Agribusiness Fund, operational requirements for its utilization, and area sub-projects now under study which would meet the Fund's eligibility criteria. From these sessions, 51 potential sub-projects were identified as summarized in the following table.

New Agribusiness Projects in Selected Regions Identified by Central Bank

Constraint and Location	Type	Number of Sub-Projects	Amount
I. Inadequate Marketing Facilities			
A. Southern Sierra	Storage	3	$ 670,000
B. Cajamarca	Storage	1	45,000
C. Cuzco	Warehouse	1	45,000
II. Insufficient Processing Facilities			
A. North Coast	Balanced feed, animal protein	8	2,400,000
B. Cuzco and Madre de Dios	Potato, Animal Protein, Corn, Hides, Yucca, Fruits, Cacao	18	5,250,000
C. Puno and Abancay	Quinua, Animal Protein, Fruits	9	4,700,000
D. Arequipa	Fruits	1	150,000
E. Cajamarca	Dairy	2	125,000
III. Inadequate Input (Goods and Services) Industries			
A. Cuzco	Transport, tools machinery	4	1,550,000
B. Cajamarca	Machinery, Services	4	75,000
		51	$15,010,000

All of the sub-projects are proposed new agribusiness ventures; most have completed the prefeasibility stage of development; and none yet have an assured source of financing. The total estimated cost of these sub-projects exceeds $15,000,000. Approximately 30% of the total amount corresponds to associative enterprise agribusiness sub-projects, with the balance being developed by private sector groups or social property entities. The Central Bank study is based on a limited sample of departments and should therefore not be considered an all-inclusive list of potential new agribusiness ventures. However, the sub-projects identified and the enthusiasm shown for the program in the areas visited convinced the Central Bank that the Rural Development Agribusiness Fund could play an important role in stimulating sector development and that the proposed initial resources for the Fund would be utilized in a reasonable time period.

In addition to new ventures, existing agribusinesses are expected to be prime candidates for developing sub-projects which serve the target group and thus qualify for Fund financing. Project consultants are presently studying potential sub-projects by existing agribusinesses for plant expansion and modernization programs as well as sub-projects which benefit the target group by reestablishing linkages between producers and processors. The latter is likely to include medium-term working capital requirements to facilitate the flow of quality produce from small farmers to agro-industries. Since the Agrarian reform, agro-industries no longer engage in the cultivation process but rather entirely rely on receipt of appropriate raw materials from the rural sector. In some agro-industries, existing plant capacity is underutilized due to an inability to obtain sufficient quantities and proper qualities of raw materials. Financing constriants have precluded these agribusiness from establishing contractual relationships with producers that would benefit producers by stabilizing markets and processors by stabilizing the raw material supply and improving quality. Such linkages could include provisions for delivery of improved seeds and technical assistance from processors to small farmers as well. The potential demand by existing agribusiness for sub-loans that meet the Fund's basic objectives is likely to be considerable.

The final technique for assessing demand included field surveys by the USAID and project consultants to verify the Central Bank's original projections and assess the likelihood for timely utilization of the Project's resources. This effort, again on a limited sample basis, attempted to select the most promissing (from an impact and feasibility viewpoint) of the new venture sub-projects from the Central Bank's study and merge these with attractive "ready-to-go" sub-projects by existing industries. Known agribusiness investment opportunities in the Tarapoto region were also included, resulting from investigation of the Sub-Tropical Lands Project area. The results of this analysis are included in Annex III as an illustrative sub-project list. The list includes 62 sub-projects with an estimated total cost of $19.9 million. The sub-project list has been divided into three categories. The first category includes sub-projects that are nearly ready for financing and that are clearly bankable. Feasibility studies for these sub-projects are well advanced and funds would be needed during the early part of next year. The second category includes sub-projects at the pre-feasibility stage which are being developed by an entrepreneur; however further study will be needed to determine definite costs and assess final feasibility. These sub-projects could be ready for financing within eighteen months. The final category includes sub-projects which have been studied by various promotional agencies and have been determined to be necessary and feasible, but specific entrepreneurs have not been identified. These could be expected to be ready for financing no earlier than the second year of the program.

The Project Committee believes that field identification of sub-projects can identify only a fraction of available projects which have potential for improving small farmer income. It is expected that as the Central Banks begins active promotion of agribusiness sub-lending that there will be many more sub-projects identified and developed which meet the Project's eligibility criteria. The list in Annex III, however, provides a point of reference and basis for the conclusion that the proposed initial magnitude of the Rural Development Agribusiness Fund is reasonable, and that the AID loan and Central Bank counterpart resources will be able to be disbursed in a timely manner. The time period estimated to be needed to commit the Fund's original capital is three years, with full loan disbursement completed within 3 1/2 years.

Further analysis and study of potential sub-projects will be undertaken for the PP analysis, including a full description and economic analysis of two or three illustrative sub-projects to demonstrate the potential benefits which will accrue to the target group of small farmers and associative enterprises.

D. Interest Rates

At the present time, we anticipate the following likely interest rate structure for the Rural Development Agribusiness Fund: a 16% annual rate to end-users, a 7% annual rate spread to the participating ICI, and a 5% basic annual rate to the Central Bank. The balance of 4% would accrue to the Fund for recapitalization purposes and to aid in maintaining the Fund's value. Future changes in the rate to end-users as discussed in Section II.B would trigger a corresponding adjustment in the percentage available for recapitalization. The Central Bank's rediscount rate to participating ICI's would be set at the rate to the end-user less the 7% ICI spread, and under present circumstances would equal 9%.

The 16% annual rate to end-users appears to accord reasonably well with the basic interest charges on medium and long-term credits granted for developmental purposes by the Industrial Bank, COFIDE, the Agrarian Bank, and the Housing Bank. (See also the discussion in Annex II.) At present, the evidence for particular credit lines comparable to the proposed Fund suggests that a 16% annual interest charge is neither excessively low nor high. Even though short-term credits bear a higher interest rate (17.5%), potential sub-borrowers from the Fund have costs which the borrowers of short-term do not have. The more important costs are the costs of presenting bankable collateral guarantees and the cost of proving the developmental impact of sub-projects. With the elimination of on-farm production lending from the scope of the Project, we see no compelling justification for differential interest rates to end-users.

Based on discussions with the Central Bank and ICI's, the 7% annual interest spread for the ICI's appears adequate to cover costs associated with sub-loan processing and coverage of default risk, and provide an ample profit margin on the ICI's resources devoted to Project sub-loans. It should be recognized that the cost of processing any particular sub-loan is not a linear function, e.g. a percentage of the sub-loan, and therefore costs cannot be adequately represented as a fixed annual percentage charge. It may be reasonable to permit a higher spread to ICI's on sub-loans that are smaller than a stipulated amount in order to avoid discrimination against such sub-loans. At present, the evidence is not yet conclusive, and we will need to explore this issue further with the Central Bank in preparing the PP.

The 5% annual return to the Central Bank will yield a gross profit margin of 3% during the A.I.D. Loan grace period and 2% thereafter as the Central Bank will be the Borrower under the Loan and will repay A.I.D. This does not appear excessive when compared with the responsibilities and likely expenses of the Central Bank in establishing a special unit for Fund administration, promotion, evaluation and technical assistance to ICI's. Such expenses have been estimated tentatively at $500,000 for the implementation period, roughly equivalent to the earnings which will accrue to the Central Bank during the same time. A detailed budget for the Central Bank's special unit will be presented in the PP.

As noted, the Fund will be recapitalized with earnings to help maintain its ability to continue agribusiness sub-lending. An additional mechanism to maintain the value of the Fund will be to require of the Central Bank an annual contribution to the Fund to maintain the total value of the Fund in terms of US. dollars. All profits generated by the difference between the Central Bank's rediscount rate to the ICI's and the basic annual rate of 5% for Central Bank expenses will be applied to the Fund and the Central Bank will be obligated to make up the shortfall in local currency each year necessary for the maintenance of the Fund's value in US dollars.

The annual Central Bank contribution provision will represent a significant Central Bank commitment to the institutionalization of the Rural Development Agribusiness Fund. It will also stimulate periodic review of the adequacy of the Fund's interest rate structure. If the GOP succeeds in reducing inflationary pressures and the need for exchange devaluations, the 4 percentage-point flow to the Fund (which occurs with the present structure of interest rates) may be adequate to maintain dollar value. If high rates of inflation persist, the Central Bank will undoubtedly increase interest rates which will lead to an increase in earnings and the value of the Fund, thereby reducing the amount of annual additional Central Bank contributions to the Fund.

E. PP Development Schedule

The Mission intends to submit the PP for the Rural Development Agribusiness Fund by early August 1977 for FY 77 funding consideration. The intensive review will be completed during May-July by the USAID with the assistance of consultants from GAMCO, INC. during the month of May.

Part Three - Credit Aspects of Proposed FY 78 Loan for Development of Sub-Tropical Lands

A. The Rationale for Medium and Long-term Credit for the Sub-Tropical Lands Project Area

With the redesign of the Rural Development Agribusiness Fund in the manner and for the reasons described in Part One of this report, and the availability of credit for agro-industries no longer being considered in the design of the Sub-Tropical Lands Development Project (as was originally contemplated in the PRP), no similarity of purpose exists between the Fund and the medium to long-term credits required for capitalization of farming operations in the Sub-Tropical Lands Project. The credits available under each project are to be utilized for different purposes and will overlap only in a geographical sense. Medium to long-term credits in the Sub-Tropical Lands Project will principally finance land clearing and leveling, and perhaps other on-farm improvements, pasture establishment, and livestock acquisition. The Agribusiness Fund will provide financing for agro-industrial or agribusiness enterprises such as marketing and processing facilities, and agricultural goods and services input industries. While the Agribusiness Fund will operate country-wide, it is believed that attractive opportunities will exist for its use in the land development area, thus providing additional capital for the zone. Thus, the USAID views the two projects as being mutually complementary.

Since no duplication of effort exists between the two proposed A.I.D. loans, the USAID has examined other likely sources of concessional credit -- IDB and the World Bank -- to determine the availability of credit from those sources through existing or future programs in the area of the Sub-Tropical Lands Development Project. As noted in Part One, IDB's credit portfolio has included several lines of credit to the Agrarian Bank. Loan #322 for $12,000,000 was designed to finance part of the foreign exchange costs of a global credit program for beneficiaries of the Agrarian Reform. It is now nearly fully disbursed. IDB Loan #277 of $23.3 million for small and medium irrigation works (linea global) will be completed in 1978. Beneficiaries include associative groups and individual farmers in the coast and sierra. A new loan of $30 million has been recently approved by IDB to provide medium and long-term credit to an additional 75 associative enterprises and to the groups benefitted by the linea global program. However, explicitly excluded from the use of the new loan is Agrarian Zone IX, which includes the Sub-Tropical Lands Development Project area.

Conversations with a World Bank Mission revealed that its credits are little used in the project zone, with most of the current portfolio being directed toward the coast. Only 44 World Bank sub-loans were granted in the project area in 1976, and these totaled less than $250,000. The current loan expires in November 1977. The proposed new World Bank loan will include a substantial earmarking of funds for the coastal sugar cooperatives. However, it is hoped that the Sub-Tropical Lands Project will alleviate basic constraints to credit utilization, thereby facilitating the increased use of World Bank credit funds in the Project area.

B. Demand for Credit in the Sub-Tropical Lands Project Area

1. Background: The isolation of the project area has been a major factor contributing to the restricted use of credit for farm improvement. Weak demand in the local market and reliance on air transportation to reach large markets has led farmers to produce high value commodities (meat and tobacco) as cash crops. EPSA (Empresa Pública de Servicios Agropecuarios), the GOP's buying agent, has lacked the ability either to store or to ship bulk commodities such as grain in the project area, and the Agrarian Bank, therefore, has followed a policy of lending only for a restricted number of commodities. This has led to a situation where, for example, although soybeans can be produced in quantity in the zone, EPSA could not buy them nor would the Bank lend money for their production.

In the foregoing situation, the Agrarian Bank maintained only an agency and two offices in the zone and staffed them with a minimum of personnel. As a result, only about 2,000 out of 12,000 farmers have been served by formal credit institutions.

Another factor restricting credit utilization in the zone is land tenure. Without a certificate of occupancy, a farmer cannot be granted an Agrarian Bank loan. Since current estimates are that only 30% of the farmers actually have titles or certificates of occupancy for their land, the vast majority are presently ineligible to receive loans.

2. Factors Affecting Future Demand: The Sub-Tropical Lands Development Project is being designed to eliminate all of the factors restricting the use of agricultural credit in the zone. First, the isolation of the zone will end by 1978 with the opening of the Tarapoto-Rio Nieva Highway. The Land Development Project itself will improve the internal transportation grid, linking production areas to the trunk highway. This, in turn, will facilitate marketing and allow the Agrarian Bank to lend for production of all non-perishable commodities.

Second, the General Director of the Agrarian Bank has expressed his formal approval of up-grading the Tarapoto agency to Branch level and expanding other Banking facilities within the zone. This implies the assignment of more personnel and equipment for the credit system.

Third, EPSA, under the Land Development Loan and/or with its own funds will expand the storage system within the zone in accordance with production estimates.

Fourth, the Ministry of Agriculture is prepared, given loan financing, to accelerate issuance of titles and certificates of occupation, thus increasing the number of farmers eligible for Agrarian Bank credit.

3. Demand for Medium and Long Term Credit: The Agrarian Bank is primarily a short-term lender with 92% of its credit dedicated to production and marketing loans. For medium and long-term credit, the Bank relies heavily on external development assistance loans. In the project area, however, such financing has not been applied and agriculture remains virtually uncapitalized for the reasons cited above.

The Agrarian Bank has made projections of the likely demand for credit, apart from land clearing requirements, in the project zone that would exist with the alleviation of present constraints. These projections are shown in the table below, and indicate a demand for credit on the order of $18.3 million over the next five years. It is expected that the proposed new World Bank Loan would be able to provide funding to meet a portion of this demand.

Agrarian Bank Projections of Credit Demand for Medium and Long-Term On-Farm Investments in Sub-Tropical Lands Development Project Area

(Millions of U.S. Dollars)

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Land Leveling	.4	.8	.8	.8	1.2	4.0
Permanent Crops/Pastures	.5	.6	.7	.9	1.1	3.8
Livestock (cattle and pigs)	.6	.9	1.2	1.6	1.8	6.1
Machinery and Equipment	.3	.4	.6	.8	.9	3.0
Livestock Installation and Improvements	.1	.1	.2	.2	.3	.9
Tools	.1	.1	.1	.1	.1	.5
	2.0	2.9	3.6	4.4	5.4	18.3

Source: Agrarian Bank, Iquitos Branch

As noted, land clearing requirements are not included in the above table, and because of the critical nature and timing of this input, the USAID Project Committee recommends that land clearing be built into the design of the Sub-Tropical Lands Project to assure funding availability and proper phasing with other project activities. It is recommended that a credit fund on the order of $3.5 - $4.0 million be established to finance land clearing and perhaps other on-farm improvements which cannot be expected to be met with funding from the World Bank.

Concerning land clearing, several variables remain to be evaluated and exact procedures have not been agreed upon, e.g. the rate at which equipment, yet to be selected, can clear land of various categories and whether equipment will operate year round and in multiple shifts. It is expected that loans of four years duration will be granted from the credit fund to be established in the Agrarian Bank for the purpose of clearing land. A clearance rate of about 6,000 hectares a year at a cost of about $200/hectare is expected. The following loan schedule for land clearance credit represents our current best estimate of probable availability of land clearing services.

	(US.$000) YEAR					
	1	2	3	4	5	6
Land Clearance Loans	600	1,200	1,200	1,200	1,200	1,200
Repayments	-	150	450	750	1,050	1,200
Balance* in Credit Fund	2,900	1,850	1,100	650	500	500

Actual demand will depend upon the farmers' willingness to incur long-term debt in order to improve the productivity of the land. In turn, this willingness is grounded in the farmers' attachment to the land (secure ownership or occupancy) and their perception of the costs and risks of the operation. It is likely that, during the first two years, established farmers will take principal advantage of the land clearing service. Tractors equipped with plows will clear established fields of stumps, roots and rocks which will make possible the convenient use of conventional tractors in crop production. Working with well established farmers will help demonstrate the advantages of land clearance and simultaneous deep plowing to others who would ordinarily abandon partially cleared land after a few years, especially if the titling process can proceed in advance of such services. The total need for land clearing services in the project area is considerable, given the fact that the project area contains about 130,000 hectares of potential

* Beginning with credit fund of $3.5 million, assuming uncollectible loans equal interest payments.

crop land, of which only about 20% or 26,000 are presently being farmed. At the estimated rate of clearing, the land development project could manage only 27,000 hectares in five years, leaving a great deal of potential crop-land to be cleared, or partially cleared by hand. Thus, even with the project, there will be unmet needs, at least during the active life of the loan and the useful life of the original equipment procured thereunder.

The foregoing assumes approximately the same levels of funding for different categories of investment as presented in the Sub-Tropical Lands PRP which are subject to change during the intensive review now in progress. In addition, the amount budgeted for medium to long-term credit may need to be increased to accommodate on-farm infrastructure investments other than land clearing, e.g. the purchase of livestock, construction of fences, and irrigation works, should World Bank funding be postponed or not be available for the Project zone. Further analysis of this issue will be undertaken in the Sub-Tropical Lands Project Paper.

AID 1020-28 (11-73)

PROJECT DESIGN SUMMARY
LOGICAL FRAMEWORK

Life of Project:
From FY 77 to FY ______
Total U. S. Funding $10,000,000
Date Prepared: 3/22/77

Project Title & Number: RURAL DEVELOPMENT AGRIBUSINESS FUND

NARRATIVE SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	IMPORTANT ASSUMPTIONS
Program or Sector Goal: The broader objective to which this project contributes: To increase food production, employment and incomes of rural poor, and improve nutrition ------ Sub-goal: To alleviate identified typical farm level constraints to increased target group income through the expansion of markets for small farmer products and the provision of agricultural-related goods and services.	Measures of Goal Achievement: Food production increases equal to demand growth. Employment and incomes of target group increase. ------ Introduction of new technology resulting in greater productivity. Increased value added accruing to rural sector. (Cont.)*	National Statistics, census and sample survey data. ------ Project data and records *(Cont.) Measures........ Greater availability of agricultural inputs. More secure markets and stabilized prices for target group production.	Assumptions for achieving goal targets: 1. Other donor programs in sector continue. 2. Adequate production incentives (prices) maintained. 3. GOP concern for rural poor continues. 4. Internal stability maintained especially for land tenure.
Project Purpose: 1. To establish in the Central Bank an effective facility for rediscounting loans made by financial institutions to sub-borrowers which process or market agricultural products or provide complementary goods and services to the agricultural sector. 2. To establish a program of promotion and development of such agribusinesses, including appropriate technical assistance, which will maximize benefits to small farmers and the rural poor.	Conditions that will indicate purpose has been achieved: End of project status. 1. Demonstrated Fund capability to maintain its level of rediscounting. 2. All Project funds placed in sub-projects meeting pre-established eligibility criteria. 3. Real capital value of Fund equal to $14.7 million. (Cont.)**	Central Bank and ICI records. Project data and records. **(Cont.) Conditions......... 4. Fund reflows are being used for agribusiness purposes. 5. A system of sub-project identification and promotion is functioning smoothly.	Assumptions for achieving purpose: 1. Gains of Agrarian Reform continue to be consolidated. 2. Banking system becomes increasingly convinced of viability of agri-business lending. 3. Investment incentives for agri-business are adequate. 4. Crop production and on-farm capital credit are available from other sources.
Outputs: 1. Sub-loans rediscounted (value in millions US.$). 2. Number of participating ICIs. 3. Operations Manual distributed to ICIs. 4. Promotional seminars held. 5. Evaluation system established. 6. Policy changes effected which facilitate or encourage agribusiness lending.	Magnitude of Outputs: Yr.1 / Yr.2 / Yr.3 1. 3.75 / 7.5 / 14.7 2. 3 / 6 / 9 3. to be completed within 120 days of loan agreement signat. 4. 7 / 10 / 12 5. formal evaluations conducted 6. N/A	Central Bank and ICI records. Project records.	Assumptions for achieving outputs: 1. Central Bank is aggressive in promoting the Fund. 2. Incentives to induce ICI interest and participation are adequate. 3. Effective demand for credit continues to exist.
Inputs: (In millions of US.$) 1. A.I.D. : Fund Capitalization $ 9.8 Technical Assistance $ 0.2 $10.0 2. GOP : Fund Capitalization $ 4.9 Administration/Evaluation/ Technical Assistance and Promotion $ 0.5 $ 5.4	Implementation Target (Type and Quantity) Cumulative (In Million US.$) Yr.1 / Yr.2 / Yr.3 $2.5 / $5.0 / $9.8 $0.1 / $0.15 / $0.2 $1.25 / $2.5 / $4.9 $0.2 / $0.35 / $0.5	1. USAID records. 2. Central Bank records.	Assumptions for providing inputs: 1. All funds available on timely basis. 2. No unexpected problems in meeting conditions and covenants set forth in loan agreement.

PERU'S FINANCIAL SYSTEM

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I. STRUCTURE OF PERU'S FINANCIAL SYSTEM

Peru's organized financial system consists of several banking institutions and of a number of non-bank financial intermediaries. In terms of basic structure, we refer to the banking institutions as bank financial intermediaries and the other financial institutions as non-bank financial intermediaries. The regulatory and control mechanisms affecting the bank financial intermediaries are more clearly structured than those affecting the non-bank financial intermediaries and are similar to those found in other Latin American countries and throughout the world with the primary regulatory responsibility residing in a Central Bank. The degree of institutional and regulatory heterogeneity for the non-bank financial intermediaries is greater than for bank financial intermediaries. This situation is typical for many countries with incomplete capital markets.

One of the chief purposes underlying the creation of organized financial intermediation is the generation of savings and their efficient allocation toward investment. Financial intermediaries engage in financial operations between persons or economic units by means of pieces of paper; and although such intermediation can occur in the context of relatively unorganized markets, the inherent economies of scale and acceptance of risk of default generally leads to the creation of organized financial institutions, i.e. firms which engage exclusively in the business of financial intermediation. In most countries, governmental agencies supervise the operations of financial intermediaries in order to prevent abuses. The operations of bank intermediaries are usually subject to controls arising from: (i) the power of banks to create money; (ii) the need to prevent bank failure; and (iii) the desire to prevent unfair competitive practices. The latter considerations generally predominate in the regulations affecting non-bank financial intermediaries.

The structure of Peru's financial intermediation system has undergone substantial changes in the past two decades in regard to number of financial intermediaries and to a lesser extent in regard to their functions. Since 1968 the government has generally expanded its sphere of influence in the financial system by legal changes and ownership control. At present, Peru's bank financial intermediaries include the Central Bank, the commercial banks, the state development banks, Banco de la Nación, and the private development banks. The general lines of control for the bank financial intermediaries suggest the following scheme:

Central Bank - (Banco Central de Reserva del Perú)

- Commercial Banks
  - Associated Banks
  - Private Banks
  - Private Foreign Branch Banks
- Private Development Banks
  (BIC = Banco de la Industria de la Contrucción)
  (BANPECO = Banco Peruano de los Constructores)
- State Development Banks
  (a) Industrial Bank
  (b) Agricultural Bank
  (c) Mining Bank
  (d) Central Mortgage Bank
  (e) Housing Bank
- Caja de Ahorros de Lima

Non-bank financial intermediaries in Peru are a collection of entities whose principal activity is the intermediation of credit at medium and long-term. They differ from bank financial intermediaries fundamentally in regard to their ability to create money, that is, their liabilities must be converted to money prior to being utilized to acquire goods and services. Although the non-bank financial intermediaries are subject to state regulation, the line of authority is by no means as clear as those which exist in regard to bank financial intermediaries.

The major non-bank financial intermediaries can be grouped as follows (with Spanish names in parentheses):

(1) Development Finance Corporation (COFIDE, i.e. Corporación Financiera de Desarrollo)

(2) Savings and Loan Cooperatives (Sistema Cooperativa de Ahorro y Crédito)

(3) Investment Companies (Compañias Financieras Privadas)

(4) Insurance Companies (Compañias de Seguros y Capitalización)

(5) Savings and Loan Associations (Caja de Ahorro y Préstamo para Vivienda)

At the end of 1975, the consolidated accounts for bank financial intermediaries indicated net domestic assets amounting to S/.153.4 billion and liabilities to the private sector amounting to S/.141.9 billion, i.e. equivalent to US.$3.41 billion and US.$3.15 billion respectively (at the then existing rate of exchange at the end of 1975 of S/.45.00 to US.$1.00). The net domestic assets of the non-bank financial intermediaries amounted to S/.45.3 billion and their liabilities to the private sector amounted to S/.35.9 billion, i.e. equivalent to US.$1.0 billion and US.$0.80 billion respectively. The consolidated accounts for bank and non-bank financial intermediaries as a whole indicated net domestic assets of S/.190.5 billion and liabilities to the private sector of S/.173.8 billion at the end of 1975. The consolidation of accounts reduces the magnitude of total assets and total liabilities because a portion of the assets of one set of institutions are liabilities to another set of institutions. The interconnectedness of the financial system as a whole signifies that a sizeable portion of assets of particular intermediaries are liabilities of other intermediaries. For this reason, data on assets and liabilities for each intermediary in isolation usually overstates its financial power.

II. THE BANKING SYSTEM

A. The Commercial Banks

The commercial banks when considered as a whole constitute the most important financial intermediary in Peru. The commercial banking system includes seven national banks, i.e., those which have their main office in the Lima/Callao area, three of which are the so-called "associated banks" which are owned by the Banco de la Nación, six regional banks which have a separate legal regime, two private development banks, one savings bank, and the branches of four foreign banks. At the end of 1975, these banks offered their services at 767 offices throughout the country.

Beginning in 1969, the Government initiated a policy intended to strengthen the commercial banking sector. The Government nationalized three banks (Banco Popular, Banco Continental, and Banco Internacional) and they are now the Associated Banks. However, there is virtually no distinction between private national commercial banks and the associated banks in regard to legal reserve requirements and credit regulations. The Government also strengthened the remaining commercial banks by requiring privately-owned banks to increase their share capital to a minimum of S/. 150 million. The increase in capital could be accomplished through reserve capitalization, new stock issues, or mergers. The latter course was adopted in three cases during 1971. Further mergers are being encouraged by legislation which removed stamp, registration, and transfer taxes from such operations.

In an attempt to make the commercial banks more responsive to the needs of borrowers, the Government made several important changes in the early 1970's. Some of the reforms involved interest rate and administrative regulations, but the most important change was the promulgation of an organic law for the Regional Banks, i.e., those whose main office is not in the Lima/Callao area. The Regional Bank Law (Decree-Law 18967) was issued on September 21, 1971 to promote balanced growth throughout the different regions of the country. This law offers the regional banks liberal tax benefits and authorizes them to issue an attractive deposit liability called a certificate of deposit. In return for the benefits given, the regional banks are required to invest in the regions where they are authorized to operate.

By Decree-Law 19043 of November 25, 1971, the Government of Peru required that all new banks must be owned 100 percent by Peruvians and that the share capital of existing banks be at least 80 percent in Peruvian hands. (Previously, 75 percent Peruvian ownership was required). This regulation implemented the provisions of the Cartagena Agreement on the treatment of foreign capital.

Historically the commercial banks have generally made loans and credits of a relatively short-term nature. Their credits are purely in domestic money and their liabilities are composed of various types of deposits, e.g., demand deposits, savings deposits, and term deposits. The credit operations are typically overdrafts, credits of specific term, and the discount of documents. Their investments are in fixed assets and financial assets, the latter are principally bonds issued by public sector entities. In addition to credit operations, commercial banks are authorized to perform various other services for their clients, including those related to foreign exchange transactions, the opening of credit documents, operations related to financial securities, the granting of guarantees and bankers' acceptances, collection services, and the renting of safe deposit boxes.

Two commercial banks, the Banco de la Industria de la Construcción and the Banco Peruano de los Constructores, both created in the 1960's, have characteristics similar to those of other commercial banks. The main differences are that their credits are directed solely to the construction sector and that they are specifically permitted to operate at medium - term in regard to their deposits and credits.

The Caja de Ahorros de Lima, although nominally classified as a commercial bank, is governed by a separate set of legal statutes. In addition to engaging in operations permitted to other commercial banks, this institution is authorized to operate at medium and long-term in the money market directing credit to housing and to issue savings bonds.

TABLE I

COMMERCIAL BANKS BY TYPE AND GROSS ASSETS
(April 30, 1976)

	Gross Assets (Billions of Soles)
PRIVATE COMMERCIAL BANKS	60.7
Banco de Crédito del Perú	38.9
Banco Wiese Ltdo.	10.6
Banco Comercial del Perú	5.9
Banco de Lima	5.3
ASSOCIATED BANKS	88.9
Banco Internacional del Perú	17.8
Banco Popular del Perú	44.3
Banco Continental	26.8
REGIONAL BANKS	7.5
Banco Regional del Norte	1.0
Banco Nor-Perú	1.4
Banco Regional Sur Medio y Callao	1.8
Banco de los Andes	0.9
Banco Amazónico	1.3
Banco del Sur del Perú	1.1
FOREIGN BRANCH BANKS	5.2
Banco de Londres y América del Sud Ltdo.	1.0
Citibank	1.8
Bank of Tokyo	1.6
Bank of America	0.8
PRIVATE DEVELOPMENT BANKS	3.7
Banco de la Industria de la Construcción	1.9
Banco Peruano de los Constructores	1.8
CAJA DE AHORROS DE LIMA	4.5
TOTAL	170.5

B. The Central Bank

The Banco Central de Reserva del Perú (hereinafter cited as the Central Bank) was established in 1931. Its principal duties are to conduct monetary, credit, and foreign exchange policies of the Government of Peru. It has at its disposal a wide array of monetary policy instruments to control credit expansion and to channel commercial bank credit toward specific economic sectors. These instruments include rediscount operations, legal reserve requirements, the power to set interest rate ceilings on loans and deposits, and selective credit controls. The utilization of monetary policy instruments in recent years is discussed further in Part IV. As is typical for a Central Bank, its liabilities to the private sector consist primarily in the currency issue. Its net domestic assets consist mainly in claims on the government, the Banco de la Nación, the commercial banks, and the state development banks.

C. The Banco de la Nación

The government-owned Banco de la Nación was established in 1965 as the fiscal agent for the State. Its functions included then, as now, collecting taxes, holding deposits for the Government and the public sector entities, and making payments on behalf of the State. Since its founding, it has acquired additional responsibilities, such as guaranteeing public sector obligations, servicing the public debt, and administering the draft foreign exchange market. In addition, it owns the three associated banks. In 1970 it was authorized (by Decree Law 18118) to undertake all types of commercial, credit, and banking operations both with the private as well as the public sector. In order to obtain enough resources to carry out its functions, the Banco de la Nación was made holder of part of the marginal reserve requirements placed on commercial bank deposits as of April 1969 as well as the holder of all deposits of public sector entities as of August 1971 (Decree Law 18955.

The Banco de la Nación receives only a small portion of its resources by means of direct liabilities with the private sector, e.g., demand, time, and savings, and foreign exchange deposits. The bulk of its domestic liabilities are to commercial banks and to the Central Bank. However, in addition to these sources of funds, it obtains funds from external sources as well as from the governmental sector. In recent years the growth of Peru's social security system has led to a large accumulation of funds in the Banco de la Nación which, in turn, has allowed it to channel substantial resources to the state development banks and to the associated banks and to heavily influence the banking system's lending capacity. 1/ Therefore, due to its direct control over bank liquidity, the Banco de la Nación has assumed an increasingly important role in the execution of monetary policy.

D. The State Development Banks

In terms of total financial resources and credit to the private sector the Agricultural Bank, the Industrial Bank, and the Central Mortgage Bank are the larger of the state development banks, the Housing Bank and Mining Bank are distinctly smaller (see Table II). Apart from the Central Mortgage Bank, which sells mortgage bonds to the public, most of the state development banks receive only small proportions of their total resources directly from the private sector but utilize the bulk of their financial resources providing credit to the private sector.

1. Banco Agrario del Perú

The Banco Agrario del Perú was created in 1931, its organic law directs it to promote agricultural production by providing farmers with necessary credit resources. At the end of 1975 the Banco Agrario (hereinafter cited as the Agricultural Bank) accounted for approximately 35 percent of state development bank lending to the private sector and about 15 percent of all bank financial intermediary credit to the private sector. The Agricultural Bank maintains 105 offices throughout Peru, by means of 18 branches, 52 agencies, and 35 inspectorates.

In its lending operations, the Agricultural Bank is authorized to make loans to promote production of agricultural, forestry, and livestock products and, in general, has a mandate to use a wide variety of technical and financial means. Up to 1976, the Agricultural Bank distinguished between loans to small, medium, and large farming (but only by size of loan). In 1975 the Agricultural Bank made 65,874 loans for a total of S/. 14.84 billion. Of this amount 1,727 loans in the amount of S/. 9.62 billion were made to associative agricultural enterprises (cooperatives, agricultural committees, pre-cooperatives, agricultural social interest societies, and communities). The remainder were to individual agricultural proprietors, to which the Agricultural Bank lent S/. 15.07 billion in 64,025 loans during 1975. Small farmer. received 56,012 loans in the

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1/ In 1975 and 1976 the financial requirements of public sector non-financial entities grew by substantial magnitudes, and, on balance, the Banco de la Nación's credits to these enterprises were financed by means of external borrowing.

amount of S/. 2.29 billion; medium farmers received 5,024 loans in the amount of S/. 0.90 billion, and large farmers received 2,989 loans in the amount of 1.82 billion soles. By value, 92 percent of all loans were classified by the Agricultural Bank as short-term, i.e., less than two-year term. The above data indicate that the average loan to small farmers was S/. 40,884, the average loan to medium farmers was S/. 179,140 and the average loan to large farmers was S/. 608,899. These averages accord with the Agricultural Bank's practice of specific classes of borrowers by size of amount lent. Loans for small farmers range up to S/. 100,000, those for medium farmers extend between S/. 100,000 and S/. 500,000, and those for large farming may exceed S/. 500,000.

According to the organic law governing the Agricultural Bank (Law 21,227 of July 22, 1975), the basic categories of loans that it makes shall be for support, capitalization, and commercialization. Support loans (principally for crop production campaigns) shall have terms not exceeding two years and generally do not exceed one year; capitalization loans can have terms of up to 20 years, and exceptionally up to 25 year term; and the commercialization loans are limited to one-year term. The Bank is authorized to finance the acquisition of land only for the consolidation of minifundio and for the construction of plants owned by producers to process agricultural products.

Prior to July 1, 1976 the interest rates charged by the Bank were basically governed by a system of preferences in favor of small farmers and associative units, with the size of loans also having some influence. The maximum rates for these borrowers was 10 percent per annum, but the rates for medium and large farmers were 12 percent and 13 percent per annum respectively. As of March 1, 1977, the Bank's basic interest rate is 16 percent per annum with a 14 percent preferencial rate for associative enterprises.

The Agricultural Bank administers numerous external credits which the Government of Peru has obtained and entrusted to the Bank. The purpose, terms, and procedures of those loans differs according to the specific contractual arrangements. These external credits are from USAID, the World Bank (IBRD), the Inter-American Development Bank (IDB) and the Government of the Netherlands. The following loans received by the Bank in the past few years aim at increasing the funds available for its agricultural credit activities. In June 1972 a $12.0 million Inter-American

Bank loan was granted to the Bank to finance the foreign exchange cost of the Agricultural Bank's global credit program for associative entities - beneficiaries of the agrarian reform. In September 1973 the World Bank (IBRD) made a $25.0 million loan to the Agricultural Bank to finance loans to agricultural production cooperatives, service cooperatives, and to small and medium farmers. In September 1976, A.I.D. and the Government of Peru signed a $7.0 million loan for the development of Agricultural Cooperative Federations (CENTRALES) to be administered by the Agricultural Bank. In December 1976 the Inter-American Development Bank authorized a $30.0 million loan to the Agricultural Bank to finance two sub-programs; the granting of credits to associative productive enterprises of small and medium farmers and the granting of credits to farmers in twelve irrigation districts on an individual or collective basis.

2. Banco Industrial del Perú

The Banco Industrial (hereinafter cited as the Industrial Bank) was founded in 1933 and began operations in October 1937 as a mixed banking enterprise with state and private capital. Its operations are governed by the charter formulated in June 1962 and since revised on several occasions. Its paid-in capital as of December 31, 1974 was S/. 1.9 billion of which 89 percent corresponded to public sector and 11 percent to private sector participation.

The Industrial Bank is authorized to pursue the promotion and development of industrial activities by means of loans and discounts, the granting of guarantees, investing in equity participation, receiving demand and time deposits, issuing and placing obligations, obtaining loans from domestic and foreign entities and performing any other activities permitted to Peruvian commercial banks. The financial resources of the Industrial Bank originate principally from paid-in capital, deposits of the Banco de la Nación, lines of credit extended to it by the Central Bank, and external credits, principally from the Inter-American Development Bank. The Industrial Bank also operates several trust funds on behalf of the Government of Peru. These funds are: (a) the Fishing Development Fund, of which the Bank is administrator, (b) the Contingent Fund, of which the Bank is depositary, (c) the Fund for Financing the Promotion of Industrial Enterprises, of which the Bank is fiduciary, and (d) the Non-Traditional Export Fund, of which the Bank is fiduciary and (e) the Rural Enterprises Development Fund, of which the Bank is administrator. The Fishing Development Fund was created in March 1970 for the purpose of consolidating national fishing industries. Although the net worth of this Fund was only $3.1 million at the end of 1974, the Industrial Bank had made approximately

$96 million of its own resources available to this Fund. The Contingency Fund was created in February 1972 to refinance the outstanding debt which fishmeal and fish oil enterprises had with state and associated banks upon their takeover by the Government. (The loan portfolio of this Fund is quite small). The Fund for Financing the Promotion of Industrial Enterprises was created in August 1970 for the purpose of financing industrial activities through the investment of agrarian reform bonds. This investment may be utilized only for the following: (i) financing up to fifty percent of the social capital of new enterprises or the expansion of existing enterprises and (ii) financing up to eighty percent of the corresponding feasibility studies. The net worth of this Fund at the end of 1974 approximated $14 million. The resources of the Non-Traditional Export Fund totaled $97 million at the end of 1974 and these resources were given to the Industrial Bank as paid-in capital. The Rural Enterprises Development Fund is being capitalized under a $10.0 million A.I.D. Loan to the Government of Peru; this loan was signed in November 1974.

Apart from these funds, the Industrial Bank undertakes the following types of financial activities: (a) ordinary loans, (b) supervised loans, (c) extraordinary loans, (d) other loans, and (e) contingent responsibility activities. The ordinary loans constitute the basic lending activity of the Industrial Bank. In the four-year period 1971-1974, the Industrial Bank made 753 ordinary loans totalling the equivalent of $128.4 million. About three fourth of these loans by value were to enterprises in the Lima/Callao area, and approximately 56 percent financed fixed investment and the remainder financed working capital. The general terms attached to ordinary loans are a maximum period of ten years, a maximum participation of 75 percent, (as of July 1, 1976) a maximum 17.5 interest rate, a 1.0 percent per annum commission on the value of the loan, and a 2.0 percent charge on a loan with payment in arrears. The normal terms for ordinary loans is three to six years and normally a one-year grace period is given for loans financing fixed investment.

Supervised loans are mainly for enterprises outside the Lima/Callao area. During the four-year period 1971-1974 the Bank made 6,490 loans totalling $16.2 million in this category. By value, 64 percent was for working capital and 67 percent financed the production of consumer goods. Most of these loans were for periods of two to five years and nearly all loans were for less than the equivalent of $10,000.

The Bank's other significant lending categories relate to the Fishing Development Fund, with 1, 273 loans totalling $141 million in the period 1971-1974, and the Non-Traditional Export Fund with $121 million in loans in the period 1971-1974, the bulk of which financed the export sale of fishing boats. In addition, as of March 1977 the Bank had financed over 1,000 loans totalling S/. 243 million under the Rural Enterprises Fund.

3. Banco Minero del Peru

The smallest of five state development banks is the Banco Minero (hereinafter cited as the Mining Bank). This Bank is authorized to make loans in the mining sector to Peruvian nationals only (i.e., to firms the capital of which Peruvian residents hold a participation of at least 60 percent). The Bank's loans are basically from five to ten year maturity with a one-year grace period and can be classified in two groups in regard to presently - applicable interest rates. Interest rates on loans to small mines are as follows: up to S/.5 million, 10 percent per annum with no commission; more than S/.5 million, 14 percent per annum with a 1 percent commission. Small mines are defined as producing less than 10,000 metric tons of ore per year. Interest rates on loans to medium mines are 16 percent per annum plus 1 percent commission.

Besides its lending operations, the Mining Bank fulfills a number of other functions, serving as a marketing agency for several small mines, a supplier of machinery and equiipment to the small miners through an extensive warehouse network, administrator of the Mining Investment Fund, supplier of technical advice through its own laboratories and, wherever necessary, as a direct investor in mines or in small concentrating plants. The functions of the Mining Bank were expanded in 1971 by Decree Law 18882 to include buying, selling, importing, and exporting of precious minerals (except those derived directly from metallurgical processes), stones and pearls.

4. Banco Central Hipotecario del Peru

The Banco Central Hipotecario (hereinafter cited as the Central Mortgage Bank) was founded in 1926 as a corporation with private, public, and banking sector ownership of its capital. The Central Mortgage Bank is the strongest bank in the savings field and obtains the bulk of its funds from the private sector by means of a fixed-yield security called a cédula hipotecaria de ahorros, i.e. mortgage bond. The Bank was granted authority to issue cédulas in 1955 (by Decree Law 12464).

The Central Mortgage Bank finance principally middle-and upper-income housing. However, it should also be noted that a portion of the private sector savings mobilized by cédulas are directed to the public sector through the requirement since 1971) on the Bank to invest fifty percent of the resources obtained from sales of cédula in government bonds. Nevertheless, during the period 1970-1974 the Central Mortgage Bank made 22,708 housing loans, and in 1974 the average loan amount was equivalent to U.S.$ 8,475.

A basic housing loan of the Central Mortgage Bank is for up to 75 percent of the total value of the housing unit and land. Usually, borrowers are expected to hold title to the land, which thus supplies the remaining 25 percent. Thus, in actual practice the bank usually lends for about 100% of the value of the house. The Bank's mortgages have a term of 20 years and the interest will vary from 14.5% to more than 17%. In the latter case developers, who do a large amount of construction ultimately financed by the Central Mortgage Bank, can charge a one percent commission.

For loans in excess of S/.1,026,000, the bank does not lend the whole amount in cash. Rather, a system of cédulas comes into play whereby one part of the loan is given in cash, with the remaining given in cédulas. Cédulas carry a face value of S/.1,000 each, but are not redeemable by the bank for cash. They can be kept by the borrower or sold in the market. In recent years, these cédulas have had 14 percent coupon rate, are generally of 30-year term, and are traded on the market from 89 to 97 percent of par value.

5. Banco de la Vivienda

The other bank with responsibility in the area of housing and construction is the Banco de la Vivienda (hereinafter cited as the Housing Bank). This Bank, as contrasted with the other four development banks which were created in the period 1929-1944 was established in 1962 principally to furnish technical and financial support to the savings and loan associations (mutuales).

The major purposes of the Bank are to promote the public and private development of housing in Peru, the concession of loans to promote home ownership, and the creation and development of savings and loan associations (mutuales) for housing. At present, the mutuales operate in Peru under the direct and permanent control of the Bank. The Banco de la Vivienda obtains financial resources to carry out housing programs principally through the marshalling of domestic savings, and by incurring other types of domestic and foreign financial obligations.

Decree Law 17,873 (of October 29, 1969) raised the Bank to the rank of a central bank for institutions devoted to home financing, provided it with new resources, and gave it control of the operations of refinancing or rediscounting loans for the mutuales. Several obligatory mechanisms were created to increase the Housing Bank's domestic financial resources. These mechanisms include the following: (i) The full amount of the legal reserves of the savings and loan associations, the bulk of which was previously maintained with the commercial banks, was transferred to the Housing Bank. (ii) All private construction companies were obliged to subscribe to the Bank's newly created mortgage development bonds in an amount of at least equal to 2 percent of the value of their ongoing construction projects. (iii) The liquid reserves of the insurance companies also were to be invested in these bond as well as 18 percent of the social security institutions' total resources. (iv) The commercial banks were required to invest 3 percent to their assets allocated under the selective credit scheme in these bonds and were allowed to discharge part of their marginal reserve requirements in interest-earning deposits at the Housing Bank. As a result of these measures, the Housing Bank's financial resources increased fivefold in the first year after the above obligatory mechanisms were instituted.

The programs carried out by the Banco de la Vivienda are wide and varied and a recent categorization states seven principal program: (1) housing and infrastructure; (2) urban renewal and rehabilitation; (3) urban infrastructure; (4) community facilities; (5) experimental programs; (6) large-scale housing programs; and (7) promotion of the construction industry. The Bank carries out housing and infrastructure programs in coordination with the Ministry of Housing and Construction and with the mutuales. Urban renewal projects are in conjunction with EMADI PERU (the Public Agency for Administration of Real Estate). The Bank has made loans to the Lima Water and Sewer Company on behalf of projects located in the so-called "Pueblos Jovenes" of Lima. The Bank has also financed schools, medical clinics, and community centers in several cities. The bank is also financing experimental housing projects sponsored by the Ministry of Housing and Construction. The major large-scale housing project presently being financed by the Bank is the first stage of the 12,000 unit Los Proceres project in Lima. The Bank also makes financing available to builders and suppliers by means of loans, discounted notes, and the purchase of portfolios.

There has been a continuing relationship between the Housing Bank and U.S. Agency for International Development. The first A.I.D. loan to the Bank was in 1962 in the amount of \$7.5 million which served as the initial capitalization of the bank and to stimulate expansion of the mutuales. In 1965 a second A.I.D. loan in amount of \$6.0 was made to the Bank. During the mid-and late 1960's a series of six Housing Guaranty Loans (in amount of \$17.7 million) were made to the Bank. Shortly after the devastating May 1970 earthquake, A.I.D. made a \$10.5 million grant to Peru for emergency reconstruction in the disaster zone. In 1972, A.I.D. made a \$15 million loan for urban reconstruction and a \$28.3 million Housing Guaranty Loan to the Bank, and in 1976 A.I.D. made a \$15.0 million Housing Guaranty Loan which is administered by the Bank.

6. Sources of Funds

Table II suggests that, on the whole, the state development banks extend credit to the private sector that is substantially larger than their liabilities to the private sector. Although these banks do receive funds from the private sector, apart from the Central Mortgage Bank and to a lesser extend the Housing Bank, the bulk of the funds utilized by these banks are from the banking sector and come from the private sector through other banking sector institutions.

In recent years, and particularly in the period from 1969 to mid-1975, the Central Bank channeled injections of reserve money to the state development banks and within this group principally to the Industrial Bank and the Agricultural Bank. Since mid-1975, the Central Bank extended substantial credit to the commercial banks and the Banco de la Nacion because the severe loss in international reserves reduced the liquidity of these banks.

Apart from Central Bank credits, up to November 1976 the state development banks were also the beneficiaries of a complicated set of reserve requirement rules appliable to commercial banks whereby required reserves could by fulfilled through investments in interest-bearing securities of the Industrial Bank, the Mining Bank, the Agricultural Bank, public investment bonds or deposits in the Banco de la Nación. An example of the outcome in terms of transferring credit is the fact that although the marginal reserve requirement for commercial banks with head offices in Lima was 50 percent (in addition to a 20 percent basic reserve requirement in the case of sight deposits), reserves held as vault cash and on deposit in the Central Bank rarely exceeded 10 percent.

TABLE II

SOURCES AND USES OF FUNDS OF PERU'S DEVELOPMENT BANKS

December 31, 1975 (Million of Soles)

	Banco Agrario	Banco Industrial	Banco Minero	Banco Hipotecario	Banco de la Vivienda
SOURCES OF FUNDS	17,635	17,991	2,459	21,232	7,272
I. Own Resources	4,973	3,753	1,310	766	1,083
II. Other Resources	12,662	14,238	1,149	20,466	6,189
A. Domestic Resources	7,569	10,723	1,913	20,840	5,373
1. Public Sector	81	43	29	228	21
2. Private Sector	1,343	481	128	450	1,868
3. Banking Sector	1,265	2,316	106	426	1,170
4. Securities Issued	5	-	-	19,736	2,314
5. Central Bank	4,875	7,883	1,650	-	-
B. External Resources	751	2,896	21	-	1,342
C. Other Account (Net)	4,342	619	-785	-374	-526
USES OF FUNDS	17,635	17,991	2,459	21,232	7,272
I. Financing or credit	16,953	17,693	2,355	18,307	6,778
A. Public Sector	715	3,934	41	7,526	2,399
B. Private Sector	16,238	13,215	2,314	10,730	4,282
C. Banking Sector	-	544	-	51	97
II. Available Funds	682	298	104	2,925	494
A. Cash	457	29	25	65	12
B. Deposits in Central Bank	63	135	49	-	225
C. Deposits in Banco de la Nación	2	2	11	2	35
D. Deposits in Commercial Banks	61	59	11	2,851	222
E. Deposits in Foreign Banks	39	30	18	-	-
F. Swaps	60	43	-	7	-

SOURCE: Banco Central de Reserva del Perú

III. NON-BANK FINANCIAL INTERMEDIARIES

The non-bank financial intermediaries engage principally in the intermediation of funds at medium and long term. The institutional structure of this sector is heterogeneous and the operational modes are varied. The liabilities of several of the non-bank financial intermediaries entail various legal benefits. For example, various liability instruments of COFIDE and of the savings and loan associations entail tax benefits. In addition, the savings and loan associations and savings and loan cooperatives offer depositors the possibility of obtaining credit as well as earnings on deposit instruments.

A. COFIDE

COFIDE was established as an autonomous state enterprise in March 1971, principally to stimulate and promote Peruvian enterpreneurial activity, coordinate and guarantee the financing of state enterprises, mobilize resources for priority projects of state, reformed private, private and social property enterprises, and expand the domestic capital market. It has also been designated to act as a holding company of a number of state enterprises which are in turn holding companies in the industrial and tourism sectors. By law COFIDE has the following functions: (i) lending at medium and long-term (for fixed assets and working capital) on its own account to state, reformed private, private and social property enterprises; (ii) issuing guarantees on behalf of these enterprises, either on its own account or as the Government's agent; (iii) arranging and/or participating in the financing of state enterprises other than state banks, either on its own account or on behalf of the Government; (iv) acting as a holding company of a number of state holding companies in the industrial and tourism sector; (v) keeping in custody the Governments shares in other state enterprises; (vi) promoting new enterprises and stregthening new ones mainly by participating in their capital; (vii) financing through loans and grants and occasionally preparing preinvestment studies; and (viii) broadening the capital market by offering to the public its participation in non-public enterprises as well as its own shares and bonds. In addition, by law all medium and long-term borrowings of state enterprises require COFIDE's approval.

At the end of 1975 the bulk of COFIDE's paid-in capital was held by the Government and the remainder by individuals and companies which had received COFIDE's "D" shares in partial payments of debt resulting from the agrarian reform. A third group of shares, the "C" shares, which had been held by private share-holders under the Government tax-exempt reinvestment-of-earnings mechanisms were converted to "C" bonds effective January 1, 1975. (The "C" shares had a fixed minimum interest of 8 percent per annum and the investment in such bonds could be deducted from taxable income over a minimum period of three years.) The "C" bonds have a ten-year term, and currently bear a

16 percent coupon rate. The purchase of them is not deductible from taxable income but they bear a tax credit equivalent to 35 percent of their value. In the first quarter of 1977 over S/.1,000 million of "C" bonds were sold. This high rate of placement is undoubtedly related to their tax benefits (which brings their annual yield to 24.6 percent).

One of the major reasons for COFIDE's creation was to coordinate decision making for all state enterprise financing, and initially COFIDE was to own the government's equity shares in all state enterprises. However, subsequent legislation provided that COFIDE would have neither management nor profit and loss responsibility for these enterprises but would only hold their shares in custody. However, in August 1974 COFIDE was assigned full ownership, profit and loss responsibility and a decisive role in financial decisions affecting four major state manufacturing and tourism enterprises; they are SIDERPERU (steel), INDUPERU (general manufacturing), ENTURPERU (tourism), and EPPAPERU (artisan activity). These enterprises are second-tier holding companies assigned ownership of all state enterprises in their sectors.

COFIDE also has an important role in financing activities related to CONAPS and FONAPS. CONAPS (the Comisión Nacional de Propiedad Social) is the central agency responsible for implementing national social property policy and it has decision making power related to the constitution and dissolution of social property enterprises, their hiring policies, and their wage and salary policies. FONAPS (Fondo Nacional de Propiedad Social) is the financial organ for social property enterprises and is responsible for the provision of transitory capital to these enterprises. At present both FONAPS and COFIDE are responsible for determining project feasibility and arranging for the financing of social property enterprises whose formation has been approved by CONAPS.

In discussing COFIDE's financial operations in recent years, it is important to distinguish between COFIDE's operations and those performed on behalf of the Government. About 40 percent of COFIDE's own operations have been with private non-financial enterprises (without state participation) and its loan portfolio with such enterprises amounted to approximately S/.8.0 billion as of September 30, 1976. Almost 90 percent of its lending has been for fixed capital requirements and 85 percent of COFIDE's loans have maturities in excess of five years. Loans of in excess of S/.200 million accounted for over 68 percent of the total loan amount.

B. Savings and Loan Associations, i.e. The Mutuales System

The savings and loan system consists of 17 private associations (mutuales) which are regulated by the Banco de la Vivienda. There are seven in Lima, ten outside of Lima, and five branches (also outside of Lima). The mutuales are non-profit associations authorized to promote the formation of capital under their administration for the purpose of making loans for the acquisition, construction, and improvement of houses. The major sources of funds of the mutuales are savings and time deposits, and nearly all funds are used for loans to private sector borrowers.

Mutuales can make two basic types of loans-mortgage and non-mortgage. Mortgage loans are for new housing, and can be with terms up to for twenty years. Non-mortgage loans are for housing-related facilities such as home improvement and are for five to seven year term. The mortgage loans for housing are limited by law to value for house and land of less than $10,000. During 1974 the mutuales made 5,709 mortgage loans at an average loan amount of $7,125 (S/.309,000). In most cases, the loans are for 80 percent of total value. In 1974 the mutuales made 2,128 non-mortgage loans at an average loan amount of $1,660 (S/.72,000). The mutuales experienced rapid growth in deposits in the late 1960's and early 1970's. In recent years, deposit growth has slowed. Since 1971 their share of the savings market has been reduced due to strong competition from the cédulas of the Central Mortgage Bank.

C. Savings and Loan Cooperatives

These cooperatives are basically credit unions. Members own and control these cooperatives on the basis of one member, one vote, and deposits are usually in the form of shares. These shares are transferrable according to the statutes of each credit union, and bear a interest rate not to exceed 11.5 percent annually (as of March 1, 1977). The principal attraction for members is access to credit, with most credit, with most credit unions limiting the amount lent to a member to three to five times the amount of the individuals share capital.

The bulk of the assets and liabilities of Peruvian credit unions represent transactions with members. At the end of 1974 total assets (also total liabilities) of all credit unions amounted to S/.10.6 billion according to Central Bank data, with S/.9.4 billion in loans and S/.9.1 billion in share capital. It is estimated that there are over 520 credit unions in operation in Peru. In 1973 they made over 290,000 loans averaging $490 each. It is thought that most of the loans are utilized for the purchase of household goods, home improvements, and family emergencies.

D. Investment Companies

As of 1971 there were thirty-eight financieras operating in Peru. Most of these firms were limited to and, in some cases, owned by commercial banks and their financial resources come from bond issues, private sector term deposits, and direct commercial bank credit. The financieras loan portfolio were composed of consumer credit and of industrial and commercial loans, mostly to the fishing and fishmeal industries.

Law 18957 (of September 1971) defined the role of the financieras and established an organic body of regulations governing their operations. This law set a minimum capital requirement of S/.40 million to enterprises utilizing the title "financiera", set one year as the minimum term of credit they could offer, and required that 30 percent of their credit be in excess of two-year term, and made them subject to regulations of the Superintendency of Banking and Insurance and of the Central Bank. A financiera is prohibited from owning shares of other companies in amounts in excess of 25 percent of its capital and 20 percent of its loan and investment portfolio and is prohibited from investing in real estate (apart from its own offices). In regard to its loan portfolio, a financiera cannot lend for financing the sale of consumer goods and Law 18957 states that loans and investments should be oriented to industry and mining. The Central Bank has subsequently permitted lending for construction, tourism and partially for commerce. In regard to deposits, the financieras are authorized to receive deposits at terms of not less than 360 days and rates of interest on deposits depend on the term of the deposit.

Only seven of the thirty-eight financieras decided to comply with the new regulations. However, the lending operations of the financieras were not greatly affected, and by mid-1973 the lending operations of the reduced group of financieras exceeded the 1971 volume of the larger group. At the end of 1975, the gross assets of the financieras amounted to S/.5.1 billion. Term deposits are the principal source of funds (S/.2.5 billion at the end of 1975) and loans are the principal use of funds (S/.3.2 billion at the end of 1975). In addition, a major source of business for the financieras consists in granting credit guarantees. At the end of 1975 the amount guaranteed was S/.8.9 billion. The bulk of these guarantees were related to construction.

It may be noted that certain activities permitted to the financieras by law have not been utilized by them as yet. They have not as yet engaged in the intermediation of external funds (even though domestic ownership need not exceed 51 percent of the capital of a _financiera_. In addition, they have not as yet engaged in significant operations as development banks, i.e., identifying projects, undertaking the related studies, and forming new enterprises.

E. Insurance Companies

The insurance companies engage in the system of financial intermediation principally through the investment of their technical reserves. Various laws control the investments permitted to insurance companies. Supreme Decree No.297-68 HC allocates the paid-in capital of insurance companies as follows: real estate (40 percent), Public Investment Bonds (20 percent), other public sector debt (10 percent), other domestic investment (10 percent), and the balance in securities registered on the Lima Stock Exchange. The investment of technical reserves are allocated as follows: apartment buildings for low-income workers (50 percent), shares or bonds of construction companies (15 percent), mortgage loans (10 percent), mortgage bonds and Treasury bonds (20 percent), and the remainder in cash or deposits with the banking system. There are various other regulations governing the minimum size of paid capital, the construction, and maintenance of legal reserves, and technical reserves. At the end of 1975, the twenty-one insurance companies operating in Peru had a total capital and reserves in the amount of S/.6.6 billion (including S/.1.7 billion of paid-in capital).

F. Sources and Uses of Funds

Table III indicates the sources and uses of funds of the Peru's major non-bank financial intermediaries. Although the information provided by Table III may be somewhat out of date, the consistency of treatment and the dearth of data on savings and loan cooperatives argue in favor of this presentation. These data contain few surprises and indicate that the _mutuales_, the savings and loan cooperatives, and the _financieras_ receive most of their funds from the private sector and channel most of their credit to the private sector without engaging in substantial operations with the banking sector.

COFIDE and the insurance companies are obviously special cases. COFIDE's own resources and external resources supply the bulk of its funds and the public sector (particularly state enterprises) is a significant user of COFIDE credit. The insurance companies differ from the other financial intermediaries in that their "own" resources are a major source of funds and from the fact that the public sector and banking sectors are major users of insurance company credit. For the insurance companies, "own" resources are mainly reserves required by prudence and law. The bulk of the financing provided by insurance companies to the public sector and to the banking sectors undoubtedly originates in legal requirements. The insurance companies are the only non-bank intermediaries with substantial holdings of real property.

TABLE III

SOURCES AND USES OF FUNDS OF PERU'S MAJOR NON-BANK FINANCIAL INTERMEDIARIES

December 31, 1974 (Million of Soles)

	COFIDE	Mutuales	Savings & Loan Cooperatives	Financieras	Insurance Companies
SOURCES OF FUNDS	8,218.3	8,626.2	10,606.7	2,694.4	6,658.1
I. Own Resources	3,775.5	591.0	1,030.0	532.7	4,341.6
II. Other Resources	4,442.8	8,035.2	9,563.2	2,161.7	2,316.5
A. Domestic Resources	1,654.6	7,974.7	9,563.2	2,161.7	1,943.2
1. Private Sector	282.0	7,974.7	9,563.2	1,891.0	1,943.2
a. Demand Deposits	4.5	380.6	109.1	130.1	89.9
b. Term Deposits	5.7	3,150.0	64.2	1,601.6	-.-
c. Savings Deposits	-.-	4,444.1	310.9	-.-	-.-
d. Share Deposits	-.-	-.-	9,079.0	-.-	-.-
e. Bonds	271.8	-.-	-.-	159.3	-.-
f. Tech.Reserves-Life Insurance					1,853.0
2. Banking Sector	1,372.6	-.-	-.-	270.7	-.-
B. External Resources	2,788.2	60.5	13.5	-.-	373.3
C. Other	-.-	-.-	-.-	-.-	-.-
USES OF FUNDS	8,218.3	8,626.2	10,606.7	2,694.4	6,658.1
I. Financing or credit	7,940.4	8,141.3	9,868.6	2,632.6	5,059.8
A. Public Sector	5,773.6	35.2	32.4	150.6	859.3
1. Central Government	-13.3	112.6	34.3	111.3	724.8
2. State Enterprises	5,778.0	-1.8	0.5	39.7	131.4
3. Other	-1.1	-75.6	-2.4	-0.4	3.1
B. Private Sector	2,166.8	8,039.9	9,341.9	2,482.0	2,502.4
C. Banking Sector	-.-	66.2	494.3	-.-	1,698.1
D. Other	-.-	-.-	-.-	-.-	-.-
II. Other Assets	277.9	484.9	738.1	61.8	1,598.3
A. Property	30.4	249.4	677.5	38.6	2,301.2
B. Other	247.5	235.5	60.6	23.2	-703.0

SOURCE: Banco Central de Reserva del Perú

IV. The Instruments of Monetary Policy

A. An Overview

The monetary policy instruments in Peru which have the most impact upon the stock of money and volume of credit are legal reserve requirements and the volume Central Bank credit, i.e., rediscounts and direct credits. Selective credit controls and statutary interest rate maximum are policy instruments of lesser importance in controlling the stock of money and volume of credit, but they are important in determining the allocation as well as the cost of credit.

The period 1962-1969 was one of relative inactivity in the use of monetary policy instruments. Although the Central Bank regulated all interest rates and imposed legal reserve requirements on domestic and foreign deposits, they were changed infrequently. There were no portfolio requirements on commercial banks or other financial intermediaries. The stock of money was controlled mainly by movements in the Central Bank's credit to the public sector and its rediscounts with the banking system.

Beginning in 1969 governmental policies in the area of credit allocation become more explicit and refined. Up to 1969 there were few specific policies apart from those which defined the scope of various financial intermediaries and, in particular, the credit activities of the state development banks. In regard to commercial banks, in the period 1969-1976 legal reserve requirements were employed simultaneously as an instrument of control over the stock of money and as an instrument to channel funds to other financial institutions. In addition, specific loan portfolio requirements were applied to commercial banks.

During the period 1962-1975, interest rates remained relatively rigid in regard to credits and savings deposits. Throughout this period the maximum interest charge allowed to commercial banks on loans and overdrafts was 12 percent per annum plus a 1 percent commission. Interest rates on savings deposits (typically 5 percent) and time deposits (typically 7 percent) remained fixed throughout the 1962-1975 period. The most notable change were elimination of rates of interest below 9 percent on the cédulas of the Central Mortgage Bank and of the savings and loan associations. On the lending side, from 1968 on there was a tendency toward increasing diversity in the rates applied to credits of particular types and purposes, particularly by the state development banks. Since mid-1976 there have been two increases in the structure of interest rates. These increases affected the liabilities and assets of all financial intermediaries.

B. Reserve Requirements

Up to November 1976, legal reserve requirements applied to commercial banks were relatively complicated, consisting in minimum, basic, and marginal requirements on deposit liabilities without regard to the type of liability and a complicated set of regulations whereby a sizeable proportion of these reserves could be invested in securities of .. state development banks bearing low rates of interest (as is noted in Part III). In later 1976 and early 1977 the legal reserve requirements for the commercial banks were completely revised.

The new system of legal reserve requirements for commercial banks is as follows:

(i) As of November 29, 1976 reserve requirements for commercial banks with principal offices in Lima are 46 percent for demand deposits and deposits of less than 90 day-term and 31 percent for deposits with terms in excess of 90 days and savings deposits. Reserves may be held in vault cash and/or on deposit with the Central Bank (and bearing 5.5 percent interest per annum). Reserves held in the form of deposits with the state development banks, the Banco de la Nación, and public sector bonds, were withdrawn and replaced by credit lines from the Central Bank bearing interest charges equivalent to the previous average for the funds supplied directly by commercial banks.

(ii) The legal reserve requirements for the regional commercial banks were altered as of March 7, 1977. The new requirements are 23 percent for demand deposits and deposits of less than 90 day-term and 6 percent for deposits with terms in excess of 90 days and savings deposits. Reserves may be held in vault cash and/ or deposited with the Central Bank (and bearing 12.0 percent interest per annum).

(iii) The legal reserve requirements for the two construction - related commercial banks and for the state development banks were set at 25 percent for demand deposits and deposits of less than 90 day-term and 6 percent for deposits with terms in excess of 90 days and savings deposits.

The percentages selected as the new reserve requirements approximated the overall level of legal reserves held for each type of deposit under the previous system. Previously, reserve deposits in the Central Bank did not earn interest, but investments counted as reserve requirements earned interest. The new interest rates on reserves deposited at the Central Bank is approximately equal to the average rate of return received by commercial banks on their reserve holdings under the previous system. The Central Bank also undertook to compensate through rediscounts and lines of credit all those financial institutions which stood to lose the deposits (and investments) of the commercial banks.

C. Commercial Bank Loan Portfolio Requirements

Loan portfolio requirements implemented in April 1969 for commercial banks required that all commercial banks with principal offices in Lima/Callao direct 60 percent of the increase in their credit after May 1, 1969 to priority uses in agriculture (10 percent), fishing (7 percent), industry (40 percent), and construction (3 percent). However, the detailed allocative guidelines were revised subsequently on various occassions to facilitate compliance, to adjust to changing circumstances, and to fit them to the evolving industrial and other government policies. In March 1971, commercial banks were authorized to cover deficiencies in credit to agriculture and fishing by purchases of Agrarian Development Bonds, and deficiencies in lending for fishing through credit to the Fishing Development Fund within the Industrial Bank. Beginning October 1971, portfolio norms could be met through the purchase of Public Investment Bonds, and banks were required to hold at least 20 percent of the increase in credit in Public Investment Bonds -- a requirement which was abolished in September 1975. Finally, in March 1972 all intra-sectoral guidelines were suspended; the only remaining requirement was that Lima-based commercial banks were to dedicate at least 60 percent of the total increase in credit to first priority and second-priority industries or, alternatively, to purchase Public Investment Bonds by the amount of the total deficiency.1/

1/ Under law 18350 (July 30, 1970) first priority industries are basic industries such as steel, non-ferrous metals, chemicals, fertilizers, cement, and paper and specific industries, such as the manufacturers of capital goods for essential purposes; second priority industries are manufacturers of essential consumer goods and goods used in productive activities.

Further revisions of commercial bank loan portfolio requirements are presently under study by the Central Bank. We are informed that proposed revisions will probably create areas of first and second priority (a long different guidelines from Decree Law 18350) rather than to set rigid percentages for narrowly-defined economic sectors.

D. The Structure and Level of Interest Rates

The Government of Peru has employed the structure of interest rates as a major tool for providing concessionary financing to selected high-priority purposes. Accordingly the cost of credit varies widely depending on the priority of the purpose and the source of funds use. Important changes were made in interest rate levels in 1976 and 1977. The Central Bank was empowered to make changes in a broad array of interest rates on loans and deposits by means of Decree Law 21,504 (May 25, 1976).1/ Table IV indicates the basic interest rates paid on the major types of deposits and fixed-yield securities issued by Peruvian financial intermediaries as of June 30, 1976, as of July 1, 1976 and as of March 1, 1977. Table V indicates the basic interest charges on the major types of credits extended by Peruvian financial intermediaries at these same dates.

The interest rates on savings and time deposits were increased by a minimum of 6 percentage points per annum and more favorable differential rates were applied to time deposits of up ot one year term. The yields on fixed-yield securities (mortgage cédulas, financiera bonds, and COFIDE bonds) were also increased generally by 5 to 8 percentage points. Commercial banks were also permitted to apy on interest rate of up to 2.0 percent on demand deposits, but to date none has done so.

The basic interest charges on short-term credits was raised from 12.0 percent per annum to 17.5 percent per annum. The basic charges for medium and long-term credits was also increased, but the magnitudes of increase and absolute rates of interest vary

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1/ Decree Law 21504 modified Article 59 of the basic charter of the Central Bank giving that institution the power to increase interest rates up to maximum set by the Executive Power by means of a Supreme Decree emitted by the Ministry of Economy and Finance. Previously the charter stated that the Central Bank could not authorize interest rates which exceeded the maximum established by general and specific laws.

greatly depending upon the financial institution, the purpose of the credit, and , in some instances, borrower characteristics. The interest rates shown in Table V are only a selected sample of the predominant credit windows. Moreover, it should be noted that stated interest rates are always lower than credit costs calculated as an annual percentage charge. For example, commercial banks usually charge a commission of 2.0 percent and apply a tax of 0.5 percent and the interest charge is normally subtracted from the face value of the loan. In addition, commercial banks often require compensatory balances. These features undoubtedly increase the cost of credit states as an annual percentage charge. The structure of interest rates on the credit operations of Peruvian financial intermediaries suggests a relatively complex structure of rates.

The relative rigidity in the structure of interest rates during the period 1962-1975 was maintained in the face of substantial fluctuations in the rate inflation, and furthermore interest rates were low in comparison with an average annual rate of inflation approximating 10 percent. Low real interest rates could exist (even without the intervening mechanisms of selective credit regulations) because financial intermediaries profits relate principally to the spread on the funds they intermediate rather than to absolute interest rates, which may be positive or negative in real terms (i.e. the interest rate less the rate of inflation).

In any event, the Government of Peru has become convinced that higher interest rates are necessary to prevent large-scale disintermediation and has increased interest rates twice in the past year. While it would not be realistic to expect the Government to move to move to positive interest rates in real terms immediately, the recent changes mark a major shift in policy. The Government has indicated that it does have the longer-range goal of moving toward positive real interest rates, a goal that may be obtained by successive reductions in the rate of inflation and/or further increases in institutional interest rates. Although conclusive data are not available, there are reports that the large margin between deposit earnings and effective loan rates has given rise to a credit market outside the institutional channels of the financial intermediaries. In our judgement this is a relatively recent phenomena, dating from the past two to three years in the Lima area.

TABLE IV

ANNUAL INTEREST RATES ON DEPOSIT AND OTHER LIABILITIES OF PERUVIAN FINANCIAL INTERMEDIARIES

	Up to June 30, 1976	As of July 1, 1976	As of March 1, 1977
For Commercial Banks,* and State Development Banks			
Demand Deposits	-.-	2.0	2.0
Savings Deposits	5.0	9.0	11.5
Time Deposits			
From 90 to 179 days	7.0	10.0*	13.0*
From 180 to 269 days	7.0	11.0*	14.0*
From 270 to 359 days	7.0	12.0*	15.0*
360 days and over	7.0	13.0*	16.0*
Central Mortgage Bank			
Demand Deposits	-.-	2.0	2.0
Savings Deposits	5.0	9.0	11.5
Mortgage certificates	9.0	11.0	14.0
Savings and Loan Associations			
Savings deposits	6.0	9.0	12.5
Credit Cooperatives			
Deposits	6.0	6.0	11.5
Financieras			
Time deposits			
From 360 to 539 days	9.5	13.0	16.0
From 540 to 719 days	10.0	14.0	17.0
From 720 to 899 days	10.5	15.0	18.0
From 900 to 1,078 days	11.0	16.0	18.5
1,080 days and over	11.5	17.0	19.0
Bonds	9.0	12.0	15.0
COFIDE			
Type "C" Bonds	8.0	13.0	16.0
Basic Industry Bonds	6.0	10.0	16.0

*For regional banks, the rate is 0.5 percent higher.

TABLE V

ANNUAL INTEREST RATES ON SELECTED CREDITS OF PERUVIAN FINANCIAL INTERMEDIARIES

	Up to June 30,1976	As of July 1,1976	As of March 1,1977
Commercial Banks			
Credits	12.0	15.5	17.5
Regional selective credits by associated banks			
- in specified areas	9.0	11.0	13.0
- in rest of country	10.0	12.0	14.0
Banco de la Nación			
Credits to public sector enterprises, decentralized agencies, local government and private sector	12.0	15.5	N.A.
Agricultural Bank			
Credits to individuals			
- for working capital	7.0-10.0	10.0-14.0	16.0
- for capital goods	12.0*	14.0	16.0
- for commercialization	12.0*	15.0	19.0
Credits to cooperatives			
- for capital goods	10.0	14.0	16.0
- for commercialization	10.0	12.0	19.0
Industrial Bank			
Short-term credits	12.0	15.5	17.5
Medium & Long-term credits			
-for handicrafts and small industry	6.0-10.0	9.5-13.5	9-15.5
-for medium & large industry	12.0	15.5	13-17.5
Mining Bank			
Overdrafts & discounts	12.0	15.5	17.5
Small mines			
- special mines	5.0	8.0	10.0
- other mines	10.0	12.0	14.0
Medium mines	11.0	14.0	16.0
Housing Bank			
Credits to savings & loan association	8.5	9.5	**
Credits to housing cooperatives	6.0	7.0	**
Credits to low income housing projects	8.5	9.5	**
Credits not related to housing	12.0	15.0	**

* The rate was 10.0% for small farmers.
** No longer applicable.

TABLE V (cont'd)

	Up to June 30,1976	As of July 1,1976	As of March 1,1977
For Housing			
- elemental & basic nucleus			13
- elemental & basic house			14
- house almost finished & furnished			15
- improvement of housing			17.5
Central Mortgage Bank			
Credits for purchase, construction, & finishing of single housing units	11.0	13.5	14.5
Regular Mortgages	12.0	14.5	17.0
COFIDE			
Credits to public sector enterprises			
- for capital goods	11.0	14.5	14.5-17.5
- for working capital	13.0	16.5	16.5-19.5
Credits to non-public enterprises			
- for capital goods	12.0	15.5	15.5-18.5
- for working capital	14.0	17.5	17.5-20.5
Financieras			
Credits	12.0	19.0	21.5
Savings and Loan Associations			
Credits	12.0	14.5	17.5
Credit Cooperatives			
Loans			
- up to one year	12.0	12.0	17.5
- over one year	12.0	12.0	21.5

E. Central Bank Rediscount Facilities

The Central Bank operates two selective rediscount facilities and numerous lines of credit. The status of the latter lines of credit on November 15, 1976 is shown in Table IV. It is fairly obvious that several of these credit lines originate principally in the financial problems which come within the province of Central Bank operations as a lender of last resort. The utilized amounts of these lines of credit amounted to S/.11,402.8 million on November 15, 1976. These credit lines were greatly expanded following the change in reserve requirements for commercial banks subsequent to this date. In general, the nature and purposes of the particular lines of credit indicates that relatively little supervision is required other than those related to general monetary policy considerations.

The two discount facilities operated by the Central Bank which do involve more refined identification of borrowers and closer supervision are the (1) regional selective rediscount facility and (2) the special rediscount facility. The regional selective rediscount facility is limited to firms with capital up to S/.20 million, individuals, small enterprises without accounting systems and social property enterprises located outside the Lima/Callao area. This facility rediscount credits for the following purposes: agriculture, fishing for domestic consumption, logging, industries of firstaand second priority, tourism and handicrafts. The terms of credit is, in general, up to 180 days and the maximum limit is S/.6.7 million and the interests rates are 13 and 14 percent with rediscount rate ranging from 6.0 percent to 10.5 percent. The rediscount facility is available to regional banks and the beginning in 1977 to all other commercial banks. On December 31, 1976, S/.395 million in credit was outstanding. The special rediscount facility has idential characteristics to the regional facility; however it allows consideration of firms and loan amounts which do not meet the latter's requirements.

TABLE VI

THE CENTRAL BANK's LINES OF CREDIT
(as of November 15,1976)

Recipient Bank	Rediscount Rate (percent)	Maturity	Amount Authorized (Nov.15,1976;million of soles)	Amount Utilized (Nov.15,1976;million of soles)	Description
		III. Other Special Lines of Credit			
Banco Internacional	7.5	90 days	variable	1,542	Credits to the Associated Banks in order to compensate for the withdrawal of deposits by the Banco de la Nación.
Banco Popular	7.5	90 days	variable	1,836	
Banco Continental	9.5	90 days	variable	2,054	
Banco Popular	1.0 1/	--	1,000	1,000	Credit for general Liquidity.
Banco Regional del Norte	5%, guaranteed by bonds, or 9% guaranteed by loan documents	1 year	variable	30	Credit granted in support of program to solve portfolio difficulties of these banks.
Banco Regional del Sur Medio y Callao		1 year	variable	55	
Banco Industrial	3.0	1 year renewable	variable	3,235	Credits to finance non-traditional exports.
Banco Popular	4.0 2/	90 days	variable	900	Credits to finance purchase of vehicles by the Auxiliary Forces.
Banco Industrial	5.0	1 year renewable	variable	450.8	Credits to finance grain transport ships.
Banco Industrial	5.0	1 year renewable	1,000	300	Credits to finance purchase of boats and fishing nets.
Banco Minero	3.0	1 year re-	2,500	--	Credits to small and medium mines.
Banco de la Nación	3.5	1 year renewable.	variable	--	Credits to finance the rice crop.

1/ 4 percent starting January 2, 1977.
2/ 5 percent starting January 2, 1977.

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

TABLE VII

THE CENTRAL BANK'S REGIONAL SELECTIVE CREDIT FACILITIES

	Regional Commercial Banks Amount Utilized (million of soles)	Other Commercial Banks Amount Utilized (million of soles)
I. Regional Selective Rediscount Facility		
December 1, 1974	168	82
December 31, 1975	180	119
December 31, 1976	235	160

Characteristics of the Credit

Beneficiaries: Firms with capital up to S/.20 million, individuals, small interprises without accounting systems, social property enterprises located outside of the Lima and Callao provinces.

Destination of Credit: In all regions covered by the credit lines: agriculture and livestock; fishing for domestic consumption; industries of the first and second priority; lumber cutting and transportation under contract from a sawmill; tourism; handicraft. Exclusively in the forest region: other fishing activities; industries of the third priority and without priority; river transport; forestry; hunting and wildlife stocking. Exclusively in the mid-southern region: production wines and piscos.

Maturity: 180 days, except for credit for lumber extraction and credit for construction or expansion of hotels, which may have up to 360 days' maturity.

Credit Limits: Regulated according to the capital of the firms, and economic possibilities of the individual, with a maximum limit of S/.6.7 millions.

Interest Rates: Charged by banks: 13 percent and 14 percent; rediscount rates: ranging between 6.0 percent and 10.5 percent.

TABLE VII (Cont'd)

	Regional Banks Amount Utilized (million of soles)	Branches of Associated Banks Amount Utilized (million of soles)
II. Special Rediscount Facility		
January 31, 1975	12	9
December 31, 1975	23	7
December 31, 1976	17	18

Characteristics of the Credit

Destination of Credit	Financing of projects of special interest for regional development, for firms and loans which do not meet the requirements of the Regional Selective Rediscount Facility.
Maturity and Interest Rates	Same as those governing credits under the Regional Selective Rediscount Facility.

POTENTIAL SUB-PROJECTS FROM DEMAND STUDY

1st. Category: Ready-to-go Sub-projects

	Sub-Project	Entrepreneur and Location	Required Investment
1.	Cheese Processing Plant	Productos Lacteos del Sur S.A. - Arequipa	$ 300,000
2.	Grain Silos Complex	Jose Ricketts - Arequipa	132,000
3.	Chocolate Confectionaries Plant	Chocolates La Iberica - Arequipa	400,000
4.	Fruit Preserves Processing Plant	Alimentos Cerro Colorado - Arequipa	160,000
5.	Balanced Feed Mill	FONGALSUP* - Arequipa	270,000
6.	Industrialization of Quinua	Industrias Alimenticias Cuzco - Cuzco	400,000
7.	Chocolate Confectionaries Plant	Mr. Moscoso - Cuzco	187,000
8.	Fruit and Chocolate Processing Plant	Efrain Vergara - Cuzco	107,000
9.	Pork Processing Plant	Jose W. Rozas - Cuzco	180,000
10.	Balanced Feed Mill	Cooperative Santa Elena - Trujillo	105,000
11.	Asparagus Processing Plant	Cadena de Conserva San Fernando - Trujillo	1,000,000
12.	Balanced Feed Mill	Gaston Tweddle V. - Trujillo	135,000
13.	Feed Mill	Jose F. de la Puente - Trujillo	455,000
14.	Feed Mill	Fernando Schroeder - Pacasmayo	300,000
15.	Poultry Processing Plant	Jose B. Jugo - Trujillo	40,000
16.	Balanced Feed Mill	CAP Ramon Castilla - Cuzco	135,000
17.	Balanced Feed Mill	CAP - Lambayeque	121,000
18.	Tannery for Small Skins	Carlos Villanueva - Trujillo	70,000
		TOTAL	$4,497,000

*This sub-borrower has a need for three more mills within the next three years.

3rd. Category: Sub-Projects Without Firm Entrepreneurs

Sub-Project	Promoting Agency and Location	Required Investment
1. Manioc processing plant	Ministry of Food - Tarapoto	$ 350,000
2. Banana processing plant	Ministry of Food - Tarapoto	275,000
3. Fruit and Juice Canning	Ministry of Food - Tarapoto	600,000
4. Pork processing plant	Ministry of Food - Tarapoto	650,000
5. Rice Mill	Ministry of Food - Tarapoto	500,000
6. Feed Mill	Ministry of Food - Tarapoto	425,000
7. Glazed Fruit processing plant	Ministry of Industry - Satipo	120,000
8. Fruit products canning plant	Ministry of Industry - Satipo	295,000
9. Dehydrated products processing plant	Ministry of Industry - Satipo	320,000
10. Fruit confectionaries processing plant	Ministry of Industry - Piura	270,000
11. Fruit processing plant	Ministry of Industry - Ica	335,000
12. Wind mills manufacturing plant	Consulting Group - Trujillo	670,000
13. Alfalfa Flour mill	Consulting Group - Trujillo	400,000
14. Feed mill	Cooperative - Puno	55,000
15. Potato processing plant	Social Property Enterprise - Puno	400,000
16. Fruit processing plant	Private Sector - Cuzco	190,000
17. Quinua and Cañigua processing plant	Private Sector - Cuzco	530,000
18. Meat processing plant	Social Property - Puno	750,000
19. Meat processing plant	Social Property - Puno	600,000
20. Dehydrated fruit products plant	Private Sector - Cuzco	400,000
21. Meat processing plant	Private Sector - Cuzco	530,000
22. Fruit storage and packing facility	Cooperative - Arequipa	155,000
23. Alfalfa Flour mill	Social Property Enterprise - Lambayeque	400,000
24. Manioc Flour mill	Private Sector - Cuzco	107,000
25. Quinua Flour mill	Cooperative - Puno	75,000
26. Grain mill	Private Sector - Cuzco	750,000
27. Service (Inputs) Center for Crops	Social Property Enterprise - Cuzco	385,000
28. Warehouse	Private Sector - Cajamarca	45,000
	TOTAL	$10,582,000