PN-AAU-299

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AGENCY FOR
INTERNATIONAL
DEVELOPMENT

UNITED STATES OF AMERICA

PERU

COUNTRY DEVELOPMENT STRATEGY STATEMENT

FY 83

January 1981

UNITED STATES INTERNATIONAL DEVELOPMENT COOPERATION AGENCY
WASHINGTON, D.C. 20523

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CDSS UPDATE

I. INTRODUCTION

After twelve years of military rule, Peru returned to democratic government in 1980. A civilian government was inaugurated on July 18, 1980, following the first general elections held since 1963. The new President, Fernando Belaunde Terry, firmly shares U.S. commitment to the maintenance of human rights, growth with equity and promotion of strong trade and investment ties. The Belaunde government is also redirecting Peru's policies from a planned to a more market-oriented economy which encourages both private and foreign investment. Yet Belaunde is presiding over a nation whose economy, while slowly recovering from current crisis will continue to be plagued with problems that require decisive solution -- high inflation, slow growth, a stagnant agriculture sector, and extremely high rates of underemployment and unemployment. The return to civilian government has increased expectations for social and economic improvement to which the GOP will be eager to respond. The Belaunde administration has already turned to AID to provide development assistance leadership in several areas.

A substantial U.S. development assistance program during the CDSS planning period 1983-87 must play a vital role in demonstrating strong support for the new democratic government and the efforts that government takes to promote equitable long-term growth and to address the chronic problems of rural and urban poverty. The actions Peru is currently taking to restore economic growth are, in the short run, reducing the government's ability to carry out programs for the poor. Efforts to deal with persistent poverty are hampered by the new civilian government's determination to enforce strict budget austerity over the next several years. AID's overall strategy during this period must be, in collaboration with other donors, to fill the gap between Peru's commitment to the poor and its still-weak fiscal position.

II. AID ASSISTANCE STRATEGY AND PROGRESS DURING PAST YEAR

USAID strategy for the CDSS planning period remains essentially unchanged from the strategy devised in the FY 81 and 82 CDSS, and can be defined under three basic headings: (1) Sierra and High Jungle Economic Growth; (2) Social Programs, with Sierra emphasis, and (3) Urban Basic Human Needs. Our strategy tends to be region-specific, addressing the problems of rural poverty and inadequate food production by concentrating resources in the sierra and high jungle regions which have the greatest production capability and potential. We will also continue to foster the GOP's nascent decentralized administration policy by working as closely as possible with regional development entities.

A. Sierra and High Jungle Economic Growth

The goal is to stimulate an agriculture-based growth in the sierra and adjacent high jungle areas which will: increase the economic value-added to non-coastal agriculture; expand production of greatly needed food; and increase income and employment opportunities for the rural poor.

In addition to continuing integrated regional development programs in the Huallaga Central and Junin/Cajamarca regions, small scale irrigation programs, and generation or rural enterprises, the Mission has initiated major new programs, since the last CDSS submission, which are designed to foster economic growth in the sierra and high jungle.

1. Agricultural Research, Extension and Education - An $11 million AID loan/grant signed in August of 1980 will assist the GOP in creating a new Ag. REE system at a time when the former system had reached a level of considerable deterioration in physical facilities, equipment, quality of personnel and program design and execution. AID funds are financing training, equipment, salary support and technical assistance in establishing national production programs, research centers and extension services.

2. Energy - An important initiative designed to address the energy problems as well as the need for employment generation in the small isolated communities of the sierra and high jungle has recently been taken by the Mission with the signing of a loan/grant totalling $10 million in September. The loan/grant will finance small hydro plant construction in regions of high priority to AID. The project will focus on productive uses of electricity in the communities benefited.

3. Rural Infrastructure - As discussed in the FY 82 CDSS, the Mission is moving toward an expansion of its regional integrated development focus beyond the priority regions of Junin, Cajamarca, and San Martín, to the Department of Pasco. To carry out development activities in this area, we will be utilizing the same institutional mechanism successfully developed in on-going projects--a Special Project Directorate with complete autonomy to manage funds and direct all projects activities. An agreement has been signed with the GOP to use P.D.&S. and Title I resources to finance estabishment of Special Project Directorate, finance studies, including social and environmental analyses, cadastral surveys, and complete an access road into the high jungle Pichis-Palcazu region--an area of considerable agricultural potential close to the largest market center in Peru. The activities will lead to development of a $20 million loan package in FY 81-82 for this area's development.

Similarly, during the course of the year, AID and the Embassy (INM) have undertaken studies of the high jungle region of Huanuco (Upper Huallaga)--a major coca growing area and source of the raw material for the illicit narcotics trade. A PID has been designed for an integrated regional development loan in the area. This project, with participation of other donors, especially the IBRD, will promote development of rural activities as an alternative to coca production.

4. Improvement of Soil Resources - One of the major constraints to increasing agricultural production, especially in the densely populated areas of the sierra, is extremely limited water and soil resources.

Much of the existing land resource has been misused, either by overgrazing or by deforestation, resulting in severe flooding and erosion. The GOP has recently adopted a National Reforestation Program which seeks to broaden significantly reforestation and soil conservation activities. AID is presently assisting in reforestation throughout the sierra through an OPG with Church World Services. A $1 million USAID Soil Conservation Grant, signed in September 1980, is assisting the GOP promote improved soil conservation and afforestation practices by strengthening the Ministry of Agriculture's institutional capacity to design and implement a national strategy for soil conservation. During the course of this FY, the Mission will be designing a follow-on loan/grant in Watershed Management which will finance a variety of irrigation, afforestation and soil conservation activities throughout the sierra and high jungle.

5. Natural Resource Preservation and Renewal - The identification of sierra and high jungle areas with the greatest agricultural potential, where AID will concentrate its resources, must be based on extensive natural resources inventories and studies. A $1 million FY 80 AID grant to the GOP's Natural Resource and Environmental Planning Office (ONERN) is assisting ONERN in the identification of natural resources and determination of land use capabilities in the AID target areas.

B. Sierra Social Programs

AID strategy, outlined in previous CDSS submissions, is to expand government services using low-cost models in health, family planning, education and nutrition to the six million rural inhabitants of the nation's poorest sierra communities.

1. Health/Family Planning - During the year, AID and the Ministry of Health have proceeded with implementation of activities financed under AID's Primary Health Care Program. Implementation has moved slowly, due to the change in government and the transition process. However, participating health regions have designed their implementation plans, commodities have been procured and training at the community health post level is underway. In response to the new government's more aggressive family planning policy, the Mission is designing a follow-on loan/grant to integrate delivery of family planning services into the Primary Health Program. A major new initiative in 1980 to provide social services to the sierra poor is a Rural Health/Sanitation loan/grant which will support construction of potable water systems and latrines and provide health education in 420 small communities in priority regions of the sierra and high jungle.

2. Nutrition - In response to the acute malnutrition that has accompanied Peru's economic recession and the chronic malnutrition which persists in the sierra, the Mission has sustained an expanded level of PL 480, Title II and OPG assistance (discussed in Section V). As it has expanded, the Mission's Title II program has emphasized substantive development activity, utilizing OPG resources in support of such long-range development programs as reforestation (CWS/SEPAS), basic infrastructure (CARE, CRS/CARITAS), pre-school education and primary health care (OFASA). New OPGs with CARITAS and OFASA were

signed this year to permit the VolAgs to continue their expanded feeding programs. The 1981 Title II program will reach an estimated 1.3 million people with a direct nutritional supplement.

3. Education - AID's involvement in this sector remain limited to on-going pre-school education and education service centers. While we are no more sanguine than last year about the prospects of significantly increasing our activities in the sector, our successful experience in pre-school education, working with education regions, and with the local volag Fe y Alegría in vocational training, encourages the possibility of support to both areas.

C. Urban Basic Human Needs

The past CDSS discussed the severe problem of urban poverty in Peru and outlined the Mission's response as the third thrust of our strategy--social programs designed to alleviate urban poverty through the provision of basic social services and infrastructure and food assistance, and programs that stimulate policies that foster a pattern of balanced urban-rural growth.

In 1980, CARE and the GOP initiated an important basic urban infrastructure program, which utilizes Title II food for workers and their families, local currency from PL 480 sales to purchase material and equipment, and OPG funds for program administration. The significance of this program, beyond the basic social infrastructure, e.g. schools, health posts, streets and sidewalks, built in Lima's pueblos jóvenes, lies in the greatly needed impetus it provides towards urban multi-sectoral planning and policy-making. Coordination for the program has been placed in a new administrative mechanism, a Multisectoral Commission composed of the Ministries of Housing, Health, Education and the National Office of Food Support, which we believe will continue to be used to manage other donor and GOP social investments in Lima's slums in the future. DSB grant funds (IIPUP program) have also been used to provide technical assistance in urban planning to the new GOP multisectoral mechanism.

The Mission hopes to provide $25 million annually through the Housing Investment Guarantee program to furnish basic services (water, sewerage, electrical connections, and home-improvement loans) to low-income urban neighborhoods. AID has recently used the HIG program to respond to one of the new President's priority initiatives--the creation of a Materials Bank which provides low income families with materials to upgrade housing. Technical assistance is also being provided to the new Bank through an AID financed OPG with the Foundation for Cooperative Housing.

III. GOP DEVELOPMENT PRIORITIES

The FY 82 CDSS, drafted before the April, 1980 election, indicated that, whatever the outcome, the new civilian government would be confronted with demands for increased social expenditures and for generation of employment opportunities, at a time when the country required the maintenance of strict budget austerity and the imposition of other fiscal measures to control inflation.

In the five months since it assumed office, the Belaunde government has concentrated its activities on the definition of policies to improve the economic situation it inherited from twelve years of military government. The task is formidable, requiring politically difficult economic policy decisions: eliminating subsidies on basic foodstuffs, reducing expenditures, balancing the budget, and other policies required to reduce rampant inflation. These policies will inevitably encounter opposition from a population that has seen its real income appreciably eroded in recent years.

The GOP's 1981 budget, like those of the previous two years, imposes strict austerity on fiscal expenditures and severely restricts domestically-financed investments in the new government's priority programs.

Preliminary budget figures for 1981 show a nominal increase of 55% in total expenditures -- an increase that will be offset by an anticipated inflation rate of over 60%, leaving a modest 3.5% increase over 1980 expenditures. Goods and services and external debt payments should increase by 15 and 19 percent respectively. Capital expenditures will be halved. The external debt in 1981 will increase 21.5% in real terms, including a substantial 43% real growth in externally financed food assistance. External debt service repayment accounts for a sizeable 35% of the 1981 budget.

Notwithstanding these severe economic constraints, the fiscal policies adopted and the attendant political difficulties anticipated, the development program of the Belaunde government is both ambitious and is fully consonant with AID's development assistance strategy.

The new government's development priorities are:

(1) to restore economic growth, with primary emphasis on the agricultural sector, and development of the high jungle area;

(2) to extend health, education and public works programs;

(3) to alleviate extreme problems of urban poverty, increase access to adequate housing and basic services.

In addition, the new government intends to make a major effort towards achieving decentralization in the provision of social services, planning and policy-making. The first tentative steps to achieve this goal were taken during the last years of the military government.

The GOP's highest development priority has been assigned to increasing agricultural production, with special emphasis on expanding the agricultural frontier in the central high jungle. A massive land redistribution has taken place in the past 12 years under the Agrarian Reform. Yet agricultural production has been declining on a per capita basis due to both a general stagnation in the agricultural sector over the past decades, as well as a devastating drought which has had a serious short-term impact on food production. Food imports reached $500 million in 1980. A further substantial increase is expected in 1981, for a total import requirement of $1 billion.

In the 5 months which have elapsed since the new government's inauguration, positive measures have been taken to strengthen the agricultural sector. Policies are presently being developed which the Mission believes will permit a significant expansion of agricultural production. The Ministry of Agriculture received emergency powers from the Congress to reorganize the sector and dismantle a substantial part of the inefficient state apparatus created under the military government. The recently approved Law of Agricultural Promotion and Development forms the basis for a new agrarian policy. The law decreases participation of the State, which has monopolized the sector over the past 12 years, in favor of an increased role for the private sector, especially in marketing of commodities. The new law assigns priority to the production of primary food products for domestic consumption; seeks to raise productivity by promoting activities which will increase yields and area under cultivation; strengthens basic applied research and extension services; and encourages private enterprises in all areas of agrarian activities.

The Mission is encouraged by the new emphasis placed by the GOP on small and medium scale irrigation with short-term pay offs to improve production on small farms in the sierra and high jungle. This low cost approach contrasts with the military government's emphasis on costly large-scale coastal irrigation projects.

Perhaps the single most important development priority for the GOP --and supported by AID-- is the integrated development of the Pichis-Palcazu central high jungle region, a major potential food supplier for Lima. An access road into the area will be completed in early 1981. Studies are presently underway - partially financed by AID - which will shape the commitment of AID and other donor development resources to build the infrastructure required to expand agricultural production in the area.

Another, equally high priority new GOP program is Cooperación Popular, a nation-wide self-help public works program first initiated in the 1960's under the President Belaunde's first administration. Cooperación Popular will generate employment and build low-cost rural infrastructure to expand food production and marketing, e.g. farm-to-market roads, small irrigation, as well as such basic social infrastructure as schools and health posts in the country's most marginal rural and urban areas.

The Belaunde government has established ambitious goals to reverse the deterioration of the long-neglected health sector. The priorities are to decrease mortality and morbidity rates, especially among infants, improve utilization of existent and new hospital infrastructure, and increase mother-child health protection. The new government has placed emphasis on voluntary fertility control through the provision of family planning services at the health post level, on a nation-wide basis, reversing the pro-natalist policy of the previous government. The Mission will respond to this important initiative by expanding its support for family planning activities.

As discussed in last year's CDSS, the principal constraint for the next few years will be central government's limited financial resources. The previous CDSS concluded that the longer-term survival of the democratic experiment would depend on the new government's adoption of a fiscal program which conforms to near-term domestic revenue constraints, but also responded to immediate needs. During its brief-tenure in office, the new government has formulated a fiscal policy designed to control inflation, maintain strict budget austerity, and stimulate private sector investment. Yet efforts to deal with urgent basic needs will be impeded by budgetary restrictions. While we believe that the GOP's development program is responsive to both immediate and long-term social and economic needs, the current economic realities will make the execution of that program very difficult in the absence of an accelerated economic recovery and the commitment of major resources by donor agencies.

Peru has been receiving approximately $250-300 million annually in foreign assistance, primarily from AID, the IDB and IBRD, and other bilateral donors, most notably West Germany and Holland. We expect that donor support, especially of the IFI's, will be increasing substantially in response to Peru's need for external assistance, improved fiscal performance, and as a demonstration of support for the new civilian government. Donor interaction and coordination has been frequent and constructive. Prospects are encouraging for the convening of a Consultative Group to ensure complementarity of donor assistance activities at a time when external resources are expanding. There is considerable latitude for such complementarity. Expanded IDB and World Bank assistance levels permit these institutions to finance basic infrastructure such as primary trunk roads and larger electric power generating facilities, which complement AID strategy. In agriculture, health and other sectors, AID will finance innovative projects which will serve as models for the IFI's programs. Examples of program complementarity are AID's integrated regional development projects in Junin/Cajamarca and the proposed Pichis-Palcazu project, which both require large investments in basic infrastructure. The IDB and

IBRD will finance construction of trunk roads and other large infrastructure in these regions. Similarly, both institutions are expected to finance activities in the proposed Upper Huallaga development project.

IV. GOP ECONOMIC PERFORMANCE

The Peruvian economy continued to improve in 1980 after the severe economic recession and financial crisis of 1976-1978. Adherence to the IMF stabilization program and a strong upsurge in mineral prices, particularly in 1979, redeemed Peru's external credit-worthiness and restored foreign exchange reserves to sound operational levels. The performance of the external sector was especially encouraging, due primarily to petroleum export earnings, (which registered a 43% increase over 1979) and record prices for minerals, especially silver and copper. The Peruvian Central Bank expects export earnings to reach $3.9 billion in 1980. Non-traditional exports, which doubled from 1978 to 1979, are expected to increase by 18% in 1980. The Central Bank projection for total 1980 imports is $3.1 billion, a 48% increase over 1979. This reflects the impact of both a new import liberalization measure that decreased maximum import tariffs to 60% and eliminated previous licensing requirements for most products, and an increase in the food import bill. Overall, adding interest payments and investment outflows, a current account surplus of approximately $370 million is forecast. The year-end 1980 international reserve level is expected to reach nearly $1.2 billion.

The domestic economy is responding, albeit slowly, to the improvement in external accounts, registering real growth in aggregate economic output and income levels. The estimated growth in real Gross Domestic Product (GDP) for 1980 is 4.5%, an increase of 1 percentage point over 1979. This upturn has been export-led and consequently export-oriented industries have benefited the most. The agriculture sector, however, continued to decline due to a drought, with an estimated decrease of 6.7% over 1979.

Behind this favorable economic picture, however, there still exists a fragile economic environment which is not clearly depicted by official data. While economic recovery is expected to continue, a number of factors will be critical in determining the pace of this momentum. Several of these were mentioned in our last CDSS and include the balance of payments and external debt position, inflation, energy policy, the Belaunde government's trade liberalization policies, and the problem of underemployment/unemployment.

Peru's net international reserve position increased by US$0.6 billion in 1980. Even with this positive improvement, the situation is not as sanguine as it may initially appear. Peru's net foreign payments on external debt will reach approximately US$1.4 billion in 1980, with debt service payments projected to increase to US$1.5 billion in 1981 due to the GOP's commitment to meet its international financial obligations without further debt rescheduling. Thus, approximately 35% of Peru's projected 1981 foreign exchange earnings will go solely to service the foreign debt. This burden will continue to be high at least until the late 1980's. A Consultative Group meeting in 1981 under IBRD auspices is expected to work to improve structure of Peru's external debt.

During 1980, petroleum export earnings amounted to 800 million dollars and their importance for Peru's external accounts is clear. The Belaunde government is taking steps to promote increased exploration and production of Peru's petroleum resources by providing greater incentives to private and foreign firms through investment tax credits. The success of the administration's petroleum policy will be an important factor in determining Peru's economic outlook during the CDSS planning period.

Mineral exports earnings amounted to US$1,349 million in 1980. Production increases in 1980 were recorded for copper, lead, silver and zinc, and were due in part to favorable external price conditions throughout the year. As in the petroleum sector, more generous investment tax credits are being planned to promote expanded production but mine expansion has a relatively long-term payoff (4-6 years). It is difficult to predict near term mineral export earnings due to the cyclical nature of prices. However, even if mineral and oil export earnings should remain high during 1981, import liberalization will also narrow Peru's trade surplus.

The major obstacle facing the Peruvian economy and in particular, in increasing real incomes,continues to be the high rate of inflation --running at 60.8% per annum for 1980 (December-December basis) as compared with 67% for 1979. Reducing inflation has become the important economic priority of the Belaunde administration. A significant decline in inflation in the short-term (to the 40% official goal for 1981) will depend upon the government's ability to withstand pressures for expansionary fiscal expenditures and immoderate wage increases. The government has adopted number of measures in that direction, including the formulation of an austere 1981 budget to reduce the fiscal deficit, the elimination of costly government subsidies on basic food products, and the raising of interest rates on time deposits to encourage domestic savings, currently depressed as a result of prevailing negative real interest rates. The Central Bank is continuing the policy of mini-devaluations, and has increased the pace in order to more fully compensate for the difference between internal and external inflation rates.

During the next year, the Belaunde economic team will undoubtedly continue the difficult task of bringing inflation under control while promoting sustained recovery for an economy only recently emerging from a deep recession. This has been a difficult task for governments throughout the world, but for Peru it also comes at a critical juncture. The Belaunde government is also faced with the rising expectations generated by the return to constitutional democracy. Meanwhile, labor unrest remains a serious issue and demands for increased wages and social benefits persist. In the first six months of 1980 alone, 2.9 million work hours were lost due to strikes. Despite recent across-the-board wage increases, labor unrest and civil violence have continued to plague the new government since its inauguration in July of 1980. While data indicate small gains in real incomes for workers during the past year, real incomes remain significantly lower than levels reached in the early 1970's. We expect the rise in real incomes to continue as the economy recovers.

In the last year's CDSS we emphasized the seriousness of the underemployment/unemployment problem in Peru, at a time when the labor force was growing at 5.0 - 6.7% per annum. Over half of the Peruvian work force remains unemployed or underemployed, i.e., working less than 40 hours per week or under the minimum wage. This situation is aggravated by a high population growth rate and continued migration from the sierra to the coastal cities. We pointed out that recovery from recession would help but that even two or three years of vigorous economic growth would not result in a recovery of the real income and employment norms of the early 1970's. Belaunde has cited the creation of jobs as among the highest priorities of his administration. His public works program will be labor-intensive, providing some new employment, but can not permanently absorb sufficient workers to make an immediate impact.

The cornerstone of the Belaunde government's economic policy is a redirection of the economy from a planned to a market-oriented economy which encourages both private and foreign investment. We believe that the policies the administration has adopted, e.g. import liberalization, continued mini-devaluation of the sol, the reduction of subsidies on basic commodities, the restoration of positive real rates of interest, and quarterly wage-price adjustment packages, should permit resurgence of a dynamic, price-directed economy capable of sustaining economic recovery. While these policies may be successful in achieving this long-term goal, particularly if aided by a robust external accounts situation, they also imply social and economic costs in the short-run, especially for the poor. The removal of subsidies for many basic foodstuffs, discussed in the following section, is illustrative of the social consequences of these policies.

V. PL 480 ASSISTANCE

In last year's CDSS, the Mission proposed consistently high levels of PL 480 Title I and II assistance throughout the CDSS planning cycle. This support was justified by (1) the need to help the new democratic government and its development budget (Title I), and (2) to combat serious acute urban malnutrition and chronic rural malnutrition, as well as to introduce a maternal child feeding program into the Primary Health Care program (Title II). Projections conform closely to last year's figures:

	FY 83	FY 84	FY 85	FY 86	FY 87
Title I	30	25	20	20	20
Title II	25	25	20	20	20

The reduction of Title II requirements from the current level of $30 million beginning in FY 83 reflects our intention to phase out of the School Feeding program by FY 83 as the GOP assumes full responsibility for funding the program .

During the course of this year, the Mission submitted a number of documents that discuss in considerable detail the Mission's justification for the size and scope of our PL 480 program: FY 82 Annual Budget Submission, pp. 65-74; LIMA 8814 (9/25/80); LIMA 10014; and USAID's comments on Peru's PL 480 Title I Self-Help Report, pouched 11/26/80. The content of these messages is summarized below.

PL 480 Title I

A. Development Support

Since the Title I program began in 1978, it has been a vital component of the USAID's overall development strategy, and has had a decisive development impact. The Mission has been able to program the precise use of funds at the time each Title I agreement is signed to assure that the use of local currency is fully integrated with USAID strategy. Local currency generated by the sale of Title I commodities has made a critical difference in achieving the success of the AID program in Peru. Title I has afforded the Mission the unique opportunity to demonstrate to the GOP the efficacy of the new innovative programs and administrative mechanisms that improve the status of the most marginal sectors of the Peruvian population. One example is the establishment of a Multi-Sectoral Urban Planning Commission to coordinate implementation of a new program designed to build greatly needed social infrastructure in the pueblos jóvenes of Lima (CARE OPG, 527-0186). This program could not have gone beyond the conceptualization stage without Title I resources. The new administrative institution is expected to continue the management of social investments in Lima slums when our financing ends.

Title I resources have similarly permitted the implementation of our development strategy for the sierra and high jungle, a strategy which could otherwise have failed in the absence of Title I support given the seriousness of the GOP budget situation. Another example of Title I use for institutional innovation is the Special Project Directorate established to implement our Sub-Tropical Lands Program. Title I provided USAID and the GOP the funds to defray crucial start-up costs and is currently permitting both an expansion of activities as well as the financing of complementary activities, e.g. road maintenance and construction, that reinforce our programs in the sierra and high jungle.

Title I has permitted the Mission to quadruple its Title II funding program by defraying the costs of transportation, warehousing and distribution of donated food for our School Feeding and VolAg programs during a period in which the GOP has been forced to impose a strict policy of budget austerity.

AID is able to utilize Title I local currency to respond quickly and positively to GOP requests for support of its high priority programs. This flexibility has become especially critical as a result of the transfer to civilian government in 1980. Title I resources have permitted the US to demonstrate its support to the new democratic government whose development priorities so closely resemble AID's. Two examples of new GOP initiatives which Title I resources will support in 1981 are (1) the development of high jungle agriculture, especially in the Pichis-Palcazu region; and (2) Cooperación Popular, the nation-wide self-help public works program.

In summary, Title I has been a decisive instrument for influencing GOP development policy. When a Consultative Group is convened, during the course of 1981, Title I will take on the additional role of permitting the GOP to finance the initial start-up of priority development projects until full external resources are made available from other donor sources.

B. Food Needs and Budget Support

Continued high levels of Title I will be required to ease Peru's large food import requirements over the next few years (approximately $1 billion in 1981) and to provide budget support for social and economic investments during a period when budgetary restrictions and service of a large external debt will hinder GOP efforts to deal with persistent poverty problems.

Peru's food import bill has been climbing rapidly over the past few years. Per capita food production has been declining. Although recent policy changes affecting the agricultural sector are encouraging, they will take years to translate into increased production sufficient to meet domestic demand for food in the next decade.

According to USDA data, the average annual per-capita agricultural production growth rate in Peru has been a negative - 3% for the past decade. With a current population growth of about 2.9% per annum and an official government projection of 2.6% annual growth rate from 1980 to the year 2000, agricultural output would have to grow by at least 2.6% per annum to maintain even the current insufficient per capita availability of agricultural production. In addition, growing urbanization (from 67.4% of total population in 1980 to 78.5% in the year 2000), an expected increase in real income of 2.0% per year, and a maturing age structure of the population, all suggest that the demand for commercialized agricultural production will grow at a pace well in excess of 2.6% p.a. --possibly by as much as 4.0% p.a. Among the causes for this poor agriculture sector performance, some of which were either directly or indirectly the result of the Agrarian Reform, and which the new government is attempting to resolve, have been the lack of adequate credit, a deteriorated agricultural research and extension system, lack of production incentives and agricultural inputs, a burdensome marketing system, price controls, and a devastating drought that has had the most serious short-term impact on production. The drought has affected the entire country, but its effects have been most heavily felt in the northern coastal region which constitutes the nation's largest food production area. Approximately two-thirds of the usual productive agricultural coastal crop land was not planted in 1980.

In the period CYs 1977-79, total agricultural imports averaged $265 million. In contrast, 1980 agricultural imports will reach over $500 million for a total of 1.5 million tons. The volume of Peru's 1981 agricultural imports are now expected to reach between $750 million and $1 billion.

An effective agricultural strategy designed to increase yields and open up new land in the high jungle will increase production of food, but it is a medium to long-term prospect requiring substantial external financing. Central government financial resources will continue to be limited and competition for their use will be intense. Sufficient financing will not be available to execute large scale agriculture projects. Title I can supply a portion of the country's short-term food requirements, as well as play a decisive role in stimulating the investments required to broaden the country's agricultural frontier into the high jungle.

How great will the need for budget support be in the next several years for agricultural development projects?

Based upon data from the 1978-80 budgets, the Mission believes that central government expenditures for the agriculture sector have been approximating $100 million annually. One-third of this budget is for operating expenses and the remainder ($70 million) is allocated for investments.

Clearly an estimated $70 million of available central government of domestic investment will not permit the GOP to move vigorously in its high priority agriculture and rural development projects, discussed in Section II. With respect to other required expenditures by the Ministry of Agriculture we believe that current operating expenses should be increased by $20 million to a total of $50 million in order to have a credible impact on crop yields. At least $10 million more annually will be needed to recapitalize a severely eroded agricultural credit system. Major capital expenditures include about $60 million on on-going irrigation projects, both large and small scale, and about $30 million for new projects (land reclamation on the coast, new small irrigation projects in the Sierra, and for the opening of promising high jungle lands). These cost categories represent a total minimum funding requirement of $150 million. Can the State allocate this magnitude of funding to agriculture?

The Mission projection of a politically and economically tenable pattern of central government expenditures for 1985 was prepared as part of a major policy paper presented in June, 1980 to the Belaunde incoming government ("Policy Issues Concerning Expansion of Arable Land in Peru"). This project was based on a forecast growth rate in GDP of 6.5% per annum from 1980 to 1985 and the U.S. dollar equivalent stated in 1977 prices. These assumptions produced the following pattern of projected central government expenditures from domestic financial resources in 1985:

	US$ Millions (1977 prices)
Government Housekeeping	80.7
Amortization	390.0
Interest	500.0
Human Resources (Education & Health)	1,210.2
Police and Military	1,088.5
Economic Sectors	764.5
TOTAL	4,033.9

The government's economic sectors include agriculture, energy, transportation, housing, and regional development. With the conservative assignment of $50 million for current expenditures on highway and road maintenance, $50 million for regional entities and $50 million for fishing, industry and tourism, the remaining $600 million can be viewed as counterpart to leverage external credits for investment purposes. The competing sectors are agriculture, highways, energy, housing and the state development banks. A maximum target of $150 million annually may be available for agriculture by 1985. The maintenance of a $20 million funding level for Title I could serve as a significant and immediate element in this $150 million domestic funding package.

PL 480 Title II

As discussed in both the previous CDSS and, in greater detail, in the FY 82 ABS (pp. 68-74), the Mission is requesting continued high levels of Title II assistance during this CDSS cycle. These levels are justified for the following reasons: (1) the important contribution of the Title II resource has made to the USAID's overall development strategy (discussed in FY 82 ABS); (2) malnutrition, especially chronic malnutrition in the rural areas, can not be expected to improve even if general economic conditions improve during the next decade; (3) difficult, but urgently needed policy decisions of the new government, e.g. lifting subsidies of basic foodstuffs, will further depress real incomes of the urban poor; (4) although Peru's balance of payments position has recently improved, its continued improvement is contingent upon such exogenous factors as export prices, increase in oil reserves, etc., which may reverse the current favorable trend. In any event, we do not expect real incomes of the target population receiving Title II food to increase appreciably during the next half-decade; and (5) the new Government's strategy to increase local food production by increasing yields, transferring technologies and opening up new lands in the high jungle, will require several years to generate meaningful results.

As we discussed in the preceeding section, Peru is emerging from a phase of recurrent economic crisis and general economic conditions have improved during the past year. Yet the nutritional situation for both the urban and rural poor remains and will continue to be unsatisfactory, despite the improvement in macro-economic trends. Even in the medium term, improved economic conditions will alleviate only acute malnutrition, an urban phenomenon resulting from losses of real income during the late 1970's. Chronic malnutrition is a characteristic of the more persistent problem cf rural poverty, especially in the sierra. As explained in the ABS, while Title II assistance will be required to combat chronic malnutrition in the sierra, continued high levels depends on the ability of the econcmy to permit substantial real increase in income for the urban poor suffering from acute malnutrition.

In September, 1980, the Mission updated a quantitative study on Malnutrition in Lima completed in May, 1979 (Airgram TOAID A-19). This September 1980 update was summarized in Lima 10014 dated October 30, 1980. The recent data suggest that, notwithstanding the improvement in Peru's external account position, there has been little change in the quantitative aspects of the nutritional situation for Lima's low income families. The study indicated that severe nutritional inadequacy presently affects a minimum of 7.6% of Lima's households (68,400 families), compared to 6.4% in September, 1978, and a present maximum estimate of 19.8% versus 21.0% in 1978. It appears that such economic variables as real wages, employment and household income indicate at best, an end to the period of economic deterioration and perhaps a slight improvement during this year. This still bleak portrait of acute urban malnutrition is corroborated by joint GOP/ USAID evaluations of the SAWS/OFASA and CARITAS feeding programs concluded at the end of 1979. Given continued high rates of inflation during the next several years (the 1981 estimate is 50%), we do not expect that the level of real wages for the urban poor will improve significantly nor produce a real improvement in their nutritional situation. Unemployment and underemployment will continue at extremely high levels, especially as rural inmigration continues. The Mission intends to periodically update its household nutrition survey in Lima and will forward results to AID/W.

While the decline in real income of the urban poor became stabilized during the past year, any real short-term economic improvement for the poor will be offset by the new government's decision to phase out food subsidies by the first quarter of 1981.

Some clarification is required regarding the general question of the relationship between food subsidies and local production raised in the review of last year's CDSS (State 124303, para. 4). In the early 1970's, price controls (not subsidies) imposed on basic food items negatively affected farm production. From 1975 to 1978, the military government provided periodic increases in the farmgate, wholesale, and retail prices of food products. By early 1978 goverment food price subsidies were limited to evaporated milk, wheat products and cooking oil. Between Mary 1978, and the end of 1979, the GOP announced its intention to remove consumer subsidies and move toward a more price-directed agricultural policy. Restrictions on production (obligatory allocations of farm land to food crops) were also lifted. These actions resulted in substantial increases in retail prices of previously subsidized food products, which increased by more than 100%. However, with the erosion of real income caused by the move to an undervalued exchange rate, consumers reduced purchases of even the most essential foods. Thus the problem affecting the farm sector was not one of artificially depressed prices nor of subsidies but rather a problem of weak domestic demand. By the end of 1979, the military government decided to apply a policy designed to increase real incomes and domestic demand by enlarging subsidies. The cost of these subsidies in 1980 is expected to reach 100 billion soles (the equivalent of US$286 million). The new civilian government has determined the impossibility of continuing this costly subsidy program which drains the economy and Peruvian government of greatly needed resources.

While the lifting of subsidies makes good fiscal sense, the measure will exact a considerable social cost. Lower-income families devote a higher proportion of total expenditures to food and, therefore, food subsidies constitute a higher proportion of their real income. For a poor urban household, 80% of total expenditures are made for food. We expect these families to suffer a reduction in real income of about 6% when food subsidies are eliminated.

Although the policy adopted by the GOP to eliminate subsidies on basic food products may be prudent, Title II assistance for urban programs at current levels will be necessary for the next 3-4 years as real income remains low and the attendant severe acute malnutrition persists.

The CDSS guidance (State 378673) questions the need for PL 480 assistance based upon Peru's currently favorable balance of payments situation. We strongly doubt that 1981 and ensuing years will witness a continued build-up of Peru's net international reserve position. Peru's balance of payments situation is presently moving rapidly from surplus to equilibrium. The latest Central Bank estimate for 1980 indicates a B/P compensatory surplus of $604 million as compared with $1,579 million for 1979. For 1981, the Central Bank projects a compensatory surplus of $79 million. Achievement of this very modest surplus will require, we suspect, that mineral prices remain near present levels. The principal cause of the comparative B/P deterioration is erosion of the trade surplus from $1,523 million in 1979 to $770 million in 1980 to a projected $66 million for 1981.

Growth of imports in 1980 has exceeded earlier forecasts and are now estimated at $3.1 billion, while the forecast for 1981 is $4.1 billion. The strong growth of imports from the 1979 level of $1,951 million results from import liberalization measures, e.g. elimination of import prohibitions and tariff reductions. Economic recovery is also serving to expand import expenditures. Food and capital-related requirements account for over 90% of total imports. The civilian government's commitment to employment generating activities and public works and its receptivity to foreign investment is likely to increase imports of capital equipment for mining, hydro-electric and other infrastructure projects. A 1981 import level of $4.1 billion is actually lower than the $4.5 billion which would obtain from the 3-year 1976 average level of $2.2 adjusted for 6% p.a. growth and 9% p.a. world inflation.

Peru's 1980 year end net international reserve position of $1,158 million does not appear at all excessive when set against 1981 projected imports, an $8 billion external debt and a public sector debt service ratio of 30-35% for the next five years. The turn-around on reserve growth appears close, i.e. growth of net reserves amounted to only $46 million during the fourth quarter of 1980.

Going beyond 1981, Peru's petroleum export prospects also give reason for caution. At present the Central Bank has not prepared a projection beyond 1981, but as noted in the FY 82 CDSS, petroleum export earnings would account for 34% of total commodity export earnings for 1980-83. Due to increased domestic consumption and some technical difficulties, recently Peru's petroleum exports have been substantially lower --65,000 barrels daily-- than the 100,000 BPD flow obtained earlier in the year. In addition to present difficulties, we have previously cautioned that without substantial increases in proven reserves, Peru would become an oil importer by mid-decade.

In regard to food imports, in the period CY 1977-79, Peru's annual agricultural imports averaged $265 million. Due principally to drought-induced production shortfalls, 1980 agricultural imports are estimated at over $500 million and 1981 agricultural imports will be even higher. Therefore, the timing of a cutback of PL 480 would appear unfortunate as it coincides with sharply increased public sector usage of foreign exchange to finance food imports.

Yet, irregardless of whether or not Peru's balance of payments position remains favorable, the use of substantial amounts of foreign exchange to import basic foods does not mean that the urban and rural poor will consume more food. As real incomes of these groups continue to remain low, additional income required to purchase imported food will simply not be available. Again, Title II food will be required to supplement the diets of the very poor until real incomes increase to the point they permit the urban poor to purchase a nutritionally adequate diet.

VI. ASSISTANCE PLANNING LEVELS

Last year's approval planning levels, beginning with $60 million in development assistance grant and loan resources in FY 82, were substantially higher than the AAPLs recently assigned to the Mission, as follows:

FY 82	FY 83	FY 84	FY 85	FY 86	FY 87
40	50	60	70	80	80

For reasons discussed in the introductory section, AID must commit the resources required during the next several years to permit the U.S. to demonstrate its support of the new government and its commitment to long term equitable growth. Especially in the early years of the CDSS cycle, the AAPLs would not provide AID with the latitude it requires to respond to urgent requests from the Belaunde administration for assistance in its highest priority development programs, especially the expansion of the agricultural frontier in the high jungle, utilization of hydroelectric energy resources, and improvement of public sector health/family planning and urban services.

The assignment of these AAPLs in FY 82-83 would create a difficult situation for the Mission which would become untenable if loan increments for the Upper Huallaga Area Development project associated with the narcotics control program are included in the AAPLs during the CDSS cycle. The Mission will be initiating priority loan projects that must be incrementally funded during the next few years. For example, loan increments for the Regional Agricultural Development project in the Pichis-Palcazu high jungle region and the Upper Huallaga Area Development project will most likely absorb $25 million alone in FY 82. Crucial new programs that further AID's strategy in family planning, watershed management and urban small business would require an additional $24 million. Including other ongoing grant resources of approximately $5 million, AID's minimum loan/grant requirements for FY 82 will reach $54 million.

Other new initiatives programmed for the next few years, e.g. a loan to provide on-farm investment credit to small, independent farmers (BANCOOP) and replications of both our successful Treated Sewage for Irrigation project and Rural Agribusiness Fund would required additional funds. These projects respond to urgent development goals shared by both AID and the new Peruvian government.

The question raised in last year's CDSS is still appropriate: Is it realistic to assign a loan/grant level this low to a poor and relatively important country such as Peru, especially during a period when we must encourage the still precarious democratic government? AID/W must reconsider its assignment of AAPLs for FYs 82 and 83 to allow the Mission to make significant efforts in all its major strategy elements.

The need for continued high levels of PL 480 assistance during the CDSS planning period was discussed above. Loans will constitute the largest portion of AID's resources. We intend to maintain counterpart requirements at the 25% minimum, until improved economic conditions permit the GOP to assume a larger share of project costs. The USAID had combined grant and loan resources in several projects to defray the foreign exchange costs of technical assistance and certain commodities. This practice will continue, for example, in our Integrated Primary Health/Family Planning project. Substantial grant levels will continue to be required to finance the Mission's large OPG portfolio which plays an increasingly important role in the USAID strategy. OPGs have been especially effective in providing VolAgs resources to implement substantive development activities in conjunction with Title II feeding, and also to give local groups the opportunity to experiment with new approaches to development projects.

The HIG program is the major USAID resource that addresses our urban basic human needs strategy. The Mission plans to provide annual levels of US$25 million in HIG resources and such new initiatives as the Materials Bank convince us that the Housing sector can effectively absorb this level of funding.