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Country Development Strategy Statement

FY 1986

PERU



January 1984

Agency for International Development
Washington, D.C. 20523

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USAID/PERU

COUNTRY DEVELOPMENT STRATEGY STATEMENT: FY 86-90

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EXECUTIVE SUMMARY

1. POLITICAL AND ECONOMIC CONDITIONS

Peru's has been devastated by the worst recession in modern times and a combination of natural disasters. Economic policy-makers are facing overwhelming problems: an estimated 11% decrease in GDP for 1983; inflation of 125% for the year; low foreign exchange reserves and increasing foreign indebtedness; a public sector deficit of over 10% of GDP; increased social and political tensions; and a terrorist movement that has increased pressures on limited budget resources and caused serious economic disruptions. Foreign exchange and budgetary shortages dictate stern austerity measures while severely limiting the GOP's ability to reconstruct disaster areas, carry forward ongoing development programs and deal with the underlying poverty and unemployment conditions that result in misery and discontent.

Peru is a poor country, with whole regions of grinding poverty. It has regressed from the 8th most developed country in the hemisphere in 1970 to 16th in 1982. Only five major countries in Latin America have lower incomes than Peru. Real wages have decreased approximately 35% since 1973. Over 60% of the economically active population is now unemployed or underemployed, earning less than the official minimum wage—around \$65 per month. Almost 6 million Peruvians live in conditions of absolute poverty (their incomes do not permit even minimally adequate consumption); another 3.5 million are relatively poor. Less than half of the population has access to potable water. Some 50% of pre-school children suffer some degree of malnutrition. Peru is one of only three Latin American countries whose average food consumption per person was less than 90% of national standards. Available data clearly understate the magnitude and severity of poverty.

Peru is trying to overcome serious development constraints and economic problems through an economic/political model of market-led, equitable growth with democracy. It is undergoing a painful structural adjustment away from import substitution and towards an export-led strategy.

Upon entering office in 1980, the Belaunde administration was determined to make the private sector the major actor in economic growth and to use market forces and price signals to substitute for the elaborate and stifling system of administrative controls built up under the military. The government eliminated most price controls, substantially increased prices of products of state enterprises and reduced their monopoly positions, and lifted restrictions on foreign trade and payments. The GOP's intention was to use import competition to increase the efficiency of domestic production and to force the domestic economy to concentrate its efforts on areas in which Peru had a comparative advantage. GOP strategy also aimed to achieve greater efficiency of resource use, increase resource mobilization and price competition in capital and product markets. These steps put in place a considerable number of valuable policies that together constitute a workable framework for effective development investments.

Yet, the government has made only partial inroads in dealing with longer-term development constraints. Several factors have impeded its ability to carry out further reforms: (1) the world recession, which weakens Peru's export markets and makes capital difficult to obtain; (2) the natural disasters, which caused over \$1 billion in production and infrastructure losses with substantial adverse impacts on foreign exchange; (3) weak public decision making and administration; and (4) poor resource management, characterized by unclear investment priorities. It is clear that the transition to a free market economy that the Belaunde administration set out to do is a more difficult task and will require more time than anticipated. Major new policy reforms during 1984-85 will be difficult. In some areas, it would be unrealistic to expect further changes. Indeed, maintaining the current policy framework would be a significant achievement, as the government faces constant pressure to curtail or reverse many elements of its program.

Peru's current crises are of such dimensions that they threaten to undo the significant progress that has been made over the last three years in establishing a workable framework for

long-term development. They are a serious setback for an economy only beginning to show signs of recovery from years of economic mismanagement and only beginning to respond to the market-oriented measures promulgated by the Belaunde administration. The present crises have made it increasingly difficult for the government to continue its market-oriented policies. It faces opposition from political parties who blame Peru's woes on these policies. In the recent municipal elections, leftist parties won a sweeping victory seen by most as a protest against current economic conditions and policies. This outcome could presage the results of the 1985 national election.

2. USAID/PERU STRATEGY: FY 84-90

The principal objectives of the USAID/Peru program are to: (1) demonstrate USG support for Peruvian democratic processes and for other USG foreign policy objectives; (2) strengthen and expand private sector institutions and development approaches; and (3) improve the lives of low income families and help Peru achieve the longer-term structural transformation of its economy. This structural transformation will require a basic shift from a productive structure based on import-substitution towards an export-driven development model that places renewed emphasis on agricultural development and incorporates higher labor value added into domestic production. In effect, Peru must make overall production, especially exports, more labor intensive. Greater emphasis must be placed on generating more productive employment and expanding the coverage of basic social services directed to low income families. To facilitate this process, sound policies, stronger institutions, more appropriate technologies and a dynamic private sector will be required.

A. Strategy in the Short Term (FY 84-86)

For development as well as foreign policy reasons, it is imperative that the USG provide immediate and quick-disbursing program assistance to help alleviate pressures on Peruvian democracy and on the market-oriented economic program. Politically, the U.S. has a stake in the success of Peruvian democracy. From a development point of view, our assistance is needed to

support the positive, market-oriented policy gains made during the last three years. Supporting these policy gains and encouraging others is of paramount importance. Whatever government assumes office in 1985, it is clear that a floundering economy, a discredited private sector and an inadequate response to natural disasters can only increase pressures for radical policy changes.

Surviving the current economic crisis is the first critical step before Peru can effectively pursue longer-term goals. How well Peru's economy and society survive will determine how fast it can direct its energies and resources to the structural transformation it needs. Investment resources, both public and private, are going to be extremely short. The struggle to reduce the public sector deficit is likely to last for several years, certainly as long as export prices remain depressed. The private sector will continue to be hard pressed to maintain employment and will not be able to provide expanded employment opportunities until domestic or export demand picks up. There will be continued pressure to provide "temporary" protection from imports.

These factors have led the Mission to conclude that the principal objectives of the USAID strategy during FY 84-85 and into FY 86 should be to: assist GOP economic recovery efforts and expand support for private sector development through program assistance for balance of payments and budget support; quickly and effectively carry out the disaster relief and reconstruction program; and successfully implement and substantially complete the ongoing USAID portfolio. As the key element in the short term strategy, the CDSS proposes an FY 1984 disaster program loan and Economic Support Funds in FY 1985 and 1986. These program assistance funds will help cushion the shocks of economic recession and natural disasters, facilitate faster implementation of ongoing development projects, and ease the transition to a more competitive productive structure. At the same time, we will continue to carry on policy dialogues with the GOP and other groups and continue our efforts at building a sounder analytical and institutional base for further development policy discussions and program formulation so that a major new USAID development

program can begin early in FY 86 when a new government assumes office in Peru.

B. Longer-term Strategy (FY 84-90)

Three inter-related themes conceptualize the Mission's longer-term program and strategy. They are: (1) supporting policies that promote, and programs that embody, rational resource use; (2) increasing incomes and employment of rural and urban low income families; and (3) expanding the efficiency and coverage of social service delivery.

(1) Supporting Policies That Promote Rational Resource Use. The ineffective use of Peru's scarce physical and financial resources has been an endemic development problem. Rational resource allocation is a cross-sectoral USAID objective emphasizing policy dialogue to (a) ensure sound GOP investment selections based on solid analytical criteria and (b) promote market-led solutions to economic growth and development. USAID's role will be to concentrate on a number of selected policy areas where A.I.D. has a comparative advantage for assisting Peru. Generally, over the longer term the Mission will encourage and assist the GOP to: (a) develop policies and mechanisms which strengthen rural and urban financial markets and which encourage savings and the maintenance of value of financial resources; (b) increase the use of market signals to allocate resources, particularly in agriculture; (c) undertake investments in productive and social areas which impact on the greatest number of low income families, taking into account financial constraints; (d) make more productive use of scarce natural resources; and (e) encourage privatization of development decision-making and decentralization to regional areas.

(2) Increasing Incomes and Employment of Rural and Urban Low Income Families. Creating a productive and self-sustaining employment base to reduce present under-employment and unemployment levels, while also absorbing a growing work force, is the most important development challenge facing the country. Poverty in Peru, including low nutrition and health levels, is to a large extent the result of inadequate productive employment. Thus, generating employment and increased

incomes will be a principal USAID objective. The private sector must play a leading role in its achievement.

(3) Expanding the Efficiency and Coverage of Social Service Delivery. Peru's present crisis has accentuated the need for economic growth-oriented investment. Nonetheless, increasing the outreach of social service delivery programs—particularly health and family planning—may be one of the most effective ways to increase the real incomes and living standards of the poor. Given current and foreseeable resource availability, however, USAID's strategy in this area will be to increase the internal efficiency (and hence coverage) of present public programs and to expand private sector (profit and non-profit) efforts in these areas, thereby drawing upon significant additional resources.

3. RELATIONSHIP OF STRATEGY TO A.I.D. POLICY AND PRIORITY AREAS

USAID's strategy is fully consistent with those priorities identified in the LAC Strategy Paper and Management Plan of supporting stabilization measures and macroeconomic assistance; carrying out policy dialogues, particularly on macroeconomic questions; expanding employment and increasing incomes through structural reform; and increasing efforts to deal with urban and regional development issues. The strategy builds on the four areas of A.I.D. concern: policy reform, increased involvement of the private sector in development, institutional development, and the transfer of technology and know-how.

A. Policy Reform

Given the growing economic and political pressures facing the Belaunde administration, the Mission's immediate policy dialogue agenda is two-fold: (1) to encourage the GOP to retain the significant reforms carried out over the last three years; and (2) to support the IMF stabilization program and encourage continued policy reform in key development areas. Over the longer run, we would like to see more rational resource allocation and a continuation of efforts to apply sounder development principles.

B. Institutional Development

The cornerstone of the long-term USAID program is to strengthen private and public institutions that can carry on development efforts long after our project funds have been expended. In the priority areas of agriculture and health, ongoing projects are providing assistance geared to improving the institutional base of the public sector. Peru's primary health care systems will require policy, management and other institutional improvements throughout the ODS period. For the most part, however, new institution-building efforts will emphasize the private sector.

C. Transfer of Technology and Know-how

Technology transfer is a valued instrument in the USAID program, reflected in our agriculture, rural development and social sector portfolios, and is closely linked with the Mission's institution-building objectives. Reflecting Peru's priorities and A.I.D.'s comparative advantages, USAID has emphasized technology transfer efforts in many fields, especially in agriculture. The priority research and technology transfer concern has been to increase crop yields and reduce production costs through the application of improved technologies, particularly for selva rice, sierra potatoes, highland grains, high value export products and crop system technologies for tropical and sub-tropical lands. The Mission will continue to emphasize these areas through ongoing activities and future programs of private sector technology dissemination. In addition, the Mission will support research on the value of women's work in the economy and biomedical research.

D. Private Sector Involvement in Development

Increased collaboration with the private sector in achieving development objectives is central to our strategy and builds on the GOP's development model. USAID's objective in encouraging greater private sector involvement in development is to increase productive employment and incomes and augment the human and financial resources available to development activities. We

will maximize private sector delivery of program resources, including export promotion, small and medium scale enterprise promotion, health and family planning delivery, and agricultural production and marketing development. Our support will include work on policy reforms important to private sector development and institutional improvements in key private sector groups. The CDSS calls for continued collaboration with PRE in advancing these objectives.

4. RESOURCE SUMMARY

USAID proposes program assistance lending during the 1984-86 period to respond to Peru's short-term needs and buttress the ongoing policy dialogue. Both are crucial to longer term development prospects. Development Assistance levels would be reduced from past years while PL-480 Title I and II assistance would continue, along with a multi-year Housing Guarantee program contingent on policy agreement with the GOP. New project starts in the immediate future will be small and limited to support of policy dialogue, institution-strengthening and the private sector. Grant resource needs will increase. Implementation of the Mission's current project portfolio will continue to be a high priority. The CDSS also proposes some relief from current staffing constraints.

A new CDSS will be prepared in January 1986. Policy analysis and sectoral assessment efforts will continue, but longer-term US development opportunities in Peru depend on the outcomes of Peru's confrontation with the current short-term economic crises and the political succession scheduled for mid-1985. The CDSS projects increased DA levels starting in FY 86.

5. MANAGEMENT ISSUES

The CDSS proposes resolution of several management issues necessary to carry out the strategy. Implementation of the current project pipeline will be impeded by shortage of GOP counterpart funds. A continuation of PL-480 Title I lending and local currency generations from the proposed program lending will assist the GOP in this area. The USAID will continue to increase the amount of staff time dedicated to project implementation.

USAID staff constraints will require some relief in the short term. During the latter part of the planning period, fewer but larger and simpler projects, continued training of Peruvian staff, and completion of ongoing office automation efforts will permit some staff savings.

A deteriorating security situation for USAID staff in Peru may seriously impede project monitoring in some areas of the country, including Lima. We are requesting OE funds to install recommended security devices in the USAID building and are monitoring carefully the conditions under which our technical advisors work in the field.

While we have reviewed the Mission operating expenses budget for potential cost savings, there is little room for reduction. Substantial decreases in OE funds would have a serious impact on the quality of execution of the ODSS strategy. Indeed, increases will be necessary to assure adequate execution of the strategy.

I. INTRODUCTION

A. Background

Peru is trying to overcome serious development constraints and economic problems through an economic/political model of market-led, equitable growth with democracy. It is undergoing a painful structural adjustment away from import substitution and towards an export-led strategy, but export markets are not promising in the short term and external capital to help finance the structural change is expensive and difficult to obtain. At the same time, Peru has suffered a combination of natural disasters having serious consequences for an unprecedented number of Peruvians.

Peru has lost the consensus it once had on its development objectives and strategy, having gone from one crisis to another for the last 15 years—a military coup, natural disasters, the military's failed development experiment, a sharp drop in fishmeal exports, and a series of domestic and international recessions. All of these events contributed to Peru's loss of development consensus. The country no longer seems to know where it wants to be 20 years from now, or agree on where it is now. As a result, there is no effective development planning or set of national goals that are widely shared. Although the government has a development philosophy, it has not clearly articulated a plan, backed up by budgetary investment decisions, to surmount constraints to broadly-based growth with equity.

Peru's development challenges come in large part from the country's fragmentation. Its extremely varied geography and limited natural resource endowments prohibit single-faceted, small-country development approaches. Many aspects of Peru's rich cultural heritage spring from its Andean populations who by language and life style are not in Peru's economic and social mainstream and are not equitably attended by national social and economic services. The small and medium farmers and herders of the mountains, the rural landless, the pioneers of the jungle, the established small and medium coastal farmers, and the inhabitants of the urban shanty towns manifest complex differences far beyond the standard models of differential development. All are

members of AID's target group of low-income families.

Peru's recent political and social history encompasses a closely-watched and much-studied effort at directed economic, social and cultural reforms designed to ensure more equal income distribution and integrate the country's minorities into the modern society and economy. The military government's development experiment failed, but its effects continue to reverberate in Peru. The experiment strained the country's public creditworthiness and tarnished Peru's attractiveness to potential equity investors. The redistribution of land and the promotion of various models of political, social and economic organization carried out during that period generally did not benefit the poorest sectors of Peru, but they did leave a potpourri of local and national administrative structures, many bankrupt and many no longer representative of their constituents' interests. At local levels, the willingness to put much credence in central government initiatives understandably has weakened.

B. Poverty in Peru

Peru is a poor country, with whole regions of grinding poverty. It has regressed from the 8th most developed country in the hemisphere to 16th (based on per capita income in 1970 and 1982). Today, only five major countries in Latin America have lower incomes than Peru: Bolivia, El Salvador, Haiti, Honduras, and Nicaragua. Real wages have decreased approximately 35% since 1973. Over 60% of the economically active population is now unemployed or underemployed, earning less than the official minimum wage--around \$65 per month. Almost 6 million Peruvians live in conditions of absolute poverty, that is, their incomes do not permit the consumption of a minimally adequate volume of food and non-food items. Another 3.5 million are deemed relatively poor according to World Bank data. Less than half of the population has access to potable water. Some 50% of pre-school children suffer some degree of malnutrition. Children die of diseases and infections that they would survive if nutrition were adequate or if preventive health care were widely offered. A recent IBRD study, reflecting the steady decrease in food production in Peru,

found Peru to be one of only three Latin American countries whose average food consumption per person was less than 90% of national standards (Haiti and Bolivia are the other two). The income distribution worsened during the military period.

The geographic location of low income families is changing, with the coast and urban areas growing faster than the rest of the country. Half of those earning less than the minimum wage are in the sierra, and one fourth are on the coast outside of Lima. Lima itself contains 18% of Peru's poor. The remaining poor are widely dispersed in the high and low jungle areas. Women form an estimated 55% of the poor. The World Bank believes that available data understate the magnitude and severity of poverty in Peru.

The extent of urban poverty reflects the rapid urbanization that Peru has experienced during the last three decades. While the pace of urbanization is slowing, secondary cities continue to grow rapidly. Internal migration, the result of powerful economic and social forces, will not be significantly reduced or redirected in the absence of decisive policies and programs to make more productive use of Peru's rural natural resource base.

C. Return to Democracy and Market-oriented Growth

After 12 years of military rule, Fernando Belaunde Terry assumed the Presidency in July 1980, after Peru's first elections in 18 years. The return to democratic government is one step in a continuous process of looking for a political and economic system that works for Peru. The first Belaunde presidency (1963-68) was filled with contentious, divisive power struggles between the old agrarian-based oligarchy and new reformers who were concerned with the well-being of the large mass of Peruvians. The military government (1968-80) promised to change the power structure. Regardless of whatever else the military government may have done, it clearly diffused the concentration of economic power away from the traditional landed oligarchy towards the new industrial elite, the public sector and wage earners in the formal economy; it also altered the dynamics of both the political process and development.

By 1980, Peru faced a set of conditions that required a basic economic transformation.

Some of these conditions sprang from the policies of the military government, while others evolved from longer-term trends:

- a distorted system of incentives, including: policies inhibiting savings and productive investment; exploitative agricultural terms of trade; high food and energy subsidies; inefficient resource prices; a tax system and labor legislation discouraging employment generation; capital and exchange regulations; and an overvalued exchange rate
- high population growth rates
- inefficient, oversized and highly protected industries not providing an adequate employment base
- complex bureaucratic controls that frustrated private initiative and expanded the underground economy
- inefficient state monopolies in agriculture, food marketing, fishing, and several other sectors
- a large, unwieldy central government bureaucracy
- stagnant total agricultural production, and declining per capita agricultural production
- persistent high levels of inflation
- a legal regime hostile to foreign investment and technology transfer
- a high foreign debt service burden and significant budgetary deficits
- many large, but only partially completed development projects of questionable future productivity.

The current Belaunde administration was elected on a campaign slogan of "Trabajar y Dejar Trabajar" (Work and Let Others Work), which signalled a development strategy and socioeconomic policy framework of dismantling the pervasive controls that stifled private entrepreneurship and distorted economic incentives. Belaunde's election was an expression as much of Peru's disenchantment with the military's directed economy as it was of the hope that democracy

would lead to better resolution of the country's social and economic problems.

Politically, the Belaunde administration has championed the institutionalization of Peruvian democracy. His administration supports and nourishes the constitutional framework. It has fully supported a free press, returning nationalized newspapers and other media to their previous owners. It re-established the civilian judiciary system and civil rights such as habeas corpus and promoted the free interplay of democratic politics. There are now over a dozen political parties across the ideological spectrum vying for the attention and support of the electorate. There is a large leftist movement that won sweeping victories in the November 1983 municipal elections in which Lima elected its first Marxist mayor. And the Belaunde government has generally respected human rights in its attempts to deal with a domestic terrorist group (Sendero Luminoso).

Economically, the Belaunde administration was determined to make the private sector the major actor in economic growth and to use market forces and price signals to substitute for the elaborate and stifling system of administrative controls built up under the military. Within its first six months, the government eliminated most price controls, substantially increased prices of products of state enterprises, particularly for petroleum products and electricity, and reduced the monopoly position of state enterprises dealing with agriculture. It also lifted some restrictions on new foreign investment.

The GOP's intention was to use import competition to increase the efficiency of domestic production and to force the domestic economy to concentrate its efforts on areas in which Peru had a comparative advantage. To this end, the government reduced tariffs substantially and eliminated major export taxes and essentially all controls on foreign exchange transactions. The GOP wiped out virtually all direct controls on imports which during the 1970s produced extremely high effective protection and attendant structural distortions (Of the 1026 items subject to quantitative restriction at the end of 1979, only 118 remained restricted at the end of 1980.). The dispersion of tariffs has been substantially reduced, and the highest tariff rate was reduced

from 155% to 60%. Despite the introduction of a tariff surcharge in 1982 as a revenue measure, the distortion of production incentives as a result of taxes and administrative restrictions on trade has been greatly reduced.

GOP strategy also aimed to achieve greater efficiency of resource use and increase domestic resource mobilization by using interest rates that gave the right incentives. The GOP sought to increase competition in capital and product markets. In addition to sharply curtailing its own subsidized discount lines, the Central Reserve Bank reduced required commercial bank reserves and increased interest rates both on deposits and loans. The net effect was to leave bank profitability intact, but increase the level of private savings mobilization. Nominal deposit and lending rates were increased in January 1981 by about 20 percentage points. This made effective rates about 70%, roughly equal to inflation at that time. Several increases since then have narrowed the gap between interest rates and inflation as inflation accelerated. Whereas price controls permeated the Peruvian economy under the military government, the present Government has eliminated controls on all but a few agricultural items and a few products produced and marketed by public agencies. The GOP has, for the most part, kept price increases for those publicly produced items in line with inflation.

The Government passed new policy measures aimed at increasing foreign and domestic private investment in agriculture, petroleum and mining. For example, the Agricultural Promotion Law approved in November, 1980 provided special tax incentives to agriculture and agroindustries; allowed commercial banks once again to extend credit to agriculture; opened the door to a greater private sector role in agricultural promotion and marketing; and permitted voluntary breakup of land reform cooperatives. (As a practical matter, legal sale of such land rarely occurs.) The Belaunde administration has also attempted to reverse the previous regime's hostility to foreign direct investment. It strongly encouraged foreign participation in petroleum exploration and mining, liberalized the restrictions on profit remittances embodied in the Andean Pact's Decision

24 and resolved several related questions in a way that gave fair treatment to foreign investors.

These steps put in place a considerable number of valuable policies. Together they constitute a workable framework for improved effectiveness of development investments. Rarely has AID had the opportunity to work with a group of decision makers who so fully shared our own concepts of what is needed for broadly-based growth and development with equity.

D. The Problem of Incomplete Reform

Even under today's extremely difficult political and economic environment, progress continues to be made. The GOP is striving to improve its fiscal management. Despite enormous pressures from left and right, it is maintaining its liberal, market-oriented economic policy framework. However, major new policy reforms during 1984-85 will be difficult. In some areas, it would be unrealistic to expect further changes. Indeed, maintaining the current policy framework would be a significant achievement.

The government faces constant pressure to curtail or reverse many elements of its program. Yet, it has made only partial inroads on dealing with longer-term development constraints. Resource mobilization is one of the most significant areas where further progress is clearly needed. Despite the government's repeated promises to reduce its deficit to about 4% of GDP, reductions below the 8% level have remained elusive. The deficit-reduction effort was undermined early on by an ambitious public investment program and the lack of revenue measures to offset the repeal of important taxes that had serious disincentive effects. Current expenditure reductions were not significant. Even as real wages decreased, public employment increased. High levels of military spending and operating losses of state enterprises also compromised budgetary reductions. The tax structure is still riddled with special exemptions and regressive as a whole. The tax base is unnecessarily small. The resulting deficits have required that Peru expand its external debt, increasing its debt servicing burden. The deficits have also sharply curtailed internal savings available for private investment and continue to pre-empt private sector uses of international credits. Despite good intentions, the GOP has allowed interest rates

to lag behind the rate of inflation. In addition, the sol remains overvalued (but less than two years ago).

In agriculture, initiatives to implement the Agricultural Promotion Law have been slow. While the removal of most price controls and the reduction of state controls over marketing have benefited agriculture, the problems of providing coherent management to land reform coops and the sale of land remain unsolved. Efforts to encourage greater private investment in the sector have had little effect. Schemes to increase private sector participation have been cumbersome, overly bureaucratic and slow to get off the ground. A new and dynamic Minister of Agriculture is strongly committed to carrying forward private sector oriented agricultural reforms in 1984-85, but the unraveling political consensus may prevent implementation of all of them.

The government has not been able to carry through on other needed reforms. The sale of numerous public sector enterprises, for example, has been constrained by incomplete political consensus on the desired role of the state in the economy and a general fear that affected workers would not find ready employment elsewhere. Government officials interested in reprivatizing state-owned firms are hampered by a lack of knowledge regarding the true value of enterprises and how to package sales to make them attractive to potential buyers. The Labor Stability Law, which provides a strong disincentive to using labor-intensive technologies, is still in effect. Despite the reduction of direct food subsidies over the past three years, they still account for over one percent of GDP. And continued housing subsidies have impeded the GOP's ability to achieve the objective of delivering shelter solutions to even larger numbers of low income families.

E. Factors Hampering Further Reforms

There is today a growing public perception that the Government's market-oriented approach is simply not working. This was manifested in recent municipal elections which saw some important leftist victories (including Lima) and a large decrease in the government party's share of mayors.

To what extent has the Government been responsible for poor economic performance and a lack of follow-through on intended reforms? In retrospect, a number of special circumstances limited the Belaunde government's program options and hampered its ability to complete its policy reform program. These circumstances will continue to be important over the near-term future.

1. The World Recession and Natural Disasters. The Belaunde Administration hoped that world prices for minerals and other commodities would remain high until their reforms took hold, and that credits would be available at reasonable interest rates. This would have provided the resources to ease the painful transitions that inevitably accompany basic policy changes. In fact, export prices fell sharply due to the world recession, and credit became expensive and difficult to obtain in the aftermath of the debt crises of several large countries. By mid-1982, GOP decision-makers were consequently beset by a growing set of economic management problems, exacerbated in 1983 by the natural disasters. The result was a crisis management mode of decision-making, with long-term objectives taking second place to more immediate economic problems. Economic difficulties narrowed the political room for rapid policy reforms and, at the same time, reduced Peru's ability to withstand the recession's financial and economic impacts.

In 1973, the Morales Bermudez government, faced with many of the same constraints encountered by the Belaunde administration, including a critical balance of payments situation and recession, began a stabilization program and a series of financial measures which were painful for many Peruvians. However, its stabilization/recovery program was accompanied by a robust world economy and very favorable prices for primary exports. The success of orthodox economic policies in the last two years of the military period encouraged the Belaunde Administration to continue and expand them, but the strength of the world economy that gave the military government the means to cushion the domestic impact of its policies in 1978 and 1979 was denied to the new democratic government.

2. The Continuing Influence of the Military Experiment. Perhaps more significant than the sheer magnitude of legislation and general dirigiste orientation of the economy under the

military is the fact that 12 years of statist policy have created interest groups among bureaucrats, politicians and business leaders for state intervention in many areas of the economy, despite a top leadership which finally believes in promoting market forces and private initiative.

3. Weak Public Decision Making and Administration. The new administration inherited the complex administrative procedures used by the military government, but lacked its strong line authorities. Government decision making and operations have been slowed down by a need to achieve political consensus on difficult decisions. It also has had to contend with onerous administrative procedures, lack of financial resources, inadequate institutional structures, and extremely weak mid-level management and technical staffs.

4. Poor Resource Management. During the last three years, GOP resource management has been characterized by unclear priorities. Thus, allowing the sol to become overvalued in 1981 subsidized imports, prejudiced exports and made later adjustments more difficult. Likewise, financing huge public enterprise deficits in 1982 with short-term foreign credits exacerbated debt servicing problems in 1983. Moreover, several attempts to reduce the deficit by cutting expenditures left current expenditures virtually untouched; capital expenditure cuts were made proportionally rather than on the basis of judgments as to the economic value of alternative investments. Complementary tax payment compliance efforts were not undertaken until recently.

F. The Present Crises

Peru today is in the midst of the most serious economic crisis in its modern history. Over the past year, a catastrophic combination of stagflation, natural disasters, and terrorist turmoil has buffeted this already poor country and intensified poverty. Unprecedented floods and drought caused over \$1.0 billion in losses and a growing terrorist movement continues to disrupt large areas of Peru, reduce tourism revenues and increase social and political tensions. Foreign exchange and budgetary shortages dictate stern austerity measures while severely limiting the GOP's ability to carry out development programs, finance reconstruction and deal with the

underlying conditions that spawn terrorism.

These events have produced a setback for an economy only beginning to show signs of recovery from years of economic mismanagement and only beginning to respond to the market-oriented measures promulgated by the Belaunde administration. The present crisis has made it increasingly difficult for the government to continue its market-oriented policies. It faces opposition from political parties who blame Peru's woes on these policies. It also faces opposition from entrenched interests across the political spectrum whose customary positions were eroded first by the economic reforms and second by the combined effects of economic recession and natural disasters.

G. Conclusions

A number of general conclusions may be derived from the above. First, many factors have had an impact on economic performance and on the pace of reforms, but the most important over the last three years are the domestic impact of the world recession and the further deterioration of the economy caused by the natural disasters which afflicted Peru in 1983.

A second conclusion, given the impact of the recession, the disasters and the weight of Peru's recent dirigiste past on present day Peru, is that the transition to a free market economy has been—and will be—a more difficult task and require more time than anticipated.

A third conclusion is that the current economic crisis and austerity program will severely limit the government's ability to carry forward ongoing development programs and deal with the underlying poverty and unemployment conditions that are spawning a growing terrorist movement.

Fourth, it is clear that surviving the current economic crisis is the first critical step before Peru can effectively pursue longer-term goals. How well Peru's economy and society survive will determine how fast it can direct its energies and resources to the structural transformation it needs. The major danger of economic policy debate now is that political pressures for retrenchment from many of the sound policy measures implemented during the last

three years may be uncontainable.

The immediate challenge for the U.S. Government is to help Peru maintain the positive policy reforms and private sector directions initiated by the Belaunde government while strengthening those democratic forces that will ensure that these reforms are continued and deepened in the second half of the 1980s.

II. DEVELOPMENT PROSPECTS

Peru is now at a crucial juncture in its evolution as a nation. Having tried and discarded an authoritarian form of government and directed economic management, it has now turned towards market-oriented economic policies in a framework of democratic pluralism and private initiative. Whether or not it continues with those policies will depend on how well they seem to be solving the economic challenges facing the country.

Basically, Peru has to transform its productive structure to make better use of its resource endowments and lay the groundwork for solid self-sustaining growth with equity. This structural transformation will require a basic shift from the import-substitution policies that have characterized the last two decades of development strategy in Peru, towards an export-driven development model that (a) recognizes the importance of agriculture and places renewed emphasis on agricultural development and (b) incorporates higher labor value added into domestic production. In effect, Peru must make overall production, especially exports, more labor intensive.

The current challenges to economic policy revolve around two short-term conditions: (a) a sharply deteriorated economic situation, including weak economic performance, falling standards of living, and a serious liquidity crisis manifested in international and domestic credit shortages; and (b) the natural disasters, which have enormously complicated the process of establishing the financial base needed for the structural transformation of the economy.

Beyond these economic challenges, there exists a third challenge that is of over-riding importance. There are growing pressures on Peru's fragile democratic system stemming in part from the above economic factors but also from a persistent terrorist movement that has diverted human and financial resources from other pressing problems. How well these challenges are resolved is of central importance to the course of Peruvian history and to U.S. interests in Peru.

A. Economic Overview

In 1950, agriculture accounted for almost a quarter of domestic production, followed by manufacturing (including artisan industries) at about 18%. By 1960, agriculture and manufacturing

had traded places in the structure of production. The period since 1960 has seen a continued relative decline in agriculture production—it now accounts for 12% of GDP—but also no significant change in the relative importance of manufacturing. Nevertheless, manufacturing value added has quintupled since 1950, whereas agricultural value added has only doubled. Increased value added in mining, construction, and services (such as transport, finance and commerce) offset the declining importance of agriculture.

The opening of the economy to international trade by the present government in 1980 had its most adverse effects on the manufacturing sector, which previously was highly protected and which is sensitive to both upward and downward swings in the business cycle. The incentives in the 1982 Industry Law may have some beneficial impact in the long run on existing capacity, installed largely under a regime of substantial tariff and non-tariff protection, but not appropriate to the pattern of costs and prices now prevailing in the Peruvian market. There are indications that the economy has the basic resiliency to recover. Despite deteriorating conditions, total fixed investment declined only slightly from 20.7% of GDP in 1981 to 19.2% in 1982, of which roughly a half was private sector investment. In addition, agriculture grew by 13% in 1981 and almost 4% in 1982 in response to favorable weather and more adequate sector policies. The buoyancy of investment and agricultural production are positive signs for renewed growth in the medium term.

B. Short-term Problems

1. Current Economic Performance. In the short term, however, Peru's economic performance has been devastated by the worst recession in modern times. Economic policy-makers are currently facing overwhelming problems: an estimated 11% decrease in GDP for 1983; inflation of 125% for the year; decreasing foreign reserves and increasing foreign indebtedness; a public sector deficit of over 10% of GDP; increased social and political tensions; natural disasters which ravaged agriculture and infrastructure; and a terrorist movement that has placed increased

pressure on limited budget resources and caused an estimated \$300 million in damages. The recession has slowed down the GOP's most important new development initiatives, and has led to a large number of plant closings, low demand and extremely low rates of capacity utilization in manufacturing, a large number of bankruptcies and two bank failures. There are high and growing rates of unemployment and underemployment in virtually all sectors of the economy. The negative effects of the recession extend throughout the country.

In the past three years, the country has suffered a severe decline in its balance of payments as commodity prices have fallen. Peru is heavily dependent on the export of a few primary commodities (mainly minerals) whose prices are highly variable and tend to rise and fall together. The prices received for major commodity exports fell sharply during the course of 1981 and have remained severely depressed since then. Between 1980 and 1983, export values have declined 24%. At the same time, the cost of imports has climbed. In overall terms, Peru's terms of trade have declined at least 30% in the last three years.

The government's initial reaction to the domestic economic crisis and the world recession was to attempt to ride them out by maintaining a moderately expansionary stance, paying out reserves to do so. The GOP was relatively fortunate in that the banking system began the period with net reserves of \$1.3 billion. However, these reserves were not sufficient to sustain the country through three years of depressed export prices. By the end of April 1983, net reserves had fallen to \$523 million and the GOP had begun to take strong corrective fiscal and monetary measures. The Central Reserve Bank accelerated the rate of depreciation of the sol. However, given the relatively low levels of price elasticity of both export supply and import demand, the GOP has had to rely heavily on aggregate demand management to deal with the problem. GOP attempts to reduce the public sector deficit have been unsuccessful. A severe decline in public sector revenues, resulting in part from the natural disasters, aggravated the deficit problem in 1983. Current revenues of the central government are expected to decline in 1983 from approximately 18% of GDP to 14%. Thus, the burden of adjustment has had to fall heavily on

monetary policy. One result has been a credit crunch affecting both the public and private sectors.*

One of the measures which the government has taken to address the economic crisis was to seek additional international financing from private, bilateral, and multilateral sources. In mid 1983, Peru negotiated the refinancing of over \$2 billion in public and private sector short-term debt owed to commercial sources, rescheduled \$1.4 billion of public sector debt from bilateral sources and obtained new commitments of \$830 million from commercial banks. The net effect of the operation is to save \$1.65 billion in 1983-85 from interest and amortization otherwise due during the period. This rescheduling—on the heels of serious debt crises in other Latin American countries—will greatly limit future borrowings from private and public sources. Nonetheless, the GOP will have to renegotiate its foreign debt again in 1984. In addition, a three-year \$850 million Extended Fund Facility agreement with the IMF signed in June last year imposed strict limitations on the GOP budget. Unable to comply with the terms of the agreement in 1983, the GOP is negotiating a new agreement with the IMF. Until it is negotiated, major new World Bank assistance and \$200 million of U.S. commercial bank credits, due to be disbursed in September and December of 1983, will not go forward. The 1984 debt rescheduling and refinancing are also dependent on a new IMF agreement.

As a result of the economic crisis, the GOP has had to take drastic adjustment measures, including reducing credit to both public and private sectors. Peru's problem is how to use available resources to generate maximum growth recovery. Increased protection for domestic industry is a siren song attracting growing political support, despite its long-run inefficiency.

2. The Natural Disasters. As the full effects of the world recession began being felt in Peru, nature visited an extremely harsh combination of disasters on the country. While their effects unfolded slowly, they eventually affected over 1.3 million Peruvians in a direct and serious fashion. Heavy flooding in the north, mudslides and landslides in the central part, and

* See the disaster-related program assistance PAAD for further discussion of the effects of the liquidity crisis on the private sector.

serious drought in the south combined to cause major infrastructure damage, agricultural production and livestock losses and a major drop in foreign exchange. In the flood zones, infrastructure destruction—especially to roads, irrigation systems, housing, and oil production facilities—came to an estimated \$400 million. Agricultural crops worth an estimated \$150 million were lost, including 31% of the national cotton crop, 20% of the rice crop, and 17% of the corn crop. Some \$400 million of industrial production, mainly petroleum and fishmeal, were also lost. In the drought areas, agricultural crop losses exceed \$120 million, including 27% of national potato production, 26% of barley and up to 70% of assorted other crops. In addition, the loss of livestock meat, milk and fiber production of around 25% of national totals and valued at over \$30 million was an especially rough blow to the poorest sectors of this poor zone. In addition to impacting on employment and inflation, these losses also affected the balance of payments, causing \$650 million in increased imports and decreased exports.

The human tragedy behind these figures can never be adequately expressed. As food availability decreased, malnutrition jumped; morbidity and mortality figures tripled in some areas—especially among infants, children and the aged. Income from wages and agricultural production went into a nosedive. Of course, the poorest segments of society were the most severely affected.

In order to start relief and reconstruction programs, the GOP obligated wage earners to buy reconstruction bonds equal to 10% of their gross wages. The GOP reprogrammed existing foreign credits and entered into new debt to supplement international relief efforts. The need to reconstruct increased pressure on the budget in 1983 and will continue to do so in 1984 and beyond as the GOP believes that reconstruction must proceed with all deliberate speed.

The recovery of agricultural production and rural incomes depends not only on the rehabilitation or reconstruction of production and transportation infrastructure but also on a return to normal weather patterns. Recent reports indicate that irregular weather conditions are continuing in the south sierra in 1984. This year's crop will not exceed 50% of normal, and it

may be much less. If so, it would be catastrophic to the poor farmers of the southern highlands. Their food reserves and much of their savings have been used up just to survive this long.

C. Development Implications of Macroeconomic Conditions

The present and likely future state of the Peruvian economy has a number of implications for development prospects. First, investment resources, both public and private, are going to be extremely short. The struggle to reduce the public sector deficit is likely to last for several years, certainly as long as export prices remain depressed. During this period, requests for significantly increased public sector investment or additions to recurrent costs, no matter how worthy in principle, cannot be met. The private sector will continue to be hard pressed to maintain employment and will not be able to provide expanded employment opportunities until domestic or export demand picks up sharply. There will be continued pressure to provide "temporary" protection from imports. Except for agriculture, protectionist measures would represent a step backwards in Peru's efforts to improve resource utilization.

The size of the existing external debt—\$12.7 billion—implies that the supply of savings for new investment will be limited essentially to domestic savings for the foreseeable future. Thus, it is essential to increase the level of domestic savings and to increase the efficiency with which these resources are utilized. The continuing degree of price distortions in the economy implies that there is considerable scope for increasing output and income by improving the efficiency of resource use.

The need for efficient use of extremely scarce investment resources also means that the GOP must persevere in its present attempt to rationalize industrial, agricultural, and food pricing policies. It is important that it not succumb to the temptation to resolve the short-term problems of some members of the society (typically the better off) at the cost of lower incomes for the rest of society. Industrial protectionism is perhaps the greatest temptation at present.

Finally, the poor prospects for most of Peru's traditional export products implies that

considerable effort must be devoted to the development and expansion of other sources of export earnings if the external sector is not to be a serious obstacle to renewed growth and increased income opportunities for the poor.

D. Longer-term Development Problems

In order to restore longer-term dynamism to its economy, and in addition to dealing with the short-term crises, Peru must come to grips with a number of critical problems, as follows:

1. Inadequate Resource Mobilization and Utilization. Serious constraints to more productive use of resources exist at the macro and sectoral levels. (a) Insufficient resource mobilization. Total savings in Peru decreased from 22% of GDP in 1960-2 to 8% in 1975-76 and currently stand at 4% of GDP. Private savings declined sharply as a result of the ineffectual redistributive policies of the military government. Total business savings were reduced substantially by the impact of inadequate operating performance and financial policies of the state enterprises, particularly those implementing government subsidy policies. Government savings fell over a long period due to poor tax policies and administration, becoming highly negative in the 1970s and again in 1983 as a result of major public current and capital account spending programs that did not have an adequate revenue base. Without adequate savings levels, capitalization cannot take place and public or private investment expenditures must be financed through deficit financing—essentially Peru's formula for the past 15 years. Experience has clearly demonstrated that Peru must change that formula. Likewise, inflationary finance is of questionable value when all of its short-term and long-term effects are taken into account. Inflation distorts investment decisions and generally gives disincentives to financial savings, thus weakening the capital markets through which savings can be mobilized efficiently. Wage earners, particularly the urban poor, are often least able to protect themselves against its effects. (b) Inefficient resource use. While the allocation of public investment has improved relative to that of the military regimes, wide differences remain in the rates of return on different government investments. The State is still using public resources in areas where

private capital could be mobilized. GOP subsidies have not been effective or efficient redistribution mechanisms at the same time as they generated enormous costs and distortions affecting large sectors of the economy. Many scarce resources such as agricultural land and water for irrigation are treated virtually as free goods, resulting in inefficient use. Resource use—specifically the targeting of resources—is particularly poor in social service delivery.

2. Low Incomes and Employment. Providing a sustainable employment base for Peru's rapidly growing population is one of the most urgent priorities facing Peru now and in the future. Figures for 1983 indicate that over 60% of the population is unemployed or underemployed, especially women who are a significant (but often unpaid) part of the labor force. The recession and disasters have cost Peru many of the jobs created since 1980. More than half of the labor force now earns less than the minimum wage. Social problems and severely limited demand in the domestic market are the result.

According to IBRD and USAID studies, keeping up with the projected increase in the labor force—without reducing present unemployment and underemployment rates—will require the creation of approximately 195,000 jobs per year. Large cities and market towns are expected to generate the large majority of this increase, most likely in agribusiness, small-scale manufacturing and related service industries. At prevailing capital-labor ratios, an annual investment of \$5.5 billion (in 1980 prices) would be necessary to absorb new urban job seekers in the modern industrial sector—clearly beyond Peru's resource abilities. Therefore, cheaper, more labor-absorptive means of production will be a necessity in Peru's future growth strategy. Agriculture, agribusiness and small urban enterprises hold out some promise in this regard. Employment in agricultural production activities would cost about one-fourth as much as in the modern industrial sector. Rationalization of the productive structure is needed, and policies and legislation which now discriminate against labor-intensive economic activities or against employment (by subsidizing capital or by giving disincentives to expanding employment) have to be

reformed.

3. Faltering Food Production and Agricultural Productivity. Except for brief interludes, per capita agricultural production has declined steadily for nearly two decades and is now 15% below the levels of 1970. Less land is in production now than in 1965, and yield and productivity increases have lagged behind population growth. This has led to rising food imports (approximately \$400 million in 1983) and to reduced per capita food intake (now less than 90% of average daily requirements). Indeed, one survey found that the calorie deficit increased over the last ten years from 14 to 26% for the middle class and from 22 to 40% for low income groups. This trend was confirmed in the recent USAID Nutrition Assessment.

Numerous adverse factors affect agricultural production, including cycles of negative climatic conditions and a limited land base. Mismanagement and decapitalization of both financial and human resources characterized the sector for over a decade. Yet, as noted by the Presidential Agricultural Mission which visited Peru in 1982, Peru could have a productive, efficient agricultural sector—but interrelated and overlapping constraints inhibit growth and expansion of the production/marketing system. These include: (a) policy and regulatory disincentives to private investment in agricultural marketing and production; (b) inadequate distribution, use and management of water; (c) limited development of input and product markets; (d) limited capability in technology development, adaptation and transfer; and (e) shortage of a qualified human capital base to manage both public and private sector activities. The exodus of private financial, technical, managerial and entrepreneurial resources from agriculture has left an unresponsive and deteriorating production/marketing system that relies heavily on still-weak public sector services and that lacks the skills and incentives required for growth. Symptomatic of the sector's problems is that whereas agriculture received 15% of banking system loans in 1957-58, the percentage dropped to 2.4% in 1977-78.

4. Limited Social Service Coverage. Over the long-run, Peru must improve the coverage of social services of particular importance to the poor: health/family planning, education, and

shelter and urban services. Despite the increase in resources allocated to these areas by the current government, there are major gaps in overall coverage, largely as a result of how resources are targeted and how services are financed. Both inhibit services from reaching the greatest possible number of poor.

Health: Ministry of Health (MOH) services reach only approximately 42% of the Peruvian population, and per capita costs (\$25 in 1981) are high for the limited coverage provided. Although access to and utilization of government-provided health services must be considered inadequate, the costs of expanding effective coverage within this system are formidable. The recurrent cost requirements of the present MOH infrastructure already exceed available finances; there are chronic shortages of funds and drugs, as well as chronic management and administrative problems. Furthermore, the pressure to deliver primarily urban-based curative services and provide all services free makes it very difficult for the system to deliver high quality, basic curative and preventive services to a greater number of people.

Education: Basic primary schooling is available to about three-fourths of the population—relatively good coverage—but learning is limited by a lack of qualified teachers and classroom materials. Drop-out rates are high, especially in the first three grades. Community contributions to classroom construction have extended physical infrastructure somewhat, but mushrooming poor urban areas need more facilities and the rural system is even worse. Ministry of Education budgets are inadequate to the job of expanding, maintaining and equipping facilities. Vocational and skills training programs need to be increased to prepare people, especially the poor and women, for productive employment.

Shelter and Basic Urban Services: Unlike other social services, the GOP is dedicating considerable resources to urban services. However, despite some recent improvements, a high proportion of this funding has been allocated to relatively costly dwellings that require large subsidies to make them affordable to lower and middle income families. The explicit and implicit

subsidies are beyond the capacity of Peru's current economic performance and the GOP budget to sustain. Further, housing sector resources are almost completely unprotected against inflation and rapidly lose their real value as a pool of longer-term resources for the sector. Women who are heads of households have little access to public housing programs, and the poor in general cannot afford even the subsidized prices.

5. Rapid Population Growth. Peru's rapid population growth is a serious impediment to development. The current population growth rate is 2.6%, while the total fertility rate is high—5.2 live births per woman. At current fertility rates, Peru's population of 18.7 million would reach 69 million by the year 2025. Recent projections, which are based on significantly reduced fertility rates, indicate that the present population is more likely to grow to 28 million in the year 2000 and to 41 million by 2025. Major reductions in fertility are not likely to be achieved without a large expansion of contraceptive use (only 41% of women living in conjugal union now practice family planning). Even if fertility rates fall, continued population growth will exacerbate existing serious shortages of basic goods and services such as education, health services, jobs and food. The need to expand family planning services rapidly is great.

Peru was one of the first countries in Latin America to establish a national population policy and a national population council to carry it out. However, implementation has not been accorded a high priority in the government's programs. Efforts to improve and expand service delivery are hampered by the lack of integration of different service delivery efforts and, despite considerable progress, continued implementation weaknesses.

6. Urbanization and Centralization. Peru's urban population (by census definition) has grown from 40% in 1960 to 65% in 1981 and is expected to reach 80% by the year 2000. While the census definition overstates the population with access to even minimal urban services and amenities, half the population is in towns and cities of 5,000 people or more. From one third to one half of the urban population lives in shanty towns (pueblos juvenes). Despite rapid absolute growth, Lima and other cities are growing at significantly lower rates than in the past.

Medium-sized secondary cities and market towns are absorbing an increasing percentage of migrants.

Significant investments in urban infrastructure will thus be required. Over the next decade, approximately 700,000 new urban families will be seeking housing solutions. Providing for replacement of deteriorated housing and some reduction in overcrowding would increase the total need to 860,000 urban units over this period. Additionally, over two million urban housing units suffer from major deficiencies in essential public utilities. Close to 900,000 homes are not served by pipe water, 1.05 million units lack sewerage connections, and close to 700,000 do not have electricity. By any definition, there is a serious housing shortage in Peru.

Migration flows are a response to investment patterns, even if past investment may not have reflected resource productivity potential. However, migration from rural to urban areas, or from sierra to coastal areas, can have some positive aspects, since the concentration of people can make investment efficiencies possible, allowing greater long-run productivity of investments in human capital and in production-oriented physical infrastructure. The USAID's recent urban sector study concluded that, in this sense, Peru's population is not necessarily "overconcentrated" in Lima. Nevertheless, migration is a short term problem, as migrants face tremendous problems in finding jobs and getting basic social services. In addition, there are many socioeconomic inefficiencies that often accompany large population concentrations, such as pollution, extensive personal travel time, and impersonal social relations.

A more balanced regional investment program could create geographically more balanced economic opportunities. The idea of decentralizing administrative and decision-making functions from Lima and the central government to outlying regional areas and local governments has been much discussed throughout Peruvian history. The Belaunde administration entered office strongly committed to the Constitutional mandate of developing decentralized governmental units at the municipal, departmental and regional levels and decentralizing Lima-based ministries and autonomous agencies. The municipalities were given greater local autonomy in 1980 through the

election of their own mayors. In 1981, Departmental Development Corporations (CORDEs) were established, with a broader mandate than the organizations that preceded them, to carry out local interest public works and other locally-planned development projects.

However, the GOP has not been able to provide the necessary technical and financial resources to develop the CORDEs and the municipalities. Greater local autonomy and revenues are needed to promote more effective decentralization even within the Peruvian concept of a unitary state. In addition, greater efforts are needed to rationalize and coordinate the various GOP decentralization mechanisms (the CORDEs, municipalities and the regional offices of central government agencies). In this way, Peru would be able to take better advantage of the dispersion in the spatial distribution of settlements and productive activities to pursue a development investment policy based on economic efficiency and regional comparative advantages.

7. Other Development Problems. In addition to the above long-term development constraints, many other factors impose conditions on the efficiency of development investments in Peru and the country's ability to progress. Fragmented social structures—different languages, customs and mores—make national integration difficult. In addition, numerous attitudinal and administrative barriers discriminate against women and the poor as economic actors.

The geography is extremely rugged. It hampers the easy flow of people, goods and information and makes infrastructure and service programs costly. The arable land base is small—3% is suitable for crops—and not well matched with water resources, requiring costly irrigation investments. Unless petroleum exploration is increased and results in significant new reserves, Peru will be a net importer of petroleum well before the end of this decade. Alternative energy resources are limited and expensive to develop. Thus, energy is clearly a medium-term problem of great significance. Mineral resources, while abundant, face declining, volatile markets and require heavy capital investments at a very high cost per job created. Natural resources, including fisheries, forests and soils, continue to be used unwisely, causing growing environmental damage and early depletion.

In addition, Peru is prone to natural disasters. The droughts and floods which affected Peru in 1983 are part of a recurrent historical pattern that includes earthquakes, extensive landslides, shifts in water temperatures that reduce fishing resources, and erratic changes in weather patterns causing periodic droughts in the south sierra and floods along the coast. In the past 35 years, Peru has been hit by three major earthquakes, three major droughts, extensive floods along the coast, periodic landslides, strange shifts in ocean currents that disrupt fishing resources and weather patterns, and earthquake predictions that have frightened off tourists. These natural disasters have cost the country billions of dollars in lost production, exports and reconstruction costs and seriously set back the overall development of Peru.

III. USAID/PERU STRATEGY: FY 84-90

A. Strategy Framework

The principal objectives of the USAID/Peru program are to: (1) demonstrate USG support for Peruvian democratic processes and for other USG foreign policy objectives; (2) strengthen and expand private sector institutions and development approaches; and (3) improve the lives of low income families and help Peru achieve the longer-term structural transformation of its economy that is necessary to do this. Central to the structural transformation process is greater emphasis on agriculture and exports so as to make better use of available resources, especially the labor of low income rural and urban families. Greater emphasis must also be placed on increasing agricultural production, generating more productive employment, and expanding the coverage of programs directed to low income families that provide health and family planning services, potable water, better nutrition, skills training and housing and urban services. To facilitate this structural transformation, sound policies, stronger institutions, more appropriate technologies and a dynamic private sector will be required.

Peru's current crises are of such dimensions that they threaten to undo the significant progress that has been made over the last three years in establishing a workable framework for long-term development. They may pull Peru back into the orbit of statist economic control which it rejected only recently. USAID program strategy must address Peru's present critical situation. We therefore propose to focus the FY 84-85 program on Peru's most immediate needs.

During this period we will place primary emphasis on implementing our ongoing development and reconstruction programs, on providing a Disaster Program Loan in early FY 1984 and an ESF-funded Program Loan in early 1985, and on continuing our PL-480 Title I and II assistance. At the same time, we will advance our policy dialogues with the GOP and other groups and continue our efforts at building a sounder analytical and institutional base for further development policy discussions and program formulation. Finally, we will start a small number of new initiatives which will emphasize the use of private sector institutions to deliver program resources.

It should be clear that conceptually we are proposing one overall strategy that has two time phases, with some elements directed to short-term problems, and other elements directed to long-term problems, but many having applicability to both. In the short term, we intend to complete implementation of most of our ongoing development projects and provide fast-disbursing balance of payments and budget support that can cushion the shocks caused by unprecedented natural disasters, economic recession and the transition to a new internationally competitive productive structure. These efforts will also support a more orderly transition to a new democratically elected administration in mid-1985, help strengthen private sector policies and facilitate more rapid implementation of ongoing development programs that have been stopped or significantly slowed down by the lack of GOP budgetary resources. At the same time, we will continue to pursue longer-term development objectives through our ongoing program and selected small initiatives. However, except for fast-disbursing program-type loans and a possible HG, large new AID development projects will not be initiated until FY 86 and beyond.

The views and programs of a new Peruvian administration will be shaped by its perceptions of the successes and failures of the incumbent government. For example, it is unlikely that a private sector-oriented strategy discredited by unprecedented economic recession and massive unemployment and underemployment can serve as a model for the next government. Yet, despite the uncertainties that surround the next several years, there are numerous development problems that, given Peru's long-term development constraints, will likely be the focus of USAID strategy regardless of the specific directions of a new government. These are outlined below as part of the Mission's longer-term development strategy. However, while our basic objectives will not change, the opportunities available to the Mission surely will, depending on the development philosophy of the new administration. Events in the next eighteen months may cause an evolution of the present government's policies. On the other hand, the 1985 presidential elections may well be a watershed for Peruvian development and AID strategy if the overall policy framework is

significantly changed. Hence, the Mission will present a new CDSS in January, 1986 to allow AID to review its longer-term development opportunities and strategy at that time.

B. U.S. Response to the Present Crises

For development as well as foreign policy reasons, it is imperative that the USG provide immediate and quick-disbursing assistance to help alleviate pressures on Peruvian democracy and on the market-oriented economic program. Politically, the U.S. has a stake in the success of Peruvian democracy, a stake that depends to an important degree on how well the present GOP can respond to serious economic internal-external imbalances. The failure of the Peru model, economically or politically, would be a setback for both US foreign policy and development objectives. From a development point of view, our assistance is needed to support the positive, market-oriented policy gains made during the last three years. Supporting these policy gains and encouraging others is of paramount importance—in the short run, because those policies are the point of departure for any new government and, in the long run, because any real progress in ameliorating Peru's basic development problems is ultimately linked to them. We have a known government with which to work, and it has established favorable policies that merit special support. We should likewise encourage the new administration to continue these policies. Whatever government assumes office in 1985, it is clear that a floundering economy, a discredited private sector and an inadequate response to natural disasters can only increase pressures for radical policy changes.

C. Strategy in the Short Term (FY 84-86)

Four factors have played an important role in the design of the Mission's short-term strategy: (1) the deteriorated economic situation, including the GOP's critical financial problems and the serious liquidity crisis affecting the private sector; (2) the impact of the natural disasters; (3) growing pressures on a fragile democratic system coming from the above factors, a persistent terrorist movement, and upcoming elections; and (4) the level of resources available in the present USAID program.

These factors have led the Mission to conclude that the principal objectives of the USAID strategy during FY 84-85 and into FY 86 should be to: quickly and effectively carry out the disaster relief and reconstruction program; assist GOP economic recovery efforts and expand support for private sector development; and successfully implement and substantially complete the ongoing portfolio. In addition, the Mission will further expand the analytical and institutional bases for carrying out policy discussions and developing project initiatives so that a major new USAID development program can begin early in FY 86 when a new government assumes office in Peru.

1. Providing Effective Disaster Relief, Rehabilitation, and Reconstruction. Disaster recovery has been and will be a major activity in the Mission's FY 83 and FY 84 programs. A.I.D. has provided over \$105 million to: reopen key access roads; distribute urgently needed relief supplies, medicines, vaccines and medical equipment in flooded areas in the north; distribute 14,000 MT of emergency Title II commodities to 550,000 disaster victims in both the northern and southern disaster zones; reconstruct homes, businesses and enterprises affected by the disasters; renew agricultural input and product marketing and production infrastructure; and carry out a wide range of other activities to expedite relief, rehabilitation and reconstruction efforts. We have requested additional Title II emergency foods for the southern drought zone and a disaster-related program assistance loan.

To implement the relief effort, USAID has provided technical assistance and expertise to the GOP to prioritize and effectively plan disaster rehabilitation and reconstruction efforts and has worked closely with Peruvian and U.S. PVOs who have considerable outreach capacities in the disaster areas. A.I.D. is also providing assistance to expand PVO management and outreach capacities. The provision of quickly-disbursable assistance has been a major USAID contribution; equally important is the focus of strengthening Peru's institutional capacity to manage its recovery efforts.

One objective of our strategy is to maximize the longer-term impact of disaster

recovery efforts. To this end, USAID assistance is strengthening the Departmental Development Corporations of Piura, Puno and other affected departments. Together with other Mission activities, this will contribute to carrying out Peru's decentralization objectives. In the shelter sector, the Mission's \$12.5 million disaster HG will help concentrate GOP efforts by providing only basic solutions affordable by the poor. These features reflect our conviction that even short-term assistance should be fashioned in such a way as to reinforce AID's areas of priority concern.

2. Stimulating Economic Recovery and Private Sector Growth. Peru's weak financial position limits the GOP's ability to cushion the domestic economy from the full effects of the world recession and the natural disasters. In 1981 and 1982, it was able to maintain a mildly expansionary fiscal policy even though that implied losing foreign exchange reserves. In 1983, Peru could not afford to lose more reserves and thus the GOP had to allow the economy to deflate, at the cost of reduced economic activity and employment. For 1984, Peru cannot expect much recovery based on an improved world economy. It must find resources to stimulate production and employment and improve the effectiveness of resource use.

Access to significant foreign credit will thus be of critical importance in meeting Peru's short-term financing needs and in strengthening international lender confidence in Peru. A new IMF agreement is the key to a workable stabilization program in the short term, as are new commercial bank credits and a rescheduling of most debt maturing in 1984. However, more resources will be necessary in order to prevent draconian measures needed to protect the balance of payments and in order to alleviate the worst effects of continued recession.

Beyond the need for foreign exchange, there is also a critical gap in GOP budgetary resources and in local currency credit for the Peruvian private sector. Approximately half of the loss in GDP in 1983 is directly attributable to the natural disasters. Combined with the effects of weak external markets, the disasters have caused significant drops in incomes and employment. Potentially viable firms in industry, commerce and agriculture are being squeezed by declining

real credit availabilities and worsening cash flows. They need credit to survive this period of depressed internal and external demand for their goods and services. Internationally competitive firms are needed to lead economic recovery and increase incomes and employment. Additional special steps are needed to spur employment, especially in the disaster areas, as budgetary shortfalls continue to restrict the ability of the GOP to expand income and employment opportunities in the short run.

The Mission has presented a disaster program loan request directed to assisting Peru alleviate the macroeconomic consequences of the disasters. The loan will quickly bolster the balance of payments through dollar disbursements and, with the local currencies generated thereby, stimulate productive employment in disaster areas and help meet the liquidity needs of selected private sector firms. Dollar disbursements will encourage GOP compliance with critical targets for macroeconomic management.

The economy should improve somewhat in 1985, with a rebuilding of some bases for long-term growth. Peru's ability to take advantage of better external demand will be conditioned by two factors: (a) how well it uses its limited resources; and (b) how quickly it can progress towards transforming Peru's productive structure. The economic policies in place over the next several years will thus be of special importance to long-term growth. However, the GOP's fiscal position will continue to be weak, despite the important revenue enhancement and budget austerity measures adopted to date. This will limit public sector investments, and especially Peru's ability to move forward with development programs.

We therefore propose an ESF-funded program of two loans in FY 85 and FY 86 that would (a) provide support for high-priority development investments, including budget support for key GOP ministries and agencies; (b) expand credit to sectoral programs such as agriculture and industry; and (c) provide counterpart for IDB, World Bank and other donor activities. The dollar resources would support improved performance on key cross-sectoral development policies and

macroeconomic management targets, while the availability of sectoral resources would be conditioned on the maintenance of selected policies important to that sector.

The development and political stakes are such that we must provide balance of payments and budget support to cushion economic and political disruptions and tensions prior to the elections. Otherwise, the private sector, market-oriented model may be held in the minds of a growing number of people as the cause of Peru's economic woes rather than part of the solution. The availability of these program loan funds in FY 84 and early FY 85 would be a significant incentive to maintaining good economic development policies during the crucial pre-election period and show our support for democracy and the private sector, market-oriented model of development. Program loan funds in FY 86 would be made available to support that model.

3. Accelerating Program Implementation. During the last six years, a sizeable and important AID program was built in Peru that was unexpectedly increased in 1983 by disaster assistance. A large pipeline developed in the 1979-82 period because a number of development projects encountered serious implementation delays. These problems occurred because of the complex design of some projects, weak implementing institutions, delays in contracting technical and managerial assistance, inadequate Mission staffing, and lack of GOP counterpart resources. While many of these implementation problems are being overcome—and implementation is improving—in 1983-85 the continued shortness of GOP counterpart resources and IMF limitations threaten to slow down the implementation of our development projects. Other donor programs are encountering similar problems and even more significant implementation delays.

As a result, helping the GOP accelerate program implementation will be a major across-the-board USAID priority during 1984-85. By the end of FY 85 the Mission expects to have fully implemented a major portion of ongoing projects, including those currently encountering implementation problems. All have definite long-term development importance. However, they are also important in the short run. Quick disbursement of the portfolio will provide benefits at the macro level through the availability of foreign exchange and at the sectoral levels by providing

local currency to cash-short sectors and programs. Many ongoing activities—such as the Title II program and the Urban Enterprises and high jungle area development projects—are creating employment in our target groups and thereby counter widespread unemployment and underemployment to some degree. And some key program components, such as the development and dissemination of high yield rice varieties in the high jungle, could have significant pay offs during the FY 84-85 period.

The Mission will make no major new starts with the GOP during FY 84-85 other than the program loans which will address balance of payments, budget, employment and private sector liquidity problems. This is due to implementation requirements and USAID management considerations, the GOP fiscal position, and the impact of the elections on development programming. Given GOP fiscal austerity measures, counterpart funds to support recurrent costs will be extremely limited, even with PL-480 Title I assistance. Moreover, the electoral process will undoubtedly slow down GOP decision-making prior to and even after the elections. USAID projects during this time will not significantly enlarge the call on counterpart resources (human and financial), but rather are designed to take into account normal implementation bottlenecks and further bottlenecks arising from the election process. New program lending will also help the GOP speed up implementation of AID and other donor projects by providing urgently needed counterpart funds.

4. Expanding Policy Dialogues. The FY 84-85 period will be critical in shaping future Peruvian development policies. We will use this period to extend the analytical base for sectoral policy discussions, for which several special studies, project and program evaluations, and project redesigns have been completed or are already underway. We will also be engaged in discussions with the government, other donors, and local groups regarding needed policies and development approaches. Our policy dialogue agenda at the macroeconomic and sectoral levels, which is largely a product of our current program, is described in detail in parts D.3. and F.1.

of this Section and in Section IV.

The new administration taking office at the end of FY 85 will prepare an election platform as part of its campaign and specific action plans and strategies after the elections. Thus, in addition to our own analytical work, we will have discussions with various groups to increase the breadth and sophistication of their knowledge of topics in economics and development which we believe are important to Peru at this stage in its development. The Mission will also support Peruvian academics and other intellectual leaders to publicize development alternatives (such as the work on the informal sector being carried out by the Instituto Libertad y Democracia with AID assistance). We hope that this process will shape the winner's specific action plans so that we have a base of shared viewpoints broad enough to start a new program early in FY 86. More generally, we also hope that this process will help Peru rebuild a national consensus on its long-range development objectives.

5. Alternative Short-term Strategies. The Mission considered three major alternatives to respond to Peru's current development prospects and the present economic crisis:

a. A shift to short term program assistance exclusively, including deobligation of a major part of the current Development Assistance portfolio. This could augment other requested program assistance resources through the Agency's de-ob/re-ob authority;

b. Continuation of a substantial program of new Development Assistance project starts to complement our program assistance requests. This would increase the visibility of U.S. foreign policy support for the GOP even though rapid implementation would not be assured; and

c. Severely limiting new Development Assistance activities to concentrate on support for policy dialogue while implementing ongoing pipeline projects and providing essential program assistance.

We have chosen, and this CDSS justifies, option C as the most feasible and appropriate to supporting overall U.S. interests and Peruvian development needs.

Option (a) fails because it sacrifices long term development objectives to short term

macroeconomic and disaster pressures. The benefits of the current portfolio, which is gaining disbursement momentum, in support of key Peruvian development institutions would be attenuated. Additionally, the portfolio of projects which USAID finances demonstrates the effects of important alternatives for rational resource utilization to the GOP. The urban small enterprises, private sector agricultural credit, mini-hydro generation, Integrated Regional Development, Water and Land Use in the Sierra, Agricultural Research, Extension and Education, and Agricultural Planning and other Mission projects all focus GOP attention on high-priority development investments that should be continued. As the Government is forced to choose among its investment priorities, results from our projects convey important examples for GOP decisions. Furthermore, our review of the administrative costs of portfolio deobligations and the fact that it would be difficult to use deobligated Development Assistance funds from a variety of functional accounts for program assistance raised substantial questions about the feasibility of option (a).

Option (b), while superficially attractive from a U.S. foreign policy perspective, is not feasible given current USAID and GOP absorptive capacity. The Peruvian government is expected to propose to the IMF a rapid reduction of the fiscal deficit in 1984/1985. The already constrained central government budget will be cut and cut again. Public sector employment is frozen. It is highly unlikely that the GOP could meet minimum legal counterpart requirements for new Development Assistance starts. Given USAID staffing constraints, it would be extremely difficult to develop and implement large new DA projects without additional project managers. For these reasons, this option, was also discarded.

D. Longer-term Strategy (FY 84-90)

The Mission's review of Peru's longer-term constraints pointed to a wide array of problems that inhibit Peruvian development—from physical factors such as rugged terrain and limited resources, to low agricultural productivity, an inadequate employment base for the urban and rural poor, and a limited response to the demands of urbanization.

In designing an AID strategy to meet these constraints, an important reference point is the contribution of other international and bilateral donors. This contribution has been significant since 1980 and donor plans call for continued support during the next few years (approximately \$800 to \$900 million in new obligations per year), the bulk of which will come from multilateral development banks (MDBs)—the IBRD and the IDB. Other bilateral donors (Germany, Japan, Holland, Switzerland and Canada are the major ones) provide about \$100 million in official development assistance per year as a group.

By concentrating to a large extent on major infrastructure works and sectors such as mining and energy that are important to Peru's growth, MDB programs permit AID to concentrate in areas in line with our strategy, comparative advantages and resources. MDB programs also have important policy dialogue implications for USAID. Most of the bilateral programs and the smaller multilateral agency efforts are "targets of opportunity" programs, often concentrated in a few sectoral or geographic areas. Many of these programs are clearly linked to promoting exports from donor countries to Peru. Some programs—such as the West German health activities—are in sectors where the Mission is working and where consultation and cooperation is and will continue to be important. Rarely do other bilateral donors operating in Peru have multi-year strategies or attempt to address strategic and policy issues.

As highlighted in the discussion of our short-term strategy, the Mission is working with the GOP and the private sector to overcome long-term constraints, such as improving agricultural productivity, expanding population programs, and assisting the GOP to meet the needs of growing urban populations. For the foreseeable future, the Mission expects to continue its efforts in most of these areas. The constraints identified are so central to Peru's development prospects that any new government will have to address them. The government assuming office in 1985 will face the same objective conditions and share some aspirations for Peru that transcend social class and political affiliation, such as decentralization, recognition of the importance of natural resource development, and the desire to improve the standards of living of the bottom two-thirds

of the population. In working on solving long-term constraints, AID program activities will be structured to yield results in relatively short time frames. In general, we would look for fewer but simpler projects with the GOP and a greater number of projects with the private sector.

Three inter-related themes conceptualize the Mission's longer-term program and strategy: (1) supporting policies that promote, and programs that embody, rational resource use; (2) increasing incomes and employment of rural and urban low income families; and (3) expanding the efficiency and coverage of social service delivery.

1. Supporting Policies That Promote Rational Resource Use. The ineffective use of Peru's scarce physical and financial resources has been an endemic development problem. Rational resource allocation is a cross-sectoral USAID objective emphasizing policy dialogue to (a) ensure sound GOP investment selections based on solid analytical criteria; and (b) promote market-led solutions to economic growth and development. This is obviously a broad agenda including areas ranging from foreign exchange and trade liberalization policy to agricultural price policy and food subsidies. USAID's role will be to concentrate on a number of selected policy areas where A.I.D. has a comparative advantage for assisting the GOP, based on USAID's prior experience and resources. Specific topics are outlined below in the description of our areas of program concentration. Generally, over the longer term the Mission will encourage and assist the GOP to: (a) develop policies and mechanisms which strengthen rural and urban financial markets and which encourage savings and the maintenance of value of financial resources; (b) increase the use of market signals to allocate resources, particularly in agriculture; (c) undertake investments in productive and social areas which impact on the greatest number of poor, given financial constraints; (d) make more productive use of scarce natural resources; and (e) encourage privatization of development decision-making and decentralization to regional areas.

To promote rational resource utilization, the Mission will also work closely with other donors and development agencies—~~notably~~ IDB and IRRD—so as to ensure common donor positions in these and other areas that enhance the overall impact of development assistance. In

particular, the Mission will closely coordinate with the IBRD and IMF on macroeconomic issues in negotiating program loans and pursuing our sectoral policy dialogues.

2. Increasing Incomes and Employment of Rural and Urban Low Income Families: Creating a productive and self-sustaining employment base to reduce present under-employment and unemployment levels, while also absorbing a growing work force, is the most important development challenge facing the country. Poverty in Peru, including low nutrition and health levels, is to a large extent the result of inadequate productive employment. Thus, generating employment and increased incomes will be a principal USAID objective. The private sector must play a leading role in its achievement.

The Mission will address key policy constraints to expanding employment. The program will emphasize increasing employment and incomes through: (1) programs to improve productivity in agricultural production and marketing, increase food production (which also benefits the urban poor) and expand agro-industrial exports; (2) the promotion of small and medium scale businesses in the formal and informal manufacturing, artisan and service sectors; (3) programs to enhance rural/urban integration, such as market-town development, and provide forward and backward linkages (value added), such as agribusiness and non-traditional exports; and (4) expanded vocational education and management training programs. Each project will be designed to ensure that men and women have equal access to full participation.

3. Expanding the Efficiency and Coverage of Social Service Delivery. Peru's present crisis has accentuated the need for economic growth-oriented investment. Nonetheless, increasing the outreach of social service delivery programs—particularly health and family planning—may be one of the most effective ways to increase the real incomes and living standards of the poor. Given current and foreseeable resource availability, however, rapid expansion of present programs is not feasible. USAID's strategy in this area, described in more detail in Section IV, will be to increase the efficiency (and hence coverage) of present public programs and to expand present

private sector (profit and non-profit) efforts in these areas, thereby drawing upon significant additional resources.

In expanding the efficiency of public sector efforts, particular emphasis will be given to institution-building and to policy dialogue and reform. In health, there is a critical need for improved resource management. The Mission is already working in this area through a number of projects, but a more concentrated effort in policy and management improvement will begin with a new project in FY 85. The Mission will also design activities in FY 84 and FY 85 to expand private sector participation in family planning and health (which includes nutrition and sanitation) and will continue to implement similar programs in adult vocational education.

USAID efforts will also be aimed at improving the use of resources in the shelter sector by encouraging policies that maintain the value of resources committed to the sector, and increasing the allocation of resources to the urban poor, especially women heads of households, including sites and services programs and self-help efforts such as the Materials Bank.

4. Alternative Longer-term Strategy Considerations. Beyond the short-term strategy alternatives outlined earlier, there are four alternatives that shape our consideration of longer-term strategy.

Project versus Program Assistance: Clearly Peru has reached a point where it can no longer absorb large amounts of new projectized development assistance, at least in 1984-85. While some small policy planning and institution-building projects are feasible (as are projects with the private sector), what Peru most needs in 1984-85 is fast-disbursing balance of payments and budget support. This type of program assistance is particularly vital if Peru is to utilize more rapidly the large amount of donor development assistance already in the pipeline.

However, there are major uncertainties about the most appropriate mix between program and project lending beyond FY 1986. The weight of repaying substantial foreign credits rescheduled in 1983-84 could severely squeeze Peru's balance of payments for several years after

FY 1986. For CDSS purposes we are assuming that the Peruvian and world economy will recover sufficiently by FY 1986 to permit both the orderly servicing of the country's heavy debt burden as well as the initiation of major new development programs. (We are also assuming that the new Peruvian government taking office in 1985 pursues policies that can be supported by the USG.) As a result, we expect that, having concentrated two years (1984-85) on accelerating implementation of ongoing projects (facilitated by program assistance in FY 84 85 and early FY 86), Peru will be ready to begin shifting back to large new development projects beginning in FY 86. These critical assumptions have to be further examined by the USG in late 1985 and early 1986 in preparing a new CDSS.

Sectoral and Geographic Concentration: Another strategy consideration involves the number of sectors proposed for AID involvement and whether greater sectoral or geographic concentration is justified. Three major DA-funded areas are being recommended: (1) agriculture and nutrition; (2) private sector; and (3) health and population. Our new initiatives in these areas will build upon, deepen and consolidate prior AID efforts. Given the country's serious problems in agriculture, health and population (and USAID's pioneering work in these areas), we believe it would be inappropriate to break off our involvement in these areas. Many of our private sector initiatives will be incorporated into other sector programs. Our involvement in areas such as urban development or food aid will largely be through specialized instruments such as HCs and PL-480 or will involve only small amounts of Mission and regional funding.

A related consideration is whether public sector education and energy should be added as other areas of AID concern. Energy shortages (particularly declining petroleum exports and the potential need to import) could prove to be one of Peru's most serious development problems in the 1980s. However, since other donors have large ongoing programs in these sectors—and are planning for major expansions—we expect that Peru can obtain needed funding from multilateral and other bilateral sources.

The issue of geographic concentration is dealt with below in Part E, which indicates

the Mission does not plan to have a geographically-focused program but rather will seek out those projects that address key problems and are efficient development investments.

Types of Projects: The Mission's current pipeline problem developed in part because some of our ongoing projects involve complex, multi-component designs. While such designs may have been justified given the problems being addressed, we will seek out simpler projects during the upcoming planning period. We will use AID's unique ability to begin small scale pilot activities quickly and thus lay a base for larger projects later.

Public versus Private Sector Projects: A final strategy consideration involves the most appropriate split between public and private sector activities. While both public and private sector projects are needed in Peru, several reasons lead us to seek out more private sector activities. First, Peru's serious debt burden and shortage of counterpart funds may seriously limit the number of new public sector development projects that can be undertaken even after 1985. Second, private sector institutions offer highly efficient ways of delivering AID development resources in key areas. And third, the Peruvian government assuming office in 1985 may be committed to some development policies that cannot be supported by AID (e.g., programs that involve large inefficient subsidy elements). One implication of such a private sector strategy is that a large portion of AID funds provided to Peru must be on a grant basis.

E. Strategy Implications

USAID/Peru is now operating under a CDSS designed in 1978 and updated three years ago. Much of the analysis presented there is still pertinent today, and many of the key elements of that strategy remain valid. However, subsequent analyses led the Mission to make three important changes in program approaches which the strategy presented herein incorporates: (1) a shift away from the prior geographical dimension of our strategy; (2) greater use of sector analytical techniques to sharpen the focus of policy dialogues and simultaneously identify the highest priority project interventions; and (3) a shift from largely project-oriented assistance to more

program assistance in FY 84-86.

The shift from the Mission's past geographical limitations (i.e, sierra and high jungle economic growth, sierra social service programs, and urban basic needs) is required to attend today's major development problems. Our programs in health and agriculture are essentially national in scope already. While the majority of the poorest low income families are still in the sierra, urban poverty is a serious and growing problem. The growth of Peru's urban poverty means that efforts to reduce it should be reflected in more than the Mission's social service programs. As indicated in the previous section, Peru's employment problem is a primary USAID concern and must be addressed in both rural and urban areas.

It is important to note that future projects will maintain the Mission's commitment to agriculture and rural development. Approximately one-half of the Peruvian labor force is directly or indirectly employed in agricultural production and marketing. The positive production response of the sector in 1981 and 1982 to favorable conditions, including better prices, demonstrated the sector's vitality despite the shocks of the last two decades. And, of course, rapid population growth and limited foreign exchange mean that greater domestic food production will be necessary to provide minimum diets. USAID opportunities to strengthen agriculture should not be limited by geographic constraints.

Peru's present economic situation and that foreseeable during the CDSS period require that investments be undertaken where they will be the most productive and efficient. This may require investments on the coast and in urban centers and market towns throughout the country. For example, small-scale coastal and sierra irrigation, expansion of the agricultural frontier in the high jungle and production technology changes in the sierra and high jungle are more efficient means of increasing output than expanding arable land through large-scale coastal irrigation projects. Moreover, while geographical balance will not be a Mission objective per se, it will be an important consideration when returns to alternative AID project investments appear equal. AID's emphasis on the four areas of concern—policy reform, private sector involvement,

institution building and technology transfer—and the Mission's priority of promoting rational resource utilization both require that investment flow to its best use.

Likewise, program assistance may be a more efficient means for AID to respond to Peru's short-term and longer-term development constraints than conventional project assistance. Indeed, without fast-disbursing program assistance in FY 84-86, Peru may not be able to utilize the large pipeline of development projects already approved by donor agencies. As outlined in the Administrator's Program Sector Assistance Guidance, this mechanism can serve as a useful policy dialogue tool and lead to a more integrated and comprehensive approach to a country's development needs. The FY 84 disaster program loan and FY 85-86 ESF program assistance are very important in this regard. To some degree, the disaster relief and reconstruction program moved the Mission in this direction already. Another program-sector possibility under consideration is providing recurrent cost assistance to GOP projects supported by other donors, especially the IBRD and IDB. This type of assistance would help alleviate the counterpart bottleneck expected to be significant over the next two to three years; it would be targeted to sectors and sub-sectors where AID resources can assist policy dialogues between the GOP and the donor community and to specific MDB projects of special interest to AID. It is also consistent with problems and recommendations identified in the Agency's "Recurrent Cost Problems in LDCs" policy paper. Other program-sector possibilities will be considered in AID's response to longer-term development constraints. Of course, the exceptional nature of program assistance will be fully taken into account, and any proposal along these lines will demonstrate that the proposal will lead to more effective achievement of the U.S. objectives in Peru. The program lending possibility is one way that USAID will help Peru increase the effectiveness of development assistance.

F. Relationship of Strategy to A.I.D. Policy

USAID/Peru's strategy is fully consistent with those priorities identified in the IAC Strategy paper and Management plan of supporting stabilization measures and macroeconomic

assistance; carrying out in-country dialogue with IFIs—particularly on macroeconomic questions; expanding employment and increasing incomes through structural reform; and increasing efforts to deal with urban and regional development issues. The strategy builds on the four areas of A.I.D. concern: policy reform, increased involvement of the private sector in development, institutional development, and the transfer of technology and know-how.

1. Policy Reform. Given the growing economic and political pressures facing the Belaunde administration, the Mission's immediate policy dialogue agenda is to encourage the GOP to retain the significant reforms that have been carried out over the last three years and move forward in a few selected areas. At the macro level, our program loan negotiations will support policy measures embodied in the IMF agreement now being negotiated, including: (1) a significant reduction in the public deficit through improved pricing and expenditure policies, increased fiscal revenue generation, and other resource mobilization initiatives; (2) avoidance of an overvalued exchange rate; and (3) a substantial further reduction of the level of subsidies. In general, we are seeking to support the application of sound development principles in scores of day-to-day GOP decisions.

Particular emphasis during FY 84 and FY 85 will be placed on improving resource utilization through the continued implementation of more rational agricultural input and output price policies; strengthening of rural and urban financial systems that encourage savings and better resource allocation; increasing rural and market town investments; expanding a strong family planning program; and encouraging emphasis on primary health care.

A crucial area for policy discussions with the GOP is coca eradication. The Mission will maintain close coordination with INM and contacts with the GOP through implementation of the Upper Huallaga Project. The detrimental effects on Peru of drug cultivation and traffic have been highlighted by recent events, making it an area where substantial policy and program progress could be made by INM with the support of our project and INM resources.

Policy development requires a good analytical base. As indicated above, an

important Mission objective during FY 84-85 will be to develop this base further. Ongoing projects (such as 527-0238 Agricultural Planning and Institutional Development and 527-0178 Integrated Regional Development), the FY 85 Health Policy Planning project and the population policy aspects of 527-0230 Integrated Health and Family Planning will be instrumental in assisting the Mission to expand policy dialogues in key areas with the present administration and with a new administration in 1985.

2. Institutional Development. The cornerstone of the USAID program is to strengthen private and public institutions that can carry on development efforts long after our project funds have been expended. The Mission's approach to institutional development is to address shortcomings in both the public and private sectors. In the priority areas of agriculture and health, ongoing projects are providing assistance geared to improving the institutional base of the public sector. Public sector health institutions require the policy, management and other institutional improvements to be addressed through FY 84 and FY 85 projects.

For the most part, however, new institution-building efforts during the planning period will emphasize the private sector. The Mission's objective of expanding private sector involvement in development areas will require additional institution-building efforts. PVOs and private agricultural producer organizations will be among the beneficiaries of this strategy. Of particular interest to the USAID are PVOs working in health, nutrition and family planning and those providing credit and technical assistance to small-scale entrepreneurs. Our HG program will continue to strengthen the private savings and loan system.

3. Transfer of Technology and Know-how. Technology transfer is a valued instrument in the USAID program, reflected in our agriculture, rural development and social sector portfolios, and is closely linked with the Mission's institution-building objectives. Reflecting Peru's priorities and A.I.D.'s comparative advantages, USAID has emphasized technology transfer efforts in many fields, but especially in agriculture. The priority research and technology transfer

concern has been to increase crop yields and reduce production costs through the application of improved technologies, particularly for selva rice, sierra potatoes, highland grains, high value export products and crop system technologies for tropical and sub-tropical lands. The Mission will continue to emphasize these areas through the Agricultural Research and Extension project, two high jungle development projects, and other ongoing activities, and through future efforts to involve the private sector in technology dissemination.

During the ODSS planning period, the Mission expects to institutionalize technologies under other ongoing programs, such as economic analysis methodology for small hydroelectric projects in 527-0226 Small Hydro Development, those introduced under 527-0202 OERN-Land Use and Environmental Planning, the tropical soils and livestock CRSPs, and other projects. In addition, the Mission will support research in other areas of concern, such as research on the value of women's work in the economy and biomedical research (malaria control, diarrheal vaccines, and oral rehydration). Mission private sector efforts will also be geared to promoting technology transfer between U.S. and Peruvian business, especially in agro-industry. We will continue to support AID/SCI basic development research in Peru to the extent we have the required management capacity, including disaster prevention technologies.

4. Private Sector Involvement in Development. Increased collaboration with the private sector in achieving development objectives is central to our strategy. USAID's objective in encouraging greater private sector involvement in development is to increase productive employment and incomes and increase the human and financial resources available to development activities. As described in Section IV, we will maximize private sector delivery of the content of all Mission programs, including export promotion, small and medium scale enterprise promotion, health and family planning delivery, and agricultural production and marketing development. Our support will include work on policy reform and institutional improvements in key private sector groups. With PRE support, USAID will also assist the GOP in its efforts to reprivatize state-owned enterprises and follow up on other initiatives identified by the PRE reconnaissance mission. As articulated

in the short-term strategy discussion, the Mission's most immediate private sector priority will be to provide emergency support to selected formal private enterprises to ride out the country's worst economic crisis in recent history. A key Mission objective will be to strengthen the private sector so as to permit it to lead economic recovery, expand employment and incomes and play a more dynamic leadership role in Peruvian society in the 1980s.

Beyond specific sectoral programs being considered—which are discussed in detail below and closely related to short-term efforts—the Mission will work with the GOP and private sector groups to improve the policy and regulatory climate necessary for market-oriented growth and efficient social service delivery.

During the GDSS period, the Mission will continue supporting the simplification of government procedures, regulations, and practices which inhibit investment and efficient operation of private sector institutions. This objective will be followed through sectoral programs and cross-sectoral efforts, particularly the strengthening of financial markets across all sectors and through macro-programs and policy dialogue. USAID recently assisted the GOP in establishing a Council of Economic Advisors within the Ministry of Economy and Finance and an Agricultural Policy and Analysis Group within the Ministry of Agriculture to analyze market-related issues at the macro and sectoral levels. The Mission will continue supporting these efforts to increase Peru's technical and analytical base for market-oriented policies that increase competition and resource productivity.

The Mission will continue to provide assistance to increase information gathering and distribution on private sector development opportunities, such as the recent publication of a study on non-traditional exports for the Peruvian exporters association and a study prepared by the Ministry of Labor which analyzed the labor stability law and related constraints to employment in Peru. The Agricultural Planning and Institutional Development Project is fomenting active private sector participation in the Agricultural Policy and Analysis Group and is

establishing a continuous system of production and marketing information necessary for making investment in the sector more profitable and efficient.

In addition to assisting the for-profit private sector, the Mission will support non-profit private groups (such as PVOs and cooperatives) to pursue sectoral objectives. USAID's cooperative assessment in particular emphasized the importance of credit unions and agricultural coops. Credit unions are a significant financial force at the level of popular savings and credit and serve a broad public not easily reached by other financial institutions. Agricultural service cooperatives can play a more important role in Peruvian agriculture. The Mission is analyzing the feasibility of FY 84 assistance in these areas through OPGs, including technical assistance. The Mission's cooperative sector strategy will need to be closely analyzed in the 1986 CDSS since it could well be a priority area of concern for a new government. Activities being considered for FY 84-85 could provide a basis for policy dialogue in this area and for evaluating Mission options.

PVOs will continue to play an important role in the Mission's private sector efforts in health and family planning at present as well as future efforts in shelter and small-scale enterprise development and other potential areas identified in the Mission's PVO assessments. Mission emphasis will be on strengthening the capacity of local PVOs in these and other areas of program concentration.

IV. AREAS OF PROGRAM CONCENTRATION

This section describes the implications of our strategy on program areas and outlines how we plan to pursue our objectives over the CDSS planning period. It represents our best judgment of technical priorities in responding to Peru's problems and development constraints and assumes general GOP policy continuity—an assumption that will be tested in the 1985 Peruvian congressional and presidential elections. We have analyzed many possible responses to Peru's development problems and constraints. This CDSS builds upon over 20 preparatory studies, including sectoral reviews, project and program evaluations, and assessments of GOP policies and programs (see list). These efforts enrolled the most knowledgeable talent available to us from USG agencies and from U.S. and local consulting firms, universities and PVOs.

A. Program Assistance

Goal: To support broadly-based growth with equity within a democratic context by (a) alleviating temporary balance of payments and financial constraints to increasing income and productive employment opportunities caused by the disaster and the effects of international recession and (b) supporting the maintenance and expansion of a workable framework of economic policies.

Strategy: To provide quick-disbursing foreign exchange resources through agreements that (a) encourage rational resource use (in particular, the size of the public sector deficit, the maintenance of an essentially free foreign exchange regime and an open foreign trade regime) and (b) program the local currency equivalent in high priority development investments. In the short-term, USAID program assistance will have three elements: (1) the FY 84 disaster program loan; (2) an ESF-funded program of balance of payments and budget support in FY 85 and 86; and (3) the ongoing PL-480, Title I program.

The FY 84 disaster loan, a complement to the physical reconstruction program being financed in part by AID, would provide balance of payments support to Peru while programming the local currency equivalent to fund productive employment stimulation and other counterpart uses and

SPECIAL ODSS STUDIES AND EVALUATIONS*

A. STUDIES

1. Presidential Agricultural Mission Report
(Clayton Yeutter, et al.)
2. Private Sector Assessment (Coopers & Lybrand)
3. Urban Development Background Paper (Van Huyck-PADCO)
4. Urban-Rural Linkage Study (PADCO; Mann, et al.)
5. Cooperative Status Assessment and Development Strategy for Peru
(Cooperative Resources Committee)
6. Nutrition Status Assessment (Sigma One Corp.)
7. Peruvian PVO Community Study (Planning Assistance Inc.)
8. Private Sector Family Planning Assessment (Marnane and Torres)
9. Assessment of Agricultural Constraints and Proposed USAID Strategy
(A. Brown; USAID)
10. Women in Development Study: Strategic Balance (INANDEP)
11. Vocational Training Inventory (Ministry of Education)
12. Private Sector Health Financing (MSH)
13. Inventory of Health PVOs (MSH)
14. Inventory of Environment-related PVOs (RARE Inc./IIED)
15. Irrigation Sector Assessment (Utah State; AID/W) (draft)
16. Shelter (HG) Assessment (RHUDO/LAC)
17. Informal Sector Assessment (Instituto Libertad y Democracia)
(in process)
18. Employment and Incomes in Peru (A. Toledo et al.)
19. Low Income Women in Peru: Issues and Options for USAID/Lima
(C. MacKean et al.)

B. EVALUATIONS

<u>Project No.</u>	<u>Project Title</u>
1. 527-0178	Integrated Regional Development
2. 527-0159	Agribusiness Rediscount Fund
3. 527-0163	Development of Sub-Tropical Lands
4. 527-0156	Water and Land Use in the Sierra (Impact Evaluation)
5. 527-0202	Soil Conservation
6. N/A	PL-480 Title I Program (Impact Evaluation)
7. N/A	PL-480 Title II Program (draft)

* Also consulted were prior AID/W and USAID documents; USAID project-generated reports; IBRD and IDB country studies, project appraisals, and policy papers; IMF macroeconomic reports; other donor documents; GOP planning documents and studies; etc.

to help meet the liquidity needs of selected private sector firms in surviving the current period of depressed demand and credit shortages. This disaster loan will support IMF stabilization goals.

The FY 85-86 ESF-funded program will provide continued foreign exchange support. Equally importantly, the local currency budget resources it would generate would be used to increase financing for high-priority development investments, including those of key ministries and agencies; sectoral credit programs such as for private sector agricultural and industrial production; and increase counterpart financing for IDB, World Bank and other donor projects.

In the short-term, the ongoing PL-480, Title I program would continue to be used to provide balance of payments assistance and counterpart resources for AID projects. In the long term, we will work for a multi-year arrangement to provide support for important agriculture sector policy reforms. This is further described in part F of this chapter.

B. Agriculture

Goal: (1) To increase the incomes of rural families and improve the distribution of income in Peru by upgrading agricultural productivity and expanding employment opportunities; (2) increase food production, agricultural exports and import substitutes; and (3) improve the nutritional status of rural and urban populations.

Strategy: To stimulate recapitalization of the sector, entrepreneurship, and improvements in management and technology dissemination throughout the agricultural production/marketing system. The rationale of the strategy is that, as agricultural production and profitability increase, improved incomes will go (a) to increased capitalization of the rural sector to generate self-sustaining growth, and (b) to increased consumption, by producer families and farm laborers, of agricultural as well as of non-agricultural products. As the economic multiplier effects link into market towns and larger urban centers, non-farm employment and small service business opportunities will increase. Together, these will constitute a major part of our efforts to assist the structural transformation of the economy.

The USAID program is based on the continued implementation of the recommendations of the Presidential Agricultural Mission and will focus on the following actions:

(1) Carry out policy dialogues and provide assistance to policy analyses and reformulation. The objectives are to encourage further reduction of production disincentives, private sector entry into factor and product markets within a competitive market climate, and other policy reforms. Of particular importance are activities designed to: (a) privatize resource management--including reform of regulations which inhibit doing business in Peru; (b) treat land and water as economic factors of production with a market value that provides incentives to increasing their productivity and makes them worth protecting environmentally to maximize their long-term productivity; (c) decentralize planning and programming to foster links between agricultural production areas and key market centers; (d) improve the structure and management of production and service coops; and (e) increase the nutritional impact of agricultural policy, marketing and research.

(2) Increase the efficiency of irrigation water use through improved on-farm water management and strengthened user organizations. More land will be brought under irrigation through more productive use of available water in existing systems, through rehabilitation of deteriorated systems on previously irrigated land, and through the construction of low-cost small and medium irrigation works. User-provided maintenance and improved cost recovery will be central features of our irrigation activities.

(3) Stimulate private sector factor and product market development. Strengthening the role of the private sector is central to the USAID strategy, especially in developing agricultural factor and product markets. During the CDSS period, we will promote the expansion of private sector participation in input market development (for seeds, fertilizer, farm machinery, supply and custom services, and breeding livestock production) and integrate these with other services such as credit and technology transfer. Product market development will be encouraged in food processing and other agribusinesses, especially diversified export opportunities. Finally, the

Mission will assist Peruvian efforts to promote investment in the sector, through support to publicizing information on investment opportunities and market conditions, and through export trade promotion (including international joint ventures and other linkages to markets, management skills and technology).

(4) Improve agricultural technology development, adaptation and transfer. While efforts to date have emphasized the public sector, the Mission will also stimulate private sector involvement in this area through producer associations, private firms and agribusinesses, especially for diversified crops. The Mission will examine activities in sierra livestock development, with a pasture and range management focus. In addition, farm production management and financial management capabilities will be emphasized.

(5) Expand professional manpower development efforts, both in terms of quality and quantity. Emphasis will be on managerial and technical training in research, natural resources and business management, and in strengthening the capacity of local institutions, especially universities, to undertake these efforts. Part of this objective will be achieved through increased M.S. and Ph.D. training programs in U.S. universities.

(6) Promote natural resource conservation. USAID efforts will concentrate on ongoing soil conservation, high jungle natural forest management activities, Title II supported reforestation programs and natural resource and environmental assessments. In addition, the Mission will support policies and mechanisms that contribute to the rational long-term use of other natural resources, specifically soils and water.

The combination of the above actions will result in improved incomes for market-oriented producers. The target group for improved productivity consists of commercial and potentially commercial individual small and medium farmers (283,000 families) and agrarian reform enterprises (206,000 families). As agricultural production activities become more profitable, demand for additional labor will increase. This is especially true of many export-oriented, diversified

production alternatives, such as fruits, vegetables, tubers and several edible oils. The target group for employment generation is the subsistence producers and farm laborers (547,000 families) that depend primarily on casual agricultural labor to increase their cash incomes, as well as significant numbers of the 353,000 campesino community families who depend on subsistence farming for their food and casual labor opportunities for cash incomes. Focus on these target groups is not regionally exclusive. The increasing role of women in agricultural production and rural marketing will be recognized in program design.

The Mission's ongoing portfolio supports and provides a solid framework for the strategy outlined above in key areas (e.g. policy dialogue and analysis, natural resource conservation and technology transfer). The Agricultural Policy Analysis and Management Project, for example, will significantly expand training efforts and improve the analytical base for present and future policy decisions. Despite a slow start, the Agricultural Research, Extension and Education Project is back on track and will contribute to technology generation and transfer and public institution-building objectives which complement our emphasis on the private sector. Considerable progress on dissemination of technology to the high jungle and other areas already is being made under this project.

The Mission's priority in FY 84-85 will be on implementing ongoing projects—and on commencing pilot efforts to increase the participation of the private sector (including cooperatives) in product and factor markets in FY 86 and beyond. One possibility under consideration is assisting the provision of private sector technical assistance to land reform cooperatives—a sector in which the present environment is not conducive to AID capital assistance efforts. Larger private sector initiatives designed to complement the ongoing program will begin after FY 85. Many of these initiatives may be appropriate for Title XII involvement, especially longer-term efforts.

C. Private Enterprise

Goal: To increase the incomes of urban and rural poor and their employment

opportunities; support improved resource productivity; and encourage the transition towards a freer market economy that emphasizes exports.

Strategy: To promote policy reforms in areas affecting the private sector; support small and medium-scale agriculture, agro-industry, manufacturing and service industries where the potential for increasing employment and incomes is promising; promote non-traditional exports; and enhance the contribution of the large informal sector to meeting Peru's development objectives. This strategy is based on our recent private sector assessment carried out by Coopers & Lybrand which provided a comprehensive analysis of private sector problems in Peru and proposed short and longer-range strategies for addressing these problems. In the short-run, Coopers & Lybrand (plus other consultants) identified the critical private sector liquidity crisis as the single most important measure requiring immediate USAID assistance. This requirement will be addressed by the program assistance described above in Part A.

To implement the longer-term strategy, USAID and PRE sponsored a reconnaissance mission to further evaluate other programs, such as export promotion/trading companies, investment promotion and management training. Agribusiness development was evaluated in a separate study carried out by DAI. Since Peru is an AID private sector target country, we expect to utilize both Mission and PRE funding to carry out the longer-term strategy described below.

1. Small and Medium-scale Enterprises. Recent Mission evaluations have indicated that support for medium- and small-scale enterprises and those in related service industries is a cost effective mechanism to expand employment opportunities and achieve growth and equity objectives. Emphasis will be on supporting smaller businesses through credit, technical assistance and training programs such as those assisted under our rural and urban enterprise projects, with special efforts to include low income women as beneficiaries. Cooperatives are part of our target group. We will support the development of credit unions, savings and loan institutions and similar organizations which can mobilize untapped resources and channel them to local borrowers

such as small businesses and farmers. The recent Coop Sector Assessment and follow-on studies will provide useful guidance in program and project design. However, we will not preclude support for activities involving selected larger enterprises when our target groups are the ultimate beneficiaries. Larger enterprises often have strong linkages to smaller businesses and the informal sector and are important to AID for this reason. In addition, they are likely to have the managerial talent and capital needed to undertake investments required to develop sophisticated technology transfer, in joint ventures with foreign partners. Moreover, owners of these enterprises are frequently in a position to influence policy to bring about appropriate incentives for business investment. At any rate, major technical and policy considerations in developing new projects in this area will be (a) their economic rates of return, (b) their expected impacts on direct or indirect employment expansion and increasing incomes and domestic value added, and (c) their relationship to the spatial distribution of economic activity.

2. Export Promotion. The GOP is currently in the midst of the difficult process of moving away from the previous import-substitution strategy and towards an open economy emphasizing exports. USAID has identified opportunities to support this shift and the Mission strategy includes development of projects for the provision of export financing, technical assistance in export promotion, and marketing, and investment finance for export industries. Support to the establishment of trading companies is contemplated. Further, the Mission will pursue the establishment of a management training program as well as skills training programs in the principal business schools and management training institutes, with a special emphasis on export-oriented industries. The Mission is also considering developing a free trade zone project to test and evaluate a model in which many of the legislative and operational constraints currently existing in Peru would be removed. The export promotion strategy will be implemented through formal private sector institutions such as banks, manufacturers, processors, exporters, cooperatives, and agribusinesses, as well as key public sector institutions which affect export financing and policies.

3. Informal Sector. Supporting informal sector enterprises will be an integral part of the Mission's private sector strategy during the planning period. A USAID-assisted study of the informal sector currently being prepared by a Peruvian PVO will serve as an analytical base for an expanded Mission program in this area, particularly in regards to policy needs. A preliminary recommendation of the study is to encourage the legalization of informal sector enterprises so that they have greater access to credit and other development resources. The Mission will also begin a credit and technical assistance program with one or two Peruvian PVOs during FY 84 and expand projects in this area in FY 85 and beyond. The Mission's objective will be to assist in the establishment of self-sustaining private sector mechanisms to channel assistance to informal sector enterprises, particularly those in light industry and services. One mechanism which will be explored is support to for-profit financial institutions catering to the needs of small-scale entrepreneurs. Though specific policy measures are not identified at this time, evidence so far indicates that policy reform will be an important component of this strategy--especially the reduction of legal and administrative regulations which give informal enterprises incentives to remain informal.

D. Development of Human Capital

Goal: To improve Peru's human capital base and reduce population growth so as to enhance the quality of life of the Peruvian population and increase labor productivity.

Strategy: To undertake development investments and encourage policy reforms which will improve the coverage and efficiency of health and family planning service delivery programs, improve nutrition status, and expand adult vocational, management and technical skills programs. In addition to implementing the ongoing portfolio, emphasis during the planning period will be on expanding private sector involvement in these areas.

1. Health and Population. The Mission's principal objectives will be to improve the efficiency and financial base of health and family planning delivery systems in the public and

private sectors and to expand alternative delivery systems. This will involve: (1) continued strengthening of public sector delivery programs through present Mission projects. In addition to initiating management improvements and logistical and administrative reforms, the Mission will engage in a policy dialogue to encourage better resource allocation and greater emphasis on Primary Health Care (PHC) and population programs; (2) the mobilization of resources from the non-profit and for-profit private sector, and the design and implementation of cost recovery mechanisms (e.g., user fees). The Mission's objective in both the public and private sectors is to design and implement appropriate alternative service and financing mechanism within the framework of a systems approach to health and family planning services. Especially important in this regard is the initiation in FY 84 of a contraceptive retail sales program.

Over the short-run, it is particularly important to build the analytical, institutional and political base necessary to have population issues considered favorably in the electoral campaign and in the development plans of the next Peruvian administration. The Mission will also intensify institution-building efforts with private sector groups interested in population.

In FY 85, the Health Policy, Planning and Human Resources Development project will address resource use in the sector and will continue public sector management improvement begun under existing health projects. It will also provide a forum in the coming years for the discussion of policy reform initiatives with the GOP. In addition, USAID will support efforts to expand the provision of primary health services by designing and testing appropriate alternative financing and delivery mechanisms for the public and private sectors. Thus, under the FY 85 Private Sector Health Initiatives project, the Mission will support the establishment of one or two alternative health delivery systems by providing technical assistance and credit to local groups PVOs and private physicians. The Mission will consider continuing support for primary health care through follow-on projects in primary health care services and potable water and sanitation for its longer term strategy (the LAC Strategy Plan recognizes that Peru is one of four

IAC countries whose PHC system needs further strengthening). To this end, we will consolidate ongoing Mission studies and undertake complementary work to prepare a comprehensive health sector assessment.

2. Nutrition. Improving the nutritional status of Peru's population is a specific USAID human capital development objective. Nutrition is a cross-sectoral concern influenced by agricultural policies which encourage (or discourage) food production, distribution and consumption, by health status, macro-economic policies and a wide array of other variables. In recognition of this fact, the Mission's nutrition strategy does not contemplate establishing a central coordinating and review mechanism for nutrition policy analysis and GOP nutrition programs. Rather, its objective is to encourage development planners and policy analysts to take nutrition into account in their work, particularly in the agricultural and health sectors.

Analysis under the ongoing Agricultural Planning and Institutional Development project is examining a number of pricing policies which impact on nutrition. This activity is being complemented by a centrally funded study of the Consumption Effects of Agricultural Policy which will look at the impact of agricultural and economic policies on the amounts and kinds of foods consumed by different segments of the population. In addition, the Mission will amend the Agricultural Planning and Institutional Development project to add funds for continuing analyses of food consumption issues. It will also amend the existing Integrated Health and Family Planning project (527-0230) to add financing for the introduction of community nutrition training and growth monitoring activities into the package of primary health care services supported under the Mission's health program. Another nutrition intervention already underway in the health sector is the construction of rural potable water systems.

Another important activity will be maximizing the nutritional impact of food aid, including improving the targeting of Title II supplementary feeding programs, based on the recent results of the nutrition and health status survey, the Title II program evaluation, and other

Mission studies. While the Title II program serves other development objectives, there is room for improving its nutritional impact. The Mission will also expand PVO nutrition education activities now carried out as part of their Title II food assistance programs. These amendments will provide funding for technical assistance and training activities to strengthen the PVOs in nutrition education. A new OPG will improve the technical awareness of nutrition issues of Peruvian decision-makers.

3. Human Resources. The objectives of our education and participant training programs are to improve the male and female human resource base necessary for productive employment and effective institutional management. In accordance with the LAC Regional Strategy and USAID objectives, our education program will be geared to assisting several private and public institutions in communicating the technical and business management skills necessary for productive employment. The program will also complement other Mission projects by reducing the human resource constraints in agriculture, health, and other USAID priority areas. Strengthening the capacity of local training institutions is an integral part of the Mission's program to improve business management. We will build upon the findings of the PRE reconnaissance team in conducting further assessments of business and vocational training in Peru. During the planning period, USAID will also implement its ongoing portfolio of vocational education and technical skills training programs.

A key element in the Mission's institution-building strategy is to expand in-country and U.S. training opportunities in areas of special concern to AID. Besides the LAC Training Initiatives program, recent projects and those to be designed in the future will emphasize training where human resources need to be upgraded. During the CDSS period, the Mission intends to expand its own support for training in the U.S. and Peru under a separate Training for Development project.

Our education program does not contemplate "taking on" the extremely complicated and inefficient public school system of the Ministry of Education. However, the primary education

system is highly inefficient due to high drop out rates in the first three grades. One remedy is investing in pre-school education which can dramatically reduce these rates. The Mission has in fact played a positive leadership role in developing Peru's public sector pre-school education program, and we believe that, given its innovative nature and complementarity to other Mission objectives, the program may merit future USAID support. The current evaluation of the program will guide decisions in this regard.

E. Housing and Urban Services

Goal: To improve the living conditions of Peru's low income urban families.

Strategy: To influence GOP policies and resource allocations and to reinforce the sector's institutions so as to assure the sustained delivery of basic urban services and adequate shelter to poor urban families. Specifically, the Mission will encourage the GOP to (a) maintain the value of resources being committed to the sector, (b) ensure that resources available are rationally and equitably distributed to the full range of income levels and are in accord with the beneficiary's ability to make repayments, and (c) expand the capacity to produce and deliver appropriate shelter solutions by strengthening major GOP institutions and increasing the participation of the private sector organizations, beneficiaries, and local authorities.

Peru's needs for macro-urban infrastructure investment will exceed available resources well into the future. In part, these needs are being addressed with GOP and other donor resources, particularly the MDEs. Therefore, USAID will concentrate its resources on assuring the availability of sites, basic services and shelter for the urban poor through shelter upgrading and sites and services programs. GOP sectoral institutions have already established substantial expertise and capability in this area, mainly through the Mission's Housing Guaranty (HG) programs.

HG resources will continue to be the primary USAID vehicle to implement this assistance. However, such assistance will be conditioned on acceptable policy reform and resource allocation to the target population. To leverage policy reform, USAID will negotiate a multi-year

HG program of \$100 million to be authorized in tranches of \$20 to \$25 million over a four to five year period. The policy reform objectives described above and in the PRE-USAID housing sector assessment and policy agenda will require more constituency building. This will, in turn, require technical and advisory assistance jointly funded by the Mission and PRE/HUD.

At the present time, the USAID supported policy dialogue is at a critical juncture. Current GOP housing policies include significant differences with our concerns for maintenance of value of shelter sector resources and to the utilization of physical standards and resources targeting that is appropriate in reaching the urban poor. The eventual outcome of this policy dialogue is uncertain. If appropriate agreement cannot be reached in the near term, USAID's approach, given the overall importance of the shelter sector to the problems of urban poverty in Peru, will be to maintain current programs, continue the policy analysis and discussion to provide the foundation for a more favorable GOP response in the future, and further strengthen the savings and loan system.

Beyond specific shelter sector programs, USAID will support the analysis and development of a national urban policy. The program concept recognizes that there is not an explicit urban "sector" but that urbanization is a multi-sectoral process in locationally specific urban places. While USAID's urban development strategy does not propose new multi-sectoral integrated urban programs, the Mission will support the establishment of a clearly articulated, economically achievable urban policy that sets out the basic urban development parameters within which specific sectoral initiatives can be carried out.

Support for national urban policy is now being provided through Housing Guaranty project HE-011 which is financing the study of urban policy alternatives. Additional follow-on support for this initiative will be provided during the planning period with Mission and PRE/HUD resources to prepare an urban assessment so as to integrate urban and economic development policies better.

Over the last three years, the GOP has undertaken growing decentralization efforts aimed at increasing the role of local levels of government and integrating urban and economic

development policies. In supporting the decentralization aspects of this policy, the Mission also intends to help strengthen the capacity of provincial and municipal governments and of the Departmental Development Corporations (CORDEs). This support is now being carried out through the Integrated Regional Development Project which has been reprogrammed to include assistance for the Municipal Development Institute (INFORM) and for the CORDEs. The Disaster Relief, Rehabilitation and Reconstruction project will also help further develop the CORDEs through technical assistance and the experience of implementing subprojects. Future activities will be based on continuing and expanding these initiatives, including the formulation of a National Urban Policy, and programs that are consistent with efficient decentralization.

F. Food Assistance

Goal: To support the achievement of USAID/Peru's development goals and strategic objectives and encourage GOP programs benefiting the poor.

Strategy: To help meet Peru's food import requirements (currently \$400 million) and provide local currency support for development activities; encourage increased private human and physical capital formation in self-help programs through the provision of nutritional supplements; and facilitate the expansion of GOP supplementary feeding programs.

Food assistance is an important, integrated element in the USAID program. Title I loans provide balance of payments and fiscal support; they also help finance Peru's food import requirements and expand markets for U.S. agricultural products that are needed in Peru to fill production-consumption gaps. The local currencies generated by their sale underwrite a large share of the counterpart costs of AID projects. In accordance with the Title I impact evaluation, we intend to increase Title I local currency support of high-priority development activities through a \$100 million-year Title I arrangement to be developed in FY 86 or 87 for application over a four or five year period. We will continue using the Title I agreement to negotiate policy reforms in agriculture and rural development (and related program areas) and to reinforce

targetted program implementation performance.

Title II supplementary feeding programs provide incentives for self-help efforts such as community-level productive and basic social infrastructure construction and maternal/child health programs. These programs often serve multiple development objectives, including nutrition, vocational education and environmental improvements such as potable water and soil conservation. In accordance with recently-prepared studies such as our Title II program evaluation, we will continue to improve the nutritional impact of this assistance so as to maximize the achievement of overall development objectives. Such objectives include increasing local-level productive infrastructure, vocational and nutrition education programs and other aspects of our priority program focus of improved incomes and employment of our target groups. Our interest in decentralizing investments will find expression under the Title II program with the FY 84 expansion outside of Lima of CARE's Basic Urban Infrastructure Program. We will continue to assess our current \$17.5 million Section 416 dairy products donation program to determine appropriate future uses of this authority beyond school feeding.

GOP supplementary feeding programs are currently implemented by the Ministry of Health (school feeding and maternal/child health) and ONAA, the National Food Support Office (mainly food for work and maternal/child health). ONAA also provides logistical support to PVOs implementing our Title II program. We have entered into conversations with ONAA regarding AID-assisted improvements to their operational capacity and will consider requesting Government-to-Government Title II commodities after (or as part of) a program to improve ONAA's management capacity. This will probably involve increased Title I local currency allocations, perhaps supplemented by Development Assistance funds. Over the short term, it is doubtful that Ministry of Health and ONAA supplementary feeding programs will receive significantly increased GOP budgetary allocations in any other way.

G. Special Development Activities

Peru has two assistance needs that are important in the short term and critical to

long-term development: tax administration and disaster preparedness. Both are particularly well matched to US comparative strengths. Tax administration, especially compliance, must be improved to help close the fiscal breach and to ensure equitable tax burden sharing. Our assistance would build on a major institution-building effort in the 1960s and early 1970s and on short-term assistance requested recently. We expect to fund tax assistance on an as-requested basis this year and next. Disaster preparedness is also urgently needed. Peru, prone to major natural disasters, has only a rudimentary disaster preparedness and response system. Present policies and preparedness institutions would be strengthened under an OFDA-supported long-term program (involving a regional disaster officer stationed in Lima). The recent 15-volume, OFDA-funded Lima earthquake study would be a good starting point for the program, as would the experience we and Peru gained in dealing with the many major disasters to date.

V. RESOURCE IMPLICATIONS

A. Personnel

The strategy outlined above for FY 84 and 85—support for the GOP's macro-economic stabilization program in cooperation with the IMF and MDB, continuation of the policy dialogue on key sectoral issues and expedited implementation of the regular program and disaster rehabilitation pipeline—implies selected adjustments in USAID staffing, some augmentation of the current U.S. Direct Hire staff and a substantial increase in OE funded PSCs. It is important to point out that the major U.S. response to the natural disasters in Peru during 1983 was put in place without increases in USOH staffing. Implementation of this \$105 million disaster rehabilitation and reconstruction effort, which must move quickly, will require some staffing relief.

The following table records current levels of USAID staffing and a projection of the Mission profile required in 1985 to implement the ODSS strategy successfully. It should be noted that four officers (Regional contract, 2 RLA, Regional Economist) have regional service responsibilities which dilute their availability to carry out USAID/Peru program tasks. The 1985 profile illustrates our requirements for staff adjustments between now and then.

Selected personnel increases and shifts are planned in the following areas:

1. The Program Office will increase with the addition of 1 US PSC and 2 FN PSCs to improve backstopping of PL 480 Title I counterpart generations, to expedite implementation of the complex USAID food-related PWO portfolio and to staff out policy dialogue issues. The Mission will also be requesting an IDI Food for Peace officer.

2. The Controller's office will expand by 4 FN contract professional positions to support a projected level of disbursements over 200% above the levels in FYs 82 and 83.

3. The Mission has established a new division within the Development Resources office to implement the disaster recovery program. It is currently staffed by a PSC. Three contractors will be added. In addition, two IDI capital development officers and a USDH private sector

officer are being assigned to the Office of Development Resources. A US PSC housing officer is being converted to a direct hire regional position based in Peru. This net addition of four USDH and 2 PSCs will be necessary to backstop the disaster and HG programs, continue to provide staff support for more rapid project implementation, and continue ongoing and initiate new private sector initiatives.

4. Two PSC additions are required in the Health, Nutrition and Education Office to implement the current portfolio and improve overall policy dialogue in the sectors which, with 150,000 public sector employees, have major potential for realizing efficiencies consistent with our strategy. In order to complement the ongoing program with selected high-payoff nutrition interventions, an additional USDH ceiling is required to accommodate a graduating nutrition IDI.

5. Depending on the outcome of the Mission's urban sector assessment, an Urban Development Officer may be added in FY 1985 or FY 1986. Because the need to mount more effective disaster preparedness programs in Peru, the Mission is also proposing that OFDA assign a Regional Disaster Preparedness specialist to Lima.

6. The Executive office will increase by 6 PSC positions to support the above staff increase and cope with the logistical complications of project implementation and technician assignment in a variety of sites outside of Lima. Travel services, security liaison, procurement, personnel and general services staffs will each add one FN PSC. A US PSC special assistant to the Executive Officer will increase his ability to manage the larger office.

Personnel levels in FY 86 and beyond should stay essentially static. If the work year allocations continue to be severely restricted, any reductions in FN direct hire personnel must be offset by increased FN contract personnel. In addition, the mix between USDH regular employees and IDIs will change to accommodate IDI graduations. There will be a reduced number of contract personnel as disaster reconstruction activities wind down.

PERSONNEL REQUIREMENTS: FY 84-90

	(Work Years)						
	1984	1985	1986	1987	1988	1989	1990
U.S. Direct Hire	<u>26</u>	<u>27</u>	<u>30</u>	<u>30</u>	<u>30</u>	<u>30</u>	<u>30</u>
PASA	<u>2</u>	<u>2</u>	<u>2</u>	<u>1</u>	<u>2</u>	<u>2</u>	<u>2</u>
JOC	<u>2</u>	<u>2</u>	<u>2</u>	<u>2</u>	<u>2</u>	<u>2</u>	<u>2</u>
IDI	<u>6</u>	<u>6</u>	<u>4</u>	<u>4</u>	<u>2</u>	<u>2</u>	<u>2</u>
U.S. Sub-total	<u>36</u>	<u>37</u>	<u>38</u>	<u>37</u>	<u>36</u>	<u>36</u>	<u>36</u>
FN Direct hire	<u>48</u>	<u>44</u>	<u>43</u>	<u>42</u>	<u>41</u>	<u>40</u>	<u>40</u>
D.H. Total	<u>84</u>	<u>81</u>	<u>81</u>	<u>79</u>	<u>77</u>	<u>76</u>	<u>76</u>
PSC (U.S. and Peruvian)*	<u>52</u>	<u>52</u>	<u>48</u>	<u>48</u>	<u>49</u>	<u>50</u>	<u>50</u>
TOTAL	<u>136</u>	<u>133</u>	<u>129</u>	<u>127</u>	<u>126</u>	<u>126</u>	<u>126</u>

* Operating Expense funded

B. Program Resources

The following table shows funding by functional funding categories. Starting with FY 86, the levels are indicative and will need confirmation through ABSs, CPs and eventually a new ODSS. Throughout, we have looked first at objectives, then strategy, and then funding source. The result is an integration of strategy with funding. The logic of this procedure is that changing one resource amount will cause a compensating change in other items if the strategic objectives are to be achieved.

The table shows relatively low levels of DA funding in FY 84 and FY 85 reflecting USAID's strategy of concentrating on program implementation; program lending provided through disaster assistance, ESF and PL-480 Title I; and the financing of small projects that promote policy dialogue and private sector development and that lay the foundation for future program

initiatives. We expect that DA levels will substantially increase in the FY 86-88 period, reflecting a three-year build-up of a new AID program following the 1985 Peruvian national elections. (The exact directions of this program will be the subject of a new QSS to be presented in January 1986.) DA funding levels decrease in FY 89 and FY 90 reflecting the normal period of program absorption and implementation.

The PL 480, Title I figures include a \$100 million multi-year program starting in FY 86. The amounts shown for the Title II regular program include a \$2 million increase in FY 85 over the current projection to show first some Voluntary Agency commodity monetization to expand their programs and later the start of a small Government-to-Government program with the National Food Support Office. The long-term Title II decrease is predicated on improved economic conditions and ONAA assumption of a larger share of supplementary feeding programs. The Section 416 dairy product donations to the Ministry of Health presuppose an increase in the Ministry's own funding for school feeding and maternal/child health programs.

The Housing Investment Guaranty figures for FY 84-88 are based on the start of a 5-year, \$100 million program of significant resources in exchange for key policy decisions. The disaster and ESF programs shown for FY 84, 85 and 86 respond directly to the short-term elements of our strategy.

C. Operating Expense Resources

It is imperative that the Mission's operating expense budget be increased to levels consistent with the strategy. In FY 84, this means a Mission-allotted level of \$4 million, with future changes reflecting both inflation and variations in the composition of the Mission's personnel complement.

PROJECTED RESOURCE REQUIREMENTS
(millions of dollars)

	1984	1985	1986	1987	1988	1989	1990
1. <u>DEVELOPMENT ASSISTANCE</u>							
- ARDN	15.5	10	32	40	30	20	20
Loan	9.0	1	20	25	20	10	10
Grant	6.5	9	12	15	10	10	10
- Population-Grant	1.8	4	2	2	2	2	2
- Health	.1	2	7	12	12	1	6
Loan	-	-	5	10	10	-	5
Grant	.1	2	2	2	2	1	1
- Education-Grant	.5	5	2	1	2	2	1
- SDA	0.7	2	24	20	14	13	13
Loan	-	-	20	15	10	10	10
Grant	0.7	2	4	5	4	3	3
DA SUBTOTAL	18.5	23	67	75	60	38	42
Loan	9.0	1	45	50	40	20	25
Grant	9.5	22	22	25	20	18	17
2. <u>FOOD ASSISTANCE</u>							
- PL 480, Title I	20.0	30	30	30	20	20	10
- PL 480, Title II-Regular	10.9	12	12	12	10	8	7
- PL 480, Title II-Disaster	8.0	-	-	-	-	-	-
- Section 416	-	10	10	5	5	-	-
FOOD SUBTOTAL	38.9	52	55	47	35	28	17
3. <u>HG</u>	20.0	20	20	20	20	15	15
4. <u>DISASTER ASSISTANCE</u>							
- Reconstruction Loan	31.0	-	-	-	-	-	-
- Reconstruction Grant	22.7	-	-	-	-	-	-
- Program Loan	60.0	-	-	-	-	-	-
DISASTER SUBTOTAL	113.7	-	-	-	-	-	-
5. <u>ESF</u>	-	60	60	-	-	-	-
6. TOTAL	191.1	152	202	142	115	81	74
Non-add Item: OFDA	-	1	1	1	1	1	1
PRE	3.0	4	5	5	5	5	5