PERU - PRIVATE SECTOR ASSESSMENT

VOLUME I - USAID STRATEGY

FINAL REPORT

Coopers & Lybrand
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I. INTRODUCTION

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A. Background

In a recent book entitled "Development Without Aid," the author offered the view that developing countries could strengthen their economies by encouraging the development of a dynamic self-sustaining domestic private sector. The argument is based on the historical record of several countries which allowed the market to determine the allocation of resources. In such cases there were high levels of savings, investments, exchange earnings and growth, and a subsequent minimal reliance on foreign assistance. In cases where governments blurred the distinction between ownership and management and actively managed the means of production, resource allocation distortions occured and the economy was unable to sustain itself. These governments obviously were not able to create wealth and began to rely heavily on foreign assistance for survival. They ultimately found themselves unable to break the low investment, low growth cycle. The world recession and miscalculations about the level of government revenues from oil and primary resources, which are critical to sustain these centrally controlled economies, exacerbated the situation. These crises have prompted many governments to reassess their overall economic policies and consider the private sector as an alternative vehicle for economic development.

Support for this private sector approach has been increasing. Jamaica and Sri Lanka are relatively new entrants to the field while Korea, Taiwan, and Singapore are the more traditional examples. International donor agencies have also begun promoting the private sector as one vehicle for development and are looking for creative ways in which the private sector can play a more strategic role. For example, the World Bank through its affiliate the International Finance Corporation (IFC) has provided assistance to various private sector enterprises by investing in business, securing additional foreign and local capital, and providing guidance and technical assistance.

Within this general context of fostering economic development through support of private sector initiatives, the United States Agency for International Development (USAID) has adopted a policy framework to channel resources to the private sectors of developing countries. Specifically, a goal of the agency is the growth of productive self-sustaining private sectors. USAID has targeted several countries whose policies and behaviors are supportive of a market-oriented economy and private sector development. The choice of these countries is based in part on the belief that the policy framework of that country will ensure that any USAID intervention in the private sector will have a reasonable chance of success.

In 1980 Fernando Belaunde Terry was inaugurated as president of Peru. His adminstration established the private sector as the prime vehicle for Peru's economic development and emphasized that the role of the public sector should be limited to areas where it has a comparative advantage. Several initiatives were undertaken by Belaunde which underscored his commitment to the private sector. For example, plans were developed to "privatize" several public sector companies and many disincentives to private sector investment were removed.

These initiatives and others aimed at establishing an economic and political democracy, have led USAID to believe that it has an opportunity to make a significant contribution to the Peruvian government's economic development efforts. To USAID, Peru offers unique opportunities to demonstrate the efficacy of an open political and economic system.

B. The Objective of the Study

Economic development efforts often focus on targets of opportunities: they are reactive to situations as they occur. In some circumstances this approach can succeed. But the very implication of the concept of development is that there is a broad strategy or rationale for those actions and a strong linkage between planned activities and the goals of the strategy.

The USAID mission in Peru advocates this strategic approach to economic development. In exploring ways to assist Peru in development activities, particularly those related to the private sector, USAID engaged Coopers & Lybrand to assess the current economic situation in Peru and assist in developing a private enterprise strategy which will support the government of Peru's efforts to expand a market-oriented economy. The objective of this study was to provide USAID with an understanding of Peru's business climate and the obstacles limiting the development of the private sector. From that assessment judgments were to be formulated concerning the most effective way USAID resources could be allocated over a three to five year period and a determination made of the expected results achievable at various funding levels.

With this objective in mind, Coopers & Lybrand's approach to the study centered on three sources of information: interviews, primary and secondary documentary sources, and an extensive review of the economic history of Peru since 1950.

The interviews were conducted with a broad range of Peruvian and foreign experts who have access to formal and informal assessments of the current economic situation in Peru. These people provided invaluable insights to both obstacles and opportunities for economic development. Those interviewed included politicians, labor leaders, government officials, private sector owners of small and large firms, bankers, and others whose perceptions were important to assessing the various factors influencing Peru's development.

The documentary sources provided us with factual information which formed the empirical basis for our judgments. When coupled with the subjective interpretation of events gathered from our interviews, the results provided us a sense of proportion among the various factors, allowing us to draw conclusions about the practicality of the various strategies proposed.

To gain a perspective on current events, we relied on a historical review of the period from 1950 to the present. This review identified the fundamental forces which underlie current events in Peru and put in perspective the capacity of the country to absorb major changes. Further, it highlighted the need for caution in approaching the design and focus of development activities.

From these sources the Coopers & Lybrand team analyzed the current situation and synthesized the results into a cohesive strategy for USAID support of Peru's efforts to strengthen and expand its market oriented economy.

C. Major Strategy Issues

Prior to presenting our findings we believe that certain issues should be highlighted so that our analysis can be placed in perspective. Although these issues are further elaborated in the report their importance in terms of our conclusions is such that they bear early consideration by the reader. These issues are:

- An Economic and political transition period
- Economic decentralization
- Economic goals
- Economic development and private sector development
- Public and private ownership

1. An Economic and Political Transition Period

In 1980 Peru was confronted with three significant events: the return to a democratic political process, an increased reliance on market economy, and the occurence of a world recession. The latter event has implications for the first two since it added an unanticipated negative element for Peru. In essence, it has caused the movement toward a liberalized economy to slow down and has evoked concern about the political stability of the country, from a point of perception if not reality. Our assessment of these factors has led to some fundamental conclusions. The first is that the transition to a freer market economy may take more time than anticipated as the government makes a more concerted effort to balance social and political needs with economic ones. Attempts to cushion the impact of both the recession and freer trade conditions have provoked the government to slow down efforts to reduce subsidies, denationalize industries or take other economically justified but socially and politically costly initiatives. Peru obviously is not unique in confronting a dilemma such as this. What should be unique is the ability of Peru to formulate and carry out a carefully structured transition management program which is sensitive to these seemingly competing goals and avoids the economic and social upheavals of countries which moved too rapidly toward the market in the absence of a coherent plan for change.

The second conclusion is that the interplay of these factors may have set the stage for this transition to be far deeper than expected. From a historical perspective one can conclude that shifts in Peru's political and economic power have swung between connected and interdependent power groups with essentially no significant decentralization of that power. However, the emergence of military rule in the late 1960's may have broken that pattern and established a new concept of Peru's economic, social and political institutions. The shift away from the military may emerge then as a synthesis phase during which a fundamental social, economic, and political change will be incorporated. In a way, the change to the Belaunde administration may represent both a return to some parts of the old order and a transition to the beginning of a fundamentally new structure.

The length and depth of the transition are, of course, not certain events. There are a number of possible outcomes which will either sustain or interrupt the transition and these depend upon some unforeseen factors. For example, the econmy could continue its recent low growth performance, it could experience

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increased growth with a possible large burst, or it could become stagnant and evoke a significant political and military response. Nonetheless, much is under the control of Peru and dependent on the way in which the transition is managed. Its ability to survive the current economic crisis is the first critical step before more long term goals are pursued. USAID within its limitations may have to position itself to be responsive to any of those outcomes and develop a strategy which ensures that the benefits of its programs still reach a major portion of the population despite significant political changes.

2. Economic Decentralization

If the transition is managed effectively and USAID contributes toward that management process, one result could be a relative decentralization of economic power, sectorally and regionally. We do not expect that this will happen in the near term. In fact, we feel that a rapid movement in that direction may be economically counterproductive. The market shares in most sectors indicate an oligopolistic influence and major economic decisions are still centralized to a great extent. Nonetheless, current events and a historical perspective seem to indicate that decentralization is occuring albeit slowly.

The emergence of a large informal economic sector testifies to this as does the emergence of new entrepreneurial activities in the non-traditional areas of small scale manufacturing. The economic need to diversify Peru's export base from its totally unbalanced reliance on commodities is one driving force for this change, which could be enhanced by changing the relative prices of goods in the agriculture sector. Assuming Peru systematically opens its markets and relies more on economic rather than political indicators to allocate its resources, opportunities will exist for economic power to be shared among a broader base of the population. Fostering this decentralization within practical limitations should be a cornerstone of USAID development strategy. Decentralization should not be pursued, however, as an end in itself. It should be pursued when it makes economic sense to do so.

3. Economic Goals

In formulating a strategy for development, we have concluded that the end results sought should be stated in economic terms. The reason for this is to reinforce the similarities between various competing groups. USAID will find, as it probably already knows, that even within the private sector of Peru there are various competing groups who have different opinions as to what should be done. These differences usually focus on means rather than ends. For example, we could find little disagreement that Peru needs to reduce its debt burden; yet we found a significant difference among various groups as to how this should be accomplished.

If USAID's strategy focuses on the achievement of specific economic goals which are in essence politically neutral, they will be in a position to establish effective dialogue with all of the competing factions and be better able to influence the attainment of specific social goals such as equity or political stability. Positioning itself with various groups by emphasizing what it has in common with those groups will allow USAID to demonstrate that in fact there is not an inherent conflict between economic and social goals.

4. Economic Development and Private Sector Development

An issue related to the statement of goals is the role of the private sector in the development process. For USAID to be able to deal effectively with a wide range of interest groups, the institutional image it projects can be an important element in carrying out its strategy. Appearing to favor one group over another can have obvious negative consequences since implementation of an strategy usually depends on more than one interest group. For example, the public sector in Peru as in other countries has an interdependent economic and political relationship with the private sector. It is still a formidable power group in economic terms and thus can positively or negatively influence private sector development. Putting forth as a goal the development of the private sector may in fact alienate this group.

Within the private sector itself there are a number of factions which oppose an open market since it will result in an apparent and, in some cases, actual loss of power. Their perception is that private sector development means a return to a protectionist economic environment. In essence the private sector in Peru is not a homogenous group but rather is composed of local economic elites, foreign multinationals, informal establishments, and others as well.

One approach to this complex problem is to support economic development as an end. This means that USAID is supportive of the public as well as the formal and informal private sector. USAID is still able to carry out its mandate under the Foreign Assistance Act but does so in a way which does not unduly jeopardize its neutrality by immersing itself in discussions over means versus ends. The strategy which we suggest incorporates this approach.

5. Public and Private Ownership

The next issue carries the above argument one step further. In dealing with economic development and attempting to foster the private sector as an effective means toward that end, the issues of ownership should be considered. In reviewing the situation in Peru and other countries we recommend that USAID not limit its economic development strategies to activities or institutions which are privately owned. Aside from our arguments offered about alienating groups which may be crucial to carrying out a program, we also suggest that ownership has a limited bearing on the economic activities of an institution or firm.

The argument that public sector enterprises subordinate economic goals to social or political goals does not appear strong when viewed against the fact that privately owned companies often do the same and for a sound reason - it ensures their long term survival. The essence of the problem in economic terms is not ownership _per se_, but whether in fact the firm responds to market signals. In cases where they do, state-owned firms can do as well economically as privately owned ones.

We suggest, then, that USAID's economic development strategy in Peru be based on this principle. This approach will allow it to be more flexible in dealing with the issue of development. For example, one of the prospects for USAID involvement could be the privatization of nationalized industries. One way to do this is to allow the government to own the company while contracting out the management of that company to a private sector concern. The ownership would be governmental while the management is private. However, if USAID conditions its assistance strategy on private ownership, an opportunity such as this may be prematurely disregarded.

The issues we have raised here set a framework for the remaining chapters of this report. We understand that some of these may raise discussion in some circles and that disagreements may surface. We encourage this process as a necessary step toward building a consensus. This report is the first step in a continual process of identifying problems and developing appropriate responses. In order to do this USAID will have to set in motion follow-up studies in certain areas to reassess the business climate as Peru moves through its transition period and attempts to survive the current economic crisis.

What this report does do is provide a conceptual framework for an economic development strategy and allows USAID to act purposefully within that framework. By providing a sense of direction and a list of agenda items, it can also act as the basis for a structured dialogue with the Government of Peru, an essential ingredient to successful implementation of the strategy.

D. Summary of Strategy

The strategy which we recommend for USAID/Peru is focused on assisting the government of Peru achieve specific economic goals by supporting the development of market oriented institutions.

The basic thrust of the strategy is export promotion and it has two components. The first is targeted to alleviate near term problems in the private sector caused by the current recession and the structural shift to market signals, while the second component of the strategy is focused on longer term goals pursued by the government.

The strategy is based on a cause and effect analysis of the environment within which Peruian businesses must operate. Though the issues are complex we have attempted to identify those factors which have the greatest impact on business operations and suggest an approach for USAID to alleviate the problems caused by those factors. In developing this approach the reasoning described below was applied. (See exhibit on following page.)

1. <u>Short Term Focus of Strategy</u>

In the short term the government of Peru's prime goals are to contain an inflation rate which may exceed 100% and to provide disaster relief for the parts of Peru which have been devastated by natural disasters. The strategy the government has employed to achieve those goals has created a dilemma. First, to contain inflation the government is attempting to reduce its budgetary deficit by restructuring its foreign debt and decreasing its expenditures. Second, in order to provide adequate disaster relief the government must expend funds. Though outside sources will supply some funding the bulk of it of necessity, must come from internal sources. Thus, the dilemma. To contain inflation, reduce expenditures; to provide disaster relief, increase expenditures.

Elements of the government's short term strategy, have had an effect on the overall economy and the private sector in particular. For example, restructuring the goverment debt has increased funds available to the government but because of the conditions of the loan agreement funds have taken away from the private sector. While this may indirectly help contain inflation it has created a severe liquidity problem which, in turn, has inhibited private sector investment and reduced capacity

USAID STRATEGY TO ASSIST THE GOVERNMENT OF PERU TO ACHIEVE ECONOMIC GOALS

GOVERNMENT OF PERU SHORT TERM GOALS	GOVERNMENT OF PERU STRATEGY	EFFECTS ON ECONOMY OVERALL	EFFECTS ON PRIVATE SECTOR	PRIVATE SECTOR NEEDS	USAID STRATEGY: USAID GOAL	USAID STRATEGY: USAID PROJECTS
■ Contain inflation	■ Reduce deficit by restructuring debt and decreasing expenditures	■ More funds for government debt and less funds for private sector → illiquidity →	■ Low investment/ low capacity utilization	■ Financial resources ■ Management advice	To cushion the shock to a freer market economy and to overcome the current economic crisis	■ Working capital fund ■ Debt restructure fund ■ Consulting services
■ Provide disaster relief	■ Expend internal/external funding	■ Policy dilemma → policy inconsistencies. →	■ Wait and see attitude	■ Policy stability ■ Economic information		■ Council of economic advisors ■ Economic information project

GOVERNMENT OF PERU LONGER TERM GOALS	GOVERNMENT OF PERU STRATEGY	LIMITATIONS TO IMPLEMENTING STRATEGY	PRIVATE SECTOR NEEDS	USAID STRATEGY: USAID GOALS	USAID STRATEGY: USAID PROJECTS
■ Employment generation ■ Reduce inflation ■ Generate capital ■ Increase productivity	Decentralized, diversified outward oriented market economy through:				
	1. Export promotion	1. Import substitution barriers	1. Visible/consistent trade policies		1. Private sector economic policies study group, council of economic advisors, design draft trade/labor legislation, foreign economy study group
	2. Diversified export base	2. Incentives, market knowledge, management, technology labor laws, finance, dependence on U.S. commodity market	2. Incentives and technical assistance		2. Export trading company, consulting services, technology transfer/vocational training market analysis, export promotion, export promotion fund, U.S. short term training
	3. Decentralization (Geographic, sectoral)	3. Lack of incentives to relocate (tax, labor, infrastructure)	3. Incentives and infrastructure		3. Regional integrated development project, draft trade/labor legislation, private sector economic policy study group, industrial estates/enterprises zones
	4. Foreign investment	4. Legal/regulatory framework, recession, risk in Peru	4. Upswing in economy, political stability, & legal regulatory incentives	■ To restructure the industrial sector to become more competitive, to increase domestic investment ■ To diversify export base, to develop outward oriented policies, to increase foreign investment	4. Investor search, gov't negotiation with foreign MNC. Draft trade legislation, private sector economic policy study group
	5. Domestic investment	5. Lack of identified projects, capital, stability, time orientation	5. Feasibility studies capital, shared risk		5. Feasibility/market analysis, export promotion fund, mutual fund, labor termination fund
	6. Reduce gov't expenditures • curtail gov't activities • increase role of private sector	6. Entrenched public sector, lack of capital, historical factors, social needs	6. Knowledge of gov't plans for expenditures		6. Council of economic advisors, management contracts
	7. Eliminate distortions in incentives system	7. Social reaction, knowledge of incentive effects, special interest groups	7. Consistent implementation of strategy		7. Private sector policy study group, council of economic advisors
	8. Consistent fiscal/monetary policies through plan to implement economic development model	8. Large debt, knowledge of policy effects, political forces, commodity market instability	8. Detail of economic development model		8. Council of economic advisors

utilization. Furthermore, the need to expend funds for disaster relief has resulted in the policy dilemma and perceived policy inconsistencies. In resonse to those inconsistencies the private sector has basically adopted a "wait and see" attitude adding another nibiting factor to private sector investment.

Given this situation the priority needs of the private sector, in the short term are:

- Access to finance, primarily working capital
- Management advice to use those funds effectively and to learn marketing skills
- Policy stability to allow the private sector to adjust to the transition to a market oriented economy
- Economic information to permit effective planning for business.

USAID can play an effective role in assisting the government of Peru to meet these needs of the private sector. In response to immediate financial needs we recommend the USAID establish a working capital fund and a debt restructuring fund for selected export oriented companies. These firm level projects will assist the companies in overcoming the major near term obstacle to private business development.

At the macro level USAID should focus its initial efforts on establishing a strong institutional base to meet the private sector needs for policy stability and effective economic information. We believe that macro level issues are critical to the success of the economic transition in Peru and play a key role in establishing a stable framework in which the market oriented companies can operate.

As part of USAID's near term strategy, therefore, we recommend that funding and technical assistance be provided to the Government of Peru to establish a Council of Economic Advisors. This will provide the government with a mechanism to establish and coordinate effective economic policies. As a critical input to the Council we also recommend that USAID support the establishment of a Private Sector Economic Information Group. This group or institution will also collect and disseminate economic information to private sector companies to act as a basis for planning company operations.

In sum, the USAID goal for the near term is..."to cushion the shock caused by the move to a freer market economy and to overcome the current economic crisis." This first component of USAID's strategy will position the private sector to meet the longer term economic goals of Peru.

2. Long Term Focus of Strategy

As the current economic crisis subsides the government will focus on longer term goals. These include employment generation, reducing inflation to manageable levels, generating foreign and domestic capital for investment, and increasing productivity. The longer term strategy of the government of Peru is to develop a decentralized, diversified outward oriented market economy. This strategy is to be carried out through a number of tactical initiatives ranging from export promotion to encouraging foreign investment. The thrust of this longer term strategy is based on extensive private sector involvement. Assuming that the private sector recovers from the near term economic crisis we expect that it will be able to assume that critical role.

Implementing the government's strategy and tactics is, however, hampered by various limitations in the business environment. These include the lack of market incentives in specific areas, notably agriculture; the lack of market knowledge, particularly in the international arena; perceived risk in investing in Peru; and historical factors, such as an entrenched public sector. These and other limitations translate into specific private sector needs which must be met if the government of Peru is to successfully pursue its strategy to establish an outward oriented market economy.

These needs are complex and interdependent. However, we attempted to isolate those needs so as to establish a focus for

USAID project assistance. These longer term private sector needs include:

- Visible and consistent macro trade policies
- Incentives to produce and knowledge of international markets
- Effective legal and regulatory framework within which to operate
- Long and short term capital
- Technical assistance in
  - Management Skills
  - Access to Technology

The USAID strategy to respond to those needs must reflect their complexity. Thus, the projects which we recommend must be viewed as a program of interdependent projects. For example, to meet the private sector need for visible and consistent macro trade policies we recommend a number of different projects to meet that need. These projects include:

- A Council of economic advisors
- A Private sector economic policies study group
- A project to draft trade/labor legislation
- A project to study foreign economies.

These projects are described in more detail in the report including suggestions as to their design.

The longer term USAID strategy to support a decentralized outward oriented market economy thus has two specific goals:

- To restructure the industrial sector to become more competitive and to increase domestic investment
- To diversify Peru's export base, develop outward oriented policies and to increase foreign investment.

In summary, USAID's strategy is focused on assisting Peru to develop a more diversified export oriented economy using the private sector (including market oriented public sector firms) as the prime vehicle. The strategy is focused in the near term on meeting private sector needs generated by the current economic crisis in Peru. In the longer term the focus shifts to meeting private sector needs caused by the limitations which exist in the business environment hampering the implementation of Peru's economic model for development.

E. Report Outline

The remainder of the report has three major parts. Each builds upon the other to form the logic for the proposed conceptual design of USAID's strategy. Chapter II begins with an analysis of Peru's current economic situation and describes what action the government is taking to manage the economy during the current crisis.

Chapter III addresses the medium and long-term economic goals of Peru and identifies the obstacles to achieving those goals. The economy today and in the future, however, is shaped to some extent by the economic history of Peru. Chapter III, therefore, also analyzes the period prior to the Belaunde administration and identifies the major historical issues which impact the current economic situation. The problems we discuss cannot be viewed solely in the current context or circumstances of the moment. They are historical in nature and reflect the structural rigidities of a centralized society. Nor are the problems solely economic. They must also be viewed in the context of social and political interactions which influence economic outcomes. The solutions developed must reflect the complex environment in which those solutions must be applied.*

The analyses of the current situation and recent history lead to certain conclusions about what can be done by USAID in Peru.

*For a comprehensive review of Peru's economic history see other volumes of this report: Volume II, Historic Evolution of Private Sector, 1950-1968; Volume II, Structural Reform, Economic Policies and Problems of the Private Sector, 1969-1980; Volume IV, Economic History Since 1980; and Volume V - Economic Perspectives; 1983 - 1985.

Therefore, Chapter IV describes a strategy USAID could employ to assist the government of Peru in achieving those economic goals and overcoming specific obstacles to development. The strategy is differentiated in terms of time orientation, level of funding and types of program interventions.

II. THE CURRENT ECONOMIC SITUATION

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The economy of Peru is in the midst of a severe recession. Unfortunately, this recession has occurred as the current administration has attempted to improve the performance of the economy by structurally shifting from a controlled economy to a liberalized one premised on market forces. As a result, this new economic strategy for Peru has been only partially implemented.

Domestically the recession has led to a large number of closed plants and extremely low rates of capacity utilization. Unemployment exists in virtually all sectors of the economy but the lack of accurate statistics and the existence of the informal sector probably mask the extent and magnitude of hardship. The negative effects of the recession ignore geographical boundaries and extend beyond Lima to the outer departments.

The recessed international market has also impacted Peru. Peru traditionally has exported as much as 25 percent of the value of its national product, but the weakened condition of demand in international markets has severely curtailed exports to virtually all of its trading partners. Peru will be unable to generate sufficient foreign exchange to meet its increasing dependence on imports. The domestic and worldwide recession has been compounded by the crises caused by natural disasters in Peru during 1983. From our review of the economic situation of Peru four major conclusions are drawn:

- The current situation has created an economic policy dilemma for Peru.
- The choices the government must make between competing economic goals will adversely affect the private sector.
- Short-term economic problems have led to interruptions in implementing the longer-term economic model adopted in 1980.
- Despite attempts to implement a coherent economic program Peru's economic situation is critical.

A. <u>The current situation has created an economic policy dilemma for Peru</u>

The current problems confronting the economic policymakers of the Belaunde Administration are the following:

-- recession and a decline of economic activity in the 4 to 8 percent range during 1983.

-- inflation rates, that have been between 70 and 80 percent (at annual rates) for the last several years, increased dramatically the first months of 1983 to an annual rate in excess of 100 percent.

-- limited foreign reserves for the Government to draw upon to pay current bills or to finance Government debt.

-- a need on the part of the Government to reduce government expenditures and bring them in line with revenues, thereby reducing the size of its deficit.

-- natural disasters from the storms and mud slides in the northern and central parts of Peru that are estimated to cost approximately $0.5 to $1 billion to repair.

The Government is in a dilemma. On the one hand, there is an immediate and substantial need to increase Government expenditures to counter the impact of the recent floods. Yet, the Government must reduce expenditures and minimize its deficits to avoid hyper-inflation and a worsened economic situation. The current economic situation therefore has diverted the attention of economic policymakers from their long-term economic development model to very short-term reactions to crises. One crisis has been the restructuring of the government debt with a syndicated loan headed by Citibank. The loan of $770 million (down from the originally reported amount in March of 1983) has been negotiated to alleviate the high burden of the external debts by the government. Approximately 40 percent of the loan involves stretching out previous payments over an 8 year period and the other 60 percent is new credit.

The $110 million difference between the original figure and the $770 million of the current finance package are funds that

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were to be used for export credits guaranteed by foreign governments. The elimination of this credit facility could impair Peru's ability to generate foreign reserves through export markets. This issue should be considered by USAID in its development strategy.

Although this loan will temporarily meet some of the government's financial needs and establish a reasonable payment schedule for its external debt, there is a likelihood that it will be necessary within the next several months for the government to renegotiate other loans that are coming due in 1983 and 1984. Furthermore, these loan arrangements are designed specifically for the Peruvian government; some financing arrangements for the private sector have been withdrawn as part of the loan agreement. Thus, the loan in fact may have taken away some of the credit facilities that were available to private sector enterprises in Peru, making their financial situation difficult as the current recession worsens.

To compound the financial problem for the private sector the Central Reserve Bank of Peru has been pursuing a monetary policy of restricting the growth of the money supply in an attempt to keep inflation at a steady, albeit high rate of approximately 70-80 percent per year. It is also maintaining its policy of mini-devaluations in anticipation of inflation and has been marginally successful in maintaining a stable foreign exchange environment through this policy. In the immediate future, the Central Reserve Bank faces the prospect that it will be called upon to finance the impending government deficit. To do this, it will either draw down the limited amount of foreign reserves that currently exists or pursue an inflationary monetary policy to accomodate the deficit.

In summary, the immediate economic goals for the government of Peru are relatively limited and reflect the policy dilemma that the country currently faces. First, the government must reduce government expenditures to reduce the size of the deficit yet provide disaster relief to various parts of Peru. Second, the government must encourage foreign exchange earnings. However, the international market demand for the majority of export products is low and commodity prices are still somewhat depressed. Third, it must provide policy stability in a volatile economic environment.

B. The choices between these competing goals have created a situation in which the private sector entrepreneur will most likely be adversely affected.

In our interviews we found common reactions from Peruvian entrepreneurs to the current situation:

- The current credit situation is at a critical stage, with virtually no funds available to meet the working capital requirements of business.
- There is a "wait and see" attitude on the part of the business community concerning the current economic environment. No economic decisions of consequence are being made at this time nor will they be made until the clouded economic evironment changes.
- Business believes that the economic decision-making apparatus of the government is paralyzed; the immediate concerns of government at this time are rescheduling their external debts and reacting to the recessionary environment.

The business community finds itself in a very difficult situation not only because of the economic problems caused by the recession but also by the inaction of the government. There is a belief that economic policy is not clear and provides no incentive for the business community to act until they see very positive signs from the marketplace.

The availability of funds are limited at any price (or interest rate) for even the best of business risks. As we stated, this is an indirect result of the large loan to the government which reduced available credit for the private sector. This illiquidity, particularly for working capital, could lead to a number of bankruptcies of firms that would otherwise be in the economic mainstream when the economy of Peru recovers from the current economic recession.

C. <u>Short term economic problems have led to interruptions in implementing the longer term economic development model presented in 1980.</u>

The economic situation of 1982 and 1983 have led to policies and responses on the part of government and the private sector that are inconsistent with the broad strategies of the economic development model. Furthermore, the government neglected to further elaborate and articulate the basic tenants and operational features of the development model. Thus, a review of the structure, development, and implementation of the economic development model is in order.

On the 27th of August, 1980 Prime Minister Manuel Ulloa presented an economic message to the Congress in which he outlined a basic economic and social policy of Peru which included a number of new directions and new strategies for the economy. Of particular note were the following changes in the economic responsibilities of the government and the private sector:

- For the exploration of oil, and mineral development and banking, external foreign investment would be sought to support.

- Government activities would be directed toward a limited number of sectors in the economy. Those included agriculture, electricity, highways, education and housing. These infrastructure items would be financed to the extent possible by soft external loans.

- Other activities in the economy would be left to the private sector. Public sector companies left over from the previous military regime would be moved systematically to the private sector.

- Government regulations would be minimized to provide as many incentives as possible to private businesses.

- Subsidies by the government would gradually be reduced and eventually eliminated so that prices would reflect the workings of the marketplace as opposed to controls by the government.

- Import duties would be reduced so that the economy would be open to the competitive forces of the world marketplace.

- The distribution of income would be altered by an attempt by the Peruvian government to create massive employment opportunities and increased income for the working class.

Thus, the new economic development model of Peru was based on much more extensive use of the market signals in major sectors of the economy of Peru than had been the case under the previous government.

The particulars of this general plan were not specified at that early date because it required further analysis and preparation of special strategy documents. However, the Prime Minister did present substantial detail concerning the expectation of what would occur in the economy in 1981 and these reflected the changing economic circumstances for the country. The Prime Minister specified that the economic policy was designed to increase production and employment and to gradually reduce inflation. The four basic elements of the government's anti-inflation policy would be to balance the budget, open up foreign trade, encourage savings and search for a consensus among the different economic agents.

The results of 1980 had not been good for the economy and it was the plan of Prime Minister Ulloa to reduce the public sector deficit in 1981 considerably lower than that of 1980. This was to be accomplished through reform of tax legislation and administration and through reductions in subsidies from the government. At the same time, he specified that the tariff policy of Peru had been designed to open up the economy by lowering import duties and avoiding over protection of local industries. This move to use the market economy in a more extensive way was done to create efficiency and a healthy degree of competition between domestic and foreign industry. It was also anticipated that lower import duties would expand the supply of goods and services from abroad and improve the welfare and consumption patterns of the population. With regard to tariff policy, it was anticipated that the target was to reach a relatively uniform tariff averaging 25 percent over three year's time. This was a remarkable shift from the high tariffs that existed in 1980 when some tariffs were as high as 150 percent.

Economic problems continued and Prime Minister Ulloa resigned. The new economic team confirmed in mid-February that the main thrust of Prime Minister Ulloa's economic policy would continue. Reliance upon the marketplace and market signals in the economy of Peru were to be pursued as government policies, and reducing the high level of inflation in the economy remained as a specific goal. However, a few modifications to the basic thrust of the use of the free market and the opening up of Peru's economy to the international marketplace were made by Prime Minister Schwalb. For example, in April 1983, tariff policies were used as a short-run instrument to contain the outflow of foreign reserves by raising import duties.

Despite some apparent vacillation, the current administration does have a stated economic program. Prime Minister Schwalb has budgeted for lower government expenditures and a correspondingly lower deficit for the government. His program for reordering the economy included the following:

-- 3.8 percent of gross domestic product is the maximum public sector deficit compatible with available foreign resources.

-- public investments are to maintained at 8.3 percent of gross domestic product.

-- export incentives are to be adjusted to international norms.

-- foreign borrowing would be continued to cover an estimated balance of payments deficit of $900 million of which only $100 million can be covered by allowing a fall in foreign reserve.

-- the government would continue to attempt to sell "irrelevant" state companies, preferably to Peruvian nationals.

-- the government will introduce a new employment promotion law which would abolish certain vestiges of the job security legislation.

-- the government would defend the consumer against monopolies, oligopolies, cartels and other price fixing arrangements.

In total, the program of the Prime Minister was intended to reduce inflation in favor of the consumer by cutting public sector deficits and creating greater competition in the economy of Peru. However, immediately following the elaboration of the economic framework by Prime Minister Schwalb, the Minister of Economy, Rodriguez Pastor spent the vast majority of his time negotiating the $770 million debt restructure loan.

The Minister of Economy then had to turn his attention to another economic crisis that occurred within the country, the bankruptcy of Banco Commerical del Peru. During the congressional hearings and testimony on the bankruptcy, Minister Rodriguez Pastor assessed the current economic situation and predicted that 1983 would be a year of substantial economic hardship for Peru. The Minister reconfirmed the commitment of the government to reduce the public deficit by curtailing government expenditures. Several other policies were also introduced to deal with the current economic situation. These are the following:

-- the creation of a certificate of deposit denominated in Peruvian soles and indexed for inflation so that it would be an attractive incentive for saving money in Peru and in the Peruvian currency.

-- a plan to reduce the gross public internal debts of Peru significantly.

-- restriction on the amount of investment in public sector firms.

-- immediate government attention to the repair and reconstruction of the areas of Peru affected by the natural disasters of the recent months.

D. Despite these attempts to implement an economic program Peru's current economic situation is critical.

To underscore the severity of the economic situation six areas will be covered: production and employment perspectives in

1983, the external sector, the public sector, money and inflation, economic policy and results, and economic projection for 1983-84.

1. Production and Employment Perspectives in 1983

Real growth in GDP has been declining from 3.9 percent in 1981 to 0.7 percent in 1982. For 1983 it is likely that the Peruvian economy will experience a decline of around (8) percent. It is important to mention that the government projection in the beginning of the year was 0.5 percent but at this point they are expecting a fall in GDP of (5) percent. The sectors which will suffer the greatest impact of the recession will be construction, fishing, services and manufacturing. (See Table 1.)

The comparison of the first quarter of 1983 to the first quarter of 1982 shows a decline in GDP of 10 percent. On a sectoral basis fishing experienced a contraction of 40 percent, construction 30 percent, mining 15 percent and manufacturing 14 percent. These figures provide evidence in favor of a decline in GDP on the order of (8) percent rather than the official figure of (5) percent.

The negative rate of growth in 1983 for the agricultural sector will be felt in the production of cotton, potatoes and wheat. The decline in their rates of growth will be of (30), (28) and (21) percent, respectively. The first decline will be explained by the floods in the north of Peru experienced in January - April 1983 and the latter by the drought of Arequipa and Puno in southern Peru. The contraction in mining can be explained mainly by a decrease in the production of copper, iron and oil.

The manufacturing sector decline of (12) percent in the first quarter of 1983 is due to a very strong contraction in machinery, transport equipment, basic metals, textiles, food and paper. One can conclude that the crisis in the manufacturing sector is a generalized one. Furthermore, it is experiencing shortages of credit and has acquired debt in foreign currency whose servicing

Table 1

Peru
Structure and Growth of Real GDP, 1980-83
(percentage)

	Structure 81	81/80	82/81	83/82 A	83/82 B
Agriculture	12.9	12.8	3.7	-2	-4
Fishing	0.9	-10.1	-2.0	-8	-18
Mining	9.2	-4.4	6.1	-3	-4
Manufacture	23.4	1.8	-2.7	-5	-8
Construction	5.6	9.4	2.3	-6	-20
Government	7.6	2.3	2.0	1	0
Others	40.4	4.5	0.2	-5	-8
GDP	100.0	3.9	0.7	-4	-8

A = Optimistic version
B = Realist version

Source: BCR
A and B Macroestudios

represents around 30 percent of total expenditures. (See Table 2.)

The financial sector is in the midst of a crisis whose final outcome is difficult to predict. Several banks went bankrupt (e.g. BIC, Banco Comercial, SURMEBANC) and there may be more to come. If this trend continues and if some of the large banks follow the same path, it is very likely that the government will be compelled to intervene more actively in the financial sector.

The labor market is also suffering from the severe contraction in the economy. Open unemployment is expected to increase from 7 percent of the labor force in 1980 to 12 percent in 1983. Underemployment should increase to around 30-33 percent levels. Real wages, which since 1973 to 1981, have lost 40 percent of its purchasing power, should continue this trend and experience a reduction of around 20 percent in 1982-1983.

The number of man-hours lost due to strikes increased by 12 percent during 1981/82 and for 1983 an increase of 30 percent or more can be expected.

2. The External Sector

Exports are expected to decline by 14 percent in 1983. This is explained partially by the effects of natural disasters as in the cases of cotton and sugar. Declines in copper and oil exports are anticipated because of declines in world prices. Imports on the other hand could decrease by 25 percent mainly in consumption goods, inputs and capital goods. This very high contraction on imports is explained by the strong fall in GDP and especially in industrial output and also by the economic policies that will be adopted (e.g., acceleration of mini devaluations, import tariff increases, and so forth.)

The balance of services is expected to be strongly negative, although lower than the one for 1982, following the historical trend of the Peruvian economy. However, the current acount balance will be negative and equivalent to (6.0) percent of GDP.

Table 2

Peru
Structure and Growth of Real Manufacturing Output

ISIC Groups	Structure 1981	81	82	83 I Quarter
Food	11.8	0.9	4.2	-14.0
Beverages	10.5	-1.2	2.9	13.2
Textiles	9.8	-0.2	-6.3	-14.0
Shoes	0.9	-8.5	-19.8	-25.0
Paper	1.8	-6.2	-28.1	-24.2
Printing	1.9	16.9	2.9	-5.0
Chemicals (ind.)	5.6	-0.2	8.9	-5.5
Chemicals (others)	7.4	3.2	-2.2	-2.1
Rubber	1.8	-2.3	-6.0	-27.4
Glass	1.0	0.2	13.0	-5.0
Basic metals	2.9	-9.6	-18.7	-32.0
Non-ferrous basic metals	11.0	-5.4	4.7	-18.1
Metal Products	2.9	-9.3	-6.7	-14.0
Machinery and equipment	3.3	7.7	-22.5	-10.0
Machinery and electrical equipment	5.0	13.1	-19.3	-27.0
Transport	2.2	4.9	-7.4	-25.0
Total	100.0	0.1	-2.7	-12.0

Source: BCR

Long term capital should reach the high level of U.S. $1.1 billion provided Peru receives the syndicated loan disbursed by Citibank. These loans are subject to IMF conditionality which will be evaluated on a quarterly basis. On the short term capital and errors and omissions side, one can expect (optimistically) an outflow of U.S. $400 million which means a loss in foreign reserves of U.S. $200 million. These projections can worsen very easily if the government is unable to impose in an efficient way its economic policies or if there are changes in the cabinet. (See Table 3.)

3. The Public Sector

The public sector in Peru has increased its share in GDP from 22 percent in 1970 to 50 percent in the 1980's due to the nationalization of several multinationals and the creation of several public enterprises. The number of public enterprises has increased from 18 in 1968 to 152 in 1982. The public sector was responsible during the 1970s of a third of total investment, hired 8 percent of the labor force and 22 percent of the wage earners, and commercialized up to 50 percent of Peruvian imports and 80 percent of its exports.

The public sector deficit has been increasing from 6 percent of GDP to an 8 percent during 1980-81. The main responsibilty for this situation has been apparently the public enterprises. However, this is not entirely true because in some cases (e.g., food) the deficit of the public enterprises is due to policy subsidies imposed by the central government while in other cases (e.g., electricity) the deficit is due to ambitious investment projects imposed by the central government without granting capital to them. For 1983, the IMF goals suggest that the public sector deficit should be around 4.1 percent. However, due to the critical economic situation, the lack of cuts in public investment and the funds required for the reconstruction program because of natural disasters, one could predict a public sector deficit around 8 percent of GDP. (See Table 4.)

Table 3

Peru
Balance of Payments, 1981-1983
(millions of U.S. dollars)

		1981	1982	1983 A	1983 B
	Exports	3,255	3,206	3,497	3,000
	Imports	-3,803	-3,706	-3,625	-2,800
A.	Balance of Trade	-548	-502	-128	200
B.	Balance of Services	-965	-1,138	-1,441	-1,100
C.	Current Account Balance (A+B)	-1,513	-1,640	-1,369	-900
D.	Long Term Capital	773	1,108	1,000	1,100
E.	Basic Balance (C+D)	-740	-532	-369	200
F.	Short Term Capital and Errors and Omissions	156	579	-	-400
	Balance of Payments	-584	47	-369	-200

A. BCR Original Projection
B. Macroest Projection

Source: BCR and Macroest

Table 4

Peru
Public Sector Deficit, 1980-1983

	1980	1981	1982	1893	
				A	B
I. Central Government	2.8	4.9	3.9	3.0	4.1
Revenue	20.5	17.9	18.0	16.0	16.0
Expenditure	23.3	22.8	21.9	19.0	20.1
II. Rest of the Public Sector	3.6	3.4	4.9	1.1	4.0
III. Public Sector Deficit	6.4	8.3	8.8	4.1	8.1

A. BCR Projections
B. Macroest Projection

Source: BCR and Macroest

With respect to the fiscal revenue structure it is important to note that the Peruvian tax system has been increasingly reliant on indirect taxes, of which fuels will contribute 20 percent of total revenue in 1983, taxes on production and consumption, 22 percent and import taxes, 29 percent. The latter figure may be overestimated due to the contraction of imports during this year. (See Table 5.)

The price policy for gasoline (84 octanes) will maintain its price at U.S. $1.10/gallon which includes a 50 percent tax. This source of taxation, because of its simplicity, will continue to be the most effective and productive in terms of revenue.

Government expenditure shows a relatively stable structure during 1980-82 and is expected to continue this way in 1983. It is important to notice the increase in the relative shares of defense, interests and amortization of public debt. (See Table 6.)

4. Money and Inflation

Liquidity (defined as money and quasi-money, local currency and foreign currency) grew in real terms by 1 and 7 percent respectively during 1981 and 1982, respectively. Because of the high rates of inflation experienced during these years and the increase in interest rates, money showed a decline in real terms of 17 percent in both years while quasi money increased by 12 and 19 percent respectively, of the latter the one related to foreign currency grew in real terms at a rate of 38 percent.

Net internal credit (for private and public sector) increased in real terms by 1.0 and 7.4 percent during 1981 and 1982 respectively. However, the credit to the private sector has been decreasing substantially during the last four months of 1982. It is clear that the government has adopted credit tightening for 1982 and this policy will continue (unless political factors change or the cabinet changes) during 1983. It is possible that the rate of growth of credit in real terms for the private and

Table 5

Peru
Central Government Revenues, 1980-1983
(percentage)

		1980	1981	1982	1983*
I.	Income tax	29	20	19	19
II.	Property tax	3	4	4	4
III.	International trade taxes	30	36	31	28
	1. Imports	20	31	28	29
	2. Exports	10	5	3	-1
IV.	Fuels	12	13	17	20
V.	Taxes on prod. & cons.	19	18	21	22
VI.	Others	7	9	8	7
	Total	100	100	100	100

Source: BCR

*Projection by Macroest

Table 6

Peru
Central Government Expenditures
(percentage)

		1980	1981	1982	1983
I.	Current Expenditures	66	66	70	64
	1. Defense	24	23	30	23
	2. Interests	16	17	16	17
	3. Others	26	26	24	24
II.	Capital Expenditures	19	19	16	15
III.	Amortization	15	15	14	21
	Total Expenditures	100	100	100	100

Source: BCR

public sector for 1983 will be reduced by 30 to 40 percent respectively.

Inflation during the 1980s has increased its rate from 61 to 73 percent and for 1983 the rate of inflation could reach an unprecedented level of more than 100 percent if there are not major changes in fiscal policy.

5. Objectives and Instruments of Economic Policy in Peru

With respect to the results of economic policy, Peru has shown the following development during 1977-1982.

Table 7

PERU

Results of economic policy, 1977-1982

Years	Real growth of GDP (%)	Inflation (%)	Current Account Balance (as % of GDP)	Unemployment (% of Labor Force)	Fiscal Def/GDP (%)	Saving/GDP
1977	(1.0)	32.4	7.4	8.4	10.1	7.2
1978	(1.8)	73.7	1.8	8.0	6.1	11.0
1979	3.8	66.7	5.3	6.5	1.5	18.4
1980	3.1	60.8	0.4	7.1	6.6	17.3
1981	3.9	72.7	7.5	6.8	8.2	12.8
1982	0.7	72.9	8.4	8.0	8.8	14.4
1983	(8.0)	110.0	6.0	14.0	8.1	15.0

The evolution of some of the instruments of Peruvian economic policy have been the following:

Table 8

PERU

Instruments of Economic Policy, 1977-1982

Years	Devaluation (%)	Import tariff (%)	Interest Rates: Domestic Curr. (Min.)	Interest Rates: Foreign Curr.	Tax Incidence (%)	Reserve Requirement (%)
1977	88	69	17.5	14.9		43
1978	51	69	31.5			47
1979	28	46	32.5	42	18.0	53
1980	37	34	32.5	55	20.5	49
1981	48	32	32.5	71	17.9	32
1982	96	37	55.0	114	18.0	

In terms of economic policy objectives we observe that during 1977-80 an improvement of the performance of the Peruvian economy was experienced in terms of higher growth, less inflation, external sector equilibrium, fiscal deficit reduction and increase in domestic savings. The stabilization and adjustment process applied during 1976-78 started to yield positive results in the next two years when strong devaluations were applied, interest rates were increased and tax incidence raised. These adjustments in key prices of the economy, together with a very large increase on export prices led to a recovery process and an improvement of the general economic situation.

The period 1980-82, however, shows a deterioration of the economic results due in part because of the world economic recession, the exaggerated external debt acquired, and the approach to economic policy. The latter can be explained by the adoption of a neo-liberal economic model together with 'populist' policies in public investment. The reduction of the rate of devaluation, the liberalization of imports (in a period where the world crisis was hitting hardest) and the dichotomy and distortion of interest rates led to a deterioration of the economic indicators. Peru is on the verge of hyperinflation and facing a large disequilibrium in its balance of payments. It will need to adopt strong measures to adjust its economy.

6. Economic Prospects for 1984-85

Under the assumptions of political stability, the absence of cabinet changes which would imply major changes in the economic policy and the adjustment of economic policy, we could expect some economic recovery during 1984-85.

For 1984-85, GDP could grow between 1.5 - 2.5 percent, agricultural production could recover (if natural disasters do not repeat themselves) and fishing could see positive growth. Mining and petroleum could also experience significant increase in their activities. Manufacturing and commerce would however continue to stagnate until the second half of 1984 and early 1985.

The level of unemployment could experience some reduction and the rate of inflation could start to decline to the 60 percent level. Finally, the balance of payments could show much more equilibrated levels than those experienced in former years.

7. Summary

Although the intentions of the Belaunde administration were to move quickly and forcefully in the direction of turning the economy toward the mechanisms of the marketplace, the original burst of activity of the administration was quickly shattered by the economic realities of the 1980s. Economic hardships internal to Peru as well from the international economic situation were thrust upon the new government, and the long term strategy and goals of the government had to be put aside in favor of the short term economic issues confronting the government. These include containment of inflation, reducing the balance of payments and government deficits, and restructing and reducing the government debt. The fiscal crisis remains today and is likely to continue throughout 1983. Until the international marketplace improves significantly and until the prices the basic commodities emerge from their low levels, there is not likely to be substantial attention given by the government to the economic development model of Peru. The broad outline of the approach has been put in

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place but not all of its elements have been made operational. Until the current set of economic crises is over, it is doubtful that an economic development plan will be the focus of economic policy.

III. ECONOMIC GOALS AND OBSTACLES TO THEIR ATTAINMENT

CHAPTER III. ECONOMIC GOALS AND OBSTACLES TO THEIR ATTAINMENT

The current economic situation in Peru is, as we stated, severe. Collapsing commodity prices, high interest rates on existing debts, weak markets for exports, and the absence of an articulated well-managed economic plan have all contributed to the problem. The key to these problems lies externally with the economic recovery apparently now underway in the United States. Internally, it rests in the ability of Peru to develop and implement a clear economic management plan within a volatile environment.

A sound economic management plan may require the government to make difficult short - term budget choices to reduce the overwhelming budget deficit. To date it has appeared unwilling or unable to do that. Secondly, it involves establishing and working toward clear medium and long - term goals as the focus of economic policies.

In this chapter we state what those medium and long term goals could be and suggest that the private sector can play a critical role in assisting the government to achieve them. We also draw attention to a economic policy orientation which we believe would facilitate the achievement of those goals and provide a sense of direction to the private sector. Finally, we analyze the current macro, sectoral, micro and historical factors which inhibit the achievement of those goals and the related policy orientation. This statement of the goals and economic policies and our assessment of obstacles provide the basis for an economic development strategy which could be adopted by USAID.

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A. Medium and Long Term Economic Goals

Looking beyond the current crisis, economic recovery in the next few years will permit the Government of Peru to devote its attention to a wider number of their stated economic goals. These intermediate and long-term goals for the Peruvian economy include employment generation, growth and policy stability. These goals translate into the following objectives:

- Expand employment opportunities to accomodate the high rate of new entrants into the labor force anticipated during the remainder of the 1980s.

- Increase economic activity through foreign and domestic investment as well as greater capacity utilization in industry. Economic growth will attract foreign investment as well as private domestic investment. The substantial unused capacity utilization that currently exists in the economy indicates that large amounts of investment in the next several years are not necessary to generate significant economic growth.

- Establish an environment of political, economic and policy stability. Such stability is necessary to ensure an economic environment based on fiscal responsibility, effective exchange rate policies, and the containment of inflation through appropriate and visible monetary policy.

- Develop mechanisms which permit a more equal distribution of income. This objective needs particular attention in the long run since the current income disparity in the population of Peru is so large.

- Increase productivity of labor and capital. This implies the appropriate use of technology and education to improve the performance and efficiency of labor and capital in the economy.

- Develop incentives and mechanisms which ensure an efficient and effective distribution of resources. Special emphasis is placed on the use of market signals and marketplace criteria to improve the efficiency of all economic operations and institutions in the economy, public and private.

- Ensure through various macro and micro mechanisms the availability of credit to efficiently meet the needs of all segments of the Peruvian economy, public and private, small and large businesses, the middle class and poor, export and domestic production. A more productive and efficient use of land and its role in the economy should be developed by reinforcing linkages between the agricultural and industrial production sector. Infrastructure should be supported to allow opportunities for the full development of regional areas.

- Implement the privatization plan for public sector firms that more appropriately belong in the private sector.

These intermediate and long term goals for the economy of Peru lead to an economic development strategy for Peru that includes much greater reliance on the private sector and greater efficiencies that can be gained by the use of the marketplace. In this overall strategy for Peru, emphasis is placed upon an outward orientation that generates jobs and foreign exchange for the economy.

Expanding the role of the export-oriented private sector is a key element of the strategy. Private sector exports in Peru have demonstrated results over the last several years. Progress has been made in increasing the dollar amount of exports, and in the last five years exports have increased from 15 percent to 25 percent of the domestic product. To a large extent, this increase has been facilitated by non-traditional exports such as manufacturing, specialized items in the fishing industry, and textiles. Manufacturing has been a major contributor to the increase in exports and currently represents about 25 percent of all exports.

There are a number of approaches to current economic problems that could be enhanced by an outward oriented policy. One is to develop a more diversified export base to absorb the shocks of international marketplace fluctuations. For example, the volatile market for commodities makes the exportation of zinc and copper a "boom and bust" situation where the good years elicit very substantial exports in commodities and where the bad years yield very small exports in those raw materials. In order to stabilize the influence of those dramatic movements in exports, a diversification of the export base could provide a cushion and a more steady export base when world commodity prices are fluctuating dramatically.

Another solution is to take advantage of opportunities to add economic value to raw materials that are mined in Peru. Possibilities exist for raw materials to be refined and in some cases to be manufactured into standard industrial items that could be exported. Moving these raw materials closer to the final product would add economic activity in Peru and would generate employment opportunities.

With the critical needs of the economy, export promotion, especially in the industrial area, offers other possibilities. For examples, export expansion can provide foreign exchange to the economy at a time when foreign exchange from other sources such as petroleum earnings is dimishing. An export-oriented industrial sector can also generate sufficient employment opportunities for the economy by focusing on labor-intensive areas. Finally, export promotion focused on those industries that have comparatively low real costs would contribute significantly to the overall efficiency of the industrial sector.

B. Current Obstacles to Achieving Economic Goals through Export Promotion Policies

However, Peru faces underlying obstacles to expanding industrial exports. The protection and import substitution policies of the 1970s have created unintended biases against exports and the high tariffs on imports of the 1970s allowed Peruvian businesses to remain economically inefficient in their production processes. These companies still maintain a substantial segment, if not all, of the internal market. Thus, the recent lowering of import duties has come at a time when some companies are ill-prepared to be competitive in the international market. Some of these companies may never be in a position to compete efficiently in the international marketplace, while other companies may have to dramatically change their management policies, reduce labor costs, and alter their technology.

This section, therefore, presents our findings of major short and long-term impediments within Peru's business and investment environment. These obstacles are not solely confined to private sector companies but also extend to enterprises which, because of their inherent operational characteristics, should be responsive to market forces.

1. Macro Obstacles

A number of national economic problems and obstacles confront Peru today. These include the recession (combined with high inflation), shifting and volatile government policies, and the historical reliance on an import substitution policy. The major macro obstacles to doing business in Peru are the following:

- The current economic recession is viewed by traditional industries as a normal business condition that will improve.

The recessed market abroad for basic minerals and commodities poses a problem for Peru's traditional export industries, most notably the mining and petroleum sectors. Basic agricultural output and exports have also been adversely affected. However, these industries have traditionally been dependent on highly volatile global markets and the phenomena of "boom and bust" cycles affecting these sectors is not uncommon. The present short-term problems of low capacity utilization and lack of profitability are significant. However, the current economic situation is viewed as a normal business condition which will eventually improve - a viewpoint not shared by managers of firms in other sectors.

- Short-term obstacles confronting existing enterprises severely limit new investment initiatives.

Businessmen have developed a short-term perspective both out of necessity and by design. Faced with declining domestic and export sales, profits and production and an increase in inventory levels, many companies justifiably feel that the short-term obstacles confronting their on-going operations are the most critical ones. Many companies are attempting to scale back their activities but the contraction process is difficult because rigidities exist in the system. For example, because of the labor stability law, businessmen do not have the flexibility to adjust their workforce and reduce what would be normally be considered a variable production cost. Labor costs in Peru are regarded as a fixed cost.

When private companies are undergoing a contraction process, short-term investment for expansion and diversification is not part of their business strategy. In the short term, the potential threats in Peru to the welfare of existing organizations is considered too high to consider new investment opportunities. Most companies believe that before any new investment initiatives could be undertaken there is a need to upgrade and rehabilitate the main activities of existing enterprises as the foundation for any future expansion or diversification efforts.

- Traditional import substitution enterprises are not prepared to compete in a market-oriented economy.

Enterprises which have traditionally relied on the domestic market and which had prospered due to the protectionist policies of the military government have been severely affected by the current economic situation. The current recession has led to substantial excess capacity in Peruvian industries.

The opening of the economy during this period of recessed markets finds inward oriented enterprises highly vulnerable to foreign competition. Companies which have largely evolved under the protectionist umbrella have not been accustomed to serious competitive pressures from imports. Within the domestic market, competition can at best be characterized as oligopolistic with a few firms dominating major segments of the consumer market.

The protectionist era created other inefficiencies which further limit the competitiveness of import substitution enterprises. First, investments in these enterprises have not been necessarily based on rational business or economic principles. For example, many investments were made in capital intensive industries where economies of scale and efficiencies could only be achieved at high production levels. However, due to the relatively small size of the domestic market, these companies were constructed for low capacities. This inherently reduced the cost-effectiveness of the product and placed some firms at a comparative disadvantage in competing in an open market.

Second, government policies encouraged the development of capital intensive industries through an overvalued local currency, subsidized credit, and lower relative import duties for machinery, equipment, and other capital goods. Other policies of the government designed to provide employment security to the labor force have created anti-labor biases in investment and operational planning, further leading companies away from utilization of labor and natural resources.

Protectionist policies of the government designed to protect one firm, oftentimes negatively affected other firms. This particularly occurred in the case of interdependent firms engaged in various stages of the production process. Inefficiencies caused by government policies and passed on from one production stage to next eventually limit the competitiveness of the finished product. For example, a company in the fishing industry reported that the cost of tin plate which was a primary input to their canning activities represented more than 70 percent of total operating costs. Under more market-oriented conditions it should have been less than 30 percent. Because the production and sale of tin plate is controlled by public sector enterprises and low cost imports are restricted, the canning company is required to operate with a higher input cost. Consequently, its competitive advantage in the export market is significantly reduced.

- <u>Government incentives favor the use of capital intensive resources.</u>

Besides high minimum wage rates, payroll taxes and measures which restrict management from adopting flexible management policies, the government provides various incentives which tend to counter its objectives for employment generation. Most noteworthy have been the historical policies of the Central Reserve Bank to maintain the real cost of capital at artificially low levels; and by the government encouraging imports of capital equipment and machinery through lower relative import duties, an overvalued domestic currency exchange rate, and tax incentives for reinvestment.

- Foreign direct investment in Peru is constrained by the small size of the domestic market, competitive factors and structural rigidities.

Traditionally, multinationals invest overseas for a variety of reasons, most notably to secure sources of raw materials, to increase sales within the host country, to take advantage of relatively low costs of labor or other production efficiencies and to provide support services to major host country clients which have located operations in the host country.

In Peru, foreign direct investment has been primarily based on safeguarding mineral deposits and petroleum reserves. To a lesser extent foreign companies have set up manufacturing operations in the country to overcome high tariff barriers for increasing their market share in the country. Also the growth of foreign banks and other financial intermediaries stems principally from a desire to increase their services to existing and potentially new multinational clients.

Our review indicates that very little foreign investment to date originated under the premise of low labor costs or other production efficiencies. These types of investments are normally characterized as host country sourcing activities whereby finished and semi-finished products are later channeled to international markets. To our knowledge very few, if any of these types of operations exist in Peru which have a significant foreign ownership content.

The characteristics of historical foreign investments have clear implications for future investment. For example, a primary obstacle to decentralizing foreign investment from extractive industries to process industries is the size of the domestic market. Even with Peru's total population of 18 million, only 6 million are economically active and have purchasing power. In addition, income distribution is highly skewed; approximately 20 percent of the population receives 60 percent of total income. This domestic market structure poses significant obstacles for companies considering the manufacture of consumer durables and nondurables to be exclusively channeled to the domestic market.

Another major obstacle to decentralizing foreign direct investment into non-traditional sectors of the Peruvian economy is related to competitive issues. While the official position of government is that both foreign and local enterprises are treated equally, the actual business environment of the foreign company is quite different than that of the domestic firm. For example, the management of several foreign companies which compete within the domestic market felt that they were scrutinized more closely with respect to compliance with the complex legal system. Some also believed that domestic firms had certain advantages because of lenient attitudes on the part of the government toward the enforcement of legislation, or their ability to influence decisions of government organizations. Furthermore, U.S. businesses believed that the Foreign Corrupt Practices Act limited their ability to deal on equal terms with domestic companies.

- Government-imposed rules and regulations are perceived by existing firms as excessive and continuously changing.

The need for more cohesive and stable policies in Peru's environment was a prime issue to private business. Many firms viewed government-imposed rules and regulations as excessive, contradictory and continuously changing. In view of the current performance of the Peruvian economy, the inability of the current administration to pursue a consistent set of policies affecting enterprises has compounded the uncertainties among businessmen.

- Potential investors also cite bureaucratic obstacles, uncertainty of the political climate and lack of adequate investment funds.

The investor's time horizon is very short under current business conditions and businessmen are behaving rationally. While there was much expectation that the democratic administration would create more confidence in government, it has not completely materialized. The private sector is losing confidence in the government to provide a stable political and regulatory environment. Businessmen we interviewed cited as deterrents to investment an overly complex regulatory environment, especially in the area of taxation, bureaucratic obstacles to obtaining business licenses, and frequent changes in trade and other policies.

Another deterrent to private sector investment cited by businessmen was the substantial debt burden of many companies. There is a shortage of long-term funds in soles, principally because of tight credit policies adopted by the Central Reserve Bank to control inflation. Foreign exchange funds appear to be more accessible but there is a general reluctance to assume the exchange risks associated with such financing. Currently, companies are experiencing difficulties in servicing existing credit lines and financial costs as a percentage of total operating costs are high. A survey by Peru Economics revealed that a large percentage of respondents indicated that financial costs were between 20 percent and 30 percent of total operating costs.

- Government policies tend to discourage inflows of foreign capital.

Foreign direct investment in Peru is governed by Decision 24 of the Andean Pact and the Peruvian Foreign Investment Code. The government offers foreign companies favorable concessions in areas of taxation and repatriation of profits. Despite these incentives, foreign ownership is restricted to 49% of ownership, although companies may be fully foreign owned if there is no attempt to take advantage of current tariff liberalization policies. The ownership issue per se may not pose significant obstacles to foreign investment initiatives. For some time there has been a general trend on the part of multinationals away from equity participation with direct management control by the parent company to more debt financing, management participation, licensing and technical assistance agreements.

If these same patterns prevail in Peru, foreign investment capital would still be restricted due to the lack of long-term debt financing and a high tax rate of 55 percent levied on royalty payments for patents, trademarks and licenses. In addition, foreign management control over operations is restricted by the Industrial Community Law which provides for workers to participate on the board of directors. It is important to point out that the Industrial Community Law also provides profit-sharing rights to workers either in the form of non-voting stock or as percentage distributions of profits. The intention of the law was to induce greater commitment from workers to the activities of the company and, by so doing, improve efficiency and profitability. But because of the involuntary nature of the profit sharing scheme, many foreign and domestic businessmen believe that the law instead has produced an additional burden to existing high tax and cost requirements.

A constraint voiced by U.S. management is the absence of an Overseas Private Investment Corporation (OPIC) guarantee program in Peru. The government requires foreign investors to forfeit their right for the country of origin to be involved in the settlement of disputes. Given Peru's recent history of expropriation, this may lead foreign companies farther away from equity participation when considering investment opportunities in the country.

- <u>The process for approving foreign investment proposals is complex and time consuming</u>.

The National Commission on Foreign Technology and Investment (CONITE) is responsible for promoting and executing various polices concerning foreign investment, technology and trademarks and for providing assistance to foreign companies in investment approval process. The process is reported to be lengthy and complex despite recent efforts by the government to streamline bureaucratic procedures and reduce maximum time periods for approving pending proposals. Competent legal services are often costly for interested investors.

From our review we found that the process is not radically different from those observed in other developing countries. The approval process is be regarded more as a nuisance rather than a substantial obstacle to investment by the experienced multinational company. On the other hand, a cumbersome and complex approval system does present obstacles to relatively small scale companies and inexperienced foreign investors.

2. Sectoral Obstacles

In our interviews with businessmen, several issues were raised concerning particular sectors of the economy. The mining, commodity, fishing and agricultural sectors have specific economic obstacles that they encounter in the current economic situation. Another sector of the economic, called the informal sector, has become a major economic issue in Peru, and it is discussed below. The major sectoral obstacles are:

- The informal sector plays a influential role in the economy but poses a dilemma to government and a threat to formal business enterprises.

Although the innerworkings of the informal sector of the Peruvian economy are in need of further research, there is evidence that it plays a significant role within the economy. This sector employs an estimated majority of the labor force, responds to market mechanisms, engages in production of multiple products and services and is highly interrelated with formal enterprises in Peru. Furthermore, there is evidence that this sector is growing rapidly.

Its emergence and rapid growth is attributed in part to the number of operating constraints within the formal business environment. For example, complex procedures for obtaining business licenses, high tax rates, labor laws and the inability of the formal sector to meet employment needs have contributed to the growth of informal business activities. These informal activities range from small fruit and vegetable vendors to large enterprises producing finished consumer products such as furniture, textiles, garments, handicrafts, as well as machinery and equipment.

Currently, competition between the formal and informal sectors appears to be balanced. The informal sector operates in a more flexible environment, but the formal sector has greater access to market channels, credit, management and technological know-how.

To businessmen within the formal sector, activities in the informal sector present certain advantages and potential threats. One advantage is that many formal sector companies rely on suppliers within the informal sector for inputs to their processes. This arrangement provides formal businesses economic flexibility by avoiding many of the costly inefficiencies created by the existing legal and regulatory framework. For example, the prices of informal sector goods are competitively determined and not government-controlled.

This interdependence between formal and informal enterprises is an effective buffer for the overall economy when the formal sector is in economic difficulty. The informal economy is able to expand or contract as the market dictates. Thus, the overall impact of a recession can be significantly overstated by the standard and "official" economic indicators. The competitive position and welfare of formal enterprises which are highly tied to the informal sector may be, in turn, understated.

The informal sector is viewed by some as a significant threat to formal enterprises. They believe that the growth of the informal sector has caused the interdependence between the two sectors to diminish to the point where the informal sector is more competitive. This competition may lead formal sector companies to exert influence within the government to curtail informal operations. As the informal sector continues to grow and gains greater economic and, perhaps, political power it may develop new economic and political tactics to protect its position.

For the government, the informal sector poses a dilemma. Recognizing its growing influence in the economy, the government must decide whether to bring the informal sector within the formal legal environment or continue to overlook its existence. The need to expand its revenue base and distribute it more evenly across productive units may force the government to formally recognize the sector and to enforce tax compliance and other laws. However, tax compliance is not evenly enforced within the formal sector, and extending it to the informal sector could be a costly burden. Furthermore, in the process of enforcing compliance it could very well impose the existing rigidities of the formal sector and topple an important and growing element in the economy.

- <u>Peru is highly dependent on the volatile markets of basic minerals and commodities.</u>

Over the years, Peru has had significant success in diversifying its export base. Today, Peru actively exports a wide range of products from petroleum, basic minerals and commodities as well as consumer and capital goods. Despite these advances, Peru's export base is still highly dependent on volatile demand and price trends of international markets. Approximately 80 percent of Peru's total exports are essentially basic minerals and commodities which have relatively inelastic demand and prices are relatively inelastic and fluctuate widely with prevailing conditions in world markets. These products are largely homogeneous and their prices are set by the international commodity exchanges. Consequently, Peruvian suppliers are constrained in their ability to control mineral and commodity prices.

In addition, traditional Peruvian industries exert little control over the supply end of the market. Production costs are largely dictated by the availability of resources and by operational economies applied in the extraction process. Although labor and capital efficiencies can play an important role in the profitability of such industries, this role appears secondary to the more fundamental supply attributes of reserves.

The international markets for non-traditional products appear to be determined more by other competitive forces. While these markets do not exhibit the same volatility that afflicts traditional exports, price and product quality are major determinants. The demand for non-traditional products appears to be more elastic than for minerals and primary commodities.

Therefore, demand for non-traditional products is more sensitive to fluctuations in the domestic foreign exchange rate vis-a-vis other currencies. With the significant growth exhibited by non-traditional exports, it is difficult to determine the extent of the comparative advantage in such exports. The many market imperfections combined with the complex system of incentives and disincentives tend to obscure the true efficiency of non-traditional industries. For example, the policy pursued by the government to keep the domestic currency overvalued in relation to other foreign currencies tends to reduce the potential competitiveness of non-traditional exports. High indirect taxes also reduce the competitiveness of these products. By comparison, subsidized import prices and credit financing as well as export incentives increase their competitiveness by virtue of decreasing operating costs.

Exporters of textiles and non-traditional fish products felt that the CERTEX rebate was necessary to retain their export competitiveness in world markets. They believe that without such incentives sales would not be able to cover costs. The CERTEX was therefore viewed as a mechanism to counter the inefficiencies created by a complex regulatory systems which tended to increase cost and render products non-competitive.

Despite the CERTEX and other subsidies which raise issues of price competitiveness, current trade flows do indicate that a demand for selected high quality, non-traditional goods exists. Textile and garment exports to the U.S. for example, had been increasing rapidly before entry barriers were thrown up by the U.S. Machinery and equipment for the mining and fishing industries and other capital goods appear to be competitive within the

Latin American markets. Exports of non-traditional fish products have also grown rapidly over the past few years.

Through various incentives, the government has encouraged the export of non-traditional products. In the short-term this will help generate badly needed foreign exchange which will be required to pay for increasing levels of imports and to service the country's significant external debt. In the long term, the policy to promote the export of non-traditional products will further diversify the country's export base and accordingly reduce the detrimental effects of volatile swings in the market of traditional products.

The market characteristics of Peru's traditional industries have had important implications on the rest of the economy as well as on the production and exports of non-traditional goods. For example, the government's policy to artificially maintain the local currency overvalued vis-a-vis other foreign exchange has reduced the overall import burden of the country without having a small numbe of select products affect the overvalued exchange rate. Although this policy effectively understates profits within the traditional product industries, it would probably not affect the total value of foreign exchange earnings generated by those industries. This is because prices for basic commodities and minerals are initially quoted in foreign exchange and because their demand is relatively price inelastic.

- Declining production in basic agricultural outputs have made the economy more import-dependent.

Land reform has been combined with price controls and lower duties on imports in the agricultural sector. Between 1969 and 1980 agricultural output has decreased from 15.1 percent to 11.6 percent of total GDP. In addition, Peru has become increasingly dependent on agricultural imports to fulfill basic subsistence needs. Between 1977 and 1981, imports of foodstuffs have increased from $182 million to $457 million, or an average annual rate of growth of 25.9 percent. Major agricultural imports in 1981 included basic cereals and sugar. Sugar, however, has historically represented one of Peru's primary export commodities. This recent shift to imports of sugar is indicative of Peru's growing dependence on imports. This dependence is not restricted to agricultural commodities but extends to other consumer products and intermediate goods as well as capital equipment. However, the difference with agricultural output is that the country has historically shown that it can be more productive and competitive than it is currently.

- The major constraint within the fishing industry is supply rather than demand based.

Within the fishing industry the major constraint to increasing productive capacity has been supply rather than demand based. Past exploitation of resources and the recent difficulties with "El Nino" have created excess capacity in the industry. The anchovy catch, which had been the industry's major export product, declined significantly within the past decade. For example, total anchovy production for fishmeal in 1980 was less than one million metric tons versus 12.3 million achieved a decade earlier.

In response to this rapid decline in production and increasing excess capacity, the industry has embarked on a program to diversify its fishing activities into species for direct human consumption and other types of species for fishmeal production. These efforts have been somewhat successful as evidenced by a steady increase in production and export of non-traditional species. However, the industry has not yet been able to effectively counter the drastic decline in output experienced during the past decade.

The problem of excess capacity does not present major long-term problems in the operations of the fishing industry. Extraction activities can be characterized as relatively flexible operations capable of adjusting within certain limits to changes in market conditions. This flexibility stems largely from the seasonal nature of the industry which makes it dependent on the supply of resources at a particular time. Because of this characteristic, companies have traditionally deployed fishing fleets on a subcontractor basis in order to adjust the availability of resources to expected demand.

Excess capacity is more problematic in the processing activities, where installed capacities are fixed and not amenable to change in order to accomodate fluctuations in market forces.

- Market channels within the fishing industry have shifted.

Aside from the current problem of excess capacity, the fishing industry in Peru is viewed as a mature industry and competitive in world markets. Unlike the manufacturing sector, fishing has had a long history of export orientation. Enterprises within the industry have established marketing and distribution networks with export markets and are knowledgeable of product quality standards and of the export process itself. However, the makeup of export products have shifted from fishmeal to species for human consumption, causing the industry to operate in a different market segment than it had previously. The customer base has changed and the established marketing channels may no longer be applicable to the current product market. The industry is therefore required to seek new markets outside previously established channels. From this arise constraints related to the availability of market information and accessibility to such markets.

3. Micro Obstacles

The current economic environment has also presented a number of obstacles to businessmen as they attempt to organize the factors of production in an efficient and cost-effective manner. The most frequently mentioned obstacles to firm operations were the lack of working capital in this recession and their general inexperience in marketing their products in export markets. The major micro obstacles are:

- Enterprises are facing severe shortages in working capital.

The severe shortage of working capital for financing operations was frequently mentioned by companies. With sales

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declining sharply, the liquidity position of many enterprises is perceived as precarious. This problem is compounded by the absence of liquidity within the financial sector for short-term credit.

Many firms believe that their leveraged position was already beyond reasonable limits and therefore would severely limit their ability and willingness to incur additional debt financing. In some cases, we observed companies which were experiencing stable sales performance but had no access to short-term credit facilities. In this latter case, the cash flow problem clearly limits the ability of enterprises to increase output and to respond to purchase orders.

Shortages in cash flow were not perceived to be a significant burden among the foreign companies interviewed. This may be attributed to the financial assistance available to Peruvian subsidiaries from the headquarters and to the tendency of banks to regard multinationals as lower credit risks.

- <u>Enterprises are reluctant to venture into export markets.</u>

The size limitations of the domestic market should encourage the development of an export base. However, companies which have traditionally relied on the protected domestic market have a limited understanding of the export process and they are generally reluctant to compete in those markets.

We found that this general reluctance is structurally based. Private manufacturers servicing the domestic market perceived that there is a need for improving product quality before Peruvian enterprises can be competitive in international markets. In addition, many companies felt that they were operating with outdated technologies. While this was not perceived as a major obstacle for competing in the domestic market, it was viewed as as a major disadvantage for an export orientation.

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- <u>The labor stability law has unintended side effects but attempts to modify it must reflect labor as well as management viewpoints.</u>

Rather than providing stability for the laborer as was originally intended, the legislation of the labor stability law has produced anti-labor biases. Because of restrictions on the flexible management of personnel, companies are exhausting all other options in their utilization of productive resources prior to creating new employment positions. This has created incentives, for example, to invest in capital versus labor-intensive processes. Other mechanisms outside the formal personnel system are being employed to overcome the rigidities of the labor law. For example, the rapid growth of the informal sector in Peru can perhaps be traced back to the rigidities of the law. Companies within the formal sector are increasing their linkages with informal channels to overcome inefficiencies created by the law. The use of subcontractor services for what would traditionally be viewed as permanent personnel has also been common. Thus, the effects of labor stability law on firm level operations was viewed by private businessmen from two perspectives. First, the effects of the law were serious impediments to their operations and a prime cause of low productivity and high operational costs. The second perspective was that the law created some problems but many of these were manageable. Other factors, such as the availability of capital and access to larger markets, were the real problems which needed to be addressed.

The issue of the labor stability law, therefore, must be placed in a perspective which recognizes that it is a complex issue and that it is simplistic to characterize it as the single most limiting factor to Peru's private sector development. First of all the intended effect of the law, labor participation, is not very different from what has been practiced for many years in Asian companies. Even in the United States labor-management relations are changing to the point where labor stability (tenure) and participation in management are becoming equally as important as wages and benefits in the contract negotiation process.

Second, the labor stability law can act as a social buffer against arbitrary management decisions. For example, at times management can disguise its own inefficiencies in marketing by laying off large numbers of workers to compensate for diminished sales. The law, in effect, places more pressure on management to set and achieve economic goals.

Third, the law acts as a form of social security. If workers were layed off someone must bear the social and economic costs. Usually this will be the government who in turn would tax the enterprises.

We recognize from our analysis that the labor stability law is a complex issue. Dealing with this management constraint may be approached by:

- accurately determining through studies the actual effects of the law on productivity and efficiency, at the firm level.
- developing draft legislation based on those studies which meets the needs of both labor and management.
- developing skills which deal with the effective management of labor.

- The lack of mobility in the workforce diminishes productivity.

Businesses perceived that their workforce was becoming increasingly non-productive because the labor laws have reduced the risk of displacement. It was also felt that the labor laws were partly responsible for low mobility within the labor force, since there is a lack of incentives to improve technical skills.

D. Historical Influences on the Current Situation.

The current obstacles to economic performance in Peru are, in part, attributable to historic factors. Some are alluded to in the previous section but a more thorough analysis is needed to fully understand their impact. This section of the report focuses on the period 1968-1980 since this period had the greatest impact on current events. However, a more thorough discussion of other periods is contained in the other four volumes of this report.

This section of the report first provides summary highlights of the legal and regulatory framework implemented by the military regime that ruled Peru throughout the seventies. Consequently, several repercussions of these policies have become basic structural issues detrimental to Peru's economic strength. An analysis of each of these issues follows the introductory discussion of the policy changes made during this period. The primary economic issues reviewed are:

- Peru's dependency on the United States
- The effect on the private sector of labor legislation enacted during the period
- The consequences of Nationalization
- The impacts of a large government bureaucracy
- The role protectionist policies have played in industrial development

While other factors undoubtedly have contributed to the present economic situation, the above issues are cited as being the most central to understanding how the years 1968-1980 have directly influenced the private sector today.

1. Legal and Regulatory Framework

The period of Peruvian history spanning the years 1968-1980 altered the foundations of the country's private sector in ways that are still being evaluated today. The introduction in 1968 of the Velasco military regime continued later in 1975 under Morales Bermudez presented Peru with some of the most sweeping economic and social reforms in the history of the region. Three of the main features of the military regime that had the most implications for Peru's private sector can be summarized as follows:

- Elimination of patterns of internal and external economic dependence.
- Increase of the role of the State in economic, political, social and cultural activities.
- Decentralization of the economic and political power sources of the country.

While many of the regime's mandates promulgated during this period were founded on careful analysis of existing inefficiences or inequities in Peru's economic system, the results experienced by the private sector were by and large detrimental to an evolution of self-sustained growth. Many historians assert that although the reformist regime proposed for the most part, a sound ideology for Peru, the military in essence borrowed many of the worst elements of divergent types of economic systems and inconsistently applied this maelstrom of macro policies to the country. Moreover, the failure of the Velasco regime to address the needs and limitations of the private sector is attributed to the insular nature of his ruling class. The people and institutions the reforms were supposed to help were not in anyway involved in the decision-making process. What resulted for Peru generally was that the standard of living for the average Peruvian did not improve appreciably, income distribution remained skewed towards those working in the modern sector and living in the coastal region, and lastly the dependence upon foreign multinationals and international finance institutions were emphasized by the experiences of the period rather than eliminated.

Some of the specific actions taken during this period were:

- expropriation of many major foreign controlled firms.
- transfer of private property owned by large conglomerates to the State.
- import substitution policies that required high per-

centage of local content for components/managerial capacity/labor requirements.

- stringent reinvestment quotas of firms' pre-tax income for industrial and technological research and development.

Highlights of the legal and regulatory framework implemented during the seventies for some industrial and agricultural sectors follow.

- <u>Industrial Manufacturers</u>

At the outset of the new regime industrial manufacturers numbered less than 800 firms which generated 80 percent of the G.D. Value of Production (and 20.2 percent of the GNP). Ten percent of these firms were foreign manufacturers concentrated within the industries of chemicals, processed foods, and soft drinks. The regime characterized the foreign firms in this sector as non-competitive and monopolistic. A series of measures were undertaken in order to severely reduce Peru's dependence on these firms for capital and equipment.

Some of the actions taken during this period were to establish industrial development objectives:

1) 1st priority - establish priority industries:

    a) minerals, chemicals, fertilizers, cement, paper
    b) capital formation industries
    c) technology-based R&D firms

2) 2nd priority - development of secondary industries

    a) essentials for the overall population
    b) intermediate goods for industry

3) 3rd priority - transfer of all industry dedicated to luxury goods/non-essentials to the basic priority industries.

In order to accomplish these efforts, tax graduation schemes and reinvestment activities were set up to stimulate this sector. In conjunction with the above, the State "economically reinforced" the regional banks in order to provide capital to priority industries as well as taking a 30 percent ownership in certain industries. Foreign industries theoretically had 180 days after the passage of this reform to reduce their foreign capital to a maximum of 30 percent total. However this policy was liberalized a few years later to accomodate the needs and limitations of the Peruvian private sector. The new policy was called the Andean Pact and it superceded the above foreign capital requirements to the extent that a 15-year graduated schedule was set up as follows (Peruvian Capital):

Beginning 1971

- starting minimum	15%
- 5 years	30%
- 10 years	45%
- 15 years	51%

Another policy intent was to improve marketing and infrastructural linkages between Peru's three major regions as an effort to decentralize the industrial base away from the concentrated Lima-Callao corridor. However, little success was encountered through their efforts.

It was believed that by nationalizing certain industries that the control over plant location and distribution channels would effectively cause a decentralized industrial base. What ultimately occurred was that most State operated industries were poorly managed or under-capitalized. Further they became an excessive burden on the national budget. As a result many businesses floundered and distribution channels were made worse than before State intervention.

- <u>Petroleum Industry</u>

This industry had long been a primary source of foreign exchange earnings for the country. However, since 93 percent of Peru's oil industry was produced by foreign companies before 1968, much of Peru's potential earnings resulted as repatriated profits.

In 1968, the Velasco regime expropriated the largest of the

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foreign producers--International Petroleum Company. The remainder of the petroleum industry was nationalized. At that time, IPC's market share constituted over 80 percent of the commercial petroleum activity in Peru.

Some of the results of these actions were as follows:

- The military regime set oil prices without regard to market fluctuations.
- The industry became highly inefficient, bureaucratic and lacking in experienced managerial talent under State control.
- Daily production fell.

Peru did not compensate IPC for the millions of dollars of losses in assets incurred from expropriation. Peru further claimed the money was owed to them in back taxes. As a result of these actions, the U.S. reacted by suspending Peruvian sugar imports which had been a strong source of foreign exchange and instituted a general diplomatic freeze. Relations were normalized in 1974 when Peru paid the U.S. $76 million, but for some time after, the doors to the U.S. marketplace as well as the international donor agencies and banks were closed. Peru later payed the U.S. $690 million but that action did not remove all of the restrictions.

- <u>Minerals</u>

This major industry group was dominated by three firms in 1968, all foreign. Moreover, at the time minerals comprised of 49.4 percent of Peru's total exports. A major source of irritation to the military government was that the terms from a previous government allowed the mineral firms to hold their fields in reserve indefinitely.

Some of the State's actions after 1968 were as follows:

- obligated the concessionaires to begin working the reserve fields
- took charge of the largest mineral fields, refining and commerce

• began extensive new prospecting

The reforms in this sector were so demanding that no one could fulfill the requirements, and after a relatively short time, the largest firm passed into State hands. As a State operated industry revenues declined precipitiously and Peru eventually tried to encourage foreign investment again by working out agreements with Japanese firms and U.S. investors in order to keep the industry expanding higher than other priority industries. The decline in foreign investment through 1968-75 was, nevertheless, substantial as is shown in the table below.

	1968	1975
Mineral Industry Foreign Investment		
USA	85.0%	37.0%
France	1.5	2.4
Japan	.9	2.9
State	--	43.9
Peru-private	15.5	10.0

• Finance Sector

Before 1968 banks had serious liquidity problems and in large part were controlled by foreign sources. Other channels of credit were expensive and difficult to obtain. Furthermore, a severe lack of coordination between banks and other lending institutions existed.

After 1968 a plan of action was devised of the following agenda:

- progressively put financial institutions under State control
- establish legislation to ensure that the State controls and directs the country's monetary and credit policy
- establish a selective credit system that guarantees financial access to a majority of nationals

- restructure the State-owned banks to improve the efficiencies of their operations

- devise incentives for the expansion of capital markets through creation of COFIDE, a development finance bank.

During the early 1970's, Peru gradually bought out majority shares of foreign banks and limited foreign ownersip of financial institutions to 20 percent. Overall fiscal policy for the country was restrictive with regards to deposit requirements, convertibility, control of currency fluctuations, and inflation, and limited credit availability for foreigners. What primarily transpired within the finance sector was the transfer of capital from the private sector to the State. The State became the primary investor in Peru and reserved credit availability for the priority industries. A public entity acting as the capital investor for Peru had several repercussions.

- Investments were typically dedicated to projects that were very slow to show a return.

- Credit was not extended to manufacturers to produce intermediate goods such as machinery and equipment for Peru's own development of priority industries. Foreign exchange reserves were used up quickly to purchase these goods as imports. The public sector became both the major importer and exporter of what had been private sector goods and services.

- Restrictive monetary polices created spiraling inflation and a devaluation of the sol.

- <u>Agriculture</u>

Like industrial sectors the reforms in this sector were intended to redistribute and reorient the agricultural sector in order to specifically alleviate production inefficiencies and reduce dependence on imports. Agriculture represented 47 percent of the country's labor force but only accounted for 15 percent of the GNP derived mostly from sugar and cotton. The Government took a very strong hand in redirecting the sector. For instance they:

- expropriated large landholdings and divided the land into small parcels, working to promote a cooperatives concept and communal property

- promoted the comercialization of agriculture through the formal sector

- fixed official prices for food and owned and operated a chain of supermarkets

- instituted high tariffs for most imported basic food products

- heavily subsidized certin agro-industries:

  -- range cattle
  -- palm oil
  -- meat processing

However, results of government intervention in this sector often created exactly the opposite effects than those desired.

- The overall value of production and efficiency were lowered.

- Decentralization efforts in marketing and distribution commodities increased costs, disrupted the normal flow of goods and created frequent shortages.

- Agricultural credit of all types was nearly impossible to obtain for small farmers or cooperatives.

The failure of agricultural reforms to facilitate agricultural growth is still influencing Peru. These historical restrictions have caused Peru to become a net importer of basic foodstuffs.

The next section of the report analyzes other basic issues that resulted from the policies implemented during 1968-1980 that have impeded Peru's economic development.

2. Peruvian-United States Dependence

An important issue affecting private sector stability in Peru is the historical dependency on the economy of the United States. The U.S. has long been Peru's primary trading partner both in terms of net imports and exports. The U.S. has also been a very good source of demand for Peru's export based economy and because of this factor, the U.S.'s prosperity transfers to Peru. Strong ties to the United State's economic trends though binds Peru to the vagaries of cyclical fluctuations. When the U.S. experiences an economic downturn as it did in 1974 and again in recent years, the Peruvian economy also lags behind in GNP. Usually the consequences of this dependence are far more severe for Peru because of their reliance on international trade to propel the economy.

U.S. Peruvian dependence was brought to the fore during the military regime of the 1970's. It was at this time that the governing rulers outlined their plan to reduce external dependence. In this case, "external dependency" consisted in the vast majority of instances, of ties with U.S. firms and investors. The regime thus set out on a formal course to purge themselves of what was in essence U.S. economic dependence. However, throughout the decade, the U.S. remained the primary market for Peruvian exports. Up until 1974, world prices for Peru's primary export commodities remained high. Concurrently, U.S. investment in Peru declined and many U.S. firms were expropriated. However, since the U.S. remained the major market for Peru's goods the Peruvian economy enjoyed a tremendous boom. Within a few years, the U.S. economy suffered a pronounced recession beginning in the mid-seventies and likewise did Peru after a buffer period of about 18 months. Export of Peruvian products declined considerably as did imports to the country because of the contraction of trade activities throughout the U.S.

Efforts to alleviate Peru's dependence on the U.S. using the radical policies at the time as instruments for change in fact tended to underscore the continued alliance between the two countries. For example, when Peru experienced a decline in their export markets in the mid-seventies, Peru tried to soften their policies to re-interest U.S. investment. The U.S. was not in a economic position to re-invest in Peru and so Peru's economy declined even further. Moreover, the economic tie between Peru and the U.S. can be charted back to the 1950's unaffected seriously by changes in governments. Regardless of governmental intervention, Peru's economic indicators closely parallel those of the United States and in effect the U.S. has become an exporter of private sector growth or decline. Peru's economy began to accelerate in the latter part of the 1970's as did the U.S.'s but sustained growth was not experienced due in large part to the inefficiencies supported by the protectionist government policies still in effect. With the gradual relaxing of Peru's import tariffs and related trade policies started late in the seventies, the private sector should be able to use the opportunity to strengthen their competitive position worldwide and decrease sole source dependence in their export markets. However, this effort will clearly consume Peru's energies for sometime. The present situation remains one of continued recession in concurrent with the United States. Likewise, thee seems to be little hope of locating as good a source of strong demand as the U.S. until the private sector improves their comparative advantage in world markets.

3. Labor Legislation

In 1978, a set of labor laws were promulgated and incorporated into the Peruvian constitution. As a result, these laws have acted as a deterrent to private sector development in many respects. The laws are intended to provide labor security measures through a system of tenure and entitlements. What in fact has resulted is that these labor laws act as a disincentive for the private sector to hire adequately. This contributes to the unemployment problem and leaves many businesses unable to remunerate terminated employees as required by law without adversely affecting their cash position. In addition, because of the constraints placed upon hiring and firing personnel, the recent lowering of import tariffs has served to expose high levels of managerial inefficiency that had been able to survive under the more protected environment. Presently, the labor laws have been one of the components that reinforce Peruvian comparative disadvantage with regard to domestic and international competition.

Under the present employment system, persons employed by firms may attain full tenure after a period of three years. After this time period, an employed person may only be dismissed for a very grave offense. In addition, the time frame between three months and three years affords the employee a trial period called "imperfect tenure" and also provides significant monetary entitlements in cases of dismissal. Except at the start-up of a new enterprise can the number of employed persons in the trial period exceed 10 percent of the permanent labor force.

The system of entitlements contained as part of Peruvian labor laws provides employed persons who have completed three months of service at termination of service, to compensation based on the length of employment. This compensation must be paid within 48 hours of termination unless the employee accepts deferrment.

What Peru's system of tenure and entitlements does in effect is translate labor costs from variable to fixed which prevents flexibility to charges in demand. The system is a further source of complications for the financial management of an enterprise especially under conditions of inflation for the following reasons:

- The number of employees terminating each year is not necessarily related to the age structure of the labor force and payments of compensation for length of service may be difficult to forecast. In certain years, the magnitude of these payments may cause a serious drain on cash reserves.

- Since enterprises are not obliged to fund the reserves for their accumulated commitments in this respect, they do have the freedom to use as they think fit the cash which must ultimately be made available for compensation payments; but this is not a healthy source of financing, not even for working capital.

The major net results of Peruvian labor laws have been the following:

- Firms have tended to invest in more capital intensive projects than they might have otherwise to avoid the added costs and risks of labor.

- The tenured nature of the labor force has caused a stagnation of talent and skills. Productivity levels declined further since the introduction of the legislation.

- Mismatching of skills and ability with job requirements were reinforced.

During the seventies, inefficiencies caused by the labor laws were sufficiently hidden because high import tariffs gave much of the private sector trade protection against competiton. However, the recent reduction in tariffs in tandem with inflation and economic recession over the last several years has helped to expose a private sector virtually crippled by its comparative disadvantage in world trade matters. This situation is unlikely to change without significant revisions of the labor laws.

4. Nationalization

One of the major components of the military regime of the seventies was the large scale nationalization of major industries in Peru. Of the major industry groupings at that time, many had been dominated by foreign controlling interests. By and large these foreign firms were expropriated and the State took charge of the operations. The public sector then needed to quickly learn how to function as an entrepreneur, investment and financial analyst and manager without previous experience and under many more government controls. One of the main effects of nationalization for the country was the inability of the public sector to generate profits on their operations. Furthermore nationalized firms were dependent upon public funds for investment. It has been shown that during this period of history, capital intensity for all industry categories increased significantly, in real terms. This is estimated to be even higher for nationalized industries. The problem associated with using the public sector to fund investment in nationalized industries was that typically they funded capital intensive endeavors that would not show a return for years to come this depleting then, limited financial resources. Also, the government's ability to gauge financial risks often appeared to be inexperienced.

As a consequence of the government's actions, nationalized industries came to represent a continual drain on the country's limited financial resources. For instance, one-half of the 1981 deficit is tied to public sector investment. Not only was Peru investing in projects with an extremely long time horizon, they were also attempting to pay off the assets of those firms that were nationalized. For example, the nationalized fishing industry represented such a large resource cost to the public sector that Peru was forced to sell back several major fleets to the private sector.

Another detrimental effect of nationalization was rampant inefficiency. On the whole the public sector did not have the technical or managerial expertise to operate these industries as for-profit ventures. The Peruvian private sector, at the time of nationalization, wasn't characteristically involved in the upper most ranks of management. As the private sector was absorbed by the public sector, they were often expected to perform well beyond what their professional experience and capability dictated. This aspect of nationalization in concert with government protectionist directives precipitated inefficiencies that are evident and perpetuated today. Peru has recognized the issue of inefficiency and is responding by deciding to gradually revert some nationalized industries to the private sector and again opening the channels for foreign investment and technical assistance. However, it is not likely that all industries will switch back to private sector. Petroperu for instance is likely to remain a State-run concern as are some others.

An apparent constraint to the de-nationalization of Peruvian industries seems to be tied to the current recession. The issue today appears to be that Peru has to determine what a "fair"

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price would be of selling off nationalized assets while facilitating those industries so that the present contracted economy won't create automatic failure.

5. Government Bureaucracy

During the military regime of the seventies, the creation of a large government bureaucracy acted as an impediment to private sector managerial growth. Throughout the decade, the regime's mandates combined to form an entrenched bureaucracy and further drained the shrinking private sector of a requisite level of resources. Over the course of nationalization, Peru's private sector, in most instances became the domain of the government. As a result, Peruvian industry increasingly affected a non-competitive profile.

The level of personnel and funds needed to operate the bureaucracy was staggering. Moreover, the growing public sector served as a drain of human resources by becoming a principal employer for the country as a whole. The siphoning of talent further limited in many respects the managerial capability of non-nationalized industries and prevented them from developing their operations on the basis of qualified management. Historical performance of the government operated private sector demonstrated that the productive capacity during the 1970's was delimited by several factors: excessive controls, red tape and paperwork, and again the size of management needed to run the bureaucracy of the military regime. Each of these constraints appeared to operate as a cause and effect situation. The regime established tremendous layers of regulatory controls on an industry by industry basis, some of which are discussed earlier. While the intent of the controls was generally to promote industrial development through protectionist policies, the number of people and level of red tape associated with compliance, licensing and transaction records served to facilitate both public and private sector inefficiency. Furthermore, economic development incentives quickly became buried in this bureaucratic morass. It became a system of protectionism at any cost. The residual impacts on the private sector today of creating a large government sector during the seventies is that the emergence of a capable managerial class hasn't developed nor has there been a noticable broadening of Peru's industrial base. The preceding decade appears to have successfully curtailed significant new business activity and many firms are now failing because of inefficiencies that were protected and reinforced by a large government bureaucracy.

6. Protectionism

The protectionist policies drafted during the 1960's and 1970's have today left Peru's private sector unable to compete in the international arena. The economic impacts of the policies actually provided too much protection and as mentioned before, hid inefficiencies. For instance, some of the measures ensured priority industries with extensive recourse to subsidized credit financing, and generous tax exemptions for re-invested profits without tying these policies to productivity levels. High import tariffs and substitution laws kept the international market from encroaching and today these protections hinder the development of sufficient industrial maturity to compete in the international marketplace. Historical data indicate that industrial capacity throughout the seventies remained below 70 percent despite the protected environment. Furthermore, the priority industries that benefited most from these policies tended to have monopolistic or oligopolistic structures which further exacerbated excess capacity because of inefficient operations and a lack of government incentives to increase productivity. Protectionist policies ultimately did not develop Peru's private sector internally but rather gave Peru a formalized blessing to reduce any competitive edge that they might possess and develop for world trade.

Another impact of the protectionist and general industrial policies of the seventies was that they tended to create uncertainty and discouraged private investment in Peru from internal and foreign sources. Moreover, Peruvian private enterprises required extremely high ROI and payback periods of less than a year to attract their venture participation. This severe reticence constricted private sector development then as well as now from both a domestic and an international perspective. Today, Peruvian firms are at a comparative disadvantage with regard to international trade. Two decades of protectionist policies have left Peru lagging far behind regarding important trade functions such as: industrial processes, resiliance against wide price swings for primary exports, increased value added on exports, and diversification of their industrial and economic base.

E. Strategy Framework for Economic Development

Based on the preceding analysis of the major impediments to achieving the overall development goals of Peru we believe the following guidelines act as a basis for a strategy to assist private sector initiatives in Peru:

- Formulate an overall economic development plan which stipulates priorties for the overall economic goals of the country, resolves conflicting policy issues of government and places the private sector into perspective vis-a-vis other elements of the economy.
- Assist traditional import substitution industries in facilitating their transition to be more market oriented.
- Diversify and expand the sources of equity and debt financing for both long and short term needs.
- Rationalize the growing importance of the informal sector to the Peruvian economy.
- Further diversify Peru's export base and reduce volatile swings in the economy.
- Create a more competitive environment within the domestic industry and decentralize the private sector.
- Improve export market channels for non traditional products.

- Reduce disincentives which limit the utilization of labor resources within the production process.
- Increase domestic value added to traditional export products.
- Create incentives for greater utilization of competitive-based resources.
- Reduce growth in Peru's dependence on imports especially in the area of agricultural products and other consumer goods. This could be done by changing the relative prices for agricultural goods.
- Revise legislation to diminish the rigidities within the current operational environment.
- Reduce perceived risk among foreign investors and improve the application process for foreign investments.
- Restore confidence in government efforts toward an open market economy.
- Create more favorable attitudes on the part of private sector investors.

IV. USAID ECONOMIC DEVELOPMENT STRATEGY

IV. USAID STRATEGY FOR ECONOMIC DEVELOPMENT

A. Background

Our report provides a comprehensive analyses of Peru's current economic situation. From our interviews and the source documents that we reviewed it is evident that a systematic economic development program based on an outward oriented economic policy and focused on the private sector, is essential. However, there are a number of obstacles which must be overcome. These obstacles include insufficient domestic purchasing power, a diminished international demand for exports, unpredictable major fluctuations in inflation and exchange rates, large government deficits, slow economic growth and inconsistent policy responses to all of those problems. Furthermore, Peru is distant from its export markets, its geographical stratification creates special infrastructure needs, and fluctuating prices of its export commodities have resulted in characteristic "boom and bust" cycles throughout Peru's history. From a social point of view there is a stratification of its population and alienation of its socio-ethnic population. These social problems are aggravated by migration to Lima and a subsequent centralization of the population. From an external point of view, there is a perception of political instability with the possibility of socio-political upheaval and military intervention.

Aside from these generalized obstacles a number of specific obstacles exist for private sector development. From our interviews with a broad range of individuals and groups and from our independent assessment, we identified several key problems and categorized them according to a macro, sectoral and micro focus. As a basis for developing a USAID strategy, we have organized these problems in relative priority with the more severe problems listed first. However, in any dynamic situation, it is difficult to establish a very rigid prioritization.

Macro obstacles

- Short-term obstacles confronting existing enterprises severely limit new investment initiatives.
- Foreign direct investment is constrained by the small size of the domestic market, competitive factors and structural rigidities.
- Traditional import substitution enterprises are not prepared to compete in a market-oriented economy.
- Government imposed rules and regulations are perceived as excessive and continuously changing.
- Potential investors also cite bureaucratic obstacles, uncertainty of the political climate and lack of adequate investment funds.
- Government policies also tend to discourage inflows of foreign capital.
- The current economic recession is viewed by traditional industries as a normal business condition that will improve.
- Government incentives favor the use of capital intensive resources.
- The process for approving investment proposals is complex and time consuming.

Sectoral obstacles

- Declining production in basic agricultural outputs has made the economy more import dependent.
- Peru is highly dependent on the volatile markets of basic minerals and commodities.
- Market channels within the fishing industry have shifted.
- The major constraint within the fishing industry is supply rather than demand based.
- The informal sector plays an influential role in the economy but poses a dilemma to government and a threat to formal business enterprises.

Micro obstacles

- Enterprises are facing severe shortages in working capital.

USAID STRATEGY TO ASSIST THE GOVERNMENT OF PERU TO ACHIEVE ECONOMIC GOALS

					USAID STRATEGY	
GOVERNMENT OF PERU SHORT TERM GOALS	GOVERNMENT OF PERU STRATEGY	EFFECTS ON ECONOMY OVERALL	EFFECTS ON PRIVATE SECTOR	PRIVATE SECTOR NEEDS	USAID GOAL	USAID PROJECTS
■ Contain inflation	■ Reduce deficit by restructuring debt and decreasing expenditures	■ More funds for government debt and less funds for private sector → illiquidity →	■ Low investment/ low capacity utilization	■ Financial resources ■ Management advice	To cushion the shock to a freer market economy and to overcome the current economic crisis	■ Working capital fund ■ Debt restructure fund ■ Consulting services
■ Provide disaster relief	■ Expend internal/external funding	■ Policy dilemma → policy inconsistencies. →	■ Wait and see attitude	■ Policy stability ■ Economic information		■ Council of economic advisors ■ Economic information project

GOVERNMENT OF PERU LONGER TERM GOALS	GOVERNMENT OF PERU STRATEGY	LIMITATIONS TO IMPLEMENTING STRATEGY	PRIVATE SECTOR NEEDS	USAID STRATEGY: USAID GOALS	USAID STRATEGY: USAID PROJECTS
■ Employment generation ■ Reduce inflation ■ Generate capital ■ Increase productivity	Decentralized, diversified outward oriented market economy through:				
	1. Export promotion	1. Import substitution barriers	1. Visible/consistent trade policies		1. Private sector economic policies study group, council of economic advisors, design draft trade/labor legislation, foreign economy study group
	2. Diversified export base	2. Incentives, market knowledge, management, technology labor laws, finance, dependence on U.S. commodity market	2. Incentives and technical assistance		2. Export trading company, consulting services, technology transfer/vocational training market analysis, export promotion, export promotion fund, U.S. short term training
	3. Decentralization (Geographic, sectoral)	3. Lack of incentives to relocate (tax, labor. infrastructure)	3. Incentives and infrastructure		3. Regional integrated development project, draft trade/labor legislation, private sector economic policy study group, industrial estates/enterprises zones
	4. Foreign investment	4. Legal/regulatory framework, recession, risk in Peru	4. Upswing in economy, political stability, & legal regulatory incentives	■ To restructure the industrial sector to become more competitive, to increase domestic investment ■ To diversify export base, to develop outward oriented policies, to increase foreign investment	4. Investor search, gov't negotiation with foreign MNC. Draft trade legislation, private sector economic policy study group
	5. Domestic investment	5. Lack of identified projects, capital, stability, time orientation	5. Feasibility studies capital, shared risk		5. Feasibility/market analysis, export promotion fund, mutual fund, labor termination fund
	6. Reduce gov't expenditures • curtail gov't activities • increase role of private sector	6. Entrenched public sector, lack of capital, historical factors, social needs	6. Knowledge of gov't plans for expenditures		6. Council of economic advisors, management contracts
	7. Eliminate distortions in incentives system	7. Social reaction, knowledge of incentive effects, special interest groups	7. Consistent implementation of strategy		7. Private sector policy study group, council of economic advisors
	8. Consistent fiscal/monetary policies through plan to implement economic development model	8. Large debt, knowledge of policy effects, political forces, commodity market instability	8. Detail of economic development model		8. Council of economic advisors

- Enterprises are reluctant to venture into export markets.

- The labor stability law has unintended side effects.

- Little mobility exists in the workforce and diminishes productivity.

All of this emphasizes that a significant reversal of Peru's current economic situation probably will not be accomplished in the near term. Rather, some of these problems can only be overcome by an effective program which manages this economic transition based on a comprehensive plan of action.

This economic transition management program is supported by a number of significant comparative advantages that Peru possesses. These include natural resources in the sectors of mining, petroleum, agriculture and fishing. There also are highly capable managers and technicians, although the number of them is not sufficient at the current time.

There are also many examples of successful private sector activities which act as models of successful performance and demonstrate what can be done in the private sector. For example, in terms of companies, Gloria, S.A., has a successful outreach program which provides technological information and assistance to small-scale farms. This economic linkage between a large MNC and small entrepreneurs could act as a model structure through which USAID could provide financial and technological resources to small-scale farms and industries.

On the operations side we observed companies in the textile industry which successfully compete in the international market. Likewise, the ability of the fishing industry to shift from fishmeal to human consumption product markets demonstrates that effective management is key a variable in ensuring the economic viability of a company.

In terms of support to the private sector, several institutions successfully provide a variety of services to the private sector. These include ESAN which is strong in management education; the Center for Research (Universidad del Pacifico) which provides economic information services to private sector companies; and the TECSUP project which demonstrates the willingness of Peruvian private entrepreneurs to take the initative in areas where they have identified a need. Another example of this positive approach is the Association of Exporters (ADEX) whose members are searching for ways to establish an Export Trading Company. All of these examples demonstrate a dynamic private sector which can act as a prime force for change to take place in the Peruvian Economy.

In addition to private sector initiatives, the government of Peru is committed to economic and social change and has made significant inroads in that direction. The current economic crisis provides a prime motivating force for these changes to take place. The experience of other countries in Latin America demonstrate the negative consequences that Peru could face if significant policy reforms are not undertaken in a systematic way and if significant long lasting inroads are not made on the economic and social front. These possible outcomes reinforce the need for change perhaps more so at this time than at any other time in Peru's history.

B. Formulating the USAID Strategy

The strategy which we recommend for USAID/Peru is focused on assisting the government of Peru achieve specific economic goals by supporting the development of market oriented institutions. The basic thrust of the strategy is export promotion and it has two components. The thrust and division of the strategy is based on a synthesis and prioritization of the problems described above inhibiting private sector development. The first component is targeted to alleviate problems in the private sector caused by the current recession and the structural shift to market signals, while the second component of the strategy is focused on longer term goals pursued by the government. (See exhibit on following page.)

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The strategy is based on a cause and effect analysis of the environment within which Peruian businesses must operate. Though the issues are complex we have attempted to identify those factors which have the greatest impact on business operations and suggest an approach for USAID to alleviate the problems caused by those factors. In developing this approach the reasoning described below was applied.

1. Short Term Focus of Strategy

In the short term the government of Peru's prime goals are to contain an inflation rate which may exceed 100% and to provide disaster relief for the parts of Peru which have been devastated by natural disasters. The strategy the government has employed to achieve those goals has created a dilemma. First, to contain inflation the government is attempting to reduce its budgetary deficit by restructuring its foreign debt and decreasing its expenditures. Second, in order to provide adequate disaster relief the government must expend funds. Though outside sources will supply some funding, the bulk of it must, of necessity, come from internal sources. Thus, the dilemma. To contain inflation: reduce expenditures. To provide disaster relief: increase expenditures.

Elements of the governments short term strategy, have had an effect on the overall economy and the private sector in particular. For example, restructuring the goverment debt has increased funds available to the government but because of the conditions of the loan agreement funds have taken away from the private sector. While this may indirectly help contain inflation it has created a severe liquidity problem which, in turn, has inhibited private sector investment and reduced capacity utilization. Furthermore, the need to expend funds for disaster relief has resulted in the policy dilemma and perceived policy inconsistencies. In response to those inconsistencies the private sector has basically adopted a "wait and see" attitude adding another inhibiting factor to private sector investment.

Given this situation the priority needs of the private sector are:

- Access to finance, primarily working capital
- Management advice to use those funds effectively and to learn marketing skills
- Policy stability to allow the private sector to adjust to the transition to a market oriented economy
- Economic information to permit effective planning for business.

USAID can play an effective role in assisting the government of Peru to meet the needs of the private sector In response to immediate financial needs we recommend the USAID establish a working capital fund and a debt restructuring fund for selected export oriented companies. These firm level projects will assist the companies in overcoming the major near term obstacle to private business development.

At the macro level USAID should focus its initial efforts on establishing a strong institutional base to meet the private sector needs for policy stability and effective economic information. We believe that macro level issues are critical to the success of the economic transition in Peru and play a key role in establishing a stable framework in which the market oriented companies can operate.

As part of USAID's near term strategy, therefore, we recommend that funding and technical assistance be provided to the Government of Peru to establish a Council of Economic Advisors. This will provide the government with a mechanism through which it can establish and coordinate effective economic policies. As a critical input to the Council we also recommend that USAID support the establishment of a Private Sector Economic Information Group. This group or institution will also collect and disseminate economic information to private sector companies to act as a basis for planning company operations.

In sum, the USAID goal for the near term is..."to cushion the shock caused by the move to a freer market economy and to overcome the current economic crisis." This first component of USAID's strategy will position the private sector to meet the longer term economic goals of Peru.

2. Long Term Focus of Strategy

As the current economic crisis subsides the government will focus on longer term goals. These include employment generation, reducing inflation to manageable levels, generating foreign and domestic capital for investment, and increasing productivity. The longer - term strategy of the government of Peru is to develop a decentralized, diverisified outward oriented market economy. This strategy is to be carried out through a number of tactical initiatives ranging from export promotion to encouraging foreign investment.The thrust of this longer term strategy is based on extensive private sector involvement. Assuming that the private sector recovers from the near term economic crisis we expect that it will be able to assume that critical role.

Implementing the governments strategy and tactics is, however, hampered by various limitations in the business environment. These include the lack of market incentives in specific areas, notably agriculture; the lack of market knowledge, particularly in the international arena; perceived risk in investing in Peru; and historical factors, such as an entrenched public sector. These and other limitations translate into specific private sector needs which must be met if the government of Peru is to successfully pursue its strategy to establish an outward oriented market economy.

These needs are complex and interdependent However, we attempted to isolate those needs so as to establish a focus for USAID project assistance. These longer - term private sector needs include:

- Visible and consistent macro trade policies

- Incentives to produce for and knowledge of international markets

- Effective legal and regulatory framework within which to operate

- Long and short term capital

- Technical assistance in
  - Management Skills
  - Access to Technology

The USAID strategy to respond to those needs must reflect their complexity. Thus, the projects which we recommend must be viewed as a program of interdependent projects. For example, to meet the private sector need for visible and consistent macro trade policies we recommend a number of different projects to meet that need. These projects include:

- A Council of economic advisors

- A Private sector economic policies study group

- A project to draft trade/labor legislation

- A project to study foreign economies.

The longer term USAID strategy to support a decentralized outward oriented market economy thus has two specific longer term goals:

- To restructure the industrial sector to become more competitive and to increase domestic investment

- To diversify Peru's export base, develop outward oriented policies and to increase foreign investment.

In summary, USAID's strategy is focused on assisting Peru to develop a more diversified export oriented economy using the private sector (including market oriented public sector firms) as the prime vehicle. The strategy is focused in the near term on meeting private sector needs generated by the current economic crisis in Peru. In the longer term the focus shifts to meeting private sector needs caused by the limitations which exist in the business environment hampering the implementation of Peru's economic model for development.

C. Policy Guidelines

The goal and objectives of the strategy should be guided by certain principles which will modify the specific program activities USAID develops to achieve those end results. These principles are:

- The strategy should be focused on economic units which respond to market signals. Primarily this will involve privately owned enterprises but does not a priori exclude publically owned ones.

- The strategy should be based on achieving economic goals which are agreeable to a broad range of constituency groups. It must be viewed as politically and ideologically neutral.

- The strategy should be sectorally focused but flexible to respond to opportunities not originally anticipated. Initially it should focus on the development of agribusiness and manufacturing for products which are related to an outward oriented economy and which capitalize on Peru's comparative advantages in labor and resources.

- The strategy should suport activities which result in a regional and sectoral decentralization of economic power. Initially the strategy should focus on the formal private and/or public sector enterprises but in later years should be in a position to assist the large informal sector.

- Part of this decentralization will be assisted by efforts which diversify Peru's export base. USAID's strategy should build upon economic linkages and networks as they currently exist. Though the thrust of the strategy will be upon decentralization, both regionally and sectorally it recognizes that USAID must deal with various interest groups which under current circumstances are economically centralized and oligopolistic in nature. These include multinationals and some of the economic elite who have centralized power. Nonetheless, because of the interdependent networks that exist between them and some of the more non-traditional entrepreneurs, working with them at this time is in the long-term interest of economic decentralization.
- The strategy must include support for macro policy changes as well as support for firm level operations.

- It must link USAID activities in support of the agriculture sector with those of the industrial sector by promoting tandem policies and activities.

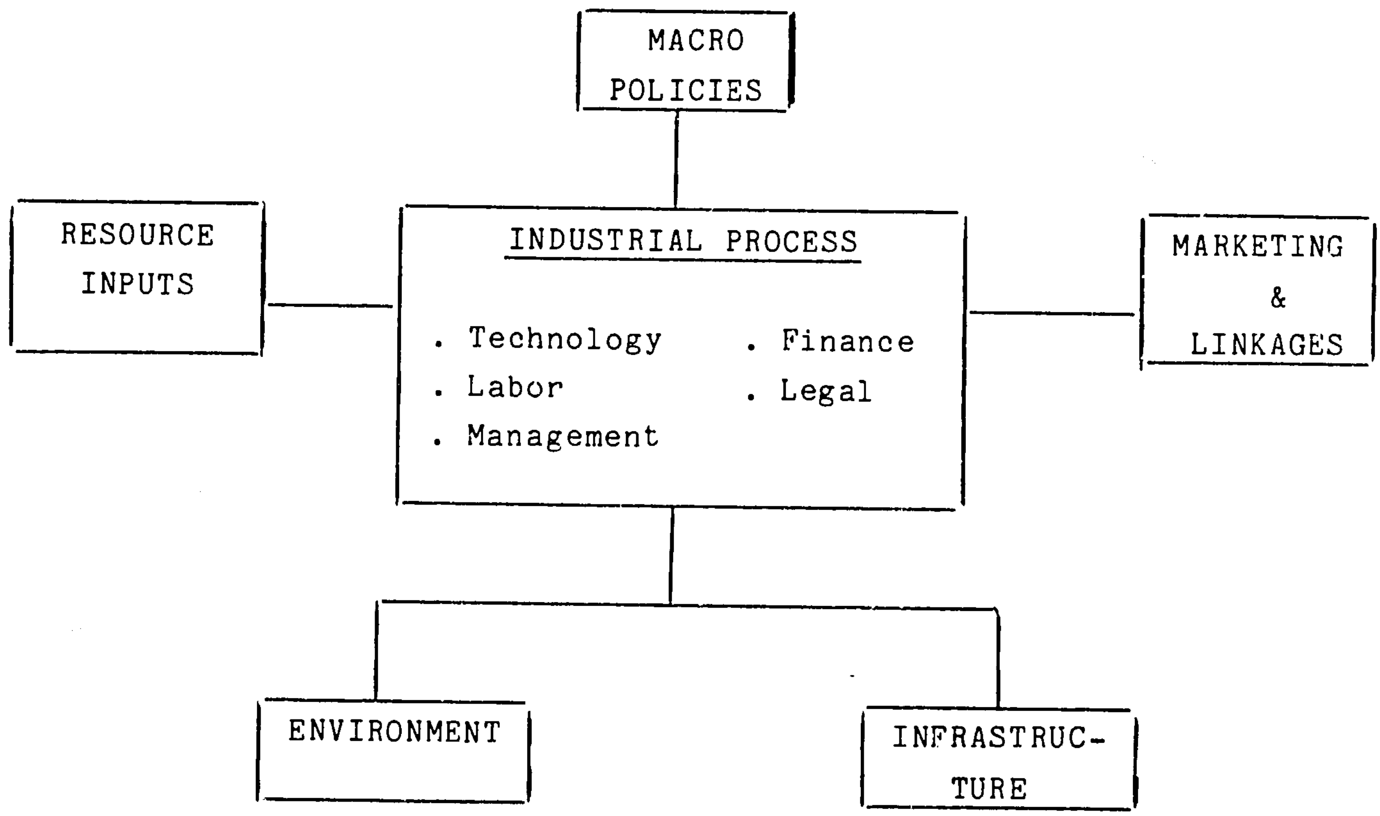
- The strategy should be phased to coincide with the rrent crisis and recovery of Peru's economy. Historically this recovery has followed twelve to eighteen months behind the U.S. economy. Part of initial USAID activities should be aimed at positioning itself to assist increased private sector investment at that later time. Other efforts should be focused in expanding the manufacturing sector during the anticipated recovery period. This focus should encourage Peru to capitalize on an opportunity which they have neglected during past economic upswings.

- Finally, the strategy must recognize that economic obstacles and opportunities are a set of complex interdependent variables and must be dealt with as a system rather than as isolated components. The strategy than should avoid developing isolated projects to resolve isolated problems.

D. A Structure For Possible USAID Interventions

The problems confronting Peru are complex and interrelated and it is impossible to develop projects which are focused on only one problem. However, it is possible to narrow those problems by order of magnitude and focus support activities on those whose solutions will produce the greater economic impact. Figure 1 on the following page identifies the possible intervention points for USAID to consider

POSSIBLE ENTRY POINTS FOR USAID PROGRAMS



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From our analysis of the problems confronting Peru's economic development we believe that these intervention points can be categorized in terms of the order of magnitude of the problems to be resolved.

- The first priority is to provide assistance in the form of working capital, long term capital via loans or equity participation. (FINANCE)
- The second priority is to provide practical marketing related services and management advisory services. In addition projects which provide specific advisory services for studies to support policy development should be initiated. (MARKETING, MANAGEMENT, MACRO)
- The third priority should be to provide technology services to industry including further credit for technology acquisition and use. Projects which support firm level vocational training should also be developed. (TECHNOLOGY, VOCATIONAL TRAINING)
- The fourth priority area should be the development of infrastructure. (INFRASTRUCTURE)

E. Recommended Programs

The next step in the analysis of a conceptual design was to develop a series of projects which we believe achieve the three objectives of USAID strategy by resolving the specific problems Peru is currently facing. The following list identifies the recommended projects while a more complete description of each is contained in Section L of this chapter.

Problem Area	Projects
. FINANCE	.. Working capital loans provided through private commercial banks or COFIDE.
	.. Export Promotion Fund
	.. Mutual Funds
	.. Finance Advisory Services
	.. Debt Restructuring Fund
	.. Labor Termination Fund
. MARKETING	.. Market analysis studies
	.. Develop Export Trading Companies
	.. Export Promotion
	.. Project to establish free trade zones
. MANAGEMENT	.. Consulting services to solve specific medium and small company problems. Linked with management training
	.. U.S. short term training in specialized subjects with emphasis on finance and international trade
	.. Economic Information Program
	.. Private Sector Economic/ Policy Studies Group

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- MANAGEMENT, (Cont.)
  - Combined Public and Private Sector Foreign Study Group
  - Management Contracts to manage public sector companies.
- MACRO
  - Regional Integrated Project
  - Project to provide negotiation services for Peru's negotiations with foreign investors
  - Project to provide studies for background information on economic policy (combined agriculture and industrial sectors)
  - Project to design draft legislation for labor and trade issues.
- TECHNOLOGY
  - Project for medium and small scale industries which links services of VITA, IESC, and multinationals to assess technology needs, identify sources and arrange financing.
- VOCATIONAL TRAINING
  - Project to provide vocational training at the firm level when required to overcome short or medium term problems. Preferrably linked to other projects.
  - Expansion of current project to provide specialized training in accounting and information systems.
- INFRASTRUCTURE
  - Project to establish industrial estates in selected urban area.

F. Sequencing of Programs to Meet Objectives of Strategy

The assumption we made is that the USAID strategy will cover a period of five years. This is done for illustrative purposes and the timing of the project design and execution can be adjusted to meet specific needs. The important aspect is that the strategy has three objectives and those objectives relate to a three part economic transition period. However, periods can and will overlap and some projects what we designate for one period can be moved to another. We have included a matrix which relates the objectives of the strategy to a specific time period and in turn identifies the projects which we believe reduces specified obstacles.

G. Funding Levels

In implementing the strategy three possible funding levels were considered - $50 million, $100 million, and $150 million. Each level was correlated with our analysis of the most critical obstacles to development described in Chapter III and a judgement was made as to which program areas should receive priority at the various funding levels. The figures used should be viewed as orders of magnitude rather than absolute project cost. The table in the following page identifies projects at the various funding levels.

In the construction of this table, we have included only the dollar amount of recommended investments. Not all of these programs yield the same in terms of dollar benefits or return on investment. There are several of the recommended programs which would yield substantial returns although their funding levels are relatively small. For example, in the macro area the project to establish a Council of Economic Advisors in Peru could, in our opinion, have a substantial return in the immediate future as the Government of Peru designs economic policies to guide the economy toward economic recovery and sustainable growth. The nature of the Council project is such, however, that the maximum cost of investment of the project is near $2 million. The benefit/cost

USAID ECONOMIC DEVELOPMENT STRATEGY

	PHASE I (Yr 1)	PHASE II (Yr 2-3)	PHASE III (Yr 4-5)
	OBJECTIVE: To cushion the shock to a freer market economy and to overcome the current economic crisis.	OBJECTIVE: To restructure the industrial sector to become more competitive. To increase domestic investment.	OBJECTIVE: To diversify export base, to develop outward oriented policies, to increase foreign investment.
FINANCE	. Working Capital Loans . Labor Termination Fund . Debt Restructure Fund	. Mutual Fund . Financial Advisory Services	. Export Promotion Fund
MARKETING		. Export Promo on . Investor Search Project . Market Analysis Studies . Free Trade Zone	. Export Trading Companies
MANAGEMENT	. Consulting Services . Economic Information Project . Public/Private Sector Foreign Economy Study Group	. U.S. Short Term Training for Mid-level Managers . Private Sector Economic Policy Studies Group . Management Contracts	
MACRO	. Project To Conduct Background Studies For Combined Policies on Agriculture and Industrial Sectors . Project to Design Draft Legislation for Labor and Trade Issues and for Foreign Investment Policies	. Project to Provide Negotiation Services to Assist Peru with Foreign Multinationals . Feasibility and Planning Project for Regional Integrated Development Project.	. Regional Integrated Development Project
TECHNOLOGY		. Project For Medium and Small scale industries which links services of VITA, IESC and Multinationals to Access Technology needs. Identify Sources and Arrange Financing	
VOCATIONAL TRAINING		. Project To Provide Firm Level Vocational Training to Overcome Short/Medium Term Problems. (Preferably Linked 'th Other Projects) . Expansion of Current Project To Provide Specialized Training in Accounting Basic Information Systems	
INFRASTRUCTURE		. Project to Establish Industrial Estates	

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RECOMMENDED USAID INVESTMENTS
AT VARIOUS FUNDING LEVELS
(IN $ MILLIONS)

PROGRAM / FUNDING LEVEL	$50 M	$100 M	$150M
FINANCE			
• Working Capital loans	5.0	6.0	8.0
• Labor Termination Fund	0	0	2.0
• Mutual Fund	0	0	6.0
• Financial Advisory Services	4.0	4.0	4.0
• Debt Restructuring Fund	3.0	4.0	5.0
• Export Promotion Fund	15.0	32.0	40.5
MARKETING			
• Export Promotion	2.0	4.0	4.0
• Investor Search Project	0	3.0	4.0
• Market Analysis Project	2.0	3.0	3.0
• Free Trade Zones	3.0	6.0	10.0
• Export Trading Companies	8.0	10.0	10.0
MANAGEMENT			
• Consulting Services	1.0	2.0	3.0
• Economic Information Project	0	0	2.0
• Public/Private Sector Foreign Economy Study Group	0	2.0	2.0
• U.S. Short Term Training for Mid-level Managers	0	0	5.0
• Private Sector Economic Policy Studies Group	0	2.0	2.0
• Management Contracts	0	2.0	3.0
MACRO			
• Project to conduct Background studies for combined policies on Agriculture and Industrial sectors	1.0	2.0	2.0
• Project to Study Increased Involvement of OPIC			
• Project to Provide Negotiation Services to Assist Peru with Multinationals	0	1.0	1.0
• Feasibility and Planning Project for Regional Integrated Development Project	0	1.0	1.0
• Regional Integrated Development Project	0	9.0	12.0
• Project to design draft legislation	1.0	1.0	1.0
TECHNOLOGY			
• Project for medium/small scale scale industries linking VITA and IESC activities	4.0	5.0	5.0
VOCATIONAL TRAINING			
• Project to provide firm level vocational training to overcome short/medium term problems	0	0	6.0
• Expansion of current project to provide specialized training in accounting and information systems	1.0	1.0	3.0
INFRASTRUCTURE			
• Project to establish Industrial Estates	0	0	6.0
	$50 M	$100 M	$150 M

ratio for the project, if the benefits could be quantifiable, could be large, and perhaps on the order of 50 to 1. Other small investment projects would likely have large returns or benefits; for example, consulting services and exporting trading companies. It would be anticipated that the larger projects such as Regional Integrated Development Project and the infrastructure project would have proportionately smaller returns compared to the cost of the investment.

1. Low Investment in Strategy

At the $50 million level USAID resources should be focused on the creation, disbursement and effective use of capital, development of markets and market information, the development of sound macro policies, and technical assistance to medium and small enterprises. All of these should be focused on the goal of increasing exports and diversifying the export base. The projects therefore should be aimed at assistance to firms at the micro level, and policy reform at sectoral and macro levels related to exports. Together these initiatives should provide a strong base for companies in the agribusiness and manufacturing sectors to recover from the current recession and expand their markets. Subsequent impacts on foreign exchange earnings, employment generation, and capacity utilization should be positive. Domestic investment should also increase as opportunities increase in the export market as the effects of the current recession diminish.

In the obstacle area of finance we have recommended $27.0 million as an investment. This would be aimed at alleviating the current liquidity problems for firms through the provision of working capital loans ($5.0M) for export oriented companies. In order to reduce the excessive financial costs for firms, $3.0M is identified for a fund to reschedule their debt. As a financial mechanism for companies who are able to invest or for other export related capital needs, $15.0 M is "seed money" to establish an export promotion fund. This is a critical financial base for support to the agribusiness and manufacturing areas and can be expanded through participation of the World Bank, other donor agencies and commercial banks, both foreign and domestic. Thus, the initial $15.0M can leverage other financial resources and in turn allow USAID resources to multiply.

In order to ensure the effective use of that capital a total of $6.0M is for projects related to financial advisory services, management consulting, and specialized training in accounting and other skills. Again these projects would be sectorally and firm level focused and designed to complement the activities of the export promotion fund, debt restructuring fund, and working capital loans.

To remove obstacles in the marketing area, a total of $15.0M is allocated. Prime importance should be given to feasibility studies, legal and regulatory analysis, and technical assistance for the establishment of export trading companies ($8.0M). To support the effective workings of an ETC and other export firms $3.0M is allocated to expanding free trade zones in Peru. Assistance would be provided for feasibility studies, legal issues, infrastructure and so forth. To assist firms in gaining access to and knowledge of other markets $4.0M will be targeted for export promotion and market analyses, particularly related to determining comparative advantage in certain sectors.

As a commitment to decentralization and in a effort to provide a strong technical base to produce competitive products $4.0M is targeted to provide technology assistance to medium and small scale industries. The firms selected for particular attention would be those in agribusiness and manufacturing who are export oriented and those firms who have strong linkages to multinationals, export trading companies and those who operate within industrial free trade zones.

Finally, major efforts should be aimed at establishing a policy framework which encourages investments and allows the economy to grow. For the purpose $2.0M is targeted to provide background studies and policy analysis to link agriculture and industrial policies, and to analyze the impact of factors such as labor legislation and trade regulation on productivity and investment. From these analyses, drafts of proposed changes could be made to assist the government of Peru in policy development.

2. Medium investment in strategy

At the $100M level the basic thrust of USAID strategy should remain the same while adding some complementary projects. All of the projects described above would remain in the program but with some projects receiving significant increases in funding. For example, the export promotion fund would be increased by $17.0M.

In the marketing area an investor search project ($3.0M) would be added to stimulate foreign investment particularly focused to attract small and medium level U.S. enterprises. This could be coupled with the free trade zones project to give that activity more depth.

In the management area three new projects would be added. $2.0M is allocated to support a series of foreign economy study groups. Composed of a broad range of individuals, they would be given the task of analyzing how various countries have moved from closed economies to more open ones. Practical in nature, these reports would provide operational guidance to Peruvian entrepreneurs.

Additionally $2.0M would assist in the establishment of a Private Sector Economic Policy Study group. This would be a new institution not affiliated with the National Institute of Planning, but rather as an adjunct to a trade association, chamber of commerce, or university. Its focus would be to research policy issues of particular relevance to private sector (formal, informal, large, medium, small) which act as a concrete basis for policy dialogue between the private sector and the government.

At this funding level efforts could be initiated to assist the privatization of certain public sector companies. In this regard $2.0M is identified for studying the feasibility of using management contracts in lieu of the current plan to sell these companies.

Additional projects added at this level would be a project to assist the government of Peru to establish negotiation criteria for foreign multinationals, and developing a regional integrated development project. In this latter project USAID resources would be channeled to a particular area such as Arequipa and an integrated group of projects (e.g. finance, marketing, management) would be targeted to selected companies within that region.

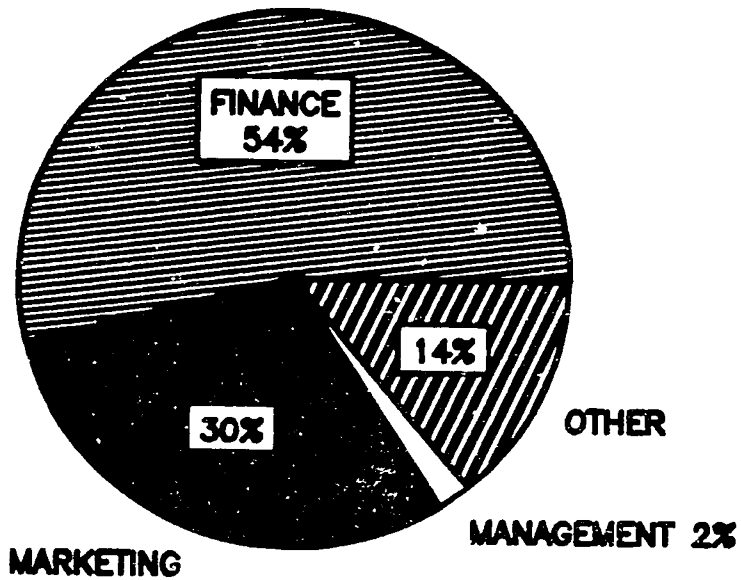
3. High Investment in Strategy

At the $150M level USAID's strategy of developing an export oriented, decentralized market economy is reinforced by additional funding to the projects identified above but moves outward to more innovative projects. (The chart on the next page illustrates the shift of resources at two levels of funding.)

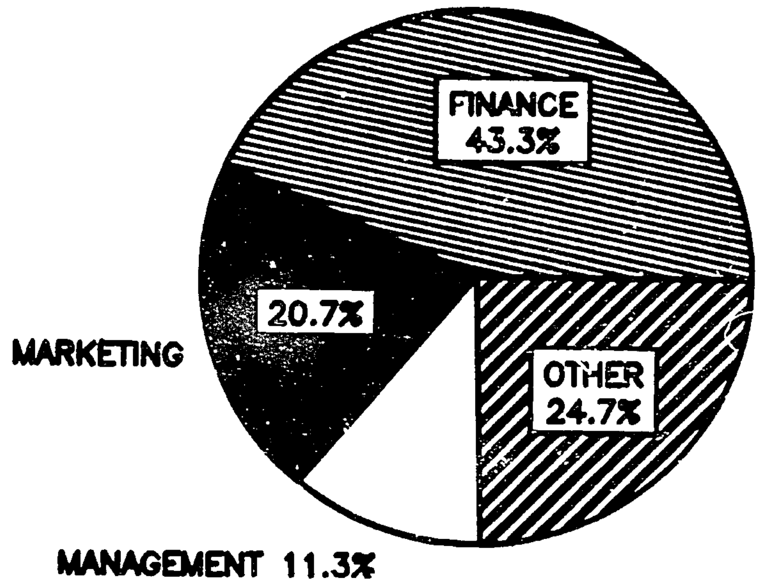
In the finance area two additional funds are established. The first is a labor termination fund ($2.0M) which pools the resources of companies who have to pay severence to workers who leave a company, a chronic problem in Peru. Further, a mutual fund ($6.0M) could be established on a limited basis to allow investors to share the risk among investments in several companies.

In the management area a project for $2.0M is aimed at providing on a regular basis industry specific economic information for private sector managers. In addition, $5.0M is added to provide short term training in the U.S. for selected mid-level managers. This could be an add-on to many of the previously described projects and should be focused on those companies which are export oriented.

U.S. AID
PRIVATE SECTOR DEVELOPMENT



$50M FUNDING PACKAGE



$150M FUNDING PACKAGE

As an adjunct to the management consulting service project and the technology transfer project $6.0M is allocated to vocational training at the firm level to solve specific company problems. It is primarily aimed at upgrading the skills of workers and not at preparatory skills. Finally, at that funding level $6.0M is identified for infrastructure particularly related for establishing industrial estates in the jungle area as it begins to open to industry.

H. Beneficiaries of the Program

For private sector economic development, the beneficiaries are generally those persons and businesses that take advantage of the marketplace. For example, in the working capital fund, those firms which meet their needs through the fund will be contributing products and employment in the marketplace during the recovery rather than being bankrupt. The beneficiaries will thus be consumers and persons employed by the firms. In the marketing studies, the ultimate beneficiaries are the consumers that purchase the product and the employment generated in the export oriented firms that identify market opportunities through these studies.

I. Management of the Strategy

The situation in Peru is characterized by uncertainty. One of the principles of the recommended strategy is that it is flexible to respond to changing circumstances and this depends on USAID continually assessing the needs of the private sector and their response to shifts in governmental policy. To do this assessment, we recommend that USAID use the private sector officer within the mission in three ways: first, to establish an advisory group composed of leading businessmen, labor leaders, management educator/consultants, and others as appropriate. This group would act as a liaison with the private sector and USAID to discuss program/project content and execution, provide feedback as to changing needs, and offer entry for USAID to specific elements of the private sector. In addition, it would provide USAID with information to base its policy dialogue with the government of Peru on matters pertaining to private sector development. Second, the private sector officer could act as a liaison with consulting groups during project implementation to ensure that coordination occurs between contractors and that the projects are working in tandem. As the strategy is implemented over the years, these contractors could become part of the advisory group and provide useful operational data to support future policy initiatives, or the restructuring/refocusing of projects as circumstances change. Third, the project officer can act as referral service for the projects and stimulate demand for their services within the private sector. Though the projects we recommend are based on our analysis of need, some elements of the private sector may not know of the existence of the services offered when a project is implemented. This is a problem related to the heterogenous nature of that sector as opposed to the homogeneous nature of governmental agencies through which more traditional projects are implemented. This can be overcome by the private sector officer maintaining continual contacts with various associations and organizations in the formal sector as well as through existing contacts in the informal sector.

The management of the strategy thus suggests that USAID play a key coordination role for the private sector in Peru, and position itself to guide its resources to meet changing needs.

J. Project linkages within strategy

The projects which we describe stand alone in terms of our overall recommended strategy. Each could be designed and implemented in a way which addresses a specific problem. However, experience with the problem of economic development through the private sector indicates that strong linkages between project activities must be established, primarily through the management and focus of the projects. For example, in many cases in Peru providing financial assistance to a group of companies will not of itself solve a problem unless those resources are applied effectively. The application of the funds usually is contingent upon solving problems of another nature such as knowledge of available markets or appropriateness of technology required. To deal with this complex situation three related solutions are apparent. First, a formal diagnostic component is designed into each project. This allows the project executors to determine if the services of that project will meet their intended outcomes or if other solutions are applicable. Second, a formal referral mechanism is also designed into the project allowing project executors to refer clients to other projects if the diagnostic indicates a need. Third, single projects are grouped into a program which has a common management group, and a common focus.

In implementing the strategy we recommend that these three solutions be incorporated into the design. Many of the projects, lend themselves to this type of arrangement and consequently the intended impact of USAID resources could be multiplied beyond the intended effects of a single projects. For example, the management consulting services project could be linked both to the management contracts project, and debt restructure fund; the free zone project could be linked to the investor search project and the export trading company project. Other possibilities exist and this issue of linkage should be of prime concern in the project design phase.

K. Relationship With Program of Other Donor Agencies

The World Bank (WB) and the Interamerican Development Bank (IADB) provide significant funding to Peru. In 1982 the World Bank Approved \$286.7m for Peru with the majority of funds identified for transportation (\$93.0m), energy (81.2), agriculture (\$40.6m), and water supply and sewerage (\$40.6m). However, \$26.0m was targeted for small scale enterprises and another \$5.3m for industry.

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The IADB similarly targets its resources to energy and infrastructure. For example, though it targeted $291.15m for Peru in 1982 only $35.0m or 12% was identified as industry related.

Discussion with these donors led to some conclusions about their relationship with SAID's strategy. First, both donors are heavily involved in infrastructure and energy and their capacity to fund projects of this nature give them a comparative advantage vis-a-vis USAID.

Second, both the WB and IADB emphasis on energy should be encouraged in light of the economic crisis. In the short term Peru needs to generate a significant amount of foreign exchange and most likely this will occur through the traditional export area of mineral resources and surplus oil. The need for Peru to avoid becoming an oil importer is critical and attempts by the WB and the IABD to develop alternative domestic sources of energy should be supported. Where USAID may play a role is through policy dialogue with the government of Peru to support efforts by the other donor agencies to create a policy climate in which foreign investment can systematically explore oil resources.

USAID's strategy as outlined in this report is thus supported by the activities of other donor agencies and is complementary to their development objectives. However, we suggest that this strategy be shared with the other donor agencies and a donor coordination council be established to formally discuss the allocation of resources in the industrial sector in order to target similar objectives and recipients. For example, the project to establish an export promotion fund would be an effective vehicle through which USAID and other donor agencies could leverage their combined financial resources. The USAID private sector advisory group, described above, could be an important input to help shape the programs of other donors to effectively address the needs of the Peruvian private sector in a more focused way.

L. Project Descriptions

In the following section we provide a conceptual design for the projects which we recommend as the tactical application of USAID's strategy for economic development in Peru. They are focused primarily on the private sector but include some interventions in the public sector.

The project descriptions are intended to provide a sound foundation upon which more exact design work can be based. We expect that at the design stage there will be an opportunity to restructure projects as new information is generated and discussions of this report are completed.

INDEX TO PROJECTS

● F I N A N C E

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WORKING CAPITAL LOANS

In the current economic recession, the greatest need is to counter the illiquidity that exists in the economy for private sector funds. Recent loan from international banks to the Government of Peru has addressed its needs for restructuring and rescheduling its loans, however a by-product of that loan has been the withdrawal of numerous lines of credit from private sector firms in the Peruvian economy. This has led to a situation where financing is not available at any rate of interest and yet there are working capital needs for funds to maintain normal business activities during the recession. Furthermore, because of rapid inflation, working capital needs will increase reflecting the amount of inflation in the economy.

The goal of the project is to provide working capital funds for established firms with established products and production techniques as well as international markets for that products. This will ensure that sound economic entities will contribute foreign exchange and employment during the economic recovery without going into bankruptcy or interrupting the flow of goods to the marketplace during the current recession. Funds for working capital needs would be made available to the banking system for use by selective and targeted industries. Several criteria that should be used for the dispersal would be the following:

- exporting firms
- small and medium size firms
- selected industries such as agro-industry and manufacturing
- a sharing of risk in part by the banks
- terms would be competitive and short term, in most cases, not more than one year.

In summary, this working capital fund would meet the immediate and most essential needs of private sector firms in the immediate future.

EXPORT PROMOTION FUND

1. Goal and Approach

The goal of the project is to promote economic growth and employment in Peru by providing an export promotion fund for medium and long-term lending, accessible to private enterprises which are export related. The fund has two key objectives:

- to provide long-term capital for investment by lengthening and leveraging liquidity
- to create alternative sources of capital by strengthening linkages within the banking community

In Peru lending by commerical banks is limited to short term loans generally for operating expenses, although these are apparently frequently rolled over, disguising longer term loans. The banking community is reluctant to make long term loans, given the perceived risk in the Peruvian environment and the opportunity cost of funds which could be invested more lucratively elsewhere. By sharing the risk of long term investments, the fund will encourage greater private investment and thus play a key role in strenghtening linkages between (and among) the banks and private sector companies.

The creative element of the option is its flexibility. While its key feature is the channel, it can incorporate a wide range of modes, targets and terms. Further, it is a dynamic approach in that it can evolve in a number of directions over time to accommodate the changing needs and interests of both the GOP and AID.

2. Institution

A key to the program's success is that USAID funding will be channeled through a new, independent, nonbureaucratic fund unencumbered by existing staff or other agendas. As will be elaborated upon below, the fund will not operate as an institution but rather as a flow-through mechanism between AID and financial institutions. It will serve as a complement rather than a competitor to existing institutions such as COFIDE. In time, we expect it to be self-generating, continuing to mobilize capital even in the absence of AID participation.

3. Operation

a. Funding Levels and Sources. The fund should be initiated by a substantial commitment from USAID, perhaps $8-12 million annually at the outset. The annual commitments could gradually rise to a level of, perhaps, $20 million. The increments would be based upon a review of the fund's performance, and the speed of disbursement, and availability of USAID resources.

Another factor would be the level of participation by other donors, including the GOP. Advantages of GOP participation include the possible enhancement of a constructive economic dialogue and availability of local currency for lending. Disadvangages, at least at the ouset, might be the potential risk of a delayed startup, and the increased complexity of decison-making. Similarly, participation by other bilateral or multilateral donors, such as the World Bank or Inter-American Development Bank, poses greater complexity and the loss of a clear U. S. identity, offset by the gain of political neutrality. Joint participation, whether by the GOP and/or other donors, also offers the potential to dilute tied USAID requirements. In weighing the advantages and disadvantages of other donor participation, USAID must evaluate the level of visibility it desires, the problem of tied procurement rules, the complexity of administering the fund, and the potential for policy leverage offered by joint or sole USAID funding. The key to the fund is precisely its flexibility; it can start off with U. S. funding be be designed to accommodate future participation by other donors, including the possibility of an eventual phase-out of U. S. participation or operation as a revolving fund.

b. <u>Mechanism</u>. The fund will shift as much responsibility as possible for project creation, appraisal and administration, away from USAID and onto existing financial institutions. In other words, the financial sector and the private sector companies, should become the driving force to bring industrial projects to the fund. The question arises, how can banks and private sector companies be encouraged to do so? In order to answer this question, we need to understand the types of risks that are involved.

Given the term structure of their deposits, banks are unwilling (and in cases unable) to lend long term, since they would then face a large interest rate risk. As a basic principle, we would argue that economic agents should not be forced to bear risks over which they have no control. Thus it would be desirable for the fund to absorb the risks of interest rate fluctuations, thereby giving banks greater freedom to lend long term. At the same time, banks should be expected to bear default risk, since it is their proper function to judge the degree of risk involved and to decide whether to accept or reject that degree of risk. Since the fund will rely on the judgments of the banks regarding the viability of the projects being funded, it is vital that banks have a strong incentive to do a good job. Bankers seem quite prepared to bear some of this burden, although reluctant to bear all the credit risk unless they were backed by a Government guarantee. Of course a 100% guarantee would eliminate the risk of default entirely and thereby defeat the purpose. It may be worthwhile to consider a partial guarantee, however. This could be part of the rediscount facility at the Central Bank. With regard to companies, we would argue that they should not be asked to bear any interest rate or foreign exchange risk, since they influence neither.

The ability of the fund to leverage additional private funds, we expect, will be attractive.

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The fund could participate then through three distinct mechanisms, separately or as a hybrid:

(1) The fund could make loans to companies that are cofinanced by banks or other financial institutions such as insurance companies (present Peruvian law modified) or the investment funds or professional syndicates. A participating bank, which was itself extending a loan or equity participation to a project, would present a project to the fund to meet additional foreign exchange or local currency needs. The cofinancing institution would thus be supplying both financing (and therefore sharing the risk) and professional judgment as to the project's viability. The latter is especially important given the fund's intended minimum staff.

As argued earlier, it is critical that the default risk be shared by the fund and the bank throughout the period. Any percentage sharing ratio is possible. Bankers in principle seem to be willing to take 50 percent or more. The interest rate risk would be borne by the fund. Bankers would be unwilling to accept terms of longer than seven years; to allow for this the banks could receive all their repayment in the earlier maturities, while the last few might accrue exclusively to the fund.

(2) The fund could provide all of the needed funds for an industrial project loan in the form of a term deposit with the bank. This approach thus reduces the liquidity risk of banks traditionally reluctant to tie up their funds for long term lending, while the bank faces all of the credit risk in return for the potential income from the term deposits. Like the first mechanism, this approach minimizes the management drain on the fund and AID by relying on the project appraisal capability of the bank or other participating financial institution.

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(3) As a variant of the second mechanism, the fund could place tranches with selected banks with guidelines for the types of investments that would be permissible. In other words, rather than waiting for a bank to come forward with a specific project, as in the second approach, the fund would deposit a sum, in advance of any specific project ready for funding. The proposal might be attractive to banks, in that they would receive a block of funds at once, and poses the least administrative burden for the fund, but has the possible disadvantage of reducing the fund's control over project selection and timing. To prevent speculation a commitment fee should be charged on unused funds.

c. Management. Two approaches are possible for managing the fund, which could operate independently of any existing Peruvian institution. The fund could be managed by a skeleton staff consisting of a Director and Assistant Director, each with previous banking experience, and appropriate clerical support. Alternatively, management of the fund could be contracted out to a professional financial management firm such as an international investment banking house. In either case, the fund would be audited by an independent accountant who would monitor disbursements, and advised, e.g., on contractural arrangements, by an outside attorney. The staff or contractor would be responsible for management of the funds, i.e., treasury operations, if the first or second options were chosen.

In either case the fund would be overseen by a board of directors composed of five to seven Peruvian and foreign bankers, government representatives and members of the business community, rotated on a staggered basis every two years. It should be emphasized that the fund must operate independently. The function of the board would be to establish review policies and guidelines for the fund, to review the fund's effectiveness periodically, and formally to approve loans, already evaluated by the banks.

d. Eligibility. The financial partners (or recipients of term deposits) should include a representative mix of commercial banks including foreign branch banks, and development finance institutions. Other financial institutions such as insurance companies and pension funds could participate directly or belong to syndicates managed by banks. This of course, would necessitate a change in the law governing investments by this latter group.

Projects eligible for loan or equity assistance would include captial plant and modernization and in the case of new or spinoff companies, new facilities. As a focusing and rationing device should the demand for the use of the fund exceed its availability, the Board may wish to consider guidelines such as:

- high economic rate of return
- industries in which Peru has comparative advantage
- labor intensive industries
- public sector companies participating in an experimental management autonomy program
- joint public/private sector industrial projects
- companies whose managers have participated in financial and management training programs
- feeder industries to the export sector

One comprehensive approach would be to earmark all funds, at least for the initial years, to a particular sector, such as agro-business or export manufacturing. A proportion of the funds could be earmarked for small enterprise.

e. Terms. The banks or participating financial institutions would pay a fee for the use of the fund contribution, perhaps the Central Bank's maximum industrial rate less a spread sufficient to attract bank participation. The borrower would be lent, in turn, the fund contribution at that rate or less, depending on whether concessional rates are necessary to attract borrowers given the costs of tied U. S. aid. A progressive interest scheme

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might be effective, especially for new businesses, in which borrowers pay 75 percent of the CBE the first year, 80 percent the next, and so on, until the full rate is reached. The fund would make up the difference. This system imposes interest rate risk on both the borrower and the fund, given the fluctuating CBE band, which is undesirable. As an alternative the fund could charge a fixed rate, with a gradually increasing fixed schedule of rates for the first five years. A ten year repayment schedule, with a two year grace period, is envisioned.

The fund may wish to target some of the interest repayments (e.g., 2 percent out of a 12 percent rate) for a particular purpose, such as vocational training, or accounting or management assistance. Such peripheral programs imply, of course, a more extensive staff than the skeletal version envisioned at the outset.

4. Advantages

The fund approach offers a number of advantages:

- Flexibility to incorporate a number of donors, financial mechanisms, recipients and to accommodate changes over time.
- Inceases ties among the banking system and public industrial firms.
- Leverages and lengthens liquidity for industrial projects.
- Encourages greater investment from the capital market.
- Shifts the burden of project review and management from AID to the financial burden.
- Potentially strengthens links between AID and other donors.
- Could evolve into a mechanism that could consolidate other AID programs in which funds for specific purposes have not been spent.
- Could become a revolving fund and hence a permanent source of investable resources.

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- Has the potential to coordinate with other AID programs.

5. Disadvantages

- Start-up time may be marginally longer than would be required by direct funding of banks.

- Depending on the size, composition and vested interests of the board of directors, there could be potential infighting over criteria and other issues.

- An excessively complex weighting scheme for rationing funds could bog down the disbursement process or be a disincentive to bank participation.

- Without concessionary interest, at least in the early years of repayment, participants may not be interested, given the added costs of tied USAID.

- Because projects will be screened through banks, finanical rate of return will undoubtedly be an inherent criteria. Thus, some socially desirable projects with low financial rates of return may be screened out before even reaching the fund.

FORMATION OF MUTUAL FUNDS IN PERU

Current Situation

Mining and agriculture appear to be possible areas of activity where private sector investments would benefit the Peruvian economy. Potential private investors, however, may be reluctant to incur the risks attached to investments in either area - in mining on account of the unpredictable fluctations of world market prices, and in agriculture on account of the vagaries of the Peruvian climate. They might be more willing to invest their funds in a combination of enterprises operating in those two and possibly other lines of activity, with the expectations that unfavorable results in one area might be compensated by favorable results in another.

Proposed Project

A mutual-funds type of financial institution could offer an opportunity to provide investments of this nature. These institutions would issue shares to raise investment capital for equity participation in private sector enterprises, not only in mining and agriculture but also in other areas of activity such as industries processing domestic raw materials or agro-industries. The investments made by the financial institutions would be divided between the various areas of activity in predetermined proportions laid down by statute. Separate institutions could be formed to invest in different regions ("costa", "sierra" and "selva") or national institutions could divide their investments between regions also in accordance with statutory proportions. The diversification of the investments both by regional location and area of activity should be devised in such a manner as to minimize the impact on the overall financial results of unfavorable factors in certain ventures.

To achieve this objective, the aggregate amount of funds invested in any one area (sectoral and/or regional) should never exceed its statutory proportion of the paid-up capital of the

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institution plus the free reserves. To avoid temporary disproportions while some of the paid-up capital is not yet invested in equity participation, investments in any one area should not exceed its statutory ratios to investments in other areas by more than 20 percent. (For example, with a paid-up capital of soles 100,000 million and the following assumptions:

		Amounts in Millions of Soles		
				Upper limits (underlined)
Area	Statutory Allocation	Absolute Maximum Investment	Already Invested	Ratio To Area
A	50%	50,000	30,000	
B		15,000 (5/3) =	25,000 (1.2) =	30,000
C		12,000 (5/2) =	30,000 (5/2) =	36,000
B	30%	30,000	15,000	
A		30,000 (3/5) =	18,000 (1.2) =	21,600
C		12,000 (3/2) =	18,000 (1.2) =	21,600
C	20%	20,000	12,000	
A		30,000 (2/5) =	12,000 (1.2) =	14,400
B		15,000 (2/3) =	10,000 (1.2) =	12,000
Total	100%	100,000	57,000	

Investments in areas A and C having reached their limits (as measured by their ratios to investment in Area B) may not be increased as long as the investment in Area B remains at the level of 15,000. If the investment in Area B alone is increased up to 21,600, the new limits for future investment in Areas A and C (separately) become (lower amounts, underlined):

- for Area A: by ratio with B: 21,600 (5/3) = 36,000 x 1.2 = 43,200
  " " " C: 12,000 (5/2) = 30,000 x 1.2 = 36,000
- for Area C: " " " A: 30,000 (2/5) = 12,000 x 1.2 = 14,400
  " " " B: 21,600 (2/3) = 14,400 x 1.2 = 17,280

The investments in all three areas could be increased simultaneously as long as the increased amounts fall within the absolute limits of 50, 30, and 20 billion soles and remain in the proportion of 5, 3 and 2 for investments in areas A, B and C respectively.

The success of a scheme of this sort requires that the investments meet strict criteria of profitability as projected by sound feasibility studies. We suggest that AID should make a fully paid-up contribution of, for example, 20 percent of the initial capital of the financial institution(s) against the issue of preferred shares to provide resources to pay for the feasibility studies and for operating expenses before the investments reach the stage of profitability and pay out dividends to the parent financial institution(s). The rest of the capital would have to be subscribed by private investors in the form of ordinary shares. Payment of these could be made in installments of 25 percent called up as needed, as new investment opportunities develop.

A mechanism should be set up for the ultimate release of the initial financing provided by AID. For instance, a sinking fund for the redemption of AID's preferred shares could be set up according to statutory rules calling for a yearly allocation of an appropriate percentage (e.g., 10 percent) of gross revenues from equity participation and other financial investments. When the sinking fund reaches the value of AID's preferred shares these would be redeemed and replaced by ordinary shares distributed as a bonus to the ordinary shareholders in proportion to their holdings. The prospect of this bonus should act as an additional incentive for private investors to invest in this sort of venture.

Until the preferred shares were redeemed (after several years) they would be entitled, profits permitting, to a first dividend of 10 percent of their par value but not exceeding a fixed percentage of net income as laid down in the statutes (e.g., 10 or 15 percent). The shareholders would decide what portion, if any, of the remainder of the net income should be paid out as dividends to the shareholders; that portion should be distributed between the preferred shares and ordinary shares in such a manner that the total amount paid out to each preferred share (including the first dividend mentioned above) and the amount paid out to each ordinary share should have the same percentage value in relation to the amount paid up on the shares of each class.

We believe that one or more financial institutions sponsored by AID on the pattern outlined above could act as a powerful catalyst to mobilize funds for investment in high priority ventures in the privte sector in Peru. We also suggest that institutions with different blends of investments (according to regional location or area of activity) should be set up to appeal to different categories of potential investors.

DEBT RESTRUCTURE FUND

Immediate financial assistance to indigenious enterprises in Peru can be provided through a mechanism which reschedules their debt obligations. A program of this nature would benefit enterprises currently attempting to rationalize their operational strategies in light of recent changes in market conditions, yet at the same time are burdened by high financial costs and problems of cash liquidity. Accordingly, a debt rescheduling fund can serve both the objective of immediate financial assistance as well as providing management more flexibility to manage their companies through the economic crisis.

The mechanism proposed would increase the maturity of long term debt obligation and in turn reduce annual debt servicing requirements of participating enterprises. The fund can be jointly sponsored by USAID and other international donor institutions, as well the Central Reserve Bank and financial intermediaries.

Initial capital contributions would be made to establish the fund and set up the administrative framework. The amount of initial capital required would be estimated by equating the discounted net disbursement which would accrue during the early years of activity. An interest rate differential would be charged to participating enterprises to cover administrative expenses as well as to derive a return to capital if desired.

The fund can be administered through an existing financial institution such as COFIDE, Banco Industrial de Peru or other institutions which provide term credit financing.

Applicants should be strictly screened against the recommended strategic goals and should be able to clearly show their viability in improving financial performance. Financial advisory and other management assistance can complement this program.

SUGGESTED REFORM OF THE SYSTEM OF COMPENSATION FOR LENGTH OF EMPLOYMENT

Present System

Persons who have been employed by an enterprise for more than three months are entitled, on termination of employment, to receive from that enterprise a Lump Sum proportionate to the length of time they have been employed and to the level of remuneration earned at the time of termination. The employer may pay in advance up to 50% of the accumulated entitlement to such compensation, to facilitate the purchase of land or housing.

The system is a source of complications for the financial management of the enterprise, especially under conditions of inflation, for the following reasons: first, the number of employers terminating employment each year is not necessarily related to the age structure of the force and payments of compensation for length of service may be difficult to forecast. Second, in certain years, the magnitude of these payments may cause a serious drain on the cash position.

Since enterprises are not obliged to fund the reserves for their accumulated commitments in this respect, they have the freedom to use the cash which must ultimately be made available for compensation payments however, this is not a "healthy" source of financing, not even for working capital.

For example, if the compensation reserve funds are used to finance receivables or inventories, they may not be readily convertible into available cash. On the other hand if they are kept liquid it may be difficult, under conditions of inflation, to preserve their value in real terms. This is because compensation benefits when paid out are based on current levels of remuneration automatically adjusted for inflation. Thus the enterprise may find itself unable to honor its commitments. The beneficiaries are thus exposed to the risk of delayed collection of their compensation benefits.

Proposed System

The underlying principle of the proposed system is the same as many European retirement pension schemes devised to cope with inflation. Formerly, such schemes were based on capitalization of the contributions but with high rates of inflation it became extremely difficult both to preserve the capitalized funds from erosion of their purchasing power and to maintain adequate safeguards against loss from inappropriate investments. Under the new style pension schemes contributions to a fund each year based on the remunerations of the active segment of the labor force, must provide for the retirement benefits due in the same year to the retired segment of the labor force. The scheme must encompass a sufficiently large number of enterprises so that a constant statistical average ratio can be maintained from year to year between the active and retired segments of their aggregate labor force. This allows the contributions to be maintained at fairly constant percentage rates applied to the remunerations with their total amount increasing year-by-year in proportion with the inflationary increases of the levels of remuneration. Thus, total contributions distributed in the same year provide benefits that are automatically adjusted to the rate of inflation.

One of the important points to decide is whether the system should operate under a single fund for the whole of Peru, with uniform contribution and benefit rates for all enterprises, or whether different mechanisms should be applied for different conditions of employeemnt, either through a single national fund or through separate funds differentiated by region and/or by sector of activity.

We suggest that USAID recommend to the government of Peru a reformulation of the system of compensation for length of employment on the lines indicated above. As a first step USAID could finance a study to develop a detailed design of the scheme together with a program for its implementation.

• MARKETING

MARKET ANALYSIS STUDIES

For the industrial sector to be more competitive, it must have a thorough and in-depth knowledge of the domestic or export market that is serves. As part of the process of developing new industrial products, it is necessary to study the characteristics of the market including its important segments, distribution networks, competition, pricing, and its stability and structure over long periods of time. This project would make funds available to perform a wide range of these marketing studies for an industry or group of firms in the private sector.

Several key sectors of the Peruvian economy would be selected for these special market studies. These studies could be contracted out to market analysis firms to develop an approach to identify key segments of markets and to analyze the significant factors that are necessary for successful penetration in those markets. Sme Peruvian firms could perform some of the studies, and a combination of Peruvian and U.S. firms may be optimal.

In summary, these market studies would provide substantial insights into future export product potentials and be a definite step in the direction of improving the lack of knowledge and reluctance of many Peruvians to produce for the export market.

DEVELOPMENT OF EXPORT TRADING COMPANIES

One strategy to improve economic efficiencies in the private sector can be achieved by the formation of export trading companies or ETC's. ETC's serve many useful functions and in simple terms can act as a one-stop middleman between the Peruvian supplier and the foreign purchaser. Moreover, the export trading company can reduce the costs and risks of international trade by bringing together various parties in order to combine their resources, mesh their knowledge of both exporting procedures and foreign markets and increase their bargaining power. Among the primary services an ETC can provide are the following:

- Locating buyers for Peruvian products.
- Adapting and packaging products for export.
- Providing export financing.
- Arranging shipping, insurance and customs documentation.
- Providing market intelligence.
- Organizing distribution and after-sales service.

The importance of trade to Peru has been magnified in recent years due to the worldwide recession. Moreover, the Peruvian trade situation has eroded steadily in conjunction with the dismantling of protections and policies that had previously hidden economic inefficiencies in the private sector as well as prevented a fuller exploitation of international markets.

Although foreign markets have been important to Peruvian manufacturers, many new exporters, particularly small-to-medium sized firms have been discouraged by exporting complexities such as:

- Peruvian bureaucracy and red tape
- Unfamiliarity with foreign markets

- Customs and laws
- Insufficient capital for market entry
- Lack of experience in adapting products for market abroad
- Volume too small to negotiate quantity discounts for distribution and service.

An ETC can help businesses overcome these obstacles by providing them the full-service exporting help they need. ETC services could include financing and market intelligence for successful long term penetration of foreign markets. ETC's may also represent a smart investment and can benefit a Peruvian investors business in many ways. For example:

- Complement an investors business activities and objectives by introducing new classes of customers, both domestic and foreign.
- Allow an investor to provide additional services to existing customers.
- Help defray the cost of an investor's existing international infrastructure and help him expand into new countries.
- Help identify unique investment opportunities abroad by having an active presence in foreign countries.

Because an export trading company offers many attractive benefits, nearly every segment of Peruvian business could be expected to participate in the development of these companies including:

- Combinations of small-to-medium sized companies
- Trade associations
- Complementary combinations of manufacturers and suppliers - industrial and agricultural
- Service organizations such as engineering and architectural firms
- Transportation and shipping companies

- Retailers, wholesalers and other distribution companies
- Export managers, freight forwarders and other businesses specializing in international trade.
- Large multinational corporations
- Banks, insurance companies and other financial institutions, including AID
- Venture capitalists.

ETC's can be structured with as many categories of participants as desired. However certain complementary structures may prove optimal such as a combination of several small manufacturers with non-competing products, a finance organization, a transportation company and a multinational company with an international infrastructure already in place. Regardless of the structure certain advantages and disadvantages can be cited beyond those already mentioned.

Advantages

- Provides ecomonies of scale, especially for small to medium sized firms.
- Gives the ability to target particular industries and further mobilize resources.
- Limits the risk of promoting non-traditional exports.
- Promotes improved access to channels of credit not usually available to smaller firms.
- Increased market knowledge so as to reduce the dependence on world economic variables and recessions.

Disadvantages

- Issue of control. ETC's rely on a concept that depends upon joint participation and the spirit of cooperation. Some firms may not wish to lose control of the decision making process.
- Non-complementary products or services. Competing products in ETC's are to be avoided.

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- High probability of structuring an ETC with a lack of trade know-how in many markets that are untested. They would have to make linkages with an industry group experienced in the "nuts and bolts" of trading. Such experience includes importing, exporting, brokering and countertrading.

There appear to be about five basic elements required for the success of a fully integrated export trading company. This section is intended to pose questions for further investigation about the appropriateness of promoting an ETC concept in Peru. These elements will also help in understanding possible structure options and serve as a further basis for risk evaluation and recommendations. The five elements are as follows:

- Strong Ties to Manufacturing - a strong competitive base is essential. An industrial base of high quality products with a sufficiently low price must be in place to allow for a competitive position in foreign markets.

- Reliable Foreign Sales Network - In order to attract manufacturers an ETC must have an ability to sell. In addition, an ETC must have an available mix of manufacturers providing both steady volumes and sufficient variety of products to attract overseas buyers. To sell, an ETC must have a readily available product. This means that a communications and sales network must be available to guarantee penetration.

- Management of Human Resources - A manager of an ETC must contain an integrated well coordinated array of services with specialists in each, orchestrated to make a very trade a total package.

- Management of Human Resources - A manager of an ETC must be able to function as an entrepreneur able to assess risks and respond under time constraints. He must also be comfortable in foreign cultures, have a broad product knowledge and have the support of an information network.

- Time - whatever structure is adopted, an ETC cannot be created overnight. The expectation of an ETC should therefore be reasonably long term. Time is needed to master technical procedures and skill and put them together on an integrated basis. Moreover the pecularities of foreign markets must be known and expertise developed on a variety of products for their applications to those markets.

Three particular linkage areas that represent promise in setting up ETC's in Peru are areas that AID may already support through programmatic efforts or else could easily be incorporated into their assistance plans for Peru. These are:

- Export Development Fund - a fund set up to develop Peru's export base would be an ideal source of accessible credit for an ETC. Likewise, an ETC would probably represent a better credit risk because of its organizational strengths and pool of resources than an individual manufacturer. Tapping into this type of fund would result in a less constrained ETC structure since other traditional sources of financing may be restricted by how much financing they could offer to promote exports, especially non-traditional exports.

- Free Trade Zones - There has been significant development of industrial parks and free trade zones in Peru in recent years. Getting an ETC involved could be tremendously beneficial to both. An ETC could offer new sources of supplies to assembly operations in a FTZ as well as additional financing and market intelligence. Conversely, a FTZ would provide an ETC with added trade knowledge plus a readily available distribution network.

- Technical Assistance - One of the functions of an ETC is to provide technical assistance of an integrated market/trading nature to its participants. What may be necessary for starting an ETC is technical assistance in other areas such as industrial processes or agribusiness. In addition, AID can sponsor feasibility studies, assist in the analysis of legal and regulatory frameworks, and export planning.

Overall, the concept of an ETC can mobilize important economic resources in Peru to fulfill some of the necessary steps to improving the badly deteriorated trade situation of the country's private sector.

PRIVATE INVESTMENT PROMOTION

A program of investment promotion is recommended to accelerate the development of an export oriented industry in Peru. The program offers promotion activities to attract joint ventures between domestic and foreign entrepreneurs, identify foreign investors and appropriate technology for domestic projects and assist in identifying new markets for productive outputs.

In Peru, an investment promotion program should focus on attracting small and medium size foreign companies into joint venture and licensing arrangements with local investors. Emphasis should be placed on the industrial sector in labor intensive ventures which take advantage of Peru's resources and which would predominatly be export based.

This program can complement other projects recommended for USAID such as the export promotion fund and the development of free zones. Together these provide the necessary resources to assist entrepreneurs through the various stages of the investment process and improve incentives for direct foreign investment in Peru.

INDUSTRIAL FREE ZONES

In line with the strategy recommended to USAID toward private sector initiatives, industrial free zones should be considered as a viable way to accelerate the growth of a diversified, export oriented industrial base in Peru; and to contribute toward increasing employment opportunities, attracting foreign investment and technology, geographically decentralizing industry generating foreign exchange earnings and developing the infrastructure base of remote regions of the country. Industrial free zones are able to achieve these goals by creating a more favorable investment and operating climate within the country through various forms of tax, tariff or regulatory relief. For example, current legislation in Peru provides free zone status to the entire Selva region. Various forms of tax and tariff incentives are also offered to attract more investment in this region.

Despite these benefits, the current legislation still falls short of providing a climate which can be attractive to both private and foreign investor. For example, regulatory relief in the labor area is not offered.

Other contraints to development in the Selva region arise from an inadequate infrastructure base as well as basic support services on housing, educational facilities and others.

However, the ongoing construction of the Pucalpa Free Zone provides an opportunity for USAID to sponsor a pilot program to test the effects of more flexible labor and other regulations which have created operational rigidities to private enterprises in Peru. USAID can provide legal assistance for developing a proper regulatory environment within the free zone and other services which monitor the results of free zone performance on Peru's development. Other support can be in the form of direct financial assistance for infrastructure development combined with investment and export promotion programs when initial studies indicate their feasibility.

• M A N A G E M E N T

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PROJECT TO DEVELOP A SYSTEM OF MANAGEMENT CONTRACTS TO MANAGE SELECTED PUBLICLY OWNED COMPANIES

- Project Goal

The goal of this project is to reduce governmental expenditures on state run enterprises while maintaining the economic output that these firms produce.

- Current Situation

During the military regime approximately 175 public firms were created and maintained by the government of Peru. There was no clear plan or policies for the role of this large sector and mismanagement, excess labor, undercapitalization, political interference and the inability to create wealth in the economy has caused these firms to contribute to an increased debt burden on the government. Resources which could normally be allocated to investments with a high rate of return were instead channeled to many inefficient areas via budgetary transfers. As a result the government borrowed heavily and limited the amount of finance available for private sector investment.

Recently, the governments of Peru initiated a "privatization" program to return the operation and ownership of many of these firms to the private sector. The International Finance Corporation studied the public sector firms and identified those firms which could be divested by the government. To date no firm action has been taken except that USAID was approached by CONADE to fund studies on three firms as a pilot project.

Our analysis indicates that there is a reluctance on the part of private investors to be involved in this "privitization" program for three reasons: first, there is no liquidity which could be used for investment; second, the risk of nationalization at a future date is considered too high; third, no one knows the value of companies and therefore an appropriate selling price.

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Recommended Project

The problem of liquidity, risk of nationalization, and sale value could be overcome by a two phased process for privatization. The first phase would minimize the issue of ownership by having the government of Peru maintain the assets of the company while hiring on contract a private sector firm to manage the operation of the company. On a pilot basis selected firms would be exempted from constraining labor legislation, pricing policies, control by the Comptroller General's office, and so forth. The contracted firm would manage the company for a period of five to seven years and would be allowed within certain limits to keep the profits from the operation. In addition, performance bonuses could be awarded for exceeding certain operational standards. However, in order to prevent the contractor from operating on a short-term perspective they could be required to have a 5-10 percent equity participation. Depending on initial circumstances other investors such as banks, insurance companies (assuming a change in current Peruivan law) and private investors could also participate in an equity position. USAID, in a leadership role, could also provide equity or loan guarantees for long term investments by the contracting company.

There are other risks. For example, a supplier to the company could attempt to obtain the management contract so that he would be in a position to manipulate prices for his supplies. This and other conflicts of interest could be avoided through the establishment of shadow prices and the use of independent auditors.

Once the company is on sound financial grounds and confidence in the management of the company is restored, the value of the company can be determined by shares traded in the market. As new investors are able to buy into the company, the government would reduce its equity participation and ultimately sell off the company at a time when investor confidence is high and liquidity exists for investment.

As a parallel to this effort or as a combined project USAID could finance a project for CONADE to act as a central source for information on the operation of public sector firms. As a first step the project could focus on establishing a common performance evaluation process for the management of firms. This in turn could be used as a measure of the efficiency of firms whose management activities have been contracted to a private sector group.

The design of a project of this nature should begin with a financial analysis of the companies that would be proposed as pilots for management contracts. Secondly, a review of current legislation affecting the performance of the company would be accomplished as well as the development of draft legislation which would permit more managerial autonomy for the firm. Third, an analysis of the current information and accounting practices of the firm would be accomplished and recommendation for revision made. Fourth, as a basis for expanding the project an assessment of the current organizational performance criteria would be accomplished and the design of a new common system would be undertaken.

In summary, USAID can use this project as a model to expand the program outside of the industrial sector. Management contracts with private firms may be a viable way to operate other governmental service organizations such as health, education and infrastructure.

SHORT TERM CONSULTING ASSISTANCE

This project is recommended to improve the performance of enterprises which are being severally affected by the shift in market conditions and increased competition. It proposes to consist of technical assistance in the form of teams of specialists to provide short-term, problem solving and results oriented consulting assistance to management of various enterprises. This assistance may be combined with programs which provide short term financial relief to the such enterprises.

Our review of major problems confronted by indigenous enterprises suggests that consulting services may be beneficial in the areas of long-term strategic and business planning, international trade, sale promotion and market research, finance and cash management, industrial engineering, technology management and management information.

The program we envision would be implemented through a series of short-term visits by industry-specific specialists to participating enterprises. Consulting services would be provided in a phased approach as follow:

- During the initial phase, the team of specialists together with company management would perform a brief diagnostic review of major immediate problems confronting the organization. Upon completion of this assessment a strategy would be developed outlining key objectives, individual measures to be taken and expected end-results.

- The next phase involves the implementation of the recommended strategy and specific measures for resolving the problems. Assistance by the consulting team would be provided through a series of follow-up visits to review implementation progress and provide continuing assistance for resolving problems that may arise.

- The final phase would be to develop a medium term business and marketing plan for the participating organization. This would outline a stategy for more structural improvements to the operation of the enterprise and may include such strategies as penetration into export markets, product diversification, long term financial planning, and technology improvements.

USAID would participate in this program by providing initial financial and technical assistance for creating the institutional framework upon which these services would be offered. Such a program could be institutionalized as a pilot test by either expanding the activities of a existing organization such as ESAN or the International Executive Service Corp; by combining it with financial assistance projects; or by creating an entirely new private sector organization.

We suggest that the services provided should be compensated by the participating companies. The willingness of companies to pay for these services will determine whether the institutional framework can ultimately become self sustaining.

ECONOMIC INFORMATION PROJECT

As part of Phase I, of the strategy to cushion the shock of the current economic situation, this program would address the need for more current and reliable information concerning the state of the Peruvian economy. Employment statistics are sparse, incomplete, and unreliable. Lead economic indicators are virtually nonexistent, and there is no central clearing house in government or in the private sector of economic information. This project would address this lack of economic information and provide a mechanism for gathering, disseminating and analyzing economic information.

The goal of the program would be to establish a small group of economists, located in the private sector with the charter to gather and analyze available economic information and to make it available to the private sector on a regular basis. In general, the goal would be improve private sector public awareness concerning the current economic situation and to assess the quality and completeness of the economic information for businessmen, policymakers, commentators, and analysts.

This group would need to first take inventory of existing sources of economic information, and establish a publication on a regular basis that would present economic information and an assessment of its meaning for the economy of Peru. The publication would be published on a monthly basis, and contain articles on different facets of the economy e.g., unemployment, industrial products, capital spending plans, and detailed presentation of the available economic information. This group could also develop economic data series and indices such as leading economic indicators. Initial financial support would come from USAID and a matching grant from private sector companies. USAID may wish to underwrite future financial costs for constituents who may not be able to afford the services.

PRIVATE SECTOR ECONOMIC POLICY STUDIES GROUP

As the economy of Peru makes greater use of market mechanisms and signals with the private sector as an engine of economic growth, it is important that specific research and analysis be performed cc:cerning potential areas of private sector development that could contribute most effectively to economic development. These policy studies would be performed by a group of economists established in an institute to perform this type of research. It would be anticipated that such an institute would become self-sustaining by private sector contributions once it is established and has become viable. We envision that this economic policy studies group would be similar in concept to the American Enterprise Institute in Washington, D.C.

The needs for private sector economic policy studies group is two-fold:

- Analysis of future opportunities for economic growth and development that could be accomplished through private sector initiatives.
- Analysis of major private sector activities and shifts of economic activity from the public sector to the private sector, especially shifts that have taken place since the Belaunde administration replaced the military regime.

Under this program, fruitful economic research concerning the effectiveness of private sector initiatives would be forthcoming. The dissemination of this information throughout the Peruvian economy would be useful for future development in the private sector as well as providing comparative evaluation of the impact from private sector activities compared to public sector endeavors.

Such an institute would be established with seed money and would begin with a small core staff and director who would be quite notable in the field of economics as well as being familar with the Peruvian economic situation. Someone of the status of Dr. Francisco Baraybar would represent the stature needed to fill that position. The director and the core staff would begin a series of private sector economic policy studies for potential new initiatives for the private sector. It would be anticipated that such an institute would have a board of directors with representatives from the private sector as well as limited representation from government, academia, labor and selected other.

In summary, such a policy studies group would have a substantial impact on the dissemination of information concerning private sector economic development throughout all of Peru and would make visible government and foreign donor efforts concerning private sector initiatives.

PUBLIC/PRIVATE SECTOR FOREIGN ECONOMY STUDY GROUP

This project would be designed to provide opportunities to selected public and private sector managers, goverment officials, bankers, academics, and iegal experts to study the workings of countries who have made similar economic transitions as Peru. Each study group would be asked to analyze specific issues which have a bearing on Peru's development and use those findings as an input to policy formulation and/or operational planning for Peru's private sector. Seminars could be also conducted in each host country with their private entrepreneurs to share perceptions of how the private sector is utilized. These seminars would also facilitate the development of contacts for export markets and foreign investment. By the choice of countries, examples of opportunities and obstacles could be observed as well as how that country dealt with them. West Germany, Japan, Brazil, Hong-Kong, Singapore, and Taiwan are suitable choices. Upon returning each group would be required to produce a report of specific recommendations to deal with Peruvian obstacles and opportunities.

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ECONOMIC ADVISORY SERVICES

As demonstrated by the notable deviation of economic policy for the overall guidance of the economic development model of Peru, there is a need for an identified group of economists to provide economic analysis to the government, concerning long term economic problems similar to the function of the Council of Economic Advisors in the United States. In particular, this group would provide the specifics and operational aspects of the economic development model for Peru. This group could also conduct background studies for combined policies concerning agriculture and industrial economic development.

The project would fund a small group of economists under a Chairman recruited from the economics profession within Peru would be established to perform analysis to the highest levels of government. This group would have to be insulated from day-to-day crises that exist in the government policymaking area. Thus the group would not be closely related to the budget process or to ongoing responsibilities of government ministers. A number of economic projects would need to be specified by the appropriate ministers that would be undertaken by the group, and the group would report only to the highest levels of government. In establishing this group, some assistance from persons knowledgeable of the working of the Council of Economic Advisors would be helpful.

In summary, economic advisory services would add a needed dimension to the policymaking apparatus of the government of Peru and would be an important ingredient in focusing government policy on the longer term aspects of its economic development model.

REGIONAL INTEGRATED DEVELOPMENT PROJECT

As part of an overall economic strategy for Peru, a large investment opportunity exists in the area of Arequipa that could promote regional development, a decentralization of economic activity away from Lima, export promotion and the development of agro-industry.

The USAID project could complement a large engineering project that is currently under construction in the southwest portion of Peru. The construction project involves the development of a series of canals and tunnels to bring water to a section of the Department of Arequipa and to facilitate the irrigation of 65,000 Hectares of land currently without water and the development of 850 megawatts of hydro/electric power for the Arequipa region. It is anticipated that the irrigated land would be used to grow agricultural products and to raise cattle for the Peruvian market.

The construction project that is currently in progress does not automatically mean that the Majes project is going to be a success. Completion of the construction and the delivery of water is an important step in the direction of providing essential items to the economic development of the Department of Arequipa, but it does not go the many steps necessary to ensure that the entire project is financially and economically successful. To be successful there is a need to provide a full range of activities to ensure that integrated economic development takes place in the region and that the development takes full advantage of the economic potential that exists there. For example there must be a full functioning market for the agricultural products and cattle that will be the outgrowth of the construction project.

The goal of the USAID project is to provide a fully integrated economic network that takes advantage of the existing infrastructure and economic markets that exist in the Arequipa area as well as the potential developed by the delivery of water and hydro/electric power to the region. This would involve the development of products for exports and agricultural products and cattle for agro-industry economic opportunities. For example, the cattle raised on the irrigated lands could be slaughtered and distributed to various parts of Peru and one of the by-products of this operation would be the use of cattle hides for tanning in a factory that already exists in Arequipa. The flour mill in Arequipa could also be used to process grains for the Majes project rather than importing the grain which is currenty being done.

How It Works: The USAID would provide a full range of management services and activities including funding sources for new or expanding agro-business enterprises. Special funding would be available to these agro-businesses that were export oriented. The concept of an export trading company for the area could be developed to encourage exports and to provide export credit, market assessments, technology and financial services for agricultural products and agro-industry products. The feasibiity of a number of these projects would have to be pre-determined by a number of studies done at an early stage of the larger project. The overall direction of the project would be to create private sector institutions and enterprises that would fully exploit the economic potential of the Majes project for employment opportunities in the immediate area of Arequipa and generate foreign exchange earnings through exports. It is also possible that this project could involve the privatization of the electric service offered by the hydro/electric power provided by the project. An end result could be a demonstration of the viability of private sector involvement in regional economic development.

PROJECT TO PROVIDE NEGOTIATION SERVICES
TO ASSIST PERU TO ATTRACT FOREIGN INVESTMENT

One of the goals of Peru's economic development strategy is to encourage direct foreign investment in a way which uses their economic power to achieve development goals as well a purely economic ones. However, Peru is in competition with other countries who are also seeking foreign private investment and must be able to effectively deal with these investors in a way which provides a comparative advantage for Peru. Issues such as general and sectoral policies, performance oriented policies and clear procedures and "entry" system are all important to foreign investors. These issues must be effectively developed to protect the interests of Peru and the foreign investors and then successfully negotiated.

A USAID funded project could provide the resources to analyze the policies and procedures existing today which are obstacles to foreign investment and provide a recommended system to correct current deficiencies. Further, the project could develop, through training of other technical assistance, the negotiaton skills necessary to reach workable agreements which include technology transfer for Peru.

PROJECT TO DESIGN DRAFT LEGISLATION FOR LABOR AND TRADE ISSUES

An effective strategy for economic develoment must include changes in macro policies which inhibit the thrust of that strategy. General policy areas were identified in our report including trade and labor as key ones. However, time and resources are not always available in Peru to formulate policies and related legislation. The purpose of this USAID project would be to fund technical assistance to draft legislation in areas were the Peruvian government and private sector believes improvements should be made. This draft legislation could be done by a combined team U.S international trade and labor experts and Peruvian experts. The draft legislation would be provided as a guide for discussions rather than a definitions document.

- TECHNOLOGY/
  VOCATIONAL TRAINING

PROJECT FOR VOCATIONAL TRAINING
AND TECHNOLOGY TRANSFER

The distortions caused by the import substitution policies of the 1970's in Peru created a situation in which there were few incentives to access the technology appropriate to Peru's situation. Larger firms used inappropriate technology to avoid labor laws, while medium and small scale industries had to rely on outdated technology.

Technology, however, is not synonomous with equipment. Technology is knowledge and the transfer of technology occurs only when that knowledge is applied. In Peru's situation there is a need to develop this knowledge base in industry so that the enterprises are able to compete on the international market. USAID could assist in this area by a combined project of technology transfer and vocational training. It would be aimed at improving the utilization of existing technology and assisting in the selection of new technolgies.

The project would be targeted at medium and small scale industries and would offer services at the firm level for management diagnostics, information on sources of technology, training in the use of technolgy, and U.S. and Peruvian technical assistance.

As an example of the structure of the project, it could be centered at TECSUP, SENATI or a multinational company. These groups could provide the access to small and medium firms. The implementation of the project could be a combination of Volunteers in Technical Assistance (VITA), the International Executive Service Corps (IESC), a Peruvian engineering consulting firm, and a U.S. institution such as the Westinghouse Productivity Center. This group would provide the services identified above on a problem oriented basis to firms primarily in the agribusiness and manufacturing area. They would also act as a middleman to facilitate the transfer of technology from the U.S. or other areas as appropriate. Finally, the project design would link this project to othes described in the USAID strategy.

APPENDIX

APPENDIX I

Mr. Juan Antonio Aguirre R.
President, Compania Peruana de Telefonos

Mr. Ernesto Baertl
Director General, Compania Minera Milpo S.A.

Mr. Julian Bustamante
Director General, Industrias Surge Peruana S.A.

Mr. Roberto Carrion Pollit
President, Maquinarias Datsun

Mr. Carlos Correa O.
President, Indeco Peruana S.A.

Mr. Ernesto de Losada
Director General, Ceramicas y Mosaicos S.A.

Mr. Oscar Espinosa
Investment Management, Enrique Ferryros y Cia, S.A.

Sr. Jose Grana
General Manager, Grana y Montero S.A.

Mr. Werner Haeberle
Director General, Gloria, S.A.

Mr. Juan Luis Kruger
General Manager, Gloria, S.A.

Mr. Jose Hopkins
General Manager, Fabrica de Calzado "El Diamante"

Mr. Dieter Kohler
General Manager, Horechet Peruana S.A.

Mr. Juan Alvaro Lira
Executive President, Corporacion Tecnica de Comercio S.A.

Mr. Alfredo Novoa
President, Novoa y Asociados

Mr. Miguel Pinasco
General Manager, Lima Caucho

Mr. Alberto Sacio L.
President, Belco Petroleum Company of Peru

Mr. Jose Tagle
Executive Director, Enique Ferreyros & Company, S.A.

Mr. Robert F. Moran
Vice President, Sears

Mr. Daniel Rodriquez Hoyle
Vice President, Southern Peru Copper Corporation

Mr. Michel Ledda
General Manager, Importaciones Compras y Servicios, S.A.

Mr. Alfonso Bustamante
General Manager, Abrasivos Industriales

Mr. Mario Cuzzi
Businessman, Arequipa

Mr. Reynaldo Roberts
Roberts, S.A.

Mr. Percy Gygax
Businessman, Arequipa

Mr. Carlos Cabrerizo
Businessman, Arequipa

Mr. Herman Jo Claesens
Vice President, Citibank

Mr. Roberto Anguigola Guardia
Vice President and General Manager, Bank of America

Mr. Guillermo Weise
President, Weise Bank, Ltd.

Mr. Arturo C. Porzecanski
The Morgan Bank, New York

Mr. Alonso Polar
General Manager, Banco Continental

Mr. Richard Webb
President, Central Reserve Bank

Mr. Carlos Boja
Banco Interamericano de Desarrollo

Mr. Felipo Ortiz
President, CONADE

Mr. Carlos A. Neuhaus
General Manager, COFIDE

Mr. Ignacio Basombrio
General Manager, Financiera Nacional S.A.

Mr. Fernando Correa M.
President, Banco Peruano de la Construction

Mr. Ulrich R. H. Thumm
President Representative, The World Bank

Mr. Juan Carlos Hurtado
President, Banco Agrario

Mr. Francisco Valencia
Chairman, Banco del Sur, Arequipa

Mr. Pedro-Pablo Kuczynski G.
President, First Boston International

Mr. Frank E. Griffiths
Pacific International Fair

Mr. Francisco R. Sagasti
Director General, Tecnologia Aplicada al Desarrollo, S.A.

Mr. Gonzalo Garland
President, ADEX

Mr. Cesar Martin Barreda
General Manager, Camara de Comercio de Lima

Mr. Leslie Pierce
President, Fondo de Promocion de Exportaciones No Tradicionales (FOPEX)

Mr. Carlos Mariotti C.
Partner, Alpandino Estudio Fiduciario

Mr. Henry M. DeMeyer
Director, International Executive Service Corps

Mr. Juan Francisco Baraybar
Dean, College of Economists

Mr. Raul Otero
General Manager, Empresa Minera del Peru

Mr. Scott Danaher
Economist, U.S. Embassy, Lima

Mr. Eduardo Muelle
President, Confederacion Nacional de Comerciantes

Mr. Mark Frazier
President, Frazier & Associates

Mr. Rufino Cebrecos
General Manager, FOPEX

Mr. Jonathan Cavanagh
Andean Report

Mr. Ernesto Alayza G..
Senator, Partido Popular Cristiano

Mr. Philip Bennett
Lima Times

Mr. Enrique East
Vice President, TECSUP

Mr. Ricardo Rey Polis
ESAN

Mr. Julio Cruzado Zavala
Secretary General, Confederacion de Trabajadores del Peru

Mr. Ernesto Lanatta
President, Sociedal Nacional de Industrias

Mr. Alejandro Toledo
Economist, Ministry of Labor

Mr. Armando Rivera
General Manager

Dr. Jaime Rey de Castro
Lawyer, Arequipa

Mr. Gonzalo de la Puento
Minister of Industry

Mr. Edwardo Gonzales Passano
Manager of Administration and Finance, Inversiones Nueva York, S.A.

Mr. Benito Rossi Barrios
Director, Arco Pesca, S.A.

Mr. Armando Rivera Calle
Manager, Ferrocarril del Sur

Mr. Jaime Bertie B.
Marketing Manager, Del Mar, S.A.

Mr. Walter Piazza
President, COSAPI

Mr. Hernando de Soto
Director, MINTEC

Mr. Gustao Garcia Mundaca
President, Organizacion Nacional Agraria (ONA)